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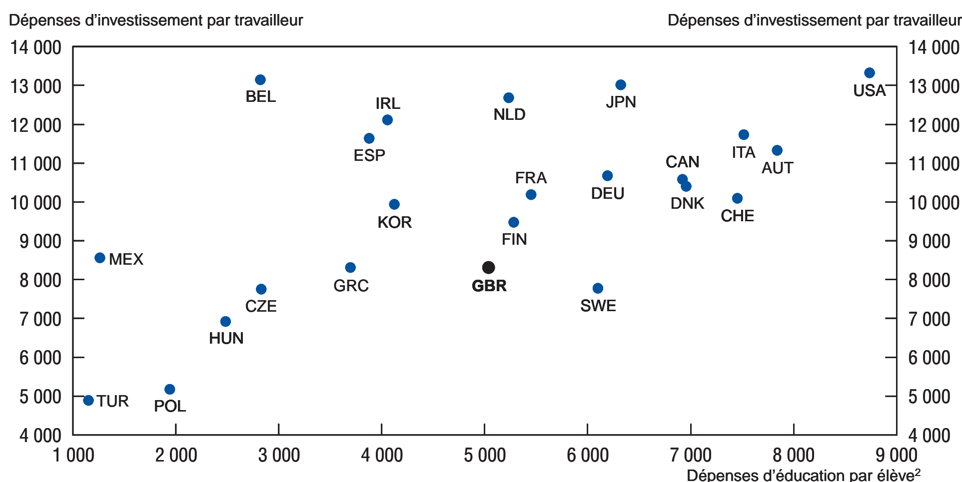
III. Raising productivity to enhance potential growth

Following the June 2001 general elections, the Government stressed that it would step up its efforts to raise productivity by pursuing policies intended to boost physical and human capital and to enhance the capacity to innovate. Despite progress in recent years, the United Kingdom continues to trail behind many other countries in terms of investment per worker and education spending per student (Figure 14), while productivity performance has remained disappointing.

Figure 14. **Investment in human and physical capital**

US dollars converted using PPPs,[1] 1998



1. PPP: Purchasing power parity.
2. Expenditure per student on public and private institutions for all levels of education (based on full-time equivalents).

Source: OECD, *Education at a glance* and OECD Analytical database.

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Table 4. **Structural reform recommendations and follow-up**

Based on previous and current *Surveys* and action taken since 2000

Previous *Surveys*	Main actions taken	Current *Survey*
Labour market		
Early results for the *New Deal* suggest some rise in labour supply, but deadweight losses are considerable.	Extension of New Deal by sector, to older workers (25 years and more, 50 plus), to Lone Parents, for Partners of Unemployed People, for Disabled People.	High dead-weight loss and low sustainability of jobs. Some options of the NDYP do not provide satisfactory results.
Minimum wage: differentiation by age should be maintained.	10.8 per cent increase from October 2001. Age differentiation is maintained.	The assessment of the impact shows little effect on employment. To be monitored closely in the event of a slowdown.
Working families tax credit introduced in October 1999. Should raise participation rates for some categories but may have slight adverse effect on number of hours worked.	£5 increase in WFTC from April 2001.	Participation rates have risen and people have been lifted out of poverty. Yet, take-up is low, and the combination with other benefits still yields high marginal income tax rates.
	Increase of Children's Tax Credit by £1.5 to £10 from April 2001.	Proposed integration of different schemes for children should bring a simplification of the system.
	Disability and carers package.	The high level of benefits provides a disincentive for the disabled to take up.
Restructure *housing benefits* so as to reduce associated work disincentives.	New rules make it easier for people to claim a "run-on" of housing benefit when they leave benefits for work (April 2001).	Incentive problems remain.
Social benefit schemes: fraud and errors remain substantial and a better control and co-ordination of access to various welfare benefits is still needed.	Social Security Fraud Act 2001.	It targets a 10 per cent reduction in fraud by March 2002.
Enhance *education level*.	Educational targets for age groups set.	Targets in the process of being reached for some age group, but 11-14-years-old group is still a problem. Make sure the exam standards are not being lowered.
	More teachers hired and new pay scheme for school teachers.	Nearly all teachers received a bonus, without an obvious link to performance.

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Table 4. **Structural reform recommendations and follow-up** (*cont.*)

Based on previous and current *Surveys* and action taken since 2000

Previous *Surveys*	Main actions taken	Current *Survey*
Product market		
Resources of the *competition authorities* need be targeted appropriately because of the proliferation of M&As.	Resources increased during 2001. Reforms of merger legislation will be included in a soon to be published Enterprise Bill.	It should be ensured that legislation is in line with EC law and does not increase the burden on companies.
Discourage large number of *mergers* notifications.	Further detailed guidance to companies was provided. Fees of £13 000 for a notification decision and £5 000 for a guidance notice are collected.	Policy has been effective.
	Criminalisation of cartel activities is proposed.	Should enhance the deterrent effect.
Concurrent enforcement of competition legislation by OFT and *sector regulators* may be difficult in practice.		The process has not been thoroughly tested yet. The high cost of sector regulators should be scrutinised. Their scope of action should focus narrowly on competition issues.
Remove impediments to efficient use of land or property stifling business development in sectors such as retailing, hotels and software.		Recommendation maintained.
Improve *corporate management* by enhancing the link between boardroom pay and performance.	Under review.	Recommendation maintained.
Improve *corporate governance*.	Proposals in the Company Law Review to suppress the need for an AGM for private companies. For others, information disclosure should be quicker and wider.	These moves may improve the situation, but will need to be kept under review.
	Reform of Insolvency Law.	Ensure that only reckless managers are punished.
Raise *entrepreneurship and innovation*.	Numerous little schemes and tax changes favour SMEs. The R&D tax credit will be extended, various funds have been launched or enlarged for university and business research support.	There should be a thorough assessment of the effectiveness of these schemes. Rationalising them should improve take-up.

Table 4. **Structural reform recommendations and follow-up** (*cont.*)

Based on previous and current *Surveys* and action taken since 2000

Previous *Surveys*	Main actions taken	Current *Survey*
	Reduced corporate tax rates, enhanced capital allowance for small firms investing in ICT equipment, improved incentives for both individuals and corporation to invest in small firms and reduced capital gains tax on business assets held by individuals.	There has been a significant rise in business investment over the past years, but it is hard to attribute this to specific policy actions.
Reduce *red tape* burden.	Regulatory Reform Act 2001.	Ensure consistency of action between the three bodies involved in regulation, the SBS, the BRTF and the RIU.
Financial market		
	Pension reforms.	Consider the possibility of a minimum level of contributions to private scheme, to ensure an adequate replacement rate.
		Reform BSP and MIG, taking into account the interaction of the Pension Credit and other benefits.
		Implement the conclusions of the Myners report.
	Implementation of the FSA.	Keep the regulatory burden proportionate to the regulatory goals.

Source: OECD.

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This chapter examines recent structural policy initiatives,[35] in particular those most likely to affect investment and productivity. The strong labour market performance in recent years has partly compensated for the drag of subdued productivity growth on living standards. It is now critical to raise labour supply further by improving the labour market programmes put in place during the last Parliament and the coherence of the tax and benefit system. Moreover, lifting education standards will be important for boosting productivity and is a key policy objective. Concerning product markets, the Government focuses on raising innovative capacity, eliminating red tape and stimulating competition. The chapter concludes with a review of policy changes affecting financial markets, focusing on the gradual switch to personal pension schemes and on financial supervision, which saw the emergence of an integrated Financial Services Authority. A synopsis of the OECD's recommendations for structural reform are provided in Table 4.

Building up human capital and raising work incentives

Human capital is critical for raising the economy's potential growth and depends not only on the growth rate of employment but also on how fast its quality improves. A number of policy initiatives have been launched in recent years to address both aspects. These are reviewed below.

Education and skills

Low investment in education over the last couple of decades has taken a toll (Figure 15).[36] According to the International Adult Literacy Survey, only a few OECD countries have a higher percentage of adults with literacy and numeracy skills at the lowest level (OECD, 2000*a*) while educational attainment is weak (Table 5). This results in a poorly skilled workforce (DfEE, 2001*a*). In addition, in-work education and training is less developed than in the OECD on average. Only for tertiary level education does the United Kingdom score relatively well. Even so, home-grown managerial skills are scarce both in the private and in the public sector, as attested *inter alia* by recourse to foreign, often US, top executives.[37] While the best UK managers compare well with the best abroad, there is a long tail of under-performers.

Against this background, the Government decided to spend more on teaching and infrastructure and to target the extra resources on specific age groups, specific projects (such as specialised schools), or specific areas. Concerning physical capital in the education sector, a priority is to renovate buildings and increase investment in information and communication technology (ICT). The required funding is large and the Government intends to involve the private sector to fill the gap. A number of public-private partnerships (PPPs) have been set up to build and run schools, although government intentions are still unclear regarding the scope of future PPPs (see Chapter IV). The number of teachers in

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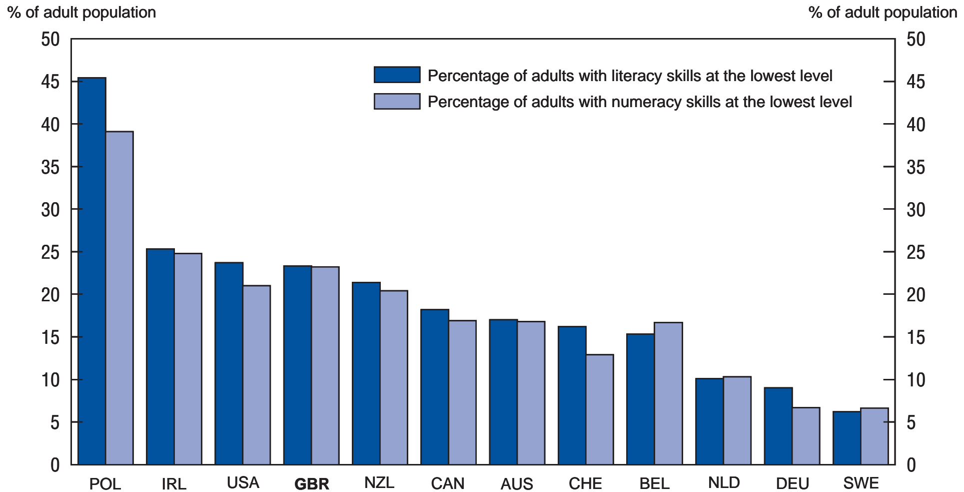
Figure 15. **Literacy and numeracy**

1994-98



Source: OECD.

Table 5. **Educational attainment**

Percentage of the population that has completed at least upper secondary or at least tertiary phases of education by gender and age group, 1999

	Men						Women					
	At least upper secondary[1]			At least tertiary			At least upper secondary[1]			At least tertiary		
Age group	25-34	55-64	total 25-64	25-34	55-64	total 25-64	25-34	55-64	total 25-64	25-34	55-64	total 25-64
United States	87	81	86	36	32	37	89	81	87	39	24	35
Japan	91	63	81	44	19	35	95	57	81	46	10	29
Germany	87	83	86	23	28	28	84	63	76	20	11	17
France[2]	76	48	65	29	14	21	77	36	59	33	11	22
United Kingdom[2]	70	61	69	29	20	26	60	39	53	28	16	24
Italy	53	25	44	9	7	10	58	17	41	11	4	9
Canada	86	64	79	42	28	37	89	60	80	52	27	41

1. Excluding ISCED 3C Short programmes.
2. Not all ISCED 3 programmes meet minimum requirements for ISCED 3C Long programmes. Full details of the ISCED 97 classification system used to define upper secondary and tertiary in individual countries are given in Annex 3 of *Education at a Glance*, OECD 2001.

Source: OECD.

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post has risen by 12 000 since 1998 to over 410 000, but bottlenecks endure. In this context, the Government attempts to entice retired teachers or professionals back into work and is recruiting heavily abroad. Performance-related payments have also been introduced.[38] However, this is not always sufficient to cover the extra costs associated with life in areas lacking teachers, such as London and more generally the South East.[39] So, in spring 2001 the Government announced a recruitment incentives package for teachers moving to work in high cost areas. In addition, the new Starter Home Initiative is helping key public sector workers buy homes.

