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This Survey *is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

The economic situation and policies of the United Kingdom were reviewed by the Committee on 11 December 2012. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 21 December 2012.

The Secretariat's draft report was prepared for the Committee by Christophe André, Dawn Holland, Jon Pareliussen and Clara Garcia, with contributions from Simon Kirby, Giulia Giupponi and Nicola Brandt, under the supervision of Piritta Sorsa. Research assistance was provided by Aurélie Delannoy, Iana Liadze, Katerina Lisenkova, Ali Orazgani, Paweł Paluchowski and Anna Rosso.

The previous Survey *of the United Kingdom was issued in March 2011.*

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BASIC STATISTICS OF UNITED KINGDOM, 2011

(The numbers in parentheses refer to the OECD average)

LAND, PEOPLE AND ELECTORAL CYCLE

Population (1 000 000):	61.8		Population density per km²	253.5	(34.3)
Under 15 (%)	17.6	(18.4)	Life expectancy (years, 2010):	80.6	(79.7)
Over 65 (%)	16.2	(14.9)	Males	78.6	(76.9)
Foreign-born (%, 2010)	11.3		Females	82.6	(82.5)
Latest 5-year average growth (%)	0.4	(0.5)	Last general election:	May 2010	

ECONOMY

GDP, current prices (billion USD)	2 435.7		Value added shares (%):		
GDP, current prices (billion, local currency)	1 519.1		Primary	0.7	(2.6)
			Industry incl. construction	23.2	(27.8)
Latest 5-year average real growth (%)	0.2	(0.8)	Services	76.2	(69.5)
GDP per capita, PPP (thousand USD)	36.3	(35.4)			

GENERAL GOVERNMENT

Expenditure (% of GDP)	48.7	(45.0)	Gross financial debt (% of GDP)	99.9	(90.2)
Revenue (% of GDP)	40.4	(38.1)	Net financial debt (% of GDP)	67.8	(58.1)

EXTERNAL ACCOUNTS

Exchange rate (GBP per USD)	0.624		Main exports (% of total merchandise exports):		
PPP exchange rate (USA = 1)	0.678		Machinery and transport equipment	31.3	
Exports of goods and services (% of GDP)	32.4	(52.7)	Chemicals and related products, n.e.s.	16.8	
Imports of goods and services (% of GDP)	34.0	(49.7)	Mineral fuels, lubricants and related materials	13.6	
Current account balance (% of GDP)	-1.9	(-0.7)			
Net international investment position (% of GDP)	-14.0		Main imports (% of total merchandise imports):		
			Machinery and transport equipment	30.3	
			Mineral fuels, lubricants and related materials	14.3	
			Manufactured goods	12.6	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year olds:	69.5	(64.9)	Unemployment rate (%):	8.0	(7.9)
Males	74.5	(73.0)	Youth (%)	21.1	(16.2)
Females	64.6	(56.8)	Long-term unemployed (%)	2.7	(2.6)
Average worked hours per year	1 625.0	(1 776.0)	Tertiary educational attainment		
Gross domestic expenditure on R&D			25-64 year-olds (%, 2010)	36.9	(30.0)
(% of GDP, 2010)	1.8				

ENVIRONMENT

Total primary energy supply per capita (toe):	3.1	(4.3)	CO_2 emissions from fuel combustion		
Renewables (%)	4.1	(8.2)	per capita (tonnes, 2009)	7.5	(9.8)
Fine particulate matter concentration			Water abstractions per capita (dam^3, 2008)	0.1	
(urban, PM_{10}, $\mu g/m^3$, 2008)	12.7	(22.0)	Municipal waste per capita (tonnes, 2010)	0.5	

SOCIETY

Income inequality (Gini coefficient, late 2000s)	34.2	(31.4)	Education outcomes (PISA score, 2009):		
			Reading	494	(493)
Relative poverty rate	18.4	(17.7)	Mathematics	492	(496)
Public and private spending (% of GDP):			Science	514	(501)
Health care (2009)	9.8	(9.6)	Share of women in parliament (%, July 2012)	22.1	(24.4)
Pensions (2007)	8.2	(8.6)	Net official development assistance (% of GNI)	0.6	(0.4)
Education (excl. tertiary, 2008)	7.1	(4.0)			

Better Life Index: *www.oecdbetterlifeindex.org/*

Note: OECD average shown when data are available for at least 75% of the member countries.
Source: OECD.STAT (*http://stats.oecd.org*); *OECD Economic Outlook Database*.

Executive summary

Recovering from the recession, improving longer-term growth potential and reducing inequality are key challenges for the UK economy. *Lingering effects from the global financial crisis, the restrictive impact from necessary fiscal consolidation and headwinds from the euro area sovereign debt crisis risk prolonging and worsening the economic downturn and hurting the long-term growth potential. Monetary policy and the operation of the automatic stabilisers should support the economy in the short term. Structural reforms, including those current implemented by the government, are crucial to boost growth and equality.*

Monetary policy is the primary tool to stimulate the economy, but the fiscal framework and earned policy credibility allow a flexible response to economic weakness. *The recovery from the recession is projected to continue to be slow and uneven. Although the scope for macroeconomic policy is becoming more circumscribed, sustained monetary stimulus through expanded quantitative easing, liquidity provision by the Bank of England and government-backed funding schemes need to continue to support the economy. The government deficit remains high and public finances will come under pressure from population ageing in the long term. The fiscal stance remains appropriate. However, if growth significantly underperforms expectations over the coming months, the flexibility of the fiscal framework should be utilised. In this regard, the Government's decision in the December 2012 Autumn Statement to continue with its existing consolidation plans and not override the automatic stabilisers in order to meet the supplementary debt target is appropriate.*

The recommendations from the Independent Commission on Banking should be implemented *to shield the taxpayer and the domestic economy from failures in the financial sector.*

The government should pursue growth-enhancing and inequality-reducing structural reforms. *A prolonged period of weak growth risks worsening social inequalities. Labour market and social policies need to mitigate this risk. In particular:*

- *The welfare reform, which introduces a Universal Credit with generous earnings disregards and a single taper rate in place of myriad means-tested benefits, will improve work incentives for many individuals. Nevertheless, work incentives could be further improved, especially for lone parents and second earners dependent on formal childcare. Measures to lower childcare costs and increase public support to make work pay for these individuals should be considered, although this comes with a fiscal cost. On the other hand, better incentives for lone parents and second earners would increase the effectiveness of the benefits reform and thereby raise the economic growth potential and reduce inequality.*
- *Active labour market policies must be reinforced to ensure that vulnerable groups do not become permanently excluded from work. Despite a highly flexible labour market that has maintained fairly high levels of employment through the downturn, unemployment is high, especially among youth and low-skilled individuals.*

- *Weak skills in some segments of the workforce hinder employment and growth, and contribute to large differentials in employment and earnings across education levels. Workers' skills need enhancement, especially among students from disadvantaged backgrounds, through improved educational outcomes, reinforcing vocational training and by facilitating transition from education to work.*

Other growth enhancing reforms should also be pursued. *Investment in productive assets is low in an international context, hampering innovation and growth. R&D support policies and corporate taxation should be reformed, with more focus on rewarding social returns in excess of private returns. Increased investment in productive infrastructure could boost long-term growth, and would justify further prioritisation in spending. Other obstacles to investment, notably linked to stringent planning rules, should also be removed. Productivity in large swathes of the public sector seems low and should be raised through better management and greater regional flexibility in public sector wages.*

Box 1. **Key policy recommendations**

Macroeconomic and financial policies

Continue to support the economy through accommodative monetary policy. Sustain quantitative easing, support for lending and liquidity provision.

The automatic stabilisers should continue to operate, as allowed by the flexibility of the fiscal framework. Maintain the strong commitment to medium-term consolidation.

Implement the main recommendations of the Independent Commission on Banking and continue to enhance financial system supervision, including monitoring of shadow banking. Ensure that the ring-fence between investment and retail banking becomes effective.

Labour market and social policies

Enhance workforce skills. Central and local government should enhance co-operation with employers on vocational education and training, and apprenticeship programmes, raise awareness of government programmes to support youth employment, especially among small and medium sized enterprises, by interventions at industry specific and local levels. Simplify the training and apprenticeship systems, enhance co-operation between local authorities, schools and enterprises in integrating graduates into the labour market.

Improve work incentives for lone parents and second earners under the Universal Credit welfare reform. Increase the refund rate for childcare, and/or reduce the taper rate for those with childcare support, and/or introduce a dedicated disregard for second earners in couples. Increase the value of free childcare by increasing flexibility for users and reduce the cost by increasing flexibility of provision.

Improve the Work Capability Assessment (WCA) and support for return to work for those who are fit. Ensure earlier intervention for people suffering from mental health problems. Monitor homelessness trends and ensure prevention and early intervention.

Monitor efficiency gains in public services. To avoid an increase in inequality, efficiency gains should be exploited in implementing fiscal consolidation. If this is not the case, new ways to improve performance should be investigated, including better management and greater regional flexibility in public sector wages.

Take steps to tackle fuel and water poverty through better targeted financial support, and measures to improve energy efficiency and resource management.

Box 1. **Key policy recommendations** *(cont.)*

Policies to boost growth and innovation

Ensure successful implementation of the planning reform. Monitor closely adequacy of development incentives for local communities, review incentives if necessary, and provide an adequate framework for strategic planning.

Invest more in productive infrastructure, with private financing and further reprioritisation of public spending.

Continue to improve the business environment and promote exports. Continue to implement the Plan for Growth. Support higher education as an export and avoid excessively restrictive limitations on student visas.

Reform some tax rules to encourage R&D. Review fiscal rules which may hamper firm growth, such as preferential tax treatment for small firms and debt finance relative to equity.

Promote green growth. Seek a higher carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a 30% EU emissions reduction target by 2020. Move towards a uniform carbon price across sectors and fuels. Examine the options for addressing road congestion and environmental impacts including the implementation of a road-pricing system on a national scale. Road pricing should be introduced on the most congested motorways, with a view to gradually extending it to other congested roads. Consider shifting part of the public support for renewable energy from technology deployment to R&D.

Assessment and recommendations

The economy is facing strong headwinds and uncertainties

The economy has been broadly flat for two years

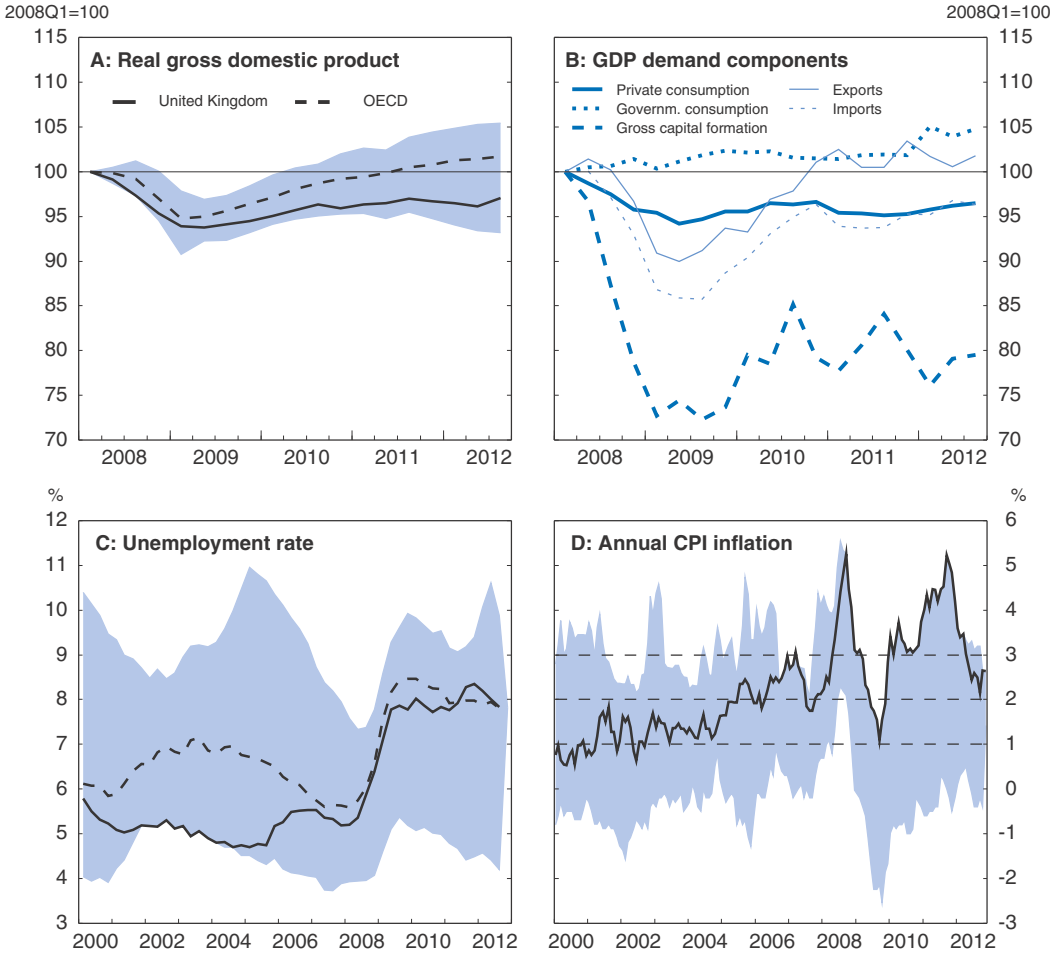
The global economic slowdown and uncertainty about the euro area outlook, alongside necessary fiscal retrenchment and private-sector deleveraging, are generating strong headwinds for the UK economy. Output has been broadly flat over the past two years and remains more than 3% lower than at its peak in the first quarter of 2008 (Figure 1, Panel A). Private consumption is being restrained by declining real disposable income, deleveraging, precautionary saving and tight access to credit. Private investment suffers from weak demand for goods and services, high uncertainty and tight financial conditions. Foreign trade was supportive in 2011, as exports benefitted from the depreciation of sterling and exceeded their pre-crisis peak, but growth in net exports turned negative in 2012 as the world economy slumped.

Activity so far in 2012 has been supported only by domestic demand, however weak (Figure 1, Panel B, Table 1). Slow growth in trading partners, especially in Europe, has dashed hopes of a prompt export-led recovery. Export growth is also hampered by the limited market share of the United Kingdom in fast-growing emerging economies, which partly results from a mismatch between UK production and emerging markets demand, and weak non-price competitiveness. The rise in unemployment has been moderate relative to output losses, with subdued wage growth and part-time employment limiting job losses (Figure 1, Panel C). Nevertheless, long-term and youth unemployment are high.

The short-term outlook is weak

Output bounced back in the third quarter of 2012, after three quarters of contraction. However, GDP numbers are distorted by a number of temporary factors and underlying growth remains subdued. Construction is still pulling output down and manufacturing and services are expanding only slowly, as a result of weak external and domestic demand. Output growth is likely to be negative for 2012 on a year-on-year basis, but should be positive in 2013 (Table 1). The timing of the recovery is, however, difficult to predict. Official and private growth projections have proved too optimistic over the past two years (Figure 2). When uncertainty diminishes, the need to rebuild capacity, backed by strong corporate balance sheets, should revive investment. Inflation is falling, driven by economic slack and the fading effects of indirect tax increases and the depreciation of sterling (Figure 1, Panel D). This will release purchasing power for households, which should support a pick-up in private consumption, although it may be weakened by precautionary saving and deleveraging. High household debt and limited access to mortgages will continue to restrain residential investment, which is still around 40% below pre-crisis levels.

Figure 1. **Main economic indicators**[1]



1. The shaded area indicates the maximum and the minimum among the seven major OECD countries.
Source: OECD Economic Outlook 92 Database.

StatLink http://dx.doi.org/10.1787/888932767593

Unemployment could rise

The outlook for unemployment remains uncertain. Unemployment has been decreasing slightly over recent quarters despite sluggish activity. However, if output growth remains weak, which can be expected if headwinds from Europe persist, unemployment and under-employment could rise. Furthermore, fiscal consolidation involves large job cuts in the public sector. The Office for Budget Responsibility (OBR) projects a fall in general government employment of around 929 000 (excluding the impact of reclassifications in the education sector) between the start of 2011 and 2018, although it expects this to be more than offset over time by an increase in market sector employment of around 2.2 million over the same period (OBR, 2012).

High uncertainty about the strength of the recovery is likely to hold back employment growth in the near term. As private sector employment is high in relation to output and involuntary part-time work is common, many firms may respond to higher demand by increasing hours worked by employees and using their workers at full potential, thereby

Table 1. **Main economic indicators for the United Kingdom**

Percentage change from previous period, unless otherwise indicated

	2010	2010	2011	2012	2013	2014
	Current prices, £ billion					
Real GDP	1 466.6	1.8	0.9	-0.1	0.9	1.6
Consumption						
Private	941.5	1.3	-0.9	1.1	1.6	1.4
Government	335.0	0.4	0.2	1.3	-3.0	-1.8
Gross fixed capital formation	218.6	3.5	-2.4	1.8	2.5	3.7
Residential	56.0	13.8	0.3	6.8	0.0	1.4
Non-residential	122.6	-0.4	2.9	3.2	5.3	6.4
Government	40.0	1.6	-20.5	-11.6	-3.8	-3.0
Stockbuilding[1]	2.9	0.9	0.4	-0.5	0.3	0.0
Total domestic demand	1 498.1	2.3	-0.4	0.8	1.0	1.1
Exports of goods and services	447.9	6.4	4.5	-0.2	2.4	3.6
Imports of goods and services	479.4	8.0	0.5	2.8	2.6	2.0
Net exports[1]	-31.5	-0.6	1.2	-1.0	-0.1	0.5
Current account balance[2]	-37.3	-2.5	-1.9	-3.3	-3.5	-3.1
Output gap[3]		-1.7	-1.4	-2.2	-2.3	-2.0
Harmonised index of consumer prices (HICP)		3.3	4.5	2.6	1.9	1.8
Core HICP		2.7	3.0	2.0	1.7	1.6
Unemployment rate[4]		7.9	8.1	8.0	8.3	8.0
Total employment		0.2	0.5	1.0	0.4	0.9
Household net saving ratio[5]		2.0	1.4	0.6	-0.1	0.1
Real compensation of employees[6]		-1.1	-2.1	-0.1	0.5	1.4
Government net lending[2, 7]		-10.1	-8.3	-6.6	-6.9	-6.0
Government gross financial liabilities[2]		85.6	99.9	105.3	110.4	113.9

Note: The fiscal numbers do not reflect the recent decision to transfer the excess cash held at the Bank of England's Asset Purchase Facility to the Exchequer. A clear and comprehensive description of the impact of this measure can be found in the December 2012 issue of the Office for Budget Responsibility's Economic and fiscal outlook.

1. Contribution to GDP growth.
2. As a percentage of GDP.
3. As a percentage of potential GDP.
4. As a percentage of labour force.
5. As a percentage of disposable income. Includes non-profit institutions serving households.
6. Compensation of employees divided by hours worked, and deflated by consumer prices.
7. Includes £28 billion of the Royal Mail pension plan assets received by government in 2012 (1.8% of GDP).

Source: OECD Economic Outlook 92 Database.

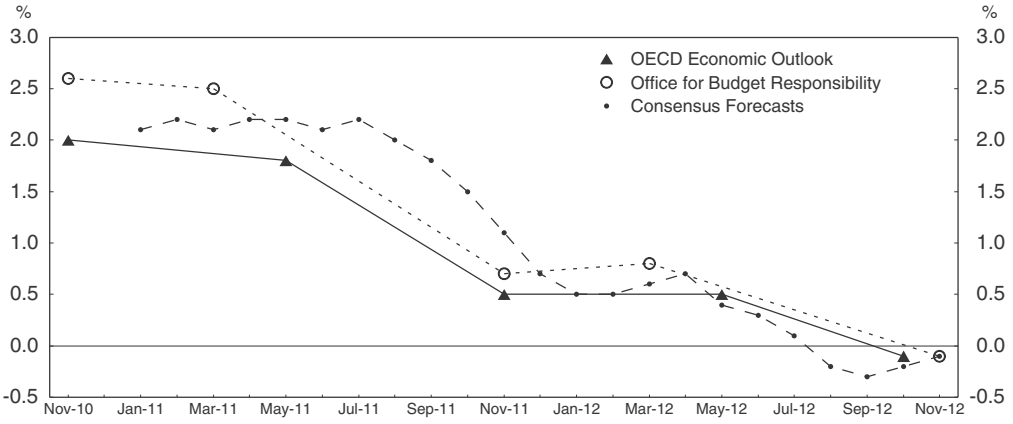
increasing productivity, before hiring more workers. Weak external demand slows the rebalancing of the economy and the ability of export and investment goods industries to compensate the destruction of jobs in declining sectors.

Risks are significant

Risks facing the economic outlook are primarily on the downside, and are particularly linked to international developments, including the euro area sovereign debt crisis, policy uncertainty in the United States and the outlook for emerging economies. Weaker euro area growth would hurt exports. Financial sector disruptions could prove even more damaging, given London's leading role in the global financial system. Banks have limited direct exposures to the sovereign and bank debt of the most vulnerable euro area economies (about 17% of their core tier 1 capital, of which about 5 percentage points to sovereigns and 12 percentage points to banks) but have larger exposures to the non-bank

Figure 2. **Projected real GDP growth in 2012 across selected forecast vintages**

Year-on-year



Source: Office for Budget Responsibility, Consensus Economics and *OECD Economic Outlook 92 Database*.

StatLink http://dx.doi.org/10.1787/888932767612

private sectors of these economies (about 65% of their core tier 1 capital). Aggregate provisions against exposures to weak European countries are at about 9% of Core Tier 1, £19 billion. Exposures to the financial system of core euro area countries, which itself is vulnerable to the periphery, are also significant. For example, UK banks' exposure to German and French banks amounts to over 40% of their core tier 1 capital (all the data for exposures and provisions are as at 2012 H2; BoE, 2012a).

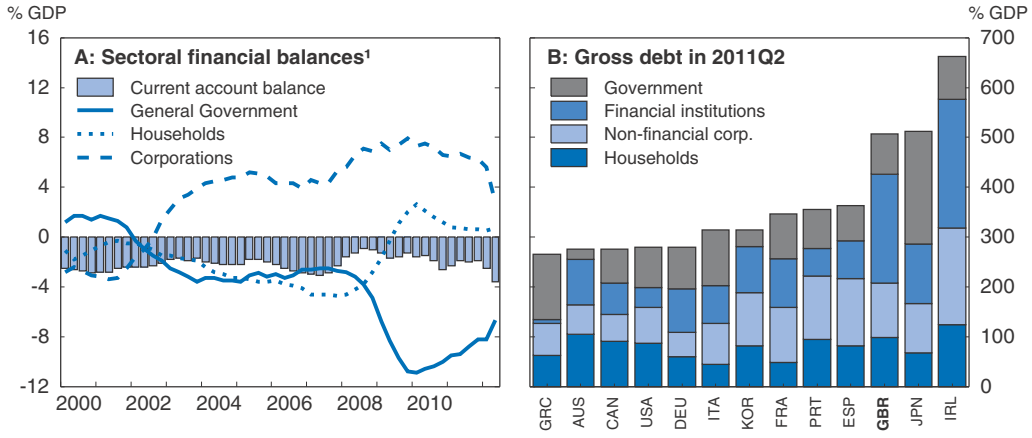
Lower growth than expected could weigh on the labour market. However, employment could also continue to surprise on the positive side. Subdued wage growth is pulling down labour costs, while the financial turmoil tends to raise the cost of capital, favouring labour-intensive activities. Falling relative labour costs may encourage firms to retain workers, especially in sectors with high skills requirements and substantial hiring and training costs. In some cases, further reductions in working hours may also limit job losses.

Policies aim at rebalancing the economy

At the heart of the government strategy is the necessary rebalancing of the economy from debt-financed private consumption and public spending towards exports and investment. Rising wealth, particularly housing, and easy access to credit encouraged households to save less (Figure 3, Panel A). Despite robust growth prior to the financial crisis, the government did not cut deficits, in part because at the time it did not appreciate the temporary nature of some revenues linked to buoyant financial and housing market activity. Strong consumption growth and an exchange rate inflated by capital inflows resulted in sizeable current account deficits. Company profits benefitted from healthy demand and low financing costs, in addition to specific contributions from the financial and housing cycle and rising oil prices. Debt increased substantially in all sectors, and total domestic debt now amounts to about five times annual output, one of the highest levels in the OECD (Figure 3, Panel B). A highly leveraged financial sector makes a sizeable contribution to overall debt, but other sectors are also heavily indebted. However, debt is generally matched by significant asset holdings.

Large private sector financial surpluses, currently around 5% of GDP, and fiscal consolidation will bring debt back to more sustainable levels over time. But lower spending

Figure 3. **Debt and net lending**



1. Four-quarter moving average.

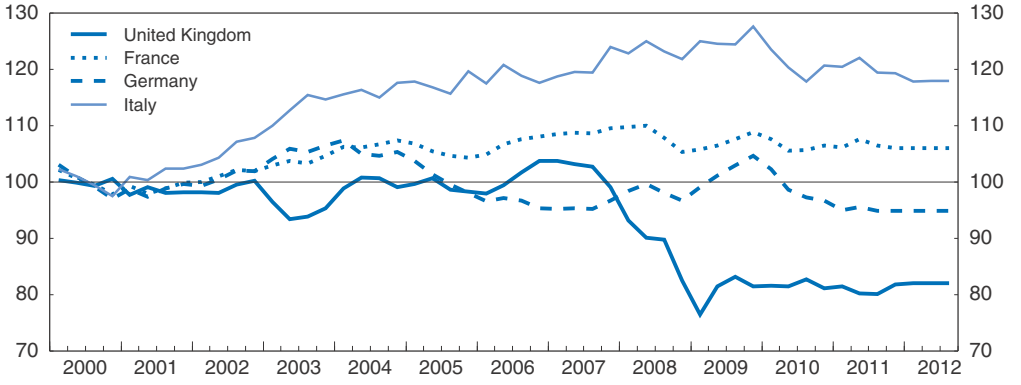
Source: Office for National Statistics and McKinsey Global (2010), "Debt and deleveraging: The global credit bubble and its economic consequences".

StatLink http://dx.doi.org/10.1787/888932767631

by households and government requires other sources of demand to revive growth. The competitiveness of the UK economy needs to be strengthened to foster export growth, which in turn will generate investment and income expansion. It is worth noting that weak export performance is caused by a lack of non-price competitiveness, as relative unit labour costs have declined sharply since 2007, owing to sterling depreciation and sluggish wage growth (Figure 4). The government's *Plan for Growth* is bringing about a wide range of structural reforms to boost the growth potential of the economy, including a new land-use planning framework, support for infrastructure projects, streamlined business regulations, lower corporation taxes, assistance to exporters, measures to reinforce competition and corporate governance, programmes to improve workers skills and facilitate access to finance and policies to promote green growth (HM Treasury-BIS, 2012).

Figure 4. **Competitiveness in the manufacturing sector**[1]

2000 = 100



1. Real effective exchange rate based on unit labour costs in manufacturing.

Source: *OECD Economic Outlook 92 Database.*

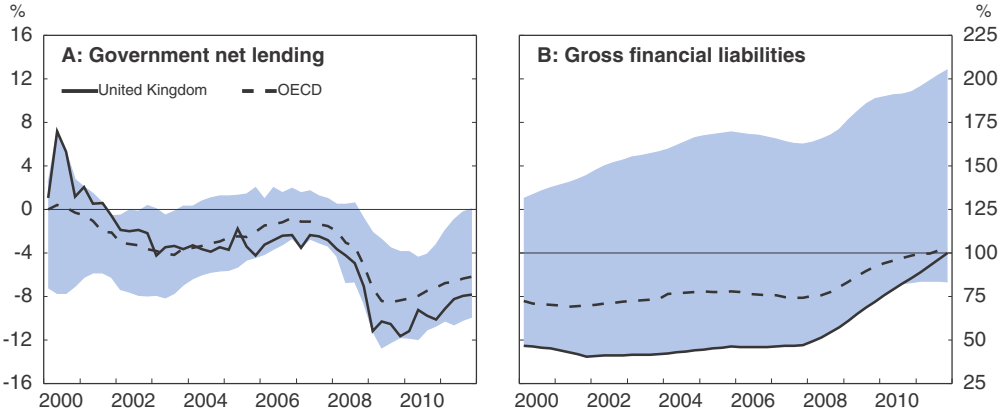
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Reducing government deficits and debt is a major objective

The government deficit reached nearly 11% of GDP in 2009, one of the highest levels in the OECD, which made fiscal adjustment imperative, even though the economy was weak (Figure 5, Panel A). The coalition government elected in 2010 embarked on an ambitious fiscal consolidation programme, setting a mandate to balance the cyclically-adjusted current balance by the end of a five-year rolling horizon and putting public sector net debt as a share of GDP on a downwards path in 2015/16. This is supported by the United Kingdom's strong institutional framework, including the independent OBR, tasked with producing the official economic and fiscal forecasts. The cyclically-adjusted government primary deficit shrank by nearly four percentage points between 2009 and 2011 (Table 2). Even though weak growth is slowing the adjustment of the headline deficit, which remains over 8% of GDP in 2012

Figure 5. **General government deficit and debt**[1]

As a percentage of GDP



1. The shaded area indicates the maximum and the minimum among the seven major OECD countries.

Source: OECD Economic Outlook 92 Database.

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Table 2. **Selected fiscal indicators**

As a percentage of GDP

	2007	2008	2009	2010	2011	2012	2013	2014
General government net lending[1]	-2.8	-5.0	-10.9	-10.1	-8.3	-6.6	-6.9	-6.0
Cyclically Adjusted Net Lending[1, 2]	-4.6	-6.2	-9.9	-9.1	-7.5	-5.6	-5.7	-4.9
Cyclically adjusted primary balance[1, 2]	-2.7	-4.4	-8.4	-6.4	-4.5	-2.7	-3.0	-2.1
Current expenditure	41.5	43.1	46.8	47.2	46.4	47.0	45.7	44.6
Current receipts	40.6	40.8	39.5	39.8	40.0	40.2	40.3	40.2
Gross fixed capital formation	1.9	2.3	2.7	2.5	2.2	2.1	1.8	1.8
Gross public debt, Maastricht criterion	44.2	52.3	67.8	79.4	85.0	89.5	93.7	96.7
Gross public debt, National Accounts definition	47.0	57.1	72.0	85.6	99.9	105.3	110.4	113.9
Net public debt	28.3	33.1	43.9	53.8	67.8	73.0	78.0	81.5

Note: The fiscal numbers do not reflect the recent decision to transfer the excess cash held at the Bank of England's Asset Purchase Facility to the Exchequer. A clear and comprehensive description of the impact of this measure can be found in the December 2012 issue of the Office for Budget Responsibility's Economic and fiscal outlook.

1. Includes £28 billion of the Royal Mail pension plan assets received by government in 2012 (1.8% of GDP).
2. As a percentage of potential GDP.

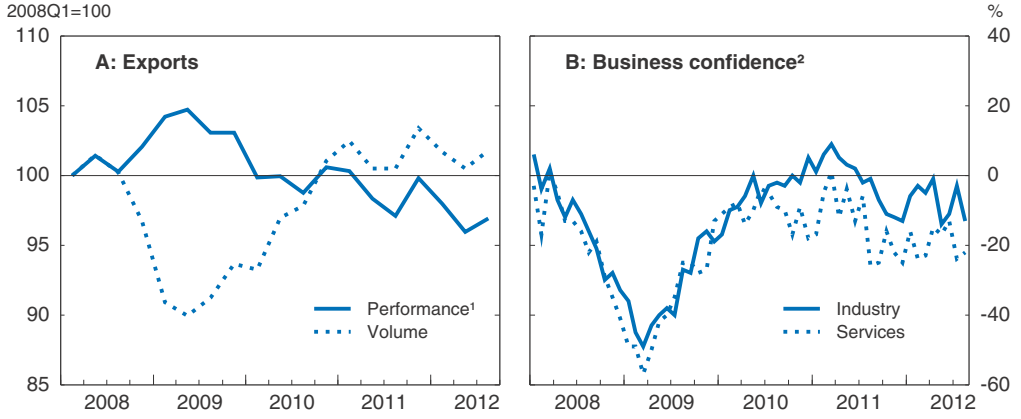
Source: OECD Economic Outlook 92 Database.

(excluding one-offs), fiscal policy has gained credibility. This has been one factor in helping to keep public borrowing costs low, which is crucial to restoring sustainable public finances, as government debt rose to over 90% of GDP (Maastricht definition) at end 2012 (Figure 5, Panel B).

Global economic conditions are weighing on the economy

Until end-2011, the economy was showing signs of rebalancing between internal and external sectors, even if at a disappointing pace given the depreciation of sterling. But renewed weakness in the euro area, associated with the sovereign debt crisis, is slowing exports, half of which traditionally go to other European Union countries (Figure 6, Panel A). The euro area crisis is also affecting business confidence, which discourages investment and hiring (Figure 6, Panel B). Financial conditions have also become tighter, as bank funding costs have risen and lenders are extremely cautious in a situation of uncertainty. This may explain part of the slow reallocation of resources towards export sectors more recently.

Figure 6. **External environment and business confidence**



1. Ratio of real exports to export markets (trade-weighted average of trading partners' imports).
2. Expressed in percentage balances, which are determined by subtracting the percentage of companies reporting decreases from the percentage of companies reporting increases.

Source: OECD Economic Outlook 92 Database and European Commission.

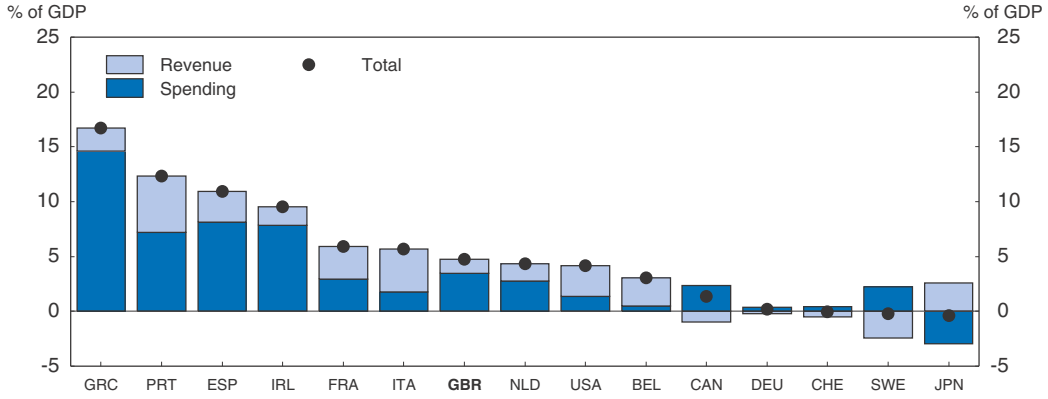
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The flexibility of the fiscal framework should be utilised if growth fails to pick up

The Government's fiscal stance remains appropriate. Medium-term fiscal consolidation is essential. With a government deficit still over 8% of GDP (excluding one-offs) and gross government debt above 80% of GDP, restoring fiscal sustainability needs to remain an overarching objective. The fiscal consolidation plan is substantial (Figure 7). Moreover, it relies for a large part on spending cuts, which across OECD countries have historically proved better at generating lasting fiscal consolidation than tax increases (Guichard *et al.*, 2007). A strong institutional framework and credibility earned by reaching fiscal objectives so far have fostered confidence in UK fiscal policymaking and the medium-term fiscal consolidation path. The fiscal framework appropriately provides flexibility to adapt to weaker than expected economic developments, which allows the operation of the automatic stabilisers. The supplementary target requiring public sector

Figure 7. **Fiscal consolidation plans**

2009-13[1]



1. Cumulative contribution to consolidation from expenditure and revenue measures.
Source: OECD Economic Outlook 91 Database and OECD Fiscal Consolidation Survey 2012.

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net debt to decline as a share of GDP by 2015/16 could be an obstacle to letting automatic stabilisers play. Postponing the date from which debt has to fall may not trigger adverse market reactions, provided the strong and credible commitment to medium-term consolidation is maintained. With the government providing further detail regarding their medium-term consolidation plans in their Autumn Statement of 5 December, the decision to continue with its existing consolidation plans and not override the automatic stabilisers to meet the supplementary debt target is appropriate. Nevertheless, global developments have shown that the consequences of losing market confidence can be sudden and severe and a sharp rise in interest rates would be particularly damaging to an economy with the United Kingdom's level of indebtedness.

Monetary policy is supportive and should be sustained

Monetary policy has appropriately played a major role in supporting the economy since the beginning of the global economic and financial crisis. The Bank of England (BoE) policy rate has remained at 0.5% since March 2009. This has provided relief to indebted firms and households facing lower revenues as a result of the downturn, and has allowed more forbearance on the part of lenders. Banks have also benefitted from lower refinancing costs. Nevertheless, lower policy rates have not been fully transmitted to lower bank lending rates, as higher risks and need for bank deleveraging have pushed spreads up.

As the policy rate came close to zero, the BoE turned to quantitative easing (QE) to support a flagging economy. QE appears to affect output and inflation mainly through the portfolio balance channel. Provided the assets acquired by the BoE and money are imperfect substitutes, investors who sell assets to the central bank acquire other long-term assets, pushing their prices up and yields down. Since March 2009, successive rounds of asset purchases financed by the issuance of central bank reserves have brought BoE holdings of long-term securities, essentially gilts, to £375 billion (nearly 25% of GDP). The Bank of England estimates that the first QE programme, implemented in 2009 (£200 billion, 14% of GDP) may have depressed gilt yields by about 100 basis points and lifted real GDP by 1.5-2% and inflation by 0.75 to 1.5 percentage points (Joyce *et al.*, 2011; Bridges and Thomas, 2012; Kapetanios *et al.*, 2012). This is comparable to the effect of a 150 to 300 basis point cut

in the policy rate. QE is estimated to have lowered investment-grade corporate bond yields by 75 basis points. As investors also diversified into foreign assets, QE could have pushed sterling down by 4%, though large uncertainty surrounds this estimate, as it is difficult to isolate other factors affecting the exchange rate (Joyce *et al.*, 2011).

Significantly above-target inflation in 2010 and 2011, resulting from the lagged effects of sterling depreciation, increases in indirect taxes and rises in energy and commodity prices prompted caution and were factored into the Monetary Policy Committee (MPC)'s decisions on QE expansion. But renewed weakness in the economy, uncertainties in the international environment, a judgement that inflation would undershoot the target in the medium term, and rapidly falling inflation led to the announcement of a resumption of QE in October 2011 and again in June 2012.

QE is not without risks (BIS, 2012; Dale, 2012; White, 2012) and could face diminishing returns (Meaning and Zhu, 2011). Though it helps public and private balance sheets in the short term, in the longer term it risks perpetuating weak balance sheets, distorting financial markets and leading to a misallocation of credit, as happened in Japan in the 1990s. However, determined government action to cut the fiscal deficit and to address the weaknesses of the financial system is limiting such risks in the United Kingdom. Low interest rates may also discourage saving. While this might be desirable to some extent in times of weak demand, it might hamper capital accumulation and growth in the longer term. As QE flattens the yield curve, it tends to erode bank margins and reduce insurance companies and pension fund returns. Nevertheless, the impact of QE on pension fund deficits, while not trivial for significantly underfunded schemes, is small compared to other influences, such as equity price movements (Bean, 2012).

