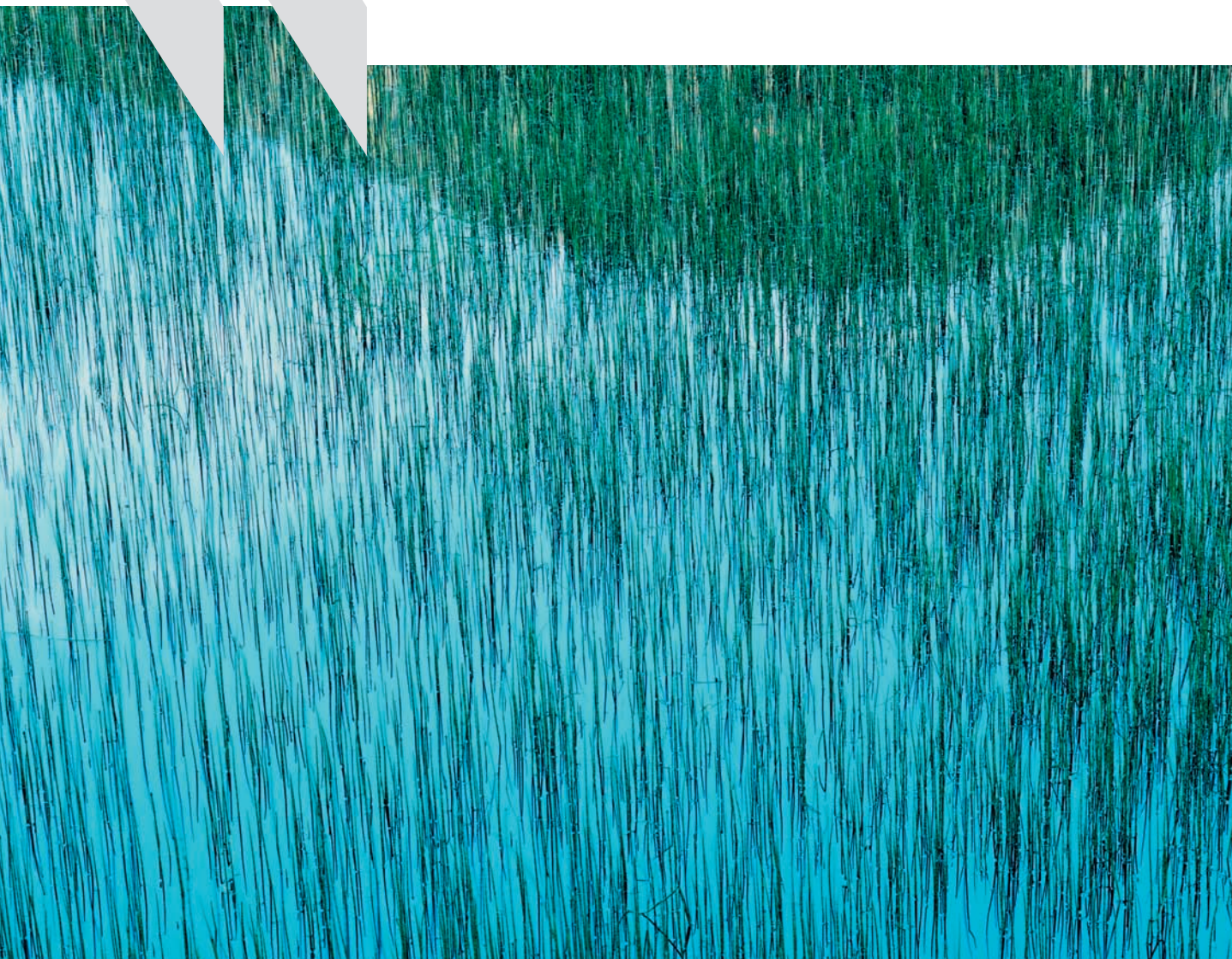




**OECD Economic Surveys**  
**UNITED KINGDOM**





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**United Kingdom**

**2009**



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*The economic situation and policies of the United Kingdom were reviewed by the Committee on 28 April 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 19 May 2009.*

*The Secretariat's draft report was prepared for the Committee by Petar Vujanovic Sebastian Barnes, Philip Davis and Peter Smith under the supervision of Peter Hoeller. Statistical assistance was provided by Joseph Chien.*

*The previous Survey of the United Kingdom was issued in September 2007.*

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## BASIC STATISTICS OF THE UNITED KINGDOM (2008)

### THE LAND

Area (2006, 1 000 km <sup>2</sup> )		Major cities (2006, thousand inhabitants)	
Total	242	Greater London	7 512
Agricultural	187	Birmingham	1 007
		Leeds	750
		Glasgow (local government district)	464

### THE PEOPLE

Thousands		Total labour force (thousands)	31 220
Population	61 346	Civilian employment (% of total)	
Net increase (annual average 2001-06)	295	Agriculture, forestry and fishing	1.3
Number of inhabitants per km <sup>2</sup>	253	Industry and construction	22.1
		Services	76.3

### PRODUCTION

Gross domestic product		Gross fixed capital investment	
In £ billion	1 443	In % of GDP	16.7
Per head (\$)	43 505	Per head (\$)	7,258

### THE GOVERNMENT

Public consumption (% of GDP)	21.9	Composition of House of Commons (seats)	
General government (% of GDP)		Labour	350
Current and capital expenditure	46.2	Conservatives	193
Current revenue	40.6	Liberal Democrat	63
Net debt	33.6	Other	40
Last general elections: 5 May 2005		Total	646

### FOREIGN TRADE

Exports of goods and services (% of GDP)	28.9	Imports of goods and services (% of GDP)	32.0
Main commodity exports (% of total)		Main commodity imports (% of total)	
Electrical machinery	10.1	Manufactured goods and articles	27.0
Manufactured goods and articles	24.3	Electrical machinery	13.8
Chemicals	17.5	Road vehicles	9.8
Mechanical machinery	12.8	Fuels	13.9

### THE CURRENCY

Monetary unit: Pound sterling		April 2009, monthly average of spot rate	
		£ per \$	0.68
		£ per €	0.90

## Executive summary

**T**he world economy is being buffeted by several shocks. The United Kingdom, like most OECD economies, is in a deep recession. House prices have fallen after an extended period of large increases which left many households over-extended. Financial conditions are tight, and the financial market crisis has threatened the stability of the financial system. External conditions are also highly unfavourable. The recovery is likely to be slow and unemployment is expected to climb significantly. Both monetary and fiscal policies have eased to cushion the severe downturn with the policy rate now at historically low levels and quantitative easing measures under way. The authorities have also moved quickly to introduce a wide range of measures to stabilise the financial system.

In the short term, the policy priority must be to further improve conditions in credit markets. This is essential for reviving the economy. Alongside this, policy should aim at damping the severity of the downturn and its impact, particularly on the labour market. Policy actions that could undermine longer-term objectives need to be avoided. Over the medium term, fiscal consolidation needs to be underpinned by an effective fiscal framework and financial market regulation and supervision needs to be overhauled. The financial crisis and its consequences are likely to lead to a permanent fall in the level of potential output. Therefore, measures to raise long-run living standards will have renewed importance.

**Restoring sound public finances and improving the fiscal framework.** As in most other OECD countries, the fiscal situation has deteriorated sharply. Room for additional fiscal stimulus is limited, although further targeted measures may be warranted if prospects weaken further. To maintain credibility and promote growth, the government should continue to develop a comprehensive plan to rein back debt to a prudent level once the recovery has taken hold. Any reformulation of the fiscal rules should provide for spending discipline and be forward-looking.

**Improving the efficiency of the health care system.** Since 2000, many aspects of the health care system have been reformed. A large increase in spending has improved outcomes in many respects, but measures of productivity of health care provision fell up to 2005, although these measures are not yet comprehensive, and other measures of NHS value for money have improved. Reforms need to continue and indeed accelerate to ensure that the NHS remains sustainable as the growth of spending slows and in the long term as the population ages.

**Putting in place a financial market framework that promotes stability.** A well regulated and supervised financial system is necessary to promote long-term growth and macroeconomic stability. During the credit cycle, some UK banks became heavily reliant on wholesale funding and lent on a large scale, which led to substantial losses. Stronger banking regulation is required and supervision needs to become more effective. The framework to manage systemic risks needs to be developed further.

**Assisting labour market adjustment and promoting productivity growth.** The unemployment rate could reach close to 10% by 2010. Over the last few years, with low unemployment levels, spending on active labour market programmes has been comparatively low.

*As unemployment has risen significantly, the government's further policy initiatives in this area are warranted, particularly those focused on the younger unemployed. The proportion of people on disability pensions remains high. The Pathways to Work scheme is now being extended across the country and should be expanded to the stock of disability benefit recipients, as the government plans to do from 2010 onwards. More also needs to be done to promote productivity growth. The priorities should be the continued improvement of the land-use planning system, providing public infrastructure, and to raise training and education levels further.*



## Assessment and recommendations

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### *The economy is in a severe recession*

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The world economy was hit by a succession of shocks during 2007 and 2008. The United Kingdom, like most OECD economies, is experiencing a severe economic downturn, and there is enormous uncertainty about the macroeconomic outlook. Since the peak, GDP has contracted by 4.2% in real terms and is projected to contract further, with a decline of 4.3% expected in 2009. Lower house prices and the slump in equity prices will depress household consumption, together with rising unemployment and weak consumer confidence. Business investment will decline owing to the challenging prospects and tight financial conditions. While sterling has depreciated by around 20% in effective terms since 2007, exports will decline due to the sharp fall in external demand. However, imports are expected to fall faster meaning that net exports will contribute positively to growth. The unemployment rate is rising sharply and could be close to 10% by 2010. Monetary and fiscal stimulus, the weaker exchange rate and some recovery in foreign demand should promote a recovery during 2010. But, this will depend critically on whether measures to stabilise the financial system are effective. Even if they succeed, growth is expected to remain well below trend as households and firms rebuild their balance sheets. The pass-through of higher import prices will slow the decline in inflation in the early part of 2009 but the weakness of demand will create substantial spare capacity in the economy, which will lead to inflation well below the official target for some time. The extent of the global downturn on activity is unclear. A slower than anticipated return to normal financial conditions would have a negative impact on the economy. Greater than anticipated declines in house prices could weigh further on consumption and increase the feedback by exerting further pressures on banks' and households' balance sheets. Significant monetary and fiscal policy stimulus is in place, and although it may not prove as effective as hoped, it is possible that the policies will have a faster and stronger positive effect than anticipated.

---

### *The credit boom has ended in a financial crisis*

---

The downturn follows prolonged growth in credit and asset prices, driven by a combination of financial innovation and regulation characterised by some as "light". Growth was strong and macroeconomic volatility unusually low. Although the credit cycle touched many assets and countries, the UK housing cycle was particularly intense: nominal house prices more than doubled in the ten years to their peak. The asset-price and credit boom was self-perpetuating for a time, as easy availability of credit stoked demand and raised asset prices, which in turn increased the value of collateral and engendered further borrowing.

In the end, this proved unsustainable. Starting in August 2007, financial market turmoil led to illiquidity in the interbank lending market. As in some other OECD countries, some UK banks were particularly exposed due to their heavy reliance on market finance rather than deposits and their extensive use of securitisation. The Bank of England has increased the availability of funds but liquidity conditions remain considerably worse than before the turmoil began. Since September 2008, the financial crisis intensified with sharp falls in asset prices; higher interest spreads on lending and a tightening of bank lending conditions. Even with cuts in official interest rates and the exchange rate depreciation, financial conditions continue to have a substantial negative impact on activity. However, since the beginning of 2009, credit conditions have shown some signs of easing.

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*The Bank rate is now close to zero  
and quantitative easing has begun*

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In response to the severe downturn, the Bank of England has lowered the official interest rate very rapidly to 0.5% in March 2009, an unprecedentedly low level. However, this overstates the degree of monetary easing because the transmission mechanism is impaired by the financial crisis and reductions in the Bank rate have not been passed on fully to the rates facing borrowers. The depreciation of sterling provides additional support but overall financial conditions are likely to restrain activity for some time. With the Bank rate now effectively at the zero bound and given that the downward pressure of the large amount of spare capacity on prices is intense, the Bank of England has begun a policy of quantitative easing. In addition to purchasing some non-financial corporate sector securities, the Bank has embarked on large-scale purchases of government debt in the secondary market using central bank money. This will raise the money supply, helping to boost nominal demand, and stabilise output and inflation. There is significant uncertainty as to what scale of quantitative easing is required to boost nominal demand sufficiently. *A policy of quantitative easing is more likely to be effective if the scope of future central bank actions is clearly signalled.*

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*Restoring the flow of credit to the real economy  
is crucial*

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Economic recovery requires that the financial system and the supply of credit are restored. Beyond measures to supply liquidity, the authorities have undertaken a wide range of system-wide policy measures to restore the banking system's ability to supply credit, including a guarantee of certain securities issued by banks. A fund to recapitalise banks was set up and a scheme to insure banks against losses on certain bad assets introduced. Three banks accepted recapitalisation funds from the government and two of them subsequently merged. Other financial institutions have raised capital from private sources. The same two large banks, one of which is now largely under public ownership, have expressed their intentions to participate in the insurance scheme. These banks have given some undertakings to increase the supply of credit. Moreover, one smaller bank has been fully nationalised, with another split into two with the retail deposits sold to a private sector purchaser and the remainder being wound down in public ownership. The government has also put in place schemes to help small and medium-sized businesses, although these measures are small relative to the stock of credit. These measures have helped to stabilise the financial system, but credit conditions remain very tight.

Restoring the supply of credit requires addressing the ability and the willingness of institutions to lend in a very unfavourable economic environment. Although each financial crisis is different and raises specific issues, international evidence indicates that government support that allows fundamentally weakened institutions to remain in business tends to increase the fiscal and economic costs of crises. It is essential that the supply of new lending is not held back any longer by banks with insufficient capital to meet losses associated with past lending. Recapitalisation and asset protection measures remain appropriate where a bank can function normally with some public assistance. Where institutions are unlikely to be viable, even with substantial assistance, other measures might be required to restore the health and stability of the financial system without undue cost to the taxpayer. The new Special Resolution Regime provides several options for such banks including transferring ownership, a special administration procedure for banks and temporary public ownership. The impact of existing policy measures on the public finances is already very large, both in terms of actual costs and the increase in implicit liabilities.

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#### *The room for fiscal manoeuvre is limited*

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Although the financial crisis may strengthen the case for additional fiscal stimulus, there is limited room for manoeuvre at the present time. In the November Pre-Budget Report, the government announced a moderate fiscal stimulus package amounting to around 1.4% of GDP in 2009, which included a temporary valued-added tax (VAT) cut to the end of 2009 and an acceleration of already planned capital spending. The 2009 Budget announced further targeted support including for employment and investment. A further deterioration in economic circumstances could require limited additional fiscal stimulus but this must be well-targeted to have a strong effect on demand and to ensure that the long-run impact of the crisis, for example on unemployment, is contained. Any stimulus package must be accompanied by credible consolidation plans. Industry-specific support should be used cautiously, if at all, and reversed quickly to avoid misallocation of resources and damage to long-term productivity.

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#### *A comprehensive plan for fiscal consolidation is required*

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The government deficit is widening rapidly and is expected to reach around 14% of GDP in 2010 according to OECD projections, which is helping to cushion the downturn. Moreover, support for the financial system has led to direct fiscal costs and substantially added to implicit government liabilities. The UK authorities have provisionally estimated that the losses may lie within a potential range from 1½ to 3½ per cent of GDP and the authorities have included the upper end of this range in their projections for borrowing and debt, as the basis for setting fiscal policy. After around the turn of the century, the underlying fiscal position weakened more than anticipated, while there was some subsequent improvement, particularly in tax receipts. Tax receipts have been significantly affected by the current downturn. According to OECD projections, the gross government debt-to-GDP ratio is now on course to reach around 90% by 2010. The November Pre-Budget Report and Budget 2009 outlined a path to fiscal consolidation starting in 2010, based on income tax rises for those on high incomes, increases in national insurance contributions and revised spending assumptions, alongside “value for money” savings. *Although the deficit should be*



allowed to support activity in the near term, the government has set out an ambitious consolidation plan for when the recovery takes hold. The delivery of the consolidation will require specifying the “value for money” savings beyond 2011-12 in the upcoming Spending Review. This would signal the commitment to getting the public finances back onto a sustainable and prudent footing. Further action may be required if the economy does not recover as quickly as anticipated.

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### *The fiscal rules should be reviewed*

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In 1997, the government introduced a principles-based fiscal framework which, alongside the new independent monetary policy regime, sought to shift the focus of macroeconomic policy to long-term sustainability within a credible and transparent framework. The fiscal framework is operationalised through two fiscal rules: the golden rule, which requires that over the economic cycle the government should borrow only to invest and that current spending (including the consumption of capital) should be paid for by taxation; and the sustainable investment rule, which requires that over the economic cycle the government should ensure the level of public debt as a proportion of national income is held at a stable and prudent level (defined as net public debt below 40% of GDP on average over the cycle running from 1997-98 to 2006-07). In November 2008, the government suspended the two fiscal rules on the grounds of extraordinary circumstances. This decision reflected the suddenness and severity of the downturn. The government has adopted a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full. The Budget projects that the cyclically adjusted budget will return to balance by 2017-18 with the net debt to GDP ratio falling from 2015-16.

The original fiscal rules could be amended in a number of ways, rather than being reinstated. *The reformulated rules should be forward looking, ensure medium-term spending discipline and account more explicitly for off balance sheet public liabilities. Finally, income tax thresholds and national insurance thresholds should be linked to wage, rather than price inflation so that fiscal drag is handled more transparently.*

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### *Health care spending has surged, but the returns so far appear modest*

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Spending on health care had traditionally been low by international comparison. However, during the 1990s it became clear that the National Health Service (NHS) was performing poorly on some health outcomes and responsiveness. Waiting times, for instance, were very long. This became a central policy concern and in 2000 the government pledged to increase spending to the European average. This pledge was conditional on the NHS undertaking a number of reforms. Health spending has indeed increased very rapidly since then, with a considerable rise in the supply of services. Health outcomes have improved, waiting times have come down sharply and the public is more satisfied with the performance of the NHS. However, available indicators suggest that the rise in inputs was faster than in outputs and that productivity of health care provision fell up to 2005, although these measures are not yet comprehensive. The reform programme needs to be followed through and fine-tuned in various areas to increase efficiency. This is essential to

sustain the NHS in the face of budgetary constraints and to deal with the pressures from population ageing.

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### *Purchasing of health care services needs to be improved*

---

The reform programme has covered many areas and the NHS has steadily evolved from being a centrally controlled organisation, towards relying much more on increased local autonomy and consumer choice. The Department of Health sets national minimum standards and allocates financing to regional entities. The principal local NHS organisations are the Primary Care Trusts (PCTs), each of which covers a population of about 400 000 people. They organise primary care and purchase other health care services (for instance, hospital care and pharmaceuticals) from NHS or other providers. This purchasing, known as commissioning, aims to improve health and well being for PCT populations within a fixed budget. Commissioning was also intended to raise competition among providers and lead to the development of new and innovative services. PCTs and general practices, many of which are also involved in commissioning, need more practical support and investment in skills to fulfil their responsibilities; attempts are being made to address these needs through regional and national programmes. To date, progress in these respects has been limited. However, a recent programme (World Class Commissioning) is seeking to improve PCT's technical commissioning capability and the health outcomes achieved. Results from the assessment of progress made in the first year (2008/09) show that PCTs have further improvement to make. Nevertheless, an evaluation of year one showed that there is great confidence within the NHS that the new programme will in time lead to an improvement in commissioning capabilities and governance. The devolution of decision-making through commissioning can result in variations in service provision, although there are national quality standards that all services are expected to meet. PCTs have statutory duties to engage with local government, patients and the public. However, local accountability arrangements may need to be further strengthened to support devolved decision making.

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### *Activity-based funding of hospitals should be improved*

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The introduction of an activity-based funding mechanism for reimbursing hospitals was a key element of the NHS reforms. It is known as Payment by Results, though it in fact rewards outputs and not outcomes, similar to the funding systems operated in other countries. A national tariff is used, with limited scope for local variation. *The current reform programme should be used to reflect priority activities and developed to reward higher quality rather than merely reflecting costs. Another way of differentiation would base the tariff on the costs of more efficient providers, thus spurring efficiency gains. Consideration should also be given to align the remuneration of personnel, which is salaried, more closely with activity.*

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### *Difficulties in reconfiguring health care provision need to be overcome*

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The reforms imply potentially radical changes to provider markets: Entry by a range of new public and private sector providers; the re-design of services by commissioners to meet

local needs; and the impact of patient choice on the sustainability of existing service providers. *Reconfigurations give rise to profound local political difficulties. There needs to be a clearer policy on entry, merger and exit of provider organisations. Much greater effort is, therefore, needed to improve the consistency and transparency of local service reconfigurations.*

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*Stronger banking regulation is needed to achieve financial stability*

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While the imperative in the short term is to restore the capacity of the banking system to supply credit, in the longer term it is a well-functioning regulatory framework that will ensure an effective and stable banking system, which is essential to sustained economic growth. The UK banking sector is among the largest, most internationally open and highly developed. Sound regulation and supervision of banks is necessary to ensure that the financial system works well. Although UK banking regulation is based on European and international standards, the UK authorities have taken a distinctive approach to the regulation and supervision of banks. This appeared to have some advantages in terms of innovation and development of the financial sector. The turning of the credit cycle, however, has underlined the weaknesses of this approach as well as the more intrusive “bank examiner” model practised in other countries. Some UK banks relied heavily on funding from the interbank market and via securitisation, and have experienced large losses on holdings of asset-backed securities. The UK housing and credit cycles were particularly pronounced and UK-owned banks held assets that were a relatively high multiple of GDP. Dealing with these problems has required comprehensive public intervention to support the banking system through guarantees, injections of capital and nationalisations. It will therefore be important for everyone to learn the lessons of this crisis for banking regulation and supervision, particularly in areas such as liquidity where previous policies were out of line with international practice. The UK has throughout the crisis maintained its open approach to financial markets.