To improve education outcomes, the Government has adopted a step-by-step strategy, setting targets per age group, and developing alternative curricula, through an increasing number of specialised schools. The first step is to improve literacy and numeracy for the 7 to 11 year-olds. In 2002, 80 per cent of this age group is to reach the standard literacy level (up from 65 per cent in 1998), and 75 per cent the standard numeracy level (up from 59 per cent). By 2000, these targets were reportedly already almost met. The targets set for the 16 year-olds were also nearly achieved but they are much less ambitious. For the 11 to 14-year-olds, further efforts are required. The government's strategy is also based on diversification. Education in secondary schools is becoming increasingly varied across schools, with a rising number of specialised establishments.[40] For instance, the so-called Beacon schools, which share best practice with other schools, help raise standards. Their number has risen rapidly, to around one thousand. Within schools, the number of alternative options included in the national curriculum has expanded (to represent up to half thereof).

While the United Kingdom scores relatively well at the tertiary level in international comparison, the Government has also set recently a target for this sector for 2010. By that time, 50 per cent of young people should have the opportunity to benefit from higher education before they reach the age of 30, from a current level of 40 per cent. However, the budgetary implications could be considerable, with investment in this area running at around £6.6 billion annually in England, although the shift to income-contingent loans for living expenses and the introduction of tuition fees for UK domiciled students have helped to reduce the costs that the taxpayer would otherwise have borne.

Vocational training is improving as well through the work-based training for young people (WBTYP) initiative, introduced in the mid-1990s. It encompasses the modern and foundation apprenticeships and the advanced modern apprenticeship programmes, which aim at providing in-work experience and qualification to 16 to 24 year-olds. Participants usually have full-employed status. Although the schemes will be reformed soon, the WBTYP has been fairly successful, with over 300 000 enrolees at the end of 2000. Around 60 per cent of the participants ended up with a full qualification and close to 70 per cent moved from the programme

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into a job. Following this relative success, funding for learning of people older than 16 years that do not pursue higher education and local funding for enterprise training have been amalgamated in an enhanced common funding system, the Learning and Skills Council since April 2001.

Thus, although education has improved for the young, there is still room for further progress for the 11 to 14 year-olds and older age groups.[41] For example, the individual learning accounts initiative that benefits adults, and was reviewed in the previous *Survey*, have experienced some difficulties. Take-up was faster than expected – with over 2.5 million accounts opened by September 2001 – and the scheme expanded beyond its capacity. Actual usage of accounts was a lot lower (though building up) and there is some evidence that there may have been disproportionate take-up by the already well educated. Due to concerns about its rapid expansion the scheme was suspended in October 2001. Further attention should also be devoted to increase the relatively low upper secondary participation rates and to lower the relatively high proportion of young people not in employment or education.

Labour market developments

As well as a more productive labour force, higher participation would tend to boost potential growth. After nine years of economic expansion, the UK's labour market performance is good, both in international comparison and from a historical perspective. The unemployment rate has steadily come down to levels unseen since the1970s, and employment has increased for both gender groups, albeit at a slightly slower pace recently, to reach close to 75 per cent of the working-age population in June 2001 (Figure 16).[42] During the last Parliament, the Government launched a variety of labour market programmes. Most important are the welfare-to-work programmes under the umbrella of the so-called New Deal, which aim at boosting participation and qualifications, with special attention for disadvantaged groups. The launch of the national minimum wage and ongoing reforms of the welfare system are also intended to reinforce work incentives.

Despite the rapid decline in unemployment, 7.7 million people of working age were classified as economically inactive in June 2001, about the same number as in the mid-1990s or the mid-1980s. Among these, 70 per cent claimed they did not want a job. For men, the main reasons are twofold, in similar proportions: they are either studying, long-term sick or disabled. By contrast, about half of the inactive women cite family care as the main reason for not entering the labour market.[43] The low participation of older men and of the disabled partly reflects the strong incentives to retire early, which led to a sharp fall in the participation rate for 60 to 64 year-old men in the early 1980s. This rate now stands at 50 per cent, against 85 per cent in the early 1970s. Moreover, the disabled are nearly seven times as likely as the others to be out of work and claiming benefits.

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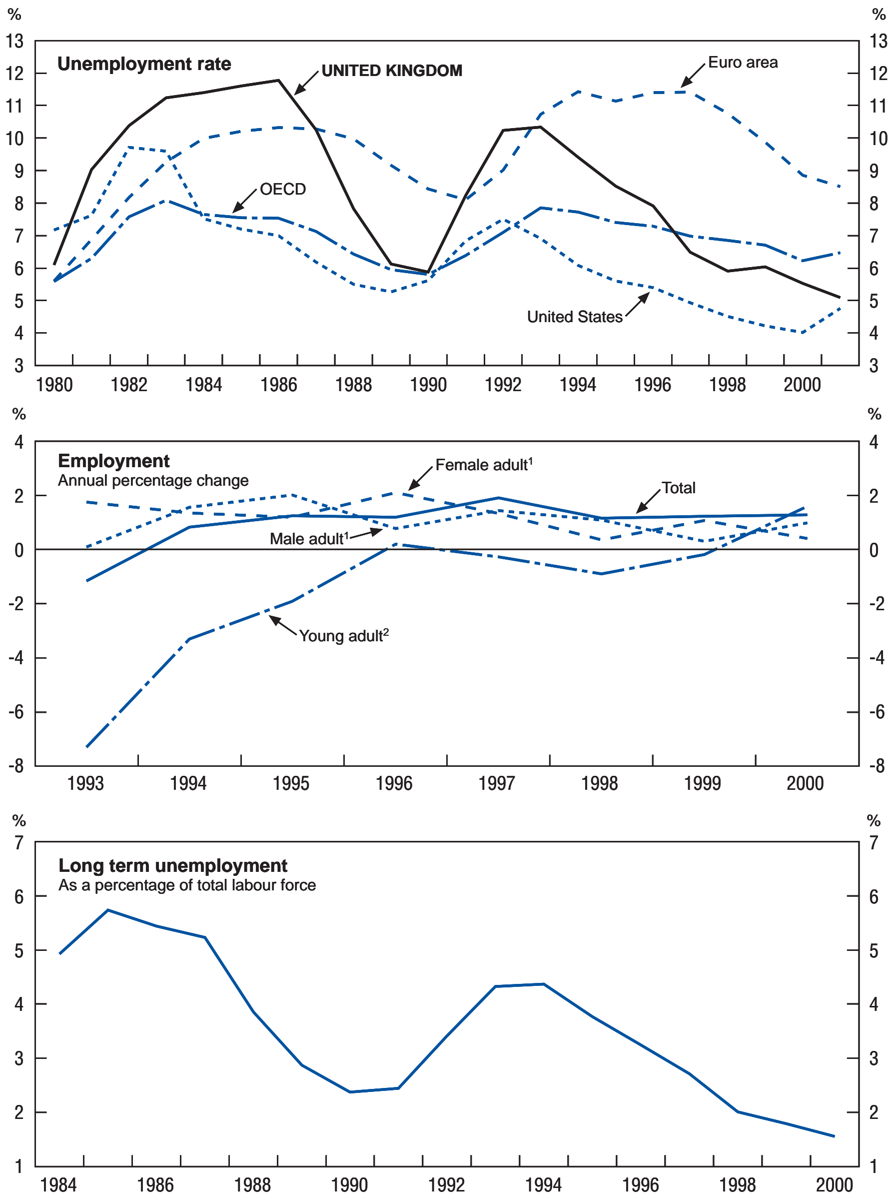
Figure 16. **Labour market indicators**



1. 25-49 years old.
2. 16-24 years old.

Source: National Statistics, *Labour Market Trends* and OECD, *Labour Force Statistics.*

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Overall, there were over 2.6 million disabled people out of work and on benefits in spring 2000.

New Deals

The New Deal was reviewed in-depth in earlier OECD surveys. In short, a New Deal for Young People (NDYP) was launched in 12 pathfinder areas in January 1998 and rolled out nationally three months later. Participation is mandatory for all 18 to 24 year-olds who are unemployed and have been claiming the job seekers allowance (JSA) for six months.[44] On entry, they embark on a four-month Gateway period: a personal adviser assists them with job search, provides career advice and prepares them for one of four options in case they have not found employment by the end of the Gateway: *i*) subsidised employment; *ii*) work on the Environmental Task Force (ETF); *iii*) work with a voluntary sector organisation; or *iv*) full-time education and training (FTET). If a participant declines, fails to take up an option or leaves an option early without good reason, a benefit sanction may be applied (two weeks loss of benefit, increasing to four weeks and then six months for subsequent violations).

A pilot version of a New Deal for the Long-term Unemployed (NDLTU), targeted at those aged 25 or over who have been unemployed for 18 months or more, started in June 1998 and provided personal advisor support and a range of options. However, from April 2001, the programme was extended and intensified on a national basis, building on the pilots and the NDYP and now offers more intensive contact and greater access to support services.

There are several other New Deal programmes, all voluntary and all including advice and guidance from a personal advisor. A New Deal for Lone Parents (NDLP), introduced nationwide in October 1998, is primarily aimed at lone parents claiming income support and, in April 2002, will be extended to all lone parents, regardless of whether or not they receive benefits. From April 2002, the NDLP will include compulsory work-focused interviews. A New Deal for people aged 50 and above (ND50+) started nation-wide in April 2000, aimed at those who have been claiming incapacity benefit, income support or JSA for at least six months. Those finding employment through the programme can receive an employment credit for up to a year. A New Deal for Partners of the Unemployed (NDPU) was rolled out nationally in April 1999. It was extended as the New Deal for Partners in April 2001, to include partners of people who have been receiving income support, incapacity benefit, invalidity care allowance or severe disablement allowance for 6 months or more. A New Deal for Disabled People (NDDP), piloted from September 1998 and extended nationally in July 2001, intends to raise awareness among employers and service providers of the employment needs of disabled people. The New Deal is also being used to address skill short-

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ages, with for instance the recent IT New Deal, which is the first sectoral, employer-led one (Box 1).

The largest programmes in terms of the number of participants are, in order, those for the young, the long-term unemployed and lone parents (Table 6). By July 2001, 684 000 people had participated in the NDYP. Of those who left the Gateway, 60 per cent left the programme and 39 per cent chose one of the four options. Of those who left the programme, 47 per cent took on an unsubsidised job. Among the four options, full time education and training has been the most in demand, although the option has witnessed poor attendance records and high dropout rates. From October 2000, however, measures to intensify the Gateway process have significantly reduced the number of inappropriate referrals to the education and training option. By July 2001 referrals were spread almost equally amongst all the options. For the NDLTU, prior to the recent reforms, the share of

Box 1. The IT New Deal

"Ambition: IT" was announced in March 2001 as a new government-business partnership building on New Deal experience. It encompasses three programmes:

– *Career Ambition* is a three-year pilot programme to help the long-term unemployed and lone parents to become technicians in the IT industry. It aims at providing 5 000 jobs typically paying between £15 000 and £20 000. It is funded up to £14.5 million by the Employment Opportunities Fund.

– *First Ambition* provides opportunities for long-term unemployed and lone parents to take up ICT training. It aims at enrolling 15 000 people in the European Computer Driving Licence* or an equivalent course in its first year.

– *Challenge Ambition* allows New Deal providers to bid for resources to market innovative ICT solutions.

The IT sector business partners for Career Ambition are Cisco Systems, FI Group, Siemens, IBM, Consignia, Cap Gemini, Ernst and Young, Dixons, Sage Group, ICL, EDS, RM plc, Oracle, BT and Microsoft. The unemployed and lone parents who attend this scheme are to be offered employment with one of these companies.

* The European Computer Driving Licence syllabus covers the key concepts of computing, its practical applications and their use in the workplace and society in general. In the United Kingdom, this programme is managed and promoted by the British Computer Society. For details, see *http://www.ecdl.com/*.

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Table 6. **New Deal summary statistics**[1]

To end of…	NDYP (July 2001)	NDLTU (July 2001)	NDLP (July 2001)	NDDP (June 2001)	ND50+ (July 2001)
Number of participants since the start of the programme	683 600	355 400	282 670	n/c	n/c
Currently participating	89 300	26 700	102 520	n/c	n/c
Number of participants who have found jobs to date	319 670	74 170	100 661	8 200	45 039
As a per cent of total participants	47	21	36	n/c	n/c

1. n/c = not comparable.
Source: Department of Work and Pensions.

leavers ending up with an unsubsidised job was only 21 per cent. For the NDLP, almost two-thirds of the leavers do not get a job.