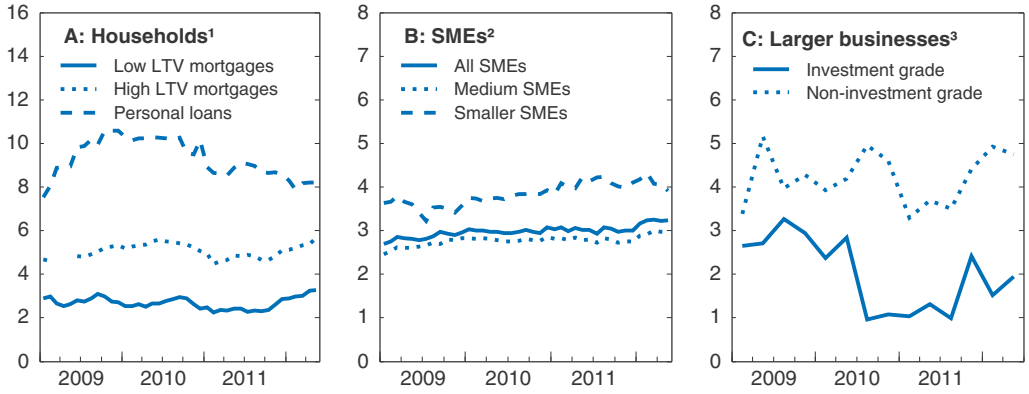
As central bank holdings of securities increase, exit from QE might become more difficult, raising expectations of future inflation. However, the MPC has made clear its decision on exit will be based on meeting the inflation target in the medium term. Inflationary risks are low, given the slack in the economy and slow wage growth. Finally, loose monetary conditions around the world might induce excessive risk taking and fuel bubbles, for example in commodity prices, housing or emerging economies' assets, posing a threat to global financial stability. Reinforced international co-operation would ensure that such risks are properly addressed.

Overall, in the current economic situation, further expansion of the asset purchase programme would be warranted if the economy stays weak. At the same time, QE's impact on financial markets should continue to be monitored closely and a clear strategy to withdraw liquidity as appropriate once the economy recovers should be devised. Other options for monetary policy expansion include cutting the policy rate to close to zero and buying private securities as part of QE. At this juncture, such options do not appear to have clear advantages over expanding QE.

Measures to ease liquidity and credit conditions are being taken

Liquidity stress associated with the euro area sovereign debt crisis has prompted the BoE to launch the Extended Collateral Term Repo Facility (ECTR), which allows banks to access short-term liquidity against a wide range of collateral for a period up to six months. High risk aversion related to concerns about financial developments in the euro area have pushed up bank funding costs markedly, impairing the flow of credit to the real economy, especially small and medium enterprises (SMEs) and households (Figure 8). The BoE, with

Figure 8. **Credit conditions**



1. Spreads on lending. In percentage points.
2. Spreads between indicative median interest rates on new SME variable-rate facilities, and the Bank rate. In per cent.
3. Spreads on syndicated loans, which typically apply to lending for larger businesses. In percentage points.

Source: Bank of England "Financial Stability Report, June 2012" and "Trends in Lending, July 2012".

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the agreement of the Treasury, has launched the Funding for Lending Scheme (FLS) in July 2012 to lower the cost of funding for banks which expand lending, with the fee paid by banks depending on banks' performance in expanding lending. Bank funding costs fell considerably after the scheme was launched and the FLS is now expected to allow credit, especially mortgages, to pick up. So far, 35 banks have signed up for the scheme. These banks account for about 82% of the eligible stock of loans to UK households and non-financial companies. Whether the FLS will increase lending significantly is uncertain, as it depends on the extent to which slow credit growth is driven by supply tightness linked to funding difficulties, as opposed to lack of demand and creditworthiness of borrowers. The authorities should monitor closely its take up and operation.

Government schemes to provide liquidity to banks during periods of stress have proved decisive in mitigating temporary funding squeezes at the height of the global financial crisis in 2009 and exit from such schemes has run smoothly. The roughly £185 billion of Treasury bills advanced under the BoE's Special Liquidity Scheme (SLS) have been repaid and debt issued under the Credit Guarantee Scheme has fallen 95% from its peak of around £140 billion (BoE, 2012b).

There is evidence that an impaired financial system can hamper the reallocation of resources across sectors, delaying the recovery and the rebalancing of the economy (Broadbent, 2012). Recoveries following financial crises tend to be weak, resulting in permanent output losses relative to long-term trends and persistent weakness in productivity growth (Reinhart and Rogoff, 2009). This is linked to a variety of factors, including the overestimation of trend growth before the crisis, persistent misallocation of capital and labour, debt overhangs and impaired financial intermediation (Borio, 2012).

The financial system is being strengthened

In the wake of the global economic and financial crisis, the United Kingdom has moved faster and more resolutely than most other OECD countries to strengthen its financial system. A new financial regulation and supervision framework is being put in

place, which gives the Bank of England responsibility for macro-prudential supervision of the financial system (through the Financial Policy Committee) and oversight of day-to-day micro-prudential supervision of financial services firms (through the Prudential Regulation Authority). Such a framework will allow better monitoring of the financial system. The Financial Policy Committee (FPC), will be established within the Bank of England, and will be responsible for identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. An interim FPC has been established to undertake, as far as possible, the role of the permanent FPC ahead of the Financial Services Bill becoming law. For example, it recently prompted adjustments in the FSA liquidity and capital regimes to respond to euro area related financial stress.

The Bank of England's November 2012 *Financial Stability Report* also recommended to the Financial Services Authority (FSA) to ensure that bank capital holdings reflect a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. Where necessary, capital should be raised or balance sheets restructured in a manner that do not hinder lending to the real economy. In an innovative, constantly evolving and internationally interconnected financial system, effective macro-prudential supervision, including monitoring of leverage, cross-border bank exposures and shadow banking, will be decisive in preventing future crises.

The government mandated the Independent Commission on Banking (ICB), to examine ways to improve stability and competition in the banking system. The commission released its final report in September 2011 and the government has committed to implement most of its recommendations, though it will reduce requirements in terms of leverage and is considering whether to allow the use of some derivatives by commercial banks to offer risk management possibilities to clients. A bill to implement the ICB recommendations has been published in October 2012 and is undergoing pre-legislative scrutiny by the Parliamentary Commission on Banking Standards, with legislation expected for 2013. There are broad similarities between the ICB and European Union Liikanen commission proposals, which should facilitate the implementation of the ICB recommendations, even though adjustments will be needed to ensure full compatibility.

The main recommendation of the ICB report is to ring-fence retail banking from global wholesale and investment banking to address the "too big to fail" problem and to shield domestic banking from global financial shocks. The role of the City of London as a major international financial centre brings huge benefits to the United Kingdom. However, as the 2008-09 crisis showed, risky financial activities may threaten financial stability, disrupt financing of the domestic economy and impose high costs on taxpayers when banks have to be bailed out. During the global financial crisis, banks driven by investment banking were the most problematic in terms of contagion and counterparty risk (Blundell-Wignall *et al*., 2009).

Ring-fencing has several advantages. It makes it easier and less costly to resolve banks that get into trouble, avoiding an excessive burden being borne by taxpayers, and it makes retail banking more resilient to external financial shocks. It also facilitates monitoring banking activities by market participants, leading to a better pricing of risk, and by the authorities, allowing better prudential regulation. Nevertheless, ensuring that the ring-fence between investment and retail banking is and remains effective will require careful financial system supervision and monitoring of shadow banking. The use of derivatives will need to be limited and carefully monitored to avoid weakening the ring fence.

The ICB also recommended that equity capital for large retail banks should be at least 10% of risk-weighted assets, and that large banking groups have primary loss-absorbing capacity of at least 17-20% by 2019, which would be one of the highest requirement in the OECD. Banks have already significantly strengthened their capital base since 2007, but the increase in capital ratios stalled in 2011 as profitability declined. Nevertheless, the core tier 1 capital ratio of the banking system was around 12% in 2011, above that of most other European countries and only slightly below that of the United States. The average leverage ratio of major UK banks also declined from 34 in 2008 to 18 in 2011 (BoE, 2012b).

Box 2. **Recommendations on macroeconomic and financial policies**

Continue to support the economy through accommodative monetary policy. Sustain quantitative easing, support for lending and liquidity provision.

The automatic stabilisers should continue to operate, as allowed by the flexibility of the fiscal framework. Maintain the strong commitment to medium-term consolidation.

Implement the main recommendations of the Independent Commission on Banking and continue to enhance financial system supervision, including by monitoring shadow banking. Ensure that the ring-fence between investment and retail banking becomes effective.

Labour market and welfare policies to encourage work and raise employability, while protecting the most vulnerable

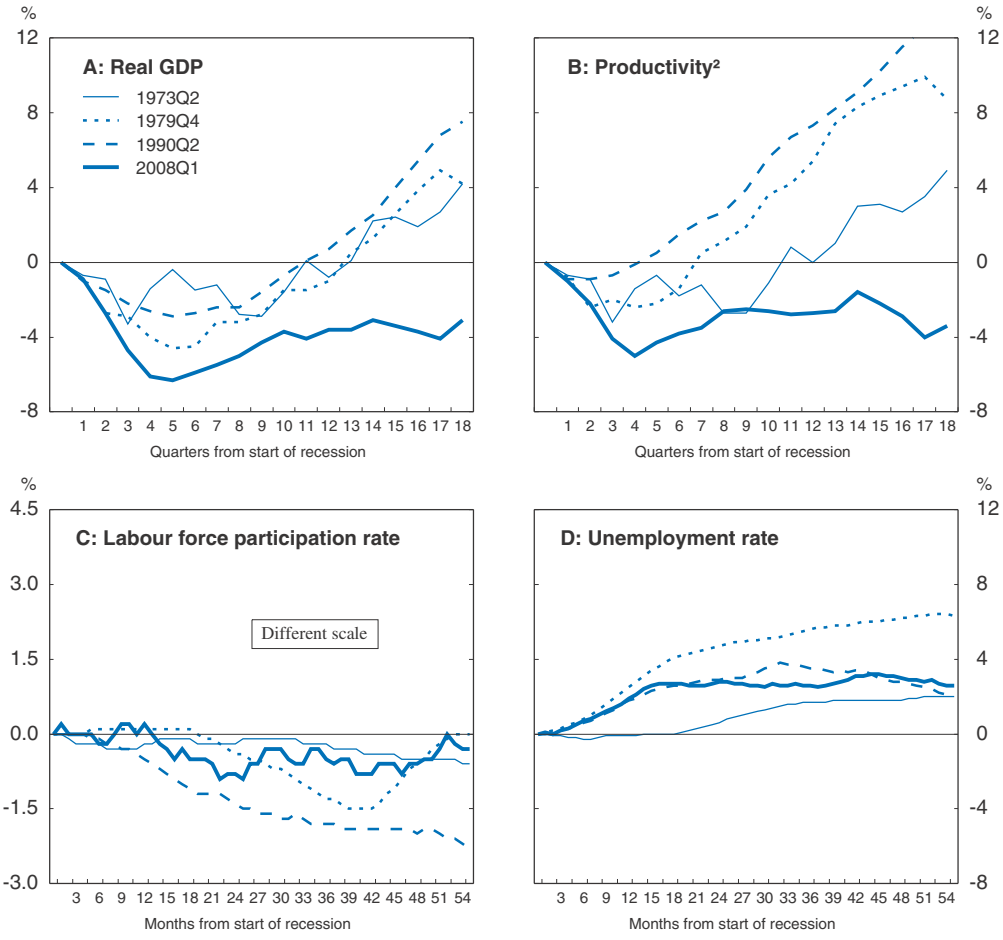
The labour market has consistently outperformed forecasts

Employment has risen by more and unemployment has risen less than expected given the path of output. The increase in the unemployment rate has been similar to that in the 1990s and much smaller than in the 1980s, despite much larger output losses (Figure 9, Panel D). At around 8% of the labour force, the unemployment rate is close to the OECD average, but nearly three points below the European Union (EU15) average. While the contraction in output is the deepest and most protracted of the post-war period, the decline in labour utilisation has been more modest, a significant part of the slack being absorbed by a fall in labour productivity (Figure 9, Panels A to C). This performance is all the more remarkable as labour participation, especially among older workers, has remained roughly constant, contrary to what happened in the 1990s. Countries which have experienced similar output losses as the United Kingdom since 2008, such as Denmark and Spain, have suffered much larger percentage falls in employment. Over the same period, the United States has experienced a far greater contraction in employment despite a recovery which has brought GDP above its pre-crisis peak.

Job losses have been significant in construction and manufacturing. The decline in construction employment looks essentially cyclical, while in manufacturing, the recession has prolonged a long-term declining trend in employment. The service sector has led the creation of jobs, although with sub-sector differences. Public administration, health and education have seen the largest increases in employment over the past four years, but cuts in public jobs are expected going forward. The flexibility of the labour market contributes to explaining the relatively limited losses in employment over recent years. Real wages have adjusted to lower productivity, limiting the pressure on companies to reduce their workforce. Adjustments in the number of hours worked by employees have also limited job losses.

Figure 9. **Labour market developments compared to previous recessions**

Deviation from the peak[1]



1. Percentage change for real GDP and productivity. Change, in percentage points, for the labour force participation rate and the unemployment rate.
2. Defined as real GDP divided by total employment.

Source: Office for National Statistics.

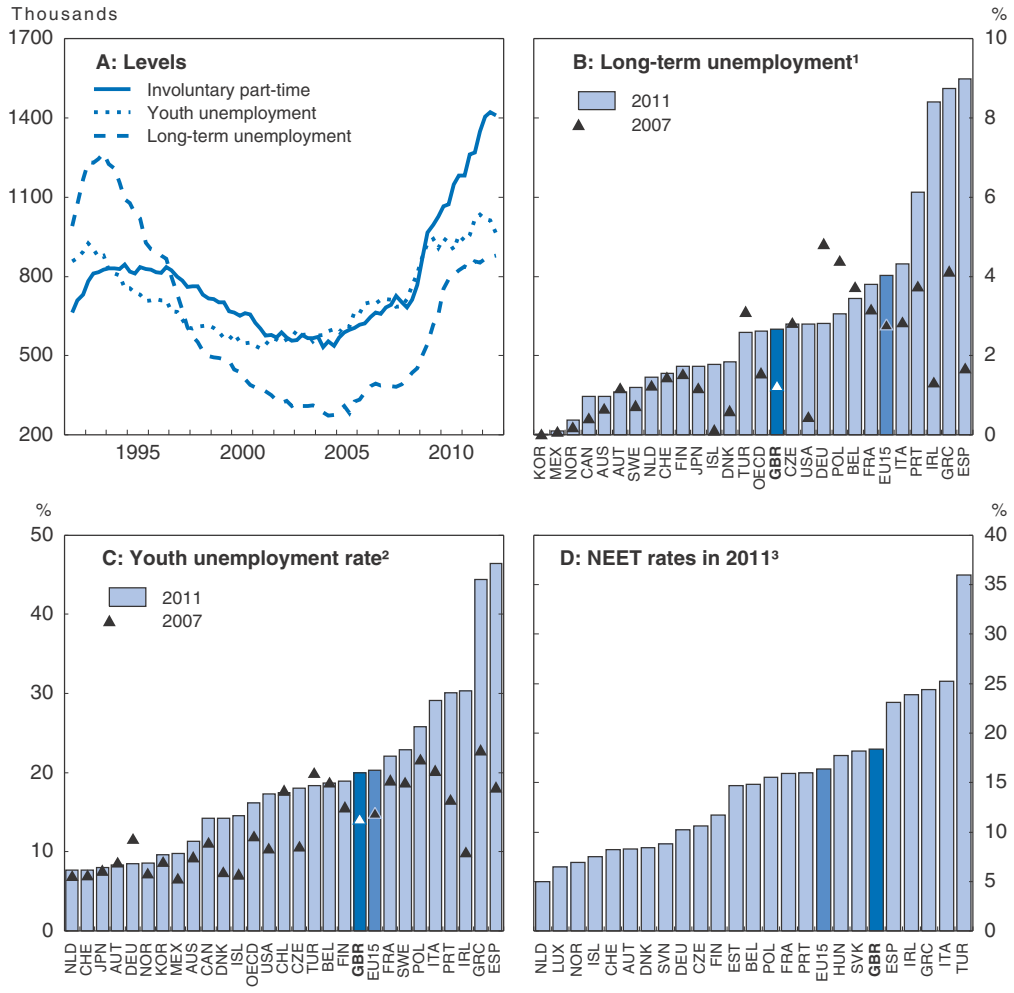
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But youth unemployment and involuntary part-time work are high

Long-term and youth unemployment, and involuntary part-time work have increased markedly, now reaching about 900 000, 950 000 and 1.4 million (Figure 10, Panel A). The long-term unemployment rate is slightly higher than the OECD average, but remains significantly below the European Union (EU15) average (Figure 10, Panel B). Even though youth unemployment has fallen recently, it is somewhat higher than in the EU15 and well above the OECD average (Figure 10, Panel C), although youth unemployment includes around 300 000 full-time students (about 30% of the total), which makes international comparisons difficult. The youth, as entrants to the labour market, are traditionally amongst the worst hit by recessions. But youth unemployment started to increase before the recession, and so it is unclear to what extent this represents a more structural problem.

Furthermore, the number of youth not in employment, education or training (NEETs) has been on a rising trend and is among the highest in Europe, being surpassed only in

Figure 10. **Long-term and youth unemployment and involuntary part time**



1. Duration of unemployment longer than one year; as a percentage of the labour force.
2. Aged 15 to 24.
3. People aged 18 to 24 not in education, employment, or training.

Source: Office for National Statistics, Eurostat and *OECD Labour Force Statistics Database*.

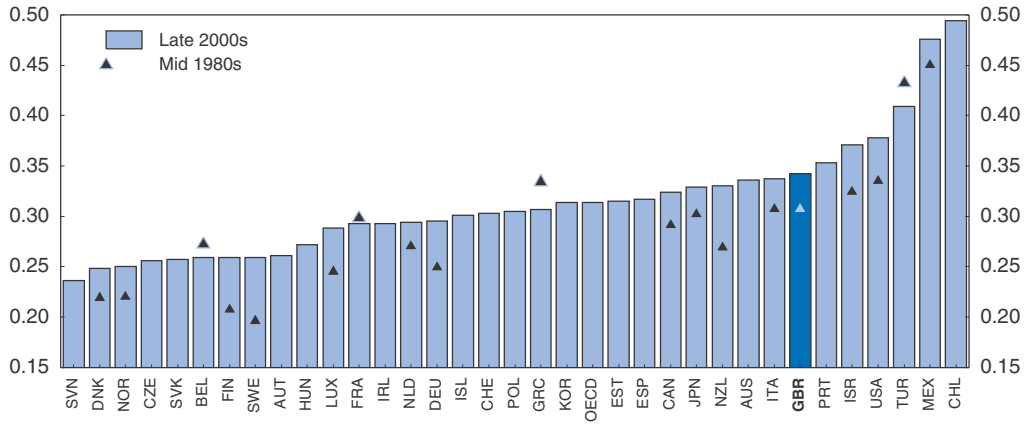
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some southern EU countries, Turkey and Ireland (Figure 10, Panel D). NEETs face a risk of lasting exclusion from work causing permanent scars for the individuals involved, weakening the long-term economic growth potential as human capital erodes, and undermining social cohesion. High unemployment and inequality are likely to have adversely affected well-being.

Inequality and poverty are high

Labour market conditions are widening the income gap between full-time employees and an increasing share of the workforce on part-time, insecure and often low-paid jobs. This comes in a context where income inequality in the United Kingdom was already high and rising before the recession, as in many other OECD (Figure 11). The underlying causes of rising inequality are linked to globalisation, technological change, as well as evolutions of product and labour market institutions, policies and regulations. Although inequality

Figure 11. **Income inequality developments**[1]



1. Measured by the Gini coefficient based on equivalised household disposable income, after taxes and transfers.
Source: OECD Database on Household Income Distribution and Poverty.

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fell in 2010-11, as the fall in real incomes was larger at the top of the income distribution than at the bottom, absolute poverty increased (Cribb *et al.*, 2012). Moreover, significant cuts in social transfers will deeply affect low income households.

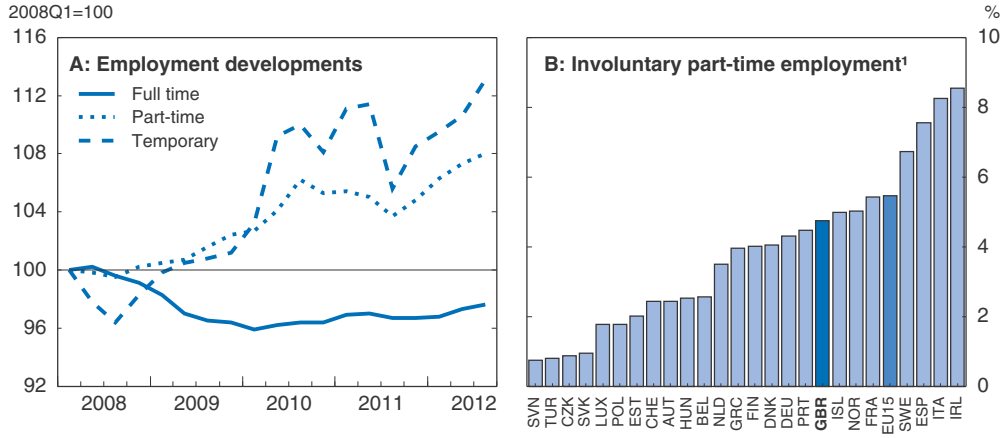
Fairness is important to ensure public support for the necessary fiscal consolidation effort, which will need to be sustained over a protracted period. Restraint on spending on public services, imposed by the budget situation, will hit the poor the hardest, as their consumption of public services is higher relative to their income than for the more affluent and they have less access to alternative services. However, efficiency gains could, at least partly, compensate for lower spending. OECD studies have estimated significant scope for efficiency enhancement both in education and health care in the United Kingdom (Sutherland *et al.*, 2007; OECD, 2010a). Reaping potential efficiency gains will be essential to preserve the quality of public services, while ensuring fiscal sustainability.

Rising fuel and to a lesser extent water prices are putting an increasing burden on low-income households. Support should be provided in an environmentally friendly way, by better targeting financial transfers and taking measures to improve energy efficiency and resource management. Gradually raising the VAT rate on domestic energy use over time from 5% to the standard rate of 20% would promote consistency in climate change policies and enhance efficiency of taxation (OECD, 2011b). Relevant distributional concerns could be addressed through targeted support. Similarly, means testing Winter Fuel Payments could more efficiently help tackle fuel poverty. As the Green Deal and Energy Company Obligation are implemented to promote investment in energy efficiency, it will be necessary to ensure that fuel poor households are not left behind. Monitoring the quality of insulation installations, possibly through a single body, would encourage investment. Streamlining the certification process for new insulation products would foster competition and innovation.

Planned public spending cuts and changes to lower rates of indexation of benefits will increase inequality further, at least in the short term. Unemployment and under-employment are also powerful drivers of inequality and poverty. Employment is the best way out of poverty, which justifies the policy focus on incentivising and supporting return to work, even though there is generally a trade-off between strengthening work incentives and reducing inequality by redistributing income, which can be mitigated by conditionality

(IFS, 2012). But being employed is not necessarily enough to get out of poverty. In-work poverty is rising, as the labour market is becoming increasingly polarised (Figure 12). The rise in part-time and involuntary temporary work in low qualified jobs can lead to in-work poverty, as on average part-timers work less than half the number of hours of full-timers and earn less than a third of their salary.

Figure 12. **Part-time and temporary work**



1. As a percentage of total employment. Refers to 2011.
Source: Office for National Statistics and Eurostat.

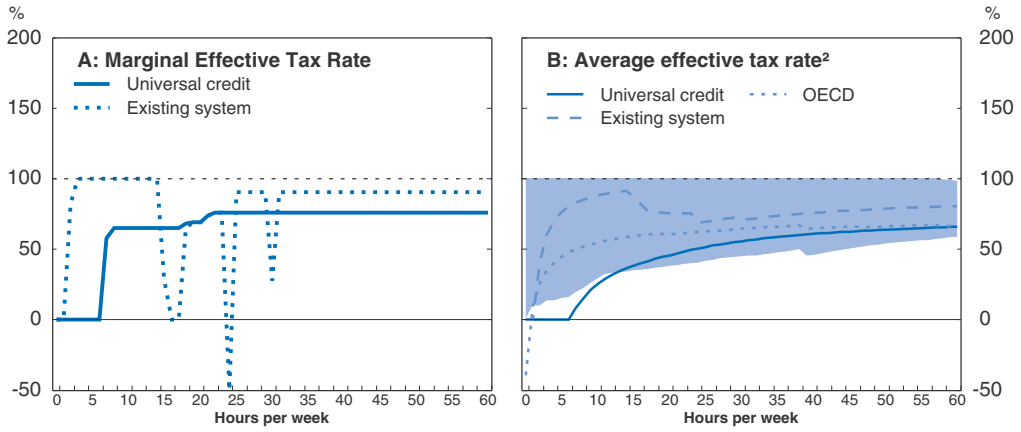
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Rationalising the welfare system and reinforcing work incentives

The welfare system protects a sizeable share of the population, including the old, disabled, unemployed, lone parents and families with children. It provides support both to those out of work and those in work on low income. As unemployment remains high, real wages decline and involuntary part-time work rises, this safety net is all the more essential. The recession and cuts in public spending risk increasing poverty. Early intervention to help those most in need, including people at risk of homelessness or suffering from mental health problems and youth not in employment, education or training, is warranted. The homelessness strategy focusing on prevention recently outlined by the Department for Communities and Local Government is welcome (DCLG, 2012a). For individuals who are able to work, policies should focus on return to work to avoid creating unemployment and poverty traps and long-term welfare dependency. The two main welfare reforms being implemented, Universal Credit and the Work Programme, are going in that direction.

The Welfare Reform Act of 2012 introduces a wide range of reforms to the benefit and tax credit system. Universal Credit will replace a myriad of means-tested benefits by a single benefit with generous earnings disregards and one single taper rate (the phasing out of the benefit as income rises). Stated goals of the Universal Credit reform include giving people incentives to work, diminishing complexity, reducing poverty and containing the rising cost of welfare dependency (DWP, 2010a). The reform represents a radical overhaul of the incentive structure. In particular, excessively high marginal and average effective tax rates have been removed, which should reduce distortions (Figure 13). The highest marginal effective tax rate (METR), the amount which will be lost in taxes and loss of benefits from earning an additional pound, stands at 76.2% after the reform. Although still high in absolute terms, this is lower than in the existing system, where the METR could reach 100%.

Figure 13. **Incentives to work for a primary earner in a couple with children**[1]



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%. The full set of model assumptions can be found in Pareliussen (2013).
2. Data for the OECD refer to 2010. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

Source: OECD calculations and OECD Taxben model.

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Universal Credit will considerably simplify the benefit system, which in the long run will most likely reduce administration costs and the potential for fraud and error. The increased simplicity for users will also increase the flexibility of the labour force, since the uncertainty of having to re-apply for benefits after a period of work represents an additional cost of entering work in the current system. Universal Credit should raise the take-up rate of benefits, which is currently estimated in the range of 75 to 85% (DWP, 2010b). The combined impact of take-up and increased entitlements for low income families is expected to lift around 900 000 individuals, including 350 000 children, out of poverty (DWP, 2011). This improvement will, however, be more than offset by previous changes to the benefit system such as cuts to the Housing Benefit and changes in indexation of benefits to the consumer price index (Brewer *et al.*, 2012; HM Treasury, 2012a).

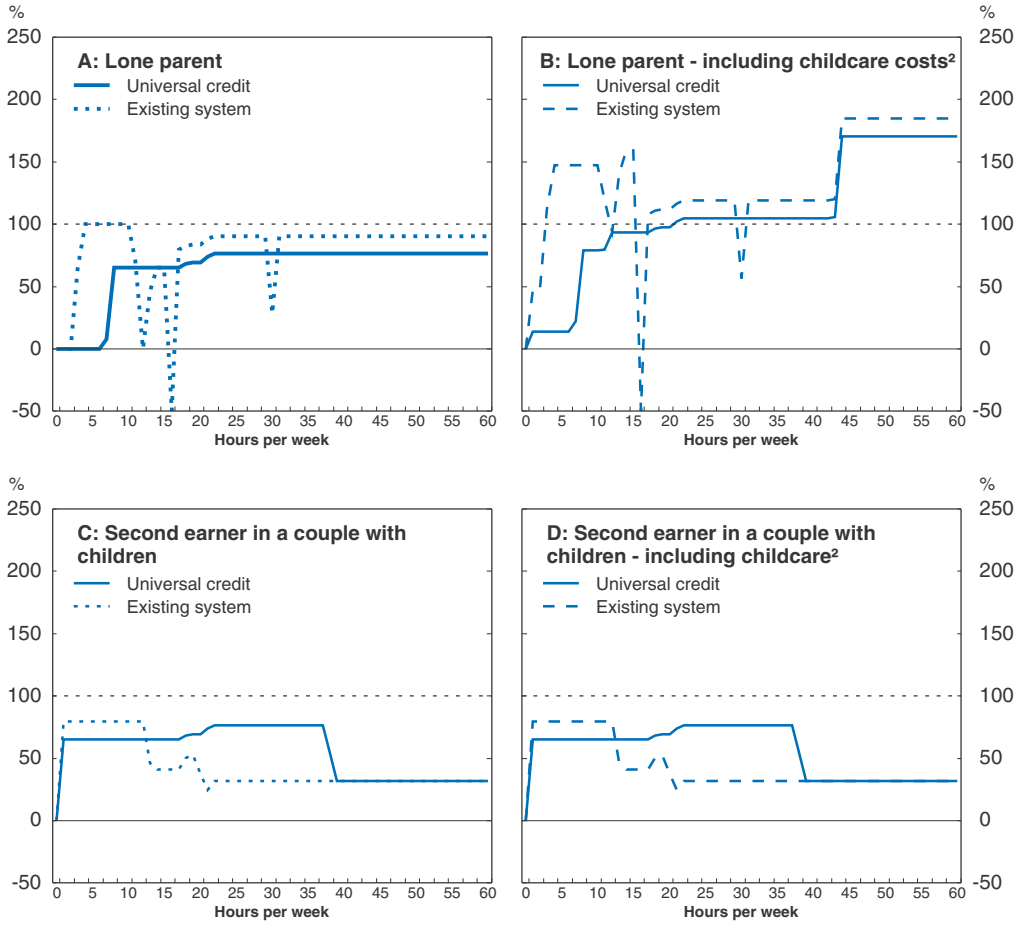
Work incentives may remain inadequate for some

Primary earners in couples, who will have higher benefit income and face lower marginal effective tax rates, stand to gain the most from the reform. Many lone parents will face lower marginal effective tax rates and also have higher benefit income (Figure 14, Panel A). While the effect of the reform for second earners will depend on individual circumstances (Figure 14, Panel C), household income will generally increase for this group. For single persons the effect of the reform is ambiguous.

The removal of the current 16-hour threshold to become eligible for childcare support in combination with the increased earnings disregards will give significantly better incentives for lone parents to work a few hours a week compared to the current system (Figure 14, Panel B). The removal of the threshold for childcare support is also positive for second earners, as the very high METRs below the 16 hour threshold in the current system are lowered considerably (Figure 14, Panel D). Still, high childcare costs can reduce the gain of the reform especially for low- to medium-wage second earners and lone parents earning more than their earnings disregard. These groups respond particularly strongly to improved incentives (OECD, 2011a). In addition, lone parents are over-represented in poor

Figure 14. **Incentives to work for lone parents and second earners**[1]

Marginal effective tax rates



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%. The full set of model assumptions can be found in Pareliussen (2013).
2. Assuming childcare costs of £4 per child per hour worked.

Source: OECD calculations.

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households, so improving lone parent's incentives to work would have the potential to reduce poverty and child poverty even further than the reform as it stands today.

A number of additional measures could strengthen the work incentives of poor families with children, including increasing the refund rate for childcare, reducing the taper rate for those who receive childcare support, and introducing a dedicated disregard for second earners in couples. The most targeted way of addressing disincentives caused by childcare costs would be to increase the refund rate for childcare costs. The rate was lowered from 80% to 70% in the 2010 spending review, with estimated savings of £350 million a year. In comparison, reducing the overall taper rate from 65 to 60% would cost approximately £1 300 million a year. On the other hand, better incentives for lone parents and second earners would increase the effectiveness of the reform and thereby increase the economic growth potential and reduce inequality. These additional costs could be partly offset by reducing the disregard, especially for primary earners in couples.

It is impossible at this point to say with certainty to what extent the Universal Credit will contribute to reducing welfare dependency and lowering the cost of the welfare system. This depends on how changes in incentives induce behavioural change. The Department for Work and Pensions (DWP) assumed that the net effect on labour supply will reduce the number of workless households by 300 000 (DWP, 2010a). This number is very sensitive to assumptions regarding labour supply elasticities, potential wages and potential work hours for inactive lone parents and second earners with children. OECD analysis based on different sets of assumptions (Pareliussen, 2013) estimates that the effect could be a reduction of the number of workless households by between 45 000 and 240 000, and an increase in labour supply equivalent to 15 000 to 85 000 full-time employees. Childcare costs are not taken into account in either of these analyses. Unless the disincentive of high childcare costs is reduced, the positive effect on labour supply is likely to be lower.

Universal Credit, is a major system change, and therefore faces the risk of implementation problems. The reform is particularly vulnerable to potential IT system failures. This could lead to unnecessary uncertainties and hardship for vulnerable groups in the transition period. The planned phased introduction of Universal Credit is helpful in mitigating these risks, and should be combined with sound contingency plans and transparent information for users (Finn and Tarr, 2012).

Active labour market policies are being reformed

The government launched the Work Programme in June 2011 to help those unemployed in need of tailored support, such as disability benefit claimants and the long-term unemployed, to undertake active and effective job-search. The two cornerstones of the programme are personalised support and payment for results. Emphasis on personalised support and early intervention is supported by international evidence (OECD, 2005; Daguerre and Etherington, 2009). The Work Programme gives providers more freedom to personalise support than previous welfare-to-work schemes, allowing more innovative approaches, and provides better incentives for service providers. It is based on sound principles, but anecdotal evidence suggests some implementation problems, including concerns about financial viability for service providers in the current challenging labour market conditions and co-ordination problems between private firms and voluntary organisations, which have led a number of charities to withdraw from the programme. To ensure the Work Programme is efficiently addressing its objectives, the government has commissioned an independent evaluation by the IES (Institute for Employment Studies).

About half of the five million people receiving out-of-work benefits are on disability benefits. This represents about 7% of the population aged 20-64 and is above the OECD average, suggesting that some disability benefit recipients could return to work under appropriate conditions. Employment and Support Allowance replaced the previous incapacity benefits in October 2008 to provide financial support for those unable to work because of illness or disability, a Work Capability Assessment (WCA) was introduced to assess claimants' functional capacity. From April 2011 existing incapacity benefit claimants are having their eligibility determined via the WCA process. Reassessing existing claimants according to new criteria is exceptional in an OECD context.

The WCA has been controversial – the British Medical Association has called for scrapping the scheme. Roughly 40% of people found fit for work appeal the decision and around 38% of those people who appeal have the decision overturned. Overall, 15% of fit for work decisions are overturned on appeal. The first *Independent Review of the* WCA

(Harrington, 2010) and the Work and Pensions Committee report on incapacity benefit reassessment (2011) both criticised how the WCA was working in practice. The second *Independent Review of the WCA* (Harrington, 2011) found that improvements had been made, but also that more needs to be done. The WCA needs further improvement to make it fairer and more effective. Furthermore, it is crucial to give strong support to people assessed as fit for work in their search for a job. Therefore, communication between WCA decision makers and service providers in the Work Programme needs to be intensified.

More than one third of new disability benefit claimants in 2008 were suffering from mental health problems, and more than 40% in the 20-34 age group. Mental health problems are gradually becoming the main cause for disability claims across OECD countries, accounting on average for a third of the total and often more than half for young people (OECD, 2010b). The United Kingdom is among the most advanced countries in terms of awareness about the costs of mental illness for employers and society as a whole, and of the mental-health benefits of employment. Integration of health and employment services is also well developed. Nevertheless, early intervention to help people suffering from mental health problems should be promoted, along with other measures to enhance the role of health professionals, employment services and employers in prevention and support for return to work.

Youth unemployment has fallen in recent months. However, tackling youth unemployment is a major challenge, with both short-term and longer-term social and economic implications. Young people must be prevented from falling into poverty and social exclusion, which would likely lead to permanent effects on their working careers. The government has taken measures focussed on giving young people the skills and opportunities to gain long-term employment in the private sector. Evaluations of private sector subsidised employment programmes in other OECD countries have frequently found a positive impact on employment (OECD, 2005).

Enhancing workforce skills is necessary to reduce inequality and promote growth

Low skills tend to be highly correlated with unemployment and large income inequalities. The United Kingdom is one of the OECD countries where the socio-economic background has the strongest influence on education achievement (Causa and Chapuis, 2009). The *2011 Economic Survey of the United Kingdom* (OECD, 2011b) suggested ways to improve educational outcomes, especially for disadvantaged children. The government has a range of policies to improve educational outcomes (Annex A.1). This *Survey* explores further how transition from education to work could be facilitated.

Although the UK Commission's Employer Skills Survey 2011 (UKCES, 2011) reveals that most of the employers who recruited education leavers found them adequately prepared for work, a significant minority was not satisfied with their work-readiness, mentioning lack of experience and motivation as the overwhelming reasons. The UKCES survey also reveals the existence of pockets of skill deficiency, notably among skilled trade occupations, where a third of all vacancies are classified as "hard-to-fill". Encouraging a proper combination of study and work may smooth the transition to work, avoid high drop-out levels, open up greater prospects at the time of full integration in the labour market, as well as enhance performances of workers in the long run.

The current skills strategy aims to improve vocational education and training (VET) and apprenticeship programmes. But employers' involvement in VET remains more

limited than in countries like Austria, Germany, Norway and Switzerland, which have been very successful in integrating young people into the labour market. In the United Kingdom, awareness of programmes to support youth employment remains insufficient, especially among small and medium sized enterprises. In April 2012 the Government launched the Youth Contract, which will offer nearly half a million 18-24 year olds new work opportunities, such as apprenticeships and other work experiences. This initiative raises employers' incentives and involvement in training and up-skilling. While funding seems adequate, co-operation among governmental units and employers needs to be fostered to make the most of the programme. More generally, promoting youth employment programmes at the industry-specific and local levels seems most promising. A simplification of the training and apprenticeship systems would also be warranted, provided that support for the various workers and employers' needs is guaranteed.

Integration of graduates into the labour market also deserves attention. The Youth Inquiry (UKCES, 2012) shows that over the past decade graduates have competed with non-graduates in the take-up of low-skill positions. The prolonged period of sub-par growth is likely to exacerbate the issue of skill mismatch among graduates and put them at greater risk of long-term unemployment and disconnection from the labour market. To facilitate the transition to work for graduates, the United Kingdom has launched the Graduate Guarantee, granting graduates access to internships, training or guidance to become self-employed. Further co-operation between local authorities, schools and enterprises would also help the integration of graduates into the labour market, by helping them building up connections with enterprises. This would also level the playing field among young people, as parental background still has a major influence on employment chances.

Box 3. **Recommendations on labour market and social policies**

Enhance workforce skills. Central and local government should enhance co-operation with employers on vocational education and training, and apprenticeship programmes, raise awareness of government programmes to support youth employment, especially among small and medium sized enterprises, by interventions at industry specific and local levels. Simplify the training and apprenticeship systems, enhance co-operation between local authorities, schools and enterprises in integrating graduates into the labour market.

Improve work incentives for lone parents and second earners under the Universal Credit welfare reform. Increase the refund rate for childcare, and/or reduce the taper rate for those with childcare support, and/or introduce a dedicated disregard for second earners in couples. Increase the value of free childcare by increasing flexibility for users and reduce the cost by increasing flexibility of provision.

Improve the Work Capability Assessment (WCA) and support for return to work for those who are fit. Ensure earlier intervention for people suffering from mental health problems. Monitor homelessness trends and ensure prevention and early intervention.

Monitor efficiency gains in public services. To avoid an increase in inequality, efficiency gains should be exploited in implementing fiscal consolidation. If this is not the case, new ways to improve performance should be investigated, including better management and greater regional flexibility in public sector wages.

Take steps to tackle fuel and water poverty through better targeted financial support, and measures to improve energy efficiency and resource management.

