I. Macroeconomic performance and prospects

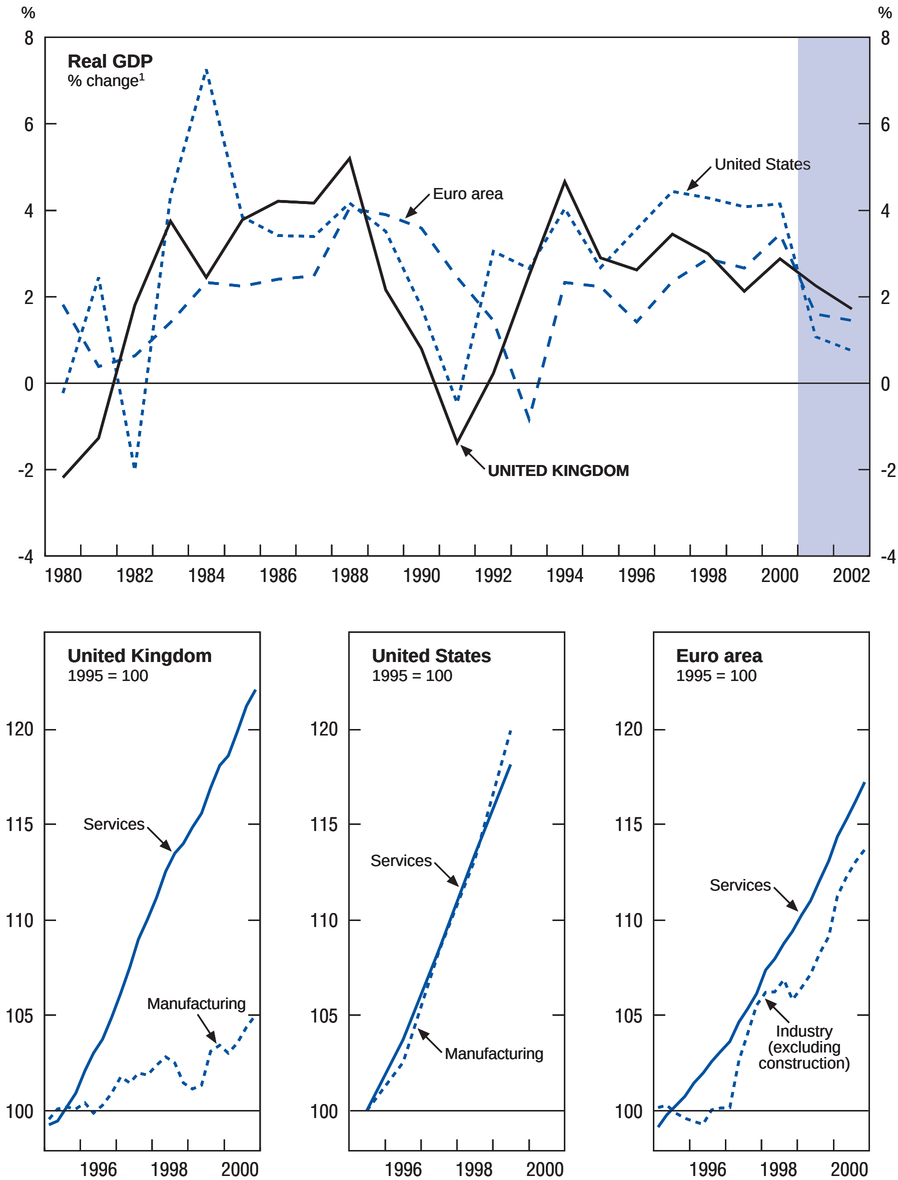
Prior to the terrorist attacks of 11 September 2001, activity in the United Kingdom had already slowed since mid-2000, reflecting soft external demand and a drop in business investment. However, the deceleration was less steep than in the United States and in the euro area. Put in a broader historical perspective, a striking feature of the ongoing cycle is its limited amplitude, notwithstanding a series of shocks including surging oil prices, weakening overseas demand and, domestically, wet weather, rail disruptions and a severe foot-and-mouth disease. Another prominent feature, not unlike in the United States, is the contrast between the momentum of consumption and the external drag, reflecting at least partly a strong exchange rate. This pattern is the mirror image of the one witnessed in the mid-1990s. Also very different from that period are the low level of unemployment and the degree of entrenchment of low inflation. Looking ahead, uncertainties have risen sharply following the terrorist attack in the United States and activity is likely to weaken further in the near term. However, as long as the present uncertainties dissipate, and helped by the monetary and fiscal stimulus currently underway, growth should recover by the middle of next year, unless the imbalances in the economy unwind abruptly.

Output: imbalances have built up

Supply: a tale of two economies

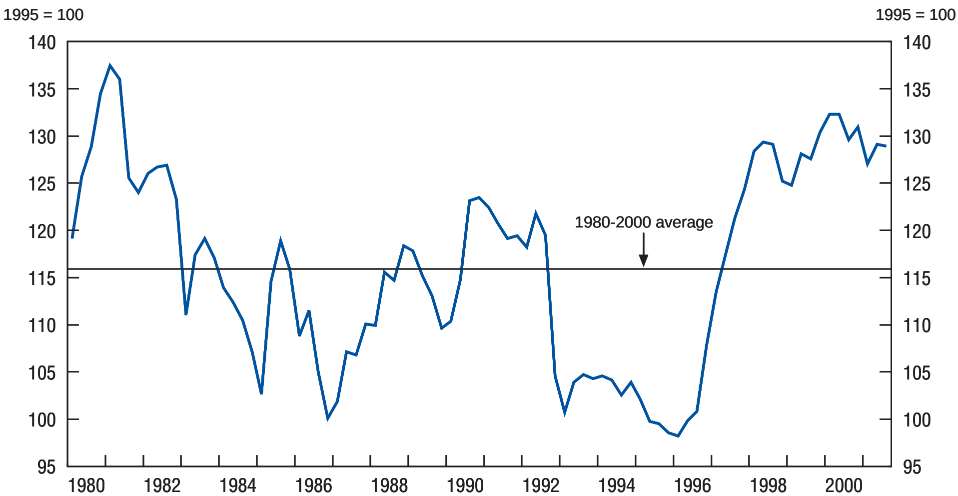
During the second half of the 1990s, annual real GDP growth averaged 2.8 per cent, a good performance by historical UK standards, and slightly better than in the euro area, albeit far less impressive than in the United States (Figure 1).[1] Against the background of a sharp real effective exchange rate appreciation (Figure 2), this robust expansion was primarily driven by the dynamism of transport and communication services as well as business services and finance, which together accounted for only 29 per cent of value added in 1995 but for 63 per cent of GDP growth between 1995 and 2000 (at constant 1995 prices). In stark contrast, manufacturing grew by a meagre 0.7 per cent per annum over this period while agriculture essentially stagnated. Within manufacturing, "new economy" sectors such as electronics and telecommunications equipment did well but "old economy" ones such as steel, textiles, or motor vehicles experienced

Figure 1. **Growth**
Value added



1. 2001 and 2002 are *Economic Outlook 70* projections.
Source: OECD.

Figure 2. **Sterling real effective exchange rate**
Based on consumer prices



Source: OECD.