A full assessment of the effectiveness of the New Deal cannot yet be carried out, owing to the lack of data and the later start of some programmes. However, the NDYP and the NDLTU before the recent reform have been running for over three years and can be subjected to a first evaluation. At first sight, the sharp drop in youth and very long-term unemployment (*i.e.* exceeding 24 months) looks very encouraging. But this cannot be entirely attributed to the New Deal, as the buoyant economic situation must have played a role. Indeed, various studies suggest that these programmes involve a sizeable dead-weight loss. According to Van Reenen (2001), the increased probability to find a job due to the NDYP programme is about 20 per cent, and Riley and Young (2001) estimated that of those leaving unemployment, between 50 and 80 per cent would have done so in the absence of the programme. This would correspond to an increase in youth employment directly due to the programme of only around 15 000 people two years into the programme. Taking into account some people on the New Deal but recorded as unemployed, the overall reduction in youth unemployment induced by the programme would be around 35 000 (House of Commons Select Committee on Education and Employment Fifth Report, 2001). This would imply a dead-weight loss of 60 per cent.[45] For the NDLTU, in its previous form, the dead-weight loss would have been around 80 per cent.

Although the informational follow-up of New Deal leavers is not complete, the available results to date show differences across options. *First*, the number of people landing in sustained jobs (in the sense of lasting over 13 weeks) is disappointing, especially for the long-term unemployed.[46] Around 40 per cent of job placements through the NDYP are not sustained. For the NDLTU, less than one sixth of the participants entered sustained jobs. *Second*, fewer than 20 per cent of those entering the FTET option achieve the qualification for which they are aiming,

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and only 45 per cent complete a course and obtain a qualification. *Third*, the voluntary sector and ETF options have been much less popular than these two, and only about a third of the leavers enter unsubsidised employment. An explanation for these relatively disappointing results might be the uneven performance of personal advisors. In some areas, particularly heavy caseloads have triggered high staff turnover. Moreover, sanctions have been inconsistently applied across regions.[47]

It is difficult to provide reliable cost-benefit estimates for the New Deal. The net cost to the Exchequer of each job created due to the NDYP is estimated at around £4 000.[48] But the quantification of the number of jobs created is surrounded by a large margin of uncertainty, as labour market developments have also been affected by other measures, such as the National Childcare Strategy, tax and benefit changes or the introduction of the national minimum wage. It is difficult to disentangle the effect of each of these on labour market participation. After attempting to take into account all of them within a macroeconomic model, Riley and Young (2001) conclude that the NDYP resulted in an aggregate benefit rather than a cost.

Overall, the early New Deal experience suggests that labour supply has increased somewhat. A disappointment, however, is that nearly half of the jobs obtained by leavers are not sustained even for 13 weeks. Moreover, many participants leave the programme for unknown destinations, which tends to undermine the evaluation of the New Deal.[49] The picture would be even bleaker if the definition of a sustained job were widened to 26 weeks. Another problem is that there may be a hard core of participants who are "recycled" through various New Deal options, calling for intensified follow-through efforts. It should be borne in mind, however, that especially in a buoyant labour market the New Deal captures the tail of the distribution of the unemployed, many of whom present severe behavioural problems and are hard to put (back) to work. However, through participation in the New Deal, recruits gain work experience, self-esteem and new skills even if they do not end up in a durable job right away.

National minimum wage

To make work more attractive and encourage labour market (re-)entry, a national minimum wage (NMW) was introduced in April 1999, at £3.60 per hour. For younger workers (up to and including 21 year-olds), the rate was set at £3.00. The NMW is not automatically indexed but adjusted at irregular intervals by the Government, taking into account the views of a Low Pay Commission (LPC, 2001). The NMW was raised to £3.70 in October 2000 and to £4.10 (or 10.8 per cent) in October 2001. A further 10 pence increase is scheduled for October 2002. For younger workers, the rate was raised to £3.20 in June 2000 and to £3.50 in October 2001, to be followed by another 10 pence one year later.[50] The LPC published its third report in spring 2001. It concluded that overall the introduction of

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the NMW did not put too much of a burden on companies. In fact, based on better data, the LPC's earlier estimate of the impact on the wage bill was revised down to around 0.35 per cent. Some specific sectors were disproportionately affected, however – particularly the hotel and restaurant sector, where prior to its introduction one-fifth of the jobs paid less than the NMW, but also small businesses in such sectors as retailing, community services and textiles.

The NMW has helped reduce the gender pay gap and narrow the overall earnings distribution, with 1.3 million people entitled to higher wages as a result of its introduction, 70 per cent of them being women and two thirds part-time workers. The number of those who benefited from the uprating in 2000 was significantly lower, however, since in a tight labour market wages had risen by more than the 2.8 per cent increase in the NMW. Compliance on the part of employers has generally been high and is improving. There remain some sectors, however, with a lower than average compliance rate, such as care, clothing and textiles, and home work. Within these, ethnic workers are particularly affected.

As noted in the previous *Survey*, the NMW was initially set at a relatively low and age-differentiated level and thus far it has operated in a rather buoyant economic environment. The October 2001 increase is substantial, even though it largely represents a catch-up with the evolution of the average wage. The Bank of England's initial estimate of its impact pointed to a 0.15 per cent boost to the average earnings index and a 0.1 per cent increase in price inflation. It also remains to be seen how the system will fare in the context of a slowdown, and whether indeed the room for discretion offered by the current set-up will be used wisely.

Taxes and benefits

To a large extent, poverty and social exclusion both drive and are driven by failure in education and in the workplace. Moreover, social exclusion is in large part inherited. Hence, insofar as interventions and reduced financial distress lead to fewer teen pregnancies or people with very low levels of literacy, fewer members of the next generation will live and raise their children in deprivation. By committing to abolish child poverty within a generation, the government's strategy does not focus only on redistributive goals, but also reflects the long-term economic objective of raising productivity, through enhanced education and participation in the labour market. Through reforming the tax and benefit system, a substantial effect on poverty can be expected even in the short run.

The poverty rate in the United Kingdom, as reflected by an income below 60 per cent of the national median,[51] is among the highest in the European Union (Figure 17). Indeed, resources are spread unevenly across households: before government intervention, the top quintile on average receives £54 400 per year in original income (earnings, occupational pensions and investments), *i.e.* around 19 times as much as the £2 800 for the bottom quintile (Lakin, 2001).[52]

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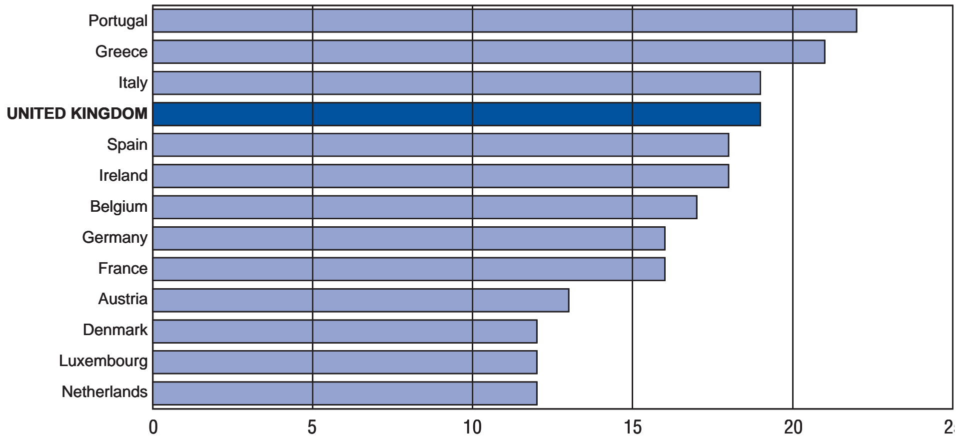
Figure 17. **Poverty**[1]
1996



1. Persons with equivalised total income below 60% of median equivalised total income (%).
Source: European Community Household Panel (ECHP), Eurostat.

However, the tax and benefit system (see Annex V) redistributes income on a significant scale (Figure 18). Cash benefits play the greatest part in reducing income inequality, raising the share of total income received by the bottom quintile from 2 to 6 per cent, while the share of the top quintile is reduced from 52 to 44 per cent. The poorest two quintiles receive 60 per cent of total cash benefits, which corresponds to £5 000 per year. The tax system has a much smaller effect on income inequality: direct taxes have a small equalising effect, but this is reversed by indirect taxation. Altogether, after taxes and benefits, the ratio of the average top quintile over the lowest quintile is reduced to four to one.

Poverty and income inequality, overall as well as for particular sub-groups of the population, have not varied much since the mid-1990s. Micro model simulations of the government's recent reforms suggest that the proportion of poor households should have fallen from 19 per cent in 1997 to 15 per cent in 2001 (Sutherland and Piachaud, 2001).[53] For children, the decline would have been from 26 to 17 per cent.[54] However, the last Household Below Average Income survey suggests that surprisingly little progress had been made by 1999/2000, with relative poverty amongst children essentially unchanged despite a significant decline in absolute poverty from the 1996/97 levels, and some decrease in the percentage of children durably trapped in poverty.

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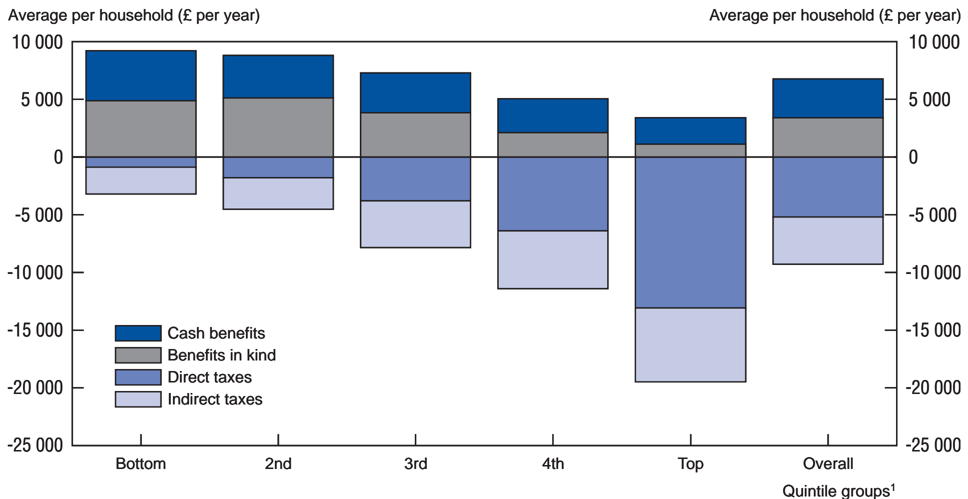
Figure 18. **Redistribution effect of the welfare system**
1999-2000



1. Households are ranked throughout by equivalised disposable incomes.
Source: National Statistics.

The main reason for this is that the figures do not yet reflect key policy measures. The figures are for the year from April 1999 to March 2000, and measures have been implemented in the meantime. The main child poverty measures came into effect towards the end of 1999, and in 2000. The Working Families' Tax Credit was introduced in October 1999, but it replaced Family Credit gradually over six months as people's claims came for renewal. A significant increase in WFTC and Income Support rates followed in Budget 2000, and were implemented in June and October 2000. Other factors could explain that poverty rates have changed little. *First*, incomes have grown briskly in recent years: as a result, relative poverty can rise even as absolute poverty declines. *Second*, there might be a lack of awareness of the various schemes, which would contribute to a low take-up rate, as is typically the case with means-tested benefits. *Last*, the tax and benefit system has become very complex and the effects of various schemes may offset each other to some extent, contributing to trapping some individuals in joblessness and/or poverty (Annex V). For example, for a partner of an unemployed on benefits, work may not pay or an employed person may be trapped in low income (Sutherland, 2001).

Another explanation may be the moving away from universal entitlements towards means-tested benefits. Although means-tested benefits allow to target the intended recipients more precisely,[55] the take-up rate can be low,[56] because of lack

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of understanding about whether people qualify for the benefit or not. In addition, means-tests are more expensive to administer and may lead to higher fraud, although the case management approach adopted by the Government, whereby all claimants have a personal advisor, might lead to some decline in this.[57] However, the overall impact of the WFTC is positive. Early evidence suggests that the WFTC has increased work incentives, especially for full time work, and those lifted out of poverty to date are likely to be working. Moreover, non-employment amongst lone parents, the main target of the measure, has decreased faster than for the whole population between 1997-99 and 1999-2000 (Brewer and Cregg, 2001).