Raising economic growth

The United Kingdom's productivity performance is low

Output growth since the end of the 2008-09 recession has been broadly flat. The level of GDP in the third quarter of 2012 is more than 3% below the pre-recession peak at the start of 008. The recovery is the slowest in the post-war period, which is in line with international evidence of sluggish recoveries following financial crises. However, UK productivity is underperforming relative to most other major OECD economies. While underperformance may to some extent be linked to higher sensitivity of the economy to financial system disruptions than in countries with smaller financial sectors, long-standing structural weaknesses, such as excessively restrictive land-use planning regulations and insufficient productive infrastructure and R&D, are also creating obstacles to growth, which should be tackled through the government's structural reform programme.

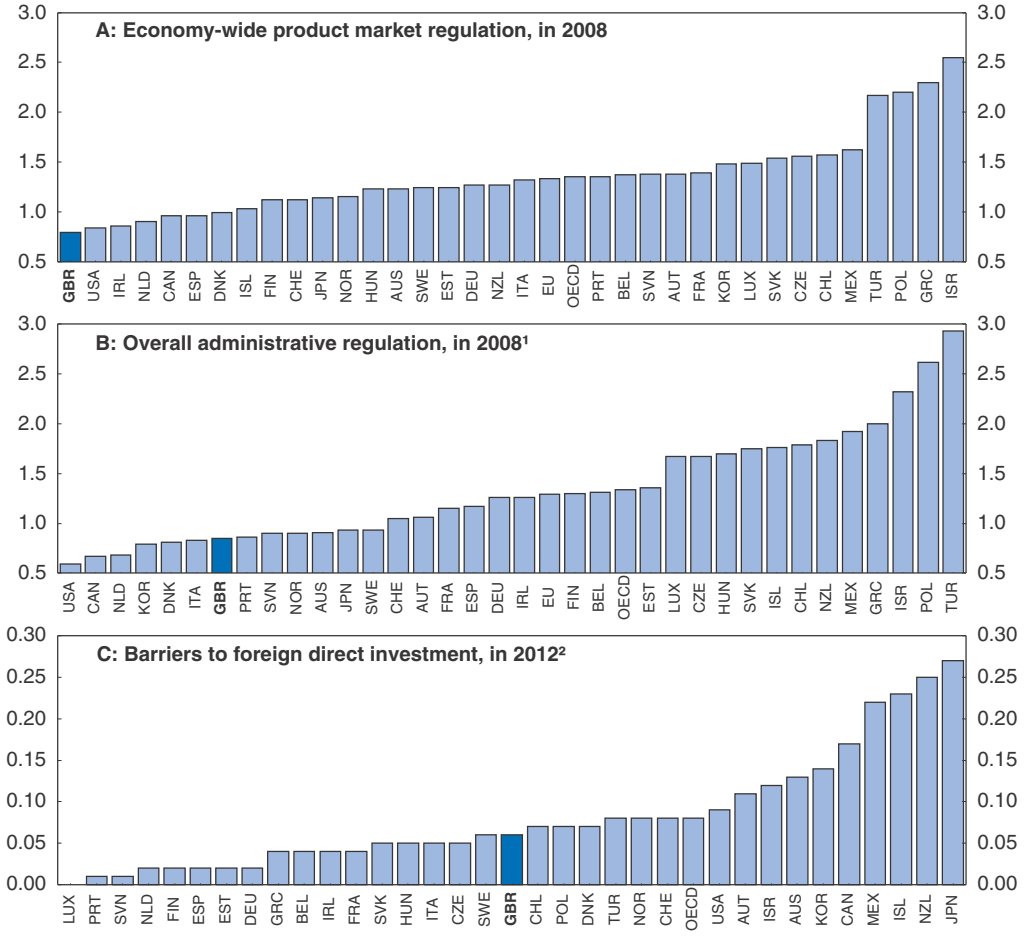
Better welfare and labour market policies have the potential to raise the employability of individuals. Smooth reallocation of labour from less to more productive activities will support output growth. A workforce with enhanced skills will contribute to the development of high productivity activities. The availability of skilled workers may foster entrepreneurship and encourage firms to produce and create jobs. Even so, increasing employment requires stronger growth. The creation of significant numbers of high-quality jobs, which is decisive to reduce inequality, requires a competitive and innovative, growth oriented economy.

To boost performance, the government initiated a *Plan for Growth* (2011) that sets out an ambitious set of measures to: *i)* encourage investment and exports as a route to a more balanced economy; *ii)* make the United Kingdom the best place in Europe to start, finance and grow a business; *iii)* create a more educated workforce that is the most flexible in Europe; *iv)* and create the most competitive tax system in the G20. Areas covered by the Plan include: access to finance, competition (*e.g.* public procurement), regulation (*e.g.* start-up regulations and dismissal procedures), education and skills, land-use planning, infrastructure, green growth, trade, investment and R&D. Significant progress in implementation has already been made in most of these areas (HM Treasury-BIS, 2012).

Strong general framework conditions for business in the United Kingdom include low levels of product market regulations, high international openness and limited red tape (Figure 15). The United Kingdom enjoyed stronger productivity growth than the OECD average from 1997 to 2007 (Figure 16).The catch-up was largely driven by improvements in the level of technology and efficiency of factor use. These improvements were associated with increased competition, openness and foreign direct investment (Barrell *et al.*, 2010). But productivity has fallen since the onset of the recession by more than the OECD average. Weak performance partly reflects low demand. The global financial crisis and ensuing recession have eroded potential GDP to an extent which is difficult to evaluate precisely, but the output gap is estimated to remain significant (Table 1). Output composition also clearly matters for productivity developments, with high-productivity industries, like the financial sector, shrinking in size and experiencing sharply lower productivity. The share of the financial and insurance sector in gross value added declined from a peak of 10.4% in 2009 to 9.4% in 2011, although it remains well above its level of around 6% in the early 2000s (Maer and Broughton, 2012). Nevertheless, the decline in productivity is broad based across the service sector and the overall level of productivity is low, especially relative to the United States, France and Germany. The

Figure 15. **Framework conditions for business**

Index scale from least to most restrictive



1. Simple average of regulatory and administrative opacity and administrative burdens on start-ups under the product market regulation domain "barriers to entrepreneurship".
2. The OECD FDI regulatory restrictiveness index looks only at statutory restrictions and does not assess the manner in which they are implemented.

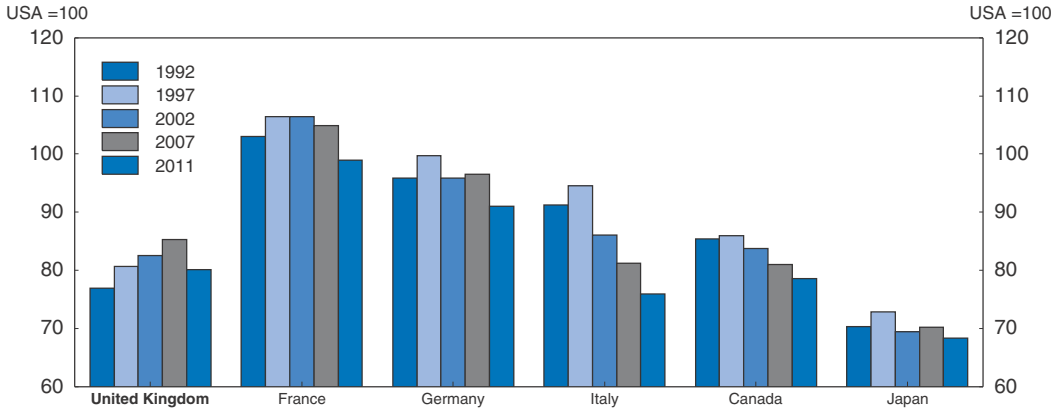
Source: OECD (2012), *Economic Policy Reforms 2012: Going for Growth*, and OECD, the OECD FDI Regulatory Restrictiveness Index (FDI Index), *www.oecd.org/investment/index*.

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extended period of economic weakness increases the risk of significant damage to the long-term capacity of the economy, through low investment and hysteresis effects in the labour market.

Innovation, including R&D, is a well known driver of growth (OECD/The World Bank, 2009). Even though R&D spending, supported by tax credits, has increased in the 2000s and public spending on science and R&D has been shielded from the impact of fiscal consolidation, it remains fairly low in an international context and relatively few firms seem to innovate (Figures 17-18). The government will change support for R&D through revising the current R&D subsidy system to increase its effectiveness as an incentive. Support for R&D should ideally reward social returns to R&D in excess of private returns. Similar to schemes in other countries, the R&D tax credit aims at this by offering financial

Figure 16. **Relative levels of productivity**[1]



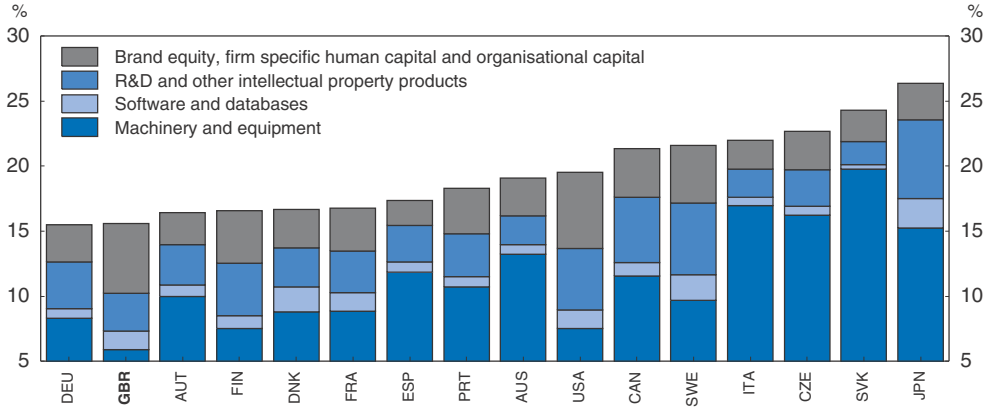
1. Refers to the ratio of GDP at 2005 PPP in USD to total hours worked, whole economy. It is assumed that self-employed work the same number of hours on average as dependent employees.

Source: OECD Economic Outlook 91 Database.

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Figure 17. **Investment in fixed and intangible assets in 2006**[1]

As a percentage of GDP



1. These estimates are based on national studies. They do not yet reflect standardised methods and definitions.

Source: OECD (2010), *Measuring Innovation: A New Perspective*, OECD Publishing.

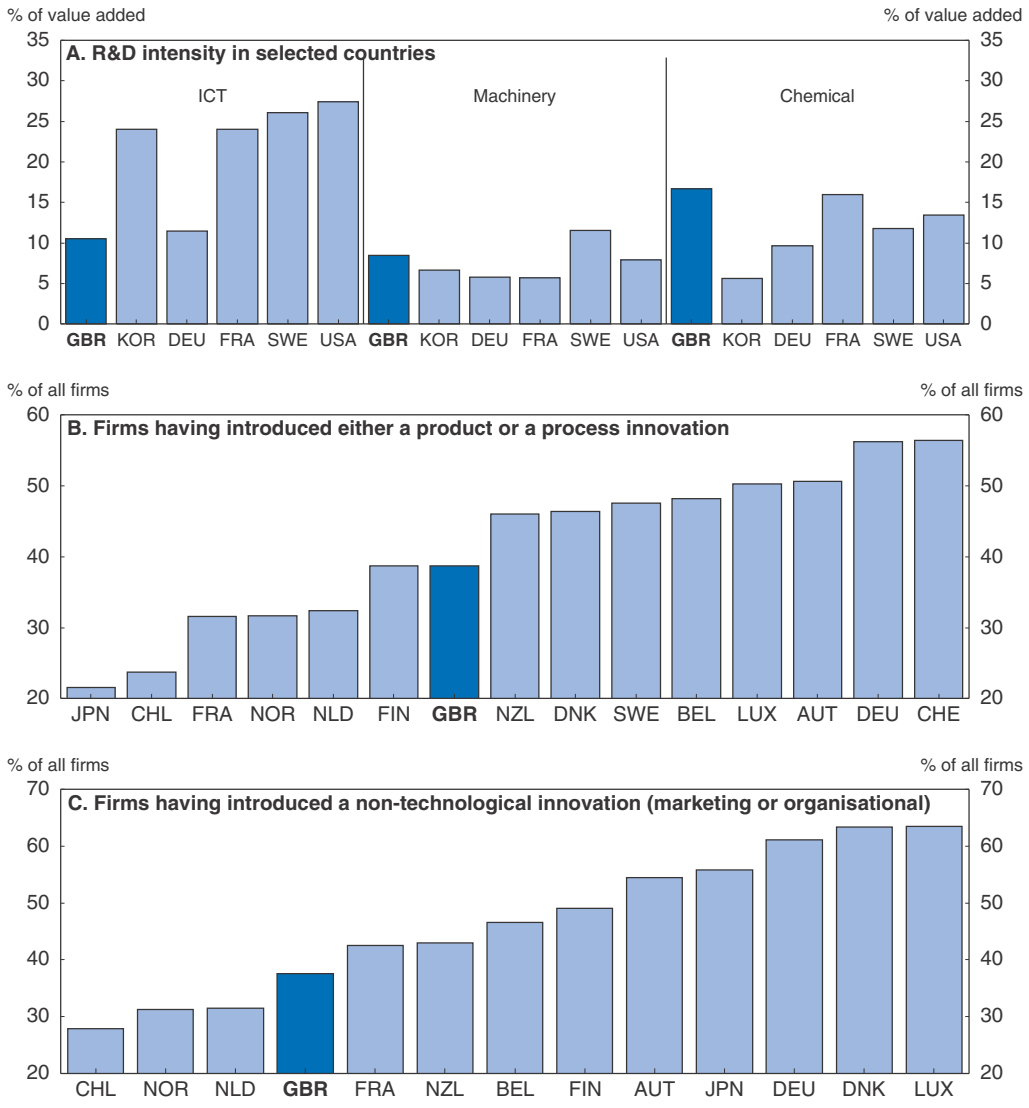
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support in proportion to eligible R&D spending, though at the risk of deadweight costs and potentially harmful tax competition between countries to attract R&D investment. From April 2013, the government will also be introducing a "Patent Box" to drive growth and investment in innovation, whereby profits related to patents will get beneficial treatment. The "Patent Box" is intended to create social returns by supporting innovation more broadly including commercial development and manufacturing of innovative products. While the intention to promote innovation is welcomed, the "Patent Box" rewards broad private income streams from all patents rather than the excess social value of innovation, which could make it a relatively weak instrument to promote research activity and implying high deadweight costs.

Reforming the tax system could also contribute to growth (IFS, 2012). The phased-in lowering of the corporate tax rate and broadening of the tax base will support growth, but

Figure 18. **R&D and innovation**

Late 2000s



Source: OECD, STAN Database and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932767916

further tax reforms should be contemplated. Small firms receive preferential tax treatment, potentially distorting the allocation of capital and weakening incentives for small and highly productive firms to expand (Crawford and Freedman, 2010). Debt finance also gets more beneficial treatment than equity, which also may hamper firm growth where equity participation often is a requisite.

Growth could also be greener

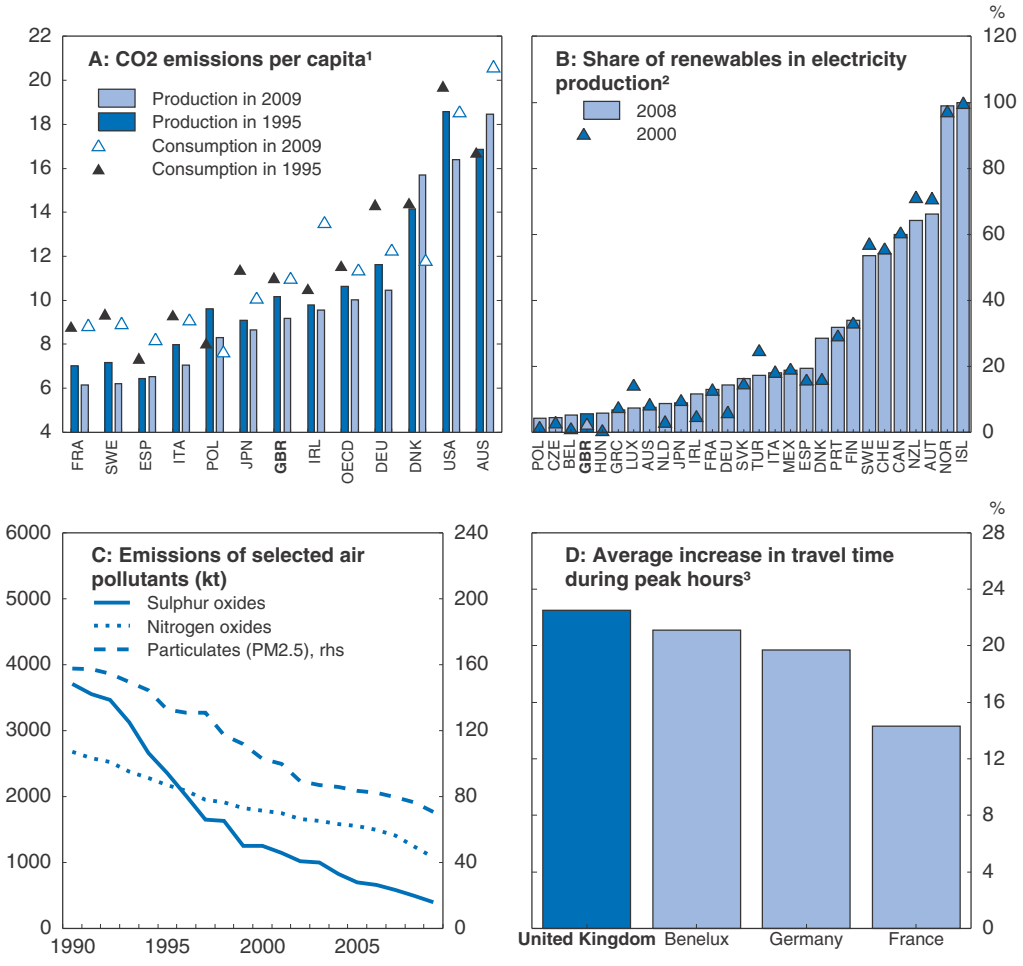
Greenhouse gas and CO_2 emissions per capita related to production are relatively low in the United Kingdom and they have decreased over recent years. However, CO_2 emissions related to consumption, including emissions incorporated in imported goods, have remained broadly stable (Figure 19, Panel A). Relying more on renewables for electricity

production is one important element of the United Kingdom's strategy to lower CO_2 emissions. While the share of renewable energies in electricity production has increased steadily over recent years, it is still significantly lower than in a number of other OECD countries (Figure 19, Panel B).

Emissions of sulphur oxide, nitrogen oxides and particulate matter have come down very fast over recent decades and air quality has never been higher since the industrial revolution (Figure 19, Panel C). Still annual mean concentrations of nitrogen dioxide exceed the limit value set by the EU to protect human health (40 µg m-3) in the vast majority of measurement zones and they may reach 80 µg m-3 or higher beside busy urban roads (DEFRA, 2011). This is partly related to road congestion.

Peak-hours congestion seems more widespread than in comparable European countries (Figure 19, Panel D). These problems seem to stem more from capacity rather than efficiency constraints, as recent OECD work suggest that the road transport sector in

Figure 19. **Selected environmental indicators**



1. In tons per capita.
2. Refers to gross electricity production.
3. As a percentage of non-congested travel time. Data refer to 2010.

Source: INRIX; Boitier, B., "CO_2 emissions production-based accounting *vs* consumption: Insights from the *WIOD Databases*" and OECD.

StatLink http://dx.doi.org/10.1787/888932767935

the United Kingdom is relatively efficient (Braconier *et al.*, 2013). Hence, higher infrastructure spending in the road transport sector together with congestion pricing would enhance long-term capacity and efficiency, improve air quality and support the economy in the short term. Road pricing should be introduced on the most congested motorways, with a view to gradually extending it to other congested roads.

Green growth could be supported further by more efficient pricing to internalise environmental externalities. In particular, gradually withdrawing VAT rebates for domestic water services and energy use would contribute to more uniform carbon pricing across sectors and fuels, making abatement more efficient (OECD, 2011b). A move towards more universal metering of water use would also contribute to greener growth.

The government has made the decision to introduce a carbon price floor for electricity generators to provide the sector with a predictable CO_2 price path that would promote innovation (HM Treasury, 2011). To avoid inefficient interaction with the European Union (EU) ETS, the government should over time seek a higher carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a 30% EU emissions reduction target by 2020. The electricity market reform, set out in the Energy Bill published in December 2012, aims at reducing the uncertainty for investment including in renewables and creating a clearer and more stable framework for investors. It should avoid overlapping policy instruments and, as far as possible, avoid picking winners.

Public support for R&D in green technologies has increased, but is still an order of magnitude lower than support for technology deployment. Given the importance of R&D for the development of new technologies, environmentally more efficient production and productivity growth, the government should ensure that its relative spending on R&D, and on technology deployment is at its most efficient level.

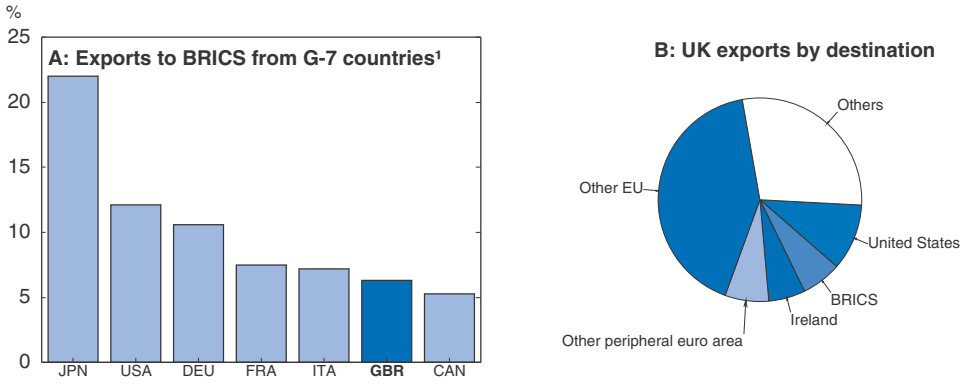
The United Kingdom has significant investment needs in green infrastructure over the coming decade, including energy, water, transport and waste. Efforts to attract private investment should concentrate on regulating these sectors in a way that prices cover costs along with a reasonable return on investment. Arrangements to attract private participation in investment should be based on a careful assessment of whether it is less costly and more efficient than public investment, and transparent accounting and sound management of implicit fiscal liabilities and risks. The government has considered giving the Green Investment Bank powers to borrow from 2015/16, once the government debt target is met and in the context of wider discussions on spending prioritisation.

Seizing opportunities offered by growing emerging markets

Exports to fast-growing emerging economies remain low (Figure 20, Panel A). The share of peripheral euro area countries (Greece, Italy, Ireland, Portugal and Spain) in exports is twice as large as that of the BRICS (Figure 20, Panel B). In a long term perspective, emerging economies are likely to account for an increasing share of world demand for goods and services. Hence, the United Kingdom needs to gain market share in these countries, which will require producing goods and services matching their demand. Measures included in the *Plan for Growth*, such as the National Export Challenge, which aims to get 100 000 more SMEs exporting by 2020, are welcome (HM Treasury-BIS, 2012). The United Kingdom would gain from further opening of foreign markets for services, which tend to be highly protected, especially in emerging economies and is arguing for opening of markets in international negotiations. Another area of excellence where exports could be developed is tertiary education. In that respect, new restrictions on student visas are unhelpful.

Figure 20. **Exports from the United Kingdom**

January to April 2012



1. As a percentage of total exports.
Source: IMF Direction of Trade Statistics.

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The land use planning reform and housing development could offer large opportunities for growth

The existing land-use planning system has been hampering the development of housing, business, infrastructure and green energy generation, weighing on the productivity and competitiveness of the economy (Barker, 2004). However major changes are already underway to improve the current land-use planning system. The government has recently introduced a new planning framework, including a presumption in favour of sustainable development and streamlined application and appeal processes (DCLG, 2012b). The new framework has the potential to facilitate the development of housing, retail trade and infrastructure, with positive consequences for growth. However, as the system is decentralised, success will require strong commitment from local authorities.

The government should closely monitor the impact of the planning reform to assess whether development incentives for local communities are sufficiently strong and review incentives if necessary. In a decentralised system, it is essential to ensure that strategic planning across local boundaries (for example on infrastructure, transport, waste management and flood prevention) is effective. Except for major national infrastructure projects under the responsibility of the Planning Inspectorate, the system relies on co-operation between local authorities, public bodies and private bodies such as infrastructure providers, but defining a more precise strategic planning framework would be desirable (OECD, 2011b). Recently announced measures to prop up housing, including easing of planning constraints, government guarantees and funding for affordable housing are welcome.

More investment in infrastructure could boost growth

Investment in infrastructure can boost both short and long-term growth, especially during economic downturns, given the long-term nature of the investment and the lower costs of inputs during recessions. Estimates of short-term multipliers also tend to be high compared to other fiscal measures. Long-term growth effects can also be large, due to economies of scale and network externalities. Empirical evidence across the OECD area

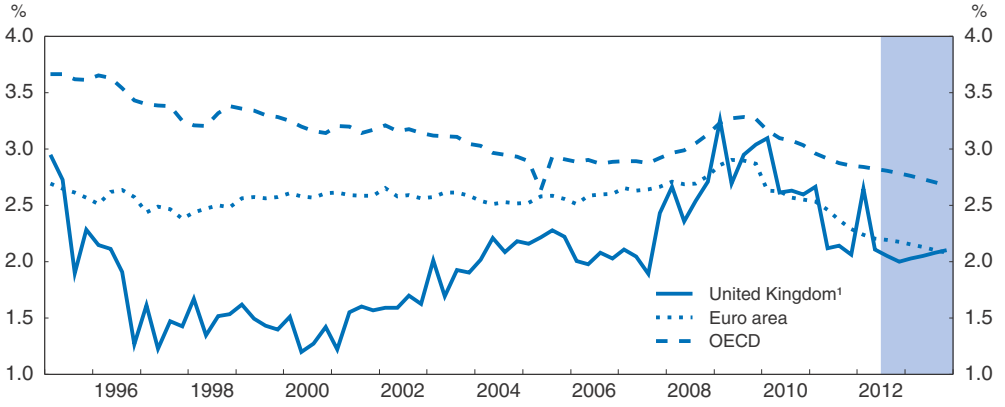
indicates that investment in infrastructure, and especially telecommunications and electricity, can raise growth (Egert *et al.*, 2009). The effect seems non-linear, with a large positive impact at low initial levels of capital.

There is a widespread perception that the quality of public infrastructure, at least in some areas, is low compared to most OECD countries. Nevertheless, the United Kingdom ranks 6th for infrastructure in the World Economic Forum *Global Competitiveness Report 2012-2013*, thanks to good marks in air transport capacity (despite the need to expand capacity in the London area), fixed telephone network, and the quality of electricity supply. But the United Kingdom ranks poorly in terms of mobile phone subscriptions and subjective indicators of quality of overall infrastructure, roads, railroads, ports and air transport. Egert *et al.* (2009) find a strong case for further investment in road and rail sectors.

Public investment has been low relative to the OECD average for a long time and, as in many other countries, is expected to fall further due to fiscal consolidation (Figure 21). Finding additional sources for financing productive infrastructure would therefore be valuable, although the private finance initiative (PFI) and public private partnerships (PPP) in the United Kingdom and other OECD countries have generally not yielded hoped for savings. Following their review of PFI, the government set out full details of their new approach to public private partnerships, to address some past concerns (HM Treasury, 2012b). As noted above, further prioritisation of direct public financing could also be considered. At Autumn Statement 2011 and Autumn Statement 2012, the government took action to fund additional infrastructure spending by using the savings from current expenditure generated over the Spending Review 2010 period. The 2012 capital package will fund £5.5 billion additional infrastructure and support long-term private investment including in new roads, science infrastructure and free schools. Stronger growth from infrastructure investment could also raise fiscal revenues and lower social expenditure offsetting part of the cost of these investments.

Figure 21. **Public investment**

As a percentage of GDP



1. The graph does not display the drop in investment that occurred in 2005Q2 due to the transfer of nuclear reactors from British Nuclear Fuels (a public corporation) to the Nuclear Decommissioning Authority (a central government body).

Source: OECD calculations.

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Box 4. **Recommendations on policies to boost growth and innovation**

Ensure successful implementation of the planning reform. Monitor closely adequacy of development incentives for local communities, review incentives if necessary, and provide an adequate framework for strategic planning.

Invest more in productive infrastructure, with private financing and further reprioritisation of public spending.

Continue to improve the business environment and promote exports. Continue to implement the Plan for Growth. Support higher education as an export and avoid excessively restrictive limitations on student visas.

Reform some tax rules to encourage R&D. Review fiscal rules which may hamper firm growth, such as preferential tax treatment for small firms and debt finance relative to equity.

Promote green growth. Seek a higher carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a 30% EU emissions reduction target by 2020. Move towards a uniform carbon price across sectors and fuels. Examine the options for addressing road congestion and environmental impacts including the implementation of a road-pricing system on a national scale. Road pricing should be introduced on the most congested motorways, with a view to gradually extending it to other congested roads. Consider shifting part of the public support for renewable energy from technology deployment to R&D.

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ANNEX A.1

Progress in structural reform

This annex reviews actions taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Recommendations	Action taken since the previous *Survey* (March 2011)
	Education
Focus pre-schooling resources more strongly on disadvantaged children. Consider intensified outreach through home support for the most disadvantaged children.	The government has created a statutory entitlement to 15 hours per week of free early education for disadvantaged two year olds. This will be introduced in two phases starting in September 2013. The government has refocused Sure Start Children's Centres on improving outcomes for young children and their families, with a particular focus on the most disadvantaged families, to reduce inequalities in child development.
Lessen the extensive use of grades and scores in primary and secondary schools to measure pupils, schools and the school systems performance. Increase use of data independently collected through sampling techniques, and increase the emphasis within inspection on teaching and learning. Further develop value-added indicators of schools' educational output. Give key stakeholders, including universities and employers, a greater say in school leaving qualifications (A-levels and GCSEs) and review the merits of having competing examination boards.	The government has announced an improved approach to national science sampling testing at Key Stage 2, using a pupil-level sample to track standards more robustly. New value added measures, showing the progress students have made between key stages, have been introduced into the Performance Tables. The Government have written to the Ofqual Chief Regulator setting out proposals for the reform of A levels – giving universities a much greater role in reforming the qualifications. Ofqual is expected to publish its findings soon.
Increase focus and transparency of funding for disadvantaged students. Review the effects of schooling reforms, including Free Schools, on equity, fair access and user choice for disadvantaged students. Encourage the highest quality teachers to move to the most disadvantaged schools.	The government has increased transparency of the Pupil Premium by introducing a requirement that schools report to parents on how they have used the Premium and by including in the performance tables separate results for the attainment of pupils eligible for the Premium. Free Schools introduce greater choice of provision in response to local demand. Half the Free Schools that opened in 2011 are located in the 30% most deprived communities. 45% of those opening in September 2012 are in the 25% most deprived communities. Two programmes have been put in place to encourage the highest quality teachers to move to the most disadvantaged areas: *i)* School Direct allows schools to grow their own new teachers by giving them the opportunity to recruit and train their own staff. To support schools in the most disadvantaged areas additional premiums are available to trainees and schools. *ii)* Teach First aims to place top graduates in challenging schools for at least two years as part of their Leadership Development Programme. In June 2012 the Secretary of State announced the government's support for tripling the number of participants on the programme this Parliament to 1 500 participants by 2014/15.

Recommendations	Action taken since the previous *Survey* (March 2011)
Enhance user choice and level the playing field between schools by: experimenting with proscribing the use of residence criteria in admission to local government maintained schools in some local authorities; encouraging the entry of new schools even if it temporarily creates some excess capacity; giving locally maintained schools the same opportunities for hiring staff and negotiating wages as academies and Free Schools.	The revised Schools Admissions Code that came into force in February 2012 introduced a number of changes designed to deliver a simpler, more streamlined, fair and transparent admissions process. Schools must now publish their admissions arrangements on their website for all parents to view. The Free Schools programme supports wider choice through helping groups to open new schools. The government has also streamlined the process for establishing academies making it easier for a local authority to open them and encouraging a wider range of sponsors to come forward to run them. Many maintained schools already enjoy the same freedoms as those available to academies and free schools in the recruitment of staff. For those maintained schools where the Local Authority continues to be the legal employer there is scope to have a say in those staff appointments. Day to day responsibility for recruitment rests with the head teacher and the governing body.
Simplify the system of vocational education, and focus further on high-quality apprenticeships. Raise incentives for participation for children from low income families.	The government has abolished, merged, ceased funding or scaled back the number of government organisations operating in Further Education. Government is developing a single funding system for adult skills for full implementation from the 2013/14 academic year and introducing a standard "rates matrix' to replace over 6 000 different funding rates currently in place. Government is also supporting higher apprenticeships through the Higher Apprenticeship Fund which is investing £25 million in higher apprenticeships. The government has made apprenticeships last for a minimum duration of 12 months as of August 2012. The government is supporting the development of a range of new Higher Apprenticeships to provide more higher-level skills development, critical to the economy. Advanced level apprenticeship starts have increased 75.5% in 2010/11 from 2009/10 and Higher Apprenticeship starts have increased 47.8% in the same time period. Furthermore, existing government policy has roughly £175 million per year (within this Spending Review period) allocated to learner support which is at the discretion of the colleges to allocate according to need, including those from lower-income backgrounds.
Consider lowering further the public share of funding of higher education, *e.g.* through lower university grants, and use some of the proceeds to expand the number of study places.	As of autumn 2012, all higher education institutions in England are able to charge up to a maximum of £9 000 a year for undergraduate courses, compared to up to £3 465 previously. At the same time, the proportion of funding for teaching provided by direct grant is declining. There will be continued teaching grant to support priority and high cost subjects such as medicine, science and engineering. The new system, which shifts funding from grants to repayable tuition fee loans, ensures that no first time undergraduate student will have to pay fees up-front, and ensures graduates will only be expected to pay a proportion of their salary towards the cost of their education once they are earning over £21 000. In 2012/13, the government allowed unconstrained recruitment of high-achieving students scoring the equivalent of AAB or above at A level. It also created a flexible margin of about 20 000 places to reward institutions that combine good quality with value for money and whose average tuition charge (after fee waivers) is at or below £7 500 per year. The government has announced it will go further in 2013/14. Institutions will be allowed unconstrained recruitment of students with the equivalent of ABB or above, and a further 25 000 places will be reallocated to reward high quality, good value for money institutions.
	Health
Improve flows of information to allow patients to make informed decisions.	The Department of Health's Information Strategy for health and social care in England – "The power of information", published on 21st May 2012 – set out the government's plans for delivering the objectives of better information for patients, more openness, transparency and comparability. Actions in the Strategy included giving people online access to their GP records by 2015 and rolling out legally binding information standards – including a unique identifier number – to aid integration between different systems and improve the flow of information between different care settings. The Strategy also outlines how, from 2013, people will be able to access trusted information across existing national web services through a new, comprehensive online "portal".
Improve methods and data to evaluate health care reforms.	The Health and Social Care Act was passed in March 2012, with the infrastructure for reforms (*i.e.* new organisations) due to be in place by April 2013. Monitoring and measuring the benefits of the healthcare reforms will be led by the Department of Health and the new organisations, through their Operating Frameworks and Mandates.

Recommendations	Action taken since the previous *Survey* (March 2011)
Design Payment by Results to reflect priority activities and reward higher quality. Align the remuneration of personnel more closely with activity.	Payment by Results (PbR): Under the Health and Social Care Act 2012, Monitor, the sector regulator, will be responsible for setting national prices and the rules for local modifications to prices. The scope of Payment by Results is also being expanded to mental health, cancer treatment and some community activities, which should help improve outcomes and efficiency in these areas. Commissioners already have mechanisms to reflect priority activity for their local population (through their commissioning decisions) and reward higher quality (through contract-level CQUIN payments). Agenda for Change aligns performance and objectives for non – medical staff through the link between the NHS Knowledge and Skills Framework (KSF) and appraisal. Appraisal provides personal objectives that are aligned with organisational objectives and the KSF specifies the type and level of knowledge and skill required to carry out the job successfully and achieve the agreed job objectives. In exceptional circumstances, pay progression can also be deferred at other points if there are significant weaknesses in performance.
	Financial regulation
Address the too-big-to-fail problem by breaking up major banks or creating firewalled non-operating holding company structures.	The government has accepted the recommendations of the Independent Commission on Banking to ring-fence the retail operations of major UK banks, as well as to improve their ability to absorb losses. The government accepted the Commission's recommendations in principle in December 2011, and has already introduced the first piece of legislation necessary to implement the reforms. The government has committed to having all relevant domestic legislation in place by 2015 and to implement the reforms by 2019.
Strengthen capital adequacy standards, limit bank leverage and require banks to hold adequate capital for off-balance sheet risks. Introduce dynamic provisioning to reduce the pro-cyclicality of the financial system. Develop the macro-prudential framework.	The Financial Services Bill will reform the UK's financial regulation. A key element of these reforms is the establishment of the Financial Policy Committee (FPC) within the Bank of England, which will be focused on macro-prudential analysis and action, to ensure emerging risks and vulnerabilities across the financial system as a whole are identified, monitored and effectively addressed. The government proposes to make the FPC responsible for setting the level of the UK's counter-cyclical capital buffer; provide the FPC with a direction-making power to impose sectoral capital requirements; and provide the FPC with a time-varying leverage ratio direction-making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards. An interim FPC has been established to undertake, as far as possible, the role of the permanent body ahead of the legal switch over to the new regulatory architecture.
Monitor lending standards and incentives to ensure they are aligned with long-term value creation.	Financial Policy Committee (FPC) within the Bank of England will be focused on macro-prudential analysis and action, to ensure emerging risks and vulnerabilities across the financial system as a whole are identified, monitored and effectively addressed. Those systemic risks include unsustainable levels of leverage, debt or credit growth. The FPC will also have a secondary objective to support the economic policy of the Government, including its objectives growth and employment.
	Labour market
Consider modifications to the tax and benefit system that would reduce the marginal effective tax rate faced by lone parents and one – earner couples when extending their hours or when progressing in work.	The new Universal Credit is designed to help households understand what money they receive and how choices over work affect it by introducing a much simpler benefit, with a single system of disregards and one taper that applies to all recipients. The new payment system will be launched in 2013. The smoother taper is intended to improve work incentives by reducing the METR faced by claimants, so that people are better off in work or increasing their working hours.
Improve incentives for labour force participation by second earners by reducing the high implicit taxes on returning to work caused by high childcare cost.	Universal Credit will extend support with childcare costs to those working fewer than 16 hours, allowing 80 000 additional families, who are currently not eligible for this support, to receive help with childcare costs. In June 2012 the Department for Work and Pensions and Department for Education joint-launched the Childcare Commission to look at: ways to encourage out of hours provision, so that parents are able to access care for their child when they need it; identifying any regulation that is not needed to ensure safety or quality; and how childcare helps to get parents into work and out of poverty. The Commission is expected to report in the autumn of 2012.