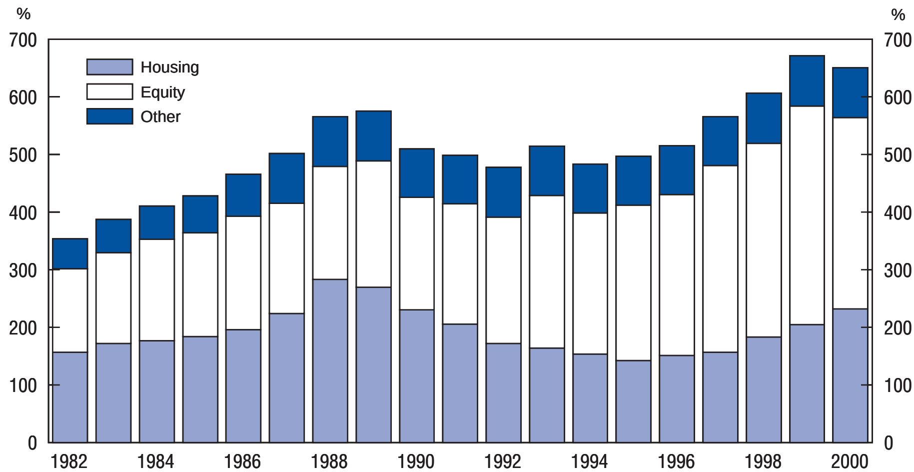
cutbacks. The contrast between manufacturing and services – which is starker than in the United States or the euro area – is also striking as regards corporate profitability, with the United Kingdom ranking third world-wide in services, but eleventh in manufacturing (Walton, 2000).[2]

The pace of GDP growth has edged down to just below potential of 2½ per cent since the summer of 2000. In part, this reflected a recession in manufacturing, but activity in parts of the service sector also slowed. The electrical and optical engineering sector in particular, which accounts for around 12 per cent of manufacturing, ceased abruptly to grow at the end of 2000, and output slumped sharply in the first half of 2001. Additionally, several high profile closures occurred amongst mobile phone producers. Besides the high-tech cycle, the foot-and-mouth epidemic contributed to reduce supply, although its effect on GDP was probably small (see Annex I).

Consumption fuels aggregate demand

Private consumption expanded steadily by around 4 per cent annually during the second half of the 1990s, supported until 1999 by sizeable wealth gains (Figure 3). In 2000, household wealth rose a bit less than income, as the fall in the value of equity holdings was only partly offset by rising house prices, and

Figure 3. **Household wealth**[1]
In per cent of annual disposable income



1. Housing wealth is calculated net of mortgage liabilities.
Source: Bank of England.

consumption decelerated slightly, while the saving ratio edged up. The latter, at around 5 per cent, is below its historical average even on an inflation-adjusted basis, and households have turned into net borrowers.[3] Private consumption has also been underpinned by intensifying competition in the mortgage and retail banking markets, which has contributed to reducing the cost of household debt. It has further been spurred by the continuous improvement in labour market conditions and the associated growing feeling of job security. In the first half of 2001, household wealth declined further, notwithstanding accelerating house prices, but the dynamism of private consumption remained intact.[4]

Overall investment has weakened

Following a lull in 1999, gross fixed capital formation accelerated in the second half of 2000, to an annualised rate of nearly 10 per cent, but fell by 1 per cent in the first half of 2001. In particular, business investment declined in the first half of 2001, both in manufacturing and to a lesser extent in services, owing to pressure on margins and a weakening outlook. This was partly offset by the rise in government and residential investment associated respectively, with plans to rejuvenate the public sector's capital stock (see chapters II and IV) and with a buoyant housing market. Meanwhile, there was a large and involuntary build-up of inventories in the first quarter, mainly in manufacturing. In the second quarter, this ceased and stockbuilding contributed negatively to growth.

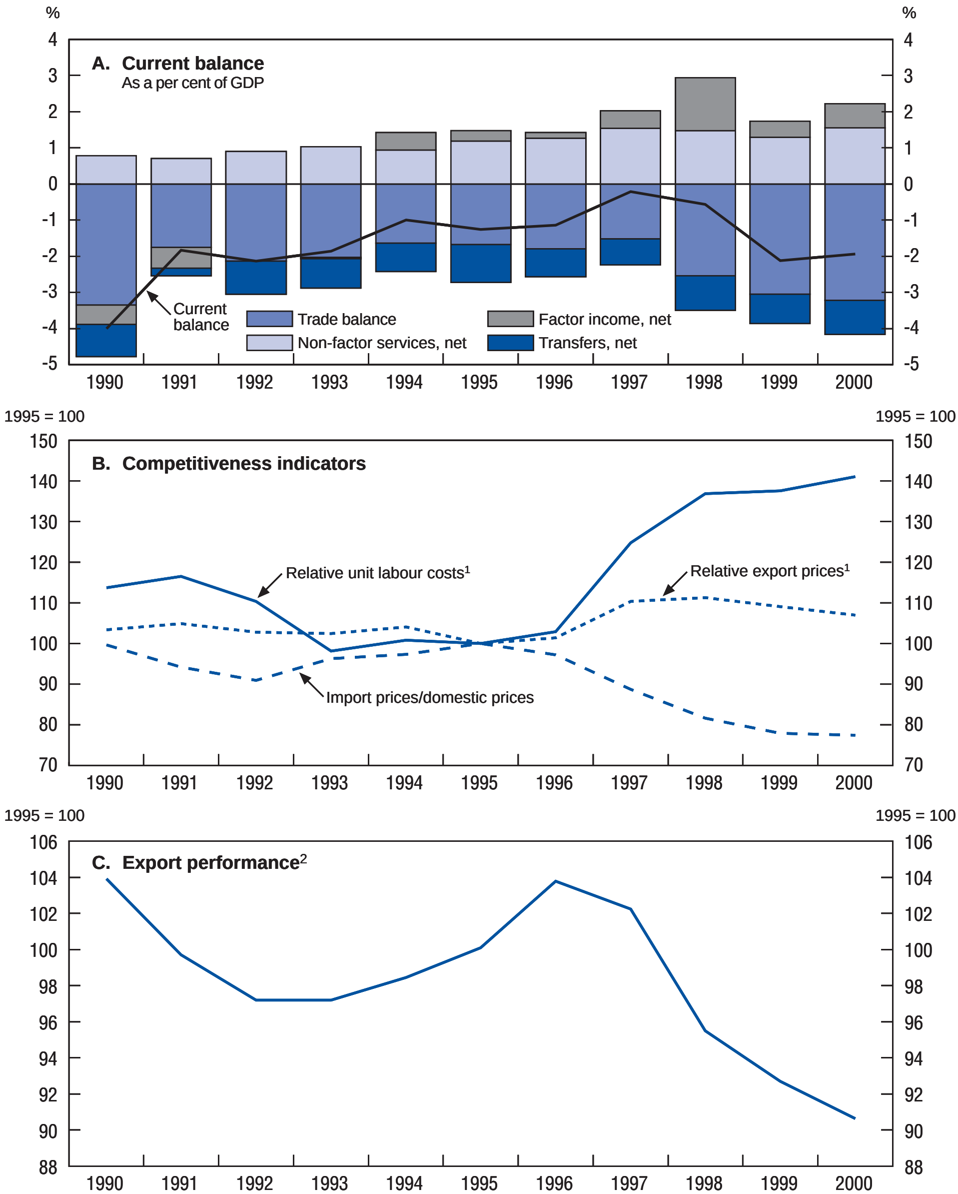
The external deficit widens

Competitiveness (as measured by relative unit labour costs) and export performance (as captured by a market share indicator) have considerably worsened since the mid-1990s, primarily because of sterling's sharp appreciation in effective terms, which saw it rise to levels not seen since the early 1980s (Figure 4 and Annex II).[5] In the process, the goods trade deficit widened from 2 per cent of GDP in the mid-1990s to 3 per cent in 2000, and the current account, which was broadly in balance in the mid-1990s, swung into a deficit reaching 2.1 per cent of GDP by 1999, though it was somewhat smaller in 2000. Consequently, for the first time in more than a century the external contribution to economic growth was negative for five years on end. The external deficit would have swelled even more had it not been for the surge in oil prices in 1999-2000, since the United Kingdom is a net oil exporter (see Annex III). In the first half of 2001, both exports and imports slowed markedly, reflecting the global slowdown and softer internal demand. The goods trade deficit increased to 3.5 per cent of GDP and excluding oil, the goods trade deficit amounted to 4 per cent of GDP. On the other hand, the current account deficit fell to 1.1 per cent of GDP, because of a sharp rise in the investment income balance.

