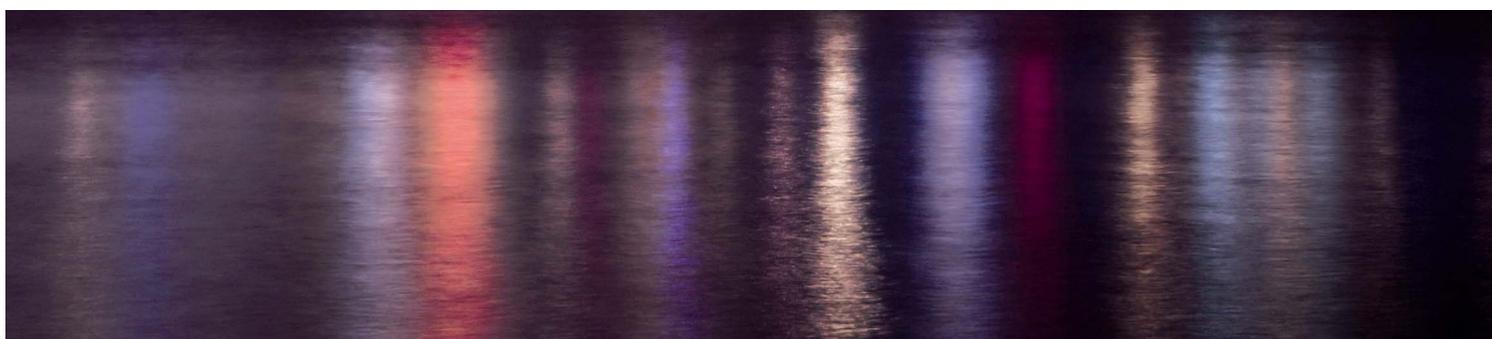




OECD Economic Surveys UNITED KINGDOM

MARCH 2011

OVERVIEW



Summary

The UK economy emerged from the 2008–09 recession with elevated public and private debt and high unemployment. Strong growth and macroeconomic stability in the run-up to the crisis had hidden a build-up of significant imbalances, influenced by overreliance on debt-finance and the financial sector, and booming asset prices. These imbalances need to be addressed to ensure a sustainable and balanced recovery. The government is pursuing a necessary and wide ranging programme of fiscal consolidation and structural reforms aimed at achieving stronger growth and a rebalancing of the economy over time.

A broad based recovery started in end-2009, but faces significant headwinds during 2011, which can be mitigated by monetary policy remaining supportive. The planned fiscal consolidation is needed to ensure that the fiscal position will be sustainable over time. Nonetheless, it adds to the headwinds from weak real income growth and a fading rebound in global trade. Monetary policy should hence remain expansionary, even if headline inflation is significantly above target, to support the recovery.

While the government's fiscal plans and reforms to the fiscal policy framework have significantly reduced fiscal risks, further improvements to the fiscal framework and reforms to make the financial sector more robust are needed. The government has embarked on an ambitious and necessary fiscal adjustment and strengthening of fiscal institutions, including the welcome creation of the Office for Budget Responsibility. Steps towards establishing a permanent fiscal framework should start to be undertaken as the public finances are returned closer to balance. The creation of a Financial Policy Committee will strengthen macro-prudential policy, but further steps are needed to deal with banks that are “too big to fail”.

Reforms to housing policy should aim to increase affordability and mitigate excessive house price volatility by enhancing the supply of available land and reducing the volatility of housing demand. Rigid housing supply and fast-rising demand have fuelled house prices, reducing affordability and contributing to macroeconomic and financial instability. Policies to increase supply should focus on lowering barriers to access to land for housing and providing sufficient incentives for local communities to allow development. The current system of housing taxation is regressive, encouraging excess demand for housing and should be modified to better reflect the value of ownership.

Further reforms are needed to improve education outcomes in England, especially among disadvantaged groups. Despite significantly increased resources, education performance in England measured by PISA scores remains static and uneven, and could be improved by focusing resources more on disadvantaged children. The new pupil premium is a step in the right direction, but funding should be even more transparent. Higher and more equal autonomy across school types, in terms of hiring and pay, would support efficient deployment of resources. The quality of vocational training should be increased. Legislated tuition fee reforms could be taken further to lower fiscal costs and expand tertiary education.

To meet ambitious climate change targets and reduce emissions, higher and more consistent carbon prices are needed. Climate change is a global challenge, and working for higher, more broadly based and stable carbon prices within the European Union should be a priority. Domestic carbon pricing policies need to be harmonised and streamlined in terms of programmes and prices. More stable conditions for renewable energy providers would support deployment, but more R&D support for new technologies may be needed. Adaptation planning needs to proceed and focus initially on low-regret investment.

Assessment and recommendations

The economy is recovering but headwinds are significant

1. The global financial crisis and the associated recession ended a 15-year period of continuous growth, rising employment and stable inflation. Significant imbalances had developed, however, in terms of public and external deficits, an excessively leveraged financial sector, high house prices and low household savings. The imbalances exacerbated the downturn during the global recession and contributed to a more pronounced fall in GDP, a larger fiscal deficit and higher inflation than in most of the OECD. A wide range of policies were introduced to support the economy and the financial sector, some of which are now being scaled back.