Recommendations	Action taken since the previous *Survey* (March 2011)
Productivity	
Facilitate the entry of new businesses by reforming planning regulations, especially in the area of retail trade. Put more weight on economic issues in the planning process.	The new National Planning Policy Framework refocuses the planning system on supporting sustainable economic growth. This includes ensuring that economic issues are given "significant weight" within the planning system. The government is also significantly simplifying planning policy so that it is easier to navigate.
Free – up land for development by reconsidering the boundaries of the "green belts" in fast – growing areas.	Local planning authorities review Green Belt boundaries constantly when implementing planning policy. In September 2012, the government announced that it is encouraging councils to use the new flexibilities set out in the National Planning Policy Framework (NPPF) to encourage local authorities to make best use of this land, whilst protecting the openness of the Green Belt in line with the requirements in the NPPF. The government is not currently planning any changes to the regulatory protections on the Green Belt.
Continue to examine the options for addressing road congestion and environmental impacts including the implementation of a road – pricing system on a national scale.	The government is committed to reducing congestion on the road network. At the Autumn Statement in November 2011, the government announced over £1 billion of new funding to reduce congestion. At the December 2012 Autumn Statement the government announced an additional £1.5 billion. Investments focus on upgrading key sections of road, removing bottlenecks, increasing capacity, extending the life of UK roads, and improving cycling infrastructure. The Department for Transport and HM Treasury are working on a feasibility study of new ownership and financing models for the national roads system. The study will not consider road pricing or tolling existing capacity. The government will set out proposals once the study has concluded in the autumn of 2012.
Housing	
Monitor the impact of the planning reform on housing supply closely to assess whether development incentives for local communities are sufficiently strong and review incentives if necessary. Provide an adequate framework for strategic planning.	The package of incentives is kept under review by the government – for example, Community Infrastructure Levy, New Homes Bonus and business rates retention are all recent reforms.
Replace the current council tax and stamp duty by a property tax based on market values. Update council tax property valuations regularly as a first step.	No action has been taken to introduce a property tax. The government has now consulted on and is currently legislating to enable the reduction of certain council tax reliefs for empty and second homes, which has the effect of moving a step towards closer alignment of property values and tax rates.
Ensure access to decent affordable housing through a mix of means-tested housing benefits and subsidies for affordable housing construction, paying attention to the diversity of local needs.	In 2011-12 the Homes and Communities Agency supported 59 451 housing completions in England and 19 967 housing starts on site. 6 September 2012, the government announced a programme to build an additional 15 000 affordable homes through a combination of government guarantees and capital funding.
Enhance competition between developers by facilitating even access to land.	The National Planning Policy Framework (NPPF) seeks to improve the supply of viable land for housing and other development. Currently, a large number of councils do not have a verifiable land supply. Under the NPPF, a presumption in favour of applications being granted – subject to certain tests – will apply where this is not the case. The government is also disposing of sufficient land to support 100 000 homes, over the 2010-15 Spending Review period.
Provide high quality apprenticeship in construction related trades to ensure no shortage of skilled workforce hinders construction growth when demand picks up.	CITB-Construction Skills, the Sector Skills Council for the construction industry, has established the Construction Skills Network (CSN) as a method of establishing the future skills and training requirements of the UK construction industry and provides a consensus view of the current and future skills training needs. Government is also supporting higher apprenticeships through the Higher Apprenticeship Fund which will support further high quality apprenticeships in construction and construction related trades.
Green growth	
Continue to seek a higher carbon price at the international level.	The government supports an increase in the EU emission reduction target to 30% by 2020. The government is actively engaging in EU level negotiations on the Commission's proposals for a decision to clarify the provisions of the EU Emissions Trading Scheme (ETS) Directive. The government believes that in order to deliver certainty to markets and businesses, the EU should go further than backloading auctions of emission allowances and will use the current negotiations on the EU ETS to argue for permanent cancellation of EU ETS allowances.

Recommendations	Action taken since the previous *Survey* (March 2011)
Implement higher and more uniform domestic carbon prices and assess how policy instruments overlap and interact. Consider ways of giving firms greater certainty about the trajectory of the carbon price they face.	Budget 2011 announced the introduction of a minimum carbon price. The carbon price floor, which starts at around £16 t/CO_2 in 2013 and increases to £30 t/CO_2 by 2020 (real 2009 prices), reduces investor uncertainty, puts a fair price on carbon and provides a stronger incentive to invest in low-carbon generation now.
Raise the VAT rate on domestic energy use over time to the standard rate. Address relevant distributional concerns through targeted support.	No action taken.
Speed up the development and deployment of low-carbon technologies, focusing on correcting the inadequate private market incentives for innovation. Facilitate longer-term renewable-energy contracts, reduce the burdens placed on renewable-energy power generators by grid connection rules, and simplify and accelerate planning procedures.	The Electricity Market Reform programme, through the Energy Bill introduced in Parliament in November 2012, is aimed at delivering secure, clean and affordable electricity, and provides long-term certainty to investors in low-carbon generation deployment. The government has also re-launched the Low Carbon Innovation and co-ordination Group. As part of this, Technology Innovation Needs Assessments have been completed for key innovation technologies, including offshore wind, bio-energy and marine, identifying the key innovation needs of specific technology families.
Use the Green Investment Bank (GIB) to subsidise projects where a low social discount rate is appropriate. To increase leverage, allow the GIB to borrow in debt markets, taking into account fiscal constraints.	The UK Green Investment Bank (GIB) is now fully operational. The UK Green Investments team set up in preparation for the UK GIB has already committed £180 million to specialist fund managers to co-invest equity in waste and non-domestic energy efficiency projects. The GIB's initial capitalisation will be £3 billion, which is sufficient that it will not need to borrow before 2015/16. The GIB will be given borrowing powers subject to meeting the target for debt to be falling as a percentage of GDP and further state aid approval being granted.
Continue to build capacity to adapt to climate change, with a focus on reducing market failures such as the appropriate provision of public goods, including information, better risk-assessment frameworks and more advanced metrics for monitoring and evaluation.	The UK is in the process of developing a National Adaptation Programme to address the risks and opportunities from climate change impacts. A comprehensive Climate Change Risk Assessment was published in January 2012 which sets out the top risks and opportunities from climate change for the UK. Based on this, national administrations are preparing adaptation programmes to address these issues. The UK National Adaptation Programme to be published in the summer of 2013 will set out the government's objectives, policies and actions in relation to climate change risks and opportunities.
	Tax system
Increase preferential and abolish zero VAT rates.	No action taken.
Reduce the complexity of the tax code.	The government established the independent Office of Tax Simplification (OTS) to provide expert advice on simplifying the tax system. Review of tax reliefs has led to the removal of around 90 pages of tax legislation. Review of small business tax has led to the introduction of a new simpler basis for small unincorporated businesses to calculate their tax from April 2013.

Chapter 1

Labour market, welfare reform and inequality

Employment has risen by more and unemployment has risen less than expected, given the path of output. Nevertheless, long-term and youth unemployment and involuntary part-time work are high. A polarised labour market risks worsening income inequality, which is high by OECD standards, despite a recent and likely temporary decline. The UK welfare system is an essential safety net, which needs to promote employment, while protecting the most vulnerable. The reformed welfare system, Universal Credit, and the employment programme for disadvantaged workers, Work Programme, will generally improve work incentives and provide support for return to work, but need to be refined. Skill deficiencies are holding back employment and fostering inequality, as low education achievements penalise children from lower socio-economic backgrounds. Vocational training needs to be strengthened and co-operation with employers reinforced. Transition from education to work can prove challenging, requiring more attention to the integration of university graduates into the labour market.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Unemployment has risen as a result of the recession and weak recovery, but less than during previous downturns in relation to output. A flexible labour market and real wages responding to productivity developments have dampened the impact of economic weakness on layoffs. Nevertheless, involuntary part-time work has increased significantly and long-term and youth unemployment are at historically high levels. Long spells out of work are likely to affect durably the level of skills and career prospects of many individuals, which could lower the productive potential of the economy and increase income inequalities, which are already high by OECD standards.

Welfare policies need to protect the most vulnerable, while avoiding creating unemployment and poverty traps. Universal Credit, a welfare reform that replaces a number of disparate benefits for working-age individuals by a universal benefit with a single taper rate, is a significant step forward in rationalising the benefit system and enhancing work incentives. However, better work incentives for lone parents and second earners are needed. The Work Programme supports return to work for benefit claimants facing significant disadvantages, including disabled people. Still, earlier, independent work capability assessments could reduce sickness-related absences and prevent more people from falling into disability benefits. High youth and long-term unemployment call for specific actions to prevent lasting exclusion from the labour market and to facilitate reallocation of the workforce as the economy undergoes structural change.

Strategies to reduce inequality and poverty are rightly focussing on promoting work and offering people opportunities to improve their standards of living, limiting reliance on government transfers. But increases in in-work poverty show that being employed does not necessarily guarantee a decent level of income. Sluggish economic growth and low productivity have pushed involuntary part-time employment up and real wages down, weighing particularly on the incomes of the least qualified segments of the workforce. To avoid a further rise in inequality, both higher employment and stronger labour productivity growth are needed. Achieving this goal requires enhancing the skills of the workforce, both through initial education, especially giving early support for disadvantaged children, and through training, apprenticeships and labour market interventions.

The chapter is organised as follows. The first two sections describe labour market trends and main drivers behind these trends; the next section investigates the impact of labour market developments on income inequality; the following section assesses welfare policies to promote employment and protect the most vulnerable, with a special focus on Universal Credit and the Work Programme. The final section outlines policies to enhance the skills of the workforce.

Employment has performed relatively well in the downturn

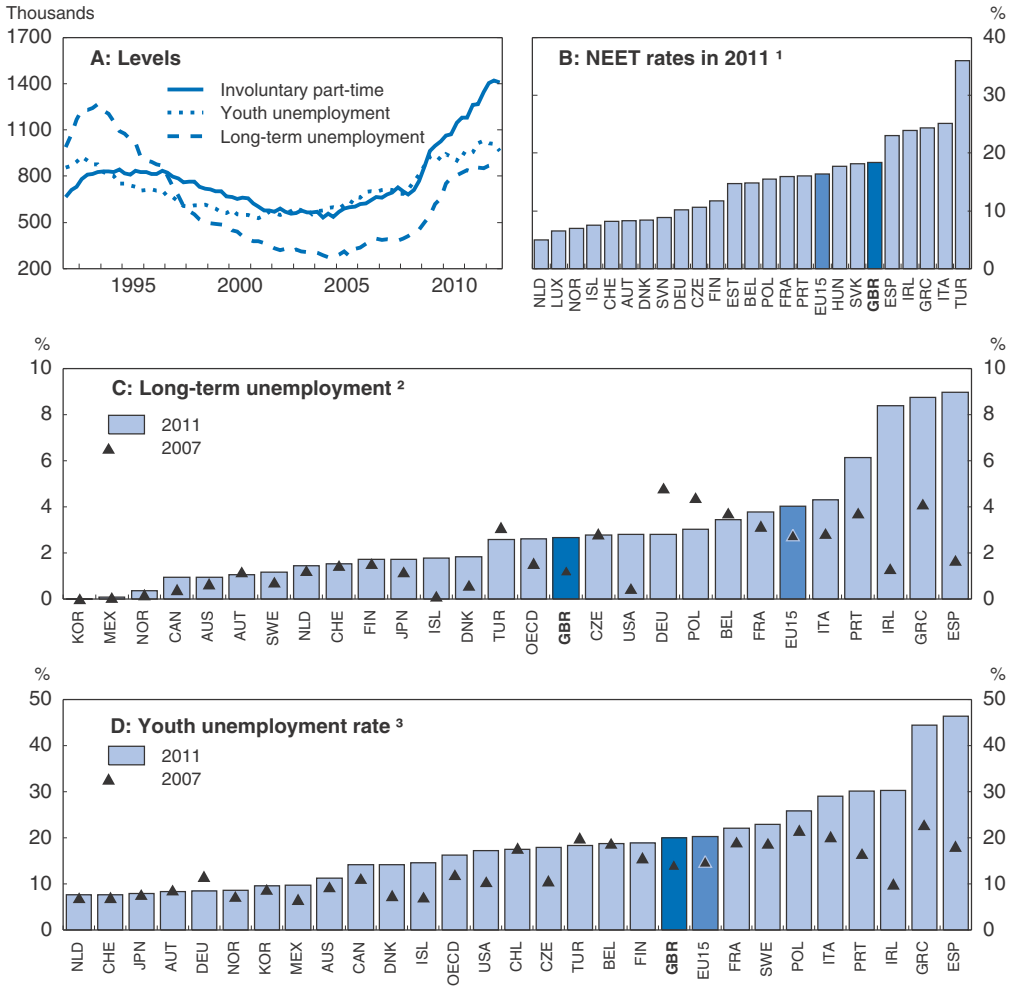
The global economic and financial crisis and the recession that followed have pushed the unemployment rate from around 5% on average over the period 2000-07 to about 8½ per cent by end-2011. Unemployment has receded somewhat since then and now

stands at slightly below 8%, which is close to the OECD average, and nearly 4 points below the euro area average.

The breakdown by activity partly explains the profile of the unemployed and the evolution of regional differences. As construction and manufacturing are predominantly male activities, the unemployment rate increased more for men than for women during the recession. Northern regions with a larger share of production jobs face larger unemployment than the more service-oriented Southern regions during the downturn. This evolution is likely to endure, as cuts in public jobs will affect the North proportionately more than the South.

While the rise in total unemployment has been more contained than most observers had feared, some trends are preoccupying. Long-term and youth unemployment, and involuntary part-time work have increased markedly, now reaching respectively about 900 000, 950 000 and 1.4 million (Figure 1.1, Panel A). The long-term unemployment rate was below the

Figure 1.1. **Long-term and youth unemployment and involuntary part time**



1. People aged 18 to 24 not in education, employment, or training.
2. Duration of unemployment longer than one year; as a percentage of the labour force.
3. Aged 15 to 24.

Source: Office for National Statistics, Eurostat and *OECD Labour Force Statistics Database*.

StatLink http://dx.doi.org/10.1787/888932767992

OECD average in 2007, but slightly higher by 2011. It remains, however, significantly below the European Union (EU15) average (Figure 1.1, Panel C). Youth unemployment is somewhat higher than in the EU15 and well above the OECD average, although this figure includes around 300 000 full-time students (about 30% of the total), which makes international comparisons difficult (Figure 1.1, Panel D). The youth as entrants to the labour market are traditionally amongst the worst hit by recessions. But youth unemployment started to increase before the recession, suggesting a more structural problem.

Another worrying trend is that the number of youth not in employment, education or training (NEETs) has been on a rising trend and is among the highest in Europe, being only surpassed in some southern EU countries, Turkey and Ireland (Figure 1.1, Panel B). It is also worth noting that the proportion of men in all NEETs in England has increased from around 40% in the early 2000s to 48% in mid-2012. The large number of NEETs raises fears of a "lost generation", with lasting exclusion from work causing permanent scars for the individuals involved, weakening the long-term economic growth potential as human capital erodes, and undermining social cohesion. Furthermore well-being losses associated with high unemployment and inequality are substantial (Box 1.1).

People with low education levels are most affected by unemployment. Those with no qualifications or below upper secondary education (level 3) accounted for 64% of the unemployed in England in 2008, while they only represented 45% of economically active adults. Low qualified young people are particularly at risk of unemployment. In 2011, 12.8%

Box 1.1. **Unemployment, inequality and well-being**

Measurement of societal well-being has been subject to large and growing attention, as a number of initiatives at the international level have highlighted the importance of going beyond GDP to evaluate economic performance and social progress (Stiglitz, Fitoussi and Sen, 2009). On top of reviews from multilateral institutions, such as the European Commission or the OECD, the United Kingdom has undertaken a national consultation to gather views on a wider concept of well-being, which will cover quality of life, environmental sustainability, as well as economic performance. This programme is being led by the Office for National Statistics, with final results scheduled for 2013. Preliminary findings from a consultation questionnaire have identified issues that matter most to British people, which include labour market aspects like availability of employment and job satisfaction (ONS, 2012). This box discusses the potential implications of the current weak labour market situation on well-being.

The relative importance of potential drivers of well-being has been extensively discussed (OECD, 2011a; Fleche *et al.*, 2011). The most influential factors in the United Kingdom are, in this order, self-reported health, employment status, perceived freedom of choice and the state of the environment. Indicators of material living standards, such as income or wealth, have a much smaller effect, in line with other OECD countries. All else equal, doubling income increases average wellbeing by only 0.1 units, in a scale of life satisfaction ranging from 1 to 10. This compares to larger well-being losses associated to becoming unemployed, 0.45 points, or gains from perceived health, for which a one point improvement (for example, from good to very good health) yields a 0.5 points increase in life satisfaction. A one point increase in perceived income inequality (on a scale of 10) reduces life satisfaction by 0.1 points. This is lower than the OECD average, but consistent with findings in other Anglo-Saxon countries (di Tella *et al.*, 2001).

Box 1.1. **Unemployment, inequality and well-being** *(cont.)*

Unemployment has a negative impact on well-being through the related income loss. However, the literature provides clear evidence that unemployment operates also through non-pecuniary channels. Even after controlling for income and other factors, several studies find that the unemployed are less happy than the employed (Di Tella *et al.*, 2001; Bohnke, 2006; Bell and Blanchflower, 2009). As shown by Goldsmith *et al.* (1996), unemployment is responsible for depression, anxiety, loss of self-esteem and personal control, which all reduce well-being. The duration of unemployment also matters, since well-being deteriorates as unemployment spells increase. Compared to pre-crisis levels, unemployment duration has increased substantially. Currently 35% of the unemployed have been unemployed for more than a year, 10 percentage points more than the pre-crisis level, inducing subsequent losses in well-being. Finally, rises in the unemployment rate do also affect the employed, primarily because of the increasing risk of becoming themselves unemployed (Clark, 2003).

A weak labour market can affect the working conditions of those in employment, with a negative impact on their well-being. Well-being deteriorates when the number of hours worked is below the level wished for. The UK Annual Population Survey reveals that involuntary part-timers incur welfare losses comparable to those suffered by the unemployed. A plausible explanation is that work helps fulfil the needs of social inclusion, status, self-esteem and engagement in collectively meaningful activities (Jahoda, 1982 and OECD, 2011b). Since the beginning of the crisis, the share of involuntary part time has almost doubled, reaching 18% of part-time employment in the first quarter of 2012. Male part-timers seem to be particularly affected, as one in two men aged between 25 and 49 working part time would like to work full time. Job insecurity is also related to a decline in wellbeing comparable to that experienced by the unemployed. The OECD's Better Life Index uses the percentage of employees on temporary contracts as a proxy for job insecurity. Though the United Kingdom registers a low share of temporary workers by international standards, the number of temporary workers that could not find a permanent job has surged since the crisis started, reaching 40% in 2012 after having remained broadly stable around 25% in the 2000s.

The worsening of the labour market situation has been unequally distributed across the labour force, as around one third of the increase in the unemployment stock has been borne by those aged 18 to 24, although they only represent one in eight in the labour force. Entering the labour market at a relatively bad time may have life-long implications that go beyond the loss of income, and affect broader determinants of well-being, such as skills depreciation, weak integration in the labour market and low self-esteem.

of 24-year olds with only GCSEs were unemployed in the United Kingdom, while the corresponding rate for A-level and university degree holders were respectively 6.7% and 4.9%. The recession has worsened the relative situation of low-skilled youth, as demand for labour from some of their traditional employers, such as retail trade and hotels and restaurants, has shrunk, even though it has recovered somewhat since 2010. Furthermore, they are facing increasing competition from recent graduates, more than a third of which are now employed in low-skill jobs.

As growth is expected to remain sluggish, unemployment could rise further in the near term. Fiscal consolidation involves large job cuts in the public sector. The Office for Budget Responsibility (OBR) projects a fall in general government employment of around 929 000 (excluding the impact of reclassifications in the education sector) between the start of 2011

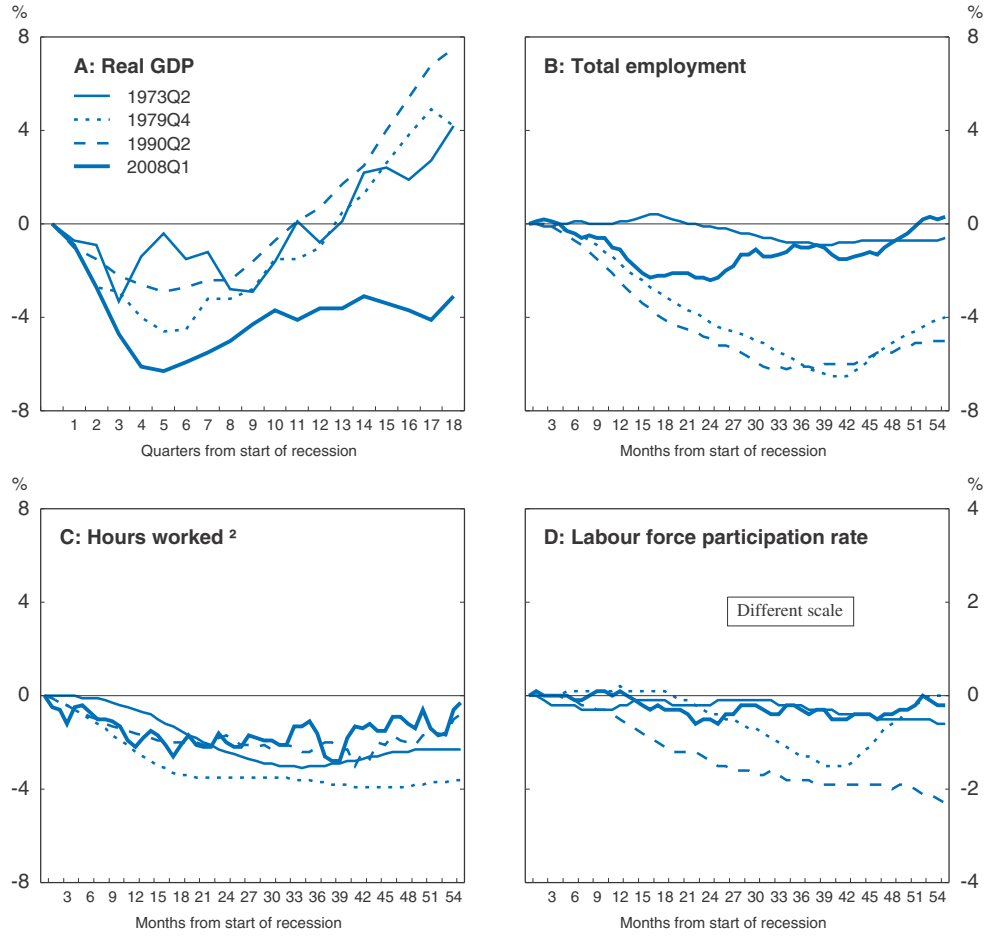
and 2018, although it expects this to be more than offset over time by an increase in market sector employment of around 2.2 million over the same period (OBR, 2012). As private sector employment currently is high in relation to output and involuntary part-time work is common, many firms may respond to higher demand by increasing hours worked by employees and using their workers at full potential, thereby increasing productivity, before hiring more workers.

The fall in employment has been limited relative to output losses

Employment has been surprisingly resilient given the depth of the recession. While output remains more than 3% below pre-crisis levels, employment has declined far less than during the recessions of the 1980s and 1990s, even though those were shallower and shorter and output had already surpassed its pre-crisis level at this stage of the cycle (Figure 1.2, Panel A and B). A reduction in the number of hours worked per employee has contributed to good employment outcomes, although it has not been larger than in previous downturns (Figure 1.2, Panel C).

Figure 1.2. **Labour market developments compared to previous recessions**

Deviation from the peak[1]



1. Percentage change for real GDP, total employment and hours worked. Change, in percentage points, for labour force participation rate.
2. Total actual weekly hours per worker.

Source: Office for National Statistics.

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From an international perspective, the United Kingdom's employment contraction has also been modest relative to output developments. Countries which have experienced similar output losses as the United Kingdom since 2008, such as Denmark and Spain have suffered worse percentage falls in employment. The United States has experienced a far greater contraction in employment despite a much stronger output recovery.

Employment losses have been concentrated in construction and manufacturing. The decline in construction employment looks essentially cyclical. In manufacturing, the recession has prolonged a long-term declining trend in employment. These trends have affected more men than women during 2008 and the first half of 2009. The service sector has continued to create jobs, although at a slow pace and with sub-sector differences. Wholesale and retail trade, transport, accommodation and food services, and finance and insurance were the worst hit. Public administration, health and education have seen the largest increases in employment over the past four years, but this trend is already being altered by cuts in public jobs, that are expected to continue going forward. This is likely to affect more women than men given the high female employment rates in these sectors. High uncertainty about the strength of the recovery is also likely to hold back employment growth. In particular, the euro area crisis is bound to hamper hiring in export industries.

A flexible labour market dampened the impact of the recession on employment

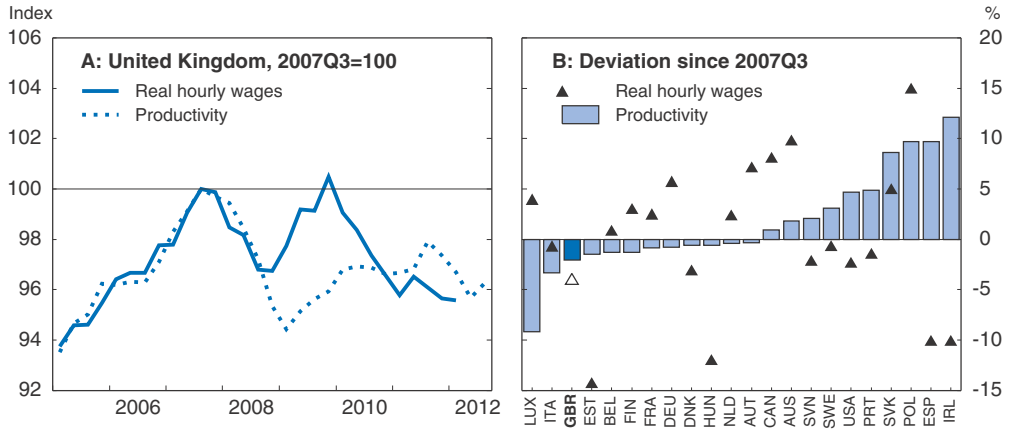
The flexibility of the UK labour market contributes to explaining the relatively limited losses in overall employment over recent years. Real wages have fallen. Part of the adjustment in labour utilisation has gone through a reduction in hours worked, limiting job losses. Furthermore, there have been fewer exits from the labour force into early retirement and inactivity than during the 1990s recession, which increases unemployment in the short term but contributes to preserving human capital and limiting social exclusion in the longer term.

Real wages are flexible

Real wages have fallen during the downturn, as moderate increases in nominal wages were outpaced by price inflation (Figure 1.3, Panel A). The adjustment of real wages to lower productivity has been greater than in many other countries where productivity has fallen (Figure 1.3, Panel B). This contrasts with the early 1990s, when hourly real wages increased, prompting firms to reduce their workforce. In the current downturn, the fall in the relative price of labour has been a major factor in allowing employers to limit layoffs, especially of skilled workers who are difficult to hire, or expand labour intensive activities, while preserving profit margins. Relative wage flexibility across sectors and occupations also helps reallocation of labour in an economy which needs rebalancing.

A number of factors could explain recent evolutions of wages (Faccini and Hackworth, 2010). Rising inflation may have facilitated the adjustment of real wages in the presence of downward rigidity in nominal wages. High unemployment expectations may have persuaded more employees to trade lower real wages for job security. Labour supply has remained strong due to steady participation and immigration, putting downward pressure on wages. Along with declining relative labour costs, it is likely that low interest rates and strong corporate balance sheets have helped companies maintain employment. The number of insolvencies and related job losses has also been much smaller than in previous recessions.

Figure 1.3. **Real wages and productivity**[1]



1. Real wages refers to compensation of employees divided by hours worked, and deflated by consumer prices. Productivity refers to real GDP divided by total employment.

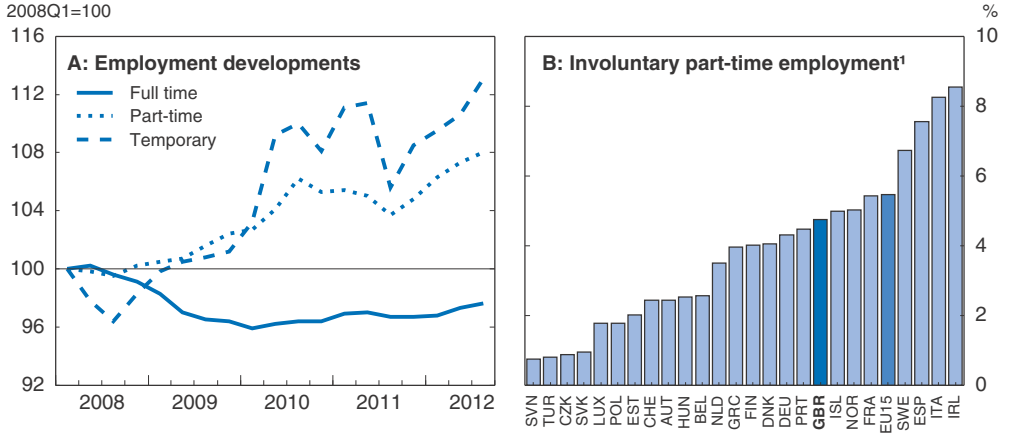
Source: Office for National Statistics and *OECD Economic Outlook 92 Database*.

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Working hours have adjusted to weak activity

Adjustments in working hours have also limited rises in unemployment. While the number of full time jobs is well below pre-crisis levels and has been broadly flat over the past two years, in line with GDP, the number of temporary and part-time jobs has increased (Figure 1.4, Panel A). Involuntary part-time work has risen sharply to 1.4 million in mid-2012 and, as a share of total employment, was close to the EU15 average in 2011 (Figure 1.4, Panel B). Part-time employment limits the number of unemployed people during downturns, reduces income losses, the burden on welfare and social exclusion. It may also mitigate the long-term consequences of prolonged slumps. Part-time jobs may provide relevant experience and skills, which could improve employment prospects when labour market conditions improve.

Figure 1.4. **Part-time and temporary work**



1. As a percentage of total employment. Refers to 2011.

Source: Office for National Statistics and Eurostat.

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Nevertheless, short working hours in low qualified jobs can lead to in-work poverty, as on average part-timers work less than half the number of hours of full-timers and earn less than a third of their salary. The increase in involuntary part-time work during the downturn has been mainly in low-paid jobs. Part-time unemployment is more likely to be involuntary for people with lower educational and occupational levels (Cam, 2012). Even though involuntary part-time work has increased for both genders, the rise is particularly sharp for men. One in two men aged between 25 and 49 working part time would like to work full time. Involuntary part-time work also affects high unemployment areas more, contributing to widening the income gap between regions.

Labour supply has remained solid

High unemployment often leads to a fall in labour force participation. As job opportunities are scarce, some people find it less attractive to get involved in the labour market. For instance, older people might retire or young people stay longer in education. Some workers drop from the labour force, as they become discouraged and no longer search for work. The decline in participation was particularly marked in the 1990s recession, with a fall of 2.5% of the working-age population.

The participation rate has remained roughly constant through the current downturn (Figure 1.2, Panel D). In particular, labour participation of older people has remained high during the downturn, as early retirement packages are less generous than in the 1990s, pathways to early retirement through disability benefits have become more restrictive and concerns have risen about levels of pensions from defined contribution schemes following losses in financial wealth in recent years (Banks *et al.*, 2011; Faccini and Hackworth, 2010). Low real wages and job insecurity might also have supported work participation, for example of second earners. Higher participation of older workers both preserves the productive capacity of the economy and potentially alleviates the long-term burden on public finances.

Labour market developments have increased inequality

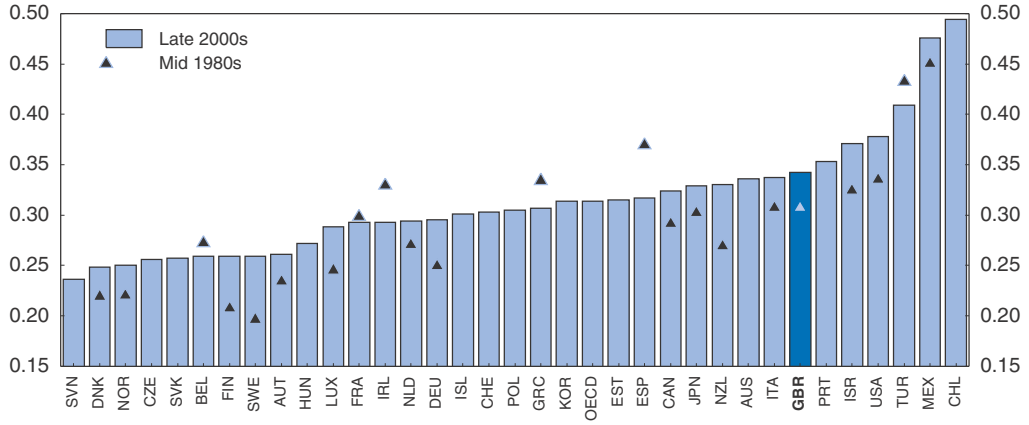
The flexibility of the labour market has contained the increase in unemployment during the sharpest output contraction in the post-war period. However, this has come at the price of large under-employment and lower wages, especially for low-skilled workers. Current labour market conditions are widening the income gap between full-time employees and an increasing share of the workforce on part-time, insecure and often low-paid jobs. This comes in a context where income inequality, measured by the Gini coefficient of disposable income, was already high and rising before the recession. Although inequality fell in 2010-11, as the fall in real incomes was larger at the top of the income distribution than at the bottom, absolute poverty increased (Cribb *et al.*, 2012). Moreover, social transfers are being cut significantly.

Policies need to protect the most vulnerable to maintain social cohesion and prevent lasting damage from the recession on people's life and the productive capacity of the economy. Furthermore, high inequality could encourage household indebtedness, thereby threatening financial stability (Kumhof and Rancière, 2010). Perceived fairness is also important to ensure public support for the necessary fiscal consolidation effort, which will need to be sustained over a protracted period.

Income inequality is high by OECD standards

The recession has exacerbated a rising trend in income inequality across the OECD (Figure 1.5). The ratio of the average income of the richest 10% of the population relative to the poorest 10% is now 10 to 1 in the United Kingdom, above the OECD average of 9 to 1, but significantly below the United States (about 14 to 1). From the mid-1980s to the late 2000s, real household income increased at an annual rate of 2.5% in the top decile but only 0.9% in the bottom decile. This is one of the widest income growth gaps in the OECD, exceeded only in Israel and Sweden (although Sweden remains a low inequality country).

Figure 1.5. **Income inequality developments**[1]



1. Measured by the Gini coefficient based on equivalised household disposable income, after taxes and transfers.
Source: OECD Database on Household Income Distribution and Poverty.

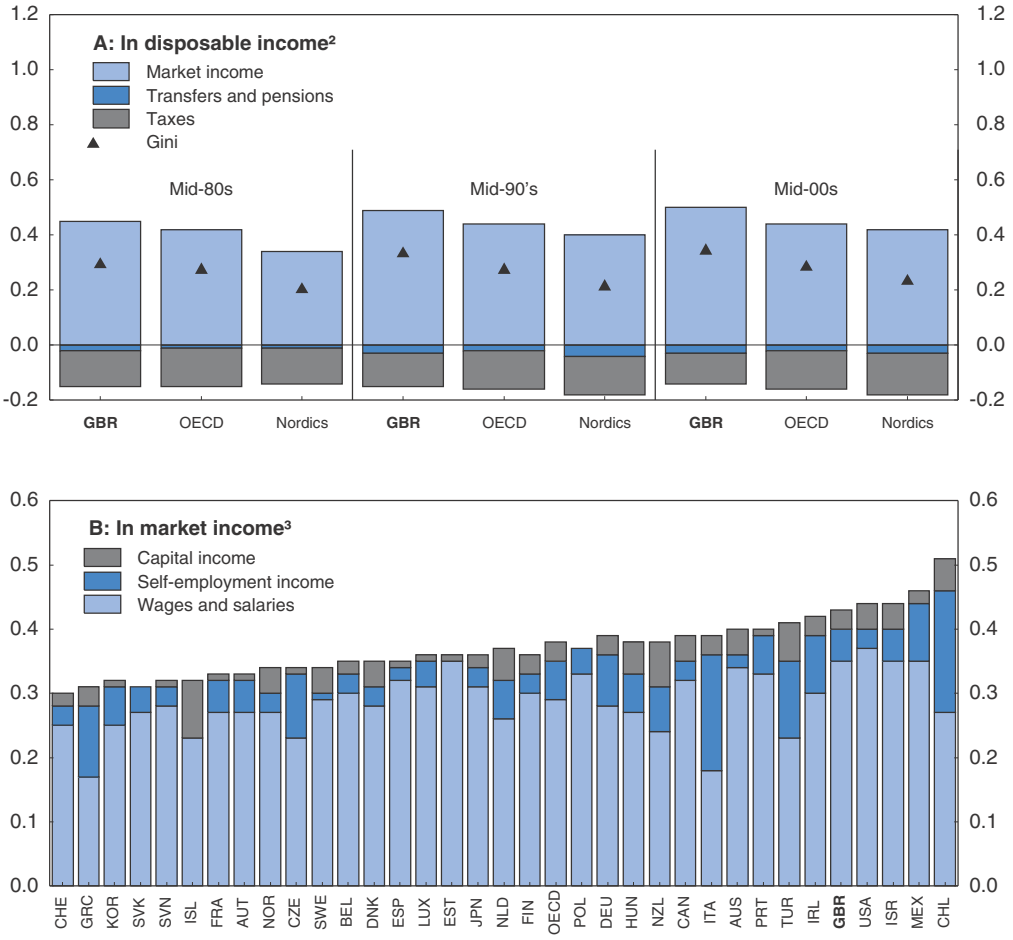
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The underlying causes of rising inequality are complex. Potential drivers are globalisation, technological change, and product and labour market institutions, policies and regulations. Globalisation has increased the global supply of low-skilled labour, affecting wages and employment prospects of workers with low qualifications. At the same time, more intense international competition for high-skilled workers has pushed up top incomes. Advances in information and communication technology (ICT) are also favouring high-skilled workers, whose task cannot be easily automated, and thereby increasing inequality (Kierzenkowski and Koske 2012). Some studies suggested technological change is a more powerful driver of inequality than globalisation (IMF, 2007; OECD, 2007a). However, disentangling these influences is difficult, as technology is a major determinant of the organisation of international supply chains (OECD, 2011c). Reforms undertaken by most OECD countries, including the United Kingdom, since the 1980s to increase competition in product markets and make labour markets more flexible have generally been positive for employment, which tends to reduce inequality, but have also widened wage disparities. These opposite effects tend to offset each other (OECD, 2011c).

Inequality is mainly driven by differences in market income

The main contribution to income inequality comes from the dispersion of market income, partly offset by redistribution through the tax and benefit system. This pattern is observed across OECD countries and has not changed much over time (Figure 1.6, Panel A). The main contribution to inequality is from wages and salaries (Figure 1.6, Panel B). While

Figure 1.6. **Contributions to inequality**[1]



1. Inequality measured by the Gini coefficient; a higher value indicates higher inequality.
2. Countries for which data are available.
3. The data for Greece, Hungary, Mexico and Turkey are net of taxes. Data for France and Ireland refer to the mid-2000s.

Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, *OECD Income Distribution and Poverty*, *OECD Social Expenditure Statistics Database*.

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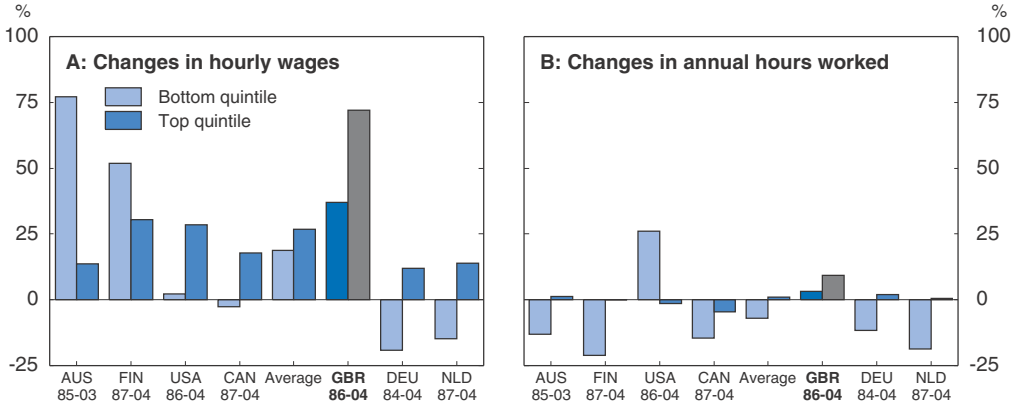
revenues from capital and self-employment are less evenly distributed than wages and salaries, their smaller share in disposable income imply a lower contribution to inequality.