Low unemployment

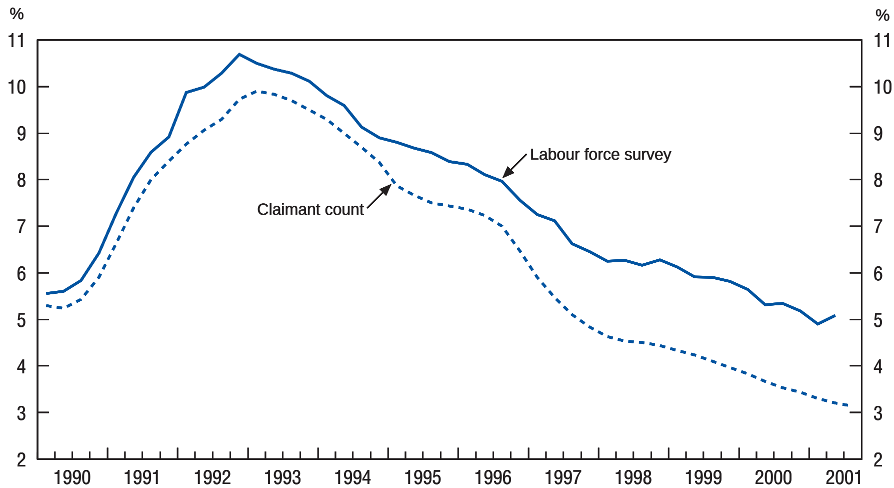
Total employment expanded at an average annual rate of 1.3 per cent during the second half of the 1990s, while labour productivity rose by only 1.5 per cent per annum, a rate significantly below the long-term trend of around 2 per cent. Although productivity growth showed a cyclical pick-up over the year to mid-2000, it has subsequently fallen back as output slowed more than employment growth, in large part reflecting the sharp downturn in the manufacturing sector. Looking more closely at labour market flows, public sector employment started to rise in 1999, for the first time in two decades, and in the year to mid-2000, more jobs were created in the public than in the private sector, reflecting significant hiring in education and, to a lesser extent, by hospital trusts. With the labour force growing by only 0.6 per cent per year since the mid-1990s, the unemployment rate, based on the labour force survey (LFS) measure, declined by almost 4 percentage points, to 5 per cent in spring 2001 (Figure 5). As employment continued to rise, even though the economy slowed, the unemployment rate remained around this level until August 2001. On the claimant count, unemployment shrank likewise, to 3.1 per cent of the labour force. For quite a while, unemployment has thus remained somewhat below most estimates of the rate compatible with stable inflation. On the other hand, actual working time as measured by the average number of hours worked per week is lower than in 1997 and has been

Figure 4. **External trade**



1. Manufacturing.
2. Export performance is the ratio between export volumes and export markets for manufactured goods.
Source: OECD.

Figure 5. **Unemployment**
As a per cent of total labour force



Source: National Statistics, *Labour Market Trends.*

stable lately at around 38 hours for full-time and 15½ hours for part-time workers, a pattern which tends to hold across sectors and occupations.

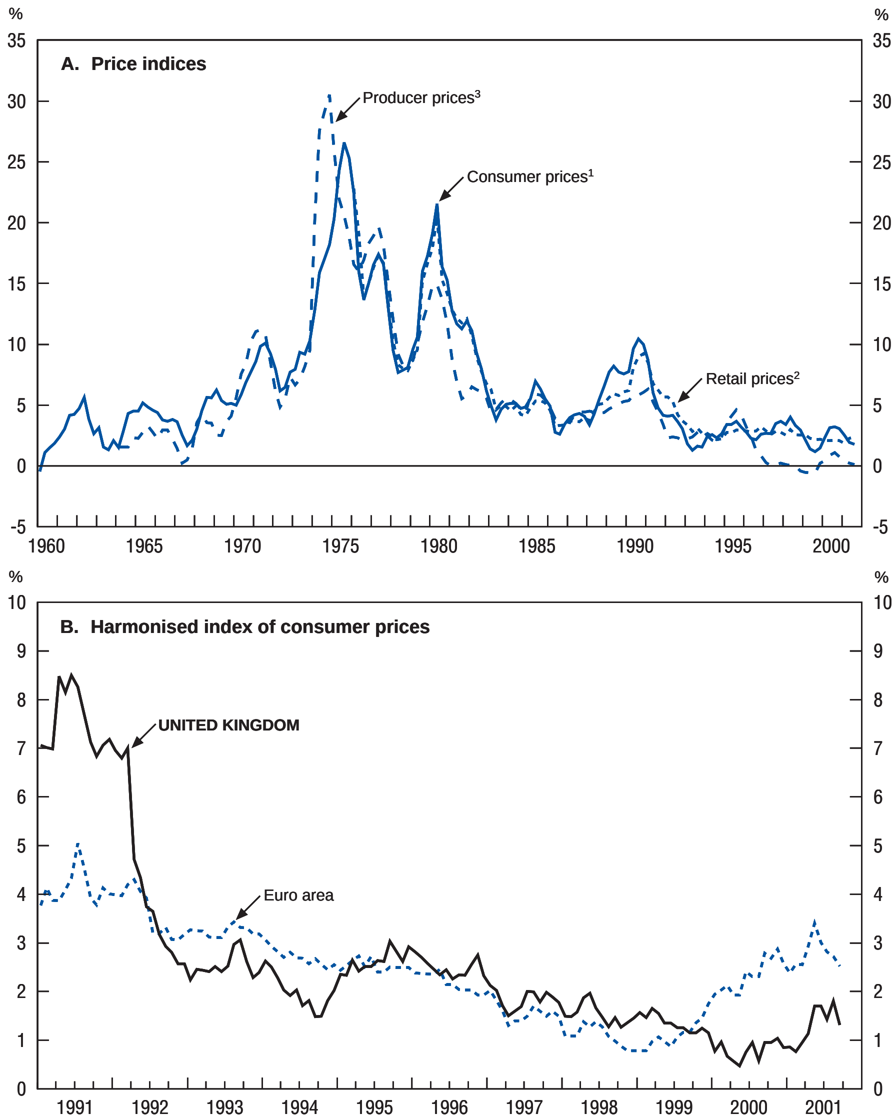
Against this background, and abstracting from erratic month-on-month fluctuations,[6] wage inflation picked up, with the headline economy-wide average earnings index (AEI) rising at around 5 per cent in summer 2001. However, with employment growth softening and some edging up of unemployment (on the LFS measure) since the summer, earnings growth has fallen back to the 4½ per cent rate that is broadly consistent with the inflation target and most estimates of trend productivity growth, though excluding bonuses the rate is still above 5 per cent. Earnings in the public sector have been rising faster than in the private sector, but to some extent at least this represented a catch-up, as for example in the case of the backdating of threshold payments to teachers joining a new salary structure. Possibly, it also reflected some intensification of competition on the demand side of the labour market between private and public employers.

Inflation was subdued, but has picked up recently

As underlined in the previous *Survey*, inflation has remained remarkably subdued in the United Kingdom over the past few years (Figure 6). Besides

Figure 6. **Inflation**

Annual percentage change



1. All items.
2. All items excluding mortgage interest payments (RPIX).
3. Products of manufacturing industries except food, beverages, tobacco and petroleum manufacturing.

Source: National Statistics and Eurostat.

disciplined macroeconomic policy – discussed in Chapter II – several factors have contributed to keeping inflation low. One is relatively low inflation in many of the United Kingdom's trading partners combined with the strength of sterling. As a result, import prices as captured by the goods and services deflator in the national accounts dropped by 14 per cent during the second half of the 1990s. Another factor is increasing competition: implementation of the EU Single Market Programme renders domestic markets more contestable and contested, and a more forceful competition policy – described in Chapter III – has been putting downward pressure on prices. More ephemerally, the direct impact of the last budget's indirect tax measures reduced retail price inflation by around half a percentage point in spring 2001. Offsetting these, however, were the effects of wet weather and foot-and-mouth disease on food prices and, perhaps more importantly, the waning of the impact of sterling's past appreciation and stronger labour cost growth. Indeed, since last spring, underlying inflation (RPIX) has picked up, moving slightly above the Bank's inflation target in August, before falling back below it in September.