2. The broad based recovery that started in end-2009 slowed in the second half of 2010. The recovery is likely to remain subdued in 2011, as the necessary fiscal tightening and a fading rebound in world trade create headwinds, before picking up again in 2012. With general government net lending close to 11% of GDP in 2009, a substantial tightening was vital to achieve a sustainable fiscal position and reassure investors. Fiscal consolidation will impact significantly on government consumption, investment and household income growth in 2011–12. Financial conditions are improving, but the financial sector continues to benefit from crisis-related support schemes and ultra-low policy rates which will eventually be withdrawn. Slow real income growth will hold back household consumption. The response of net trade to the depreciation of sterling and the recovery in export markets has so far been disappointing, although manufacturing exports have picked up strongly from a low base. But, as service exports start to recover, relative export performance is set to improve. Investment has also started to pick up and is likely to grow stronger in response to shrinking excess capacity in manufacturing and low levels of housing investment. All in all, a subdued recovery is expected over the next two years, largely driven by a rebalancing of the economy towards rising net exports and increasing investment.

3. The labour market has proved to be comparatively resilient in the recession, although unemployment has risen. Labour market adjustment comprised a significant fall in real wages due to high inflation, but also due to nominal wage restraint and shorter average working hours. The labour market recovery is expected to be slow, reflecting a subdued recovery, spare capacity among firms and shrinking public employment. Unemployment is expected to fall gradually. Low skilled workers and youth have been particularly hard hit during the recession, pointing to the importance of maintaining efficient employment services, strengthening work incentives and improving educational outcomes.

Table 1. Main economic indicators for the United Kingdom

Percentage changes from previous period, unless indicated

	2009 Current prices £ billion	2010	2011	2012
Gross domestic product	1 395.0	1.4	1.5	2.0
Consumption				
Private	910.6	1.1	1.0	1.8
Government	326.9	1.1	-1.7	-1.7
Gross fixed capital formation	203.6	2.8	3.6	4.2
Public sector	41.1	1.5	-11.7	-5.2
Residential	41.3	3.9	8.8	3.3
Business	121.3	2.8	7.0	7.1
Stockbuilding ¹	15.0	1.1	0.2	0.0
Total domestic demand	1 424.7	2.4	1.1	1.4
Exports of goods and services	390.9	5.2	6.0	6.4
Imports of goods and services	420.6	7.9	4.0	4.0
Foreign balance ¹	-29.7	-0.9	0.4	0.6
Current account balance ²	-23.9	-2.3	-2.4	-2.0
Output gap ³		-4.6	-4.5	-4.0
Consumer price index		3.3	3.3	1.8
Harmonised underlying inflation		2.9	3.3	1.8
Unemployment rate ⁴		7.8	7.7	7.5
Net households saving ratio ⁵		-0.0	-1.0	-1.1
Government financial balance ²		-9.9	-8.8	-7.2
Gross Government debt ^{2,6}		81.6	89.7	96.2

1. Contribution to GDP growth.
2. As a percentage of GDP.
3. As a percentage of potential output.
4. As a percentage of labour force.
5. As a percentage of disposable income.
6. National accounts definition.

Source: Update, based on the national accounts data released in late January 2011, of the projection presented in the *OECD Economic Outlook No. 88*.

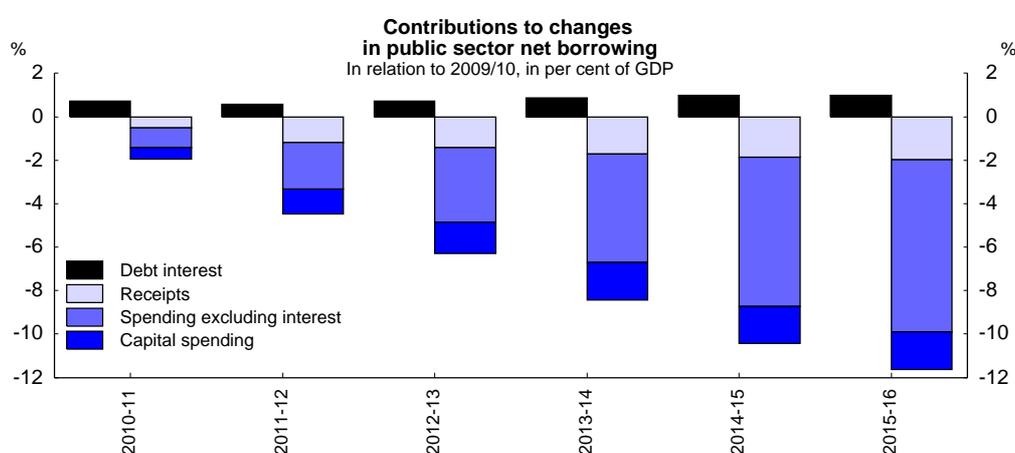
4. Significant global and domestic risks remain to the projection. Household consumption may be weaker than expected in response to sluggish growth in real incomes, a further fall in housing prices or faster-than-expected increases in interest rates. Exports may recover slower or faster, reflecting uncertainty about global demand and the longer term impact of the depreciation of sterling on exports. Furthermore, the ability of financial sector exports to recover their pre-crisis level is uncertain. Business investment may, on the other hand, recover more strongly than expected.

5. The government is pursuing a necessary and wide ranging programme of fiscal consolidation and structural reforms aimed at achieving stronger growth and a rebalancing of the economy over time. As discussed below, reforms to improve educational outcomes and the functioning of the housing market could raise productivity and long term growth. A simpler welfare-benefit system with stronger work-incentives and stronger support for activation, as outlined in the planned Universal Credit reform and the new Work Programme, could improve labour market outcomes. Furthermore, the required fiscal consolidation will imply that private sector activity will need to lead the recovery. The government has announced reforms to corporate taxation aiming at lowering firms' tax burden. The ongoing Growth Review needs to address a range of obstacles to private sector growth.