The regulation of banks should provide a high level of stability for individual institutions and, just as importantly, the system as a whole. Capital adequacy standards influence the overall level of risk taken by banks and the shareholders’ incentive to monitor risks. The overall regulatory framework in this area is determined by international standards (and within Europe by EU directives) but national authorities have substantial discretion to go beyond minimum standards. By setting individual capital guidance at which more intensive supervision is applied at a higher level than international minimal standards, the UK authorities managed to achieve what appeared to be relatively healthy levels of bank capitalisation during the upswing of the credit cycle. But, the effectiveness of this approach was partially undermined by banks’ use of off-balance sheet vehicles to hold securitised assets, even though the UK (like some other EU countries) has for many years applied detailed capital requirements in respect of off balance sheet, securitised assets and facilities to special purpose investment vehicles. *Capital adequacy standards should be strengthened in the United Kingdom and internationally, and banks required either to hold more capital for off-balance sheet risks or required to bring these risks fully on to their balance sheets. The role of external credit rating agencies for the assessment of risk should be reconsidered in the light of problems revealed during the current crisis as regards the rating of securitised products.*

Other aspects of the regulatory framework are also important to achieving a high level of stability. The quantitative regulation of liquidity has a number of recognised weaknesses

that are being addressed by the UK authorities. The proposed new liquidity regime will be a marked advance and set a high standard for UK and international banks active within the United Kingdom. Over time, the legal and regulatory framework should be monitored to ensure that there are no undue barriers to the development of a covered bond market, which could contribute to creating a more balanced mix of funding sources for the banking sector. To manage risk, bank lending standards should be subject to tighter regulation. In particular, limits should be imposed on high loan-to-value mortgages or capital requirements raised on these loans. Greater scrutiny and control should be applied to risky and fast-growing activities. To improve risk management, poorly-designed remuneration policies in banks that increase risk taking should be subject to greater regulatory and supervisory intervention. The authorities should increase information gathering in this area and provide clearer guidance about good practice, while intervening where practices are risky, including by raising capital requirements.

#### Supervision should be more effective and lessons learnt to improve crisis management

More effective banking supervision may help to limit the reoccurrence of the problems that have emerged in this financial crisis (although it must also be recognised that other countries, with more intrusive regulatory approaches, have also experienced significant problems). To achieve this, more resources need to be devoted to supervising major institutions and gathering more supervisory information, with a greater engagement by senior management of the Financial Services Authority (FSA). The FSA has taken actions to increase the resources that are directed to supervising major institutions and increasing senior management engagement with such firms. The quality of financial analysis should be improved, including greater comparative analysis, and macro-prudential considerations better integrated into supervisory assessments. More supervisory information about specific institutions should be made public to enhance transparency and encourage market discipline; this can be done by supervisors requiring institutions to publicise information, in line with international best practice. Consideration should be given to any lessons that can be learnt from more rules-based supervisory approaches applied in other OECD countries, while recognising that they also have weaknesses and limitations.

The financial crisis, particularly the failure of Northern Rock Bank, pointed to a number of weaknesses in the crisis management and resolution framework. The Special Resolution Regime introduces a new pre-insolvency trigger for failing banks and more clearly defined mechanisms for resolution of such a situation. This is useful for dealing with failing banks and, by making it less costly to trigger a failure, reduces moral hazard. For the new regime to work, the Bank of England needs to allocate sufficient resources to deal with the possibility of multiple bank failures. Consideration should be given to numerical targets for prompt corrective action, alongside qualitative judgements. The pre-crisis deposit insurance scheme did not work well, but the regime has been strengthened since 2007 by raising the coverage ceiling, removing coinsurance and improving operational aspects including reducing payment delays. The system should be pre-funded to a greater extent and consideration given to risk-based premia along the lines of schemes in some other countries.

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*The framework to manage systemic risks in the financial system should be developed*

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The high economic, fiscal and social costs of the financial crisis underscore the need for greater focus on systemic risks and to contain such booms in the future. Experience of using banking regulation and supervision to address system-wide macroprudential concerns is limited, although a few countries have applied explicit counter-cyclical policies. The Bank of England did warn of risks in its twice-yearly Financial Stability Review but this failed to have a material impact on risk-taking. The Banking Act 2009 strengthens the role of the Bank of England in this area, expanding its responsibilities and the financial system information at its disposal, as well as clarifying the role of the FSA. *The OECD welcomes the Turner Review and the UK authorities' accompanying Discussion Paper, and encourages the UK authorities to develop the ideas contained in the paper. The new framework should be monitored to ensure the relationship between the central bank and the financial regulator works effectively and that there are no gaps in information or responsibility, and a fine-tuning of the new arrangements may be necessary. Options for reducing the pro-cyclicality of financial markets should be investigated. These could include, for instance, the introduction of an overall leverage ratio covering all relevant assets, and dynamic provisioning or counter-cyclical adjustments to capital ratios. The Bank of England and the FSA should work closely together in the detailed evaluation of regulations covering new areas that might have a systemic impact.*

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*Policies should ensure that high unemployment rates do not become entrenched*

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Severe economic downturns can have pernicious and long-lasting effects on the labour market by lengthening the average duration of unemployment, thereby eroding skills and alienating retrenched workers from the job market. The incidence of long-term unemployment has been rising since 2007. In recent years, the government has introduced a range of measures aimed at increasing labour market flexibility and improving incentives for labour market participation. Existing programmes, however, may be under-resourced for the needs of the large number of people who are losing their jobs and the downturn will add to pressures on the low-skilled. The government has allocated substantial additional funding for active labour market policies in the Pre-Budget Report and in the Budget. *Any further fiscal measures could fund an expansion of these programmes. However, these measures should be subject to careful ongoing evaluation to ensure that returns are sufficient. When the economy recovers, efforts to avoid entrenched long-term unemployment and low employment among some groups will be important. The recent success of the New Deal for Young People programme in activating long-term unemployed youth could be applied more broadly. The proportion of people on disability benefits remains high. The number of beneficiaries has fallen slightly in recent years reflecting the Pathways to Work scheme and other reforms. The important next step is for the scheme to be expanded to the entire stock of disability benefit recipients as the government plans to do from 2010 onwards.*

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### *Productivity challenges for a sustained and robust recovery*

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GDP per capita increased at a strong pace in the United Kingdom in the years before the financial crisis, spurred by globalisation. This improved the relative performance of the UK economy among OECD countries. Employment increased and labour productivity growth was strong, outpacing the euro area average and close to the US rate. However, there remains a substantial labour productivity gap relative to the best performers. Moreover, it is also now clear that some aspects of the United Kingdom's recent growth performance reflected the credit cycle.

Flexible labour markets and competitive product markets should stand the economy in good stead during the recovery. However, there are a number of policy measures that need to be taken to underpin strong growth over the medium term. *Firstly, improvements in public infrastructure are required, particularly in transport where airport and road congestion and continuing problems with the rail system constrain productivity.* The government has brought forward some public investment projects on the Strategic Roads Network as part of the fiscal stimulus, and continues to target investment towards important infrastructure projects across transport modes. Overall government support for the railway over the five-year regulatory period, commencing in April 2009, will be over £ 15 billion. In addition, the government has gone some way in adopting the recommendations of recent reports on land use planning and transport infrastructure. *However, while the fiscal arrangements have lifted infrastructure investment, more will need to be done, particularly to meet the government's 2000 Ten Year Plan target.* *Secondly, although the property market is currently experiencing a severe downswing, reforms to improve the functioning of the market remain relevant to damp future swings in house prices. Planning procedures are being improved to ensure that demand is met and land released for housing purposes.* *Thirdly, raising training and education levels have to remain a priority to lift productivity and assist the low-skilled. In addition to improving the productive capacity of the economy, improved educational achievement and a better distribution of education resources would help to narrow socio-economic gaps and promote social mobility. Given the large variance in educational outcomes, continuing to improve access to pre-primary education, which has been shown to increase future education attainments particularly for children from disadvantage backgrounds, would be helpful.*





## Chapter 1

# Policies to overcome the crisis

*The United Kingdom, like many OECD economies, is experiencing a severe recession as a consequence of a series of global shocks and any recovery in 2010 is likely to be slow. The financial crisis has severely impaired the supply of credit and house prices have fallen sharply. Unemployment is expected to increase significantly. The large rise in the government deficit is providing support to demand, but the debt-to-GDP ratio will increase substantially. Room for additional fiscal stimulus is therefore limited. Monetary policy has eased and the policy rate has fallen to close to zero. However, the monetary transmission mechanism is impaired and financial conditions while improving somewhat remain restrictive. The Bank of England has begun quantitative easing measures, although these are more likely to be effective within a more transparent framework. Normal functioning of the financial system is necessary for the economy to recover and the authorities have implemented a wide range of measures to support the financial sector. These measures have helped to stabilise the financial system. Given the cyclical rise in unemployment, it will be a significant challenge to ensure that joblessness does not become entrenched, even if the UK labour market is relatively flexible.*

The UK economy, like many advanced economies, has entered a deep recession, which is likely to shape economic events for a number of years. The downturn is the result of a global credit shock, the related downturn in the world economy and partly the correction of past economic imbalances. In the UK, the sharp downturn follows a long period of continuous and strong economic growth beginning in 1992: GDP growth up to 2007 averaged 2.8% per year, leading to substantial catch up towards the best performers in the OECD in terms of GDP per capita and outpacing the euro area significantly. Employment increased from around 26 million to over 29 million and the unemployment rate fell to around 5%. In the decade since the Bank of England was granted independence, inflation has on average been on target, and volatility of output and inflation during this period was unusually low by historical norms.<sup>1</sup> As argued in the previous *Survey*, the United Kingdom gained from its openness to globalisation with a strong inflow of migrants and the further development of an internationally oriented financial sector (OECD, 2008a). The good outcomes were also partly the result of growth-enhancing policies including flexible labour markets, deregulated product markets, openness to foreign trade and investment, and the introduction of a solid monetary policy framework. However, a number of substantial financial imbalances also built up and there was a prolonged and relatively large boom in the housing sector.

The bleak short-term outlook creates new policy challenges. This chapter sets out the near-term priorities of stabilising the financial system and boosting demand, as well as limiting the long-term impact of the current downturn and putting the economy on a sustainable growth path. Monetary and fiscal policy can play an important role in supporting demand, while a range of measures are needed to support the flow of credit. The main structural policy priorities are to ensure that unemployment does not become entrenched, improving infrastructure and raising levels of training and skills. Chapter 2 discusses long-run fiscal sustainability and the fiscal institutions to ensure a sound budgetary position. Chapter 3 examines ways to bolster productivity performance of the health care system. Chapter 4 examines the need to strengthen banking regulation and supervision to ensure that the financial system is more stable and contributes to long-run growth. Chapter 5 reviews structural policy issues.

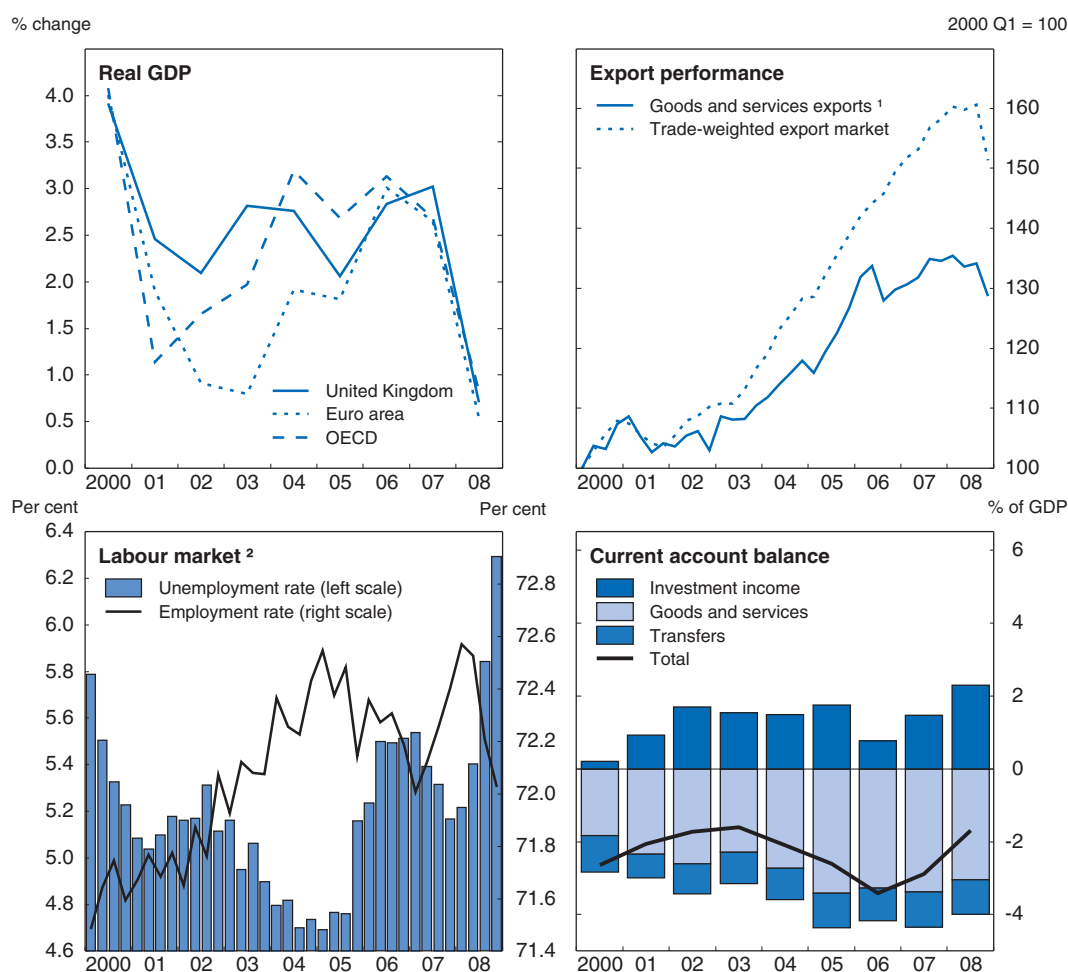
## The economy is in a severe downturn

GDP has contracted by over 4 per cent in real terms since the peak in early 2008 and is likely to contract substantially further this year as the global financial crisis depresses output and employment. The UK is a very open economy and is heavily influenced by developments in global financial markets, investment and trade. But this is also in part the reversal of unsustainable growth in recent years, which had been fuelled by the credit cycle and rising asset prices including housing. The cycle began to turn in 2007 as turmoil hit international financial markets. These effects intensified in the autumn of 2008 with the onset of a full-blown financial and banking crisis in the United Kingdom and internationally, and a sharp fall in world trade.

### Growth in recent years was unsustainable and driven by a credit boom

Despite the long period of economic expansion, developments in recent years were less robust than in earlier years, suggesting that this good performance might not have been sustainable (Figure 1.1). The composition of growth changed: export performance weakened while public expenditure expanded rapidly. From 2000 to 2005, public sector employment rose by around 12% compared with just 3% for private sector employment. The current account deficit widened further and reached over 3% of GDP in 2006. Inflation remained close to the target for most of this period. The credibility of the monetary policy framework ensured that inflation expectations remained anchored to target and wage pressures were subdued. The sharp increase in global commodity prices, which peaked in mid-2008, pushed UK inflation rapidly above target; year-on-year CPI inflation rose from 2.5% in March 2008 to peak at 5.2% in September, mainly driven by higher food and energy prices. This overshoot of the official target required the Bank of England to write explanatory letters to the Chancellor

Figure 1.1. Recent economic performance



1. Excludes MTIC fraud.

2. Unemployment in per cent of labour force; employment in per cent of working-age population. Includes OECD estimates for working-age population for 2007.

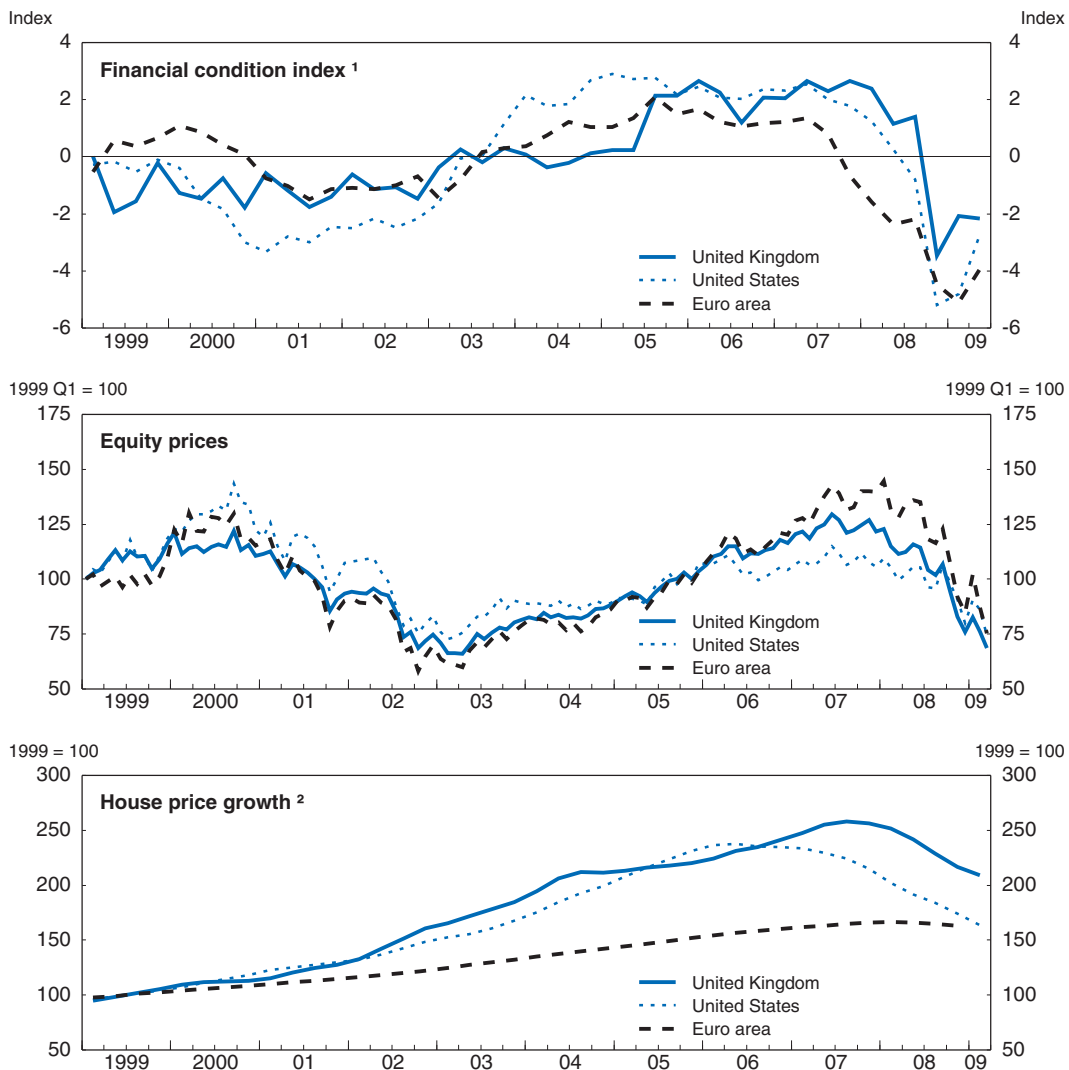
Source: OECD (2009); OECD Economic Outlook 85 database and ONS.

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of the Exchequer. Inflation has since fallen as commodity prices have plunged. Although there was some evidence of a rise in inflation expectations from surveys and financial markets, inflation expectations appear to have remained anchored to target and expectations have moderated as inflation has fallen from its peak.


Demand was boosted by the credit cycle, rising asset prices, and by a housing boom. The credit boom was broadly based across different assets and instruments, as well as across developed economies (Figure 1.2). Equity prices reached high levels. Risk premia fell to low levels in many markets. Financial market activity was also intense with many mergers and acquisitions and buyouts. This international cycle was driven by a number of

Figure 1.2. **Developments during the credit cycle**



1. A unit decline in the index implies a tightening in financial conditions sufficient to produce a reduction in the level of GDP by 1% after 4-6 quarters.
2. GBR data is average of the Halifax and Nationwide house price indices. US data is S&P Case-Shiller composite-10 index for top 10 US cities. EURO data is Euro area house price indices weighted by nominal GDP from the OECD EO85 database.

Source: S&P Case-Shiller Home Price Index; Nationwide; HBOS plc and OECD (2009); OECD Economic Outlook 85 database.

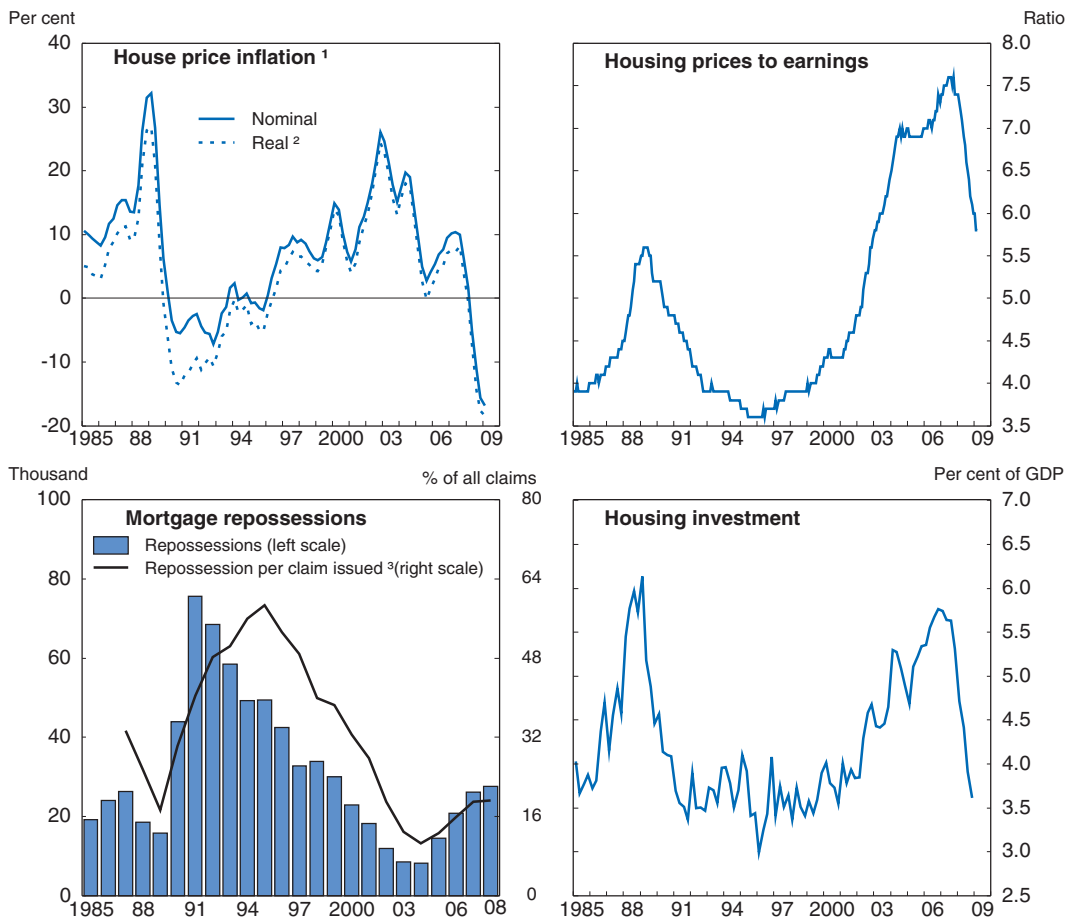
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factors. Accommodating monetary policy, particularly in the United States, combined with easing lending conditions and rapid financial innovation can explain much of the run up in credit and asset prices (Ahrend et al., 2008). For UK banks, the development of securitisation was particularly important in boosting lending, while shortcomings in the regulatory and supervisory framework may have failed to curb excessive risk-taking (Chapter 4). Broad money grew at an average annual rate of almost 10% from 2002 to 2007. Credit expanded much more rapidly than nominal income: UK bank lending to the private sector more than doubled in the five years to 2007. The favourable conditions for credit were self-perpetuating for a time, as greater availability of credit raised asset prices, increased the value of collateral and hence allowed credit-constrained households and firms to borrow more. In addition, an unusual period of low macroeconomic volatility may have reduced the perception of risk, lowering the cost of finance but increasing risk-taking.