Inequality among wage earners results both from hourly wage dispersion and from differences in hours worked. Wage dispersion in the United Kingdom is higher than in most other OECD countries. Between the mid-1980s and the mid-2000s, real hourly wages in the top quintile have increased at an annual rate of above 3%, compared to 1.8% in the bottom quintile. This pattern is common across OECD countries, as seen from the average of a sample of OECD countries for which comparable data are available (Figure 1.7, Panel A). Wage dispersion is to some extent induced by structural trends in demand for labour, for instance linked to the falling share of industry, which provides many intermediate jobs. Low educational attainments also contribute to trapping an increasing share of the population in low-paid jobs. Hence, raising workforce skills will be necessary to reduce inequality, as discussed in the last section of this chapter.

Earnings differentials are accentuated by the increasing difficulty for low-skilled workers to find full-time jobs. While the annual number of hours worked has risen by more than 9% in the top quintile between the mid-1980s and the mid-2000s, it has increased by little more than 3% in the bottom quintile. This gap is somewhat smaller than in a comparable OECD sample, where a modest rise in hours worked in the top quintile was accompanied by a substantial contraction in the bottom quintile (Figure 1.7, Panel B). The increase in involuntary part-time employment contributed to a marked increase in the polarisation of earnings, especially among working-age men. Difficult labour market conditions in the downturn are likely to increase polarisation further. High youth unemployment is also likely to increase income inequality, even beyond the short term, as a number of studies report a significant lasting effect of spells of unemployment on earnings (Arulampalam, 2000; Gregg and Tominey, 2005).

Figure 1.7. **Changes in annual hours worked and in hourly real wages by earnings quintile**[1]

Mid-1980s to mid-2000s



1. Samples are restricted to all paid workers (aged 25-64) with positive wages and positive hours worked during the reference year with information on annual hours worked. Mean wages in national currencies at constant 2005 values. Countries ranked in ascending order of changes in earnings inequality.

Source: OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

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The only sizeable inequality-reducing factor has been female employment, which increased by nearly 20 percentage points since the mid-80s. Higher female employment generally reduces inequality across the OECD, though this depends on the extent to which women entering work are in couples with high or low earners. As employment rates increased similarly for wives of top and bottom earners, the reduction in inequality resulting from higher female employment has been fairly strong. It is worth noting, however, that a gender gap remains in terms of wages. Despite having narrowed by around 20 percentage points since the introduction of the Equal Pay Act in 1975, the gender gap in median hourly earnings for a full-time job is still at 9.1% (ONS, 2011).

The gender pay gap, however, varies significantly depending on age, education level, company size and occupational type. Differently from 30 years ago, when the wage gap was already visible at entry in the labour market, nowadays it fluctuates around equality up to the age of 30, then opens up and levels off around the age of 50. This pattern suggests that maternity is likely to be a relevant factor behind wage inequalities, especially as the number

of dependent children increases. As stressed in the *Final Report of the OECD Gender Initiative to the Ministerial Council Meeting 2012* (OECD, 2012a), mothers in the United Kingdom are particularly likely to work part-time to reconcile work and care issues, a decision partly imposed by the lack of access to and high costs of childcare. The expansion of quality childcare provision and out-of-school care could ease the transition to full-time positions. Encouraging gender equality and temporary use of part-time as a solution to childcare issues could promote continuous employment patterns and consequently close the wage differential that emerges from reduced working hours and fragmented careers.

Taxes and benefits have a significant but declining redistributive impact

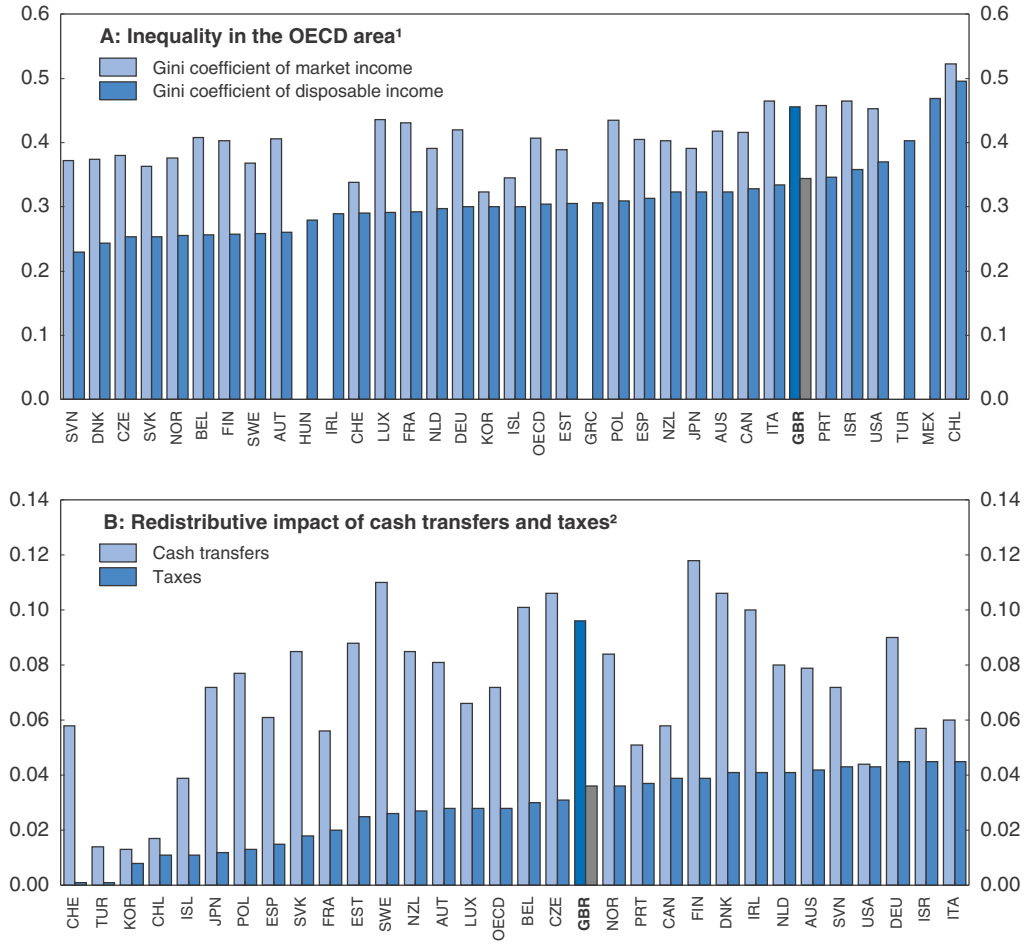
Taxes and benefits reduce the Gini coefficient from 0.45 to 0.35, which is similar to the average reduction in the OECD (Figure 1.8, Panel A). Government cash transfers to households contribute more than taxes to income redistribution (Figure 1.8, Panel B). Cash transfers in the United Kingdom are lower than the OECD average (Figure 1.11), but have strong redistributive power, as they include a smaller share of pensions and are more targeted towards low-income households than in the more universal systems prevailing in continental Europe and especially Nordic countries. Taxes play a smaller role than transfers in income redistribution, but the tax system nevertheless reduces inequality significantly. Even if tax schedules are not very progressive by OECD standards, the wide dispersion of market income results in significant redistribution through taxes.

Nevertheless, as in most other OECD countries, redistribution through the tax and benefit system has been increasingly unable to compensate for growing market-income dispersion, with redistribution offsetting only about one fourth of the increase in market income inequality between the mid-1980s and the mid-2000s. As means-tested benefits are the most redistributive instruments, policies have affected low-income households more than high income ones. As a result, relative poverty, measured as household incomes below 60% of median income, has been contained. Between 1996-97 and 2009-10, the proportion of individuals with household incomes below 60% of median income fell from 19.4% to 17.7% before housing costs and from 25.3% to 22.2% after housing costs. Relative child poverty fell from 26.7% to 19.7% before such costs, a reduction of over a quarter, but short of the previous government objective of halving relative child poverty by 2010 (Jin *et al.*, 2011).

The gap between relative poverty rates before and after housing costs highlights the burden of housing costs in the United Kingdom. The housing cost overburden rate – the percentage of the population living in households where the total housing costs (net of housing allowances) represent more than 40% of disposable income (EU housing statistics) – is one of highest in the European Union (EU), reaching nearly 41% in 2009 for tenants in the private sector, compared to an EU27 average of 25%. Recent cuts to housing benefits and the removal of indexation on actual market rents from April 2013 will increase the burden further for low-income tenants in private rental. As the supply of affordable housing is also expanding more slowly than demand, social renting is an increasingly restricted alternative. Fiscal consolidation since 2010 initially reduced inequality, as tax increases hit high-income households the most, but phased-in benefit cuts may have the opposite effect going forward (Jin *et al.*, 2011).

Reforms to the tax system could contribute to lowering inequality. The council tax, which is regressive, should be replaced by a property tax based on market values, with safeguard mechanisms for housing rich but income poor households. As well as reducing inequality, this could improve the stability of the housing market (OECD, 2011a, Chapter 2).

Figure 1.8. **Redistribution effects of cash transfers and taxes**



1. Late 2000s; working age population.
2. Point reduction in the Gini coefficients, in the late 2000s.

Source: OECD Income Distribution and Poverty Database.

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The reduced rate of VAT on domestic energy is an inefficient instrument to support low-income households, both from an economic and environmental point of view (OECD, 2011a, Chapter 4). Support for energy costs should be targeted towards low-income households. Similarly, Winter Fuel Payments, a tax free payment to help older people keep warm during winter, should be means-tested. The best way to alleviate energy poverty is through energy efficiency improvements, which should be encouraged (Box 1.2).

Given that the share of national income going to the top 1% earners has doubled since 1970, raising marginal personal tax rates might look attractive. However, international studies suggest that increasing marginal tax rates on high incomes tends to lower taxable incomes significantly, as work effort decreases and tax avoidance and evasion increase (OECD, 2011c). Lower than expected tax receipts from the 50% income tax rate above £150 000 in 2010-11 seem to confirm this finding (HMRC, 2012). Hence, the government strategy to restrict tax reliefs, close loopholes and fight tax evasion looks more promising than pushing up marginal tax rates. Active participation in the G20 and OECD

Box 1.2. **Tackling fuel and water poverty in the United Kingdom**

Rising fuel and to a lesser extent water prices are putting an increasing burden on low-income households. The number of individuals in fuel poverty reported here is based on the Low Income High Costs (LIHC) indicator proposed by Hills (2012). Individuals are considered as fuel poor if they have required fuel costs that are above the median level and would be left with a residual income below the official poverty line if they were to spend that amount. The number of households in fuel poverty is of the same order of magnitude under the current official measure, where fuel poverty is defined by required fuel costs exceeding 10% of income. More than 7 million individuals in nearly 3 million households are affected in 2009 and the fuel poverty gap is £1.1 billion, defined as the amounts by which the assessed energy needs of fuel poor households exceed the threshold for reasonable costs (Hills, 2012). Current policies are estimated to reduce the fuel poverty gap by only 10%. Furthermore, even though new policies are being put in place, fuel poverty is projected by the Hills Review to be higher in 2016 than in 2009, even assuming benign fuel price developments. Well designed policies to tackle fuel poverty, in addition to helping low-income households, would contribute to improving health and well-being through more adequate heating of some homes, and to reducing carbon emissions. This box concentrates on immediate fuel poverty relief and home energy efficiency improvements. In the longer term, promoting cost-effectiveness of energy generation, through competition and innovation is also decisive.

Fuel poverty is clearly associated with energy inefficient homes, which in England concern three quarters of fuel poor households and 90% of the fuel poverty gap. Homes in the United Kingdom tend to be less energy efficient than in Germany, the Netherlands and Nordic countries. This results partly from the high proportion of houses relative to flats – houses account for 86% of the fuel poverty gap – and the age of the housing stock – properties built before 1945 represent over a third of the housing stock and account for two thirds of the fuel poverty gap (Hills, 2012). In addition, energy efficiency standards appeared as late as 1995 in UK building regulations, compared to the late 1950s or early 1960s in Scandinavian countries (Laustsen, 2008). Low energy efficiency of homes is also a major concern from a climate change mitigation point of view, as households account for 20% of total greenhouse gas emissions (Bowen and Rydge, 2011).

The current fuel poverty policy package includes policies affecting prices, transfers and energy efficiency, but with a high weight on some poorly targeted income transfers and tax rebates. The largest single instrument in terms of funding is Winter Fuel Payments, a non means-tested benefit paid to all households with a member aged 60 or over. The VAT rate charged on domestic energy consumption is 5% instead of the standard rate of 20%. Such measures incur high deadweight losses, as non-poor households also benefit, and generate incentives for higher energy consumption. They should be replaced by measures better targeted at low income households facing high energy costs.

The new Green Deal financial mechanism addresses restrictions to access to finance and will allow households to improve the energy efficiency of their properties at no upfront cost, with the investment being paid by a charge on electricity bills. However, as the Green Deal is not targeted on fuel poor households, its impact on fuel poverty will depend on the proportion of the latter that will participate and especially receive subsidies through the Affordable Warmth obligation of the Energy Company Obligation (ECO). The ECO requires

Box 1.2. **Tackling fuel and water poverty in the United Kingdom** *(cont.)*

energy suppliers: *i)* to contribute to carbon savings in the household sector, which they are likely to do mainly through financing solid wall insulation (carbon obligation); *ii)* to reduce energy bills for some low-income and vulnerable households through financing energy-efficiency improvements (Affordable Warmth obligation). Households not taking part in the Green Deal will face higher energy bills, as the cost of subsidies and administration are expected to be passed through to customers by energy suppliers. To ensure that fuel-poor households are not left behind as overall energy efficiency improves, it is essential to ensure that enough ECO subsidies go to Affordable Warmth. Providing quality information to households will also be essential to encourage take-up (Bowen and Rydge, 2011).

Concerns about the quality of the supply of home insulation may also hold back investment. Many consumers have complained about poor quality, failure to provide the most suitable form of insulation, mis-selling and difficulty to get redress. The sector is highly concentrated and consumers would gain from more competition and choice. The Office of Fair Trading has called for improving the certification process for new products, which currently hampers innovation and market entry, and for a single body being given the responsibility for monitoring the quality of insulation installations (OFT, 2012). The government should implement these recommendations without delay. A shortage of well-trained workers in insulation techniques is an additional potential bottleneck. The government is contributing to building up skills by offering up to 1 000 "Green Deal" apprenticeships.

Water poverty is also an issue, with about 5 million households in England spending more than 3% of their income (after housing costs) on water and sewerage bills (HM Government, 2011a). The United Kingdom is projected to become drier in the coming decades and population rises mean demand for water to continue rising, putting pressure on water resources (Benzie *et al.*, 2011). The water regulator, Ofwat, has set incentives for UK water providers to reduce consumption by five litres per day per property. Water providers are progressively moving from charges based on the rateable value of property to charges based on actual water consumption, which encourages more efficient water use. Currently one third of households are metered and this proportion is expected to rise to more than a half by 2015. Meters also allow addressing affordability issues, in particular through block tariff systems, in which unit tariffs rise with consumption. This allows basic water services at relatively low price to be subsidised by consumers of greater volumes of water. Even so, some low-income households unable to reduce their water use will continue to struggle to pay their bills.

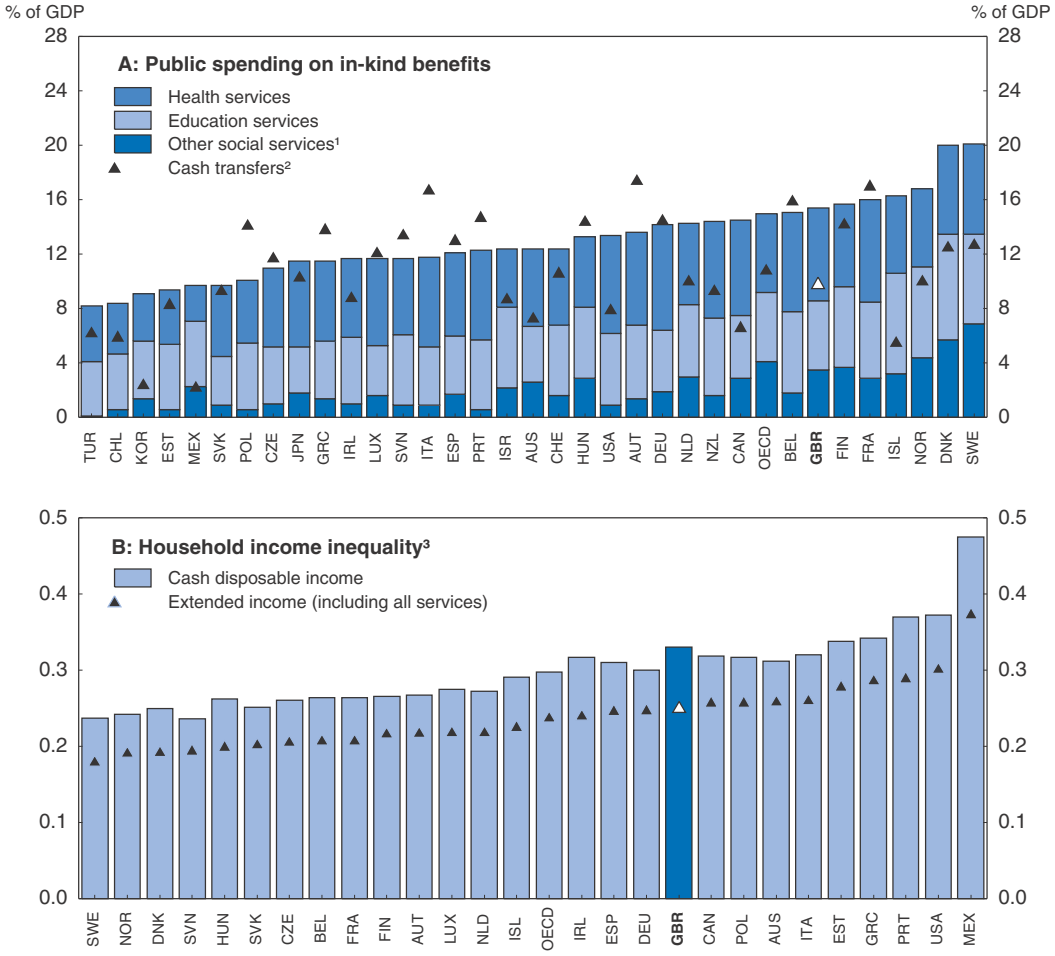
WaterSure provides a safety net that caps water bills for some poor and vulnerable households which are metered. In June 2012, the Department for Environment, Food and Rural Affairs issued guidance for water suppliers to implement social tariffs that would go beyond WaterSure, which is quite narrowly targeted (DEFRA, 2012). No general affordability threshold is set, as it is presumed that social tariffs are best set by water suppliers based on local conditions. The performance of water companies in supporting consumers at risk of affordability problems will need monitoring and benchmarking to ensure effectiveness. Schemes for improving water efficiency targeted at low-income households, which yield a double social and environmental dividend, could also be considered along similar energy schemes (Walker, 2009). Finally, as for the energy sector, regulation of the water industry needs to ensure that competition and innovation lead to the delivery of good quality services at least cost to the consumer.

sponsored Global Forum on Transparency and Exchange of Information for Tax Purposes can play a decisive role in the success of anti-evasion policies. Finally, the planned rise the State Pension age in line with increases in longevity will reinforce equity between generations.

Public services also reduce inequality

In-kind transfers through public services, especially health care and education, account for a higher share of government expenditure than cash transfers (Figure 1.9, Panel A). According to OECD estimates, including in-kind transfers into household income reduces the Gini coefficient from 0.33 to 0.25 in the United Kingdom (Figure 1.9, Panel B). Public services benefit every income group, but have a larger income-increasing effect in

Figure 1.9. **Redistributive effect of in-kind benefits**



1. Other social services include services to survivors, disabled persons, unemployed, as well as those in respect of housing and social assistance (estimates of social housing are, however, not included).
2. Cash transfers to the elderly, survivors, disabled persons, families, unemployed, as well as those in respect of social assistance. Private mandatory spending, which accounts for a large share of total social spending in some countries (in particular Chile, Germany and Switzerland), is not included here.
3. Gini coefficients.

Source: OECD Social Expenditure Database, *OECD Education Database* and OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*.

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the lower part of the income distribution, as imputed income from in-kind services constitute a higher share of lower incomes than higher ones. The estimated income-increasing effects of public health care and education are respectively 44% and 25% in the bottom quintile, compared to 5% and 3% in the top quintile. Even though such estimates need to be taken with caution given difficulties in estimating the income equivalent of in-kind benefits, it is clear that public services benefit poorer households the most.

Restraint on public spending, imposed by the budget situation, could hit the poor the hardest, as they benefit relatively more from public services and have less access to alternative services than the more affluent. However, efficiency gains could compensate for lower spending. OECD studies have estimated significant scope for efficiency enhancement both in education and health care in the United Kingdom (Sutherland *et al.*, 2007; OECD, 2010a). Better management and greater regional flexibility in public sector wages could contribute significantly. Reaping potential efficiency gains will be essential to preserve at the same time the quality of public services and fiscal sustainability.

Social housing has an important impact on lower income beneficiaries. The income-increasing effect for reduced rent tenants is 41% in the bottom quintile and 7% in the top quintile. This is the largest income-increasing effect for low-income social tenants in a sample of 21 countries for which data are available, reflecting a large social housing stock and high housing costs in the United Kingdom. Recent falls in affordable housing starts in England in a context of sharply reduced government funding and tight financial conditions are worrying. There are about 1.8 million households on waiting lists, support for private sector tenants through Local Housing Allowance is being cut and home ownership remains largely inaccessible to low-income households, even though the NewBuy scheme gives access to mortgages to first-time buyers with deposits of only 5 to 10%.

The long-term solution to improving access to housing is to build more, as the government recognises (HM Government, 2011b). In that respect, monitoring the impact of the planning reform on housing supply closely to ensure that development incentives for local communities are sufficiently strong is essential. Housing policies should also ensure access to decent affordable housing or financial support for households unable to access it through the market (OECD, 2011a, Chapter 2). The number of homeless households in priority need accepted by local authorities has increased by 25% between its trough in 2009-10 and 2011/12. Even though homelessness is less than half as high as in the early 2000s, its trend should be monitored closely, as tough economic conditions combine with housing benefit cuts and limited growth of the affordable housing stock to make access to housing more difficult. Early intervention to prevent and remedy homelessness is warranted both from a social and cost-effectiveness point of view. In that respect, the strategy focusing on prevention, recently outlined by the Department for Communities and Local Government, is welcome (DCLG, 2012).

In some countries, early childhood education and care (ECEC) services have an inequality-decreasing effect. But this is not the case in the United Kingdom, as children participation in ECEC is higher at the top than at the bottom of the income distribution (OECD, 2011c). Improving access to childcare for low income families would contribute to lowering inequality. Furthermore, as explained below, it would improve work incentives and career prospects for parents.

Redistribution via the tax and benefit system and public services play a crucial role in alleviating poverty. Nevertheless, there are limits to what redistribution can achieve. Across

OECD countries, the tax and benefit system has become less effective in mitigating inequality since the mid-1990s, as governments needed to reduce benefit levels and tighten eligibility rules to contain expenditures for social protection (OECD, 2011c). Increasingly tight constraints on public finances in the current downturn have narrowed the scope for public intervention further at a time of economic hardship. While recognising that support needs to be provided to people who are unable to work, policies now increasingly focus on return to work as the best way to lift people permanently out of relative poverty.

The next section focuses on the design of welfare benefits and their impact on work incentives. But getting people into work is not enough, as low pay and short working hours increasingly result in in-work poverty (Kenway, 2008). Reducing inequality requires an improvement in the quality of jobs, which can be obtained by raising the skills of the workforce, especially at the lower end. Indeed, OECD (2011c) finds that up-skilling has been the only force both reducing wage dispersion and increasing employment rates since the mid-1980s in the OECD. Policies to enhance workers' skills are discussed in the last section of this chapter.

Welfare policies to promote employment while protecting the most vulnerable

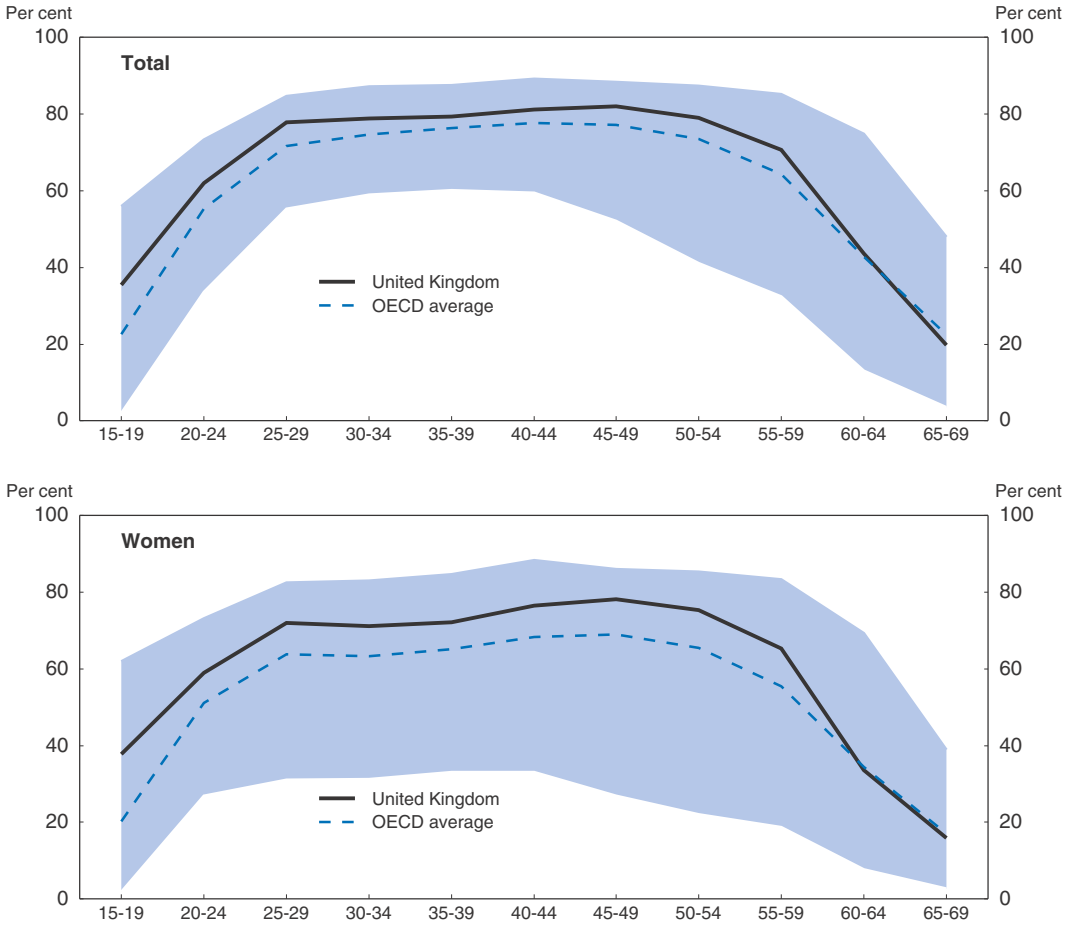
Social benefits attenuate inequality and provide an indispensable safety net for the most vulnerable households. However, they sometimes provide little work incentives, creating unemployment and poverty traps and long-term welfare dependency. The United Kingdom has been a leading country in the OECD in implementing welfare policies focussed on return to work (Daguerre and Etherington, 2009). Nevertheless, some individuals still face very poor work incentives, since taxes, National Insurance contributions and withdrawal of benefits would wipe out much of their gains from entering employment or working longer hours. The share of people on disability benefits is high by OECD standards, suggesting that some disability benefit recipients could return to work under appropriate conditions.

Employment rates are above the OECD average, reflecting in particular a flexible labour market, relatively small labour tax wedges and fairly low replacement rates in unemployment and retirement (Figure 1.10). Still, there remains a significant employment gap relative to the best performing countries, especially most Nordics, the Netherlands and Switzerland. Growth and social cohesion would benefit from pushing employment rates towards highest OECD levels. There is especially scope to raise employment rates of women – especially of child-rearing ages – and older workers. Part-time work is also much more prevalent among women than men, even if the gap is shrinking as a result of increasing involuntary part-time work due to difficult labour market conditions. Lowering childcare costs would facilitate women's employment and move towards full-time work. More personalised support and early intervention could limit further the exit of older workers from the workforce.

This section presents the main features of the UK welfare system in an OECD perspective. It then focuses on two major reforms underway to improve work incentives and support return to work, Universal Credit and the Work Programme, which are central elements of a broader government strategy for social mobility (HM Government, 2011c) and social justice (HM Government, 2012).

Figure 1.10. **Employment rates by age group**[1]

2010



1. The shaded area shows the area between the highest and lowest employment rate for each age group over all OECD countries. Note that data for Turkey and Switzerland were not available for the cohort 65-69.

Source: OECD, Labour Force Statistics Database.

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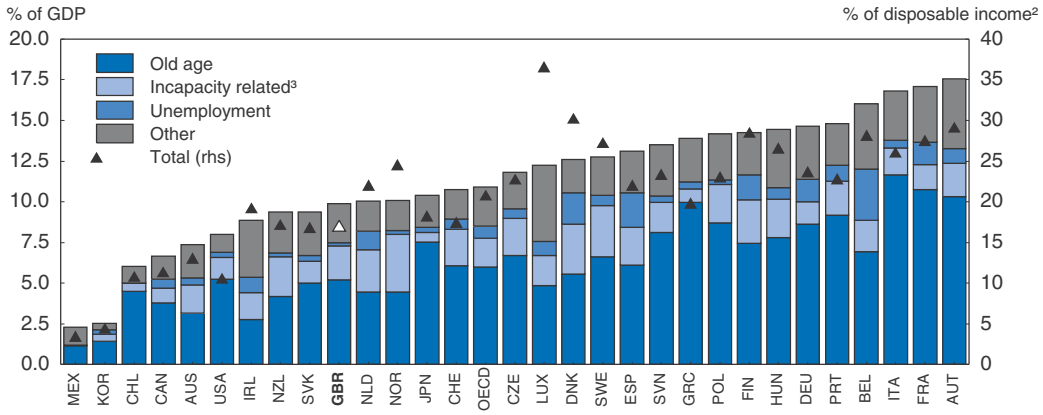
The welfare system provides an essential safety net

Public cash transfers to households represent around 10% of GDP, which is slightly below the OECD average (Figure 1.11). The welfare system is mainly designed as a safety net for those most in need, contrasting with many systems offering more universal benefits. This accounts for the much larger share of cash transfers in continental Europe.

The Family Resources Survey (FRS) sheds light on the profile of benefit recipients and the importance of benefits in their income. About half of lone parents and about a fifth of single persons and couples with children live only on benefits. Another 15% of lone parents receive more than 50% of their income in benefits (Figure 1.12, Panel A). For lone parents, benefits are on average far higher than earnings (Figure 1.12, Panel B). Overall, the welfare system protects a sizeable share of the population, notably lone parents and families with children. This safety net is essential, but poor work incentives may trap some households into relative poverty. The introduction of Universal Credit aims at tackling this issue, but work incentives in core recipient groups, especially facing high childcare costs, need to be enhanced.

Figure 1.11. **Public cash transfers**[1]

2007

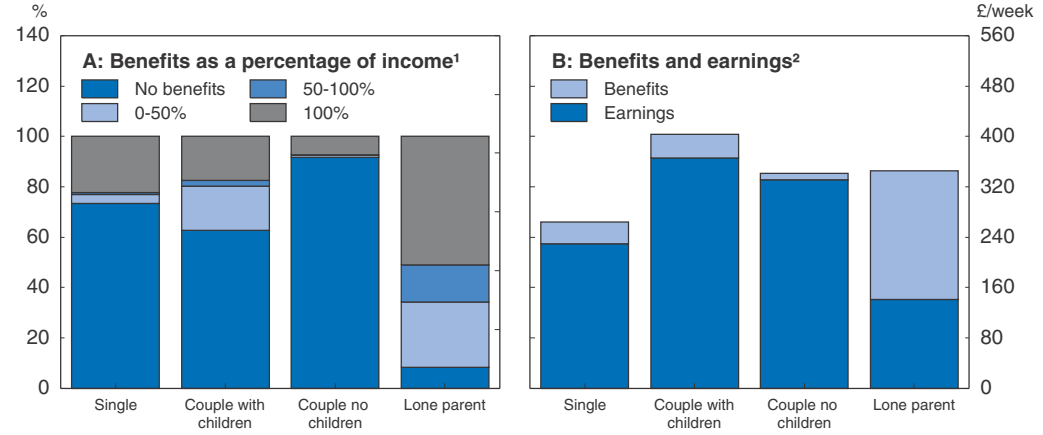


1. The data shown here exclude private mandatory spending which accounts for an important share of total social spending in some countries (in particular Chile, Germany and Switzerland). In addition, public cash transfers shown here may not fully account for those programmes and services provided, or co-financed, by local governments. Measurement gaps may be high, notably in federal countries such as Canada.
2. Refers to net household disposable income.
3. Incapacity-related spending covers expenditure on disability pensions and sick leave schemes (occupational injury and other sickness daily allowances).

Source: OECD Social Expenditure Database.

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Figure 1.12. **Benefit dependency by family type**[1]



1. Refers to gross disposable income.
2. Per adult in the household.

Source: Family Resources Survey and OECD calculations.

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Universal credit is expected to improve work incentives

The Welfare Reform Act 2012 introduces a wide range of reforms to the benefit and tax credit system (Universal Credit). Under the current system a working-age individual with low earnings and no disabilities may be entitled to receive payments from one or more of three main benefit groups; unemployment benefits and social assistance; the Housing Benefit and Council Tax Benefit and Tax Credits. Different benefits within each of these three groups are internally co-ordinated and roughly based on the same framework, while there is close to no co-ordination across the three benefit groups, leading to a rather erratic incentive structure. Under Universal Credit, the main means-tested benefits, except the Council Tax Benefit, will

be pooled into one single benefit with generous earnings disregards and one single rate of benefit withdrawal against income (taper rate). At the same time, support for childcare through the benefit system is made accessible for parents regardless of how many hours a week they work (Pareliussen, 2013). Stated goals of the Universal Credit reform include giving people incentives to work, diminishing complexity, reducing relative poverty and containing the rising cost of welfare dependency (DWP, 2010a).

Universal Credit will give better incentives to work than the current system. The highest Marginal Effective Tax Rate (METR), the amount which will be lost in taxes and loss of benefits from earning an additional pound, will be 76.2% after the reform. Although still high in absolute terms, this is lower than in the existing system, where the METR could reach 100%. Incentives to work, as measured by effective tax rates, will also be better than the OECD average for most individuals after the reform (Pareliussen, 2013). Further reducing METRs by reducing the taper rate would increase spending on benefits unless the overall level of benefits is lowered at the same time.

The reform represents a radical overhaul of the incentive structure compared to the existing system, and is in many ways a big leap into uncharted territory. It is therefore impossible to say with certainty to what extent the Universal Credit will contribute to reducing welfare dependency and hence increase the growth potential of the economy and lower the cost of the welfare system in the future. This depends on how changes in incentives induce behavioural change.

Although impact analyses rest on a number of assumptions, the conclusion that labour supply will increase as a result of the reform seems robust. The Department for Work and Pensions (DWP) assumed that the net effect on labour supply will reduce the number of workless households by 300 000 (DWP, 2010a). This number is very sensitive to assumptions regarding labour supply elasticities, potential wages and work hours especially for inactive lone parents and second earners with children. OECD analysis based on different sets of assumptions (Pareliussen, 2013) estimates a reduction of the number of workless households could be between 45 000 and 240 000, and an increase in labour supply equivalent to 15 000 to 85 000 full-time employees. Childcare costs are not taken into account in either of these analyses. Unless the disincentive of high childcare costs is reduced, the positive effect on labour supply is likely to be lower.

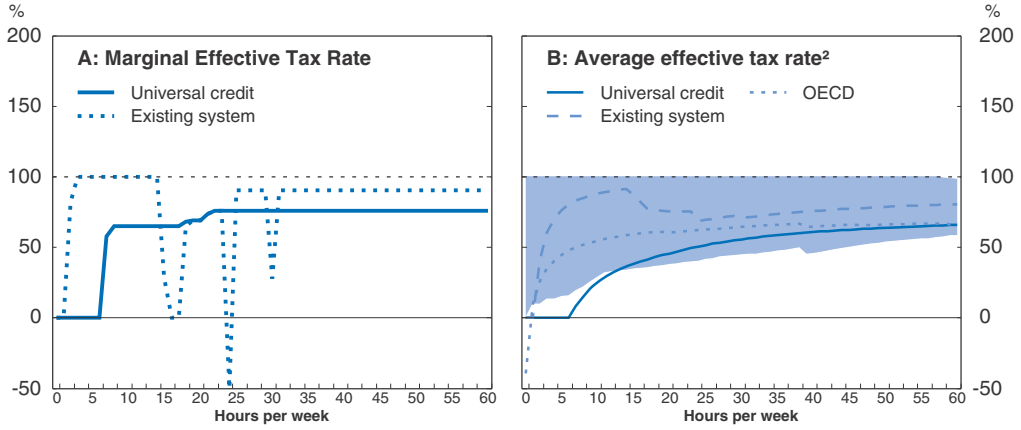
Universal Credit also represents an indisputable simplification of the benefit system, which in the long run will most likely reduce administrative costs and the potential for fraud and error. The increased simplicity for users will also increase the flexibility of the labour force, since the uncertainty of having to re-apply for benefits after a period of work represents an additional cost of entering work in the current system. On the other hand, necessary steps should be taken to ensure support to users who do not have access to services online, and to users who face challenges when going from weekly to monthly budgeting (Finn and Tarr, 2012).

Households in the bottom half of the earnings distribution will on average be better off after the reform, while those in the upper half will be marginally worse off (DWP, 2011). Take-up of benefits will increase after reform, since households who are today taking up only part of the benefits are eligible to will automatically receive their full entitlement under Universal Credit. The integrated nature of the reform will also remove the need for separate applications when moving from one benefit to another and when moving in and out of work, as the separation between out-of-work and in-work benefits is removed.

The Department of Work and Pensions estimates that some £6.9 billion to £12.7 billion worth of benefits went unclaimed compared to a total of £38.1 billion claimed in 2008-09. This represents a take-up rate in the range of 75 to 85% (DWP, 2010b). The combined impact of take-up and increased entitlements for low income families will have a further positive impact in reducing poverty and increasing equality. These aspects of the reform are expected to lift around 900 000 individuals, including 350 000 children, out of relative poverty (DWP, 2011). This improvement will, however, be more than offset by cuts to the benefit system introduced since the 2010 Spending Review, such as cuts to the Housing Benefit and changes in indexation of benefits (Brewer *et al.*, 2012; HM Treasury, 2012).

The major gainers of the introduction of the Universal Credit are primary earners in couples (Figure 1.13, Panel A and B), which will have both better marginal work incentives and higher income after the reform. Many lone parents will face better work incentives and higher income (Figure 1.14, Panels A and B). While the effect of the reform for second earners will depend on individual circumstances (Figure 1.14, Panel C and D), household income will also increase for this group. For single-persons the effect of the reform is ambiguous.