The near-term outlook and risks

Recent indicators suggest that private consumption and the housing market have remained very strong until September 2001 and that the manufacturing sector has continued to suffer in recent months. Immediately following the tragic events of 11 September, business and consumer confidence were down, but the decline was less marked than in most other OECD countries, even though the most recent data on business and consumer confidence show a marked deterioration. Looking ahead from early November 2001, foreign demand and the international climate more generally are set to worsen further for some time. However, a vigorous recovery in world trade is projected to take hold from mid-2002 onwards, from which the United Kingdom should benefit fully (Table 1). Accordingly, the current account deficit is projected to remain at close to 2 per cent of GDP.

Besides sub-par activity and demand overseas and their impact via trade, investment and confidence channels, several specific factors will contribute to shaping the UK outlook. Consumption should be supported on the public side by the acceleration of government spending described in Chapters II and IV. As regards households, a number of tax and benefit measures, detailed in Chapters II and III, will stimulate participation and consumption. The 10.8 per cent increase in the national minimum wage effective in October 2001 will work in the same direction, although by how much depends *inter alia* on the extent to which there will be a knock-on effect higher up the wage scale. Furthermore, consumption is projected to receive a small boost from the demutualisation of Friends Provident, Scottish Provident and Scottish Life, three of the largest remaining mutual organisations. The associated windfall payments are estimated at around £6 billion,

Table 1. **Recent outcomes and short-term projections**
Percentage change, constant prices

	1997	1998	1999	2000	2001H1[1]	2001[2]	2002[2]	2003[2]
Consumption								
Private	3.8	3.8	4.2	4.0	4.1	3.7	2.0	2.5
Government	0.1	1.5	2.8	1.6	2.0	2.1	3.4	3.6
Gross fixed investment	7.1	13.2	0.9	4.9	–1.0	1.4	–0.7	2.4
Private								
Business	10.5	18.9	1.7	5.1	–3.7	0.3	–2.7	1.4
Housing	5.1	–1.9	–1.3	0.8	2.1	–2.3	1.5	2.1
Government	–11.7	2.5	–1.4	11.5	19.8	19.2	11.2	10.0
Final domestic demand	3.6	5.0	3.4	3.7	2.8	3.0	1.8	2.7
Change in stockbuilding[3]	0.3	0.1	0.1	–0.3	–0.2	–0.2	0.0	0.0
Total domestic demand	3.9	5.1	3.4	3.4	2.6	2.8	1.8	2.7
Foreign balance[3]	–0.5	–2.2	–1.4	–0.7	–0.4	–0.7	–0.2	–0.3
Exports of goods and services	8.3	3.1	5.4	10.2	2.6	3.6	3.4	7.3
Imports of goods and services	9.7	9.6	8.9	10.7	3.2	4.8	3.3	7.1
Gross domestic product	3.5	3.0	2.1	2.9	2.3	2.3	1.7	2.5
Deflators								
Private consumption	2.3	2.7	1.5	0.6	1.3	1.6	2.3	2.3
GDP	2.9	2.9	2.6	1.7	2.4	2.4	2.5	2.5
Current account (% of GDP)	–0.2	–0.6	–2.1	–1.9	–1.1	–1.8	–2.0	–2.2
Total employment	2.0	1.1	1.3	1.0	1.1	0.9	0.3	0.3
Labour force	0.4	0.5	1.4	0.5	0.6	0.5	0.5	0.5
Unemployment rate[4] (in %)	6.5	5.9	6.0	5.5	5.1	5.1	5.3	5.5
Personal saving ratio (in % of income)	9.5	5.7	4.8	5.0	5.0	5.2	5.6	5.8

1. Annualised rate where applicable.
2. Projections.
3. Contributions to changes in real GDP (as a per cent of GDP in the previous year).
4. Labour Force Survey.
Source: OECD.

which is equivalent to 1 per cent of annual consumption. However, no more than a tiny portion is likely to be spent, as the payments are only partly in upfront cash and policyholders become increasingly concerned that they will not receive the target payout.[7]

Public investment is currently accelerating, consistent with the government's intention to catch up with years of underfunding. Business fixed investment is likely to suffer a further decline in the short run, against the background of a crescendo of profit warnings, weaker share prices, lower global demand and rising unused capacity in the manufacturing sector. However, it is likely to stage a recovery in response to strengthening output growth from mid-2002 onwards.

Following activity with a lag, job creation in the business sector is projected to grind to a halt in 2002, while overall employment growth is supported to some extent by fast employment growth in the public sector. With the labour force growing at its trend rate, unemployment could rise to 5½ per cent of the labour force, which is somewhat above the structural rate. Increasing labour market slack and lower bonus payments should damp labour cost pressures and inflation could fall marginally below the inflation target. With inflation close to target and a small negative output gap emerging in 2002, only a small further interest rate cut by the Bank of England is built into the projections.

Several risks surround the outlook. One is that the slowdown overseas turns out to be more pronounced than anticipated. OECD simulations suggest that if US growth were 1 percentage point lower than expected, UK growth would also be lower by a full percentage point after three years, reflecting the knock-on effects on third countries and the consequences for internal demand. The effect on the United Kingdom is roughly the same as for the euro area, the UK's dependence on trade with the United States being often overrated.[8] With inflation down by 1¼ percentage points after 3 years and no policy reaction built into the simulation, an additional monetary easing would be warranted.

Another risk stems from the imbalance between domestic demand and supply, which cannot continue indefinitely. As highlighted by the authorities themselves, at some point, "the elastic is likely to break – quite possibly through a sharp exchange rate adjustment" (George, 2001). For illustrative purposes, one can simulate the impact of a 10 per cent depreciation of the effective exchange rate. Assuming unchanged nominal interest rates and real general government consumption, the UK Treasury's model suggests that in the first year a permanent exchange rate adjustment of this magnitude would boost real GDP by about ½ per cent and would add between ½ and ¾ per cent to the retail price index excluding mortgage interest payments. In the second year, it would push the level of real GDP up by a further ¾ per cent while adding another per cent to the price level. Such simulation results, however, are highly model-specific and should not be taken too literally. In reality, the actual impact of a depreciation would also depend on the exact nature of the shock causing it, as well as on the policy reaction, which is abstracted from in the above simulation.[9]

Notes

1. It has been argued that the gap between US productivity and growth performance on the one hand, and UK and euro area performance on the other, may be overstated because efforts to better measure the "new economy" have started later in Europe than across the Atlantic (not least because it took off later in Europe). Views differ on the importance of the possible statistical distortion, see *inter alia* Kodres (2001), Vaze (2001), Oulton (2001), King (2001), Wadhwani (2001), Lequiller (2001) and Schreyer (2000).
2. International comparisons of rates of return on capital are compromised by the often poor quality of capital stock data and different methodologies used in each country to calculate them.
3. On an inflation-adjusted basis – *i.e.* controlling for the real capital losses on nominal wealth caused by inflation – the saving ratio was significantly higher in 2000 than in the late 1980s, but its decline in the course of the 1990s is similar on both measures (Davey, 2001).
4. For the impact of different types of wealth increases on consumption, see Boone *et al.* (2001).
5. Annex II discusses the degree of overvaluation of sterling. Effective appreciation is driven by the weakness of the euro and masks a significant depreciation *vis-à-vis* the US dollar.
6. Youll (2001) documents the short-run noise imparted by bonus payments, noting that over the longer run their share in the total paybill tends to increase.
7. Demutualisations reached a peak in 1997, when the windfall amounted to £37 billion. *Ex post*, it appeared that less than one quarter thereof was actually spent within a year.
8. In 1999, the United States accounted for 17 per cent of UK exports, while France and Germany accounted for, respectively, 9 and 12 per cent, and the European Union represented 53 per cent. For Germany the respective shares are 10 and 58 per cent and for France 10 per cent and 61 per cent. The data for France are for 1998.
9. With a remit defined in terms of inflation and not price level (see Chapter II), monetary policy would not necessarily have to tighten if the exchange rate shock were expected to have only a one-off price-level effect, without any tangible second-round effects.
10. Fiscal policy lags have been investigated recently by Blanchard and Perotti (2000) and Fatás and Mihov (2001), but using US data only. Given that the lags are shown to depend on the composition of the change in the stance – in particular on whether it stems from the tax or the spending side – and on the institutional set-up (*e.g.* tax collection lags) the specific numerical results obtained by these authors may not carry over to the United Kingdom.