Although many countries experienced substantial increases in house prices, the rise in the United Kingdom was particularly marked. House prices more than tripled in nominal terms in the ten years to their peak in the second half of 2007. Although some additional housing demand may be explained by lower long-term interest rates, rising incomes and demographic factors, in an environment of restricted supply, some studies find that a large part of the price rises cannot be explained by fundamental factors.<sup>2</sup> Activity in the housing market was intense, with a high volume of transactions and the development of a substantial buy-to-let market. Rising prices made it easier for homeowners to trade up to a more expensive home by leveraging the increased value of equity in their existing homes. Although planning restrictions and supply constraints channelled much of higher housing demand into prices, dwelling investment increased from around 3.5% of GDP in the mid-1990s to peak at close of 6% of GDP in 2007. House prices peaked in the second half of 2007 and then began to decline precipitously. Nominal prices are now over 20% below their peak (Figure 1.3). Arrears and repossessions have increased, and negative equity is thought to be widespread.


Higher house prices and consumption were financed by higher debt. The net household saving ratio never exceeded 1.5% of disposable income over the past decade and was negative for much of that time. Such a low saving ratio and high household indebtedness are fairly unusual in the OECD (Figure 1.4). Over the period 2002 to 2007, net household-sector wealth increased relative to personal disposable income despite weak saving mainly because of the rising value of houses. The net financial asset position of households also improved, despite rising financial liabilities, as rising equity prices boosted the value of pension fund reserves. As UK households as a whole became more leveraged with respect to housing, higher indebtedness is likely to have increased the sensitivity of households to certain risks even more because the additional leverage was concentrated among some groups of households.<sup>3</sup> Although the subprime mortgage market did not develop to the same extent as in the United States, more households took out riskier types of loans such as those with very high loan-to-value ratios or interest-only mortgages.

Although the growth of credit to private non-financial corporations was slower than to households and strong corporate profitability boosted the supply of internal funds, the corporate sector nevertheless also became considerably more leveraged (Figure 1.5). Indebtedness increased substantially for some sectors through private equity finance and leveraged buy outs. This made the corporate sector more vulnerable to financial shocks, as well as leading to difficulties when deals initially financed at very low interest rates and on favourable terms needed to be refinanced.

Figure 1.3. **The housing market**

1. Average of the Halifax and Nationwide house price indices. Base year = 1991.
2. Percentage growth of nominal prices less that of the private consumption deflator.
3. Claims issued to courts for repossessions.

Source: Source: Nationwide; HBOS plc; Council of Mortgage Lenders; Bank of England; Ministry of Justice; Financial Services Authority and OECD (2009); OECD Economic Outlook 85 database.

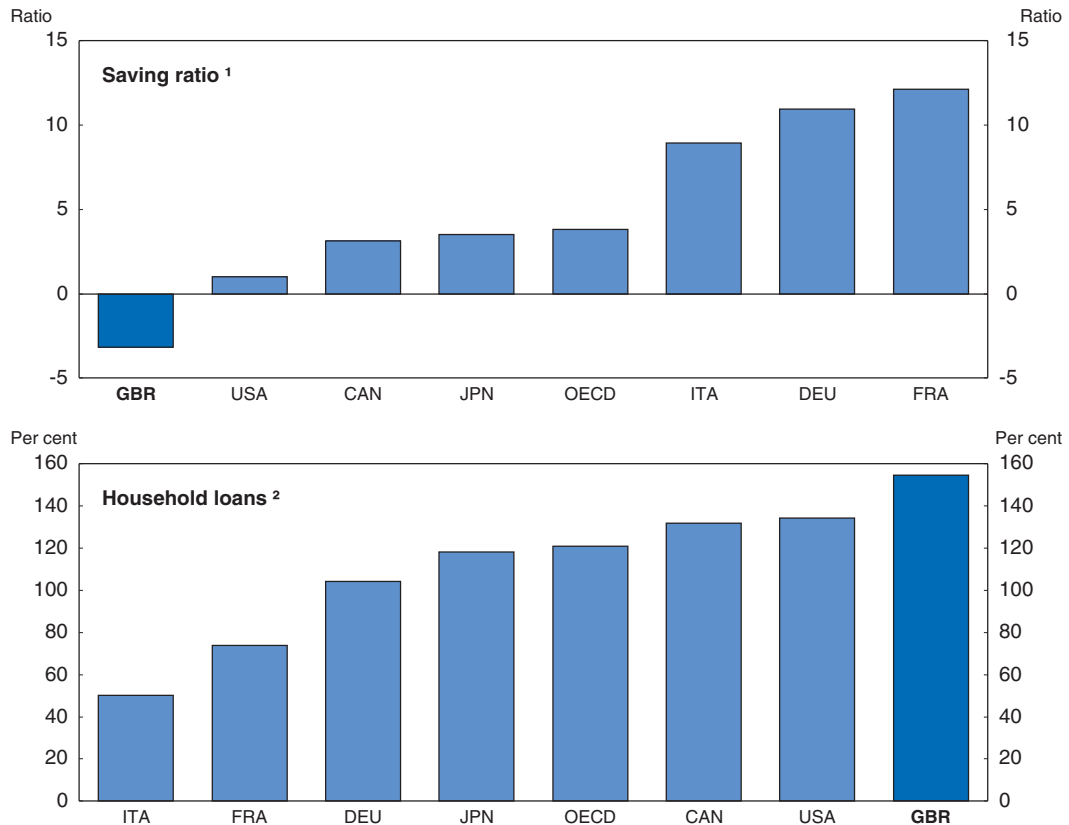
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### **Turmoil in international financial markets since August 2007**

Although there were growing imbalances in the UK economy and the housing market began to lose momentum around the end of 2007, the most immediate negative impact on the economy came from the turmoil in international financial markets starting in August 2007, triggered by higher-than-expected default rates on US subprime mortgage lending. Liquidity in interbank money markets was severely curtailed and interbank lending rates rose sharply above policy rates as a lack of trust developed between institutions as the result of uncertainty about the scale of losses on holdings of US subprime mortgages and the lack of transparency about the distribution of losses across institutions. The spread between the future expected policy rate and the 3-month unsecured interbank lending rate has been well above historical norms since the crisis took hold (Figure 1.6), and this measure is likely to understate the actual increase in costs for the average bank (ECB, 2009).

Figure 1.4. **Household saving and indebtedness**

Average of 2006-08



1. Household and non-profit institutions serving households net saving ratio.

2. As per cent of household disposable income.

Source: OECD (2009); OECD Economic Outlook 85 database and OECD Financial Accounts Statistics.


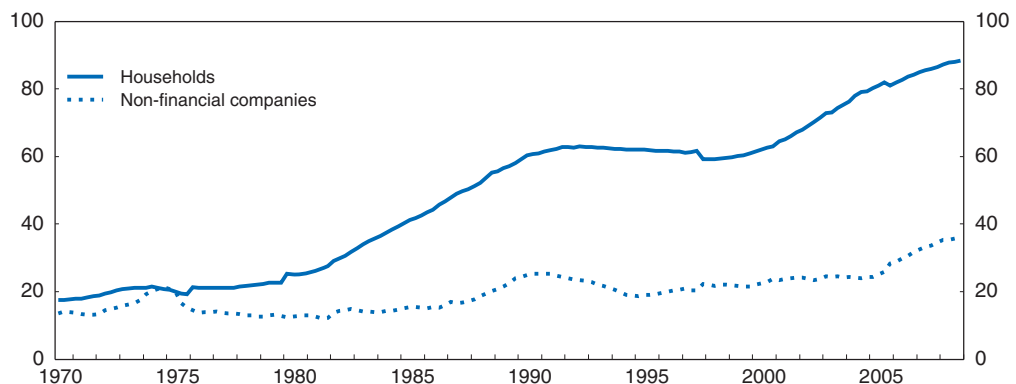
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Figure 1.5. **Bank lending to households and private non-financial corporations in the UK<sup>1</sup>**

1. Data include the value of loans that have been securitised.

Source: Bank of England and Datastream.


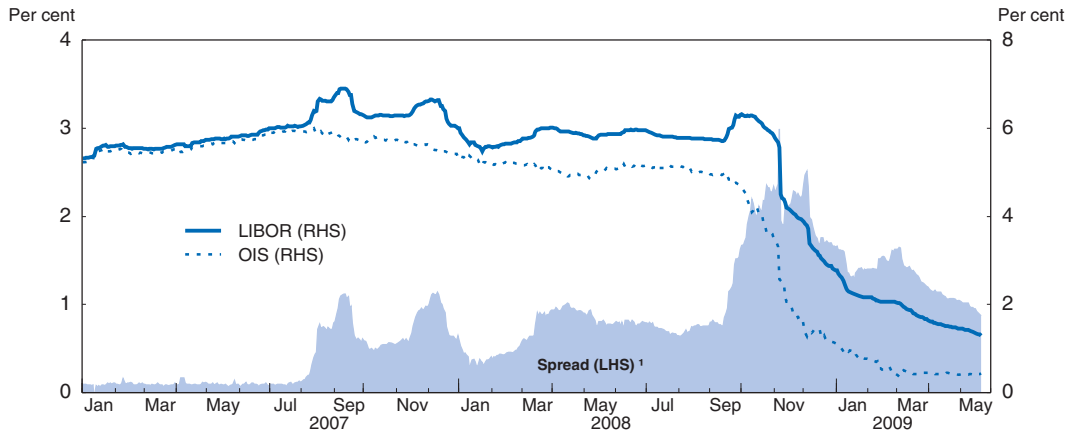
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Figure 1.6. **Three-month interbank rates and spreads relative to future expected policy rates**



1. Three-month LIBOR spread over equivalent-maturity overnight index swap (OIS).

Source: Bloomberg and HM Treasury.

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The UK financial system was particularly vulnerable to the money market turmoil. Firstly, UK banks were more heavily exposed to US subprime mortgage instruments than institutions in many other European countries, and thus experienced relatively heavy losses. Secondly, UK banks had been more reliant on borrowing in financial markets, rather than on deposits, compared with many other countries. Disruption in the interbank market therefore had a big impact. In addition, regulatory liquidity requirements were modest by international standards (Chapter 4). Thirdly, securitisation played a large role in funding mortgages and other loans. Following the problems with securitised subprime mortgages in the United States, the appetite for securitised mortgages fell across the board and issuance slumped. In particular, US institutions were no longer willing to purchase UK residential mortgage backed securities. Banks thus had to hold a larger share of new mortgage loans on their balance sheets. In addition, some special investment vehicles connected to banks required financing, as they were unable to obtain funds from capital markets, and some were consolidated on their parents' balance sheets. These tensions led to a bank run and the failure of the Northern Rock bank, the fifth largest mortgage lender at the time.

From the on-set of the financial crisis in August 2007, UK banks' demand for precautionary balances rose. Under the Bank of England's system of voluntary reserves targeting, banks were able to reflect this by setting higher reserves targets at the start of a maintenance period (MP). The Bank mechanically supplied those additional reserves in its Open Market Operations (OMOs). Where there were shocks to the demand for reserves within an MP, the Bank supplied additional reserves via fine-tuning OMOs in four MPs in 2007 and 2008, firstly in September 2007. The Bank also expanded the range around banks' reserves targets within which reserves were remunerated, in order to accommodate the additional reserves supplied and keep market rates in line with the Bank Rate. These ranges were maintained at a wider-than-normal level in order to provide banks with additional flexibility in managing their liquidity. That was necessary, in part, because there appears to have been a "stigma" attached to borrowing from the Standing Facility.

In common with other central banks, the Bank of England took a number of further measures to ease funding pressures on banks (Box 1.1). From December 2007 the Bank held

larger-than-normal three-month long-term repo OMOs against an expanded range of high-quality collateral securities, including residential mortgage-backed securities (RMBS). In April 2008 the Bank launched the Special Liquidity Scheme (SLS) which allowed banks to swap illiquid securities for liquid UK government bills for a period of up to three years. Accepting mortgage-backed securities helped directly to address the funding problems that hit UK banks as the securitisation process dried up. As the financial turmoil intensified in mid-September 2008, further measures were taken by the central bank to extend liquidity support. These included further expanding the size of long-term repo operations and further expanding the range of collateral accepted in them; and the Operational Standing Facility to address the stigma issue, and the Discount Window Facility. These policy measures helped contain the shortage of liquidity in interbank lending, but, as in other countries, the spread over expected policy rates remains higher than before the turmoil began in 2007 even if the severe tensions of late 2008 have eased.

#### Box 1.1. Main policy actions by the Bank of England to support bank liquidity

The **Special Liquidity Scheme (SLS)** allows banks to swap temporarily their high quality mortgage-backed and other securities for UK Treasury Bills for a period of up to three years. Only assets existing at the end of 2007 are eligible. The banks remain liable for any losses on the underlying assets and are required to pay a fee. Launched in April 2008, the scheme was extended in September 2008 and terminated at the end of January 2009, although the swaps may remain in existence for up to three years.

**US Dollar Repo Operations**, in coordination with the Federal Reserve and three other major central banks, provide US dollar liquidity with terms of one week, 28 and 84 days.

**Extended Collateral Long-Term Repo Operations** began in December 2007. This extended collateral eligible in weekly sterling three-month repo operations include AAA-rated asset-backed securities of residential mortgages and, since September 2008, of some corporate and consumer loans and highly-rated, asset-backed commercial paper, where the underlying assets meet the same conditions. The previous Standing Facility was replaced by the **Operational Standing Facilities** to provide emergency liquidity insurance, under which the Bank can now verify whether the use of the facility is appropriate. The rates for using the borrowing/deposit facilities were narrowed to  $\pm 25$  basis points around the Bank Rate compared with  $\pm 100$  basis points under the previous facility. Disclosure of use of the facility has been limited to average usage after the end of the relevant maintenance period.

The **Discount Window Facility (DWF)**, introduced in October 2008, enables banks to borrow long-term government securities or cash against a wide range of collateral for a period of 30 days. Four types of collateral are eligible: highly-rated sovereign bonds; other high-quality debt that is tradable in liquid markets; high-quality debt and other transferable instruments that are not tradable in liquid markets; and "own name" instruments. Fees ranging from 50 to 400 basis points or higher are levied depending on the collateral and the size of each institution's DWF exposures. Since January 2009, drawings are allowed for up to 364 days at an additional fee of 25 basis points.

These actions expanded the Bank of England's balance sheet and changed its composition: there was a shift to longer-term repo operations and, more significantly, the ratio of total assets to liabilities has increased by around 2.5 times. The commercial banks' reserve

balances at the central bank increased by around half from August 2007 to September 2008 and rose sharply again from September 2008, to around 2.5 times their pre-crisis level. This increase represents around 30% of the Bank's pre-crisis balance sheet. Since the introduction of large-scale asset purchases funded by central bank reserves in March 2009, the Bank has suspended reserves averaging and remunerated all reserves at the Bank Rate. The larger scale of activities and the wider range of collateral increase the amount of risk on the central bank's balance sheet. This raises the importance of good risk management and pricing risk appropriately. Lessons should be learnt from the current crisis on the design of monetary policy operations, both for normal times and during crises, and it is useful that the authorities have begun to address this issue through public consultation (Bank of England, 2008a).

### **The financial crisis**

The financial turmoil reached crisis proportions in September 2008, when Lehman Brothers failed, with a further tightening of credit conditions and more marked falls in asset prices. While there were most certainly confidence effects on consumption as a result of collapsing asset prices, there is some debate as to the magnitude of the direct effects of the falling assets prices on household consumption. Some studies based on econometric analysis suggests that the short - and long-term impacts of financial and housing wealth on consumption are both relatively high in the United Kingdom compared with the other large European economies (Catte *et al.*, 2004). However, the impact of housing wealth on consumption is debatable given that changes in house prices largely redistribute wealth between current and future homeowners and that the effect is difficult to identify given that there are a number of common factors that influence both variables. This is supported by the fact that private consumption as a share of GDP has been on a declining trend over the past decade, despite the strong rises in house prices seen at that time. However, even this redistribution is not necessarily neutral in terms of its impact on consumption as propensities to save may vary across the life-cycle and because some borrowers are credit constrained.

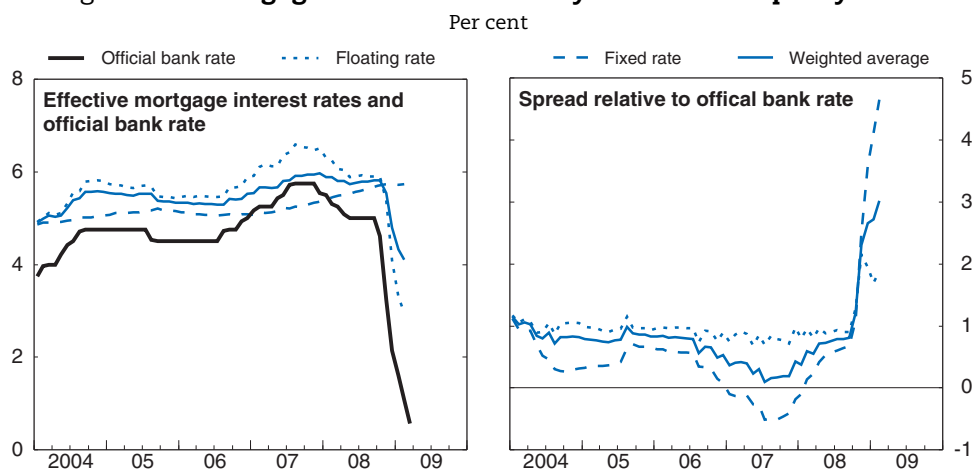
Falling asset prices are likely to have financial accelerator effects on the extension of additional credit. There are two main conventional conduits for these effects (Bernanke and Gilchrist, 1995): the balance sheet channel, whereby falls in the value of collateral or reductions in cash flow make it harder for potential borrowers to commit to repaying loans; and the bank lending channel, whereby the supply of loans is limited by the fragility of banks and their consequent inability to finance themselves and extend new loans. The balance sheet channel may have powerful effects in the UK context as part of home equity withdrawal (aggregate borrowing against housing exceeding investment) had been used to finance consumption (Catte *et al.*, 2004).

The financial crisis is having strong effects through the bank lending channel: UK banks made substantial losses on holdings of asset-based securities and other activities, such as acquisitions of foreign institutions. Their profitability has been heavily affected by higher funding costs and the lack of appetite for securitised assets. The extent of future losses depends on macroeconomic and financial developments, especially the evolution of house prices and the increase in unemployment that drives mortgages arrears, defaults and losses. The October 2008 *Financial Stability Report* (Bank of England, 2008b) presents a range of estimated credit losses from household and corporate arrears of £ 30 billion to £ 70 billion (around 2.0% to 4.8% of GDP).<sup>4</sup> This scale of losses represents a large fraction of the tier 1 capital of the banking system. The synchronised global slowdown could push losses still further. Large losses reduce banks' ability to lend by reducing capital and

making it more difficult to raise additional capital and funding. In addition, the credit crisis and falls in asset prices may reduce managerial incentives to take risks (Rajan, 2005).


Credit to private non-financial corporations contracted substantially from September 2008 and, although it recovered slightly in early 2009, it is now at a level similar to that in August 2008, contrasting with the sharp rates of growth of recent years. It is difficult to identify the effects of changes in credit supply versus demand. But, it is clear that the availability of credit has declined. The 2009 Q1 Bank of England Credit Conditions Survey (Bank of England, 2009) reports that corporate credit availability increased slightly over the past three months. A further increase in corporate credit availability is anticipated over the next three months. This development is contrary to expectations in the 2008 Q4 Survey. Although securitisations have remained scarce, corporate bond issuance has increased in early 2009. The CBI Access to Finance Survey in March 2009 reported that the balance of firms who said the availability of new finance had worsened in the last three months was 36, an easing in the balance from February's survey. This tightening in credit conditions has increased the credit-spread on bank loans over the official policy rate, so that the easing of monetary policy has had a relatively limited effect on effective mortgage rates (Figure 1.7). However, the 40% of borrowers on tracker mortgages will have benefited from the cuts in official rates. In addition, stricter conditions are being imposed on borrowers. Mortgages with loan-to-value (LTV) loans over 90% have largely become unavailable.

Figure 1.7. **Mortgage interest rates fell by less than the policy rate**<sup>1</sup>

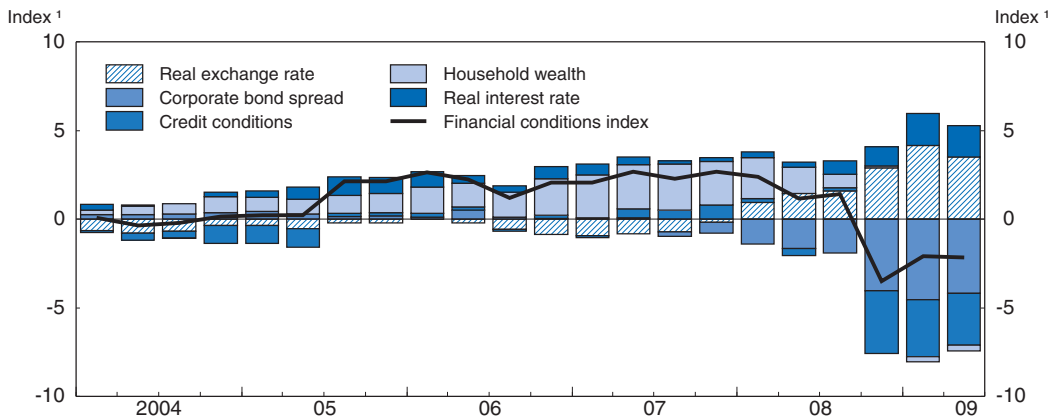


1. Monthly average of UK resident banks' sterling weighted average interest rate, loans secured on dwellings to households.

Source: Bank of England.


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The tightening in financial conditions as a result of falls in asset prices and the contraction in the supply of credit are severe. The OECD financial conditions index (FCI) summarises the impact of these developments, alongside changes in the official interest rate and the exchange rate, in a linear model of their past impact on GDP growth. This suggests that financial conditions remain close to their tightest since the series began in 1995 as more stringent credit conditions and wider loan spreads more than offset the stimulus from short-term policy rates cuts and the declining real exchange rate (Figure 1.8). Changes in financial conditions have their greatest impact with a lag of four or more quarters, so that the tightening seen in recent months will exert downward pressure on activity for some time.