Needed fiscal consolidation has started

6. The fiscal position was weak coming into the recession and worsened rapidly as output dropped and the deficit reached almost 11% of GDP in 2009. In 2010 the fiscal situation started to improve, with temporary support measures ending, initial steps towards fiscal consolidation taken and growth resuming. The government has stepped up the pace of consolidation which has significantly dampened fiscal risks. Altogether, fiscal consolidation, measured as the improvement in the cyclically-adjusted balance, amounting to 8.5% of GDP is planned between 2009/10 and 2015/16. Net debt in relation to GDP is predicted to peak at just below 70%. While fiscal risks remain, the announcement and initial implementation of the consolidation programme strikes the right balance between addressing fiscal sustainability and thereby reducing tail-risks on the one hand, and preserving short-term growth on the other.

Figure 1. Fiscal outlook and consolidation



Source: OECD, *OECD Economic Outlook 88* database and Office for Budget Responsibility.

7. Although the government is undertaking significant reforms, the economic efficiency of the tax and spending system could be improved. The United Kingdom has one of the least efficient VAT systems in the OECD, reflecting widespread application of reduced and zero rates. The VAT system became even more unbalanced when the standard rate was increased from 17.5% to 20% in January 2011 while low rates and exemptions remained unchanged. *Ending exemptions and increasing lower rates would provide a more efficient system and raise more revenues, while targeted measures should be directed at compensating poorer households.* Further efficiencies and savings could also be reaped on the spending side by addressing remaining inefficiencies in health care *through addressing excessive remunerations and by increasing competition in health care provision.* Although the government has tried to focus public investment on projects with high economic returns, the large cuts in public investment are a risk to long-term growth. *Channelling more resources to public investment would be warranted, as long as projects offer a viable rate of return. Efficiency-increasing fiscal measures should be in line with the existing profile of fiscal consolidation.* The government has announced that the increase in the state pension age to 66 years will be brought forward to 2020. *To deal with rising pension costs, a further increase of the effective retirement age should be sought, for example by increasing the State pension age further. Given the political costs related to discretionary changes in the pension age across OECD countries, an automatic adjustment in line with longevity should also be considered.*

The work on a permanent fiscal framework should be a priority

8. The United Kingdom's previous experience with fiscal rules failed to avert a deterioration in its structural fiscal position. It is therefore encouraging that the government has instituted a set of fiscal policy framework reforms. These include a new fiscal mandate and the creation of an independent Office for Budget Responsibility (OBR), which is in charge of macroeconomic and fiscal forecasting and of

evaluating whether the government's policies are in line with its mandate and supplementary debt target. The OBR will support the consolidation process, improve the quality and credibility of information and lay a sound basis for the forward-looking framework.

9. The fiscal mandate of reaching a cyclically-adjusted balance by the end of a rolling five-year horizon sets an ambitious target, while allowing automatic stabilisers to work fully in response to cyclical fluctuations in activity. Like all forward-looking rules, the framework could be vulnerable to back-loaded consolidation, whereby governments follow lax fiscal policies but promise future prudence. *During the current parliament this does not seem to be a problem given front-loaded fiscal consolidation plans, but a future permanent medium-term framework might best ensure constraints on a shorter horizon than five years, as already suggested by the government.*

10. In due course, the current mandate aimed at the necessary fiscal consolidation should be replaced by a permanent fiscal framework. *For the permanent fiscal framework the rolling five-year horizon should be retained to minimise time inconsistencies. The framework should also include a larger share of total spending than currently under an expenditure ceiling (leaving out only the most cyclical components) and a forward-looking deficit target. The target should also be set to ensure long-term fiscal sustainability, for example through a debt level target. The OBR should continue to be charged with independently monitoring the consistency of the government's fiscal policy with its mandate and targets.*

11. By setting up the OBR with a remit to produce the official macroeconomic and fiscal forecasts, the government has addressed one element behind previous fiscal indiscipline in both the United Kingdom and other OECD countries. The OBR's responsibility for forecasts and evaluating whether current policies are consistent with the fiscal targets makes it highly involved in the budget process. In the current setting, the government is responsible for analysing the fiscal impact of new policies and the OBR for judging whether announcements are sufficiently firm and detailed to incorporate in their forecast. Given the current division of labour, the OBR seems reasonably staffed. *However, if the remit was widened or the OBR took a more active role in policy costing, more resources would be needed.*

Monetary policy should remain expansionary but inflation expectations have to be watched closely

12. Inflation has remained above the Bank of England's (BoE) 2% target during most of the last few years, initially reflecting rising energy prices and high levels of capacity utilisation and later rising import prices due to the depreciation of sterling, rising energy prices and changes in the VAT rate. The underlying rate of inflation, excluding effects from taxes, reached a trough in early 2010 and is now above 2%. Headline inflation will be boosted all through 2011 by the VAT increase, but is then likely to subside and remain below the target through 2012.