11. In fact, since the onset of inflation targeting in late 1992, the four-quarter ahead forecast as recorded by Consensus Economics has on average turned out to be about half a percentage point too high.
12. The exchange rate is by no means the only source of surprises. Policymakers have also been surprised by revisions of the past, notably because of a consistent downward bias plaguing preliminary GDP estimates, documented by Barklem (2000), Symons (2001) and, in a rather unflattering comparison across G7 countries, Faust *et al.* (2000).
13. If RPIX inflation deviates more than one percentage point on either side of the symmetric 2½ per cent target, the Governor has to write a public letter to the Chancellor of the Exchequer explaining why and setting out the measures being taken to bring inflation back to the target.
14. For example, the Treasury Select Committee recently concluded: "We commend the MPC on establishing a high level of credibility; however we are concerned that in an effort to establish such credibility the MPC may have biased policy towards undershooting the target" (Treasury Select Committee, 2001).
15. Among OECD countries, cases in point include Canada and New Zealand, although in both countries less emphasis is now put on such measures than hitherto.
16. A permanent one percentage point increase in the DMCI would correspond to a permanent increase of a bit more than one percentage point in the real interest rate, or to a permanent 21.7 per cent real effective exchange rate appreciation.
17. In Figure 10, the projected DMCI is based on the assumption that RPIX inflation evolves as does the central projection in the August 2001 *Inflation Report* constant interest rate-based fan chart and that the effective exchange rate depreciates by close to 2 per cent at a two-year horizon, as assumed in this report.
18. Announcing entry into the euro area at a weaker rate *vis-à-vis* the euro, if credible, could be thought to help. But irrespective of the political considerations associated with what amounts to a constitutional rather than a monetary policy decision, such a move might not lead to a weaker effective exchange rate over the medium run, if at that horizon the euro, which is widely regarded as being undervalued, were to appreciate a lot.
19. The impact on financial fragility of these aggregate credit trends importantly depends on heterogeneity across sectors, firms and households, but this aspect relates to supervision – discussed in Chapter III – more than to the monetary stance. It may also be noted that the 1974 Consumer Credit Act is being reconsidered, with a view to target loan sharks, to reduce burdens on legitimate businesses, to ensure that market changes are better reflected in consumer credit conditions and to provide more timely and effective advice to consumers when they take out loans.
20. Some of the suggestions appeared in a report prepared by D. Kohn, Director of Monetary Affairs at the US Federal Reserve Board. This external audit and the Bank's response were published in late 2000, even though they deal with a number of sensitive matters which by the standards of traditional central banking culture would be considered as strictly internal.
21. The previous *Survey* discussed the constant interest rate assumption and this debate is not reopened here. Another debate that is not entered into here revolves around the role asset prices should play in setting monetary policy, given their role via wealth and balance sheet effects (Cecchetti *et al.*, 2000). For a concrete example of how house and share prices can be taken into account in broad financial conditions indices, see Goodhart and Hofmann (2001).

22. The bulk of the spread between RPIX and HICP inflation in recent years stems from the weighting methodology and from the treatment of housing:

    – At the lowest level of aggregation, prices are averaged using an arithmetic mean in the case of the RPIX, versus a geometric mean in the case of the HICP. In the presence of relative price variability, geometric averaging results in a lower measure of aggregate inflation. This is one of the features of the RPIX currently being reviewed by National Statistics (alongside quality adjustment, outlet selection, treatment of discounts and appropriate index population).

    – The RPIX encompasses an estimate of the notional amount that home owners would need to regularly set aside to preserve the quality of their estate, based on an index of house prices. In contrast, the HICP has no owner-occupied housing component.

23. In recent years, and largely reflecting rapid increases in house prices, the difference in coverage has on average accounted for around half a percentage point of the wedge between the HICP and the RPIX. It is hard to foresee how persistent this wedge will be in the future.

24. The long-standing Basix survey of inflation expectations shows that the general public, unlike other groups, continues to anticipate an inflation rate of close to 4 per cent. Several reasons may account for what might look like exceedingly sluggish adaptive expectations. *First*, the survey fails to specify the measure of inflation, possibly inviting respondents to take into account asset prices for example. *Second*, the survey asks to choose from a misleadingly wide range of figures (from "below zero" to "greater than 10 per cent"); a recent survey carried out by the same polling organisation for the Bank of England and offering a more restricted set of options (from "gone down" to "up by 5 per cent or more") suggests that the public's expectations are much lower and close to 2½ per cent. *Third*, the distribution of answers in the Basix survey is highly skewed, so that the mean is inflated by a few awkwardly high outliers. Moreover, if the public really expected 4 per cent inflation, nominal wage demands would presumably well exceed what is actually observed.

25. A more technical discussion of the optimal horizon for monetary policy is offered by Batini and Nelson (2000).

26. In theory, this could result in as many as 10 different views being aired: one for each MPC member plus the "collective view", which may not coincide with any of the individual views.

27. For the time being, dissenting views are reflected without attribution in Table 6B of the *Inflation Report*, which since August 1999 spells out the effects on RPIX inflation and GDP growth of assumptions deviating from those underlying the central projection.

28. This was, for instance, discussed by the House of Lords Select Committee on the Monetary Policy Committee of the Bank of England in February 2001.

29. In the United Kingdom, exchange rate policy is set by the Chancellor, while for the euro area the general orientation of exchange rate policy is set by the euro group.

30. The Chancellor indicated in June 2001 that the government's position on the conditions for entry into the euro area had not changed since October 1997 when the five economic tests were originally set out (see Box 3 in the previous Survey), and that an assessment of the economic case for joining would be carried out by the Treasury by mid-2003.

31. The stance is assessed here as the absolute change in the cyclically-adjusted public sector net borrowing (HMT, 1999).

32. Under self-assessment, which was introduced in April 1996 and concerns in particular the 8 million self-employed, the tax bill is based on the figures provided by the taxpayer without Inland Revenue first checking and agreeing them. Hence, taxpayers are now responsible for ensuring that they pay the right amount of tax. In FY1999/2000, Inland Revenue collected tax receipts of about 2 per cent of GDP through the system.

33. Thus, UK bookmakers are to end the deductions they charged punters, and to repatriate their off-shore operations. The industry welcomed it saying: "For customers, bookmakers, the racing industry and the Government, this is a win-win-win-win situation."

34. It should be recalled in this regard that the monthly fiscal accounts display a fair measure of seasonality, with the balance typically much weaker in the first quarter of the fiscal year.

35. Most initiatives concern the United Kingdom as a whole or England and Wales. However, some initiatives, for instance, in education are not implemented in Scotland, reflecting its autonomy in this area.

36. Over time, the relative position of the United Kingdom has deteriorated (Stewart *et al.*, 2001).

37. See Bosworth (1999), DTI (2001*a*), Council for Excellence in Management and Leadership (2001) and, as regards the lack of specific implementation skills in the civil service, Montague (2001).

38. Some 80 per cent of teachers receive performance-related top-ups. The latter are criticised by the unions, on the grounds that the assessment of performance is entirely left to the head teacher, even though teachers have a right to appeal to an external commission.