The large number of sick and disabled people is of greater concern (Table 7). The rate of growth of the number of people on incapacity benefits decreased during the 1990s but remains more rapid than in most OECD countries

Table 7. **Social Security benefits and related tax credits**
Fiscal year 2000/01

	£ million	Beneficiaries (thousands)	Composition (per cent)	Per cent of GDP	Characteristics	
					Contributory	Means-tested
Benefits for families[1]	**13 211**		**13**	**1.4**		
WFTC	4 600	1 150[2]	4	0.5	No	Yes
Child benefit	8 611	7 072	8	0.9	No	No
Benefits for unemployed people	**2 907**		**3**	**0.3**	For 16%	For 84%
Benefits for people on low income	**22 810**		**22**	**2.4**		
Income support	8 933	2 207	8	0.9	No	Yes
Housing benefit	11 257	3 968	11	1.2	No	Yes
Council tax benefit	2 620	4 790	2	0.3	No	Yes
Benefits for elderly people	**42 796**		**41**	**4.5**		
Basic retirement pension	33 932	10 878	32	3.6	Part	No
Earnings related pension	4 851		5	0.5	Yes	No
Minimum income guarantee	4 013	1 638	4	0.4	No	Yes
Benefits for sick and disabled people	**17 401**		**16**	**1.8**		
Incapacity benefit[3]	6 536	1 554	6	0.7	Yes	Part
Disability living allowance	6 044	2 160	6	0.6	No	No
Other disability allowances	4 821		5	0.5		
Others	**6 475**		**6**	**0.7**		
Total	**105 600**		**100**	**11.2**		

1. For the WFTC and the Child benefits, the number is based on families, not children.
2. This is the average number of families benefiting at any one time. However, the total number benefiting from WFTC at any one time during the year is likely to be higher.
3. This figure represents the incapacity benefit recipients. Incapacity benefit claimants who do not meet National Insurance contribution conditions will receive income support instead.

Source: HM Treasury, Budget 2001 and Department of Social Security, *http://www.dss.gov.uk/asd/asd4/table8*.

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and the number of recipients is high, despite poor take-up rates.[58] Although about one third of the claimants do not expect to go back to work, another third would like to work. However, the employment rate of the disabled is relatively low compared with other OECD countries. The reasons for the high rate of entry into the disability schemes are hard to pin down. The schemes probably act as a "pressure-valve", as access to other benefits becomes more difficult, and ongoing requirements to receive benefits become more onerous. Yet, the current scheme is still based on the concept of compensating people for being unable to participate in employment, rather than compensating them for the costs of disability. As such, there is still a presumption amongst some recipients that work might actually disqualify them from help. In order to address this, if someone on a disability pension takes up a job but stays for less than a year, he or she can return to the previous level of benefit should the job not work out. Two additional measures were taken. The National Insurance contribution for the disabled returning to work was marginally amended in April 2001, and as mentioned above the Government introduced the NDDP in July 2001. The disabled person's tax credit,[59] launched alongside the WFTC, was also increased. These measures, worthy as they are, seem unlikely to measure-up to the scale of the problem of unemployment amongst the disabled, nor to reduce rates of new entry significantly.

Other legislative measures

There have not been any major changes to employment legislation since the last *Survey*. Mostly, there have been marginal amendments to existing UK rules due to the implementation of EU Directives. Hence, maternity paid leave has been extended from 18 to 26 weeks, to come into force in 2003. At the same date, two weeks paid paternity leave and paid adoption leave will be introduced. On the other hand, the Government is delaying the implementation of the European directive on fixed-term work, which aims at protecting employees on fixed-term contracts by giving them similar rights to comparable permanent staff and preventing employers abusing the flexibility of the fixed-term contract. The Government is also negotiating amendments and implementation delays for certain clauses of the EU directive on informing and consulting employees.

Enhancing innovation and competition

The Government has stressed that the low level of physical investment impeded faster productivity growth. The United Kingdom has long been trailing the other G7 economies, although a significant pick-up occurred in recent years (Figure 19) and the gap with respect to France and Germany has largely closed in real terms, although not in nominal terms.[60] Increasing government investment, so long as well directed, should help improve public services – most notably health, transport and education. But stronger business investment is essential to raise the

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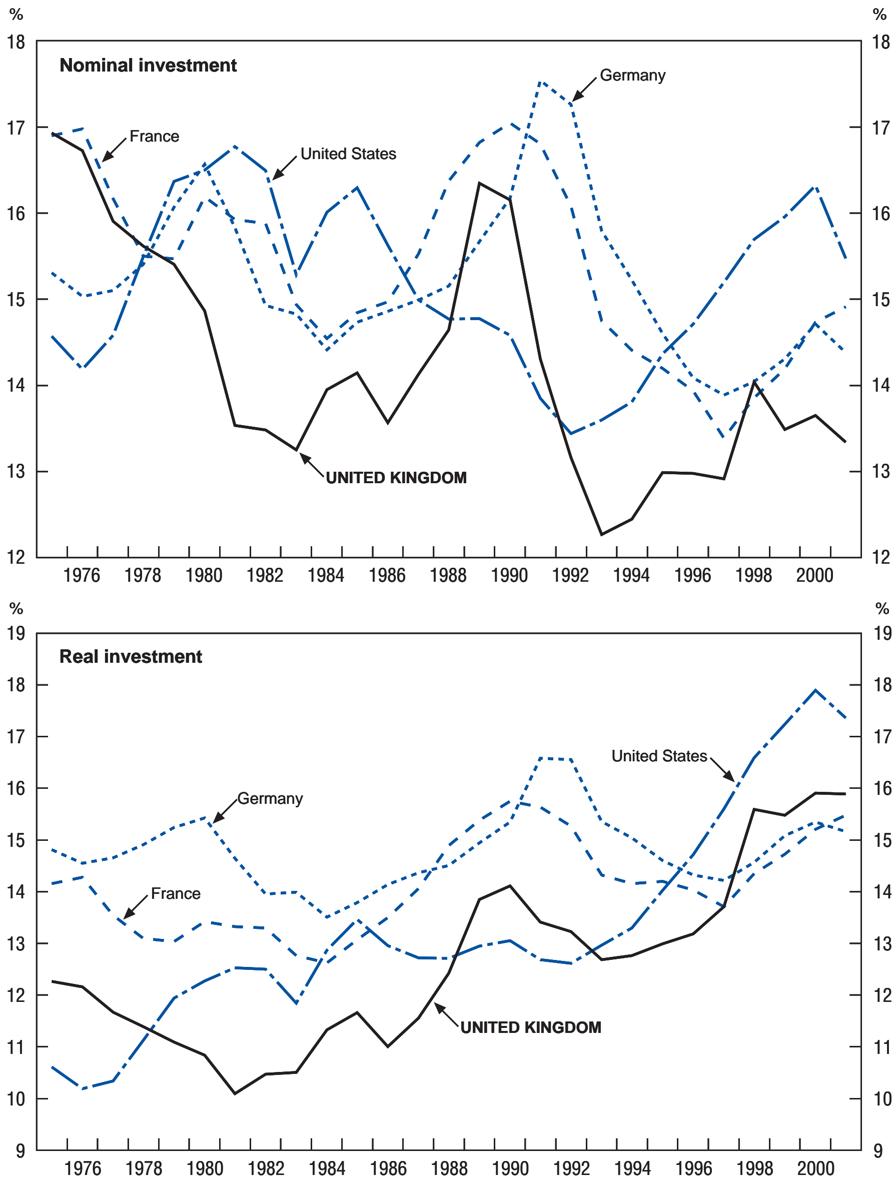
Figure 19. **Total fixed investment, excluding housing in selected G7 countries**
As a percentage of GDP



Source: OECD.

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productivity of the workforce. New plant and equipment embodying the latest technology ensure a more rapid diffusion of new ideas and production methods. Low investment in the past may partly have reflected the uncertainty generated by periodical booms and busts, which led to a greater volatility in demand and the user cost of capital than elsewhere. More recently, the new stability-oriented macroeconomic framework has probably raised business confidence and lifted investment, even though the strong exchange rate worked in the opposite direction in the exposed sector.

While the investment climate has improved, various areas remain of concern. One is the research and development (R&D) gap. While the United Kingdom has a density of scientists and highly educated workers close to the international average, it lags behind other OECD countries in terms of management skills and intermediate qualifications. Moreover, UK businesses spend less per worker on R&D than most of their major competitors, and since 1993, the United Kingdom's relative position has deteriorated, especially *vis-à-vis* the United States and Japan (OECD, MSTI database, May 2001).[61] The United Kingdom also trails the United States, France and Germany in terms of the number of patents granted or filed per head of the population, despite the quality of its academic research. As a result, innovation performance appears weak (OECD, STI Scoreboard 2001).

Barriers to entrepreneurship can also stifle innovation and business creation. Although the United Kingdom scores as having the lowest barriers to entrepreneurship in the OECD (Nicoletti *et al.*, 2000), it does not compare as favourably in terms of new business creation. The latest Global Entrepreneurship Monitor survey shows the United Kingdom performing slightly better than France and Japan, but significantly worse than Canada and the United States (Tsorbatzoglou *et al.*, 2001). The scarcity of risk capital could be one factor behind this, the proportion of informal investors being only about half that of the United States.[62] However, on both accounts the survey shows some recent improvements. Other potential explanations are less intensive use of stock options as part of compensation schemes as well as relatively higher bankruptcy and insolvency costs in the United Kingdom than in Canada and the United States. Moreover, relatively higher tax rates, compared with the United States, both at the personal and corporate levels as well as those on capital gains in the United Kingdom may also have a tendency to discourage entrepreneurship.

Promoting innovation and business creation

Against this background, the Government has launched or enhanced a great variety of schemes, reviewed in the previous *Survey*, often with a view to favouring small and medium-sized enterprises (SMEs). They include measures to foster investment in seed capital, start-ups and small companies as well as measures to alleviate the regulatory and tax burden. For example, the recent Small

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Business Research Initiative aims to increase R&D by SMEs. The Government has also improved the Smart scheme, which provides grants for specific innovation projects carried out by SMEs, when they rely on the collaboration with academia.[63] On the funding side, the Government has built on earlier schemes designed to help close the "equity gap", especially regarding early-stage venture capital, which is still below the EU average (Baygan and Freudenberg, 2000).

Red tape is costly, especially for small businesses. Dissatisfaction with the volume, complexity, clarity and rate of change of legislation runs high (Carter *et al.*, 2000).[64] Government-funded business support also needs to increase its impact, with only a small proportion of SMEs using it. A number of bodies deal with red tape. In April 2000, the Small Business Service (SBS) was launched. The SBS was established to encourage an environment that fosters enterprise, provides support to small firms on compliance with regulations and brings together all government support for small business into one organisation. The Better Regulation Task Force (BRTF) and the Regulatory Impact Unit (RIU) should contribute to lower red tape by promoting principles of quality regulation. The BRTF is an independent body advising the Government on existing and proposed regulation, while the RIU, at the Cabinet Office, monitors regulations and has designed a set of criteria, such as transparency and efficiency that all proposed regulation should satisfy. More generally, the Government has stated its intention to simplify the regulatory framework (OECD, 2002). Already the 2001 Regulatory Reform Act foresees a fast track procedure for the elimination and modernisation of some rules.[65] It remains to be seen whether these measures are effective in reducing the red tape burden. Streamlining the number of bodies and measures involved in the process could contribute to a more efficient and simpler regulatory framework.

The Government plans several changes to the taxation of SMEs. As from FY2002/03, the 10 per cent corporate tax band for the very smallest companies will be widened. The limit for defining an SME is to be expanded from £350 000 to £600 000. VAT payments are to be simplified and automatic fines for late payment removed. In order to help small businesses attract a highly skilled workforce, the Enterprise Management Incentive (EMI) scheme, which allows small companies to grant their employees tax-favoured share options, will be extended to include companies with assets worth up to £30 million.[66] More general tax measures are also in the pipeline. The capital gains tax (CGT) regime should be amended (for the third time in four years): from April 2002, the effective CGT rate for business assets will be reduced to 20 per cent after one year and 10 per cent after two years. Furthermore, the Government is consulting on how to extend the R&D tax credit scheme developed for SMEs to large corporations.[67]

The measures reviewed above are welcome to the extent that they reduce costs or offset market failure. In this respect, increasing the availability of funding contributes to reducing the equity gap, and some schemes have proven successful

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in terms of investment. Yet, they should be weighed against the revenue shortfalls and potential distortions to competition. Exemptions for small businesses should be kept to a minimum as they may affect competition and could be an impediment for small firms to grow.