Figure 1.13. **Incentives to work for a primary earner in a couple with children**[1]



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%. The full set of model assumptions can be found in Pareliussen (2013).
2. Data for the OECD refer to 2010. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

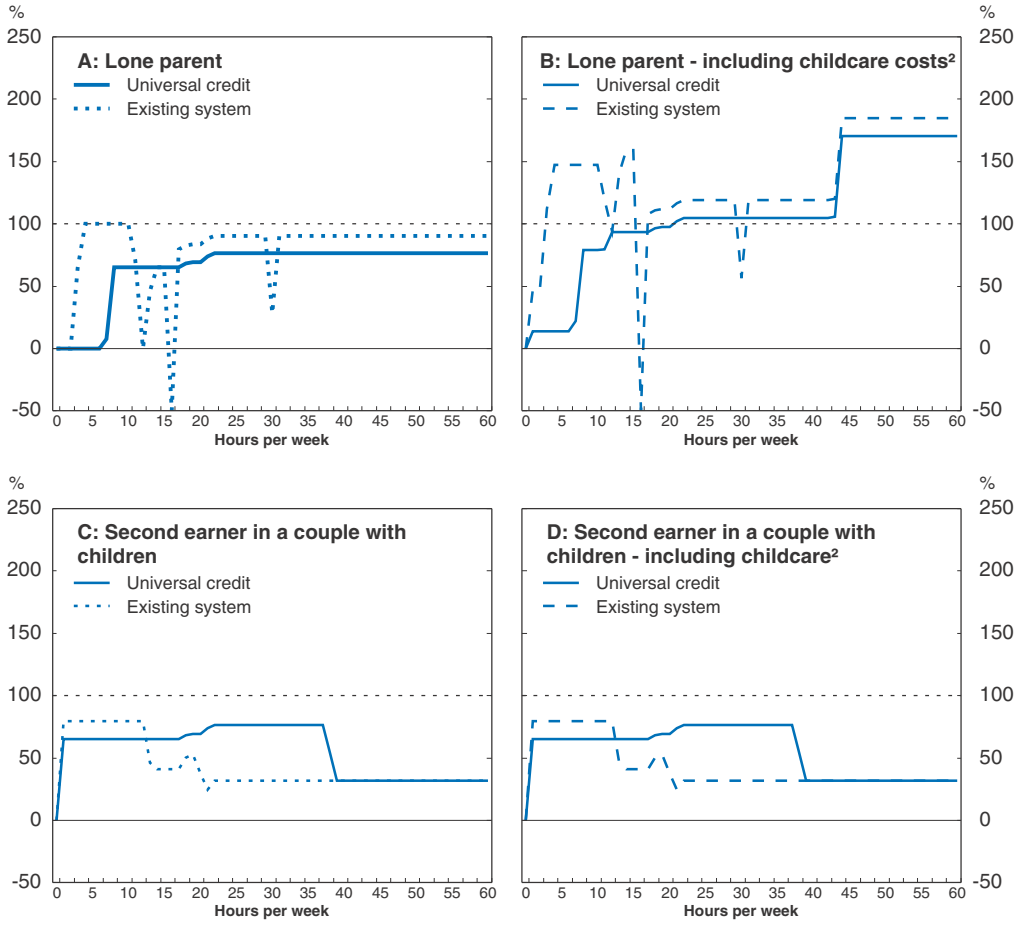
Source: OECD calculations and OECD Taxben model.

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The removal of the current 16-hour threshold to become eligible for childcare support in combination with the increased earnings disregards will give significantly better incentives for lone parents to work a few hours a week compared to the current system (Figure 1.14, Panel B). The removal of the threshold for childcare support is also positive for second earners, as the very high METRs below the 16-hour threshold in the current system are lowered considerably (Figure 1.14, Panel D). Still, high childcare costs can reduce the gain of the reform especially for low- to medium-wage second earners and lone parents earning more than their earnings disregard. These groups respond particularly well to improved incentives (OECD, 2011e). In addition lone parents are over-represented in poor households, so improving lone parent's incentives to work would have the potential to reduce relative poverty and child poverty even further than the reform as it stands today.

Figure 1.14. **Incentives to work for lone parents and second earners**[1]

Marginal effective tax rates



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%. The full set of model assumptions can be found in Pareliussen (2013).
2. Assuming childcare costs of £4 per child per hour worked.

Source: OECD calculations.

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In this area, the reform could be improved by a number of measures, although potential gains should be weighed against significant fiscal costs. Measures include increasing the refund rate for childcare, reducing the taper rate for those who receive childcare support and/or introducing a dedicated disregard for second earners in couples. The most targeted way of addressing work incentives affected by childcare costs would be to increase the refund rate for eligible childcare costs. Potential cost-driving effects on childcare provision should be considered. The rate was lowered from 80% to 70% in the 2010 spending review, with estimated savings of £350 million a year. In comparison, reducing the overall taper rate from 65 to 60% would cost approximately £1 300 million a year. On the other hand, better incentives for lone parents and second earners with children would increase the effectiveness of the reform and thereby increase the economic growth potential and reduce inequality. These costs could be partly offset by reducing the disregard, especially for primary earners in couples.

Reforms outside of the scope of Universal Credit could also be helpful in improving incentives for those dependent on formal childcare. Childcare fees, the gross amounts charged to parents regardless of the subsidy that providers may receive from public authorities or private donations, for a two-year old attending accredited early-years care and education services amount to 25% of the average wage in the United Kingdom, compared to 8% in Finland and 5% in Sweden (OECD, 2007b). This is partially explained by higher levels of provider subsidies in these Nordic countries. Net childcare costs, after deduction of cash benefits, rebates and tax concessions, vary with households characteristics, but also account for a substantially higher share of income in the United Kingdom than in Finland and Sweden. Thus, it often does not pay for both parents to hold full-time jobs. Although a large share of early years care is free, provided by the formal or informal sectors, the fact that nursery schools are often half-day raises the need for some parents to resort to private day care and take time off to transport children from one care source to another. One parent working full-time and the other part-time is the norm in the United Kingdom. The OECD has earlier suggested that childcare support needs to be provided in a more coherent way (OECD, 2005a). In this respect, the launch of a commission on childcare in June 2012 to look at how to reduce the costs of childcare for working families and the regulatory burdens on childcare providers is welcome.

The government has announced some steps to increase flexibility and to offer 15 hours of free nursery school to the 40% least advantaged 2-year olds, which in addition to improving work incentives, could have positive effects on child development and inequality. Extending the current 15 hours a week free childcare in nursery schools for 3- and 4-year olds to younger children and increasing the user flexibility of this scheme would lower childcare costs to parents and ensure that parents could make effective use of the childcare which is provided.

The Council Tax Benefit today has approximately 5.8 million claimants and represents 2.5% of total public expenditure on benefits (Jin *et. al.* 2010). The government has issued guidance setting out a framework that local authorities can use to run schemes that are consistent with the design of Universal Credit. While local authorities have an incentive to promote work, as it reduces expenditure on local council tax support schemes, measures such as these are needed to ensure that the decision to localise the benefit does not undermine the improvements in work incentives brought by the Universal Credit.

The simplicity and transparency of Universal Credit combined with better work incentives for many individuals, is a step forward. It should make it easier for people to understand that work pays. Universal Credit will furthermore provide individuals with a seamless route to enter, exit and re-enter work without running the risk of losing their entitlement. Although the marginal tax rates still remain relatively high, combined with an effective conditionality regime, the Universal Credit reform can change social attitudes to work in the long run. If the remaining weaknesses would be addressed, the gain from the reform in terms of making work pay and reducing poverty would be even bigger.

Universal Credit, as any other major system change, faces the risk of implementation problems. Universal Credit depends on real time information on income, which is to be achieved through HM Revenue and Customs Real Time Information (RTI) project. System failure in the RTI could lead to unnecessary uncertainties and hardship for vulnerable groups in the transition period, especially if Universal Credit recipients were not receiving timely and correct payments. The planned phased introduction of Universal Credit is helpful in mitigating these risks, and should be combined with sound contingency plans and transparent information for users (Finn and Tarr, 2012).

The Work Programme is a significant step forward, but activation policies are facing a tough challenge

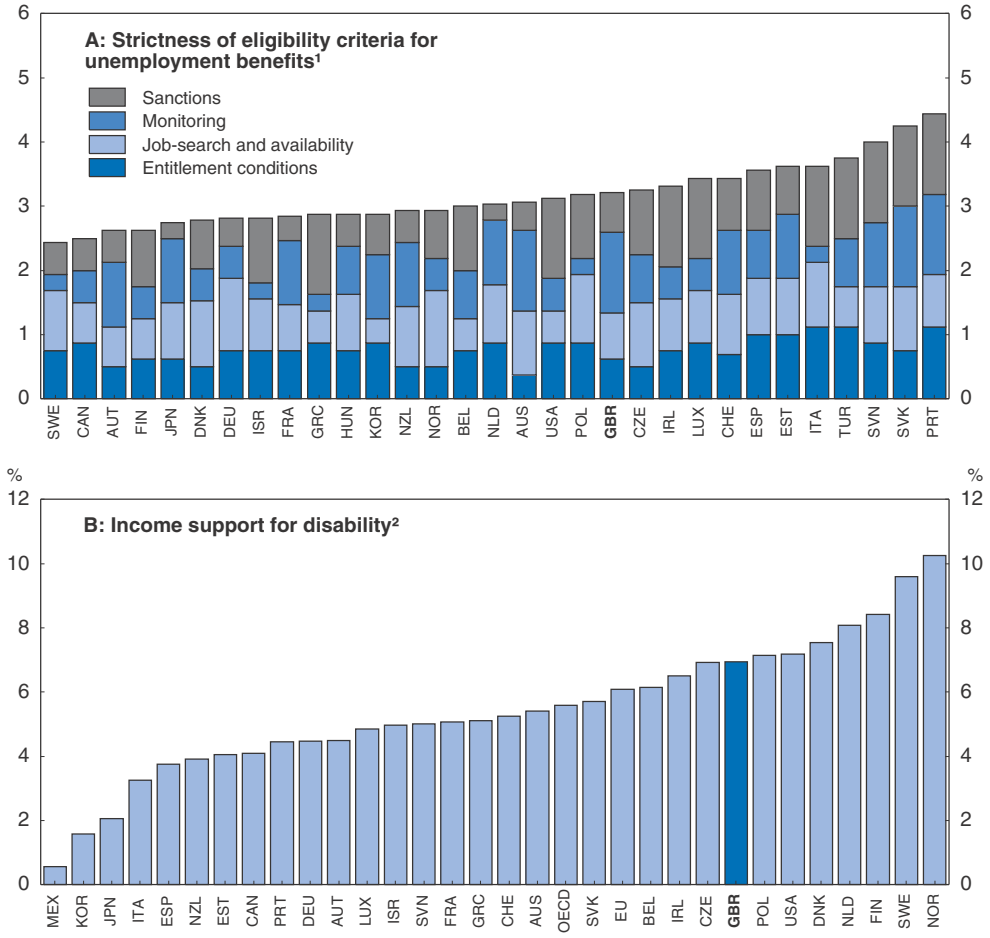
Well-designed active labour market policies (ALMPs), including job placement services, subsidised employment and training can play a major role in helping unemployed people back to work. Recent research examining a large number of ALMP programmes in a large sample of OECD and non-OECD countries suggests that job search assistance combined with sanctions for non-compliance with programme requirements and subsidised employment in the private sector can be effective in increasing participants' employment prospects. Public sector employment programmes are generally less effective, although the United Kingdom's Future Jobs Fund, a largely public and voluntary sector employment programme, shows a positive impact on unsubsidised employment (DWP, 2012). Training programmes seem to have little short-term impact, but yield better medium-term results. They are more effective when unemployment is high, perhaps because of the participation of people with higher qualifications. Training programmes targeted at young people seem less effective than programmes opened to wider groups, presumably because they include more people with labour market disadvantage. However, the design of training programmes is bound to have a great influence on their outcomes, as discussed in the next section (Card *et al.*, 2010; Kluve, 2010).

ALMP programmes are especially important at times when the economy is undergoing deep structural change and labour needs to be reallocated across economic sectors, implying more difficult human resources management and often retraining of workers. The current period of rebalancing of the UK economy, as in many other OECD countries, imposes a tough challenge on ALMPs. The United Kingdom has been at the vanguard of labour market strategies focussing on quick re-entry into the labour market, entailing strict conditionality regimes and mutual obligations between benefit claimants and public employment services. Only Australia and some US states seem to have gone further in moving people from benefits to work (Daguerre and Etherington, 2009). Eligibility criteria for unemployment benefits are among the strictest in the OECD, although somewhat lighter than in some southern and eastern Europe countries, where entitlement conditions are more restrictive and sanctions for refusing a job or an active labour market programme are tougher (Figure 1.15, Panel A).

Conditionality will be strengthened and sanctions will be tougher under Universal Credit. Monitoring of job search is among the strictest in the OECD, with a fortnightly job-search review. Well-designed ALMPs have been one of the driving forces behind the overall high UK employment rate (OECD, 2005b; RWI Essen, 2005). Nevertheless, some population groups still face substantial difficulties in accessing work, hampering their ability to improve their living conditions. This is particularly the case of disability benefit recipients and young people with low qualifications.

About 7% of the population aged 20-64 receives disability benefits, above the OECD average of less than 6%, albeit below the proportion in Nordic countries, where disability benefits tend to be more generous (Figure 1.15, Panel B). The share of people on disability benefits rose sharply between the early 1980s and the mid-1990s, partly through moves from unemployment to disability. It subsequently stabilised, as a result of falling unemployment, enhanced support for return to work and tightening of eligibility conditions. It has been declining somewhat since the mid-2000s, but remains high in international comparison, which suggests there is scope to bring it down further (OECD, 2010b).

Figure 1.15. **Eligibility to unemployment benefits and disability benefits recipiency**



1. Scores range from 1 (least strict) to 5 (most strict).
2. Refers to the percentage of the population aged 20-64 years old receiving disability benefits. Disability benefits include benefits received from schemes to which beneficiaries have paid contributions (contributory), programmes financed by general taxation (non-contributory) and work injury schemes. Data refer to 2009, except for: Luxembourg (2005); Canada, France, Italy, Spain and Poland (2007); Australia, Austria, Belgium, United Kingdom, Greece, Ireland, Japan, Korea, Slovenia (2008) and for Denmark, Estonia, Hungary, Israel and Portugal (2010).

Source: OECD (2012), *Economic Policy Reforms 2012: Going for Growth;* Venn, D. (2012), *Eligibility Criteria for Unemployment Benefits: Quantitative Indicators for OECD and EU Countries*, OECD.

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The government launched the Work Programme in June 2011 to help the unemployed in need of tailored support, such as disability benefit claimants and long-term unemployed, to undertake active and effective job-search. The two cornerstones of the programme are personalised support and payment for results. Emphasis on personalised support and early intervention is supported by international evidence (OECD, 2005b; Daguerre and Etherington, 2009). The Work Programme gives providers more freedom to personalise support than previous welfare-to-work schemes, allowing more innovative approaches. Service providers, which include private, public and voluntary sector organisations, face clear incentives to deliver sustained job outcomes for participants, as a

significant part of their remuneration comes from delayed payments, received for up to two years conditional on the participant remaining in work. Furthermore, helping customers with lower job prospects results in additional payments, mitigating incentives for cream-skimming.

While the Work Programme is based on sound principles, anecdotal evidence suggests some implementations problems, including concerns about financial viability for service providers in the current challenging labour market conditions and co-ordination problems between private firms and voluntary organisations, which have led a number of charities to withdraw from the programme. To ensure the Work Programme is efficiently addressing its objectives, the government has commissioned an independent evaluation by the IES (Institute for Employment Studies).

About half of the five million people receiving out-of-work benefits are on disability benefits and it is likely that some could go back to work under appropriate conditions. The Work Capability Assessment (WCA) was introduced in October 2008 to assess the condition of people on Employment and Support Allowance, which provides financial support for those unable to work because of illness or disability. Reassessing existing claimants according to new criteria is exceptional in an OECD context (OECD, 2010b). The WCA has been very controversial. The British Medical Association called for scrapping the scheme. Roughly 40% of people found fit for work appeal the decision and around 38% of those people who appeal have the decision overturned. Overall, 15% of fit for work decisions are overturned on appeal.

The first *Independent Review of the* WCA (Harrington, 2010) and the Work and Pensions Committee report on incapacity benefit reassessment (2011) both criticised how the WCA was working in practice. The second *Independent Review of the* WCA (Harrington, 2011) found that improvements had been made, but also that more needs to be done. The WCA needs further improvement to make it fairer and more effective. Many people currently on benefits could gain from going back to work under appropriate conditions. However, being fit for work is often perceived as "failing" the assessment (Harrington, 2011). To remedy this situation, better communication about the aims of the programme is needed. Furthermore, it is crucial to give strong support to people assessed as fit for work in their search for a job. Therefore, co-operation between WCA decision makers and service providers in the Work Programme needs to be intensified.

More than one third of new disability benefit claimants in 2009 were suffering from mental health problems and this proportion was even exceeding 40% in the 20-34 age group. This is not unique to the United Kingdom, as mental health problems are gradually becoming the main cause for disability claims across OECD countries, accounting on average for a third of the total and often more than half for young people (OECD, 2012b). According to an evaluation for the OECD Mental Health and Work project (OECD, 2013), the United Kingdom is among the most advanced countries in terms of awareness about the costs of mental illness for employers and society as a whole, and of the mental-health benefits of employment. Integration of health and employment services is also well developed, as illustrated by the Improving Access to Psychological Therapies (IAPT) initiative which aims to provide access to both evidence-based psychological therapies and matching employment services.

However, the benefit system lacks focus on early intervention, which could prevent more people from needlessly moving into benefits and support quick return to work. At

present, support for return to work would typically only come after 9 to 12 months on sick leave. Fit-for-Work Service (FFWS) pilots provide employees in the early stages of sickness absence (normally 4-12 weeks of absence) with case-managed multidisciplinary support to enable a quick return-to-work. The results of the pilots are encouraging and this type of early intervention should be expanded further. Health care professionals' role in helping return to work should be enhanced by the diffusion of evidence-based guidelines and closer monitoring of the use of the "fit note", which should include an assessment of capability to work in other activities for people no longer able to carry on their previous activity.

As recommended by the *Independent Review of Sickness Absence* (Black and Frost, 2011), an independent in-depth physical and/or mental health assessment of individuals on sick leave should take place after a few weeks of absence, to advise on needs for rehabilitation and support for return to work. In addition, the capacity of public employment services to identify psychological problems through adequate screening tools, provide psychological services and refer people in need to health services in a timely manner should be developed. Employers should also be encouraged to play a greater role in the prevention of work-related diseases and the rehabilitation of workers, whether through occupational health regulations or incentives, such as the tax relief for expenditure by employers to keep sick employees in work proposed by the *Independent Review of Sickness Absence*.

Skill deficiencies are also holding back employment and fostering inequality

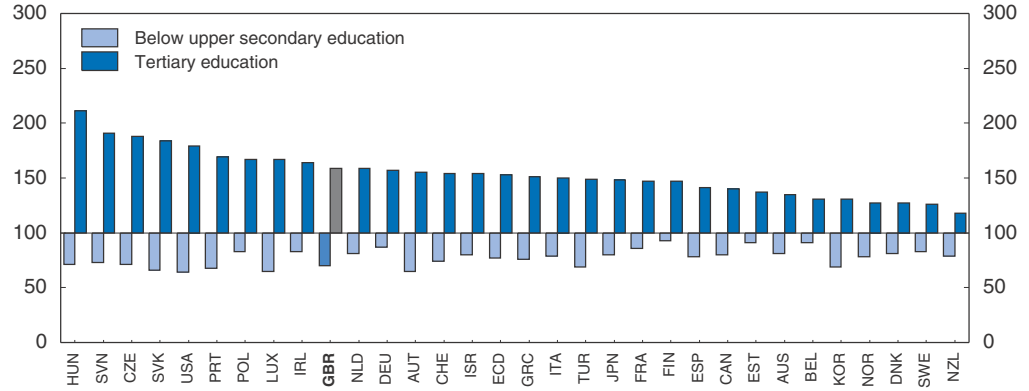
Low education achievements penalise children from lower socio-economic backgrounds

Tackling youth unemployment is a major challenge, with both short term and longer term social and economic implications. Young people must be prevented from falling into relative poverty and social exclusion, which would likely lead to permanent effects on their working careers. The government has appropriately taken measures focussed on giving young people the skills and opportunities to gain long-term employment in the private sector. The Youth Contract is designed to provide 18-24 year-olds with nearly half a million new opportunities, in the form of apprenticeships and work experience placements. Subsidies will encourage businesses to recruit young people and offer apprenticeships. Evaluations of private sector subsidised employment programmes in other OECD countries have frequently found a positive impact on employment (OECD, 2005b). Nevertheless, the impact of the Youth Contract on sustained employment of young people will need to be monitored closely.

People with low education levels are most at risk of unemployment. Education premia for people with tertiary education in the United Kingdom are among the highest in the OECD, while pay penalties affecting individuals without basic qualifications are larger than the OECD average (Figure 1.16 and OECD, 2011d). Skill deficiency during adulthood is the obvious outcome of poor performances at school. According to PISA data, the impact of parental background on young people's cognitive skills varies substantially across countries. In France, New Zealand, the United States and the United Kingdom, the socio-economic background has the strongest influence on education achievements (Causa and Chapuis, 2009). Given that a strong intergenerational persistence in schooling achievements has important consequences for equality and social mobility, skill development and more equal opportunities through the education system are of crucial importance.

Figure 1.16. **Relative earnings from employment by level of educational attainment**[1]

Upper secondary and post-secondary non-tertiary education = 100



1. Refers to 25-64 year-olds. Data for 2009 or latest available year.

Source: OECD (2011), *Education at a Glance 2011*.

StatLink http://dx.doi.org/10.1787/888932768277

The government has taken steps to reform the education system, which are consistent with the recommendations from the *2011 OECD Economic Survey of the United Kingdom* (OECD, 2011a) outlined in Box 1.3. The focus on disadvantaged children is being reinforced through the statutory entitlement to 15 hours per week of free early education for disadvantaged two year olds, which will be introduced in two phases, starting in September 2013. The monitoring of the Pupil Premium, which is allocated to schools to work with pupils who have been registered for free school meals at any point in the last six years, is being improved by introducing a requirement that schools report to parents on how they have used the Premium and by including in the performance tables separate results for the attainment of pupils eligible for the Premium. The government has been reviewing A-levels, giving universities a much greater role in reforming the qualifications, which should address the problem of grade inflation witnessed over recent years (OECD, 2011a).

Transition from education to work can prove challenging

Young people undertaking the complex process of transition from education to work do not always approach the labour market with the appropriate skills and qualifications. Although the UK Commission's Employer Skills Survey 2011 (UKCES, 2011b) reveals that most of the employers who recruited education leavers found them adequately prepared for work, a significant minority was not satisfied with their work-readiness, mentioning lack of experience and motivation as the overwhelming reasons. The survey also reveals the existence of pockets of skill deficiency, notably among skilled trade occupations, where a third of all vacancies are classified as "hard-to-fill". This evidence suggests that increasing opportunities for young people to gain experience would be beneficial.

Encouraging a proper combination of study and work may smooth the transition to work, avoid high drop-out levels, open up greater prospects at the time of full integration in the labour market, as well as enhance performances of workers in the long run. In this respect, student jobs, internships and apprenticeships could be crucial in pulling the youth out of the vicious circle "no job without experience; no experience without job". While on-the-job training would allow young people to compensate for gaps in school education, a

Box 1.3. **Improving educational outcomes and raising skills***

Education and human capital are crucial drivers of employment, output growth and well-being. Better educational performance improves labour market outcomes, enhances workers' productivity, reduces income inequalities and promotes intergenerational mobility and social cohesion. It contributes to higher life satisfaction through better employment, income and social relations (OECD, 2011a). In the United Kingdom, wide gaps in education and skills and a low level of intergenerational mobility generate large inequalities relative to many other OECD countries. Over the past decade, several reforms have aimed at tackling income inequalities through the improvement of educational attainment and social mobility. Nevertheless, the scope for deeper skill accumulation and more equal opportunities remains substantial. This box discusses current issues and potential interventions to raise skill levels among the population and especially the most disadvantaged social groups.

The provision of high-quality pre-schooling delivers high private and public economic returns, especially for children from disadvantaged backgrounds. Indeed, a lack of skills or access to credit for the creation of a nurturing environment at home, and little awareness of the returns to education may lead to under-investment in schooling. Yet, cognitive and non-cognitive skill accumulation during early childhood is crucial for later skill formation (Cuhna and Heckman, 2010; Chowdry *et al.*, 2010). Programmes such as the Sure Start Children's Centres and the Early Years entitlement expanded pre-schooling since the beginning of the 2000s, leading to an enrolment rate of 95% for 3 to 4 year-old children (well above the OECD average of 72%). Impact evaluations of the programmes are blurred. Despite some recent evidence of behavioural and health benefits, assessments on cognitive skills indicate minor effects (Merrell *et al.*, 2007). Furthermore, the impact of parents' income on children educational performances has been worsening in recent years. Given the broader effect of pre-schooling on disadvantaged children (Hopkins *et al.*, 2010; Goodman and Sianesi, 2005), resources should be geared towards deprived families, which should also be the target of wider outreach activities and, possibly, of child/parent home support in the neediest cases.

The relationship between spending on education and schooling performances has proven to be weak at the international level and in many OECD countries (Sutherland *et al.*, 2009; OECD, 2007c). Despite a real spending per pupil increase of 4.8% annually between 1997 and 2010, assessments of cognitive improvements are mixed. Unlike national indicators, international data report a sharp fall in the productivity of education for the United Kingdom. Estimates by Sutherland *et al.* (2007) suggest that moving the primary and secondary school systems to the OECD best-practice would allow delivering current output using 20% less resources. Firstly, given the relevance of quality teaching for schooling achievements (Hanushek and Wossman, 2007; Slater *et al.*, 2009), recruiting and retaining better teachers should be a priority. Individual schools should be provided with tools and incentives to hire, reward and replace teachers according to their performance. Extending these practices to Local Authority maintained schools could also increase their competitiveness relative to independent schools, academies, faith schools and Free Schools. Indeed, although the spreading of alternative school arrangements widens the scope of users' choice, it may exacerbate the correlation between socio-economic backgrounds and school resources and quality. Teaching practices could be also improved by reducing the extensive reliance of the system on test scores, and rather develop more comprehensive indicators of school performance. Indeed, despite being important, benchmarking is deemed to have incentivised grades inflation, "teaching to tests" and scarce attention to the development of non-cognitive skills.

Box 1.3. **Improving educational outcomes and raising skills*** *(cont.)*

The impact of the socio-economic background on PISA scores is higher in the United Kingdom than in most OECD countries (OECD, 2011d; Causa and Chapuis, 2009), suggesting that skill accumulation might not be adequate for a large share of the population exiting compulsory schooling, with adverse consequences on drop-out rates, labour market opportunities and income inequality. Exceptionally wide skill differentials and high income and education persistence across generations mirror the poor functioning of deprivation funding in the United Kingdom. Indeed, the complexity of the system is deemed responsible for low levels of pass-through of governmental funding from local authorities to schools, which tend to face low incentives to spend on and retain disadvantaged students. By making the system smoother and introducing a pupil premium, the government has started to address these issues. However, solving underlying incentive problems would require that the pupil premium increases and becomes the only means of deprivation funding, since the current system of transfers from local authorities to schools lacks transparency and proper targeting of pupils in need. Additionally, school spending for disadvantaged children could be incentivised through improved user choice. Needy families living in areas with low-quality oversubscribed schools have often limited or no alternatives. Preventing the use of residence-based criteria for admission and encouraging the entry of new schools would be warranted as recommended in the *OECD Economic Survey of the United Kingdom 2011* (OECD, 2011a).

Participation rates in non-compulsory education have been increasing in recent years, but cross-country comparisons reveal that they are still low. The number of young people neither in education nor in employment or training (NEETs) has swelled during the recession and is among the highest in the OECD. The government's commitment to raise the compulsory participation age to 17 in 2013 and 18 in 2015 will increase participation in education and training. What is most important, though, is that students are equipped with the adequate skills to enter the labour market. Available evidence suggests that some vocational training has a low or even negative impact on future returns (Machin and Vignoles, 2006), with the exception of some high-quality apprenticeships. Reducing the complexity of the system and the fragmentation of the programmes, while increasing the quality and the number of available positions, may enhance the attractiveness of vocational training, having a positive impact on labour market outcomes and productivity.

Tertiary education attainment levels are in line with the OECD average. The outstanding quality of universities and the above-average returns to tertiary schooling have spurred participation in recent years. Nonetheless, little evidence of falling returns over time suggests that demand for the highly skilled has kept the pace of supply (Walker and Zhu, 2008). Increasing the available positions, while maintaining high standards of quality, would promote human capital accumulation, economic growth, equality and social mobility. Furthermore, high private returns justify recent reforms making students bear a larger share of the costs. In such a way, savings from lower public funding could be used to expand available positions, especially in those fields with higher social and private returns. At the same time, however, government interventions should provide support to the neediest, who are currently underrepresented among graduates and whose access to tertiary education might be further discouraged by higher fees.

* This Box is largely based on Chapter 3 of the *2011 OECD Economic Survey of the United Kingdom* (OECD, 2011a).

forward-looking perspective to raise skills would also warrant the predisposition of second-chance schools, through which drop-outs could resume education and gain qualifications buttressing their employability. England has launched a programme of education and training guarantees until the age of 19, built on a closer co-operation between schools, training providers and employment stakeholders (OECD, 2010c). Connection services, which are in charge of providing assistance to young people, collect and transmit information on school leavers, training and placement, basically serving as a job brokerage service that ensures awareness of employment opportunities among young people.

Vocational training needs to be strengthened and co-operation with employers reinforced

The current UK skills strategy aims at improving the level of workplace skills through the support of vocational education and training (VET) and apprenticeship programmes. Although England and Wales are strongly committed to achieving the skill targets set out in the *Leitch review* (HM Treasury, 2006) and have made available substantial resources to this aim, the degree of business involvement in VET and the provision of work-related training are low and often declining (UKCES, 2012).

As a crucial step towards the up-skilling of the workforce, employer engagement should be clearly encouraged. Employers' engagement in policy design and delivery is much stronger in Austria, Germany, Norway and Switzerland (Hoeckel *et al.,* 2009), which feature essentially dual systems in which employers cover on-the-job training, while the state funds off-the-job training and education. These countries have developed systems of effective co-operation and checks and balances among social partners that ensure successful policy implementation and effectiveness. Employers are in the best position to evaluate whether the contents of VET programmes respond appropriately to labour market requirements, and therefore to provide advice for policy development. At the same time the involvement of business makes them understand better the institutional system and respond more broadly to governmental initiatives.

While past initiatives have been strongly targeted at the public sector, efforts should now be geared towards the private sector and small and medium sized enterprises in particular. In April 2012 the Youth Contract was launched, offering nearly half a million 18-24 year olds new work opportunities, such as apprenticeships and other work experience. Within the £1 billion package, a wage incentive one-off payment worth up to £2 275 per person will be granted to employers who recruit young people from the Work Programme or Jobcentre plus over the next three years. Additional financial and operational aid will be provided to those employing young people with disabilities.

As regards apprenticeships, on top of covering training costs, the National Apprenticeship Service will make £1 500 grants available to small and medium sized employers hiring their first 16-24 year old apprentices. By raising employers' incentives and involvement in training and up-skilling, the initiative is going in the right direction. While funding seems adequate, co-operation among governmental units and employers should be enhanced to make the most of the programme. Recent moves in this area are a positive move in the direction of giving employers a larger role, for example by directly funding employers to deliver skills provision through Employer Ownership Pilot funding – extended to £340 million at Autumn Statement 2012. Local Enterprise Partnerships has also been given a larger strategic role in the skills system to help direct skills provision to meet local employers needs.

It is vital to raise awareness – currently mostly confined to large and public enterprises – of the programmes to support youth employment. Available evidence suggests that national campaigns to raise awareness have not proven effective (UKCES, 2011a). Well established initiatives tend to be better known. Consequently, the government could build on existing technology and links with business to promote youth employment at a more industry specific and local level. Further involvement of local authorities, which have good knowledge of local social and labour market conditions could help in that respect. A simplification of the training and apprenticeship systems would also be warranted, provided that support for the various workers and employers' needs is guaranteed. The wide variety and complexity of funding, the re-branding of programmes and the multiplicity of stakeholders, along with the large number of qualifications, makes it difficult for employers to understand, find and undertake the practices fitting their needs. In this respect the UKCES (2008) laid out proposals of simplification endorsed by the government.

Integration of university graduates into the labour market also deserves attention

Enhancing the work readiness of school leavers along the entire education ladder is more crucial than ever in the current context of youth under-employment. The Youth Inquiry (UKCES, 2012) shows that over the past decade graduates have competed with non-graduates in the take-up of low-skill positions. Even though tertiary educational attainment is an advantage, it is of paramount importance that graduates acquire qualifications and skills that correspond to the needs of the labour market and enhance career prospects. The crisis is likely to exacerbate the issue of skill-mismatch among graduates and to put them at risk of long-term unemployment and disconnection from the labour market. To facilitate the transition to work for graduates, the United Kingdom has launched the Graduate Guarantee, granting graduates access to internships, training or guidance to become self-employed. In addition, the Department for Business, Innovation and Skills (BIS) manages the Graduate Talent Pool website, useful for posting of and application to internships for tertiary students.

Only a quarter of employers recruit young people directly from school (UKCES, 2011a). Previous experience is cited as a key factor for recruitment by almost one quarter of employers. This requirement along with the widespread use of informal recruitment methods can put young people at a serious disadvantage, preventing them from gaining experience and building their own social capital, with severe consequences on social mobility.

Employers can support young people in several ways. There is a large demand of interaction with business among students, which could be met by employers through the proactive offer of visits to enterprises, career advice, mock interviews or business games, such as company-led workshops or competitions on real business cases. These activities would allow young people to engage with the business world, build-up their own social capital and make informed choices at their entry in the labour market. They could also count as valuable assets for recruitment purposes. Selection and hiring practices still appear not very transparent and too much reliant on informal channels. Parental background still has a major influence on school choice and employment chances, so that opportunities of work engagement are not evenly distributed among school-leavers. In order to level the playing field among young people, local authorities should co-operate with the schooling system to strengthen connections with enterprises, for instance through internet portals, social media or other communication tools to manage student-employer engagement activities.

Better welfare and labour market policies have the potential to raise the employability of individuals. Smooth reallocation of labour from less to more productive activities will support output growth. A workforce with enhanced skills will contribute to the development of high productivity activities. The availability of skilled workers may foster entrepreneurship and encourage firms to produce and create jobs. Even so, labour market policies can only contribute significantly to increasing employment in association with other policies. Weak demand for labour resulting from slow economic growth could prevent the expansion of employment which should result from enhanced work incentives and ALMPs (Immervoll and Pearson, 2009). The creation of significant numbers of high-quality jobs, which is decisive to reduce inequality, requires a competitive and innovative, growth-oriented economy (see Chapter 2).

Box 1.4. **Recommendations on labour market and social policies**

Enhance workforce skills. Central and local government should enhance co-operation with employers on vocational education and training, and apprenticeship programmes, raise awareness of government programmes to support youth employment, especially among small and medium sized enterprises, by interventions at industry specific and local levels. Simplify the training and apprenticeship systems, enhance co-operation between local authorities, schools and enterprises in integrating graduates into the labour market.

Improve work incentives for lone parents and second earners under the Universal Credit welfare reform. Increase the refund rate for childcare, and/or reduce the taper rate for those with childcare support, and/or introduce a dedicated disregard for second earners in couples. Increase the value of free childcare by increasing flexibility for users and reduce the cost by increasing flexibility of provision.

Improve the Work Capability Assessment (WCA) and support for return to work for those who are fit. Ensure earlier intervention for people suffering from mental health problems. Monitor homelessness trends and ensure prevention and early intervention.

Monitor efficiency gains in public services. To avoid an increase in inequality, efficiency gains should be exploited in implementing fiscal consolidation. If this is not the case, new ways to improve performance should be investigated, including better management and greater regional flexibility in public sector wages.

Take steps to tackle fuel and water poverty through better targeted financial support, and measures to improve energy efficiency and resource management.

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Chapter 2

Growth, productivity and innovation

Productivity remains low compared to the best performing OECD economies, despite significant catch-up in the decade preceding the global economic and financial crisis and a supportive business environment. The crisis has impacted on the level and growth of productivity, reflecting cyclical factors like labour hoarding during the recent slowdown, persistent factors linked to the financial crisis, overlaying long-standing structural factors like planning, innovation, insufficient infrastructure, public sector inefficiencies and weak export performance. A Plan for Growth set by the government aims at enhancing the potential of the economy and rebalancing towards exports and investment. Investment in infrastructure needs to be supported by removing land-use planning constraints and addressing the lack of financing. The weak productivity in the public sector could be improved through better management and greater regional flexibility in public sector wages. The low R&D intensity compared to other OECD countries could be addressed by better rewarding innovation through the tax system. Innovation and development of green technologies should be supported by more uniform carbon pricing and enhanced innovation policies, which can be a win-win policy for both environmental sustainability and growth. Other growth opportunities will also need to be better seized. Higher education is among the United Kingdom's most important exports and has strong growth potential, which should not be hampered by excessive restrictions on student visas. Demand from emerging markets is likely to expand, especially in financial and business services, where the United Kingdom has a competitive edge.

Since mid-2010, the level of productivity has on average been around 10% below a continuation of its pre-crisis trend (BoE, 2012). This differs sharply from the experience during the previous three recessions and recoveries, and is related to better resilience of employment in the latest recession. As the overall level of productivity in the United Kingdom remains low compared to other major OECD economies, despite increases in the run-up to the financial crisis, raising productivity remains a challenge for future sustainable growth.

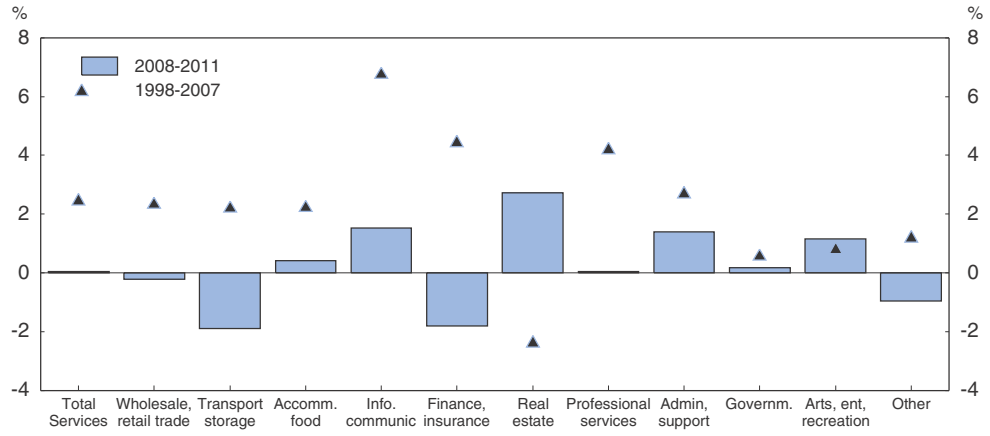
Weak productivity growth since the financial crisis is not unique to the UK, but a common development across much of Europe, partly linked to the vulnerable banking system and sovereign debt crisis. There is evidence that an impaired financial system can hamper the reallocation of resources across sectors, delaying the recovery and the rebalancing of the economy (Broadbent, 2012). Recoveries following financial crises tend to be weak, resulting in permanent output losses relative to long-term trends and persistent weakness in productivity growth (Reinhart and Rogoff, 2009). This is linked to a variety of factors, including the overestimation of trend growth before the crisis, persistent misallocation of capital and labour, debt overhangs and impaired financial intermediation (Borio, 2012).