Figure 1.8. **UK financial conditions index**<sup>1</sup>

1. A unit decline in the index implies a tightening in financial conditions sufficient to produce a reduction in the level of GDP by 1% after 4-6 quarters.

Source: OECD (2009); OECD Economic Outlook 85 database.

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### The near-term economic outlook is challenging

Output contracted by over 4% in real terms from its peak in mid-2008 and is expected to contract further, with a projected decline of 4.3% in 2009 (Table 1.1). Consumption will decline as households rebuild their balance sheets, unemployment rises and confidence remains low. Business investment will also decline due to weak sales prospects and tight financial conditions. Construction activity has fallen by 6.4% from its peak in the first quarter of 2008 and new orders have reached record lows. The sharp fall in external demand due to the synchronised global downturn will lead to a contraction in exports in all advanced economies, and the UK is no exception despite the improvement in competitiveness due to the substantial depreciation of sterling, which also helps through

Table 1.1. **Short-term outlook**<sup>1</sup>  
Percentage change

	Outcomes				Projections	
	2005	2006	2007	2008	2009	2010
<b>Real gross domestic product (GDP)</b>	2.1	2.8	3.0	0.7	-4.3	0.0
Private consumption	1.9	2.1	3.1	1.4	-3.4	-0.3
Government consumption	1.7	1.6	1.5	3.4	4.8	1.0
Gross fixed investment	2.2	6.0	6.8	-3.1	-12.5	-4.2
Total domestic demand	1.9	2.6	3.5	0.6	-5.0	-0.5
Net exports <sup>2</sup>	0.1	0.1	-0.7	0.2	0.8	0.5
<b>Memorandum items</b>						
Inflation: CPI	2.0	2.3	2.3	3.6	1.9	1.0
Inflation: underlying <sup>3</sup>	1.4	1.3	1.6	1.6	1.0	1.2
Employment	1.0	0.9	0.7	0.8	-2.3	-2.6
Unemployment rate (% of labour force)	4.8	5.4	5.4	5.7	8.2	9.7
Current account balance (% of GDP)	-2.6	-3.4	-2.9	-1.7	-2.6	-2.4
Government net lending (% of GDP)	-3.3	-2.7	-2.7	-5.5	-12.8	-14.0

1. Projections are those published in the Economic Outlook 85.

2. Contribution to GDP growth.

3. Excluding energy, food, alcohol and tobacco.

Source: OECD (2009), Economic Outlook 85, and OECD calculations.

import substitution. Tight credit conditions and high uncertainty may reduce the rate at which firms seek to take advantage of the more competitive exchange rate. The large swing in the government deficit is supporting demand and the modest fiscal package, including the temporary reduction in the value-added tax (VAT) rate, will have some positive impact in the short term. The fiscal and monetary easing, combined with the weaker exchange rate and some recovery in foreign demand, should underpin a recovery in 2010 if measures to stabilise the financial system are effective. Even if these measures succeed, the upturn is expected to be weak with growth remaining well below trend for some time as households and firms continue to rebuild their balance sheets. Moreover, the financial crisis is likely to lead to a permanent fall in the level of potential output (Box 1.2).

### Box 1.2. **The financial crisis, potential output and macroeconomic policy**

Short economic downturns are typically followed by an economic recovery that takes GDP back to a long-term growth path that is consistent with the trend prior to the downturn, with a period of relatively rapid post-recession growth as the economy re-employs resources that were under-utilised during the downturn. However, there is evidence to suggest that if a downturn is protracted and, in particular, if it is also associated with a financial crisis, then the economy's level of potential output (long-term growth path) can be significantly lower for a period of time extending well beyond the recovery, and even to some degree, eroded permanently. Understanding the degree to which potential output is affected by an economic downturn is important from a policy perspective – and especially so if fiscal or monetary policies are used to stimulate demand during a downturn and must then be reversed to prevent overshooting and rising inflationary pressures as economic activity picks up again. If potential output has shifted onto a new (lower) path over the course of the downturn then determining what neutral policy settings are once the economy begins to recover becomes more difficult (Orphanides *et al.*, 2000).

While there will undoubtedly be a slowdown in potential output growth due to the recession, whether there will be a permanent loss in the level of potential output is a more contentious issue. Research on this question is subject to the usual problems in calculating and projecting trend output, and particularly because recessions involving financial crises are often associated with booms prior to the onset of the downturn. Cerra and Saxena (2008) show for a broad range of countries that a component of the output losses associated with financial crises is permanent.

Longer-term potential output can fall as a result of an extended downturn for several reasons. Participation in the labour market typically declines during a downturn as discouraged job seekers leave the labour force, some of them permanently. Likewise, the ranks of the long-term unemployed swell and unemployment spells lengthen, leading to the erosion of the skills of retrenched workers, who become permanently detached from the labour market. The effect on productivity growth is difficult to surmise. While research and development spending is normally one of the first victims of a downturn, the net long-term impact of a downturn on total factor productivity (TFP) growth is ambiguous, in part because the most productive firms are likely to survive. Likewise the impacts of government policy responses to a downturn can have both positive and negative effects. For instance, counter-cyclical spending on infrastructure can have positive long-term effects, while spending that distorts behaviour, such as subsidies to specific industries, can have detrimental effects on the level of potential output.

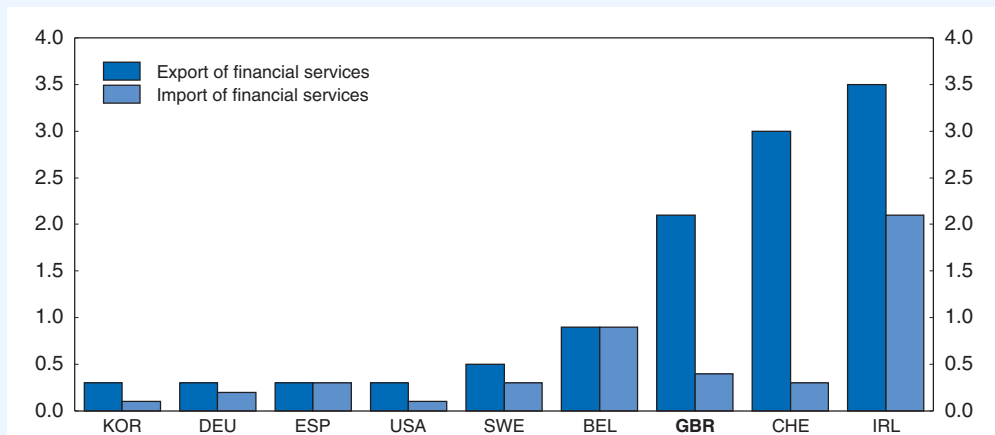
**Box 1.2. The financial crisis, potential output and macroeconomic policy (cont.)**

Financial crises are associated with deep and extended downturns in OECD countries (IMF, 2008b, Reinhart and Rogoff, 2009, Furceri and Mourougane, 2009) and are likely to exacerbate the negative effects on potential output growth for a number of reasons. While in normal downturns the creditworthiness of borrowers declines, resulting in a contraction of lending, financial crises often involve an additional erosion in lending as banks are forced to deleverage. The current episode has been especially notable because of the breadth of the crisis which has meant that the financial intermediary role of banks has been impaired and other funding sources, particularly for firms, have come under severe stress. However, a credit crunch might also solicit some positive supply responses. For instance, the large falls in equity and house prices might lead to the perception by households that their debt levels are too high and they therefore may boost labour supply and older workers may choose to postpone retirement (IFS, 2009).


In comparison to other countries, the impact of the disruption in the financial sector is likely to be more severe in the United Kingdom, not in small part because of the relatively large role the sector plays in the economy. In 2006, UK exports of financial services were equivalent to over 2% of GDP (Figure 1.9) and compensation to the financial and business services sector accounted for almost one quarter of total compensation. Value-added from financial intermediation was around 8% of GDP, well above the level in any other major European country. It is likely that the UK financial sector will contract substantially (in part due to the withdrawal of a large number of foreign players) and may remain smaller. Also the run up in dwelling prices prior up to the end of 2007 was especially pronounced in the United Kingdom and there may be a perception of an overhang that acts to mute investment in that sector for some years as prices decline and affordability levels readjust to more historical levels.

**Figure 1.9. Trade in financial services**

Per cent of GDP



Source: OECD Statistics on International Trade in Services and National Account.

StatLink  <http://dx.doi.org/10.1787/647738547782>



**Box 1.2. The financial crisis, potential output and macroeconomic policy (cont.)**

In Budget 2009 the government assumed a phased reduction to potential output of around 5% over the three years between Q3 2007 and Q3 2010. Potential output growth is assumed to return to 2.75% thereafter. This implies that potential output will be permanently around 5% lower compared to the 2008 Budget estimates. It is difficult to benchmark these Treasury estimates against other studies because quantifying the impacts of various shocks on potential growth depends very much on the assumptions and therefore the vintage of the study. The Institute for Fiscal Studies (IFS, 2009) estimates a fall in potential output of around 4% over 4 years. Estimates based on a similar methodology (Cerra and Saxena, 2008) and based on past experience of crises in OECD countries suggest a range of -2% to -8%. These figures may be an upper bound as the methodology is based on actual rather than potential output. However, the sample does not include a global slowdown of the current scale. Recent OECD (OECD, 2009b) estimates have the level of potential output around 2.8% lower at the end of 2010 relative to estimates made one year earlier (OECD, 2008a).

The number of unemployed reached over 2.2 million by March 2009 and the unemployment rate climbed to 7.1%, up from 5.2% a year earlier. In comparison to the previous recessions, job losses in the current downturn are much more evenly spread across the country and are affecting all age groups. Conditions in the labour market usually lag GDP growth by two to three quarters, which means conditions will deteriorate considerably more through 2009 and into 2010, with the number of unemployed projected to eclipse 3 million by the end of 2010.

Rising slack in product and labour markets will put downward pressure on inflation. Headline inflation is expected to remain below the target rate of 2% for an extended period. Its profile will continue to be affected by the temporary reduction of the VAT rate from 17.5% to 15% in December 2008 and will also be affected by the reversal of the cut at the end of December 2009, as well as the fading inflation effect of the large depreciation of sterling and the lagged effects of recent monetary policy easing.

There is enormous uncertainty about the macroeconomic outlook partly due to the fact that it is difficult to predict the end of the financial crisis and the unprecedented nature of the global slowdown. A swifter than expected recovery in financial conditions or a more powerful effect of current economic policy measures could lead to a stronger recovery. Restoring normal functioning to the financial system may take longer than assumed here and the housing market may decline further or with a greater than anticipated impact on the household and banking sectors. The outlook for consumption depends heavily on the speed with which the saving rate increases, as households rebuild their balance sheets and build up precautionary savings. Financial crises are associated with deep and prolonged downturns (Furceri and Mourougane, 2009), although there is a range of different experiences across past episodes. While currency depreciations of the scale of the recent decline in sterling have played a role in recoveries from past financial crises such as the Nordic banking crisis of the early 1990s, it is less clear how effective this mechanism would be against the background of a highly synchronised fall in global demand.

## Policy needs to repair credit supply and boost activity

Macroeconomic policy faces a severe challenge to counter the weakness of aggregate demand. As outlined above, there are two underlying difficulties: the financial crisis has

impaired the normal supply of credit and demand has slumped. There are strong interactions between these two forces as the lack of credit reduces demand, and weak economic activity increases pressures on the financial system and further hampers the supply of credit. For a recovery to take hold, it will be imperative to restore confidence in financial markets. Through this current episode monetary and fiscal policies are unusually closely intertwined with each other and both are important for the resolution of the financial crisis.

### **Monetary policy**

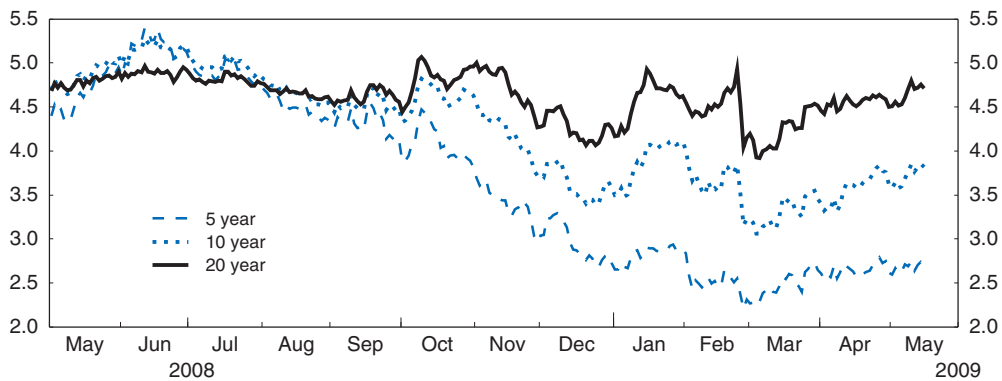
Monetary policy has responded to the financial crisis and the rapid slowdown in activity with a swift series of reductions in interest rates: the policy rate was cut from 5% before the October 2008 meeting to 0.5% in March 2009, the lowest rate on record. The overall decline in the policy rate is comparable to past sharp slowdowns, such as the early 1980s or early 1990s, even though the scope for cutting nominal interest rates has been more limited than in the past due to a lower prevailing level of inflation. In terms of the real interest rate, the current policy rate implies *ex ante* real interest rates that are mildly negative in the short run. This appears very low compared with the experience of recent decades, although it is hard to estimate *ex ante* interest rates because of uncertainty about inflation expectations. The pass-through of changes in the policy rate to households and firms has been hindered by the financial crisis as the cost of bank funding and credit spreads have increased. The degree of monetary stimulus provided by the reduction in policy rates is therefore weaker than would typically be associated with a change of this size. With the policy rate at 0.5%, there is little if any scope to reduce the rate further.

This degree of monetary stimulus appeared unlikely to be sufficient to support demand and bring inflation back up to target quickly, a point indicated in the Bank of England's February *Inflation Report*, which with the policy rate very close to its floor of 0.5% and based on constant interest rates, showed a profile for expected inflation remaining close to 1% until at least 2012. The Monetary Policy Committee agreed that the Bank should therefore undertake explicit quantitative easing measures. The programme of asset purchases announced so far totals £ 125 billion, which constitutes an increase of around 130% in narrow money and is equivalent to 9% of nominal GDP. The United Kingdom's implementation of quantitative easing is both larger and faster than the programme that operated in Japan over a four year period starting in 2001 and which totalled around 7% of GDP. The Bank of England expects gilts to comprise the majority of purchases with the remaining purchases being of corporate paper. This approach is intended both to increase the supply of broad money, and to improve conditions in the corporate debt markets to encourage lending from outside the banking system. Although any increase in the supply of credit to the private sector will help, this strategy is constrained by the limited ability of central banks to provide credit to the private non-financial sector.

The key objective of quantitative easing is to raise nominal demand. The quantitative easing measures sharply increase the amount of base money, while reducing private holdings of government debt, which changes the composition of private portfolios and should reduce the opportunity cost of holding money by lowering nominal interest rates. This effect may be limited if money demand is very elastic because the impact on interest rates will be small and the money multiplier will be low. This was the experience of Japan with quantitative easing in the early 2000s and the large increase in UK banks' reserves


held at the central bank suggests a willingness to hoard cash. The announcement of quantitative easing and initial operations of the Bank of England substantially lowered long-term interest rates although rates have subsequently increased (Figure 1.10). Lack of clarity about the Bank's future holdings of government debt and the interaction with the substantial debt issuance by the government may have reduced the impact of the quantitative easing policy on interest rates by creating a risk of future capital losses for bond holders if the supply of government bonds in private hands were to increase more than anticipated in the future.

Figure 1.10. **Gilt yields by maturity**<sup>1</sup>  
Per cent



1. The rate at which an individual nominal cash flow on some future date is discounted to determine its present value.

Source: Bank of England.

StatLink  <http://dx.doi.org/10.1787/647741521004>

The main mechanism by which quantitative easing can bring forward nominal demand is by generating sufficiently high and immediate expectations of inflation to lower the real interest rate (Svensson, 2003). The Bank of England's own experience shows how transparency and good communication can help to create the right conditions for policy to be most effective. More explicit guidance should be provided to influence expectations of near-term inflation. Furthermore, clear commitments should be made about how quantitative easing measures would be unwound.

### **Policies to increase the supply of credit and repair the financial system**

Restoring confidence in financial markets and the normal supply of credit is necessary for achieving a sustained recovery. Policy can contribute through the use of the government's balance sheet and legal authority to strengthen the banking system and provide credit. While the priority is to restore credit supply quickly, the potentially very large fiscal burden of supporting the financial system makes avoiding excessive fiscal costs and risks an essential part of the appropriate response. There is no one-size fits all solution for banking crises because each crisis has specific characteristics, and the best solution depends on the nature of the difficulties being encountered and the institutional framework and wider circumstances of each country (OECD, 2002), while the small number of examples of past crises in OECD economies limits the understanding of what works best. There is, however, evidence from the cross-country experience that suggests that allowing

impaired institutions to continue to operate for extended periods of time can significantly increase the fiscal costs associated with resolving banking crises.

Policy measures to date have largely been targeted at supporting the banking system (Box 1.3). The scope of measures is similar in some areas to other OECD countries: almost all have strengthened deposit insurance and guaranteed part of banks' liabilities, and most have recapitalised their banks (Furceri and Mourougane, 2009). The UK approach has been comprehensive: it is alone with the United States in having set up an insurance scheme for troubled assets and the use of direct interventions to provide credit to non-financial sectors is also unusual. Moreover, throughout the crisis, the UK has maintained an open and non-protectionist approach to the financial sector. Overall, the level of support provided by the UK authorities is a large share of GDP compared with other OECD countries: the outlay of bank recapitalisations has been around 2.5% of GDP to date and government explicit and implicit liabilities have increased very substantially, with public debt likely to increase by an amount likely to be in the range of 70-100% of GDP from the large banks brought into the public sector (ONS, 2009).

### Box 1.3. Main policy actions to support the supply of credit

#### Actions taken to support lending by banks

The newly-established **Bank Recapitalisation Fund** has been used by the government to invest in the capital of banks. This was initially to assist banks in reaching a tier 1 capital to risk-adjusted assets ratio of 8% and a core tier 1 ratio of 4% under a stress scenario. The government has provided £ 37 billion (2½ per cent of GDP, 1% of domestically-owned UK-resident banks' total assets) of capital to two banking groups. Capital has been provided through a mix of ordinary and preference shares.

The **Government's Credit Guarantee Scheme (CGS)**, introduced in October 2008, guarantees for a fee new senior unsecured bank borrowing for maturities of up to 36 months issued in the period up to December 2009, on "appropriate commercial terms" to assist in refinancing maturing wholesale funding. The Government expects take up of the scheme to cover £ 250 billion of wholesale funding. To be eligible to participate in the scheme institutions are required to raise or commit to raise additional tier-1 capital to the level considered appropriate by the government.

The **Asset Protection Scheme**, introduced in January 2009, protects larger banks from certain future credit losses. Eligible assets include portfolios of commercial and residential property loans, and asset-backed securities. Financial institutions pay a fee and retain a large "first loss" exposure as well a residual second loss exposure to future losses. Two banks have so far indicated their intention to join the scheme: RBS will place £ 325 billion of assets in the scheme and Lloyds Banking Group £ 260 billion, around a fifth of its total loan book. Participating banks must meet a number of scheme conditions and make a verifiable commitment to raise lending: £ 25 billion for RBS and £ 14 billion for Lloyds Banking Group, with around three quarters for corporate lending.

The **Asset-Backed Securities Guarantee Scheme** became available in April 2009 for banks and building societies to use, at first until October 2009, alongside the existing CGS to support their lending in the economy. The scheme, which was approved by the European Commission, extends the funding options open to banks and building societies under the existing CGS to include high quality residential mortgage-backed securities.

### Box 1.3. Main policy actions to support the supply of credit (cont.)

A number of **institution-specific measures** were taken: guarantees and eventual nationalisation of Northern Rock; amending competition law to enable financial stability considerations to be taken into account facilitating the merger of HBOS and Lloyds TSB; the nationalisation of Bradford and Bingley, followed immediately by the sale and transfer of its retail deposit business to Santander and winding down of the remainder of its assets in public ownership. Having initially planned to shrink Northern Rock's book, the government now plans to increase its mortgage lending by up to £ 14 billion over the next two years.

#### **Actions taken to provide credit directly**

The **Asset Purchase Facility (APF)** came into operation in early 2009, and allows the Bank of England to directly purchase high-quality assets including corporate bonds, commercial paper, syndicated loans and a limited range of asset-backed securities. In the first phase of its operation, between 18 February and 5 March, the APF was used to ease corporate credit conditions and was financed by the issue of Treasury bills. At this time, the fund had a budget of up to £ 50 billion, of which £ 985 million was used, and the Bank was indemnified against possible losses by the Treasury. In the second phase of the APF, after 5 March, the facility became an instrument of monetary policy, funded by the creation of reserves, and has a budget of up to £ 150 billion. Private sector assets are still being bought via the APF, but now as part of the mix of assets purchased to meet the inflation target.

The **Working Capital Scheme** run by the Department for Business, Enterprise and Regulatory Reform (BERR) will guarantee 50% of £ 20 billion of short-term loans for smaller businesses. Banks pay a premium for the guarantee, depending on the composition of the loan portfolio. This scheme came into operation in March 2009 and extends a previous scheme for small exporters. In addition, there are other smaller schemes: the **Enterprise Finance Guarantee Scheme** provides 75% government guarantees on secured loans of up to 10 years for businesses with turnover up to £ 25 million and has a fund of £ 1 billion (extending the Small Business Finance Scheme, also worth £ 1 billion outlined in the 2008 Pre-Budget Report); and the **Capital for Enterprise Fund** which provides a small amount of funding for businesses to turn debt into equity.

Banks must be both able and willing to lend for credit to flow normally. The ability to lend is constrained by the large scale of actual and prospective losses on banks' outstanding loans and other assets, combined with uncertainty about the scale of these losses. This needs to be addressed either by raising additional capital, dealing with the troubled assets from banks' balance sheets or scaling down liabilities. The United Kingdom was the first country to move on bank recapitalisation. Banks were required to raise approximately an additional £ 50 billion of tier-1 capital based on the authorities' assessment of the amount required to allow each institution to continue lending normally, while dealing with a recession and meeting regulatory standards. The new capital standards were applied to all major banks. Some UK banks have been able to raise additional capital from private sources or asset sales. Two institutions have received capital from the government, one of which is now largely publicly owned and the other over 40% government owned. Given the sharp deterioration in the world economy, further steps have been needed to allow banks to return to lending on normal commercial criteria. The fiscal costs of the capital injections are material, although these will ultimately depend on the market value of these investments when they are sold. Preference shares

were used for part of the capital raising: these yield a high return, typically around 12%, but in the case of one bank this preference share investment has been replaced by common equity and the second bank is planning to take a similar step.