Yet another reform of competition policy

Direct measures to foster innovation and growth will only fully bear fruit if supported by a sound competition framework. A competitive market, allowing entry of new and innovative firms – together with a level playing field, a light regulatory regime and well-developed and functioning infrastructure – are key to a high level of investment.

Higher prices can reflect a low degree of competition. For example, despite the intervention of the UK Competition Commission (CC), and even though the gap has shrunk somewhat since last year, car prices remain much higher than in the euro area (European Commission, 2001). More generally, a peer review of UK competition policy undertaken by Pricewaterhouse Coopers on behalf of the Department of Trade and Industry reached mixed conclusions. On the whole, the UK competition regime was found to be marginally more effective, on average, than most other European regimes, but markedly less so than the US and German regimes (DTI, 2001*b*). Excluding mergers, its relative strength stems from the quality of economic analysis, the clarity of procedures and the speed of decision-making. Concerning mergers, the lack of political independence was identified as the main issue.

The Competition Act 1998, which came into effect in March 2000, overhauled the competition framework and responded to some of the concerns raised earlier on (OECD, 1996). The organisation of competition policy was streamlined and the investigation powers of the Office of Fair Trading (OFT) enhanced. More generally, the regime has become more closely aligned with EU practices and procedures, which was welcomed by business, limits forum shopping, and seems sensible in a single market. However, the concerns raised with respect to mergers were not addressed, and the Secretary of State for Trade and Industry still dealt ultimately with mergers. However, it was recently announced that, save in exceptional circumstances, the Secretary of State of Trade and Industry would accept the advice received from the OFT on whether or not to refer merger cases to the Competition Commission. Given the evolution of the number of mergers, this should help reduce delays in treating cases and raises transparency.

On the heels of the June 2001 elections, the Government announced its intention to strengthen competition policy, with a series of measures to feature in a forthcoming DTI Enterprise Bill. A white paper was subsequently published setting out a blueprint for a new regime (DTI, 2001*c*). Two important measures are to grant more independence to the OFT and the Competition Commission, espe-

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cially on mergers, and to stiffen sanctions for infringing cartel regulations. Aside from merger policy, it is surprising to see further reform so soon after the implementation of Competition Act 1998. Indeed, the OFT and the CC are still in the process of implementing the measures embodied in the 1998 reform. At the same time, the limited evidence available so far does point to some improvements. The number of complaints has doubled, and in a number of cases, infringing organisations have altered their behaviour when told of the complaint made to the OFT.

The white paper suggests granting extended responsibilities to the CC and the OFT. The CC would see its investigative power extended, and would deal with damages for harmed parties. The OFT would be headed by a board, with members appointed on the basis of their expertise in the competition field. The OFT would also set up a new unit, which would investigate markets on its own initiative, handle complaints from consumer groups as well as individuals and examine government regulation.

The white paper also details proposals concerning the merger regime. *Firstly*, ministers would refrain from intervening in merger decisions, and the competition authorities would have the final word in deciding on mergers, except when "exceptional public interest" issues arise, such as national security. As long as exceptions are kept to a minimum, this should enhance the transparency of the system. *Secondly*, the threshold beyond which mergers qualify for investigation would be amended, the asset threshold being replaced by a turnover one, on the grounds that the increasing role of intangibles, especially in service industries, makes assets less relevant. Yet, choosing the right level might prove to be tricky: if it is too low, it imposes an excessive burden on both business and competition authorities; if it is too high, it does not act as a filter anymore. *Thirdly*, the "public interest" test, against which mergers are currently assessed, would be foregone. This test, set out in the Fair Trading Act 1973, is broad ranging, taking into account factors such as the impact on the environment and employment, although in practice competition authorities have tended to focus mainly on competition issues.[68] For investigations, the white paper proposes to use a more stringent "substantial lessening of competition test", as is currently done in the United States, Canada and Australia.

Finally, a controversial proposal is the criminalisation of cartel behaviour, as is currently the case in the United States, Canada, Japan, Korea and some European countries. The Government argues that it would focus the minds of those tempted to engage in such an activity and that innocent managers have nothing to fear. The Confederation of British Industry has pointed out that the Competition Act 1998 already foresees fines of up to 10 per cent of turnover, for up to three years. This deterrent, however, may be less powerful than individual responsibility under the criminal code. Since the Competition Act came into force, no company has been found guilty of cartel behaviour, and only two companies have incurred a condemnation for

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abusing a dominant position.[69] While eight investigations into cartels have been launched, there have been over forty cases launched in total in which there are reasonable grounds to suspect infringement of the prohibitions in the Act. The other cases include refusal to supply, predation and resale price maintenance. Hence, it is difficult to assess the deterrent effect of the current set-up.

Regulating utilities

Sectors or utilities, where natural monopoly plays a role, cannot be governed by general competition legislation. This is most notably the case in gas and electricity, water and railways. For those, there is a need for specific regulation. The UK regime is based on sector regulators, which have powers concurrent to those of the OFT to enforce the Competition Act in their sectors.[70] It was complemented by the Utilities Act 2000, which is still in the process of being implemented. Since the last *Survey*, the main change has been the merger of the gas and electricity regulators into a single energy regulator, the Office of Gas and Electricity Markets (OFGEM).[71] At the same time, the Gas Consumers Council expanded to cover electricity issues as well and is now called Energywatch. It looks after all consumers' (households and companies) interests and is able to obtain and publish information from energy suppliers and regulators.

Some concerns about the effectiveness of the sectoral regulators have been raised. A Treasury report (HMT, 2001*a*) highlighted their growing costs. The operating costs of the four utility regulators soared in recent years to some £100 million in FY2000/01. However, this is equivalent to no more than 0.2 per cent of the turnover of these utilities. The increase reflects a temporary factor, the transition costs associated with the introduction of a very substantive reform agenda to extend market-based arrangements in both the gas and electricity sector and the widening scope of the regulators' functions. Beyond sectoral regulation, they also have to monitor compliance with environmental and social criteria. In the case of gas, electricity, railways, airports and the Civil Aviation Authority (CAA), they also have some responsibility for safety.

Another official report (Better Regulatory Task Force, 2001) highlighted some concerns about the "regulatory culture". One example of this is the view that OFGEM and the Government have introduced or propose to introduce major reform initiatives with very substantial transitional costs for the private sector without first demonstrating that these will yield net benefits. Another example is the controversy that has developed around OFGEM's proposal to introduce a market abuse licence condition for certain electricity generator licences. This proposal was rejected in an appeal to the CC on substantive grounds, but was subsequently supported by the Government in March and August 2001. Hence, OFGEM and the Government will now introduce its proposal in a manner which will not provide a reference to the CC, thereby undermining the independence of the CC.

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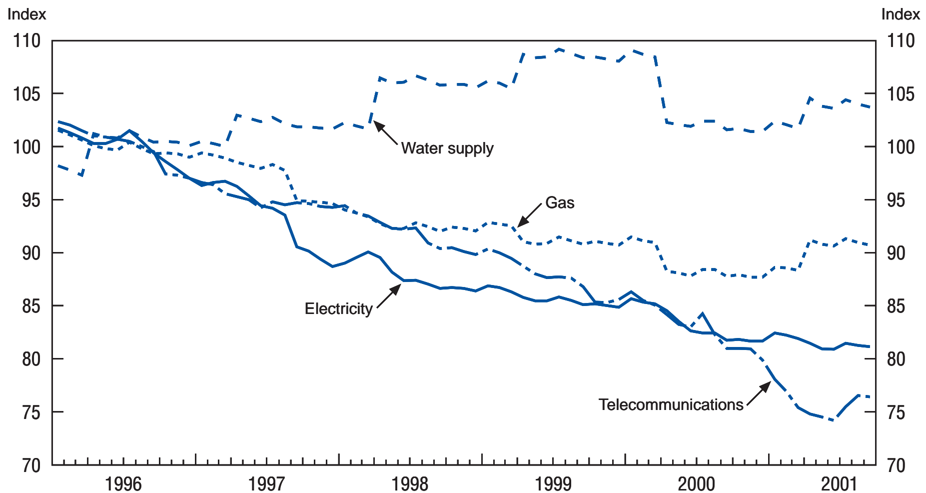
Figure 20. **Utility prices**
Total HICP = 100



Source: Eurostat.

On the retail side of the utilities market, it is too early to evaluate the impact of the new competition and consumer protection framework, but the benefits of earlier privatisation and liberalisation have led to a significant reduction in relative prices (Figure 20). Some of the earlier competition problems in the utilities markets have or will be addressed by the very substantive reform agenda in the energy sector. It will take some time for these complex market-oriented reforms to bed down and there is a range of views about the worth of some of the prospective reforms in the gas market, given the likely size of transitional and transactions costs. As well, it remains to be seen whether new efforts in the rail sector, that have been necessary to address the safety issues thrown up under the previous system, will result in a sustainable regulatory framework. Moreover, the telecommunications regulator appears to have difficulties to persuade British Telecom to open its local exchanges to competition.[72]

Modernising company law

The current Company Law is out of date and complex. It is the product of a nineteenth century institutional set-up and of a succession of technical amendments that lacked a long-term view and clear underlying concepts (Jordan, 1998).[73] As a result, companies striving to act responsibly – *vis-à-vis* shareholders, employ-

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ees, creditors, trading-partners or the wider community – are sometimes uncertain where their legal duties lie, and information about company performance often does not meet today's needs. Among other things, a modern company law will need to take into account the dramatic changes in ownership structure that have occurred over the last decades, with the share of individual holding of equities dwindling and institutional holdings now accounting for the bulk of listed equity. Against this background, a far-reaching and independent review was begun in early 1998 and its final report published in mid-2001 (Company Law Review Steering Group, 2001). The review proposes a simpler framework, a greater role for shareholders and more timely legislative adaptations in the future.

The proposals include a default regime that will suit the majority of companies. The proposed default regime is primarily for private companies, rather than focusing on small companies. This default regime would allow lighter reporting requirements, the removal of the requirement for an Annual General Meeting (AGM), a simplification of capital requirements and streamlined administrative procedures. For accounting and auditing purposes, however, the regime would not make the distinction between private and public, but rather between small and other companies.

Concerning corporate governance, the ultimate objective is to enhance the accountability of management towards shareholders. There could be more stringent requirements that would increase transparency and disclosure from the management side, through a statutory statement of directors' responsibilities towards employees, suppliers and customers, as well as shareholders. It is also proposed that directors' contracts be shortened and regularly reviewed. Effective control by the shareholders should be improved by increased disclosure of the firm's strategy and operations, and a speedier procedure for their publication, particularly through enhanced use of electronic media. An Operating and Financial Review, for larger companies, published alongside the documentation for the AGM, presenting the strategy and details of future plans, as well as any relationships with a wide range of other parties, such as employees and suppliers, where these were material to an understanding of the business, would provide for a more thorough evaluation of the company's operations and long-term strategy. Furthermore, institutional fund managers would have to disclose to those they represented the way in which they have exercised their power during the AGM. The process of executing votes on key company resolutions would be audited, and companies should report on the votes recorded on all resolutions put to the poll.

Although there is no real consensus in the literature on the efficiency of different corporate systems, a number of studies have underlined weaknesses in management control in the United Kingdom (OECD, 1998). Compared to previous attempts at modernising company law, some progress is proposed in this review,

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particularly regarding the voting behaviour of institutional investors. However, boardroom pay remains an open issue, with increases in executive pay that continue to often far outstrip wage adjustments and show only a weak link with company performance.

Finally, to ensure that legislation evolves with the business landscape a Company Law and Reporting Commission would keep it under review, and make suggestions to the Government. It would be supported by three other structures, which already exist but whose areas of expertise would be marginally amended. The Standards Board would make detailed rules on accounting and reporting, and more generally on business conduct requirements. The Private Companies Committee would pay special attention to the impact of company law and reporting requirements on private companies. The Reporting Review Panel would be the watchdog of public and large private companies' reporting procedures, ensuring they comply with the requirements of the Companies Act.