There is clearly no single factor that can explain the sharp drop in the level of UK productivity since 2007. More likely it is down to the cumulative effects of a number of factors, that include mis-measurement, hoarding skilled labour, real wage moderation, structural shifts in production and persistent effects related to the financial crisis, with forbearance and an impaired banking system preventing an efficient allocation of capital. On top of this, longer-term structural factors related to the end of a product innovation cycle, fading impact of earlier structural policy reforms, planning, innovation, insufficient infrastructure, public sector inefficiencies and weak export performance are holding back productivity growth. This chapter examines briefly some structural factors that may have influenced recent trends in productivity growth in the United Kingdom. It then focuses on factors that may explain the relatively low productivity level, and considers how policies can enhance the growth potential of the economy.

Part of the recent decline in productivity growth is likely to be structural

Although part of the productivity decline is likely to be cyclical, it may also reflect the end of the pre-crisis product innovation cycle in certain sectors. The strong pre-crisis productivity growth was boosted by product innovation, focused on bio-technology, information and communication technology (ICT) and finance. Productivity growth in the services sectors averaged about 2½ per cent before 2007 and within services, the professional, financial and ICT services sectors performed exceptionally well (Figure 2.1). The United Kingdom clearly stood out among OECD countries as one of the productivity leaders in finance, insurance and business services over the period 1998-2007 (Figure 2.2), with average productivity growth in excess of 6% per annum. These developments were

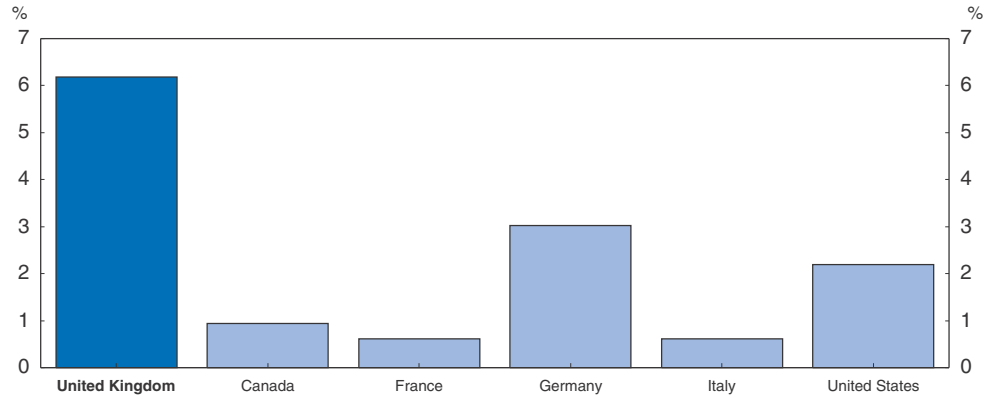
Figure 2.1. **Productivity growth in the services sectors**[1]



1. Output per hour worked.
Source: Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888932768296

Figure 2.2. **Productivity in finance, insurance and business services**[1]
1998-2007



1. Average annual growth of GDP per hour worked.
Source: OECD Productivity Database.

StatLink http://dx.doi.org/10.1787/888932768315

facilitated by the flexible labour market, and knowledge economy factors such as a rise in ICT capital use that was greater than in many OECD peers and close links between business and university level research and innovation (Corry *et al.*, 2011, Barrell *et al.*, 2011).

Part of the strong growth exhibited by the financial services sector in the run-up to the crisis may however, be cyclical or illusory. Some of the innovations in finance may have transferred rents rather than increased output (Weale, 2009). A correction to this overvaluation may explain part of the downward shift in the measured level of productivity in this sector since 2007. Other measurement issues, such as expected revisions to the measured level of employment in line with Census 2011, misallocation of intangible investment in the national accounts, ongoing decline in energy extraction output, may also distort the measured level of productivity. Nonetheless, the drop in productivity since 2007 is clearly widely spread across the economy, and supported by several measures of activity and the labour market, and measurement issues can only account for a fraction of the decline.

Other structural factors affecting productivity growth could be the fading impact of important structural reforms earlier in the decade, and a change in the structure of the economy. Significant advances were made in competition and deregulation over the decade prior to the financial crisis, related for example to the restructuring of the gas industry in 1995 and the Competition Act of 2000, which are likely to have boosted productivity over some years. The gradual decline in traditionally higher productivity manufacturing over the past decade and rise in lower productivity services sectors, including the public sector, may also explain some of the productivity decline (see Chapter 1 on employment developments). Boosting the relatively low level of productivity is a major challenge for structural policies.

To boost potential growth, the government initiated in 2011 the *Plan for Growth,* which aims at dealing with the various factors that are known to affect potential growth, such as factor input growth and quality. Labour supply is influenced by institutions, preferences and demographics. Capital input depends on the expected return on investment, which is affected by the tax structure and the country-specific risk profile, as well as the rate of depreciation. The productive capacity of factor inputs depends on their innate quality, for example the skill level of the workforce, and on the technology used to combine factor inputs, which is related to the country's institutions, the domestic research capacity and access to innovations developed abroad. The Plan sets out an ambitious set of measures to: *i)* encourage a more balanced economy through investment and exports; *ii)* make the United Kingdom the best place in Europe to start, finance and grow a business; *iii)* create a more educated workforce that is the most flexible in Europe; *iv)* create the most competitive tax system in the G20. The remainder of the chapter examines in more detail the various factors that affect the level of productivity in the United Kingdom and related policies.

The level of productivity underperforms compared to OECD peers

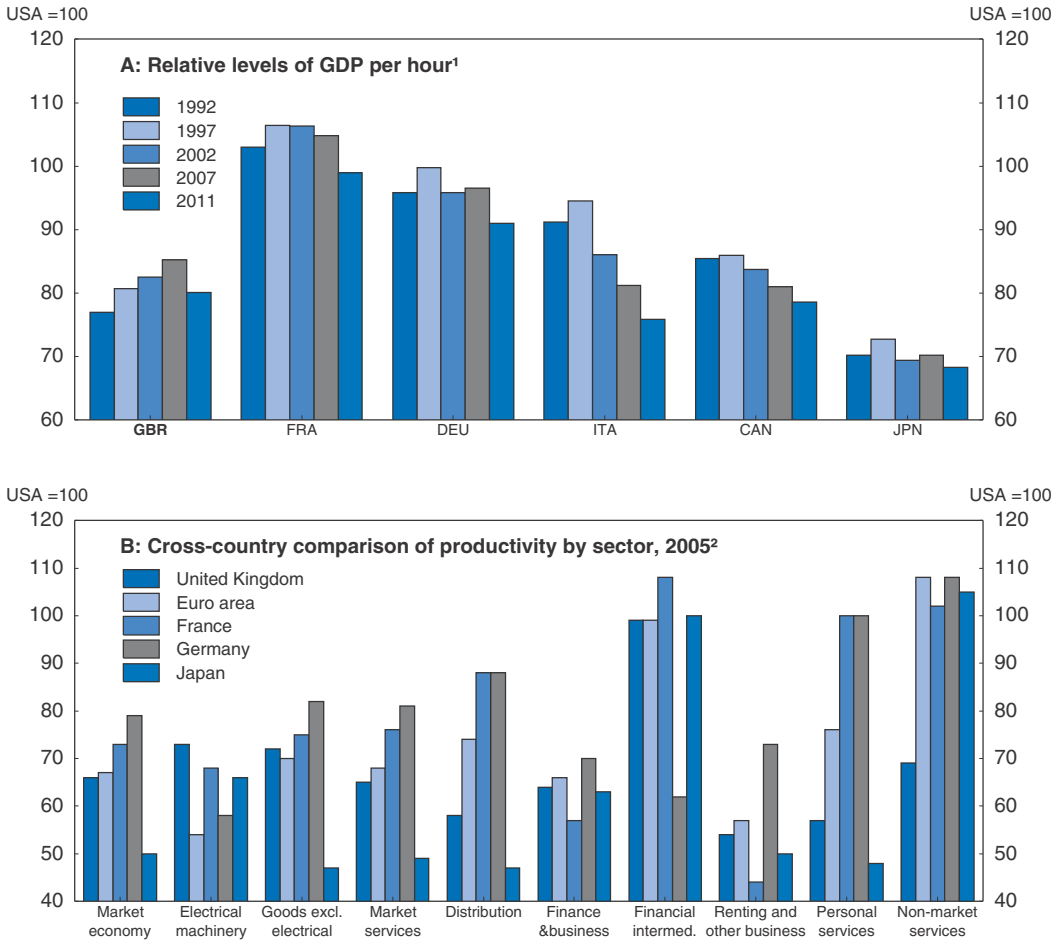
The overall level of productivity in the United Kingdom remains low, especially relative to the United States, France and Germany (Figure 2.3, Panel A), despite catch-up before the global economic and financial crisis. In 2011 output per person hour in the United Kingdom relative to the United States stood below its level in 1997, with one hour of work in the United Kingdom producing on average 80% of what an hour of work in the United States could produce. The sectors with the largest gaps before the crisis were distribution, renting, and personal services, while financial intermediation was at par with the United States (Figure 2.3, Panel B).

Skills and management quality are important factors

Two key factors are repeatedly highlighted to explain the relatively poor performance of overall UK productivity: the skill level of the workforce and the leadership and management practices. The skills gap is discussed in Chapter 1, and highlights the contrast between the top quality university education available in the United Kingdom, and the low level of skills among school leavers relative to other countries, with PISA scores in the United Kingdom below average for the OECD.

Management quality can explain part of the productivity differences between the United Kingdom and the United States (Homkes, 2012). The management gap is largely attributable to the prevalence of family-owned and managed firms in the United Kingdom, which tend to exhibit relatively poor management practices (Bloom and Van Reenen, 2007). In addition, skill levels in the United Kingdom are low by international standards, for both

Figure 2.3. **Productivity**



1. Refers to the ratio of GDP at 2005 PPP in USD to total hour's worked, whole economy. It is assumed that self-employed work the same number of hours on average as dependent employees.
2. Value added per hour worked.

Source: Inklaar and Timmer (2008) and *OECD Economic Outlook* 91 *Database*.

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managers and non-managers, and competition is weaker than in the United States. Management practices in the public sector are particularly poor, and this may help explain the poor productivity performance of the public sector. This is not simply a United Kingdom phenomenon, and in fact Bloom *et al* (2012) show that management of schools and hospitals in the United Kingdom ranks favourably relative to other European countries.

Moves to encourage links between universities and firms in order to disseminate research output and innovation should be encouraged. Hart (2012) proposes forging stronger links between business schools and firms, especially SME's, to improve management know-how and encourage the growth and expansion of smaller firms. However, Banerjee (2012) cautions that the lack of business expertise and management skills in SMEs is not necessarily well addressed by business schools. Policy designed to tackle the shortage of high quality management skills will have to address both issues – ensuring that the teaching within business schools is designed to develop the skills needed

by both SMEs and large corporations, and forging stronger links between the business schools and active business. The UK Government has recently introduced the Growth Accelerator programme to support SMEs with high growth potential, through facilitating access for these companies to other forms of support, including skills development, mentoring and coaching, and this may help to address this problem. Other policies that can be expected to improve management quality include strengthening product market competition (Bloom, Draca, and Van Reenen, 2011), removing tax rules that favour family-run firms, and increasing the educational attainment of both managers and non-managers within the workforce.

Policies for higher productivity

Investment in tangible capital, especially infrastructure, should be increased

Investment in tangible capital is an essential element of economic growth. A steady flow of fixed capital investment is needed just to replenish the existing capital stock as its value and usefulness depreciates, and in a growing economy additional investment is needed to maintain a stable capital-output ratio. Certain types of tangible investment, such as infrastructure development, also have the potential to raise the rate of productivity across the economy, by improving communications and reducing transport costs. This section looks at the accumulation of tangible capital – both private and public – before and after the crisis, to see how the United Kingdom compares to other countries. It also assesses the impact of fiscal consolidation on government investment, and restraints on access to finance in the private sector.

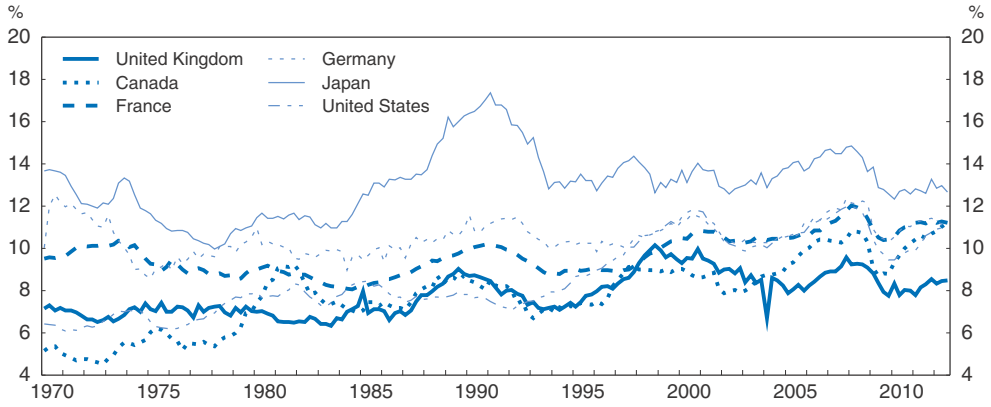
Business investment as a share of GDP in the United Kingdom has historically been lower than in other G7 countries (Figure 2.4). Nonetheless, growth accounting estimates indicate that the rate of capital deepening in the United Kingdom since 1997 has not been out of line with other G7 economies (Table 2.1). While there has been a mild deterioration in the business investment to GDP ratio since the financial crisis, the magnitude of decline has been smaller than in most other G7 economies, and the ratio remains broadly in line with recent history.

Despite the policy rate staying at a record low level since the beginning of 2009, SMEs have faced tightening lending conditions (Figure 2.5 and Bank of England, 2012). One reason why SMEs face particularly constrained access to finance is difficulty with credit risk assessment. Differentiating mortgage borrowers is fairly straightforward. Not so with small firms, as borrowing by a firm is always a speculation on the success of their business and it is much harder for banks to guess which firms will succeed. Heightened risk aversion within the banking sector, partly due to new banking regulation related to implementation of the Basel III/Independent Commission on Banking capital buffers, and partly due to concerns regarding the exposure to impaired assets, especially within the euro area, is severely restricting banks' willingness to lend to SMEs (Fisher, 2012).

Housing investment has also experienced a substantial drop since 2007. Both housing starts and the number of property transactions have declined sharply since then. Availability of secured credit to households fell dramatically after the fourth quarter of 2007 and has seen only a modest recovery since late 2009 (Bank of England, 2012). These modest improvements stalled in the second quarter of 2012. The United Kingdom is highly integrated within the European financial system and trade network, and the current financial and macroeconomic uncertainty hanging over the euro area is clearly holding back both the supply and demand for investment credit in the United Kingdom.

Figure 2.4. **Business investment**[1]

As a percentage of GDP



1. Prior to 1991, the series for Germany is derived from the *NiGEM Database*, based on figures for the former Federal Republic of Germany. The graph does not display a drop in investment in 2005Q2 due to the transfer of nuclear reactors from British Nuclear Fuels (a public corporation) to the Nuclear Decommissioning Authority (a central government body).

Source: OECD Economic Outlook 92 Database.

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Table 2.1. **Decomposition of average annual growth rates of value added**

		UK	France	Germany	Italy	US	Japan
Average annual growth of GDP (%)							
GDP, volume	1998-2007	2.9	2.3	1.7	1.4	3.0	1.0
	2008-11	-0.8	0.1	0.6	-1.2	0.2	-0.7
of which:				*Percentage point contr. to average annual GDP growth*			
Hourly labour input	1998-2007	0.6	0.5	0.0	1.1	0.9	-0.8
	2008-11	-0.4	-0.1	0.5	-1.1	-1.1	-1.8
Output per person hour	1998-2007	2.3	1.8	1.7	0.4	2.0	1.8
	2008-11	-0.4	0.2	0.1	-0.1	1.3	1.1
of which:				*Percentage point contr. to average annual growth in output per person-hour*			
Labour composition	1998-2007	0.5	0.3	0.1	0.2	0.3	0.4
	2008-11	0.1	0.2	0.1	0.1	0.1	0.1
ICT capital per hour	1998-2007	0.7	0.5	0.3	0.3	0.7	0.2
	2008-11	0.3	0.3	0.3	0.2	0.4	0.2
Non-ICT capital per hour	1998-2007	0.6	0.8	0.3	0.7	0.7	0.3
	2008-11	0.4	0.7	0.2	0.2	0.3	-0.1
TFP	1998-2007	0.6	0.2	1.0	-0.8	0.4	0.9
	2008-11	-1.2	-1.0	-0.5	-0.6	0.5	0.8
Contr. from knowledge Econ[1].	1998-2007	1.7	0.9	1.4	-0.4	1.4	1.5
	2008-11	-0.8	-0.5	-0.1	-0.3	1.1	1.2

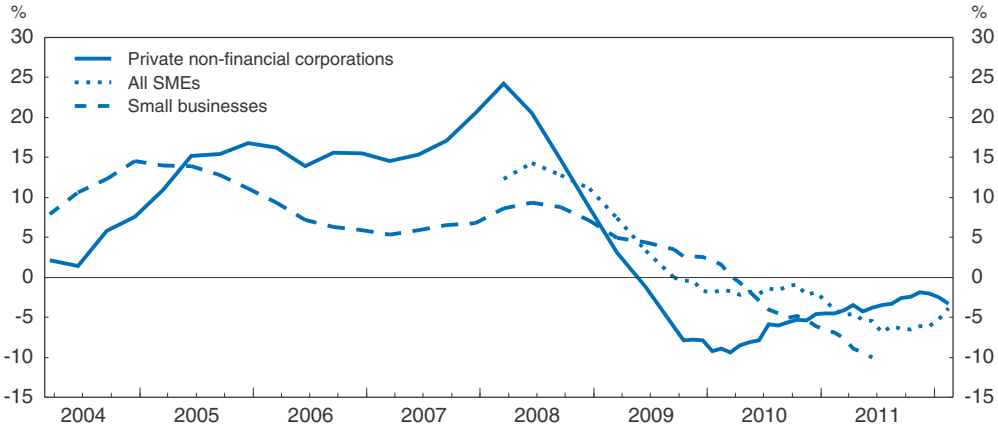
1. Defined as the sum of labour composition, ICT capital per hour and TFP, as in Corry *et al.* (2011).

Source: Derived from The Conference Board *"Total Economy Database"*, January 2012, *www.conference-board.org/data/economydatabase/*. Data reproduced with permission from The Conference Board, Inc. © 2012, The Conference Board, Inc.

The government has launched several initiatives to facilitate the flow of funds in the economy. The National Loan Guarantee Scheme (NLGS) was launched on 20 March 2012 to help smaller businesses to access affordable finance. The scheme aims to provide up to £20 billion of government guarantees on unsecured borrowing by banks, enabling them to borrow at a cheaper rate. Banks participating in the scheme have to pass on the lower

Figure 2.5. **Lending by firm size**

Year-on-year percentage change



Source: Bank of England "Trends in lending", April 2012.

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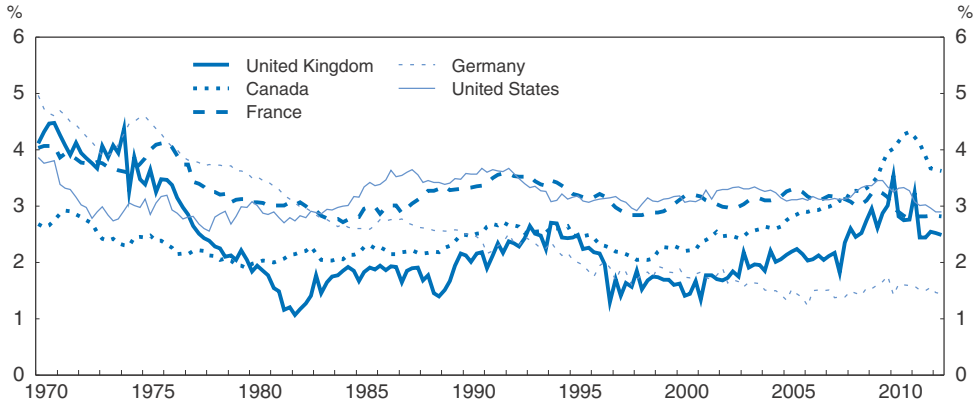
borrowing cost to small businesses. Businesses taking out an NLGS loan get a 1 percentage point discount compared to what they would otherwise have received from their bank outside the scheme. The scheme has provided over £2.5 billion in loans (12½ per cent of the target level) to over 16 000 businesses so far.

Another initiative to stimulate lending was unveiled in July this year. The Funding for Lending Scheme (FLS) is designed to stimulate lending to businesses of all sizes and to households. Under the scheme banks are allowed to borrow from the Bank of England for up to 4 years, using their assets as collateral. The FLS provides strong incentives to banks to lower borrowing cost and increase availability of business loans and mortgages, because lending performance will determine the fee banks pay on funding and the amount banks are allowed to borrow from the Bank of England. Participating banks will be able to borrow up to 5 per cent of their stock of existing loans to the UK non-financial sector, and also any net increase in lending from end-June 2012 to end-December 2013. So far, 35 banks have signed up for the scheme. These banks account for about 82% of the eligible stock of loans to UK households and non-financial companies. Whether the FLS will increase lending significantly is uncertain, as it depends on the extent to which slow credit growth is driven by supply tightness linked to funding difficulties, as opposed to lack of demand and creditworthiness of borrowers. The authorities should monitor closely its take up and operation.

In addition to business investment, government investment has tended to be lower than in most of the other G7 economies (Figure 2.6). While government investment as a share of GDP rose significantly during the financial crisis, due to the investment-focussed stimulus package, the introduction of fiscal austerity has returned it to a downward trajectory. According to OBR (2012), public sector net investment is expected to contract from 2.6% of GDP in 2010-11 to 1.1% of GDP in 2016-17. Under these plans, government investment is likely to be significantly lower than in the other large OECD economies. Over the medium-term, investment rates this low may well be sub-optimal. Raising the level of government investment should be considered as part of the next *Spending Review*.

Figure 2.6. **Government investment**[1]

As a percentage of GDP



1. Prior to 1991, the series for Germany is derived from the NiGEM database, based on figures for the former Federal Republic of Germany. The graph does not display a drop in investment in 2005Q2 due to the transfer of nuclear reactors from British Nuclear Fuels (a public corporation) to the Nuclear Decommissioning Authority (a central government body).

Source: OECD Economic Outlook 91 Database.

StatLink http://dx.doi.org/10.1787/888932768391

Empirical evidence indicates that investments in infrastructure across the OECD, and especially telecommunications and electricity, have a fairly robust impact on growth (Egert *et al.*, 2009). Ageing infrastructure and a growing population contribute to existing pressures on the United Kingdom's infrastructure network. The OECD *Going for Growth* reports, starting from 2005, put investment in infrastructure, especially in transport, as one of the main priorities for the United Kingdom. This is partly related to road congestion. Peak-hours congestion seems more widespread than in comparable European countries. These problems seem to stem more from capacity than efficiency constraints (Braconier *et al.*, 2013). Higher infrastructure spending in the road transport sector together with congestion pricing would enhance long-term capacity and efficiency, improve air quality and even support the economy in the short term. The United Kingdom also has significant investment needs in some other sectors that use the environment intensively, such as electricity and water. The electricity market reform, set out in the Energy Bill published in December 2012, aims at reducing the uncertainty for investment including in renewables and creating a clearer and more stable framework for investors. It should avoid overlapping policy instruments and, as far as possible, avoid picking winners.

The Government's *National Infrastructure Plan,* first set out in 2011 and updated in 2012, identifies over 500 priority infrastructure projects valued at over £330 billion in investment by 2015 for the economy to remain competitive in the global market. If achieved this would be a significant increase over the £113 billion invested between 2005 and 2010. In principle, planned infrastructure projects could be moved forward. One key obstacle to expanding investment in the short-term is the lengthy process of securing approval for projects that are not yet "shovel-ready". However, government investment cutbacks since 2010 suggest there are likely to be many projects that have recently been cancelled or postponed, that could be re-introduced at relatively short notice.

A second obstacle to expanding investment is the insufficient capacity to initiate many infrastructure projects directly through the public sector. Historically infrastructure development has relied heavily on private sector finance, planning and implementation.

Both private and public financing will be needed to meet the United Kingdom's infrastructure investment needs. The balance between the two should be based on a careful analysis of the relative financing costs and of relative advantages in managing different operations and risks. The costs of project financing are significantly higher than those of the government debt and this difference has increased since the financial crisis in 2009 (HM Treasury, 2011a; National Audit Office, 2010). These higher financing costs have to be compensated with higher efficiency of the private sector. Public sector financing should be a real alternative when the advantages of private financing are questionable, and should be considered through spending reprioritisation.

In July 2012, the Government announced that it will guarantee loans for up to £40 billion worth of priority infrastructure projects. This is designed to provide access to financing capacity (for larger projects) and long-term debt (for all projects) which are currently insufficient in the market to meet the need of projects requiring finance in the near term. The guarantee scheme is not designed to support all of the £330 billion planned infrastructure projects identified in *National Infrastructure Plan 2012*. Projects must meet a number of criteria to be eligible, including starting in the next two years and being privately financed.

One vehicle for infrastructure investment will be the Green Investment Bank that will be initially endowed with £3 billion to invest in green energy and waste projects. However, the Bank will not be allowed to borrow in the debt markets until the national debt to GDP ratio starts to decline (2015 on current estimates). The annual investment in climate change mitigation and other environmentally-related infrastructure projects of a number of national investment banks in OECD countries is significantly higher than what the Green Investment Bank would be able to fund initially. One option would be to allow the Green Investment Bank to borrow in the debt markets, subject to transparent accounting and sound management of implicit fiscal liabilities that this would create.

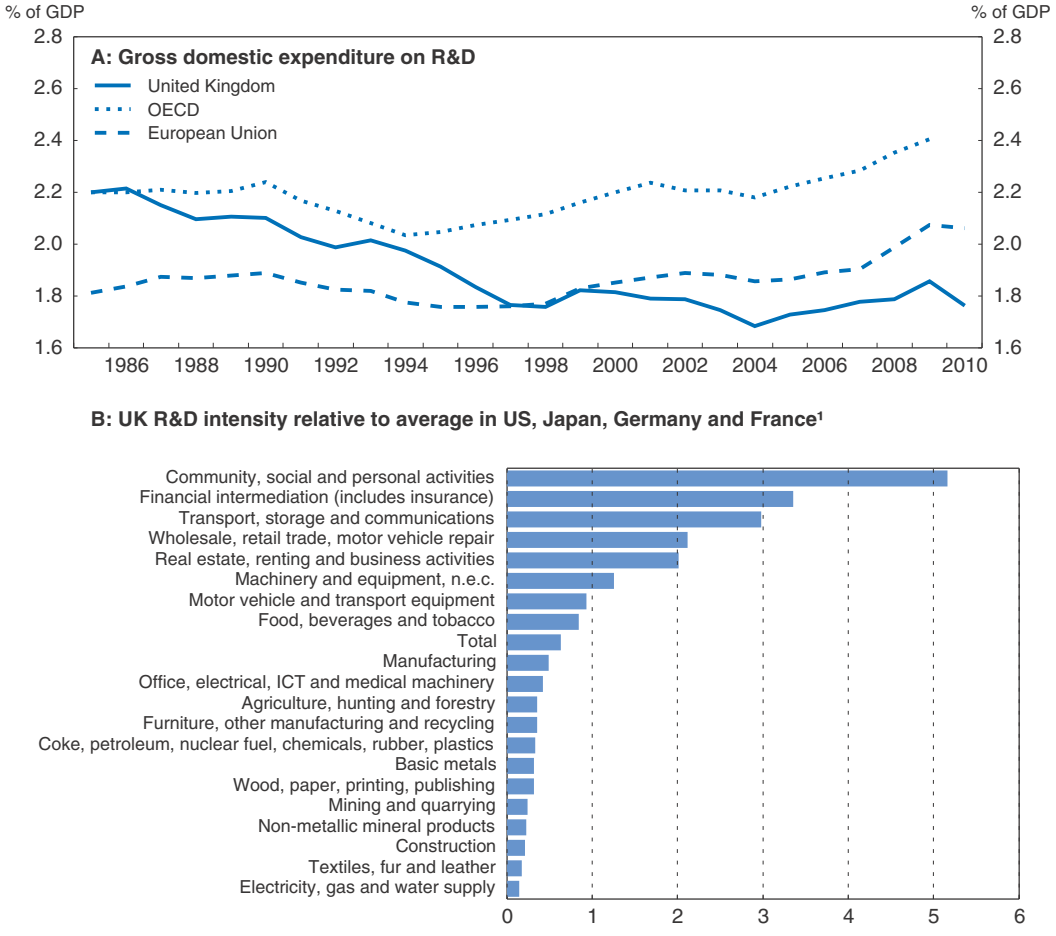
The *Infrastructure Cost Review Report 2010* and *Government Construction Strategy 2011* set targets for reducing the costs of construction and infrastructure projects by about 15%. Progress reports published in 2012 indicate that the proposed levels of savings are possible, at least in principle. These cost cutting initiatives, if successful, could leave room for an expansion of the infrastructure investment programme without adding pressure to the government budget constraint. The risk is that the cost saving will result in lost production or quality and will be counterproductive.

Investment in R&D capital is also important for productivity

While investment in tangible capital is an essential element of economic growth, productivity enhancement over the last decades has increasingly been driven by investment in intangible assets. Intangible assets include R&D, firm-specific training, market research, advertising, software, mineral exploration, development of new designs and products in certain sectors and improvements in organisational structure (Piekkola, 2011). Intangible investment is not well measured. Recent projects such as INNODRIVE (Görzig *et al*., 2010) have started to compile cross-country comparable estimates of the stock of intangible capital. The vast majority of spending on intangibles is not entered as investment in the national accounts, but as intermediate consumption. As such its direct contribution to value added may be undervalued. The exceptions include software investment, computerised databases, mineral exploration and copyright/licencing costs, which are all included in gross fixed capital formation.

Investment in R&D is the most straightforward component of intangible capital to measure, as it has been collected by national statistics offices in an internationally standardised way for several decades. By this measure, the United Kingdom performs poorly relative to other countries (Figure 2.7, Panel A). The relatively low level of R&D investment is of particular concern when looked at in an historical perspective. The share of R&D expenditure in output fell from around 2.2% in 1985 to 1.8% in 2010, with both public and business R&D contributing to the decline. This is in contrast to the evolution in the European Union and the OECD as a whole. If strong growth over the decade to 2007 was supported by solid research capacity that allowed the United Kingdom to excel in the latest product innovation cycle, there are concerns that the failure to maintain and expand the research capacity over this period at the same rate as elsewhere may have eroded the United Kingdom's competitive edge. The United Kingdom may find it more difficult to take a leading role in the next product innovation cycle. However, R&D spending is only a partial measure of intangible capital and the UK is a leader in some of the other components, as discussed below.

Figure 2.7. **Investment in R&D capital**



1. In 2007. Industry level R&D as a share of industry value added, relative to the average in the United States, Japan, Germany and France. Missing observations were ignored.

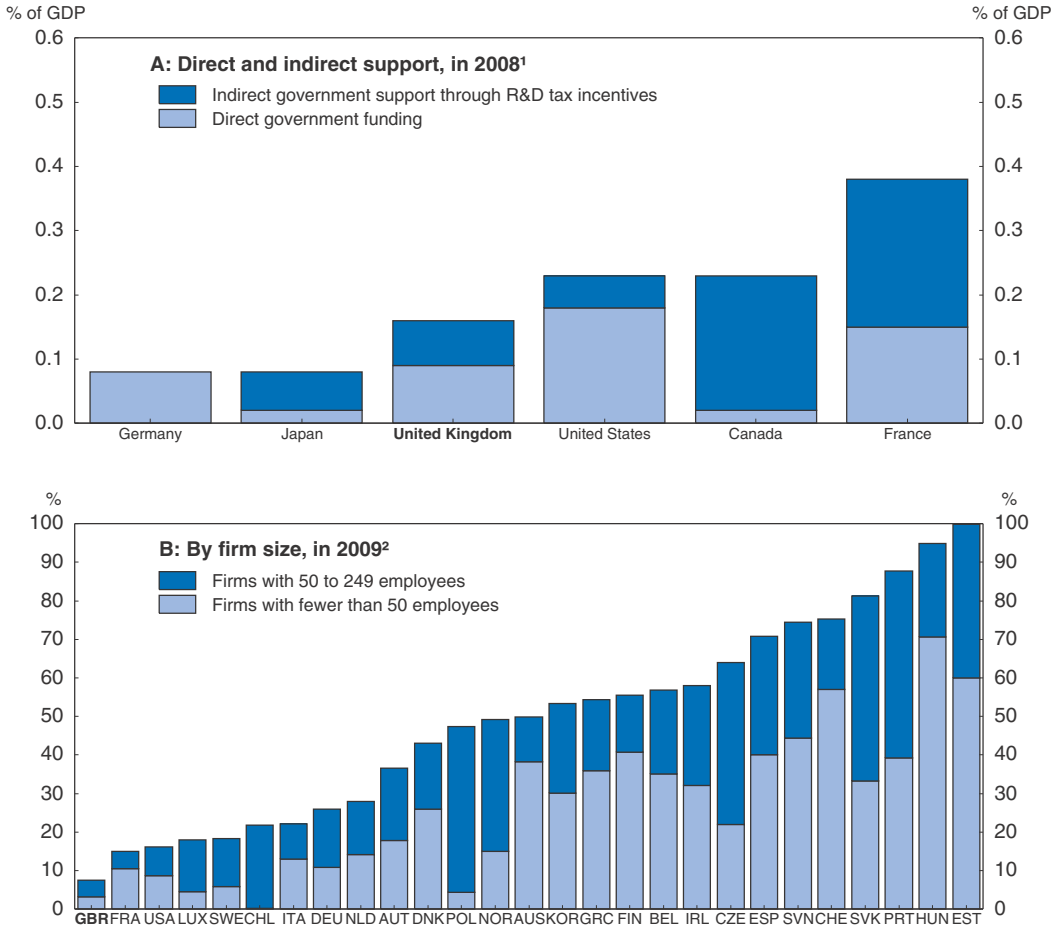
Source: OECD Main Science and Technology Indicators, *OECD STI Database* and EU KLEMS.

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Correcting for the industrial structure of the economy closes the R&D gap with other large OECD economies only to some extent. There is a clear bias towards R&D in the service sectors, and research intensity in these sectors exceeds the average of the other four large technology frontier countries: the United States, Germany, France and Japan (Figure 2.7, Panel B). Research intensity in the manufacturing sector is below average across the board, with the exception of the lower-tech machinery and equipment industry.

In the last decade, the previous government introduced a number of measures to address the relative weakness of R&D investment in the United Kingdom. The introduction of a 10 Year Funding Framework for research in 2004 included a commitment to increase the level of funding for research in line with GDP growth and increased collaboration between government and businesses in the conduct of R&D. However, the level of government support for R&D remains relatively modest compared to support in countries such as the United States, Canada and France (Figure 2.8, Panel A). This is particularly evident in the case of funding R&D for SME's, which received the lowest level of public support for R&D in the

Figure 2.8. **Government support of business R&D**



1. Refers to 2009 for Canada and United Kingdom. No data available for R&D tax incentives in Germany.
2. Per cent of total government-financed Business Expenditure on R&D. Refers to 2008 for Australia, France, Korea, Portugal, Spain, Switzerland, and United Kingdom; to 2007 for Austria, Belgium, Denmark, Germany, Italy, Luxembourg, Poland and United States and to 2005 for Ireland.

Source: OECD Science, Technology and Industry Scoreboard 2011.

StatLink http://dx.doi.org/10.1787/888932768429

OECD (Figure 2.8, Panel B) in 2008-2009. Since that time, the new Coalition Government has taken steps to increase support for R&D by SMEs through both tax and spending measures. On tax, from 1 April 2012, the rate of relief under the SME R&D tax credit scheme increases to 225% of qualifying R&D costs, one of the most competitive rates in the world.

On spending, in December 2011 the Coalition Government published its Innovation and Research Strategy for Growth. This included several measures to support R&D, including an additional £75 million of public funds to support small business innovation. In addition, the Life Sciences Strategy provides a £180 million Biomedical Catalyst Fund to provide support for SMEs or academics looking to develop innovative solutions to healthcare challenges.

In parallel with the 10 Year Funding Framework, the previous government set a target for overall R&D to reach 2.5% of GDP by 2014. While some modest progress in increasing R&D intensity was made between 2004 and 2008, only about 6% of the targeted rise was achieved over the first four years of the 10 year timeframe. The economic downturn resulted in levels of investment stagnating or slightly declining during 2008-10. However, there was a 6% increase in Business Expenditure on R&D (BERD) in 2011, with both civil and defence BERD increasing. However, as a share of GDP, the overall level of business R&D investment remains at 1.1%, which is low compared to other countries, and concentrated in both a relatively small number of sectors and geographical areas. R&D is an important driver of innovation and growth, and the United Kingdom is clearly lagging the other major OECD countries in terms of R&D intensity (Figure 2.7).

In Spending Review 2010, the Coalition Government protected Science & Research programme funding at £4.6 billion per year over the period 2011-12 to 2014-15 within a ring-fence. Subsequent to the Spending Review, capital funding for science, research and innovation purposes over this period has been increased by £1.5 billion, including a £600 million addition in Autumn Statement 2012. In Budget 2012, a UK Research Investment Partnership Fund was launched with £100 million of public money to support new university research infrastructure built in partnership with business and charities, where the contribution from private sources was at least twice as large as the one of the public sector. The policy is aimed at encouraging long term strategic research partnerships between universities and the private sector. This Fund was boosted by a further £200 million of public money in October 2012. There is further scope to increase the level of research undertaken over the medium term, particularly in those sectors such as energy where levels of investment are low by international standards. Given the longer-term implications of the R&D base, it is important that in the short-run the current level of R&D spending funded by the government is not reduced further as part of the fiscal consolidation measures. Over the longer-term the aim should be to increase this budget.

The primary programme of support for R&D is through the Large and Small Companies R&D Tax Credit programmes, which were introduced for SMEs in 2000-01, and extended to larger companies in 2002-03. The small company R&D Tax Credit was increased in both April 2011 and April 2012. R&D tax credits have been shown to significantly affect spending on R&D in the United Kingdom, and are an effective policy tool to incentivise investment in R&D, even though they may incur deadweight costs and generate harmful tax competition between countries to attract R&D investment. A study by Bloom *et al.* (2002) looked at R&D tax credits in nine advanced economies between 1979 and 1997, and found that a 10% fall in R&D costs produced a 10% increase in R&D spending in the long-run. This falls near the elasticity median of a survey by HMRC (An Evaluation of Research and Development Tax

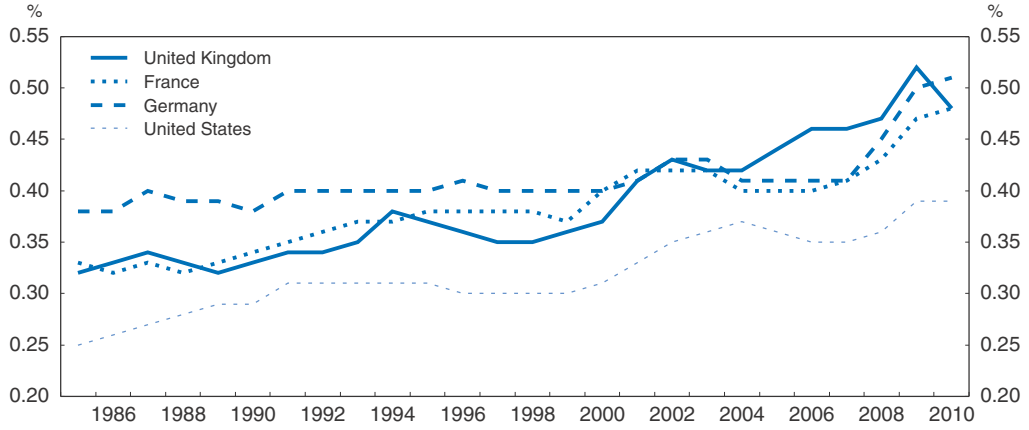
Credits), which comprehensively details the results of 20 different studies on R&D tax credits. Barnes *et al* (2011) find that a 10 percentage point rise in R&D tax credits can raise GDP by 0.8% after 10 years, demonstrating the clear gains to this policy.