The Asset Protection Scheme (APS) removes some of the risk around impaired assets on a substantial portion of banks' balance sheets. Combined with new capital, this should assist banks to return to normal lending practices. Two banking groups have indicated their intention to participate in the scheme. In return for taking on the risk of potential losses on these assets under the APS (up to a theoretical maximum of around one quarter of GDP), the taxpayer receives a significant fee. Although there is an extremely high degree of involvement between the authorities and the banks, there is a risk that residual asymmetric information about the underlying value of the assets leads to adverse selection of assets in the schemes, affecting the government's return on a risk-adjusted basis. The APS will need to provide incentives for impaired assets to be well-managed: banks have good incentives where they are liable for future losses but the incentives are reduced once losses exceed that amount. However, through step-in rights and other measures, plans are in place to ensure that assets are well managed.

While there were early hopes that the government recapitalisation scheme would restore confidence and make banks more robust to a recession, the deterioration in circumstances has made strengthening the banks in the face of potentially large losses and supporting the real economy the objective. To avoid new lending being held back by prospective losses associated with past lending, a thorough evaluation of the needs and viability of systemic banks needs to be made (OECD, 2002); in evaluating participation in the APS and other government schemes, the UK authorities have conducted detailed stress tests on banks' balance sheets. Recapitalisation remains appropriate, where a bank can function normally with only limited public assistance. Asset protection can deal with uncertainty about impaired assets on bank balance sheets. In some cases, a different approach may be required. In the past, the options for UK banks in distress were limited by the absence of specific legal procedures to deal with institutions in financial difficulties. Normal procedures, which are slow and complex, would have been inappropriate for banks as they are heavily reliant on short-term financing and because of links between institutions in the financial system. The new Special Resolution Regime, however, now provides several options for banks that could not survive without large-scale support, including transferring ownership (to a private sector purchaser, or to a bridge bank), a special administration procedure and temporary public ownership. These tools are, however, largely designed for small and medium-sized institutions. These provide mechanisms by which the banking system can be strengthened by dealing with bad assets from balance sheets and restructuring banks' liabilities, as well as raising further capital. The impact on the public finances should be contained and more of the burden of losses on past lending carried by banks' shareholders and other creditors. This would have the further benefit of reducing moral hazard as private investors would have to bear more of the costs.

Although nationalisation creates risks that institutions will be mismanaged or credit poorly allocated, this approach may have some advantages for institutions that are already heavily dependent on public support. Full public ownership would allow banks to be managed to meet the objective of supplying credit according to normal commercial conditions, rather than being managed in the interest of the voting shareholders and their management who may prefer to pay dividends, reward managers or buy very safe assets

rather than lend in the normal way, although conditions on any support provided can deal with these issues with banks remaining in the private sector.<sup>5</sup> Any nationalisation should be temporary and well-managed: meeting the government's objectives should be placed in the hands of an independent body. Nationalisation or some restructuring of banks that are not viable could result in the creation of a "bad bank" or investment fund to hold troubled assets. This may free the management of banks from having to focus on working out bad loans rather than new lending (Jonung, 2009). A centralised asset management company might help to maximise recovery rates and speed up the learning process about how to deal with complex assets, such as asset-backed securities.

Given the weak economic outlook, banks' willingness to lend would be subdued even in the absence of any constraints on their ability to lend. But banks may have become excessively risk averse after years of exuberance and prefer to hold very safe assets, even if risk spreads on loans to the private sector are high. The willingness to lend may be further reduced by a collective action problem: the returns on any loan depends on the overall level of credit supplied, through the level of activity and asset prices, but each bank is only able to determine its own lending. At the margin, each bank's individual interest may be to lend less than is optimal from the perspective of the banking system as a whole. To raise the availability of credit, government support has been accompanied by undertakings to maintain the supply of credit: use of the extended Credit Guaranteed Scheme (CGS) and the APS requires specific amounts of new lending.<sup>6</sup> Though the impact of the lending targets is hard to verify, they should support the supply of credit somewhat.

Given the difficulties with resolving bank crises quickly, an alternative and also complementary policy is to supply credit directly to the private non-financial sector. The United Kingdom has sought to do this through measures, such as the Asset Purchase Facility (APF) and Working Capital Scheme. The APF supports the provision of finance via commercial paper and corporate bonds, and the Bank of England is consulting on how to extend the APF to support the provision of finance through loans. An important consideration is to design structures that supplement rather than displace private sector provision, and in particular that complement the private sector's role in allocating credit to companies that have a viable business model.

### **Policies to assist mortgagees**

Mortgage repossessions have increased substantially over the past year, reaching around 40 000 in 2008, up from 28 000 in 2007. There has also been a steep increase in the number of people falling behind with their mortgage repayments. Defaulting mortgagees who end up losing their homes, particularly in circumstances of rapidly falling house prices where capital losses upon resale are likely, can end up repaying these debts for many years, and can also become a substantial burden on public housing, which is already overstretched. While the very low level of interest rates have undoubtedly helped to stop repossessions from climbing as sharply as during the previous downturn, recent actions taken by the government may also have helped. Regulation of mortgages by the Financial Services authority (FSA), introduced by the government in 2004 is supported by a new pre-action protocol introduced in November 2008. This imposes a greater responsibility on lenders to demonstrate that they have explored alternatives to repossessions.

A programme to assist those having trouble making mortgage payments due to job loss has existed for some years and the eligibility criteria have been relaxed recently. Under the Support for Mortgage Interest (SMI) scheme, homeowners who have lost their jobs can

claim assistance after 13 weeks (down from 39 weeks) and for up to the first £ 200 000 of their mortgage (up from £ 100 000). Currently 220 000 households are receiving assistance under the SMI scheme (DWP, 2009). An additional scheme was introduced in January 2009, the Mortgage Rescue Scheme (MRS), which aims to help around 6 000 low-income “priority need” households. It allows eligible households to either sell a part share in their home and reduce monthly payments, or sell their home and remain in the property as a tenant paying an affordable rent. As the mortgage rescue process takes around five months to complete, at present the number of households who have completed this process is small. The Homeowner Mortgage Support Scheme (HMSS), introduced in April 2009, will allow lenders to reduce monthly mortgage payments by deferring some of borrower’s interest payments for up to two years, where this is appropriate to their individual circumstances and subject to suitable independent debt advice, with the government guaranteeing the lender against a portion of any loss incurred on the deferred interest. To be eligible, borrowers must have lost their job or experienced a substantial fall in income and have savings below £ 16 000 (as for the SMI benefit payment).

### **Fiscal policy**

To date the government has chosen a temporary cut in VAT, to bring forward planned capital expenditure and a temporary increase in capital allowances as the conduits of short-term fiscal policy stimulus. It is likely that the cut to the VAT was chosen principally due to timeliness factors – income and corporate tax cuts in the United Kingdom are administratively complex and can involve delays of up to six months. However, while studies suggest that value-added tax cuts are typically associated with low multipliers (OECD, 2009a), the withdrawal of the VAT cut in December 2009 should promote some bring-forward of consumption expenditure in anticipation of higher prices. The choice to bring forward capital expenditure was judicious as a significant proportion of these investment projects were both pre-identified and pre-approved and thereby avoided the most significant objection to using investment for fiscal stimulus – namely timeliness. Putting in place a timely fiscal stimulus package is laudable. Now that the downturn looks to be protracted more focus should now also be directed towards programmes that aim at ameliorating its longer term impact, particularly on the labour market (see below). To this end the UK authorities have set out policies which both increase capacity within the job centres to sustain the high numbers of individuals currently moving off benefits in the early months of each claim and provide support to find work for those who remain unemployed for longer periods, and secondly, provide for a guaranteed job training or work placement for all 18-24-year olds who reach 12 months unemployed, to ensure no young people are left behind due to long term unemployment. The United Kingdom currently spends relatively little on labour market programmes and given the success of a number of existing schemes, the policies announced in the Budget to expand these programmes are welcome.

Studies suggest that short-term fiscal multipliers in the United Kingdom are quite low relative to other OECD countries (OECD, 2009a). The final increase in GDP from a £ 1 increase in government expenditure is estimated to be around £ 0.40, taking into account both the first-round impact of the stimulus on activity and second-round effects. Such a low multiplier is consistent with the trade openness of the UK economy, and may be further affected by the unusual circumstances of the current crisis. Given that households are credit constrained as the result of financial problems, the impact of fiscal



stimulus may be higher. However, unusually high uncertainty, combined with the need to rebuild household and business balance sheets may create an unusually high propensity to save out of additional income.

After around the turn of the century, the underlying fiscal position weakened more than anticipated. While there was some subsequent improvement particularly in tax receipts in around 2002/03, like in most other OECD countries, public finances are set to deteriorate further as the current downturn progresses. Given the projected state of the budget, there is limited room for further fiscal manoeuvre. Indeed, as a result of the impact of what is projected to be a protracted economic contraction and the potential for net costs from the financial sector stabilisation, public debt is likely to climb to and even exceed levels of some other large European countries. The Budget projections do however already incorporate for fiscal policy purposes a provisional estimate for losses from interventions designed to support financial stability. The government provisionally estimates these losses may lie within the range of 1½ to 3½ per cent of GDP. For fiscal policy purposes the high end of this range is included in Budget projections for borrowing and debt, and these estimates will be updated in subsequent Budgets and Pre-Budget Reports. There may be risks going forward; including that if sentiment were to shift, the debt dynamics could deteriorate, although the UK's long average maturity structure mitigates this to some extent. Nevertheless, the VAT rate rise at the end of 2009, along with other consolidation measures announced in the 2008 Pre-Budget Report and 2009 Budget and due to take effect in 2010 and 2011, will lead to a fiscal tightening. The Budget was correct to target further support at schemes that mitigate the long-term negative impacts of the recession. If economic circumstances deteriorate significantly more than projected, further fiscal measures could be warranted, but any further fiscal stimulus should be accompanied by a strong and credible commitment to a robust fiscal consolidation once the recovery takes hold.

In any event, given the projected significant rise in public debt especially in light of the future fiscal costs of aging and health care, the government needs to ensure that it delivers on its commitment to implement a sustained fiscal consolidation once the recovery takes hold and the plans it has announced to achieve this, so that public finances are put back on a secure and sustainable footing. Continued articulation of this should help to instil confidence and thereby promote a more rapid recovery. It is appropriate that the plan for consolidation includes both revenue raising measures and concrete expenditure constraint. It is also appropriate that budget consolidation and debt reduction has been planned so as to minimise the cost to employment and economic welfare – overly aggressive action could needlessly prolong the economic downturn and indeed may be counterproductive in terms of fiscal consolidation.

Putting in place an effective permanent fiscal framework would also help in promoting confidence and getting public finances back in order. The original fiscal rules could be amended in a number of ways, rather than being reinstated (Chapter 2).

### ***Policies to prevent unemployment from becoming entrenched***

A number of policies can help to mute the most harmful and long-lasting impacts of economic downturns, including policies that offer assistance to the swelling ranks of the unemployed. If left unaided, the unemployed are likely to lose skills and become detached from the labour market, and therefore reducing the probability of reemployment once conditions improve. Not only does this build up of long-term unemployment constitute a

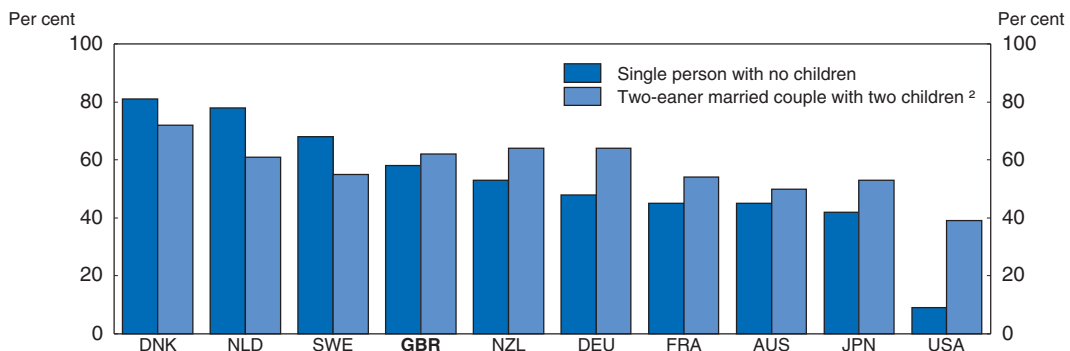
considerable long-term burden on the public purse, but poverty and hardship rates also increase.

The UK labour market is relatively flexible, and this speeds up adjustment both through the downturn and once the recovery takes hold. It is nevertheless important to ensure that short-term unemployment does not become entrenched and that the economy is able to return as quickly as possible to low structural levels of unemployment. As the unemployment rate picked up following the early 1990s recession, the share of the labour force unemployed for one year or more almost doubled to around 4%. The share of long-term unemployed did not return to its 1990 level until the late 1990s, after which it fell to around 1% by 2003.

Evidence suggests that strong incentives to work, including activation requirements, reduce long-term unemployment. Replacement rates from the UK Jobseeker's Allowance are generally low because, for those who qualify, the payment is a fixed level rather than proportional to the previous wage. Indeed gross replacement rates were reduced under the New Deal reforms introduced in 1998 and are now lower than during the 1990s recession. In addition, the non-means-tested contribution-based element lasts only for the first six months. Despite the overall incentives to work, the flat-rate nature of the unemployment payment and the importance of housing benefits implies the net replacement rates are comparatively high at low income levels (Figure 1.11). Any negative effects from these policies, that are not offset by conditionality or other parts of the policy framework, should be monitored carefully and the design of benefits altered if it is necessary to boost work incentives for those with relatively low earnings potential.

Figure 1.11. **Net replacement rates: Long-term unemployment**

67 per cent average wage level<sup>1</sup>



1. After tax and including unemployment benefits, social assistance, family and housing benefits in the 60th month of benefit receipt.

2. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.

Source: OECD, Tax-Benefit Model.

StatLink  <http://dx.doi.org/10.1787/647761405531>

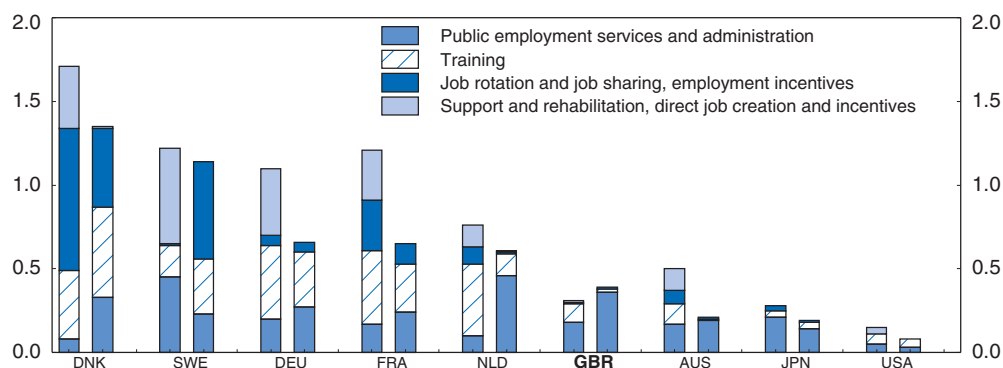
Policies currently in place in the United Kingdom, such as in-work transfers and mutual obligation activity requirements, encourage the unemployed to actively re-engage with the labour market, but their efficacy will be tested through the coming period of low demand for labour. Especially challenging in the current downturn will be dealing with the unique composition of job losses across different sectors of the economy, and any regional variations that emerge. While the regional variance in unemployment has been

particularly low to date in comparison to previous downturns, certain industries are being effected more severely, including the construction and financial services sectors, and policy measures should try to cater for these differences. Moreover, whilst unemployment in the construction sector will, to some extent, be cyclical, shifts in other sectors might be structural and will prove to be especially challenging for policy makers and employment service providers.

With the deterioration in the labour market, resources for job market programmes will be spread increasingly thinly, requiring that programmes be directed to where they are likely to be most effective. This will require that programmes be tailored to the characteristics of the unemployed. For instance, job-placement services should focus on qualified workers, while for low-skilled workers training, hiring incentives and public sector job creation (including subsidised work) are likely to be better value for money. However, any policy changes should strive not to undermine the long-term integrity of mutual-obligation. Temporary job creation schemes are one way to both effectively relax job search requirements while not abandoning the ethos of mutual-obligation.

The government released a welfare reform green paper in mid-2008 and a white paper at the end of 2008 laying out further measures (DWP, 2008a and 2008b). These policy proposals will provide enhanced services for jobseekers, simplify the working age benefit system, provide greater support for disabled people, strengthen local partnerships with businesses, and enhance the role of back-to-work providers. However, there was little focus on more intensive active labour market programmes for the unemployed – the primary focus was for economically inactive groups. Active labour market programmes can help to keep the unemployed close to the labour market, ensuring that they do not become discouraged or lose key skills. UK public expenditure on labour market policies is low by international comparison largely because unemployment was low in recent years (Figure 1.12). However even during the last downturn spending on active labour market programmes remained low compared to many other countries in which job rotation and sharing, job creation and other incentives played a much larger role during periods of high unemployment. Resources under the New Deal have been targeted to helping groups with little experience in the labour market and who are marginally attached to the labour force

Figure 1.12. **Public expenditure on active labour market policy (ALMP)**<sup>1</sup>  
Per cent of GDP



1. First bar represents ALMP in the year of peak unemployment rate during the 1990s. Second bar represents ALMP in 2006 for all countries, except Denmark, for which it is 2004.

Source: OECD Employment Statistics.

such as the New Deal for Young People aimed at 18-24 year olds without jobs, and the New Deal for Lone Parents. To ensure that adequate support is given to avoid unemployment becoming entrenched, more public resources should be devoted to labour market policies and new programmes developed to respond to current problems. To this end the New Deal for Young People could serve as a model for programmes aimed at assisting the broader population of unemployed.

Other programmes that could be considered include a temporary reduction in employer national insurance contributions, which have been shown to be especially effective in encouraging employment during downturns, and temporary work subsidies that assist with reductions in the hours worked by employees. Subsidy schemes of this sort operate in a number of countries including Germany where they are targeted at firms suffering a drop in demand that is deemed to be temporary. The government pays 60% of the wage loss by the reduction in hours worked, implying a net reduction in take home pay. The maximum duration of the scheme in Germany was 6 months but has recently been extended to 18 months. However, there may be difficulties in effectively targeting such programmes, which can also be expensive, so care should be taken before diverting funds from other active labour market measures towards subsidies for reduced working hours. Finally, hiring subsidies paid to firms can be effective particularly if they target disadvantaged groups, but these should be based on “net” employment changes to prevent switching.

### Notes

1. Haldane (2009), shows that during the “Golden Decade” the standard deviation of UK GDP growth was on average four times lower than the long run average and seven times lower for inflation.
2. See “Recent house price developments: the role of fundamentals”, Chapter 3 of OECD (2005).
3. See “Has the Rise in Debt Made Households More Vulnerable”, Chapter 3 of OECD (2006).
4. See Box 4 “Recapitalising UK banks” of October 2008 *Financial Stability Report*. The reported range refers to the 90% confidence interval of cumulated potential write-offs in the three years to 2011, consistent with Bank of England projections of UK household and corporate insolvencies and with stress estimates of loss given default.
5. Government investments are managed on a “commercial basis” by a new arm’s-length company, UK Financial Investments Limited (UKFI), whose objectives are to “protect and create value for the taxpayer as shareholder, with due regard to financial stability and acting in a way that promotes competition”.
6. The nationalised Northern Rock Bank has also made similar arrangements.

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## Chapter 2

# Restoring sound public finances

*As in most other OECD countries, the fiscal situation in the UK has deteriorated sharply. While to date the discretionary fiscal stimulus has been relatively modest, after around the turn of the century the underlying fiscal position weakened more than anticipated. While there was some subsequent improvement, particularly in tax receipts, the severe impact of the downturn on the public finances and the borrowing related to the rescue of the financial sector will take public debt to levels in line with or even exceeding other European economies. The government has set out a commitment to bring the cyclically-adjusted current budget back in balance and ensure debt is falling as a proportion of GDP once the economy is recovering, and has announced fiscal consolidation plans worth over £ 50 billion. The government needs to ensure it delivers on its commitment to implement a sustained consolidation. While the Code of Fiscal Stability provides the foundations for a sound fiscal framework the government should consider reformulating the fiscal rules once uncertainties have reduced. Any reformulation should provide for expenditure discipline, and be forward looking. The current temporary operating rule that was put in place with the suspension of the fiscal rules in the November 2008 PBR is forward looking in this way.*

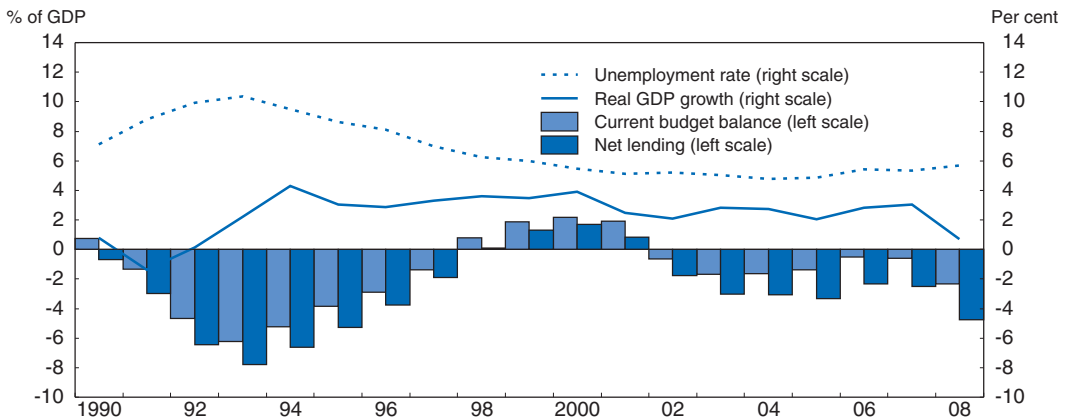
The current UK fiscal framework has been in place since 1997 but now faces its most serious challenge: the economy is in a protracted downturn and the financial crisis is proving to be very costly. Over the decade following the introduction of the fiscal framework, public debt remained below most other G7 countries and the current budget was on average in balance.<sup>1</sup> Over the period there was a significant expansion in expenditure, especially on health, education and infrastructure, underpinned by forecast revenues which did not grow as early as anticipated. The government identified an economic cycle between 1997-98 and 2006-07, and this judgement has been audited by the independent National Audit Office as being reasonable. On this basis the fiscal rules were met.

Whilst the principles-based *Code of Fiscal Stability* framework has remained in place, the rules that operationalised it were suspended in late 2008, and a temporary operating rule was introduced. This suspension of the fiscal rules is expected to last for several years and was unavoidable given the severity of the downturn. While there is controversy with regard to the precise identification of the cycle and the judgement that the fiscal rules have been met, there is little to be gained from looking backwards. This chapter recommends that the fiscal rules should be reformulated while keeping the broader framework articulated by the *Code of Fiscal Stability*.