Insolvency law

Business creation should not be unduly deterred by fear of failure. Until the early 1980s, there was a standard procedure to manage bankruptcies, irrespective of the origin of the failure. The Insolvency Act 1986 introduced some flexibility, with the option of company voluntary arrangements (CVA) that allowed insolvent companies to keep going under an administrator, while debts are paid off. But in practice, CVAs have seldom been used, and insolvent companies were much more likely to face administrative receivership, instigated by a secured creditor. The Government now proposes to reform the procedure, to replace administrative receivership (which is a unilateral procedure, not recognised as an insolvency procedure internationally) into administration, which is subject to ultimate supervision by the courts. The reform will also reduce the priority of tax authorities as creditors. Another important proposal aims at reducing the stigma of bankruptcy on individuals. Reckless managerial behaviour would be treated more severely, by imposing a bankruptcy restriction order (BRO) lasting between two and fifteen years. On the other hand, the length of bankruptcy restriction for "standard failures" would be reduced to one year at most. Yet, there would be more responsibility on the director, who would be financially liable for a period of up to three years, regardless of whether or not he has been discharged. The distinction between honest and dishonest bankruptcies might, in practice, be difficult to establish.

Improving financial intermediation

The financial sector has always played a prominent role in the United Kingdom, representing nearly 6 per cent of value added in 1999 (against about 4.5 per cent in France and Germany, but 8.2 per cent in the United States) and 4.3 per cent of total employment, (against 3.4 per cent in France and Germany and

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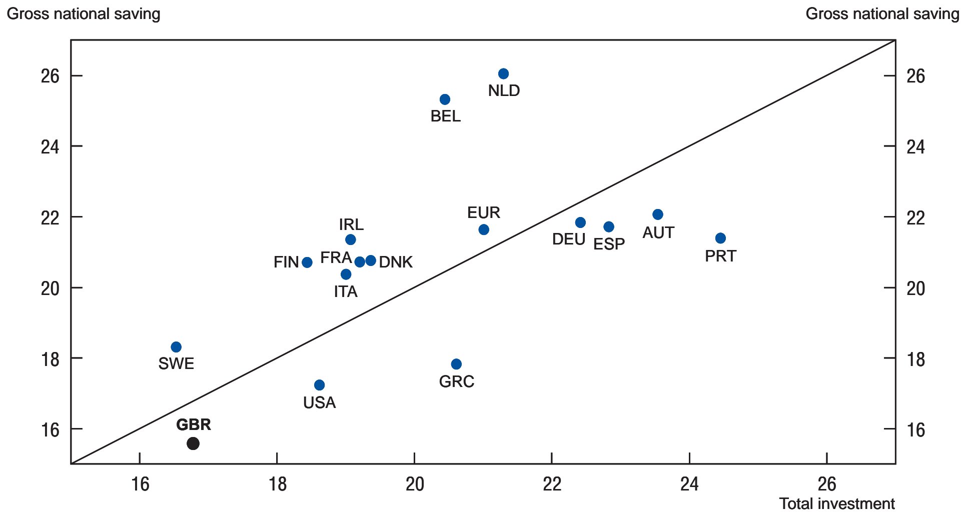
Figure 21. **Investment and saving**
Average 1991-2000, in per cent of GDP



Source: OECD.

similar to the United States). Its fortunes therefore have a greater direct impact on overall macroeconomic performance than elsewhere, apart from the United States. Financial intermediation also has an indirect impact, which depends on how well it matches and boosts saving and investment. Notwithstanding a thriving City, saving and investment tend to be lower in the United Kingdom than in other OECD countries (Figure 21). Furthermore, the efficiency of the financial sector has become even more important with the gradual shift of the pension system from state to private finance.

Will pension reforms increase saving?

Starting in the 1980s, the relative importance of state-funded pensions declined, and the role of privately-financed pension arrangements, generally based on a mix of employer and employee contributions, increased. More recently, measures have been taken to enhance the role of private pensions for middle-income individuals, and to provide poor pensioners with a minimum income. The result is a complex three-tier system (Box 2 and Figure 22).

The new framework raises a number of questions. *First*, a high fraction of the population still does not make sufficient contributions to a private pension to

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Box 2. Main elements of the pension system and recent changes

– The first tier provides a minimum pension to all pensioners. Since April 1999, all individuals get a modest flat-rate Basic State Pension (BSP), financed on a pay-as-you go basis. In addition, those with low-incomes and little wealth are eligible for the Minimum Income Guarantee (MIG) top-up, which currently brings their income up to £92.15 per week for a single pensioner and £140.55 for a couple. They may also benefit from the housing and council tax benefits. To give an incentive to save to people just above the threshold for MIG, the Government has proposed the introduction of a Pension Credit from April 2003 (as explained in more detail by Clark, 2001).

– The second tier is the most complex, and has been significantly modified by the 1999 Welfare Reform and Pensions Act (WRPA). Until April 2002, employees receiving earnings within a certain band (£67-£535 per week in FY2000/01) build up entitlements to the State Earnings-Related Pension scheme (SERPS), in addition to the BSP, unless they choose to contract out of SERPS. In this case, they must join either their employer's occupational pension scheme or a personal pension scheme. Then, both employee and employers receive a rebate on their national insurance contributions (NIC). There is no legal obligation for an employer to set up an occupational pension scheme nor for an employee to join. Both the BSP and the SERPS are financed from the NIC.

– The recent reforms spelled out in the WRPA will modify this system as follows:

  - The SERPS will be replaced by a state second pension (SSP) from April 2002. Initially earnings-related, it is proposed to become flat-rate in time, even though contributions will remain earnings-related, a feature intended to provide an incentive to middle and high-income earners to contract out.
  - New stakeholder pension schemes (SHPs) will be introduced in 2001, principally intended to give an incentive for middle-income earners to join a private personal pension scheme. All businesses with five or more employees are required to arrange a SHP for their staff. All SHP are registered with the Occupational Pensions Regulatory Authority (OPRA).* Employees may directly contribute from their wage (in return for lower NIC), but employers do not have to make any contribution on their employees' behalf.

– The third tier consists of other, voluntary private retirement saving, involving additional contributions into occupational pension plans, additional saving through personal pensions, or other financial assets, supported by a preferential tax treatment, as for the other elements of the pension systems.

Coverage of the workforce by occupational pension schemes has been fairly static at around 50 per cent since the late 1960s. Of the remainder, about half are members of SERPS and half have opted out into a personal pension scheme. On the other hand, self-employed are only required to have a basic pension.

* OPRA is responsible for registering stakeholder pension schemes, regulating compliance with the registration requirements, regulating scheme management including the payment of contributions to the scheme, and enforcing the conditions that define a stakeholder pension and allow it to be registered.

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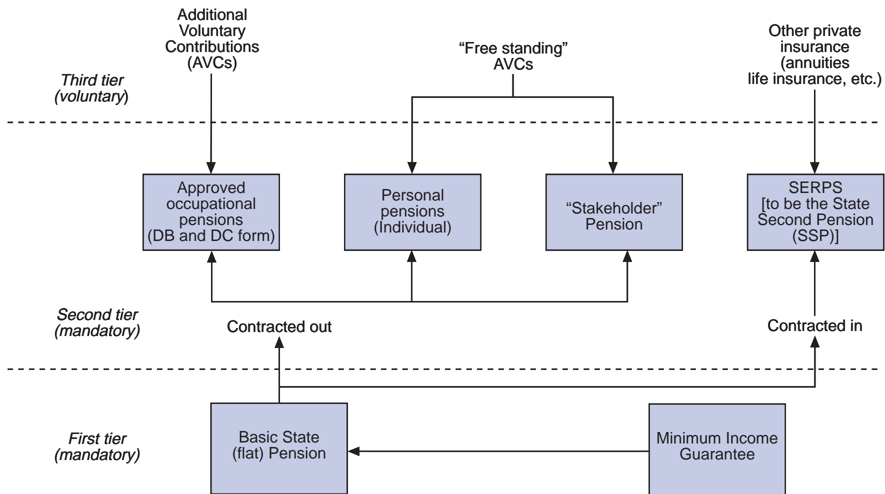
Figure 22. **The pension system**

2001

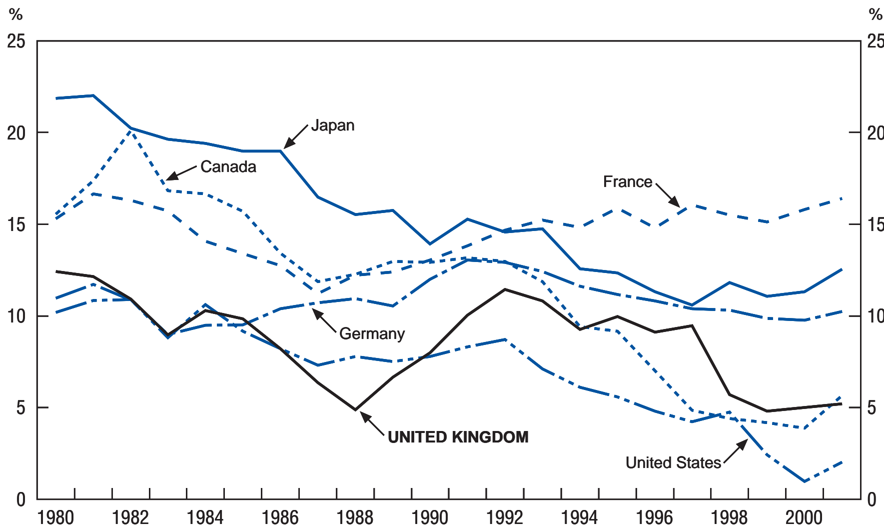


Source: Disney, Emmerson and Tanner (1999).

obtain an adequate replacement rate upon retirement (Disney *et al.*, 2001*a*). *Second*, the existence of an income and assets-tested benefit system in social care may prove to be a disincentive to household retirement saving. *Third*, the current configuration leads to a largely income-assets tested system. As the BSP is indexed on prices (while the MIG is indexed on earnings), its earnings value will decline rapidly over the years.[74] Thus, in order to keep low-income pensioners out of poverty, an earnings-linked MIG risks covering an increasing number of people. The Pension Credit will be introduced to tackle the disincentive to save induced by the MIG. The relationship of the Pension Credit with Housing Benefit and Council Tax Benefit (CTB), described in Annex V, needs to be designed carefully in order to ensure pensioners do not fall into a poverty trap. At the same time, it will make stakeholder pensions for low-income savers less attractive. Overall, there is a tension between the short-term aim of lifting pensioners out of poverty and the long-term objectives.

At the aggregate level, there is some evidence that the reforms that occurred over the last fifteen years have not significantly increased the aggregate saving rate, because they have not changed saving behaviour with respect to retirement sufficiently (Disney *et al.*, 2001*b*). Notwithstanding a switch from Social Security pension contributions towards private pension contributions over the last

Figure 23. **Evolution of the household saving rate**



Source: OECD.

decades, the additional saving through personal pensions and in the holding of equities has been confined to individuals in the upper end of the income distribution, for whom it largely represented substitution between savings vehicles. Aggregate data do not show a significant rise in retirement saving, and none in total household saving (Figure 23).[75]

Regulating pension funds

A crucial element for the future attractiveness of the private sector pension vehicles will be an efficiently operating capital market, providing adequate protection for individuals. The 1995 Pensions Act established the Operational Pensions Regulatory Authority (OPRA) as the regulatory authority for the pensions industry, financed by a general levy on pension schemes. Every pension scheme has to appoint an auditor and an actuary, who must report to OPRA on the scheme's administration. The Act also established the Pensions Compensation Board (PCB), which administers a compensation scheme, funded via a specific compensation levy. This set-up regulates the operation of trustees and protects individuals in case of insolvency of the company and in cases of misbehaviour. It requires trustees to prepare and maintain a statement of investment principles specifying the strategic objectives of the pension fund according to a set of criteria on investments.