13. With policy rates close to zero, quantitative easing (QE) at £200 billion (14% of GDP) and liquidity schemes still in place, monetary policy is highly expansionary. This is appropriate given the large output gap, the modest underlying inflation rate and significant headwinds from fiscal contraction and lingering credit constraints. *From this perspective, policy rates should rise only slowly from mid-2011 onwards as long as inflation expectations do not drift too far from the target. QE should be withdrawn in an orderly and pre-announced fashion once policy rates have risen from their current low level. The BoE will, however, need to react sooner if inflation expectations begin to rise considerably or feed through to significant wage increases.*

Despite progress, more financial sector reforms are needed

14. The UK financial system was severely affected by the financial crisis, which exposed weaknesses in the supervisory, crisis management and resolution frameworks. The authorities have addressed some major weaknesses: the deposit insurance has been strengthened, liquidity management has been reinforced and a special resolution regime for deposit-taking institutions has been established.

15. The United Kingdom will need to implement the Basel III agreement and European Union legislation enhancing European supervisory architecture and crisis resolution mechanisms. In addition, a new national regulatory framework is being put in place giving the BoE a clear mandate to monitor risks in the financial system as a whole, along with instruments to ensure financial stability. A new Financial Policy Committee in charge of macro-prudential regulation and a Prudential Regulation Authority in charge of micro-prudential regulation will be established within the BoE. A separate Financial Conduct Authority will regulate conduct in financial services and markets. These reforms improve the regulatory and supervisory framework significantly, but leave the “too-big-to-fail” problem to be addressed. The government-appointed Independent Commission on Banking (the Vickers commission) is due to give recommendations in September 2011 on measures to reform the banking system and promote stability and competition, including the issue of separating retail and investment banking functions. Several instruments can be used to encourage “too-big-to-fail” institutions to take fewer risks, including bank levies and additional capital requirements. *More radical reforms, such as breaking up major banks or building a “firewall” between higher risk investment and commercial banking could also be considered.*

The new financial architecture needs to be put in place rapidly

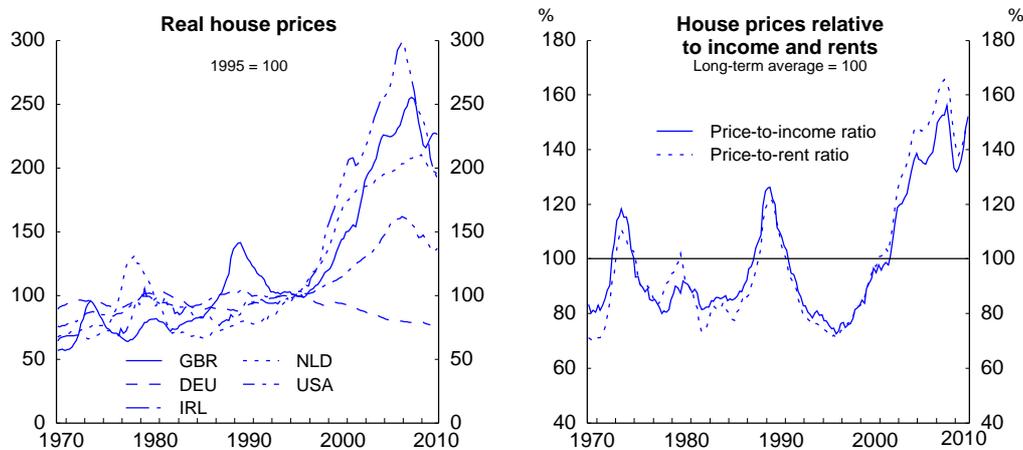
16. Financial reforms will be phased in over several years and successfully implementing new rules will be challenging for regulators. It is essential that the momentum for reform is maintained as memories of the crisis fade and as lobbying from the financial sector tries to loosen regulations. Macro-prudential policy instruments will need to be defined and implemented rapidly.

17. Limiting leverage, that aggravated the impact of the crisis, should be a priority. Capital adequacy ratios based on risk-weighted assets have promoted capital arbitrage, allowing banks to reduce risk-weighted assets using off-balance sheet vehicles and derivatives, increasing leverage and risk-taking. *The leverage ratio should cover all relevant assets, including off-balance sheet exposures. Financial authorities also need to minimise regulatory arbitrage by ensuring consistent regulation of non-bank financial institutions, such as pension funds and insurance companies. They also need to react promptly to evolutions in the relations between traditional banking and “shadow banking” which have played a prominent role in the global financial system in recent years.*

Tight housing supply hampers affordability and increases volatility

18. A combination of favourable economic and financial conditions and a tight housing supply led to sharp increases in real house prices in the United Kingdom between the mid-1990s and the end of 2007. This resulted in a significant deterioration in affordability and high housing market volatility, which affects the wider economy through various channels. Construction constitutes a volatile and labour-intensive sector of the economy, which contributed significantly to output and job losses during the recession. Unsustainable developments in the mortgage market have also put substantial strains on the financial system.

Figure 2. Housing prices

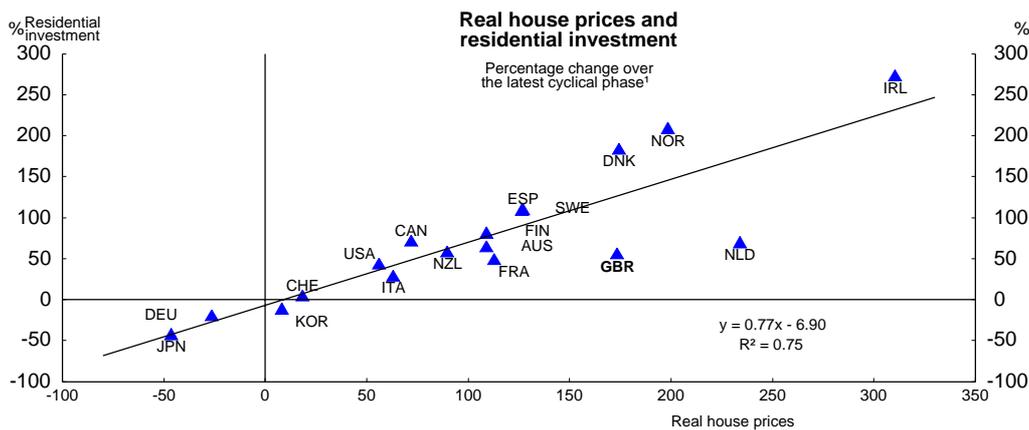


Source: National sources and OECD calculations.