39. These reflect mainly housing costs, which are substantially higher in these areas.

40. The recently published White Paper on "Excellence in Schools" (DfEE, 2001*b*) proposes to extend the areas of specialisation as well as the number of specialised schools. Specialised schools achieve higher exam scores and will be required to share practice and funding with less well-performing schools.

41. Some measures need further assessment. For example, the Office of Her Majesty's Chief Inspector of Schools in England reports that among the six pilot Education Action Zones (described in the previous *Survey*) there was too much variability to draw any conclusion as to their impact on schools (House of Commons Select Committee on Education and Employment, 2001).

42. While overall unemployment is relatively low, pockets of distress remain locally, as highlighted in the previous *Survey*.

43. The likelihood of women being economically active still varies considerably according to the presence, or not, of a partner, and the number of dependent children: 75 per cent of lone mothers with one child or more were economically inactive in spring 2000, against 23 per cent with a partner and one child, not least reflecting the high cost of childcare.

44. In practice, a number of young people falling in this category fail to enrol in the NDYP (*e.g.* some of the homeless residents of the charity Centrepoint).

45. This is confirmed by a comparison of the evolution of unemployment for different age groups. Over 1997-2000 or 1998-2000, total claimant unemployment of the 18-24 years old group fell less (in per cent) than total claimant unemployment for all ages, and marginally less than for 25-29-years-olds.

46. This also implies that the dead-weight loss reported above is probably higher.
47. The way sanctions have been applied across options suggests that the ETF has been seen as the option of last resort. Most sanctions apply there to people declining to enter the option, whereas 58 per cent of the sanctions imposed on participants in the FTET option resulted from voluntarily leaving the option or misbehaviour.
48. See Riley and Young (2001) and Van Reenen (2001). Higher estimates, as provided by the Centre for Policy Studies for example (£14 300), reflect differences in netting out associated costs and benefits. Van Reenen (2001) undertook some sensitivity analysis to the assumptions underlying cost and benefits computations and found that in all cases social benefits exceeded social costs.
49. An early study suggested, however, that the actual destinations of those leavers were not significantly different from the known destinations (Hales and Collins, 1999).
50. Against the advice of the LPC, the Government did not lower the 21-year age limit, despite the fact that the wage distribution for the 21-year-olds is very similar to that of the 22-year-olds. Workers aged 18 to 21, especially the low-skilled, have relatively poorer labour market outcomes than those aged 22 and above. It was on this basis that the Government decided to retain 21-year-olds on the youth rate.
51. This is a measure of relative poverty, as opposed to the headline absolute poverty measure used in the United States (referring to the cost of a minimal basket of goods and services). For more detailed comparisons between the two measures, see for example Brewer (2001*a*).
52. The Gini coefficient for equivalised original income stood at 0.53 at the end of the 1990s, up from 0.46 in 1981 (it was broadly stable over the second half of the 1990s). The Gini coefficient measures income inequality and ranges from 0 to 1: the higher the coefficient, the more unequal the income distribution. Equivalisation adjusts household incomes to take into account their size and composition: for instance, a single person's income of £6 100 would be treated as equivalent to an income of £10 000 for a couple without children.
53. The reforms included in these simulations are the Working Families Tax Credit (October 1999), the child benefit (since 1997), the Council Tax Credit (April 2001), and the increase in income support since 1999.
54. The poverty gap – defined as the total shortfall of household equivalised income for each child below the poverty line – was expected to shrink a bit less in proportional terms than the headcount of poor children. Yet overall, and taking into account the upward shift of the poverty line entailed by the tax and benefit measures, child poverty would have been reduced by between one quarter and one third, by 2001.
55. Overall, most household types gained on average through the personal tax and benefit changes made during the last Parliament, but families with children and pensioners have benefited most (Brewer, 2001*b*). As 31 per cent of single pensioners and 59 per cent of lone parents are poor, compared with 23 per cent for all family types, the targeting was effective.
56. The Government has not yet published WFTC take-up rates, but the latest published statistics show that in May 2001 over 1.25 million families were benefiting from the WFTC. The Government estimates the long run caseload to be 1.4 million. The take up of Family Credit was between 66 and 70 per cent by caseload, excluding self-employed, and between 73 and 79 per cent by expenditure, for FY1998/99. However it is the lowest of all take-ups. For example, income support take-up was between 79 and 89 per cent by caseload, and between 88 and 95 per cent by expenditure in FY1998/99.

57. So far, the Government estimates that fraud in social security benefits costs the taxpayer at least £2 billion per year. The draft Social Security Fraud Act 2001, which has recently been presented to Parliament, aims at reducing fraud by at least 10 per cent by March 2002. The Bill includes measures to increase information sharing, the possibility of reducing or withdrawing benefits, and financial penalties for employer fraud.
58. The take-up rates of many of the benefits for the disabled is only about 50 per cent (Walker *et al.*, 2000).
59. Only 25 000 disabled workers are benefiting from this credit, a small number given the 1.4 million people who wish to work.
60. A focus on total fixed investment, excluding housing, but including government, is justified because government investment also contributes to growth. Also, with the expansion of various PPPs, the boundary between public and private investment shifts over time.
61. However, this masks some disparities across sectors: except pharmaceuticals, aerospace and health, R&D as a proportion of sales is lower in the United Kingdom than the OECD average. Moreover, government R&D is low compared to other OECD countries and its share is declining.
62. Informal investment refers to individuals who invest in start-ups which are not their own.
63. See the consultation document on "Increasing Innovation", HM Treasury, Inland Revenue, March 2001.
64. Recent regulatory changes include the Working Time Regulation (1998), the Unfair Dismissal and Statement of Reasons for Dismissal Order (1999), the Employment Relations Act (1999), the Part Time Workers Regulation (2000) and the National Minimum Wage Act (1998).
65. So far, the measures adopted are a reform of the law on gaming machines and proposals to relax licensing restrictions on New Year's eve.
66. The incentive has proven popular as more than 480 companies had awarded EMI options to over 2 600 employees until the end of February 2001.
67. There is a special treatment of R&D for SMEs (introduced in the Finance Bill 2000) and of R&D capital expenditure in all firms. However, since R&D is made up of around 40 per cent wages and salaries, 50 per cent current expenditures and 10 per cent capital expenditures, it does not provide a very significant subsidy to overall R&D (Bloom *et al.*, 2001).
68. Since the 1980s, the Secretaries of State and Industry have publicly promised to base their own decisions only on competition criteria.
69. The first case of abuse of a dominant position to be fined is that of the pharmaceutical company NAPP, which supplied sustained release morphine to patients at excessively high prices, while granting hospitals discounts that blocked competitors. The OFT has fined NAPP £3.21 million and made proposals to end the infringement, in particular by reducing the price of the drug to the community and limiting the degree to which community prices can exceed hospital prices. NAPP has appealed to the CC Appeals Tribunal. The second case is Aberdeen Journals Ltd., found to be dominant in the market for the supply of advertising space in local newspapers, and to have engaged in predatory pricing. A £1.33 million fine was imposed.
70. The regulators have all the powers of the Director General of Fair Trading (DGFT) to apply and enforce the Act to deal with anti-competitive agreements or abuse of mar-

ket dominance relating to relevant activities in their designated sector. The DGFT alone, however, has powers to issue guidance on penalties and to make and amend the DGFT's procedural rules.