The government will create a new tax incentive to support innovation, by introducing a "Patent-box" in April 2013, whereby income-streams from manufactured products related to patents will get beneficial treatment. Support for R&D should ideally reward social returns generated by R&D in excess of private returns. It is questionable whether the "Patent box" will do that in an efficient way, as it rewards broad private income streams from patents rather than the excess social value of innovation. Greater support for R&D in the higher education sector, and for links between the university and business sector would allow social returns to be exploited more effectively.

Investment in R&D within the higher education sector and by foreign firms operating in the United Kingdom is relatively strong by international standards. The share of higher education spending on R&D in GDP has been on an upward trend since 1985, although the financial crisis has also taken a toll on spending from this sector (Figure 2.9). As the strong research capacity in the higher education sector has been a key driver of productivity growth in the United Kingdom, it is vital that cuts in government funding do not materially affect university-based R&D on a more permanent basis.

Figure 2.9. **Spending by tertiary educational institutions on R&D**

As a percentage of GDP



Source: OECD Main Science and Technology Indicators.

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Support to other intangible investment and innovation can also play a role

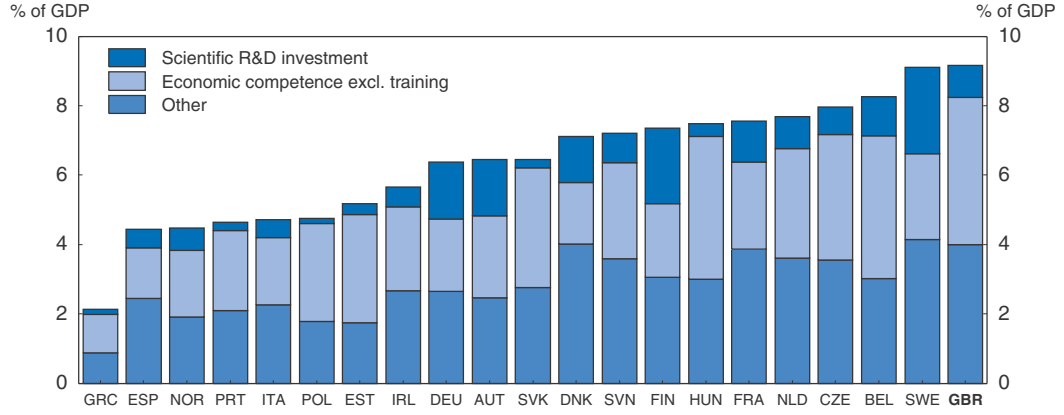
R&D is only one component of intangible investment, which also includes other types of assets such as organisational structure capital and brand equity. Businesses invest heavily in broader innovation such as branding, training, design and improvements in business process. These intangible investments are new sources of growth, not only in high-tech companies, but also logistics providers, facilities managers, professional services firms and manufacturers. Yet, measuring these investments is not straightforward, as it does not have a physical or financial embodiment. Using a direct expenditure approach, and as part of the INNODRIVE project, Jona-Lasinio *et al*. (2011) constructed intangible capital estimates by type as shares of GDP for the EU27 and Norway between 1995

and 2005. Figure 2.10 is derived from these estimates, and shows little evidence that the United Kingdom is under-investing in intangibles in an international context, except in R&D. It is a top performer when accounting for all intangible investment, along with Sweden, with investment in intangibles amounting to about 9% of GDP in 2005.

The importance of intangible capital as a driver of productivity growth is being increasingly recognised, even though current spending on intangibles in the national accounts is mostly treated as intermediate consumption rather than as investment, which results in the underestimation of the gross value added (GVA). In 2005, only a fifth of total UK intangible investments were accounted for in GVA, including computerised information, mineral exploration, and copyright and license costs (Figure 2.11). Scientific R&D represented only about 10% of all business intangible investment, while investment in organisational structures accounted for about a third.

Figure 2.10. **Investment in intangibles and scientific R&D**

2005

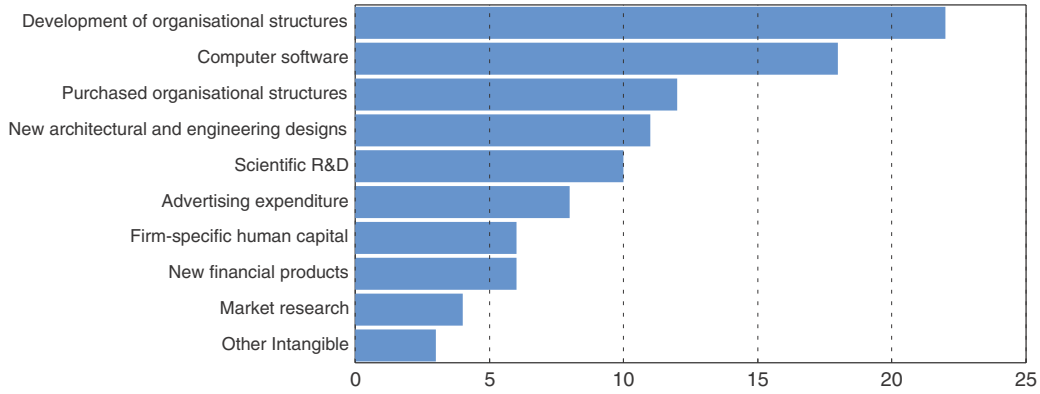


Source: *INNODRIVE National Intangibles Database*, May 2011.

StatLink http://dx.doi.org/10.1787/888932768467

Figure 2.11. **Distribution of intangible investment in the United Kingdom**[1]

2005



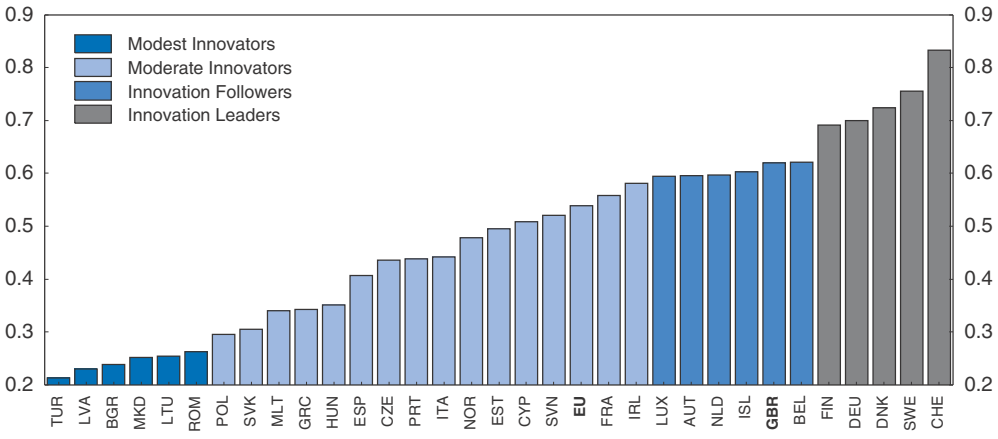
1. Accounted as investment in the National Accounts. Other intangible include computer databases, mineral exploration, and copyright and license costs.

Source: Derived from *INNODRIVE National Intangibles Database*, May 2011.

StatLink http://dx.doi.org/10.1787/888932768486

Recent studies demonstrate that intangible capital contributes to productivity growth and supports innovation (Haskel, 2012). In particular, a positive association between productivity and organisation capital and the presence of positive spillovers is identified (Riley and Robinson, 2011). According to the Innovation Union Scoreboard (IUS) the United Kingdom is classified as an "Innovation Follower" (Figure 2.12). Relatively few firms in the United Kingdom seem to innovate, suggesting that there is a large potential to boost performance in this area.

Figure 2.12. **Comparison of innovation performance**



Source: Innovation Union Scoreboard (2011).

StatLink http://dx.doi.org/10.1787/888932768505

Successful implementation of many existing policies should help promote intangible investment with an important impact on productivity. Policies such as the NLGS and FLS discussed above aim to support investment and through this innovative capacity of SME's. Other recent policy developments in this area include the *Innovation and Research Strategy for Growth* (2011), focussing on supporting business R&D in areas in which the United Kingdom excels and the *Growth and Innovation Fund* (GIF), which is designed to help employers develop their own innovative skills solutions. GIF is planning to co-invest up to £34 million with employers in 2012-13, with similar levels of investment planned for the following two years.

Predictable and broad-based environmental policies would support green innovation

Innovation will be necessary to develop new technologies that use the environment more efficiently. Pricing environmental externalities through taxes, cap-and-trade systems or other types or regulations is essential to create the incentives for generating innovations that would reduce emissions or other kinds of harmful impact on the environment. Working towards a more uniform carbon price across the economy will be important in this respect. The Government has made the decision to introduce a carbon price floor for electricity generators to provide the sector with a predictable CO_2 price path, consistent with medium-term emission reduction goals (HM Treasury, 2011b). The higher CO_2 price in the UK will not necessarily lead to lower emissions at an EU level, rather it would tend to weaken the EU ETS price as demand from the UK electricity sector for allowances would fall, although it may provide a stronger UK-specific signal to invest in infrastructure and

technologies that are less carbon-intensive. However, over time the government should seek to avoid inefficient interaction with the EU ETS, and a higher carbon price at the international level. This could be achieved through a tightening of the EU-ETS caps, which would also help to reduce European-wide emissions. To gain some additional credibility the Government could ask the Climate Change Committee for an independent assessment of the appropriate carbon price floor and carbon price support rate.

In addition to high and predictable prices for externalities, public support for R&D investment in environmentally friendly technologies is needed (Acemoglu *et al.*, 2012). This is particularly important in the initial phase to create a sufficient market size for green technologies that would facilitate further technological progress in this field. In this respect, it is a concern that research, development and demonstration (RD&D) in the energy sector has declined substantially since the 1980s. Given that the decline coincides with the liberalisation of the energy sector, it can be interpreted as a sign that market failures related to innovation were not addressed sufficiently at least in the initial years after the reform (Jamasb and Pollitt, 2008). The recent resurge in energy RD&D is owing to increased spending on renewable energies, associated with the government's goals and policies to promote these technologies. Nevertheless, overall spending on energy RD&D remains lower than in many other OECD countries. Patent counts for environmentally-related technologies, on the other hand, which are a measure of output of R&D investment – albeit imperfect – are comparatively high, which suggests that R&D investments are relatively efficient.

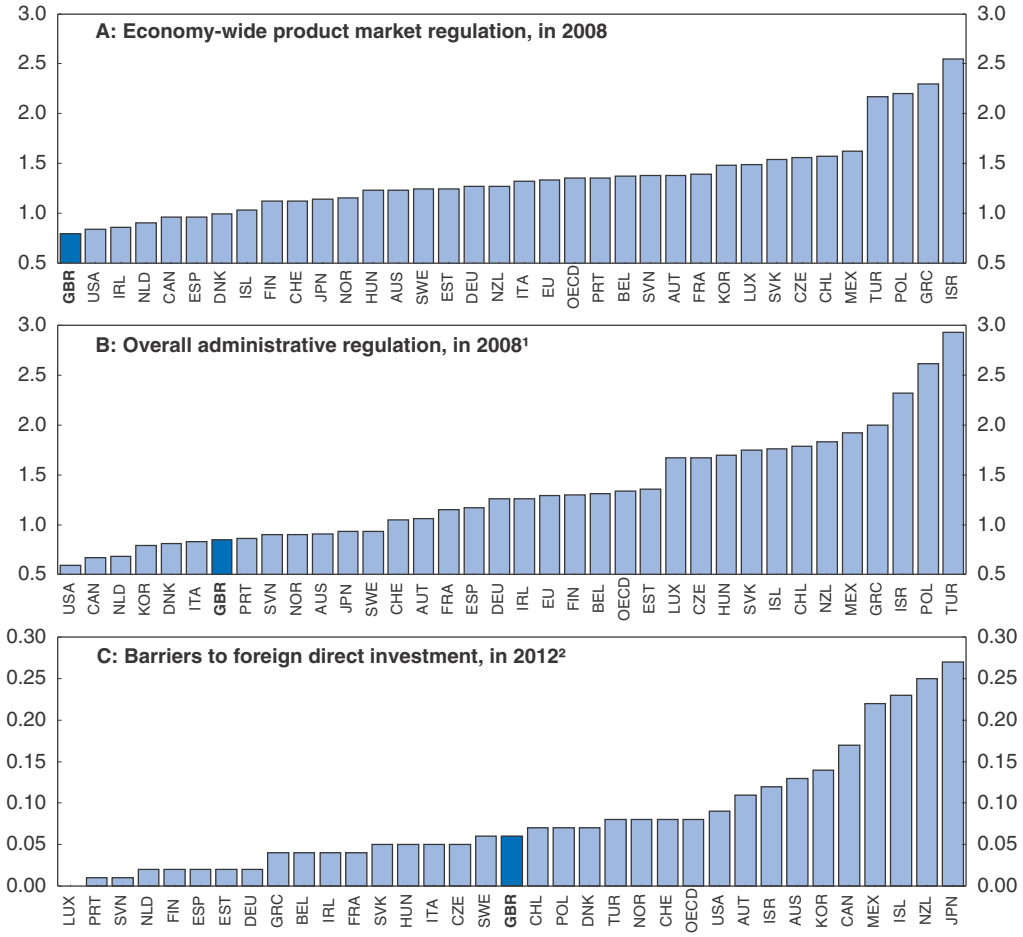
One issue to consider is the balance between R&D support for renewables and for renewables deployment. While government support for R&D for renewable remains at tens of millions of pounds, support for the deployment of renewables, is more billions of pounds and is expected to remain at this level or even increase (Jamasb and Pollitt, 2008; Select Committee of Financial Affairs, 2011, House of Commons, 2012). Aid for the deployment of specific technologies can be justified, especially where economies of scale are important. Support for these activities may also help to address the relatively low level of investment in the UK in later stage innovation activities such as demonstration, which are essential in this sector, as highlighted by the Stern Report on the economics of climate change, which recommended a 5-fold increase in support for deployment activities. The UK currently invests around 40% of R&D expenditure in this area, compared to 65% in the US. However, support for deployment risks being associated with misallocation and deadweight costs. Therefore, it should be subject to regular review and then be gradually withdrawn. The government should consider whether some of the support currently devoted to technology deployment should be shifted to public support for R&D.

Competition, tax and regulation

The United Kingdom benefits from relatively strong general conditions for business, with low levels of product market regulation. In the World Economic Forum's *Global Competitiveness Report 2012-2013* it was ranked 8th, which is respectively two and four ranks higher than in the previous and preceding years. Its strengths include well-developed and efficient labour markets, and sophisticated and innovative businesses, although there are concerns that its large fiscal deficits and increasing public debt will begin to weigh on competitiveness. The regulatory environment is generally viewed as conducive to growth. According to the OECD product market regulation (PMR) index, in 2008 the United Kingdom was ranked least restrictive of all the OECD countries for product market regulation and seventh least restrictive for overall administrative regulation (Figure 2.13, Panel A and B).

Figure 2.13. **Framework conditions for business**

Index scale from least to most restrictive



1. Simple average of regulatory and administrative opacity and administrative burdens on start-ups under the product market regulation domain "barriers to entrepreneurship".
2. The OECD FDI regulatory restrictiveness index looks only at statutory restrictions and does not assess the manner in which they are implemented.

Source: OECD (2012), *Economic Policy Reforms 2012: Going for Growth*, and OECD, the *OECD FDI Regulatory Restrictiveness Index (FDI Index)*, *www.oecd.org/investment/index*.

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Foreign companies have also identified the United Kingdom as a good place to do business, in part because of its favourable regulatory environment, with barriers to foreign direct investment (FDI) somewhat below the OECD average (Figure 2.13, Panel C). FDI in 2011 was $77.1 billion, the highest level in Europe and only surpassed by Brazil, China, Hong Kong, China and the United States (UN, 2012). FDI is an important source of productivity growth, given the high share of R&D that is conducted by foreign firms, and it is important to ensure that the economy remains an attractive location for foreign firms. The *Plan for Growth 2011* recognises this, and includes measures to make it less costly for micro and start-up businesses to comply with both UK and EU regulations.

According to the *Global Competitiveness Report 2011-12* the most problematic factor for doing business in 2011-12 was the level of taxation. The *Plan for Growth 2011* acknowledges that the level of taxation has risen and the system is considered complex and unstable, making it difficult for businesses to plan, invest and recruit. According to the *Paying Taxes*

Report 2012, which compares the ease of paying taxes in more than 150 countries around the world, the United Kingdom scores relatively high on the number of tax payments (17th) and time required to comply with tax regulation (24th). But it performs poorly on the level of taxation (82nd). The *Plan for Growth 2011* sets out to address this problem, with the ambitious aim of establishing the most competitive tax system in the G20.

The *Mirrlees Review* (2010) prepared a detailed discussion of the ideal tax system for a developed open economy and formulated recommendations for the United Kingdom. According to the report the seven major flaws in the tax system are: disincentives to work for people with low potential earnings; unnecessary complexity and inconsistency between different parts of the system; disincentives to save; absence of a consistent system of environmental taxes; corporation taxes that discourage business investment and favour debt finance over equity finance; inefficient and inequitable taxation of land and property; and distributional goals pursued in inefficient and inconsistent ways. Reforming the tax system to address the recommendations of the *Mirrlees Review* (2010) is a huge undertaking, but would support the goals set out in the *Plan for Growth 2011*. The recent rise in the tax threshold and introduction of the Universal Credit are steps in this direction (see Chapter 1). Other measures include simplifying the tax system and reducing the corporate tax rate from 28% in 2010 to 21% by 2014.

Further tax reforms should also be contemplated. Small firms receive preferential tax treatment, distorting the allocation of capital and potentially weakening incentives for small and highly productive firms to expand (Crawford and Freedman, 2010). Debt finance also gets more beneficial treatment than equity, which may hamper firm growth where equity participation often is a requisite.

The government has pledged in its coalition agreement to increase its share of environmental taxes in overall government revenues. Using taxes to bring the private costs of environmental externalities more in line with social costs will reduce environmental damages and preserve the natural asset base. Using extra revenues from environmental taxes to limit increases in other taxes that would otherwise be necessary to safeguard fiscal sustainability, will improve the impact of higher environmental taxes on the overall efficiency of the tax system (Fullerton *et al.*, 2012).

In 2010, the share of environmentally related taxes in total tax revenues was above the OECD average. As in most countries, taxes on energy products, primarily fuel duties, account for the greatest share of environmental tax revenues, more than 75% in 2010. The postponed rise in fuel duty scheduled to be introduced in 2013 has been cancelled and subsequent rises have been moved from April to September of each year. Fuel prices are more in line with social costs than in many other OECD countries (Figure 2.14). Nevertheless, taxes on diesel should rise faster than on petrol to achieve a more uniform carbon price.

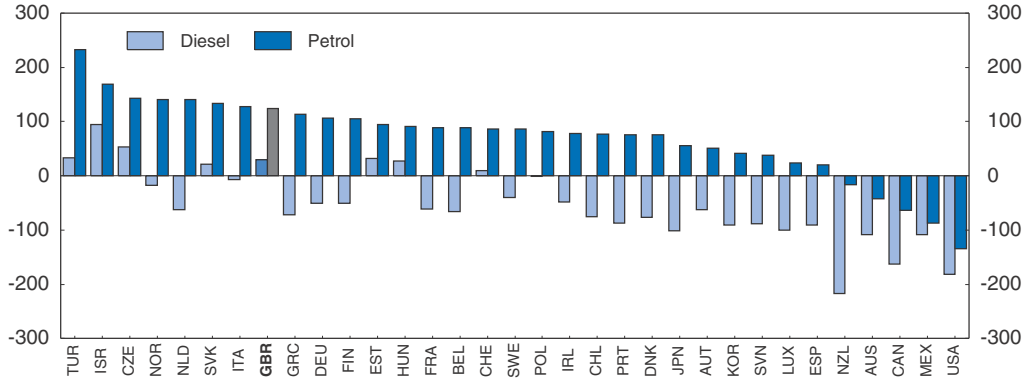
Additional measures that could be introduced to improve the efficiency of environmental taxation include gradually withdrawing VAT rebates for domestic water services and energy use, and a move towards more universal metering of water use.

A better land-use planning would also boost investment and productivity

A sound system of planning regulation is essential to achieve a balance between economic development, environmental quality and social wellbeing. Reform of the planning system has been on the political agenda for economic development for decades, as it is an

Figure 2.14. **Implicit diesel and petrol prices after adjusting for local externalities**[1]

EUR/tonne of CO_2 in 2012Q1



1. The implicit carbon price for diesel and gasoline is obtained by subtracting the external costs of negative externalities from the carbon price implied by excise taxes. Data refers to 2010 Q4 on diesel for Canada, and diesel and petrol for the United States.

Source: OECD calculations.

StatLink http://dx.doi.org/10.1787/888932768543

obstacle to the expansion of the housing stock which has failed to keep pace with population growth, acts as a barrier to infrastructure development, and makes the construction and the retail sectors less competitive than elsewhere. A number of policy initiatives have been introduced since the 1990s (*e.g.* Planning and Compensation Act 1991; Housing White Paper, 1995; Planning Policy Guidance 6, 1996; Urban White Paper, 2000; Planning Green Paper, 2001; Planning and Compulsory Purchase Act 2004; Planning Act 2008), but these have so far failed to materially address the high construction and infrastructure costs or housing shortages prevalent in many regions of the United Kingdom. The Office of Budget Responsibility's assessment of the *Plan for Growth 2011* identified planning reform as the area with the biggest potential impact on medium-term growth prospects, but also as one of the greatest areas of uncertainty, as previous planning initiatives have largely failed to deliver the anticipated impacts on economic development and growth.

Frequent changes to regulation in themselves can hinder investment, as developers require clarity and certainty in the regulatory framework to minimise the risk of their investment. Any reforms that are introduced should take a long-term view, with broad agreement across the political spectrum. In its *Plan for Growth 2011* the government outlined its views on the current failings of the planning system: overly bureaucratic, costly for business, unresponsive to demand, overly complex, the cause of frequent complaint from businesses, and one of the leading concerns for potential overseas investors. These are broadly in line with the shortcomings identified in the Barker Reviews of Land Use Planning (2006) and Housing Supply (2004). Some of the most recent policy initiatives on planning – the Localism Act 2011 and the National Planning Policy Framework (2012) – overturn policies introduced as recently as 2008, but aim to deliver a simplified and more expedient planning system and introduce incentives to local communities to encourage growth and development in a sustainable manner.

High house prices are linked to planning restrictions

Planning regulation affects the economy through a series of channels. It affects access to land for building and so the stock of available homes. This in turn affects house prices,

rents and the price of commercial property. It also limits potential infrastructure investment, which as discussed above is important for productivity growth. Hilber and Vermeulen (2010) find evidence that excessive planning restrictions increase not just the level but also the volatility of house prices. High prices and low availability of housing restrict mobility and the smooth functioning of the labour market. Delays and uncertainty act as barriers to entry within the construction sector and deter investment overall. Firms and inward investors have expressed deep concerns regarding the planning system, which they view as a barrier to investment. In particular, uncertainty regarding the evolution of policy stifles longer-term investment planning. There have been no significant new entrants to the house building market for many years, suggesting that planning also acts as a barrier to entry and restricts competition within the sector (CBI, 2011).

Like any form of regulation, planning necessarily adds an additional layer of cost to any development project. Some of these costs are direct – such as the cost of building permits – and some are indirect and less easily measured, such as delays and uncertainty in planning application outcomes. The Treasury's Infrastructure Cost Review (2010) concluded that among the EU27, different measures of construction costs and civil engineering costs consistently ranked the United Kingdom among the 4 most expensive countries in the European Union. Non-cost barriers related to inefficiency and inconsistency in the planning regulations were cited as key reasons why development costs are in excess of those seen in other European countries. The costs to the economy of housing development control is estimated to reach about £3 billion (0.2% of GDP) per annum (Ball, 2010).

OECD (2011) shows that the price elasticity of housing supply and the response of housing supply to demand is very low by international standards. This suggests that planning regulation introduces a market failure into the construction sector, which is an important factor behind high house prices. The need to increase housing supply is widely recognized (Nickell, 2011). Over the last two decades, home building has failed to meet the national targets set by demographic projections. The unexpectedly sharp rise in inward migration over the last decade has put additional pressure on the existing housing stock. The DCLG Green Paper (2007) set a target of 2 million new homes by 2016. Only 670 000 new homes were built over the period 2007-2011, although much of this disappointment should be attributed to the state of the economy, which has affected both the ability and incentive to invest in housing.

The *Plan for Growth 2011* identified the construction sector as one of the areas with clear opportunities for growth, but the performance of this sector has continued to deteriorate. Much of this is attributable to the impaired banking system, which continues to suffer from heightened risk related to the evolution of events in the euro area. Social housing, in particular, is lagging demand. In part, this is attributable to a government policy shift away from building social housing. In September 2012, the government announced that it will inject £300 million to provide up to an additional 15 000 affordable homes through the use of loan guarantees, asset management flexibilities and capital funding. While this will close only a small fraction of the gap between available social housing and waiting list demand, it is a welcome move towards the expansion of the social housing stock. Additional measures are expected to encourage investment in a further 55 000 new homes, largely on stalled and vacant sites, and provide £50 billion in guarantees for major infrastructure projects and housing investment.

The key priorities of the latest planning legislation introduced through the Localism Act 2011 and National Planning Policy Framework are to simplify and accelerate the planning process and introduce financial incentives to local communities to allow development. Planning is guided by national legislation, with a local plan design and permissions determined by local authorities in conjunction with stakeholders. The national legislation is set out in the National Planning Policy Framework, a new 50 page document that replaces close to 1 000 pages of detailed regulations in the previous national framework. It is hoped that streamlined national legislation will allow greater flexibility at the local level, will be more straightforward for new developers to digest and will help to accelerate the decision process of local authorities. There is a risk that the lack of detail could introduce greater confusion and lengthy legal challenges. Nonetheless, a simplified planning system is welcome and expected to reduce the time involved in preparing an application as well as the time required to reach a decision. This can spur productivity and growth in construction and infrastructure investment.

Other measures to accelerate development include reducing the timescale for non-planning consents to a maximum of 13 weeks; imposing a maximum timescale of 12 months, including appeal, for planning applications; introducing a fast track planning process for major public and private investments in new infrastructure; and a presumption in favour of sustainable development. Essentially, the latter will ensure approval of projects that meet certain environmental, economic and social criteria. These measures can be expected to encourage sound infrastructure and housing development.

Local incentives to encourage development should be monitored

The New Homes Bonus is designed to create incentives for local authorities to promote growth. Much of the failure to expand the housing stock can be attributed to strong opposition to building from the local community, as it is faced with the costs of development (disruption, loss of open spaces, etc.) while the returns on the development are accrued elsewhere. The New Homes Bonus will match funding that accrues from council tax on expanded local housing with funding to build affordable homes for the following six years. A total of £431 million has been allocated for the 2012-13 financial year. While the move to introduce financial compensation to encourage development is welcome, it is not clear that the incentive scheme proposed will be sufficient to overcome local opposition (Leunig, 2011). According to Nathan and Overman (2011a and 2011b), current incentives are not large enough to achieve national objectives in terms of delivering more land for development and contrary to expectations, in the short to medium term, may even decrease the supply of most productive developable land. Little evidence of an effect of the New Homes Bonus on housing starts has been identified so far.

In a decentralised system, it is essential to ensure that strategic planning across local boundaries (for example on infrastructure, transport, waste management and flood prevention) is effective. The system relies on co-operation between local authorities, public bodies and private bodies such as infrastructure providers, but defining a more precise strategic planning framework would be desirable (OECD, 2011).

A review of the Green Belt boundaries is advised

The government has committed to maintaining the integrity of the Green Belt, which covers 12.4% of England and was introduced in 1955 to prevent urban sprawl by restricting development around the largest and most historic towns and cities. Barker (2004 and 2006)

recommended reviewing the boundaries and quality of Green Belt land, but the coalition government is opposed to such a review and has reversed policies put forward by the previous government that opened the potential for development within a small fraction of the Green Belts surrounding South Bristol and Hertfordshire. While it is important to guard against uncontrolled urban sprawl, it is not clear that boundaries designated in the 1950s are necessarily the most appropriate way to protect the environment and preserve the character of historic towns. Much of the popular support for Green Belts is partly based on misconceptions that the protected regions are Areas of Outstanding National Beauty. Much of the Green Belt land is actually fairly low quality, and the inflexibility of Green Belts leads to development "jumping the belt", which has social and environmental costs in terms of longer commuting times – a common example being Oxford and Cambridge (Nathan and Overman, 2011a and 2011b).

A thorough review of the Green Belt boundaries is recommended, with the aim of making some of the land available for building houses and ensuring that the designated Green Belts provide high quality green areas. As Barker (2004) points out, building 120 000 homes per year in the South East over 10 years would only absorb ¾ per cent of the undeveloped land stock. There are strong social and economic arguments to release some protected lands for development. There may also be agglomeration benefits of encouraging cities to become denser in some cases. This would require loosening skyline restrictions.

Improving external competitiveness and prospects can enhance growth potential

The United Kingdom has failed to tap into the rapidly growing demand of countries such as China, and has also lost market share within Europe (Table 2.2). Exports remain concentrated to the low-growth European Union and the United States. For example, the

Table 2.2. **UK export destination and export shares in 2011**

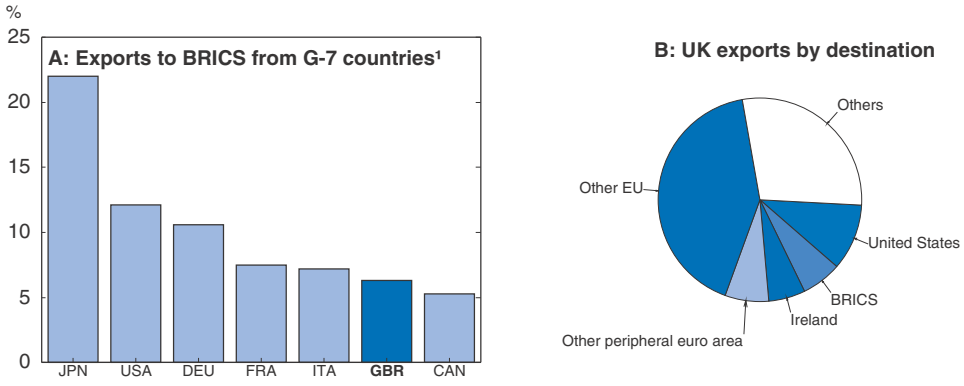
	Share of goods exports in %		Share of service exports in %
5 largest export partners, goods		*5 largest export partners, services*	
EU27	53.2	EU27	38.6
United States	13.3	United States	20.7
China (incl. Hong Kong)	4.9	Switzerland	4.8
Arabian Gulf countries[1]	2.5	Australia	3.0
India	1.9	Japan	2.5
Total	75.8	Total	69.6
BRIC			
Brazil	0.8		0.6
Russia	1.7		1.2
India	1.9		1.4
China (incl. Hong Kong)	4.9		2.7
Total BRIC	9.3		5.9
Regions			
Europe	59.9		48.9
Americas	17.2		26.9
Asia	17.4		16.5
Australasia and Oceania	1.7		3.3
Africa	3.8		4.2

1. Listed in the *Pink Book* as Residual Gulf Arabian countries.
Source: ONS *Pink Book*.

share of peripheral euro area countries (Greece, Italy, Ireland, Portugal and Spain) in exports is twice as large as that of the BRICS (Figure 2.15), which has made the United Kingdom vulnerable to the current euro area crisis. The share of exports to China is still low, although China is the world's second biggest importer of goods and services. The share of total service exports to the BRIC economies is even lower than for goods.

Figure 2.15. **Exports from the United Kingdom**

January to April 2012



1. As a percentage of total exports.
Source: IMF Direction of Trade Statistics.

StatLink http://dx.doi.org/10.1787/888932768562

To engage more successfully in emerging market trade, the United Kingdom would need to offer goods and services that meet their demand. At the broad sectoral level, exports do not appear to be a very close match to import demand in the BRIC economies, especially with China (Table 2.3). Germany appears to have a much closer industrial structure to the imported goods demanded in China, which partly explains its recent success in penetrating this market. Much of this reflects the relatively small weight on services in import demand of the BRIC economies. The main service export destinations are in advanced economies with a mature financial sector. It is possible that service exports to emerging economies will gain momentum once these reach a more advanced stage of development and begin to develop a higher demand for service imports. The relatively strong demand for non-financial business services in Brazil and India suggests that there may be scope to increase involvement in these markets. Import penetration in Brazil in particular remains relatively modest, and this is likely to be a strong growth market over the medium-term, as the economy becomes more deeply integrated into the global trading system.

Other sectors where the United Kingdom has a revealed comparative advantage include finance, insurance, pharmaceuticals and the manufacture of beverages (European Competitiveness Report, 2011). Those sectors may have a greater scope for developing high growth firms, and support to firms in the sectors that are considering entry into export markets has the potential for high returns.

The Trade and Investment agency (UKTI) provides assistance with advice, research and training to exporters. Export promotion programmes that enable the creation of long-term business relationships have been found to be successful at supporting firms that are considering entry into export markets (Spence, 2003). However, entering the export market

Table 2.3. **UK and German export structure compared to import structure of BRIC's**

	UK	Germany	China	India	Brazil	Russia	BRIC
Goods							
Food and live animals, beverages and tobacco	3.9	4.3	1.7	1.2	3.0	9.5	2.7
Crude materials,inedible (except fuels), animal and vegetable oils and fats	1.8	1.9	14.8	4.9	2.3	2.2	10.3
Mineral fuels, etc.	8.6	1.9	13.8	23.3	13.8	1.3	13.8
Chemicals and related products, not classified elsewhere	10.6	12.2	9.1	7.2	13.8	9.6	9.3
Basic manufactures	7.4	11.3	7.5	11.4	8.5	9.6	8.5
Machinery, transport equipment	19.8	39.7	31.6	13.4	28.5	34.6	28.5
Miscellaneous manufactured articles	7.2	8.6	6.4	2.2	4.5	8.3	5.7
Goods not classified elsewhere	3.9	4.6	2.4	9.9	0.0	1.8	3.4
Services							
transportation	4.9	3.7	4.2	10.5	4.6	3.7	5.3
Travel	4.7	2.2	3.6	2.3	6.7	8.2	4.3
Other	27.2	9.5	4.9	13.6	14.3	11.1	8.1
of which:							
Financial	7.3	0.8	0.1	1.5	0.7	0.5	0.5
Other business	11.6	4.8	2.3	9.0	8.5	4.9	4.4
Correlation UK			0.34	0.43	0.74	0.58	0.48
Correlation Germany			0.80	0.25	0.84	0.96	0.85

Source: Derived from UN Comtrade and IMF *Balance of Payments Statistics*.

entails significant upfront costs, which is a barrier to entry for many smaller and less productive firms. Research indicates that export promotion policies should aim to create and reduce information gaps (Greenaway and Kneller, 2004).

In the 1980s, the United Kingdom moved away from strong industry promotion aided by subsidies. Now, the focus is on so called "horizontal" (as opposed to "selective") policies, which aim to provide structural support such as education, R&D and infrastructure. These horizontal policies are crucial to ensure competitiveness. In particular with regards to services, a well educated labour force is essential to produce high quality, innovative products which can compete on the global market. Therefore, a good educational policy, which ensures a broad provision of high quality education, also constitutes a crucial export promotion policy in the wider sense. The provision of good transport infrastructure, which as discussed above is often cited as deficient, can help to create clusters which are vital to regional value chains. Measures included in the *Plan for Growth*, such as the National Export Challenge, which aims to get 100 000 more SMEs exporting by 2020, are welcome (HM Treasury-BIS, 2012).

In the age of globalisation, traditional policies geared towards innovation are important but need to be complemented by further policies focusing on creating more value in the international value chain. Based on a detailed analysis of manufacturing, Baldwin and Everett (2012) demonstrate that activities such as transport, business and finance add value in modern manufacturing, and conclude that policies need to focus on greater EU integration to enhance value creation by manufacturing. Given the UK's strength in the business and finance sectors, after allowing for supply chains, trade integration with the BRIC economies may be more developed than traditional trade statistics indicate. In any event, there is clearly scope for the UK to increase its involvement in these markets going forward.

Higher education as a service export

In times of globalisation, higher education exports are in demand, making a substantial contribution to the economy. Although largely evaluated positively, internationalisation of higher education has attracted some criticism focussing on the progressive marketisation of higher education and its increasing transformation from a public good towards an industry. UK universities have an outstanding research performance and reputation, which is reflected in international university rankings such as the QS ranking, the Times Higher Education world rankings or the Academic Rankings of World Universities. After the United States, the United Kingdom is the preferred destination of international students. In the academic year 2010-11, nearly 300 000 foreign non-EU students, mainly from China and India, were willing to pay higher, international tuition fee rates to study in the United Kingdom. In addition, 130 000 non-UK students from the EU were enrolled in a full or part-time course at a UK higher education institution and paying the same fees as British students.

In total, international students constitute about 17% of the student population. In addition to foreign students resident in the United Kingdom**,** 500 000 students were enrolled in UK higher education institutions abroad in 2010-11. This includes overseas partner organisations, distance learning and overseas campus locations. In the academic year 2010-11, non-EU foreign overseas students contributed about 11% of the total income of higher education institutions by fee payments alone (tuition fees comprise about a third of the total income). In 2000-01, the share was about 5.5% and in 2005-06, about 8%.

Several reports have demonstrated the importance of UK education exports. Lenton (2007) estimated that the total wider value of educational exports exceeded the value contributed by the automotive industry and the financial services industry. Research by Conlon *et al.* (2011) estimates that higher education exports, including spending by students in the United Kingdom, added about £7.9 billion to the economy in the 2008-09 academic year. Their projections forecast higher education exports to grow by 4% annually. However, this projection did not take into account the current changes to the student visa system, which may have negative consequences for higher education exports.

Currently, the government is in the process of enforcing stricter rules on student immigration, aiming at eliminating abuse from the system. It has scrapped the post-graduation visa which entitled foreign students to stay in the country for up to two years following graduation from a UK institution. It has made obtaining a student visa tougher, so that the number of student visas issued dropped by about 20% from June 2011 to June 2012, although the number of visa applications to study at universities has risen slightly. The London Metropolitan University lost its foreign student licence, which might affect up to 2 700 students and endanger the university's financial viability. Concerns were raised that these measures may harm education exports in the medium to long-run, by discouraging prospective foreign students from taking up a course in the United Kingdom. The government's immigration target may act as a further obstacle to the expansion of this strong export market. Policies should aim to support higher education as an export, which may require some modification to current immigration and higher education policy.

Box 2.1. **Recommendations on policies to boost growth and innovation**

Ensure successful implementation of the planning reform. Monitor closely adequacy of development incentives for local communities, review incentives if necessary, and provide an adequate framework for strategic planning.

Invest more in infrastructure, with private financing and further reprioritisation of public spending.

Continue to improve the business environment and promote exports. Continue to implement the Plan for Growth. Support higher education as an export and avoid excessively restrictive limitations on student visas.

Reform some tax rules to encourage R&D. Review fiscal rules which may hamper firm growth, such as preferential tax treatment for small firms and debt finance relative to equity. Examine whether incentives for risk-taking in the tax system are sufficient, given the asymmetric tax treatment of profits and losses.

Promote green growth. Seek a higher carbon price at the international level through tighter quotas within the EU emission trading system (EU ETS) and the adoption of a 30% EU emissions reduction target by 2020. Move towards a uniform carbon price across sectors and fuels. Examine the options for addressing road congestion and environmental impacts including the implementation of a road-pricing system on a national scale. Road pricing should be introduced on the most congested motorways, with a view to gradually extending it to other congested roads. Consider shifting part of the public support for renewable energy from technology deployment to R&D.

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