More flexible planning regulations and reviewing Green Belt designation would increase land availability

19. The response of housing supply to demand in the United Kingdom has been one of the lowest among OECD countries over the last 20 years. Hence, making the land use planning system more flexible, more predictable and more responsive to market signals, without compromising its social and environmental objectives, is essential. Even though England is a high-density country, especially in the South, there is scope to make more land available for building houses. In particular, Green Belts constitute a major obstacle to development around cities, where housing is often needed. *Replacing Green Belts by land-use restrictions that better reflect environmental designations would free up land for housing, while preserving the environment.*

Figure 3. Housing supply is unresponsive to demand pressures



1. The latest cyclical phase corresponds to the expansion that ended in 2006-2007 for most countries. For Japan and Germany, it corresponds to the ongoing downturn.

Source: DCLG tables 244 and 401, *OECD Economic Outlook database* and national sources.

Providing local communities with sufficient incentives will be key to raising housing supply

20. The new government has launched a major overhaul of the planning system, replacing top-down building targets with incentives for local communities to allow development. In that context, setting the right level of incentives for local authorities is essential. In the light of often strong local resistance to new construction, it remains to be seen whether the incentives provided by the government, including the New Homes Bonus, will be sufficient to generate numbers of planning permissions compatible with increasing demand. *The evolution of housing completions should be monitored very closely and the level of incentives revised if needed. After the recent removal of the regional level of planning, ensuring the continuity of strategic planning of infrastructure and public services is also crucial.*

Housing taxation should be reformed to improve efficiency and curb price swings

21. The council tax is regressive and based on outdated valuations, while the stamp duty penalises mobility by increasing transaction costs. *Ideally, the current council tax and stamp duty should be replaced by a property tax based on market values. As a first step, the council tax could be based on regularly updated property valuations. Furthermore, linking the property tax to market values could substantially dampen cyclical fluctuations of house prices, as rising prices would result in higher taxes, which would slow housing demand growth.*

Focusing pre-school spending in England on disadvantaged children could improve equality and efficiency

22. Providing high-quality pre-schooling to children from disadvantaged backgrounds can yield high social and economic returns and support social mobility, which appears low in the United Kingdom. The accumulation of both cognitive and non-cognitive skills during early childhood has high knock-on effects, and complementarities for later skill-formation. Enrolment in pre-schooling has expanded rapidly in England, fuelled by the Sure Start and the Early Years programmes.

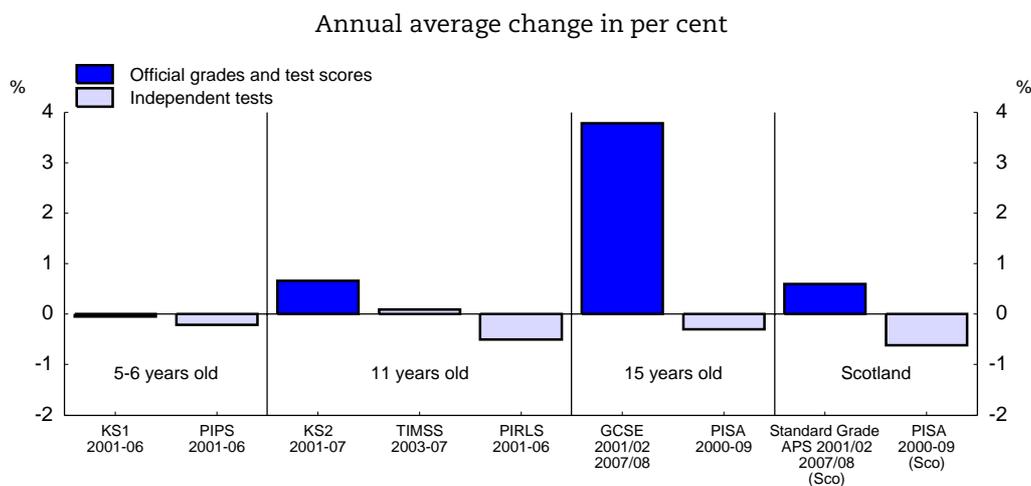
23. There is mixed evidence on the effects of the expansion of pre-schooling in England. In general, disadvantaged children stand to gain significantly from pre-school participation. Evidence of effects on non-disadvantaged children is mixed, although some health and behavioural benefits seem to have arisen from the Sure Start programme. To improve pre-schooling outcomes among disadvantaged children while containing costs, overall efficiency needs to increase and resources should be geared more towards disadvantaged families. *Outreach activities focused on disadvantaged families should be expanded. Providing additional support for the neediest, for example through complementing pre-schooling with parent/child support in the home environment, should be considered.*

Additional indicators of educational performance should be developed to complement grades and test scores