71. The two sectors are increasingly linked: 40 per cent of electricity is now generated by gas, and companies are now active in both markets, often offering "dual fuel deals".
72. Since the previous survey, the telecommunications and broadcasting regulators have merged in a single regulator, OFCOM.
73. The earlier comprehensive reviews of company legislation are the Cohen Committee Report (1945) and the Jenkins Committee Report (1962).
74. Blake (2001) estimates that the BSP, which is around 16 per cent of today's national average earnings, will only represent 10 per cent by 2025.
75. Disney *et al.* (2001*a*) find a positive but small net effect on the saving rate of around 0.2 per cent of GDP in 1990, when the possibility of contracting out of state pensions was offered. Similar systems, as in Canada for example, did not trigger any rise in savings either.
76. Nevertheless, the Government has decided not to legislate on this issue, but rather has given the City two years to come up with its own proposals.
77. Namely: *i*) to confine decision making with professionals endowed with appropriate skills and expertise, *ii*) to establish clear objectives and time scales for managers, *iii*) to implement performances measurement, and *iv*) to produce regular reports on the investment strategy to members and the public.
78. This would require fund managers to intervene in companies, for example by voting, whenever they believe this can enhance corporate performance, and hence the value of the investment.
79. The MFR, created by the Pensions Act 1995, aims both at protecting pensioners in the case of a company's insolvency and safeguarding from fraud. It imposes a minimum level of assets that must be matched by liabilities. In practice, it defines benchmark discount rates that should be used for valuing a pension scheme's liabilities, most notably the market yield on government securities. In response, pension funds sought to minimise their exposure to interest rate fluctuations by allocating a greater share of their portfolios to government securities, at the expense of equities. This results in standardised portfolios, that is not necessarily efficient as a consumer umbrella, and can even distort financial markets (Blake, 2001).
80. At the same time, the need for reform was underscored by some lapses in supervision, revealed notably by the Mirror Group pension scandal, the collapse of Bank of Credit and Commerce International and of Barings Bank, and in the insurance sector the heavy losses incurred by Lloyds, which drove it to the brink of bankruptcy.
81. The merger process is expected to be completed in November 2001.
82. However, reports in the 1990s suggested growing dissatisfaction with the previous regime of self-regulation and the self-regulatory organisations (*e.g.* Mayer, 2000).
83. The procedure for a troubled insurance company is relatively straightforward. The Policyholders Protection Board (PPB) was established by the Policyholders Protection Act (1975 Act), and will be superseded by the Financial Services Compensation Schemes (FSCS) as a result of the Financial Services and Markets Act (FSMA) 2000 from December 2001. The rules governing the FSCS are a matter for the FSA, which is currently conducting a consultation process. Currently, the PPB is funded by the insurance industry. Claims under UK policies can be met by the PPB in two ways:

i) Valid claims made under compulsory insurance, which includes third party motor insurance and compulsory employers' liability insurance are met 100 per cent.

ii) Valid claims made by private individuals under non compulsory insurance are payable to 90 per cent of the agreed value of the claim.

Claims by businesses, except for claims under compulsory insurance policies, will generally rank with other creditors of the company to be paid in due course by the provisional liquidator to the extent that funds are available.

84. Direct costs are linked to bailout operations, and more indirect and longer-term costs are due to the impact of financial markets on growth (Leahy *et al.*, 2001).

85. In 1984, it rescued Johnson Matthey Bankers Ltd. because of its stated concern that failure could trigger problems elsewhere, especially in the interbank gold market.

86. In UK policy documents reference is made usually to finances of the public sector, which is broader than general government. Capital grants from the Government to state-owned companies are included in general government outlays, and so is expenditure by public bodies outside government departments, unless they are part of state-owned companies (this is the case if for example, a regulatory activity is carried out by a state-owned company). Local authorities and social security institutions are also in general government. However, if public service providers are organised in trusts or partnerships selling their services to a government department, such providers are outside general government. This is the case in the United Kingdom, where National Health Service Trusts are part of the public sector but not comprised in general government. Hence out-of-pocket payments by users are not in general government revenue either and only the grants or fees paid by the relevant department on behalf of the users are included in general government expenditure – similar to subsidies to state-owned companies. Due to privatisation of public companies, the differences between general government and public sector spending levels have come to be insignificant.

87. For a number of reasons, international and inter-temporal comparisons of public expenditure may be misleading due to differences in institutions and accounting conventions with regard to social transfers, see Adema (2000). Specifically, the extent to which social benefits are taxed varies across countries and over time and mandatory or voluntary private arrangements providing close substitutes to public social expenditure are usually not taken into account.

88. Based on National Accounts numbers for general government.

89. This table reports expenditure as a percentage of trend rather than actual GDP in order to remove the impact of GDP volatility on the denominator.

90. Meanwhile, with the National Health Service being funded largely by general tax revenues and providing universal health care free of charge, the United Kingdom has the most redistributive health care system of a sample of countries including Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, Switzerland and the United States. This reflects the large share of expenditure funded by general taxes, and its relative progressivity. See Wagstaff *et al.* (1999) and Van Dorslaer *et al.* (2000).

91. The privatisation of the National Bus Company has been less problematic as the coach operators recovered part of the clientele of the railways.

92. Each budget cycle a ritual dance between spending departments and the Treasury would typically continue until time ran out and core Ministers (the Star Chamber) or the Prime Minister had to step in.
93. Accrual accounting and budgeting recognises the financial implications of transactions when they occur, irrespective when cash is paid or received.
94. The Government thus *de facto* pre-empted key elements of the IMF's *Code on Good Practices* and the OECD *Best Practices* on fiscal transparency, akin to the reforms introduced by New Zealand and Australia (the Fiscal Responsibility Act and the Charter of Budget Honesty, respectively).
95. The United Kingdom is not unique in this regard: in Germany the golden rule is enshrined in the constitution, and is used by most individual states in the United States, while Australia adopted it recently.
96. The basic assumptions underlying this projection are the following. Trend GDP growth is assumed to be 2¼ per cent per year rather than the central estimate of 2½ per cent. As a result, the output gap, which is estimated to be 0.6 per cent in 2000/01, would steadily fall to zero by the end of the projection period. Net investment is projected to gradually approach the target of 1.8 per cent of GDP.
97. The *Code* stipulates that discretionary fiscal policy could be used in support of monetary policy through changes in the fiscal stance, "where prudent and sensible". Its thrust is clearly to avoid a pro-cyclical fiscal stance, *i.e.* to stimulate in an upswing or to tighten in a downturn, but does not exclude anti-cyclical fiscal policy. The prominence given to automatic stabilisers has prompted the Government to provide estimates of the structural fiscal balances since 1997. The methodology adopted for these calculations is broadly similar to that used by the IMF, OECD and the European Commission.
98. Generational accounts for the United Kingdom suggest that intergenerational equity is practically achieved on the basis of current fiscal policy, given that a simultaneous increase in health and education spending, as intended by the Government, is directed to different age groups. See Agulnik *et al.* (2000), Banks *et al.* (2000) and Carderelli *et al.* (2000). On the other hand, it could be argued that the "unchanged policy" assumptions, on which such accounts are based, are not realistic.
99. In a system of pure accrual accounting public-private partnerships and publicly funded investment are broadly equivalent from a budgeting point of view, because capital charges would be the same in both cases. However, in national accounts terms, off-budget investment gives rise to a decline in the surplus on current account equivalent to the total capital charges whereas on-budget investment would have this effect only for the amount of the depreciation charge.
100. Van den Noord (2000).
101. Earlier work by the OECD suggests that the budget would need to be in structural surplus of around ½ per cent of GDP to reduce the probability of breaching the ceiling within five years to 10 per cent (Dalsgaard and de Serres, 2000). However, this is based on the previous policy framework which may have been conducive to larger economic volatility than the present framework.
102. The Government has started to produce detailed medium-term projections for public expenditure every two years for a planning horizon of three years, in the so-called Spending Reviews. The first Review was published in July 1998 and spanned the period from fiscal year 1999/2000 to 2001/02. The second Review was published in July 2000, and covered 2001/02 to 2003/04. The third Review for the period 2003/04 to 2005/06 has been scheduled for July 2002.

103. While spending departments will be held accountable for success or failure of investment projects, the Treasury retains a role in monitoring and advising project teams at all stages of the investment process, including planning, procurement and implementation.

104. The five policy areas with a cross-departmental PSA are Sure Start (a programme for disadvantaged children aged 0-3), Welfare to Work (a programme providing employment opportunities for the young and the long-term unemployed), the Criminal Justice System, Action against Illegal Drugs and Local Government issues.