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A recent review found that in practice savers' money could be better invested, as capital is not well allocated (Myners, 2001). More specifically, the review pointed towards a lack of professionalism of trustees in charge of pension funds: most of them are not paid, do not have the required skills, and tend to rely on investment consulting firms for advice, whose performance is usually not reviewed. The design of the funds was also found to be poor. The time scale over which the fund performance should be assessed is too short (being quarterly or annual), the so-called "peer-group" benchmarks induce herd behaviour and risk control procedures lead fund managers to cling closely to stock market indices. Finally, charges are often unduly high, which may be partly due to the costs of broking commissions, which have so far been subjected to insufficient scrutiny.[76]

Against this background, the Government has established a set of principles for institutional investment decision-making, which have been gathered in a Code that will be reviewed in two years.[77] It also announced a series of measures, including most prominently:

– Legislation to require trustees to be familiar with investment issues.

– The requirement for trustees to establish a clear strategy for the funds, appropriately timed, and a regular assessment of the objectives and the associated risks.

– The reduction of regulatory obstacles to pension funds investing in private equity limited partnerships, by removing the requirement to invest through an FSA-authorised person.

– The incorporation of the principle of the US Department of Labor interpretative bulletin on shareholder activism into UK law, so as to enhance active fund management.[78]

– The abolishment of the minimum funding requirement (MFR) for pension funds and its replacement by a long-term scheme-specific funding standard, with additional protective measures, including a statutory duty of care for the scheme actuary, stricter rules on voluntary wind-up and extended compensation for fraud.[79]

Further reforms of the treatment of pension funds and other institutional investors may be on the horizon. The Government has launched a simplification of the regulation of private pensions, aiming at reducing the bureaucratic burdens on providers and making them easier to understand for scheme members. It has also set up a review of the market for medium and long-term retail investment, looking at two main issues: whether the consumer is well served with products that are low cost and offer attractive returns in relation to the risks involved; and whether the incentives for investment performance that operate in the industry lead to an effective allocation of capital.

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Reorganising financial supervision

There is no single model of financial services and market regulation in the world. Nevertheless, while the debate inevitably reflects country-specific factors, there have been reforms in many countries in recent years, mirroring the evolution of the structure of financial systems and the business of regulated firms. The decision to bring together various supervisory agencies was taken in the knowledge that linkages within the financial services industry had been growing for some time and that traditional functional distinctions between firms were eroding quickly. An integrated regulatory response was seen as the best option for addressing market changes in a way that was beneficial for consumers and appropriate for firms.[80]

Against this background, the United Kingdom opted for a highly integrated supervision model. In 1997, the Bank of England was granted a larger measure of independence and kept in charge of systemic stability, acting as the lender of last resort. The responsibility for prudential regulation and supervision of banks, however, was transferred to a new Financial Services Authority (FSA). The latter has also absorbed all the other specialised City regulators, including the Building Societies Commission, the Friendly Societies Commission, the Investment Management Regulatory Organisation, the Personal Investment Authority, the Register of Friendly Societies and the Securities and Futures Authority. It also took over the Treasury's supervision responsibilities for insurance. After a four-year transitional period, the FSA is now fully in charge of prudential as well as conduct of business regulation for all financial institutions.[81] It is one of the most powerful and centralised financial regulators world-wide, writing the rules, monitoring the industry, and handing out civil and criminal sanctions. It is also responsible for the listing authority function previously undertaken by the Stock Exchange. Its statutory objectives are to: *i*) maintain confidence in the UK financial system; *ii*) promote public understanding thereof, including awareness of the benefits and risks associated with different kinds of investment; *iii*) secure the appropriate degree of protection for consumers; and *iv*) reduce the extent to which a business carried on by a regulated person can be used for purposes relating to financial crime.

In principle, highly integrated supervision has several pros and cons. A possible problem is that the large field of competence might blur its objectives and strategy whereas sectorally specialised agencies might have been more focused and hence more effective regulators.[82] A single agency may also become overly bureaucratic and centralised, leading to "one-size-fits-all" type regulation. On the other hand, while a multiple-agency regime may create a potential for regulatory arbitrage and inconsistent regulation, a single agency should lead to homogeneous prudential requirements across different lines of business. From the point of view of the financial institutions, the focus on institutions rather than

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parts of them should trigger a more personalised supervision and a more efficient relationship with the regulator, avoiding the trap of a "box-ticking" approach to regulation. More globally, a single agency should have a better understanding and monitoring not only of individual financial institution risks but also of financial market risks as a whole. To avoid a one-size-fits-all approach, the FSA has divided supervised firms into four categories (A-D) on the basis of risks that these firms pose to the FSA's statutory objectives. The intensity of the supervisory regime will vary according to classification. The FSA's programme of risk-based supervision (Arrow) is designed to ensure this categorisation is kept under review. On site supervision and dialogue with firms is a long-standing feature of UK financial supervision. The FSA is building on this tradition.

On the operational side a variety of regulatory regimes will be replaced by one regime focused on meeting the four statutory objectives. The regulatory approach is intended to be flexible, focusing on issues, markets and firms where it is warranted by an assessment of the impact and probability of the risks these pose to the FSA meeting the objectives. The Rules and Guidance, which will apply to authorised firms, have been brought together in the FSA's Handbook. The regime makes clear the responsibility of firms' management for the conduct of their business. A firm must take care to maintain effective arrangements for compliance with requirements under the regulatory system. The regime for tackling market abuse has been changed. The market abuse regime will also allow the FSA to take action against individuals engaged in the misuse of information, the creation of false or misleading impressions or market distortion. Senior management will be directly responsible for the creation and revision of suitable compliance arrangements, as well as the implementation of management performance and risk assessment.

In introducing a wide-ranging new regime for all authorised firms, there have been concerns that compliance costs would rise. The United Kingdom has, however, put in place mechanisms to constrain such increases. There is a statutory obligation on the FSA to have regard to the costs it imposes being proportionate to the expected benefits. To this end, it must conduct a cost-benefit analysis of proposed rule changes. Regulatory initiatives must also be taken before statutory practitioner panels and practitioners are represented on the FSA Board. The FSA is also committed to publishing for comment all proposed rule changes and encourages industry participation at an early stage through discussion papers (FSA, 2001).

Although it is still too early to assess the merits of the new regime, a recent study came to mixed conclusions (Lascelles, 2001). On the one hand, it is perceived that the regime is becoming more legalistic and rule-driven, with increasing compliance costs. The relationship between the City and the FSA is also considered bureaucratic, resting on impersonal relationships owing to a high

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turnover in the FSA staff. On the other hand, there is no evidence that the City would have lost any attractiveness as the major European financial centre and there are a number of mechanisms through which firms can make representations to the FSA on a range of issues. However, a financial regime is most thoroughly tested when the economy enters a downturn or difficulties at large financial institution occurs. In this respect the FSA is currently coping with Equitable Life Assurance Society (Box 3) and the provisional liquidation of Independent Insurance.[83] Moreover, even before 11 September lower stock prices led a number of life insurers to come close to fail the resilience tests. They require these companies to meet all liabilities even if the value of their equity assets falls by 25 per cent. Following the further sharp stock market decline after 11 September the FSA relaxed part of this rule, because it did not want to force insurers to sell equities as a result of market volatility which had reduced equity values to a low point relative to long term trends. The key part of the resilience test (namely a requirement to consider further potential falls by reference to trends in company earnings relative to fixed interest yields) is though still in place and is designed to strike a balance between the objective of protecting balance sheets against adverse movements in equity values (relative to long-term trends) and maintaining market confidence. This episode shows that the rules of the resilience test do not work well as they were waived as soon as they became binding and the change in rules encourages weaker life insurers to take greater risks by staying in equities.

One of the main innovations introduced in 1997 is the separation of the function of banking supervision from that of the lender of last resort (LORL), for which the Bank of England continues to be responsible. Advocates for a narrow role of the central bank argue that it should only provide liquidity to the market through large operations, when faced with systemic risk, on the grounds that the market will efficiently allocate liquidity to worthy institutions. Yet, the web of adverse externalities and risks of contagion in financial crises provides a case against pure *laissez-faire*.[84] Indeed, not that long ago, in 1984, the Bank of England rescued a private bank.[85] More recently, in 1991, it intervened in response to pressure on the interbank market, resulting from a number of clearing banks' withdrawal of funds from smaller banks and building societies. It was also called upon in the later scandals of the BCCI and Barings, although in those cases no rescue actions were taken.

Admitting a role for the central bank as a LOLR raises the question of the gains from linking this function with prudential supervision. The latter will confer a high level of knowledge of each institution's financial situation, which in turn could be used to assess the health of the overall financial system. Should the LOLR be deprived of this information, it could be argued that it should lend funds only to institutions that could readily borrow them in the free markets. Against this background, the Treasury, the Bank of England and the FSA signed a memorandum of understanding in October 1997. The latter requires the FSA to provide the Bank

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Box 3. Equitable Life

The facts

Equitable Life is one of the major UK mutual societies, selling life insurance and pension products. Until 1988, it sold policies with a guaranteed annuity rate (GAR) of 7 per cent. This might have looked reasonable at the time but in the 1990s interest rates declined, and GAR rates began to exceed rates available in the open market in 1993. While the problem was short lived as annuity rates soon rose again, Equitable responded to the possibility of recurring problems by introducing a policy of differential bonuses. The effect was to allow annuitants to draw the same income from the same value of fund, regardless of whether the annuitant had a GAR contract or not. This policy became effective again from the middle of 1997, as the GAR became valuable when set against the background of declining annuity rates. Some GAR policyholders contested the policy of the Society and took it to court. The House of Lords decided in July 2000 in favour of GAR annuitants: they were entitled to the same bonus as non-GAR policyholders and an annuity based on their guaranteed rates. The House of Lords also ruled against any "ring-fencing" of the liability within the GAR policyholders. This gave rise to potentially significant extra costs for the society. It decided that it would meet these costs by withholding further allocations of final bonuses for seven months in 2000. It then sought a purchaser, believing that the proceeds from the sale would enable the society to restore the withheld bonuses. However, no offers were received for the whole of the business. The society decided that it should close to new business and subsequently sold part of its business operations to Halifax Group for £500 million with up to a further £500 million payable contingent on certain outcomes being achieved, such as policyholders giving up guarantee.

Some questions for the new framework

The Equitable Life case is a test for the prudential supervision framework, raising questions as to the protection and awareness of consumers, the monitoring of financial institutions and the procedures of the FSA.

On the client side, savers have seen the value of their funds cut by a large amount, which might even grow whilst a solution is looked for. The consumers' disarray illustrates their lack of understanding of financial products. At a time where the State is increasingly transferring the responsibility of pensions to the private sector, it underlines the necessity of putting in place appropriate consumer protection, adviser training and disclosure rules. The more educated the consumer and the better financial disclosure regulation, the greater will be market discipline in complementing and/or replacing regulation.

The affair also raises questions concerning supervision procedures. The Treasury Select Committee of the House of Commons reported in March 2001 that the prudential regulator should have raised the issue of GAR, as they were defined, as early as 1993. It also uncovered deficiencies in the account reports, with differences between the statutory accounts and the documents for the regulators.

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Box 3. **Equitable Life** (*cont.*)

Overall, the efficiency of prudential supervision is put into question, regarding both its ability to identify risks and its speed to react to events and to put subsequent procedures in place, both for consumers and for the firm's management. The Equitable Life problem has been investigated by the FSA, which has published a report and drew recommendations for the life insurance industry (FSA, 2001). More particularly, the report recommends that the FSA:

- Restructures the current prudential framework so that the required minimum capital reflects all the risks in the business.
- Adopts a more proactive attitude towards regulation and the assessment of risk.
- Increases communication within the different divisions of the FSA, more particularly those concerning prudential supervision, conduct of business and customers' interests.
- Reviews its rules on disclosure so as to strike the right balance between preserving some confidentiality in the interest of maintaining financial stability, operating in a transparent manner, and satisfying customer information requirements through meaningful public disclosure. To this aim, the information provided by firms should be enhanced to be timely and sufficient to assess the risk of customer detriment.

free and open access to supervisory records, cross-sitting of FSA and Bank top management in their counterparty's governing body and monthly meetings of a standing committee of the institutions' top managers.