24. Despite sharply rising school spending per pupil during the last ten years, improvements in schooling outcomes have been limited in the United Kingdom. Average PISA scores, measuring cognitive skills of 15-year olds, have been stagnant and trail strong performers such as Finland, Korea and the Netherlands. The use of benchmarking in England is more widespread than in virtually any other OECD country. Transparent and accurate benchmarking procedures are crucial for measuring student and school performance, but “high-stake” tests can produce perverse incentives. The extensive reliance on National Curriculum Tests and General Certificate of Secondary Education (GCSE) scores for evaluating the performance of students, schools and the school system raises several concerns. Evidence suggests that improvement in exam grades is out of line with independent indicators of performance, suggesting grade inflation could be a significant factor. Furthermore, the focus on test scores incentivises “teaching to tests” and strategic behaviour and could lead to negligence of non-cognitive skill formation. To address these shortcomings the government should:

- *Further develop value-added indicators of schools' educational output to provide more relevant information to parents, students and regulators.*
- *Increase the emphasis within inspection on teaching and learning including through more lesson observation and assessment of pupils' work, so that inspectors consider this evidence alongside attainment data in reaching their judgements on the effectiveness of schools.*
- *Develop methods to measure educational outcomes through independently collected data as a complement to grades and test scores.*
- *Ensure that universities and employers have a greater say in qualification content and procedures (A-levels and GCSEs).*

Figure 4. Test scores in England and Scotland



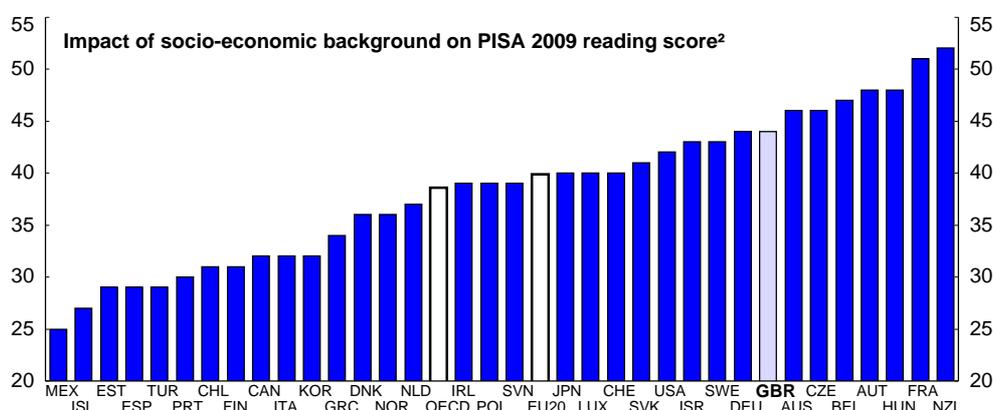
Source: PISA database, and other sources.

Wider user choice for all students requires further reforms

25. Schooling outcomes in the United Kingdom are among the more unequal in the OECD area. This leaves many students from weaker socio-economic backgrounds with insufficient levels of competence, which hampers their chances in the labour market and higher education. Further reforms are needed to improve the outcomes for students from disadvantaged backgrounds to raise their life chances and overall productivity.

26. The unequal educational outcomes partly reflect a complex, multi-layered and poorly functioning deprivation funding system for primary and secondary schools in England. The implicit compensation for disadvantaged students that the government provides to local authorities is only partially spent on disadvantaged schools and students. This mismatch partly reflects the complexity of the funding system. By moving to a less complex system and introducing an explicit pupil premium, the government has started to address these problems. The premium is, however, relatively low in an international perspective and it is not clear that it will cover the extra costs of admitting disadvantaged students. *The government needs to ensure incentives are sufficiently large to incentivise schools to admit disadvantaged students. To maximise transparency the government should consider increasing the pupil premium, within the overall budget constraint on public spending, and making it the only source of deprivation funding.*

Figure 5. Educational indicators¹



1. Aggregates are unweighted average of available countries.
2. Score point difference associated with one unit increase in the PISA index of social and cultural status.

Source: PISA 2009.

27. One way to ensure that schools spend deprivation funds on the disadvantaged student is to improve user choice for these students. User choice remains relatively limited for students from disadvantaged backgrounds, as admission criteria by residence limit choice geographically. Although user choice reforms can have positive effects, they could potentially lead to increased segregation. *The government should therefore experiment with proscribing the use of residence criteria in admission to local government maintained schools in some local authorities and evaluate the effects carefully. Locally maintained schools should have the same opportunities for hiring staff and negotiating wages as academies and Free Schools.*

28. User choice is also limited by low supply flexibility through entry and exit and high capacity utilisation, leaving locally maintained schools with a captive market. *Entry of new schools should be encouraged even if it temporarily creates some excess capacity. Decisions on opening new schools should rely on the quality of the business plan and should not be left to local authorities but to another appropriate body.*

The quality of vocational training should be higher to make participation worthwhile

29. Participation in education and training among 16 to 18-year-olds remains relatively low compared with other OECD countries, partly reflecting weak performance in earlier parts of the school system, but also a confusing and rapidly changing array of often low quality vocational programmes. *The system of vocational education should be simplified. A further focus on high-quality apprenticeships is warranted. Given that the government has abolished the education maintenance allowance, it needs to find alternative measures to efficiently raise incentives for participation for children from low income families.*

The increase in the tuition fee ceiling is reasonable and should pave the way for higher participation in tertiary education