## Recent fiscal performance

Following the recovery from the recession of the early 1990s and through the early years of the fiscal framework, the United Kingdom recorded solid improvements in its budget position, driven by both strong growth in revenues, and by declining expenditure as a share of GDP. This period coincided with robust economic growth and steady declines in the unemployment rate (Figure 2.1). However, around the turn of the century the budget

Figure 2.1. GDP growth, unemployment and the current budget balance



Source: OECD (2009); OECD Economic Outlook 85 database and ONS.

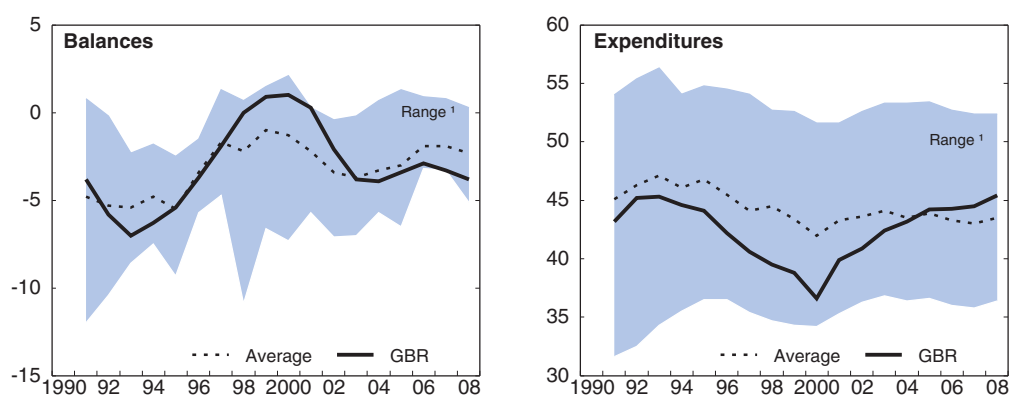
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moved into deficit. While on average G7 countries maintained government outlays roughly constant as a share of GDP, the United Kingdom recorded a significant increase (Figure 2.2, right panel). Over the decade to 2008 total government outlays as a share of GDP increased by almost 5 percentage points, the largest increase among the G7 countries, and taking the United Kingdom from below the G7 average to just above it, albeit significantly below France and slightly below Italy by 2008 (Table 2.1). This increase in expenditures was driven by the UK authorities judgement of the need to invest in public services alongside its expectations of higher future revenues including increases in National Insurance contributions.

Figure 2.2. **G7 fiscal balances and outlays**

Per cent of GDP



1. G7 countries outcomes

Source: OECD (2009); OECD Economic Outlook 85 database.

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Table 2.1. **Fiscal balances, outlays and government debt in the G7**

General government, per cent of nominal GDP

	Cyclically-adjusted balances (Average 2005-08)	Total outlays (2008)	Increase in outlays (1997 to 2008) <sup>1</sup>	Net financial liabilities (2008) <sup>2</sup>
United States	-3.6	38.6	3.2	46.2
Japan	-3.1	36.4	0.7	87.8
Germany	-1.1	43.4	-4.9	43.2
France	-2.9	52.5	-1.6	36.2
Italy	-2.7	48.4	-1.9	87.2
United Kingdom	-3.3	45.4	4.8	32.6
Canada	0.8	39.6	-4.7	22.3

1. Percentage point increase.

2. On a national accounts basis.

Source: OECD (2009); OECD Economic Outlook 85 database.

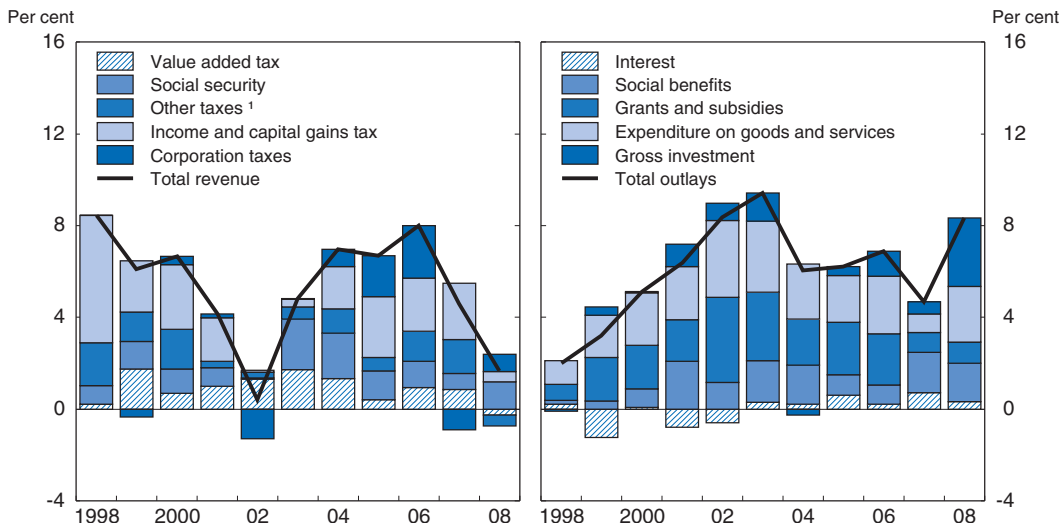
Coming into the current downturn, the United Kingdom had the advantage of relatively low levels of net government debt. In comparison to other G7 countries, only Canada had a lower level of public net debt as a percentage of GDP in 2008 (Table 2.1). Through the early period of the fiscal framework the United Kingdom was among the best performers in the G7 in terms of cyclically-adjusted balances, but by 2006 it had become amongst the worst (Figure 2.2, left panel) with the cyclically-adjusted balance averaging -

3.3% of GDP between 2005 and 2008. And as noted above, it was the United Kingdom's planned rise in spending alongside an unanticipated shortfall in forecast receipts that largely accounts for the deterioration in budget outcomes relative to most other G7 countries.

Of the major components of government outlays, social security related expenditure remained low through the period since around 2000, as a result of the healthy labour market, while expenditure on goods and services recorded only a moderate increase (Figure 2.3). Public expenditure capital and resource budgets expanded significantly throughout this period, with the largest overall increases recorded in the National Health Service. Significant spending increases were also recorded in education.<sup>2</sup> Public sector employment (including central government, local government and public corporations) grew strongly between 1998 and 2005, reversing the trend decline since the early 1980s (Figure 2.4). Office

Figure 2.3. **Budget revenue and expenditure components**

Central government

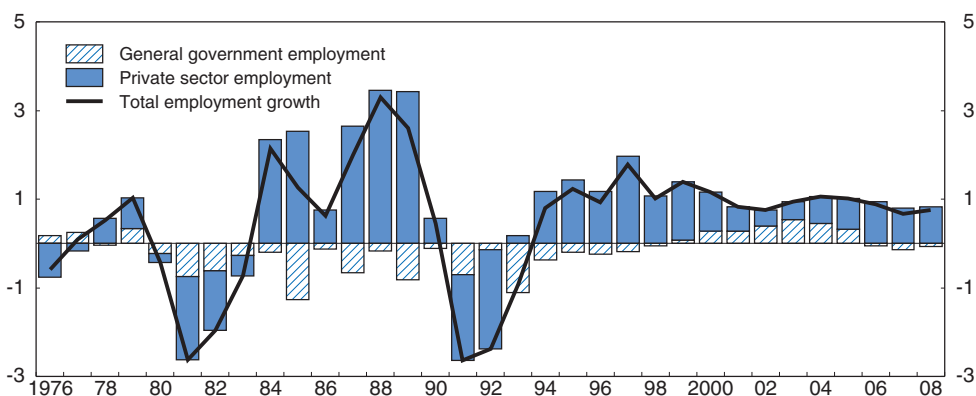


1. Other taxes include taxes on production.

Source: OECD (2009); OECD Economic Outlook 85 database and ONS.

StatLink <http://dx.doi.org/10.1787/647815635734>

Figure 2.4. **Government and private sector contributions to employment growth**



Source: OECD (2009); OECD Economic Outlook 85 database.

StatLink <http://dx.doi.org/10.1787/647816822242>

of National Statistics data show that public sector employment grew by around 12% between 2000 and 2005 while in contrast private sector employment grew by just 6% over the same period.<sup>3</sup>

Variation in revenue also played a role in explaining the deterioration in public finances in the past few years (Figure 2.3, left panel). It was increases in social security contributions announced in the 2002 Budget that were meant to have paid for the expansion in health spending. However, while this change did contribute noticeably to revenue growth in 2003 and 2004, it was not sufficient to offset the large spending increases. Indeed the expansion in discretionary expenditure that began at around the turn of the century coincided with a period of weakening revenue growth, particularly in both income and corporation taxes. The net result was that the spending increases that began in 2000-01 and accelerated in 2002-03 moved the current balance into deficit in 2001, although the government had almost closed this deficit when the crisis hit. Public net debt climbed from a low of around 30% of GDP in 2001 to 37.2% (excluding borrowing related to bank nationalisations) by 2007.<sup>4</sup> Despite increasing, this figure was low compared to other European countries.

## Outlook for net lending and government debt

### **The fiscal stimulus**

The 2008 Pre-Budget Report (PBR) introduced a temporary fiscal stimulus costing around 1.6% of GDP over the two years 2008 and 2009 (Box 2.1). The most significant expansionary components of the package were a cut in the standard VAT rate from 17.5 to 15.0% (to be reversed at the end of December 2009),<sup>5</sup> and a bringing-forward of planned capital spending. The 2009 Budget announced further targeted measures, including those on employment and investment intended to support the recovery. While there are arguments in favour of a vigorous fiscal stimulus, particularly in the current circumstances where firms and households face liquidity constraints due to the financial crisis and the monetary policy mechanism is impaired, the government also faces tight fiscal constraints.<sup>6</sup> In a cross country-study, Reinhart and Rogoff (2009) show that the increase in government debt typically associated with financial crises comes about not due to the cost of bailing out and recapitalising the banking sector, but from the cyclical impacts of prolonged downturns on revenue and spending, as well as borrowing related to counter-cyclical fiscal measures. In the UK, strong growth in the financial industry and robust activity in the housing sector prior to the downturn provided rich streams of revenue to the government. Both are likely to decline significantly. Moreover, the recovery is projected to be export and investment led which both tend to be much less revenue-rich (OECD, 2009).

In the PBR in November 2008, the government forecast that the current balance deficit could peak at 5.3% of GDP in 2009-10 and that it would return to balance by 2015-16. Additionally, net public debt was projected to plateau at around 57% of GDP in 2013-14. The updated Budget figures in April 2009 reflected a further deterioration in prospects linked to the weaker global outlook for growth. It forecast that the current balance deficit could peak at 9.4% in 2010-11 and that it would return to balance by 2017-18 and that net public debt would continue to plateau in 2013-14 but now at around 80%, including the government's provisional estimate for as yet unrealised losses from financial sector interventions of 3½ per cent of GDP. Since the housing market turned at the end of 2007, the financial

### Box 2.1. Fiscal stimulus in the Pre-Budget Report 2008 and Budget 2009

The United Kingdom was one of the first OECD countries to implement a fiscal stimulus package aimed at cushioning the current downturn. In the Pre-Budget Report (PBR) released in November 2008, the government announced a number of measures.

The key stimulatory elements of the Pre-Budget Report package included:

- A temporary reduction in the VAT rate from 17.5% to 15% from 1 December 2008 to 31 December 2009, which was expected to cost the government around £ 12 billion in lost revenue (0.8% of GDP).
- A bringing forward of planned capital spending from 2010-11 mostly related to housing, education and transport infrastructure amounting to around £ 3 billion.
- The government announced that it would begin indexing the income tax personal allowance (zero tax threshold level of income) and basic rate limit starting in 2009-10 costing around £ 3 billion in the first year. This is in part intended to offset the burden on low-income earners of announced increases in National Insurance Contributions (NIC) set for 2011-12 (see below).

The 2009 Budget announced further targeted measures focused on providing targeted support for those most affected by the downturn and on ensuring a sustained recovery including support for employment and investment.

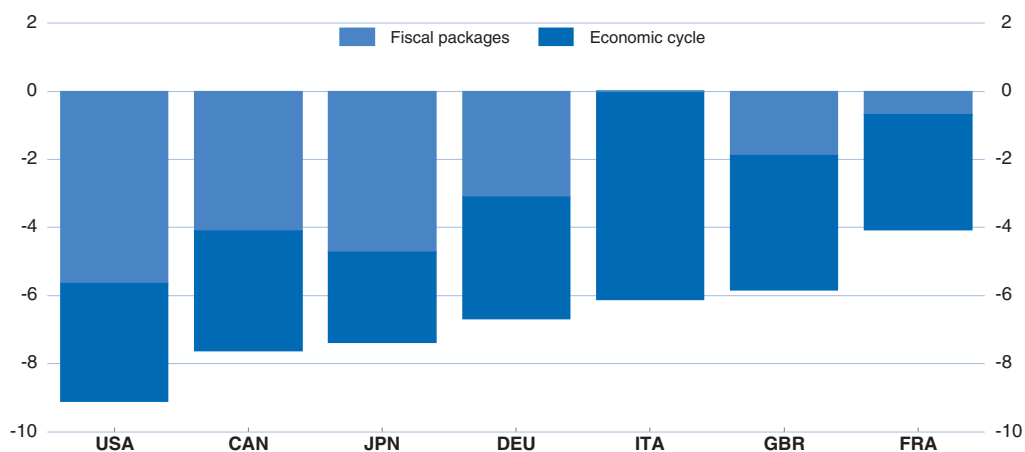
In line with the temporary fiscal operating rules, the government also announced future revenue raising plans with a view to bringing the current budget back into balance in the medium term. These measures included:

- Increases in the employee, employer and self-employed rates of National Insurance Contributions of 0.5% starting in April 2011 which together are expected to raise around £ 5 billion in the first year of the increase.
- Budget 2009 announced that the income tax personal allowance would be fully withdrawn for those earning over £ 100 000 from April 2010 which is expected to raise around £ 1 billion in its first year, extending the measure announced in the PBR.
- The introduction from April 2010 of a new top tax bracket of 45% for incomes over £ 150 000 which is expected to raise around £ 0.7 billion in its first year. In Budget 2009 this policy was amended, now providing for a new top tax bracket of 50% for incomes over £ 150 000 to be implemented from April 2010.
- From April 2011 tax relief on pension contributions will be restricted for those with incomes of £ 150 000 and over, and tapered down until it is 20%, which is expected to raise £ 3 billion in 2012-13.
- Increases in alcohol and tobacco duties effective immediately post PBR 2008 that together were expected to raise around £ 1 billion annually.
- Increases in fuel duty effective immediately post Budget 2009, which were expected to raise £ 0.6 billion in 2009-10 rising to £ 1.7 billion in 2011-12.
- PBR announced additional “Value for money” savings in public expenditure amounting to £ 5 billion in 2010-11, the details of which were set out in Budget 2009. The 2007 Comprehensive Spending Review set a target of £ 30 billion in value-for-money savings by 2010-11 and the Pre-Budget Report aised this target by an additional £ 5 billion.

sector entered into crisis and oil prices collapsed around mid-2008, taxation from these revenue-rich sources has fallen significantly.<sup>7</sup> The 2008 PBR projections incorporated a shock to the level of trend output of around 4%, with a further 1% downward adjustment made in the Budget. Moreover, in addition a sizeable output gap is opening up, affecting other cyclically-sensitive revenue and spending components, and is not expected to close for several years. On the other hand, the VAT rate cut of December 2008 is temporary and some tax increases are planned for 2010-11 and 2011-12, including an across-the-board increase in National Insurance Contributions, changes to income tax for those with higher incomes and revised spending assumptions have been set.

The official deficit and debt projections published in the Budget and PBR are plausible (IFS, 2009). OECD estimates of the impact of the downturn and the accompanying fiscal stimulus on the budget balance are presented in Figure 2.5 in which one can see the large impact of the cycle, while the stimulus package is relatively small. Projections are very sensitive to the profile of the output gap. These estimates do not include off-balance-sheet contingent liabilities. Budget projections do include provisional estimates for the net impact of (as yet unrealised) losses on interventions in the financial sector to support financial stability. The Government provisionally estimates that these might lie within the range £ 20 to £ 50 billion (1½ to 3½ per cent of GDP). For fiscal policy purposes the public finance projections include the high end of this range and these estimates will be updated in subsequent Budgets and Pre-Budget Reports.

Figure 2.5. **Automatic and discretionary fiscal impulse in response to the crisis**  
Impact on fiscal deficits cumulated over the period 2008-10



Note: The impact of the economic cycle is derived as the sum of the cyclical components of fiscal balances over the period 2008-10. Not included are: effects linked to the initial net lending position; discretionary measures which were not decided in response to the crisis, even if they are implemented over the period 2008-2010; discretionary measures related to the crisis that have no direct impact on fiscal balances measured on a national account basis (e.g. change in the timing of payments for taxes and government procurement, investment by public enterprises, as well as loans and purchases of assets by the government); the disappearance of exceptional revenue buoyancy; the effect of the asset cycle on the value of government assets and liabilities, as well as other factors which would have contributed to variations in fiscal balances even in the absence of the crisis (e.g. ageing related fiscal pressures).

Source: OECD (2009); OECD Economic Outlook 85 database.

StatLink  <http://dx.doi.org/10.1787/647821518016>

There is thus little room for further fiscal manoeuvre. A further deterioration in economic circumstances may warrant limited additional fiscal stimulus but this would need to be targeted at having the greatest impact on demand and ensuring that the long-run impact of the crisis, for example on unemployment, is contained. Any stimulus package must be accompanied by credible consolidation plans.

### Cost of financial stabilisation

Experience in other countries suggests that dealing with banking crises can have very substantial fiscal costs. This is illustrated in Table 2.2 which shows estimates by Honohan and Klingebiel (2003) of the fiscal costs associated with past episodes up to 2003. These estimates include costs of defaults on loans made by the central bank, capital injections to insolvent or weak banks, the capitalised value of lending to insolvent banks or borrowers and the costs of compensating depositors and other creditors, but not the costs associated with fiscal stimuli and the automatic stabilisers.

Table 2.2. **Fiscal costs of past banking crises**  
In per cent of GDP

	Episode	Direct fiscal cost
Australia	1989-1992	1.9
Finland	1991-1994	11.0
France	1994-1995	0.7
New Zealand	1987-1990	1.0
Norway	1987-1993	8.0
Sweden	1991-1994	4.0
United States	1981-1991	3.2

Source: Honohan and Klingebiel (2003), "The Fiscal Cost Implications of an Accommodating Approach to Banking Crises", *Journal of Banking and Finance*, No. 27.

The government's role in stabilising the financial system has already added very large liabilities to the public balance sheet. The bulk of these liabilities are contingent and are at least partly offset by assets. Moreover, these may indeed yield a positive return to the government in the medium term, but they do represent a considerable assumption of risk onto the public balance sheet.<sup>8</sup> The long term impact of these interventions to stabilise the financial system on the sustainability of the public finances will be determined not by the face value of the liabilities the government has incurred, but by any eventual profit or loss that accrues on them, taking account of fees received and the value of investments when they are sold.

The government's interventions in the financial sector began in 2007 when the Government authorised the Bank of England to provide a liquidity support facility to Northern Rock, a mid-sized bank which specialised in mortgage lending. This was followed in February 2008 with the nationalisation of Northern Rock. The impact of nationalisation on national accounts-based measures of public debt was around £ 100 billion (7% of GDP) on top of a liquidity support loan valued at around £ 27 billion; a significant proportion of the latter has been paid back.<sup>9</sup> This impact resulted from a definition of public debt which did not net off the majority of financial assets held by Northern Rock. In September 2008, Bradford and Bingley, which specialised in the buy-to-let mortgage market, was declared by Financial Services Authority (FSA) to be not meeting threshold conditions for deposit-

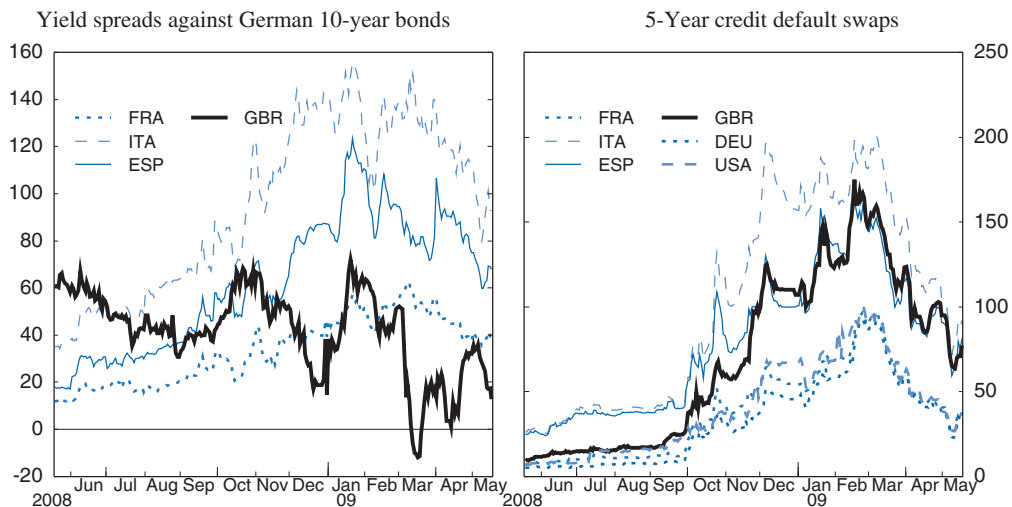
taking institutions. The bank's retail deposits were transferred to Abbey National (owned by the Spanish bank Group Santander). The remainder of the business was nationalised with the intention of winding it down, adding £ 50 billion to net public debt on a national accounts basis, again as the majority of financial assets did not net off in the measure (ONS, 2008). As part of the transfer to Abbey National, the Financial Services Compensation Scheme (FSCS) made a payment of £ 14 billion for deposits and the Treasury paid £ 4 billion for the remainder. A further £ 6 billion was provided by the government as a working capital facility. The government's decision to compensate the UK depositors following the default of several Icelandic banks in October 2008, added another £ 7 billion to public liabilities, in large part in the form of loans to cover liabilities borne by the FSCS.

In October 2008 the government announced the formation of the Bank Reconstruction Fund, committing £ 25 billion in funds, with an additional £ 25 billion if required, to assist banks to raise their Tier 1 capital in exchange for preference shares or permanent interest bearing shares. The final total take up was £ 37 billion. In January 2009, the ONS announced that the resulting government investments in the Royal Bank of Scotland (RBS) (70% public ownership) and the Lloyds Banking Group (formally HBOS and Lloyds TSB) (43.5% of public ownership) would be added to net public debt, although full incorporation into the public finance tables would take some time given the complexities involved. Also in October 2008, the government offered to guarantee new short and medium term senior unsecured debt issuance by banks and building societies to assist in refinancing maturing wholesale funding obligations. The guarantee is provided against a fee on commercial terms. Over £ 100 billion of debt issued by eligible institutions has been guaranteed under the scheme. In January the Government announced the introduction of the Asset Protection Scheme to provide to participating institutions protection against credit losses on a set of legacy assets. To date two banks have nominated assets to the value of £ 585 billion (around 40% of GDP) to be covered.