105. A striking example of this was the former PSA concerning the National Health Service, which set a target for the reduction of the number of patients waiting more than a year. This gave an incentive to treat new patients with priority and keep patients who had been on a waiting list for over a year waiting even longer. This was corrected in the new PSA, which targets a reduction in the maximum wait for treatment.

106. Unlike competitive tendering and outsourcing, the concept of "public-private partnerships" may have different meanings across countries. For instance, in the United States it often refers to programmes for technological innovation linking publicly funded research with industry application.

107. In the United States the use of private prisons has grown rapidly from a capacity of 1 200 prisoners in 1985 to almost 50 000 ten years later. Still, only 3 per cent of all prisoners are held in privately operated prisons. Savings from outsourcing this activity to private companies through competitive tendering generally amount to 10 per cent of the cost, largely due to publicly employed prison guards on average earning 15 per cent higher wages than private guards.

108. For example, the French toll road system allows rationing based on variation in toll levels during the day and managing traffic flows by expanding or reducing the number of tollgates.

109. The implications for long-term fiscal sustainability are similar in both cases. Consequently, the increased use of private finance of public services might call for reconsidering the present practice of not including public obligations under such schemes in the measures of public debt when evaluating the government's debt position.

110. For example the Lewisham concession of the Dockland Light Railway extension in east London was put into operation almost a year before planned.

111. Although, in a sufficiently large market this may not be a problem, since there would be a continuous flow of contracts despite their long duration.

112. DETR (2000). The Local Government Association (2000) largely shares these recommendations.

113. The recent devolution of legislative and executive power to Scotland, Wales and Northern Ireland have raised this share somewhat (the numbers in Figure 30 refer to 1997, the latest year for which internationally comparable data are available). However, the overall picture has not changed much to date (see Table 10).

114. The share of local government in the total tax take in the United Kingdom has been found to be the second-lowest of a sample of 19 OECD countries after the Netherlands, see OECD (1999). However, this stylised fact conveys little information on the UK's relative position against other OECD countries concerning sub-central tax autonomy, which depends also on the power of local governments to set tax rates and/or bases.

115. The SSA formula attempts to capture variations in the cost of providing services due to factors that are beyond the control of any individual authority. Local authorities do not necessarily have to spend exactly the amounts indicated by the formula, as this depends on the level of efficiency achieved (higher efficiency means they could spend less) or the actual rate of council tax (a higher rate means they could spend more than the formula indicates).

116. This is due mostly to changes in the population data that enter the formula and *ad hoc* changes to the formula. Moreover, the grant system relies too much on the mechanical use of statistics and seldom draws on wider evidence.

117. The arrangements for investment in council housing would also remain separate.

Glossary of acronyms

AGM	Annual General Meeting
AME	Annually Managed Expenditure
BRTF	Better Regulation Task Force
BSP	Basic State Pension
BT	British Telecom
CC	Competition Commission
CGT	Capital Gains Tax
CTC	Children's Tax Credit
CVA	Company Voluntary Arrangements
DEL	Departmental Expenditure Limit
DGFT	Director General of Fair Trading
DMCI	Dynamic Monetary Conditions Index
DTI	Department of Trade and Industry
EC	European Commission
ECB	European Central Bank
EMI	Enterprise Management Incentive
ETF	Environmental Task Force
EU	European Union
EUR	Euro
FMD	Foot-and-Mouth Disease
FSA	Financial Services Authority
FSCS	Financial Services Compensation Schemes
FTET	Full-Time Education and Training
FY	Financial Year
G10	Group of ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, United States) plus Switzerland
GAR	Guaranteed Annuity Rate
GDP	Gross Domestic Product
GP	General Practitioner
HB	Housing Benefit
HICP	Harmonised Index of Consumer Prices
HMT	Her Majesty's Treasury
ICT	Information and Communication Technology
IMF	International Monetary Fund
ISA	Individual Savings Accounts
IT	Information Technology
JSA	Job Seeker Allowance
LEA	Local Education Authority

LFS	Labour Force Survey
LOLR	Lender Of Last Resort
M&A	Mergers and Acquisitions
MAFF	Ministry of Agriculture, Food and Fisheries
MCI	Monetary Conditions Index
METR	Marginal Effective Tax Rate
MFR	Minimum Funding Requirement
MIG	Minimum Income Guarantee
MPC	Monetary Policy Committee
NAO	National Audit Office
NDDP	New Deal for Disabled People
NDLP	New Deal for Lone Parents
NDLTU	New Deal for Long-Term Unemployed
NDYP	New Deal for Young People
NHS	National Health Service
NIC	National Insurance Contributions
NMW	National Minimum Wage
OFGEM	Office of Gas and Electricity Markets
OFT	Office of Fair Trading
OPRA	Occupational Pensions Regulatory Authority
PBR	Pre-Budget Report
PFI	Private Finance Initiative
PPB	Policyholders Protection Board
PPP	Public-Private Partnership
PSA	Public Service Agreements
PSBR	Public-Sector Borrowing Requirement
R&D	Research and Development
RIU	Regulatory Impact Unit
RPIX	Retail Price Index excluding mortgage interest payments
RPIY	Retail Price Index excluding mortgage interest payments and indirect taxes
SBS	Small Business Service
SERPS	State Earnings-Related Pension Scheme
SME	Small and Medium-sized Enterprises
SR	Spending Review
SRA	Strategic Rail Authority
SSA	Standard Spending Assessment
UMTS	Universal Mobile Telephone Systems (third generation mobile telephone systems)
VAT	Value Added Tax
WBTYP	Work-Based Training for Young People
WFTC	Working Families Tax Credit
WRPA	Welfare Reform and Pensions Act

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BASIC STATISTICS OF THE UNITED KINGDOM (2000)

THE LAND

Area (1 000 km^2):		Major cities (thousand inhabitants, 1997):	
Total	241	Greater London	7 122
Agricultural (1997)	187	Birmingham	1 014
		Leeds	727
		Glasgow	612

THE PEOPLE

Population (thousands, mid-2000)	59 756	Total labour force (thousands)	29 572
Number of inhabitants per km^2	248	Civilian employment (% of total):	
Net increase in population, 1997-2001, estimated annual average (thousands)	154	Agriculture, forestry and fishing	1.5
		Industry and construction	25.1
		Services	73.1

PRODUCTION

Gross domestic product:		Gross fixed capital investment:	
In £ billion	943.4	As a % of GDP	17.5
Per head (US$)	23 930	Per head (US$)	4 192

THE GOVERNMENT

Public consumption (% of GDP)	18.5	Composition of House of Commons (number of seats):	
General government (% of GDP):		Labour	410
Current and capital expenditure	37.0	Conservatives	164
Current revenue	39.0	Liberal	52
Net debt	33.1	Ulster Unionists	6
Last general elections: 7 June 2001		Other	27
		Total	659

FOREIGN TRADE

Exports of goods and services (% of GDP)	28.1	Imports of goods and services (% of GDP)	29.8
Main commodity exports (% of total):		Main commodity imports (% of total):	
Chemicals	13.3	Manufactured goods and articles	28.6
Manufactured goods and articles	23.4	Electrical machinery	23.4
Electrical machinery	22.6	Road vehicles	10.8
Mechanical machinery	11.8	Mechanical machinery and other transport equipment	11.7

THE CURRENCY

Monetary unit: Pound sterling		September 2001, average of daily rates:	
		£ per US$	0.683
		£ per euro	0.623

Note: An international comparison of certain basic statistics is given in an annex table.

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The economic situation and policies of the United Kingdom *were reviewed by the* Committee *on* 22 October 2001. *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* 13 November 2001.

•

The Secretariat's *draft report was prepared for the* Committee *by* Paul van den Noord, Vincent Koen *and* Laurence Boone *under the supervision of* Peter Hoeller.

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