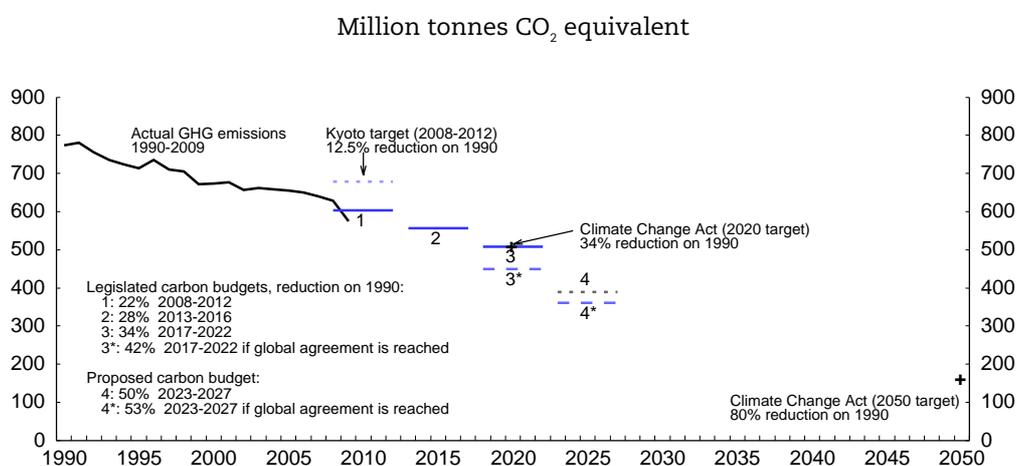
30. Relative demand for tertiary education is high, partly due to elevated private returns to education. Expanding tertiary education is therefore warranted, but in view of the high levels of public subsidies students should pay a larger share of the costs. The government's proposal to allow universities to increase tuition fees significantly switches some of the costs of funding higher education from taxpayers to graduates. *The government could pursue reforms to further lower the public share of funding, e.g. through lower grants to universities. Some of the proceeds could be used to expand the number of study places. While the proposed changes in the grant and loan system should ensure that*

universities remain open for students from disadvantaged backgrounds, the government should keep a close eye on this issue.

International agreements to make carbon prices more uniform, higher and less volatile should be sought

31. The United Kingdom has set ambitious domestic targets for greenhouse-gas emissions reductions and has introduced a wide range of policies to bring them about. It has also argued strongly for collective action at a global level. Progress on lowering emissions has also been significant, with an additional boost from the recession adding to progress due to the earlier “dash for gas” and cuts in non-CO₂ gases. To address fully the central market failure associated with greenhouse gas emissions and to reach the government’s ambitious 2020 and 2050 targets, a step change in policies is needed. *Given the central role of the EUs emissions trading scheme a key element should be to seek tighter quotas within the scheme.*

Figure 6. United Kingdom GHG emissions 1990-2009 and targets to 2050



Source: DECC (2010), *UK Emissions Statistics*, with 2009 provisional data; Committee on Climate Change.

The consistency of policies needs to be improved if ambitious targets are to be met in a cost effective way

32. The current framework of climate change policies is complex and reflects different vintages of policies leading to uneven carbon prices across sectors. The low VAT rate on domestic fuels adds to the distortions. *The government should therefore assess how policy instruments overlap and interact, so that policy-makers can make the effective carbon price across industry sectors and different stages of production more uniform and co-ordinate climate-change, energy and other policies better.* Reforms should focus on simplifying, rationalising and harmonising environmental taxes. *The Climate Change Levy (CCL) and fuel duties should reflect carbon content and the low VAT rate on domestic fuels should be raised to the standard 20%. Furthermore, the CCL and the Carbon Reduction Commitment Energy Efficiency Scheme could be merged and the inefficient Climate Change Agreements should be phased out. The government should also consider ways to lower uncertainty about future carbon prices.*

Incentives for developing and deploying low-carbon technologies need to be sharpened

33. The government plans to reform the regulation of the electricity market. This provides an opportunity to reduce some of the risks faced by renewable-energy power generators by facilitating longer-term contracts and making grid connection easier. *The United Kingdom has policies such as the Renewables Obligation in place to encourage privately funded R&D. But it would be desirable for the*

government to increase public spending on R&D for new low-carbon technologies, given the “public good” nature of basic research and the low level of direct publicly-funded UK energy R&D, taking account of fiscal constraints. Support should preferably focus on areas in which the United Kingdom has a comparative advantage at the margin and in the context of international co-ordination of research efforts across technologies to share the burdens of R&D efficiently.

34. Investment in low carbon technologies is likely to be below socially efficient levels due to uncertainty about future trajectories of carbon prices and climate change policies more generally, and obstacles to long-term project financing. This calls for public sector financial intermediation. *One option would be to allow the proposed Green Investment Bank to borrow in the debt markets, subject to transparent accounting of the contingent fiscal liabilities that such borrowing would create.*

Adaptation policies should initially focus on low-hanging fruits

35. There are significant uncertainties related to future climate change impacts and thus about precise adaptation needs. Adaptation policies should therefore focus on building adaptive capacity across the UK economy, with a focus on reducing market failures. *The authorities should develop further an incremental approach to encouraging adaptation, protecting against near-term climate threats that are better understood while retaining options to respond flexibly to the evolution of risks and the knowledge base over coming decades.* It is sensible to continue to focus on the appropriate provision of public goods, including information, better risk-assessment frameworks and more advanced metrics for monitoring and evaluation.