Public debt is on a sharp upward trajectory, which in theory could push up financing costs during a recovery, crowding out private demand. There is currently a healthy appetite for gilt issues, principally from insurance companies and pension funds, and spreads over German bonds have declined substantially in recent times, in part due to the effect of the Bank of England's programme of quantitative easing as well as exchange rate movements (Figure 2.6, left panel). Nevertheless, credit default swap (CDS) rates for UK 10-year government bonds have climbed considerably higher than for German, French and United States government bonds (Figure 2.6, right panel). There is some evidence of a non-linear relationship between the level of public debt and interest rates (Bernoth *et al.*, 2006; Thomas and Wu, 2009), so that while the term structure of UK public debt is favourable relative to many other countries, the market may demand considerably higher yields if debt levels continue to rise sharply and, in those circumstances, public debt dynamics could move onto an unsustainable path. That said, the Government's Budget 2009 commitments to deliver a sustained fiscal consolidation go some way in addressing these concerns (see below).

In addition to questions about stability and affordability, higher debt also implies a transfer from the future to the present, and therefore the issue of intergenerational fairness arises, as acknowledged in the government's *Code of Fiscal Stability* fairness principle (see below), although calculations of intergenerational fairness would also need to take into account the effect of pro-cyclical tightening on current generations through lost output and the potential for longer term costs for future generations of pro-cyclical



Figure 2.6. **Sovereign debt spreads and credit default swap rates**

Source: Datastream.

StatLink  <http://dx.doi.org/10.1787/647850373346>

tightening exacerbating a downturn. Moreover, in an environment of rapidly rising debt, households may curb current consumption in the knowledge that higher future taxation will be required to pay off that debt, while interest payments to service the debt will subtract from what would otherwise have been available for expenditure on public services (or lower taxes). That said, a trade-off exists in planning fiscal consolidation and debt reduction after a downturn. On the one hand, taking action to reduce debt as quickly as possible after a downturn has ended can promote confidence, reduce interest payments and put the public balance sheet back into a sound position. On the other hand, debt reduction should be done with the least possible cost to employment and economic welfare in the near term where excessively aggressive or rapid action could needlessly prolong the economic downturn and, indeed, may be counterproductive in terms of fiscal consolidation.

### **Fiscal consolidation after the recovery takes hold**

The PBR set out a plan for fiscal consolidation that would see the cyclically-adjusted current budget back in balance by 2015/16. The consolidation laid out in the PBR includes reversing the VAT cut in December 2009, increased duties on alcohol and tobacco, changes to the income tax regime that mainly affects higher income earners, an across-the-board half a percentage point increase in National Insurance Contributions, and “value for money” public spending savings. All these measures amount to a little less than 1% of GDP in 2011-12. Alongside a further weakening in the fiscal outlook, Budget 2009 announced additional measures to support consolidation, including bringing forward and increasing the additional rate of income tax on high income earners, restricting tax relief on pension contributions for higher earners and increases in fuel duty, bringing the amount in total to around 3% of GDP by around 2013-14. Substantial deficits will persist well into the next decade and debt levels will be elevated compared with recent experience with the Budget pushing out the balanced budget target to 2017-18. Estimates suggest that reinstatement of the *sustainable debt rule* at the 40% threshold is not feasible until beyond 2020.



The government could do considerably more to accelerate its programme of fiscal consolidation dependent on how the economy evolves. Experience in other countries suggests that a focus on expenditure cuts, rather than revenue raising, is associated with more successful consolidations, particularly when coupled with explicit expenditure rules, as it is more likely to result in lower interest rate spreads and instil confidence by signalling a strong commitment by the government to a robust fiscal consolidation (Henriksson, 2007). The delivery of the consolidation will require specifying the “value for money” savings beyond 2011-12 in the upcoming Spending Review.

The government’s balance sheet position would be strengthened during the recovery by selling stakes in financial institutions acquired during the crisis. The government has set out that it will hold financial sector assets only as long as necessary, consistent with ensuring financial stability and with maximising returns to the taxpayer. The timing of any sales should be contingent on market conditions returning to normal to ensure that any sale would not be disruptive and that a fair price was ensured. In addition, the government has begun to identify what other public assets are candidates for sale. This programme should be given priority so that, once the current crisis abates and market conditions improve, public asset sales can go ahead so as to assist in reducing public debt.<sup>10</sup>

## The fiscal framework

In 1997, the government introduced a medium-term fiscal framework which, together with the new independent monetary policy regime, sought to shift the focus of macroeconomic policy to long-term sustainability within a credible and transparent framework. The new fiscal framework was set out in the *Code of Fiscal Stability* which was released in draft form with the 1998 budget and was then given legal status as part of the Finance Act 1998. The code articulated the five principles by which fiscal policy should operate:

- Transparency commits the government to operating policy according to clear rules, and to provide all the information required by the public to allow it to scrutinise the conduct of fiscal policy and the state of public finances.
- Stability requires that fiscal policy promotes high and stable growth and employment.
- Responsibility requires that government finances be handled prudently with due awareness of risks.
- Fairness requires that intergenerational factors be considered as well as distributional considerations.
- Efficiency requires that government provides value for money in the formulation of spending and taxation policy.

The Code requires that the government explicitly sets out its fiscal objectives which must then be operationalised through operating rules. While the Finance Act 1998 stipulates that any changes to the Code require parliamentary approval, the Code itself allows changes to be made to the fiscal objectives and the operating rules provided the changes are consistent with the five principles and the government gives reasons for the changes. Temporary departures from the fiscal objectives and the operating rules are also allowed provided that the government states the reasons for doing so, the period of time required to return to the existing objectives and operating rules, and the rules and objectives that are to apply over the temporary departure period.<sup>11</sup>

While the adoption of this fiscal framework was generally well received, it had several limitations. On the positive side it could be argued that the rules are helpful in maintaining fiscal discipline within the government itself, as ministers are aware of the fiscal confines within which proposed policies need to reside. Moreover the framework helps to anchor fiscal expectations which are important in establishing credibility and confidence.<sup>12</sup> However, there can be times when the five principles are mutually incompatible – for instance, fairness may not be compatible with efficiency if the government decided to increase assistance for a needy group (Emmerson *et al.*, 2004). Also, there are areas in the Code that arguably do not go quite far enough, especially with regard to transparency. For example, in contrast to the recommendations of the IMF’s “Revised Code of Good Practices on Fiscal Transparency”, which recommends that all underlying budget parameters be made available to the public, the UK code requires that just “key” parameters be published.

The Code of Fiscal Stability commits the government to clearly set out its fiscal policy objectives. The current government’s fiscal objectives are:

- i) Over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- ii) Over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

The Code of Fiscal Stability requires that operating rules be articulated by the Treasury that operationalise the fiscal objectives. The rules must be formulated to be consistent with the five principles as outlined in the Code and are intended to provide a transparent framework by which the government’s fiscal performance can be judged. The two rules that were adopted are the *golden rule* and the *sustainable investment rule*.

The *golden rule* requires that over the economic cycle the government should borrow only to invest and that current spending (including the consumption of capital) should be paid for by taxation. The principal intent of the golden rule is to ensure intergenerational fairness whereby government debt is not accumulated by the present generation to fund current spending to be paid for by future generations. The golden rule is formulated in terms of current expenditure, meaning that government investment is not included in the assessment but the consumption of the capital stock is included. This is consistent with intergenerational fairness since the benefits of investment generally accrue across generations (Fatas, 2005), and thereby seeks to address the traditionally low levels of public investment in the United Kingdom. Furthermore, by requiring a balanced current budget only on average over the economic cycle, the rule also accommodates both deliberate countercyclical fiscal policy and the operation of the automatic stabilisers during downturns. The Treasury’s estimate of the economic cycle involves judgement and this has become one of the more contentious aspects of the operation of the golden rule in practice (see below).

The *sustainable investment rule* requires that over the economic cycle, the government should ensure the level of public debt as a proportion of national income is held at a stable and prudent level. This rule accords with the principles of responsibility and stability in an intergenerational sense and stability in the sense that the accumulation of excessive levels of government debt would put at risk trust in outstanding government liabilities. The Treasury set the “prudent” level of government debt *vis-à-vis* the sustainable investment rule to be 40% of GDP in the economic cycle that ended in 2006-07.

## Criticisms of the fiscal rules

A fundamental criticism of the balance-over-the-cycle implementation of the golden rule is that it could be pro-cyclical. If it becomes evident that the rule is likely to be breached as the end of a cycle approaches, the government would be required to engage in pro-cyclical fiscal consolidation, which would exacerbate a downturn. This problem could arise due to the nature of the formulation of the *golden rule* and the need to account for mistakes, including forecasting errors, made in the past. However, there are advantages in terms of accountability of having a rule that is assessed in budget outcomes.

Another problem is with the *ex post* assessment of adherence to the fiscal rules. Contrary to the stated goal of transparency, a number of difficulties arise when attempting to independently assess the government's performance against the current fiscal rules. In the 2007 PBR and Budget 2008, the Treasury indicated that it was too soon to assess whether or not the economic cycle had ended, in light of further possible revisions to output data and the economy continuing to operate close to trend. Such an extended period of uncertainty is problematic in terms of accountability. In mid-2005 in light of revisions to National Accounts data, the government set out a revised judgement that the current economic cycle began in the first half of 1997 rather than in 1999 which was also audited as reasonable. In the PBR 2008 the government declared that the fiscal rules had been met over the previous economic cycle, which was judged to have begun in the first half of 1997 and ended in the second half of 2006. This assessment of the business cycle was independently audited and judged to be reasonable by the National Audit Office (NAO). The golden rule was deemed to have been met by 0.1% of GDP over the 9½ year cycle.

The Treasury provides a substantial amount of information about how it determines cycle endpoints, although judgement plays a very large role and this makes independent verification of compliance difficult.<sup>13</sup> The Treasury practice is to start by using an output gap approach whereby an economic cycle is defined as a period of above potential growth followed by a period of below potential growth (HM Treasury, 2008b). The Treasury has stated that it also uses other indicators of the cycle to supplement the output gap approach although precisely what relative weightings are given to these additional indicators is not explicitly outlined. This inherent difficulty of defining the economic cycle is one of the major weaknesses in the current framework, but is in the nature of any fiscal rule that attempts to take account of economic conditions.

The practice is to add together all current balances as a per cent of GDP over each year of the cycle. This methodology effectively gives greater weight to surpluses accumulated earlier in the cycle. The government was also criticised for the reclassification by the Office of National Statistics of road spending as capital which was also seen, rightly or wrongly, as the government changing the rules to its own benefit.

The exclusion of investment in the golden rule is done on the basis of national accounting conventions. This approach has been criticised because the exclusion of investment does not typically include the accumulation of human capital which may in fact earn a higher social rate of return than investment in public physical capital. However, problems with the definition of human capital and indeed its amortisation would be controversial and could introduce leeway for gaming. Similarly estimates of consumption of the physical capital stock, required to get to a net measure of public investment, are also difficult to calculate correctly.

In the PBR 2008 the government declared that the sustainable investment rule was also met with net debt being below 40% of GDP on average over the duration of the identified cycle. The one criticism with the *sustainable debt rule* is that while maintaining public debt at a responsible and sustainable level is laudable, the measure of public debt should capture all public liabilities that future generations could be liable to pay. This would include off-balance sheet items such as pension liabilities, and a number of contingent liabilities that have a very good chance of becoming genuine liabilities. These include, for instance, a number of private finance initiatives (PFI) payments (see below). The Long-term Public Finances Report, published regularly, provides a comprehensive assessment of longer term spending pressures including an assessment of wider balance sheet measures. The government has committed to produce Whole of Government Accounts for 2009-10 consistent with the move to IFRS based accounting standards.

### Options for reformulated fiscal rules

In the previous *Survey* (OECD, 2007b) a number of recommendations were made to improve the fiscal rules. These included reformulating the balanced budget rule so that it is less dependent on cycle dating and to introduce mechanisms to constrain spending, especially of cyclical revenue windfalls. There have been similar suggestions from other quarters. For instance, the Institute of Fiscal Studies (2009) has suggested that the budget should target a particular budget surplus over the forecast period with no consideration given to what has happened in the past (presumably unless the debt level is deemed to be excessive). This forward-looking approach has the advantage of not having to correct for previous forecasting errors and is analogous to the monetary authority targeting future inflation without regard to the current price level. Indeed, Honjo (2007) uses a macroeconomic model of the United Kingdom to show that targeting a current budget surplus over a rolling time horizon of between two to five years could enhance macroeconomic stability. This conclusion arises largely as a result of avoiding episodes when an unanticipated tightening in fiscal policy is required towards the end of an economic cycle in order to meet the rule which can be backward-looking in some circumstances. However, there are significant issues with the transparency and accountability with such a rule if it cannot be met in an outturn.

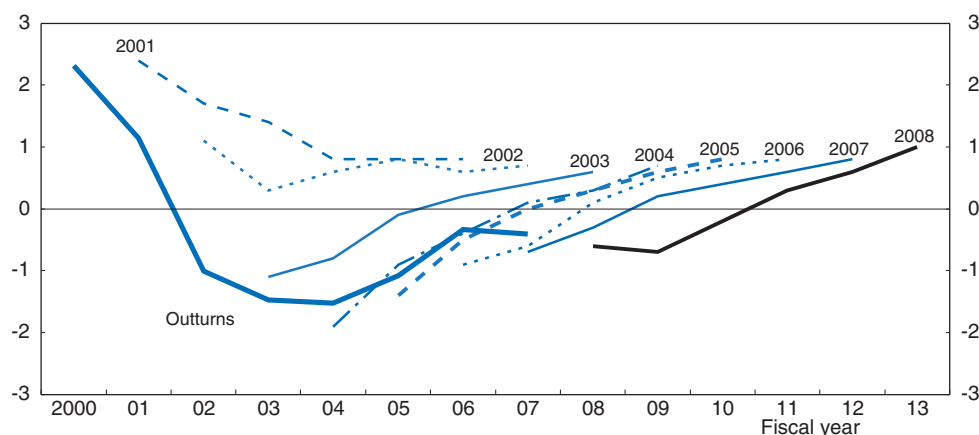
The current temporary operating rule that was put in place with the suspension of the fiscal rules in the November 2008 PBR is in essence forward looking in the way suggested above. The temporary rule is to “improve the cyclically-adjusted budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full”. The forecasts in the Budget have this adjustment taking place over an eight year period with the current budget back in balance by 2017-18.

### Independent fiscal authorities


Any forward-looking approach relies heavily on credible, unbiased forecasts – both the macroeconomic forecasts and fiscal forecasts. Fiscal forecasting is a difficult business as there are many sources of errors and these are often positively correlated. The Treasury’s performance in recent years (Figure 2.7) is not the only example that is testament to this. Indeed, overly optimistic forecasts are often the counterpart to subsequent budget overruns of the kind illustrated in Figure 2.7. This pattern of behaviour has been noted in many countries where there is an incentive for governments to make unrealistically

Figure 2.7. **Successive budget forecasts have had a similar end-point**

Current budget surplus in per cent of GDP



Source: HM Treasury, Budget Reports.

StatLink  <http://dx.doi.org/10.1787/648003248522>

optimistic growth projections *ex ante* and then subsequently blame lower-than-expected growth *ex post* for any slippage in budget outcomes *vis-à-vis* budget projections. However, there is no evidence that independent forecasts, for example from international organisations, are systematically better than the UK Treasury's forecast. Were there a systemic bias, one way to address this issue and to enhance the credibility of the forecasts would be to make their formulation more independent of government. This approach is taken to varying degree in a number of OECD countries including Austria, Belgium and the Netherlands where the macroeconomic forecasts used in the budget are prepared by an independent agency (EC, 2008). In the United Kingdom the NAO plays a role in auditing forecasts of certain budget parameters, including trend growth, which is the most important macroeconomic variable.

In many countries the role played by independent fiscal authorities goes beyond providing macroeconomic forecasts and can encompass proposing, forecasting and assessing fiscal policy itself, although it can be difficult to draw definitive conclusions about the impact of independent fiscal institutions on fiscal outcomes given the diversity of arrangements and the difficulty of stripping out the role of the institution from other factors, such as the specification of the fiscal rules. While in some quarters there is considerable resistance to independent fiscal authorities, often reflecting an unspoken view that fiscal policy is a political prerogative of elected officials, this type of delegation can be a solution to the problems of time inconsistency in fiscal policy formulation and a means of blunting the influence of pressure groups. However, while preparing macroeconomic forecasts can be done largely independent of government, forecasting revenues and expenditures requires having access to information about state finances that is typically available only within government, including data on within-year spending by departments, access to revenue trends from HM Revenue & Customs (HMRC), and assistance from individual government departments on how to correctly cost policy proposals. Moreover, for privacy and other reasons, this information is likely to remain out of the hands of the private sector, and indeed, there may even be legal issues in providing this information to certain types of independent bodies. Nevertheless, if for this reason the fiscal forecasts are constrained to remain within government, a properly constituted

independent public authority with a similar legal standing to the ONS or the NAO might be able to be instituted. Indeed, in the United Kingdom the NAO currently does play a role in auditing certain budget parameters including trend GDP growth, oil prices and the unemployment benefit claimant count, and, in addition, it has audited the Treasury's judgement on the dating of the economic cycle.<sup>14</sup> Independent fiscal authorities can also play a role in providing an *ex post* assessment of whether the fiscal rules are respected as they do in Sweden (its Fiscal Council was established in 2007) and in the Netherlands.<sup>15</sup> Independent involvement in forecasting revenues has featured in Germany since 1955 when an independent advisory committee started providing forecasts of German tax revenue under the auspices of the Federal Ministry of Finance. In the United States the Congressional Budget Office (CBO) was created in 1974 and tasked with providing budget committees and Congress with a non-partisan source of budgetary and economic information, independent of the executive branch. To assist the budget committees, the CBO prepares budget and economic projections, undertakes analysis of the President's budgetary proposals, and offers alternative spending and revenue options for lawmakers to consider. Also CBO staff can be asked to testify to Congressional committees about the outlook for the budget and the economy, as well as related issues. There is no single blueprint for enhancing accountability, as reflected in the diversity of institutional arrangements across countries. The UK's existing institutional arrangements incorporate a range of checks and balances, from the scrutiny function of Parliament, to NAO audits and comment from non-governmental organisations with fiscal expertise (such as the IFS and NIESR) and the media, all of which contribute to holding the government to account for fiscal policy decisions. In the UK outturn fiscal data are provided by the independent Office for National Statistics and the Treasury's judgement on the economic cycle is audited by the National Audit Office.

### **Expenditure rules**

As shown above, much of the deterioration in the fiscal outcomes in the United Kingdom since the turn of the century was a result of shortfalls in receipts against expectations alongside an expansion in expenditures over the early years of the century. Much of the expansion was the result of deliberate public policy. While having a clearly articulated fiscal framework is valuable, not least for public accountability, expenditure rules that supplement the broader fiscal framework have often been successful in imposing fiscal discipline. The UK's multi-annual spending framework is described below. Forward-looking multi-year expenditure limits on discrete discretionary elements of the budget are used successfully in Czech Republic, Finland, the Netherlands, Spain and Sweden where they act to restrain policy-induced spending increases. Indeed OECD (2007a) shows that episodes of fiscal consolidation are most successful when expenditure rules are in place, particularly because, when backtracking does occur, it is typically on the spending side of the budget. These expenditure limits are usually set at the beginning of a government's term in office and reflect the government's policy priorities and commitments. Expenditure limits commonly operate so that during economic upturns surpluses are saved as the expenditure rules impose an upper bound on any discretionary spending of the surpluses,<sup>16</sup> while during a downturn, as in the UK framework of public expenditure control, the automatic stabilisers are permitted to operate by virtue of the fact that the cyclical components of public expenditure, such as unemployment benefits, are excluded from the expenditure limits. In this way expenditure rules cut the nexus between

revenue and expenditure so that extra or windfall revenues do not translate directly into new spending.

One particularly attractive feature of expenditure rules is that policy proposals that potentially breach the rules are immediately identifiable and thereby ensure direct accountability and deterrence (Anderson and Minarik, 2006). In Sweden for instance, bi-annual monitoring is required by law and if there are signs of an (aggregate) overrun the government is required to prepare remedial action. In Austria financial sanctions similar to the Stability and Growth Pact (SGP) excessive deficit procedure apply, while in Germany the Fiscal Policy Council (FPC) recommends remedial policy action if an expenditure overrun is identified. Expenditure rules can also be designed so that ministers and ministries are held directly accountable for overruns. Also, like the current *golden rule*, capital expenditure can be quarantined from the expenditure rules as these are typically the first victims of fiscal consolidation efforts while other less productive but politically sensitive programmes survive. However, care needs to be taken to avoid allowing expenditure to be reclassified as capital expenditure as a means of circumventing the discipline on spending that expenditure rules impose. In Canada expenditure rules also exclude programmes that are self funding.

Expenditure rules can engender stability and predictability in the impact of the public sector on aggregate demand, making the job of monetary policy considerably easier. Deficit rules that target a balance over the cycle could entail constant adjustment as real-time information of the state of the economy comes to hand and is then subsequently revised, requiring further readjustment. The fact that deficit rules target the aggregate balance (less capital expenditure in the case of the UK's *golden rule*) while expenditure rules apply to discrete and identifiable items in the budget and explicitly exclude the more cyclical components of the budget means that there is no requirement for intra-cycle adjustments. If expenditure rules are combined with a deficit rule and the deficit rule approaches a threshold where action is required then either remedial action could be taken on the revenue side, or there could be across-the-board cuts to expenditure.

Expenditure rules operate in some countries alongside aggregate deficit targets – for instance in several European countries they supplement the SGP. In Sweden, where the aggregate target is a 2% surplus over the business cycle, the budget process proceeds from the top down so that nominal expenditure ceilings are formulated with the overall surplus target in mind. The expenditure ceilings are negotiated each year for a three-year rolling window with the third out-year added and the potential for the two existing years to be renegotiated, although this has never happened over the ten years the system has been in place. Any proposed changes, by parliament for instance, beyond the margin typically provided for policy flexibility, need to be presented as a complete package that respects the previously agreed expenditure ceilings and frameworks. In Finland the expenditure rules are set on a four year rolling basis, are expressed in real terms and include transfers to municipal governments, so that while unemployment benefits, accommodation subsidies, and interest payments are excluded, around three quarters of all central government expenditure comes under the ceilings (Anderson and Minarik, 2006).<sup>17</sup> The expenditure rules in Finland operate within the EMU fiscal framework and include a “break” mechanism that comes into force if the deficit reaches 2¾ per cent of GDP, requiring the government to take remedial action even under conditions of an economic downturn. In the Netherlands explicit expenditure caps are articulated for the three sectors of the budget: the “core”, the health sector, and the social security/labour market sector which

are negotiated between coalition partners and are expected to remain in place for the term of the government, and are therefore expressed in real terms. Sub-caps are also applied to each ministry within the “core” sector and transfers between sectors are permitted but only to fund pre-existing programmes that are experiencing expenditure overruns due to unforeseen cost pressures. New policy programmes require the consent of all coalition members by means of cabinet agreement and the cabinet must also decide how overruns in general are to be funded by nominating which ministries should contribute.