Controlling the stability of the financial system also rests on monitoring reserves and capital. The new framework will be the so-called draft Basel II Accord, published in January 2001 and currently open for consultation, with a view to coming into effect in 2005. It relies on three pillars: *i*) new capital requirements for credit risk plus an operational risk charge; *ii*) supervisory intervention when a bank's risk profile warrants it; *iii*) greater disclosure to enhance market discipline. Compared with the 1988 Accord, capital requirements will be much more closely tied to the riskiness of particular exposures. Greater allowance will be made for credit risk mitigation, be it in the form of guarantees or as regards recognition of securities as collateral. Banks will slot assets into weighting bands according to ratings delivered by eligible rating agencies, or will use their internal risk assessment models if they have the supervisor's imprimatur. Under the latter approach, books that are more concentrated than average will carry higher capital requirements, and *vice versa* (Jackson, 2001). Operational risk stemming from fraud,

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IT failures, legal problems and the like were traditionally subsumed within the overall credit risk requirement, but will now be treated separately.

Under the second pillar, prudential authorities will have to gauge the quality of risk assessment within an institution, which is likely to be a difficult task. Finally, both the measures of risks and the methodology chosen for their assessment will be publicly disclosed, acting as a signalling and enforcing device. Although this should enhance risk monitoring and transparency, it will require a significant investment for banks in human resources. Indeed, a recent report rang the alarm bell on the lack of preparation of UK institutions with respect to Basel II, especially concerning the initiation of operational and credit risk assessments (KPMG, 2001*a*). Set against this, it should be noted that the UK supervision regime already operates a well-developed form of supervisory review and takes operational risk issues into account when assessing systems and controls and in setting minimum capital ratios for banks. UK banks are well capitalised compared to the minimum 8 per cent international benchmark for capital to risk weighted assets. Compliance with Basel solvency requirements is not problematic. As in many countries, many institutions are considering the extent to which they might want to use some of the more advanced options for determining credit and operational risk capital charges. The FSA does not believe there is evidence to suggest that UK banks have specific difficulties *vis-à-vis* banks from other G10 countries. Implementation of the Basel Accord in the United Kingdom will depend critically on the timely implementation of directives at the EU level. Delays in implementation could lead to an uneven competitive playing field *vis-à-vis* the United States and Japan.

While risk management will probably improve under the new regime, challenges could lie ahead. In the event of a recession bank profitability declines because of write-offs and provisions, while more borrowers are subject to default, hence raising the measured risk of banks and therefore capital requirements. Thus, risk assessment will need to be forward-looking and be able to distinguish between the effect of the business cycle from the underlying risk trends (Clementi, 2001).

Assessment

Investing in human capital yields benefits to individuals in the form of additional earnings, improved employability and stronger attachment to the labour market and to society as a whole. Spending on teaching and infrastructure has been stepped up significantly, and specific targets for educational achievements have been set. It will take time for these changes to yield aggregate benefits, and further progress is needed in some respects, most notably for the 11 to 14 year-olds and for older age groups. Bottlenecks in hiring educational staff persist and a more radical reform of the payment scheme may be needed.

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The pursuit of a very active labour market policy has contributed to raising labour supply somewhat. Preliminary evidence on the earliest New Deal schemes suggests that they do raise the probability of finding a job, even though dead-weight losses are considerable and some options may need to be redesigned. Moreover, many long-term unemployed have faced difficulties in remaining in a job. This has been addressed by the changes to the NDLTU in April 2001. Also the recently increased national minimum wage has made joining the labour market more attractive for the low-skilled. Within a buoyant economy, it has contributed to reducing the gender gap and, to a lesser extent, inequality in pay. While it has raised wages and inflation marginally, there is no evidence so far of adverse labour demand effects.

The high level of poverty is of great concern, and is being addressed by a range of policies to raise employability (the WFTC in October 1999, the CTC in April 2001 and the NMW in April 1999) and by providing more transfers to the least well-off. Public transfers to low-income households reduce both poverty in the short term and poverty persistence. Tax credits support this process by enhancing attachment to the labour market. The low take-up rates for a number of benefits probably reflect the complexity of the system. The interaction between the various schemes and the high degree of means -testing of benefits imply that the low-paid can face very high marginal tax rates and get caught in poverty traps. The prevalence of high marginal income tax rates (METRs) has declined with the introduction of the WFTC, however. On the other hand, the number of sick and disabled benefit claimants is very high, and recent measures are unlikely to reduce entry into the disability scheme much. Compared to the extent of the reforms undertaken to make work pay and to put people back into work, results in terms of poverty reduction have yet to emerge.

Poverty had also been an important issue for pensioners, but the Minimum Income Guarantee has increased the income of the poorest pensioners. The pension system is undergoing an important transformation, which will have important implications for the level of future pensions. The continued growth of personally financed pensions, especially the introduction of stakeholder pensions, should encourage more pension saving. An immediate concern is to ensure that individuals put aside enough money to obtain an adequate replacement rate. Another option that could be considered in the longer term to encourage people to save for retirement would be to increase the level of contributions above that required for BSP and SERPS. A more permanent issue is the trade-off between increasing returns from investing in risky assets and consumer protection. In this respect a robust regulatory and competitive framework for the financial institutions is needed and the recent recommendations of the Myners report should be implemented swiftly.

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The Competition Act 1998 was a major step towards raising the effectiveness of competition policy. As it was only fully enacted in March 2000, it is too early for a full assessment. More recently, this reform was complemented by a major review of merger procedures and the proposal to criminalise cartel activities, both of which are welcome. Regarding the regulation of utilities, their regulatory remit appears too wide and their costs have increased steeply. Several proposals for reforms have been put forward. One option would be to reduce their field of competency, by handing back environmental and social issues to the relevant ministries. Similarly, it is unclear whether there is still a need for special sectoral competition-policy regimes, given that competition law has become stronger and the regulators have the power to apply it (OECD, 2002).

At the same time, Company Law is being overhauled. A comprehensive strategy has been developed to replace the former piecemeal approach. The proposed default regime for private companies will provide a lighter and clearer governance framework. For public companies, scrutiny by shareholders will be enhanced, through a higher level of disclosure and better AGM practices. Yet, some long-standing issues have not been tackled, for instance, the rather weak link between performance and remuneration at the managerial level.

Innovation and entrepreneurship should not be impeded by fear of failure. The reform of the Insolvency Law, by distinguishing reckless managers from others, goes in the right direction, even though it may not be easy to make this distinction in practice. Entrepreneurship is also supported by the efforts to reduce red tape, schemes aimed at raising R&D and venture capital and the implementation of tax changes in favour of SMEs. While some policy initiatives appear to be successful there is a multiplicity of schemes and bodies that focus on both small enterprise issues, and overall regulatory issues, which has led to a great complexity of the business environment. The Government has stated its intention to simplify the regulatory framework and should follow up with concrete measures to address the current complex system. Moreover, the benefits from these initiatives should be weighed against the potential distortions to competition and revenue shortfalls.

In the financial sector, the sectoral regulators were replaced by a new single authority, the FSA. This will integrate regulation across sectors at a time of increasing cross-sectoral convergence. It also means that banking supervision and the lender of last resort function of the Bank of England are now separated. A potential risk would be that the lender of last resort is not sufficiently well informed about the development of financial institutions. This issue has been addressed by a memorandum of understanding between HM Treasury, the Bank of England and the FSA, regular, formal and informal, contact between the institutions. There is no consensus on the best model for regulating financial markets. On the other hand, the advantage of a single big regulator is that it focuses on all

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of the financial risks of a financial institution, yet it may also become more bureaucratic and engender higher compliance costs. One early assessment of the FSA has argued along these lines, but the FSA is subject to mechanisms for ensuring that compliance costs are constrained. The FSA has currently to cope with the troubled Equitable Life company and the provisional liquidation of Independent Insurance. A tougher test for the robustness of the new framework could soon come, if the economy were to enter a more protracted slow-down, as part of the business sector is highly indebted. The FSA has already effectively relaxed the resilience test rules concerning equity holdings of life insurers in view of the downward pressures on equities.

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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.

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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).

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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).

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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.

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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.

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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-

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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:

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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.

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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.

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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.

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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.

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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

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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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Table of contents

Assessment and recommendations 9

I. Macroeconomic performance and prospects 21

Output: imbalances have built up 21
Low unemployment 25
Inflation was subdued, but has picked up recently 27
The near-term outlook and risks 29

II. Macroeconomic policy 33

Monetary management 33
The fiscal stance 43

III. Raising productivity to enhance potential growth 51

Building up human capital and raising work incentives 55
Enhancing innovation and competition 68
Improving financial intermediation 77
Assessment 88

IV. Managing public expenditure 93

Trends in public expenditure and forces shaping them 93
Implementing the new budgetary framework: progress to date 101
Involving the private sector in public services 114
Mobilising sub-central governments 124
Summing up 126

Notes 131

Glossary of acronyms 142

Bibliography 144

Annexes

I. The foot-and-mouth crisis 152
II. The pound's "fair" value 155
III. The reverberations of the oil price shock 159
IV. Asset-based welfare 162
V. Interaction of some benefit expenditures 164
VI. The medium-run framework for fiscal policy: some theoretical considerations 165
VII. Reforming the National Health System: recent progress 167
VIII. Calendar of main economic events 169

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Boxes

1. The IT New Deal 61
2. Main elements of the pension system and recent changes 79
3. Equitable Life 86
4. The Public Service Agreements 110
5. Aims, objectives and targets in Public Service Agreements – an example 112
6. Privatisation of the railways industry 115
7. The Millennium Dome 122
8. Synopsis of recommendations 128

Tables

1. Recent outcomes and short-term projections 30
2. Public sector finances: selected summary indicators 45
3. Key fiscal aggregates on a national accounts basis 46
4. Structural reform recommendations and follow-up 52
5. Educational attainment 56
6. New Deal summary statistics 62
7. Social Security benefits and related tax credits 67
8. Public sector outlays by function 96
9. Structure of government outlays by function in OECD countries 97
10. Public sector outlays by economic category and sector 100
11. Medium-term public sector finances 102
12. Meeting the Maastricht deficit ceiling in the medium term 104
13. Medium-run growth performance 105
14. Spending Review 2001: Resource and capital budgets 106
15. The 1998 and 2000 Spending Reviews: projections and outturns to date 109
16. Private finance deals for public infrastructure and other services 118
17. Capital spending by the private sector for signed PFI deals 120

Annex

A1. Alternative estimates of the pound's "equilibrium" value 158

Figures

1. Growth 22
2. Sterling real effective exchange rate 23
3. Household wealth 24
4. External trade 26
5. Unemployment 27
6. Inflation 28
7. Interest rates 34
8. MPC GDP projections 35
9. Projected *versus* observed RPIX inflation 36
10. Dynamic monetary condition index 38
11. Money and credit 39
12. Drifting apart 41
13. Fiscal position with respect to the Maastricht criteria 44
14. Investment in human and physical capital 51
15. Literacy and numeracy 56
16. Labour market indicators 59

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17. Poverty 65
18. Redistribution effect of the welfare system 66
19. Total fixed investment, excluding housing in selected G7 countries 69
20. Utility prices 75
21. Investment and saving 78
22. The pension system 80
23. Evolution of the household saving rate 81
24. Public sector expenditure, receipts and balance 94
25. Actual and cyclically-adjusted general government expenditure 95
26. Health and education expenditure 99
27. General government gross investment 100
28. Change in the departmental shares in aggregate discretionary expenditures 107
29. Structure of the railway industry in the United Kingdom 117
30. Tax receipts and expenditure by regional and local governments 124

Annex

A1. Key exchange rates 156
A2. Sterling *versus* the euro and the dollar 157
A3. Oil price 160

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BASIC STATISTICS OF THE UNITED KINGDOM (2000)

THE LAND

Area (1 000 km²):	
Total	241
Agricultural (1997)	187
Major cities (thousand inhabitants, 1997):	
Greater London	7 122
Birmingham	1 014
Leeds	727
Glasgow	612

THE PEOPLE

Population (thousands, mid-2000)	59 756
Number of inhabitants per km²	248
Net increase in population, 1997-2001, estimated annual average (thousands)	154
Total labour force (thousands)	29 572
Civilian employment (% of total):	
Agriculture, forestry and fishing	1.5
Industry and construction	25.1
Services	73.1

PRODUCTION

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

THE GOVERNMENT

Public consumption (% of GDP)	18.5
General government (% of GDP):	
Current and capital expenditure	37.0
Current revenue	39.0
Net debt	33.1

Last general elections: 7 June 2001

Composition of House of Commons (number of seats):	
Labour	410
Conservatives	164
Liberal	52
Ulster Unionists	6
Other	27
Total	659

FOREIGN TRADE

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