Chapter summaries

Chapter 1. Supporting the recovery and rebalancing the economy

The UK economy is gradually emerging from the recession and has started to rebalance away from overreliance on debt-finance and government spending towards more investment and exports. The government deficit is starting to decline, household and firm balance sheets have strengthened, but the pick-up in exports has been relatively slow despite the depreciation of sterling and the recovery in export markets. Meanwhile, the labour market has proved more resilient than in previous downturns, reflecting more labour hoarding due to falling real wages and shorter working hours. To support the recovery, monetary policy should remain expansionary, as current above target inflation rates essentially reflect temporary factors. If inflation expectations drift too far from the target, however, policy rates would need to rise earlier. The government is pursuing a necessary and wide ranging programme of fiscal consolidation and structural reforms aimed at achieving stronger growth and a rebalancing of the economy over time. Plans for fiscal consolidation, principally focusing on spending cuts, are appropriately ambitious. These plans were needed to ensure fiscal sustainability and have significantly reduced fiscal risks, contributing to lower bond yield spreads and diminished uncertainty. Fiscal plans could, however, be adjusted to better promote efficiency and long-term growth. In due course, the fiscal mandate should be modified into a permanent fiscal framework to guide fiscal policy beyond 2015/16. The UK banking sector was severely affected by the financial crisis and UK authorities have already addressed some weaknesses. Further financial sector reforms, consistent with Basel III and European initiatives to reinforce regulation and supervision, are essential to secure financial stability going forward.

Chapter 2. Improving the functioning of the housing market

A well functioning housing market is essential for economic prosperity and well-being. A combination of favourable economic and financial conditions and tight housing supply led to sharp increases in real house prices between the mid-1990s and end-2007, which spurred household consumption. While this boosted output growth, economic imbalances and financial weaknesses mounted, leaving the economy vulnerable to the global financial crisis. Current land use planning policy is excessively restrictive, making supply unresponsive to demand and contributing to creating housing shortages and reducing affordability. While additional supply in the private rental market provides an alternative to homeownership for a significant number of households, social housing waiting list numbers have increased rapidly over the past decade. A reform to replace top-down building targets with incentives for local communities to allow development is underway, but the outcomes are somewhat uncertain. Housing taxation is regressive and encourages excessive demand for housing. More effective taxation could help contain demand and stabilise the housing market.

Chapter 3. Reforming education in England

Despite significant increases in spending on child care and education during the last decade, PISA scores suggest that educational performance remains static, uneven and strongly related to parents' income and background. Better educational performance could improve labour market outcomes, raise growth, lower the consequences of a disadvantaged background and increase social mobility. Given the austere fiscal outlook, improvements have to come from higher efficiency rather than further spending. More focused pre-school spending on disadvantaged children could improve skill formation. Better-targeted funding for disadvantaged children combined with strengthened incentives for schools to attract and support these students would help raising educational outcomes. The government is increasing user choice by expanding the academies programme and introducing Free Schools, but needs to closely follow effects on fair access for disadvantaged children. The impact of increasing user choice on

educational outcomes is uncertain, but the government should experiment with proscribing the use of residence criteria in admission to local government maintained schools in some local authorities. Reforms to increase supply flexibility should be pursued. All government funded schools should enjoy the same freedom in hiring and wage setting to level the playing field across different school types. To better gauge progress and inform policy makers, schools and parents on educational outcomes, additional performance measures should be developed and steps taken to lessen the reliance on grades in performance management. Insufficient supply of high-quality vocational programmes and tertiary education study places hamper human capital formation and growth. Stabilising and simplifying vocational education by more focus on high quality apprenticeships would support participation. The government needs to find efficient measures to raise participation especially among children from low income families to replace the abolished educational maintenance allowance. Further reforms to funding of higher education could lower taxpayers' costs and help finance a needed expansion in the sector.

Chapter 4. Climate-change policy in the United Kingdom

The United Kingdom started to pursue policies to reduce greenhouse gas emissions at a relatively early date and now has a comprehensive set of measures in place. It has set clear targets for emission reductions consistent with international goals of limiting global warming and has pioneered statutory underpinning of target-setting. On the international stage, it has been an active protagonist of a global deal to limit human-induced climate change. The new government has endorsed the direction of previous policies in this area and is introducing further measures, despite heavy fiscal pressures. The United Kingdom is likely to reduce emissions by more than its near-term domestic targets and its target under the Kyoto Protocol, outperforming many OECD countries in the latter respect. But some of the success has been due to "one-off" factors such as the "dash for gas", reductions in non-CO₂ greenhouse gases in the 1990s and the recent recession, rather than explicit climate-change policies. The pace of decarbonisation of the power sector has been slow and the spread of renewable energy technologies limited. Implicit carbon prices vary across sectors, and should be harmonised and thus more efficient. The unevenness partly reflects the way in which policies have proliferated and overlap and a simplified structure would be desirable. A step-change in the pace of emission reductions is required to put the UK on the path towards its ambitious 2050 target. Given the central role of the EU emissions trading scheme, a key element of the UK strategy should be to seek tighter quotas within the EU scheme. Preparations to adapt to climate impacts also need to be stepped up, focusing on the provision of more information, better risk-assessment frameworks and more advanced metrics for monitoring and evaluation of adaptation planning.

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Further information

For further information regarding this overview, please contact:

Piritta Sorsa, e-mail: piritta.sorsa@oecd.org; tel.: +33 1 45 24 82 99; or
Henrik Braconier, e-mail: henrik.braconier@oecd.org; tel.:
+33 1 45 24 95 70; or
Christophe André, e-mail: christophe.andre@oecd.org; tel.:
+33 1 45 24 96 41.

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