In 1997 the United Kingdom introduced spending reviews which are conducted every two or three years. Spending reviews are guided by the government's policy priorities, directing resources by setting three-year Departmental Expenditure Limits (DELs) and through Public Service Agreements (PSA), which define the key improvements that the public can expect from these resources. Any spending that cannot be reasonably fixed by multi-year limits, such as social security spending, is included in Annually Managed Expenditure (AME). There were spending reviews concluded in 1998, 2000, 2002, 2004 and 2007. The 1998 and 2007 editions were Comprehensive Spending Reviews, which reviewed all government programmes from a zero baseline, while regular spending reviews focused on allocation of the marginal extra resources available for public spending. However, the UK spending reviews differ from expenditure limits used in several continental European countries in a number of aspects. They are not fixed at the beginning of the term of a newly elected government and are not fixed for the term of the government. In the United Kingdom, the DEL spending limits are fixed at spending reviews for the three years, with typically the overlapping year reviewed every two years. However, in the two most recent spending reviews (CSR07 and SR04) the overlapping year was not revised.

One reason why expenditure rules have operated so well in a number of continental European countries over the past decade may be that their governments have typically been a coalition of political interests and this may result in a strong political commitment to the expenditure frameworks. Having a more heterogeneous government means that after an election, once the coalition's policy programme has been negotiated into a set of expenditure rules, this framework becomes rigid as all parties to the negotiations understand that any renegotiation or expenditure overruns will impact on the overall framework, including those programmes that they negotiated on behalf of their constituencies. As argued by Hallerberg *et al.* (2004), in these countries the fiscal rules act to “...strengthen the credibility of what amount to fiscal contracts they sign with each other”. In the Westminster system of government, where one party typically has a majority in the lower house, reneging may be less politically costly. However, while ministers are accountable in the public domain and obliged to report to parliament, having expenditure rules that are linked to stronger ministerial accountability would mitigate this issue to some extent. Another obstacle in the UK context to enshrining the government's policy programme as articulated during an election into an array of expenditure rules is the relatively long electoral cycle (five years, in contrast to the four years of most European countries that operate expenditure rules). While it is current practice in the United Kingdom to present fiscal projections for a five year period in the Budget, these projections can be revised every six months as a normal part of the Budget and Pre-Budget Report process.



### **Revenue measures**

Surges in revenue from sources that are known to be highly volatile or emerge from unsustainable sources (such as asset price bubbles) should be largely saved. Norway for instance established a stabilisation fund to prudently handle these windfall gains from its oil sector, as has Mexico. Chile also has a budgetary mechanism in place to handle volatile revenues associated with copper price fluctuations. A framework with more rigid expenditure rules would assist in ensuring that revenue windfalls of this kind would not translate into higher expenditure. Although making allowance for asset price effects in particular would be very challenging, in the absence of a view of what equilibrium assets prices are.

Also on the revenue side, the government should move to linking income tax thresholds and national insurance thresholds to wage growth, rather than price inflation calculated by reference to the Retail Price Index (RPI) figures for September prior to the tax year in question. Up to now the definition of “unchanged policies” has assumed the latter so that even if “fiscal drag” calculated on the basis of inflation is given back in the form of tax cuts or in spending increases, the gap between wage growth and prices allowed the government to enjoy a “no-policy-change” improvement in the budgetary policy, which has been estimated by the IFS to be annually of the order of  $\frac{3}{4}$  per cent of national income (IFS, 2009). Decisions on statutory indexation are however made transparently, as the levels set are debated each year in Parliament.

### **Off-balance sheet debt**

A fiscal rule that imposes discipline on public debt levels is useful, particular from an intergenerational fairness perspective. However, as argued in the previous *Survey*, some additional mechanism that accounts for a broader definition of future public sector liabilities, including the government’s off-balance-sheet liabilities, is required to give a complete picture of the long-run sustainability of the public finances, particularly given the challenges associated with the ageing of the population. The previous *Survey* argued that the sustainable investment rule should be complemented with some consideration of the government’s off-balance sheet and contingent liabilities, including public sector pension liabilities, future Private Finance Initiative (PFI) contract payments, and national rail debt which combined could add sustainably to public debt levels.<sup>18</sup> While the government has tended to be transparent in the publication of estimates of the magnitude of these liabilities – for instance the Treasury publishes contracted payments to PFI providers for each of the next 25 years – a sustainable debt rule is less binding if a proportion of government liabilities are excluded. Moreover, large off-balance sheet liabilities may encourage creative accounting in the classification of these liabilities. A further criticism of the government’s handling of off-balance sheet items has been the infrequency of updating estimates of their value. For example, estimates of public pension liabilities have not been updated since 2006 and updated actuarial assumptions are likely to result in the updated estimates being considerably higher than the previous estimate. If liabilities are kept off the balance sheet, there are no obligations on government to keep valuations of these off-balance sheet liabilities up to date; moreover, when they are updated, there is no explicit requirement that the underlying parameters are made available. The government has committed to produce Whole of Government Accounts for 2009-10 consistent with the move to IFRS based accounting standards.

The government now owns (both complete and partial) a number of financial institutions, the liabilities of which are included in public finances data as appropriate by the ONS. The liabilities acquired are however offset by assets in these institutions and, as the government has no intention to maintain ownership in the long-term, these liabilities should be covered once a buyer is found; indeed, there is the possibility that the government could make a profit on this transaction once conditions in financial markets normalise.<sup>19</sup> Budget 2009 announced that the high end of the Government's range of estimates net losses from financial sector interventions, provisionally estimated to be £ 50 billion or 3½ per cent of GDP, would be included in Budget fiscal projections.

#### Box 2.2. Recommendations concerning medium-term fiscal policy issues

- Consideration should be given to the reformulation of the fiscal rules that supplement the *Code of Fiscal Stability* ensuring they are forward looking.
- The fiscal rules should ensure discipline on spending is imposed. Public investment and the cyclical components should continue to be excluded from the expenditure rules so as not to reintroduce a bias against public investment and so as to not impede the counter-cyclical operation of the automatic-stabilisers.
- Income tax thresholds and national insurance thresholds should be linked to wage rather than price inflation.
- The schedule for rebalancing the budget after the current economic downturn abates should be more ambitious. While some “value for money” saving have been identified in the PBR and Budget there should be more explicit targeting of programmes for expenditure cuts and temporary revenue raising measures should be considered to help expedite the rebalancing of the budget and reducing the high debt levels accumulated through the current downturn. The government should be doing its utmost to contribute positively to national saving as quickly as possible, while avoiding undermining the economic recovery.
- The Government should stick to its commitments on sales of public assets as outlined in Budget 2009.
- As relevant, public liabilities that are held off the government balance sheet should be incorporated in setting public debt targets.

#### Notes

1. Net public debt was 39.2% of GDP in 1998, declined to 30.9% in 2001 and the climbed back to 40.2% in 2008 (excluding bank nationalisation borrowing). The current budget balance recorded a surplus of 0.7% of GDP in 1998, peaking at a surplus of 2.1% in 2000 and recorded a string of modest deficits thereafter.
2. The April 2002 budget announced spending increases for the NHS of an average of around 7.4% per annum (in real terms) over five years between 2003/04 and 2007/08 – a cumulative increase of around 33%. These increases came on top of earlier increases announced in the 2000 budget, and were in response to the recommendations of the Wanless Report (published in April 2002) which highlighted the gap between public funding levels for public health in Europe and the United Kingdom. The intention was to fund the spending increases announced in 2002 through increases in National Insurance Contributions of both employers and employees. However it turned out that revenue increases did not match the expenditure increases.
3. Care must be used when making long-term comparisons, as moves are sometimes a result of definitional changes. The reclassification of corporations following privatization was the single largest cause for the decline in public sector employment over the 1980s.

4. The Office of National Statistics (ONS) publishes two public net debt series – one with the costs of nationalisations included and one without.
5. While the stimulatory effectiveness of a VAT cut is subject to debate, the announcement effects of restoring the VAT rate to its previous level are thought to be particularly strong in promoting consumers to bring forward purchases (Crossley et al., 2009).
6. Increasing debt from 37 to 57% of GDP as envisaged by the Treasury in the 2008 PBR would lift interest payments by around £ 10 billion per annum (0.7% of GDP) if financed at the current ten-year bond yield of 3.5%.
7. The Treasury estimated in the PBR that tax revenues generated in the house and financial sectors would decline from 4¼ per cent of GDP in 2007-08 to 2¾ per cent in 2008-10 before recovering to the lower level of 3½ per cent of GDP from 2013-14 onwards (HM Treasury, 2008c).
8. Sandal (2004) estimates that in the case of Norway, Sweden and Finland, while the gross public cost of bank nationalisations and privatisations was 2.0%, 3.6% and 9.0% of GDP respectively, after the assets had been resold the Norwegian tax payer ended up being a net beneficiary (0.4% of GDP) while the net public cost in Sweden was 0.2% of GDP and in Finland 5.3% of GDP.
9. As at 31 March 2009 the outstanding loan in net terms (taking account of cash held by Northern Rock at the bank of England) was £ 9.8 billion, in gross terms it stood at £ 14.6 billion. The gross outstanding loan was £ 26.9 billion at the end of 2007.
10. As part of the government's Operational Efficiency Programme (OEP) the 2008 PBR announced workstrands to examine a range of public assets (including the government's property holdings, valued at £ 370 billion) with a view to potential alternative business models including sale. These workstrands were scheduled to make recommendations for Budget 2009. PBR 2008 identified a number of specific public assets for which alternatives to total public ownership and operation could be considered. These include the Queen Elizabeth conference centre, the Royal Mint, the Land Registry, and the Ordnance Survey (the national mapping agency). Also identified for possible sale was unused electromagnetic spectrum currently allocated to the Ministry of Defence. However the government has explicitly ruled out the total privatisation of the Royal Mail.
11. It was this temporary departure provision (clause 11) that the government used in the 2008 PBR to suspend the existing operating rules temporarily.
12. Gale and Orzag (2002), Bernoth et al. (2006) and Thomas and Wu (2009) show that government bond yields are strongly correlated to future expectations of government budget balances.
13. The Treasury released a supplement to the Pre-Budget Report 2008 on measuring and dating the previous economic cycle (HM Treasury, 2008b).
14. The National Audit Office has its role in the formulation of fiscal policy laid out in the Code of Fiscal Stability. Section 26 states that: "The Treasury shall invite the National Audit Office (NAO) to audit any changes to the key assumptions and conventions underlying the Fiscal Projections. The Comptroller and Auditor General shall ensure that any advice is communicated to the Treasury and laid before Parliament."
15. In Sweden the role of the Fiscal Policy Council encompasses not only ex-post assessment of whether fiscal policy objectives are met (including long-run sustainability, the budget target, the expenditure ceilings and the consistency of fiscal policy with the economic cycle), but also examines the clarity of government proposals, reviews economic forecasts and the models that generate them. Additionally, another independent body, the National Institute of Economic Research, prepares macroeconomic forecasts for use in the budget.
16. Joumard and André (2008) show that revenue windfalls are associated with fiscal policy procyclicality and Turrini (2008) and Wierds (2007) argue that expenditure rules reduce the extent to which these windfalls translate into expenditure slippage.
17. Expenditure that are matched to European Union funding are also excluded.
18. The total liability of the unfunded public service occupational pension schemes was estimated by the Government Actuary's Department (GAD) to have been £ 650 billion (around 50% of GDP) at the beginning of 2006.
19. The government has set up an entity called "UK Financial Investments Limited" (UKFI) to manage, on a commercial basis, the government's recently acquired investments in banks.

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## Chapter 3

# The NHS: An economic health check

*The government's health reform programme since 2000 has covered many aspects of the organisation of health care and was accompanied by a sizeable increase in spending on healthcare. Many of these reforms have the potential to improve the efficiency and responsiveness of the health care system and ultimately health outcomes. This chapter provides an overview of the organisation and financing of the National Health Service, reviews its performance, assesses the reforms since the start of the decade and provides recommendations for further development.*

## The English health care system

Health care is mainly provided by a centralised public system, the National Health Service (NHS).<sup>1</sup> The bulk of its funding comes from general taxation and it is supervised by the Department of Health. As part of the Spending Review process, Parliament allocates Department of Health budgets over a three-year period, within which the Department is expected to meet all its expenditure needs, including expenditure on capital, training and research. In addition to the three-year planning framework, annual cash limits for the various parts of the NHS are rigorously enforced.

The English health care system has traditionally spent relatively little by international comparison. However, during the 1990s it became clear that the NHS was performing poorly on some health outcomes and in terms of responsiveness (for example, waiting times were long). These weaknesses became a central area of political concern, and in 2000 the government pledged to increase spending (then 7.2% of GDP) to the European average (8% of gross domestic product at that time) over the next five years (Ferriman, 2000).

This pledge was conditional on the NHS agreeing to certain reforms, designed to improve clinical quality and responsiveness. The Department of Health developed the NHS Plan (Department of Health, 2000), which set over 400 detailed targets that the NHS was expected to secure over a ten-year period in response to its increased funding. Much of the Department's energy since then has been devoted to implementing the Plan. The recent *Next Stage* review has set out a strategy for further improving quality and responsiveness within the context of the reforms enacted since 2000 (Department of Health, 2008c).

### Financing

The NHS provides the bulk of health care in England. Although the private health care sector is gaining in importance, private spending is small in international comparison. Only about 11% of the UK population is covered by private health insurance, purchased either by employers or individuals. In many cases, private insurance is stimulated by the desire to avoid long NHS waiting times (Office of Health Economics, 2008). There is little reliance on out of pocket expenditure to finance health care. User fees have historically been very low, being restricted mainly to charges for some prescription medicines from which, however, many citizens are exempt. In 2004, only 8.9% of prescriptions were paid at the full charge of £ 6.20 (House of Commons Health Committee, 2006). Dental charges add to out of pocket expenditure. In total, however, user charges accounted for only 1.3% of NHS revenue. UK residents enjoy thus an especially high level of financial protection from the consequences of illness.

### Organisation

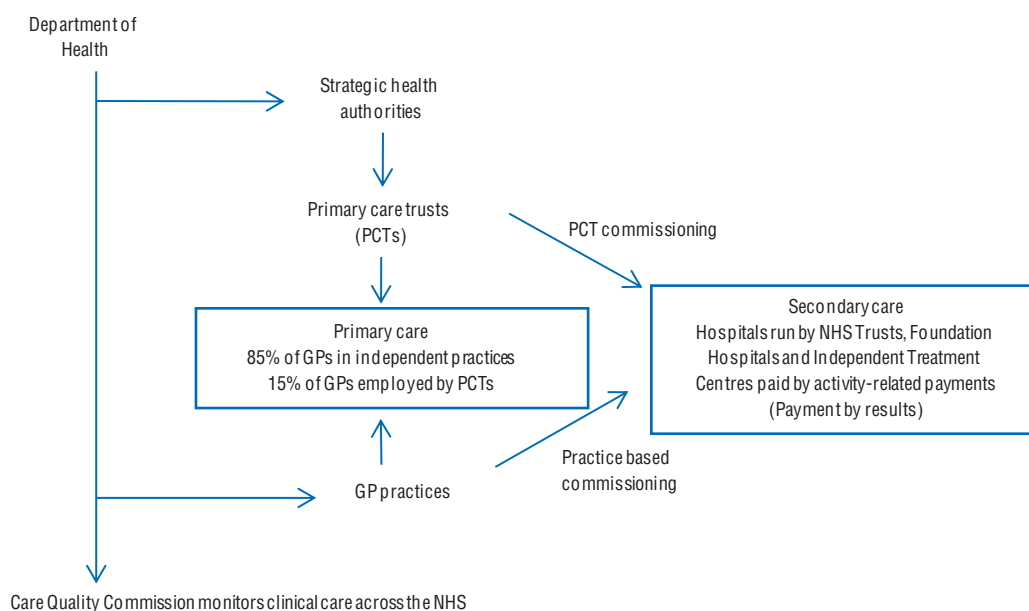
The NHS is organised on a geographical basis. The national ministry has two broad supervisory functions: setting national standards and allocating finance to regional entities. It supervises local health areas through ten Strategic Health Authorities (SHAs),



each covering a population of about 5 million. The SHAs ensure that health care within its region meets the ministry's performance criteria, and that financial limits are not breached. SHAs therefore have a broad monitoring role on behalf of the ministry.

The principal local NHS organisations, responsible for organising local health systems, are 152 Primary Care Trusts (PCTs), each covering populations of about 400 000. The PCTs have three major responsibilities: organising primary care, mainly in the form of general practice; purchasing other health care from NHS and other providers; and organising local public health initiatives. PCTs are given fixed budgets by the Department of Health, from which they purchase health care for their population, including primary and community care, hospital care, pharmaceuticals and public health interventions (Figure 3.1). The budgets are allocated largely according to a national capitation formula, adjusted for local demographic and socio-economic characteristics as well as for variations in local labour and capital costs. PCTs are expected to contain their annual expenditure within the budgetary limit.

Figure 3.1. **Financial flows in the English health care system**



Source: NHS.

PCTs organise primary care in the form of local general practitioner (GP) practices, which are an important feature of the NHS. Every citizen must be registered with a GP practice and, except in emergencies, cannot secure access to secondary NHS care without a referral by the GP to a specialist. GPs therefore perform an important gate-keeping role, and the restraint exercised by GPs in making such referrals has been an important mechanism to contain costs.

There are two broad mechanisms for funding GPs. 85% of GPs are independent contractors, with two thirds of those practicing under the terms of the national General Medical Service (GMS) contract negotiated between the Department of Health and the doctors' union (the British Medical Association). This traditional GP contract specifies

detailed terms and conditions for GP remuneration, including capitation payments for basic services, such as daily clinics, and additional payments for extra services, and a major bonus scheme for securing higher quality primary care which accounts on average for about 25% of practice income. The other 15% of GPs are salaried employees of the local PCT.

PCTs purchase secondary and tertiary care from a local market of public, private and not-for-profit sector providers. In the hospital sector, providers have traditionally been organised as NHS Trusts. These are public organisations, with boards appointed by an independent commission on behalf of the national minister. However, they are independent from the local PCT and compete for business from local PCTs. An increasing number of NHS Trusts are being converted into Foundation Trusts, once they satisfy certain performance criteria, such as good financial management and low waiting times. Like NHS Trusts, Foundation Trusts compete for local NHS business. Unlike other NHS Trusts, they are not directly accountable to the health minister, but are regulated by an independent financial regulator known as Monitor.

The contracts negotiated with local PCTs are the major source of funding for NHS and Foundation Trusts. They mainly take the form of activity-related payments based on diagnosis-related group (DRG) categories. The payment mechanisms remunerate providers according to a fixed national tariff of case payments, and are known as Payment by Results (PbR). Associated with the PbR system is an increased emphasis on patient choice. Once a GP has decided that a patient requires a referral to a hospital or other specialist service, the patient is offered a choice of providers.

There has recently been a major policy drive to increase the role of private sector provision, to increase competitive pressures, expand patient choice and reduce waiting times by creating extra capacity. A notable development is the introduction of independent treatment centres, medical organisations that provide routine diagnostic and surgery procedures for day-case and short-stay patients.

In recent years, a massive investment in information technology has been undertaken, known as the “Connecting for Health” initiative. It coordinates a number of important initiatives to make better use of IT within the health system and includes the development of a comprehensive personal electronic health record. The main intended benefits of the programme are improved patient outcomes and responsiveness and it is also expected to yield major efficiency gains in the form of better central procurement of IT, and by reducing duplication and error throughout the system. This programme has been subject to intense debate. In particular, the implementation of the patient record system has been delayed several times and is now running four years late. Some other aspects of the programme (such as “Choose and Book” for making hospital appointments on-line) have been delivered (National Audit Office, 2006a).

### **Governance and regulation**

A substantial element of central control by the Department of Health over the NHS is an inevitable feature of a tax-funded system, in which policy and spending decisions are made by ministers accountable to Parliament. However, responsibility and power have been devolved within the national framework. The recent “Next Stage” review of the NHS sets out a vision in which the role of the centre is to support, rather than to direct, local organisations: “...the role of the Department of Health is to enable the visions created by

the local NHS to become a reality, whilst ensuring that universality, minimum standards and entitlements are retained and strengthened” (Department of Health, 2008c). The intention is to move from a centrally directed health system to a regulated system in which certain core standards and guarantees are protected, but otherwise local decision-makers are given considerable local freedom.

Devolution has given rise to tensions. If local commissioners (PCTs) are to have some control over what services they purchase, some local variations in healthcare provision are likely to emerge, creating what has become known as a “postcode lottery”. The Department of Health has stated that “the NHS should be universal, but that does not mean that it should be uniform. Clear minimum standards and entitlements will exist, but not a one size fits all model” (Department of Health, 2008c). Furthermore, PCTs do have a statutory obligation to consult with local authorities, and to involve patients and the public in their decisions. However, PCT boards are not appointed through local democratic processes, and there remains a question over whether local populations will feel that PCTs have the democratic legitimacy to make substantive health-policy decisions on behalf of their communities.

An example of such tensions has been a recent debate about the degree to which NHS patients should be entitled to “top-up” their NHS treatment by purchasing privately some additional treatments (in particular, some expensive “end of life” cancer drugs) that are currently not available within the NHS. The option to purchase treatments privately has always been a feature of the health system, but some PCTs have insisted that patients doing so lose their entitlement to NHS treatment, and must therefore receive all of their care privately. The debate concerns whether such top-ups undermine the notion of fairness on which the NHS is predicated, or whether they are just an inevitable or even desirable consequence of promoting patient choice and greater patient control over treatment. The associated consultation exercise concluded that patients should be allowed to pay top-ups whilst retaining their entitlement to NHS treatment. This debate has also highlighted important methodological issues that need to be addressed by the National Institute for Health and Clinical Excellence (NICE), such as the valuation of end of life treatments.

A number of regulators ensure that minimum standards are secured. The Department of Health provides guidance on best clinical practice, in the form of National Service Frameworks for broad disease areas. It has also set targets and “core standards” that all relevant organisations are expected to meet. The NICE creates mandatory guidance on specific treatments that must be provided by all PCTs, and more general advisory guidelines that are not mandatory. It is not known what discretionary PCT services are driven out by mandatory NICE guidance. Given the increased devolution of powers to PCTs, a central question for NICE in the future will therefore be the extent to which adoption of its guidance should continue to be obligatory (House of Commons Health Committee, 2008a).

The prime regulator of quality is the Care Quality Commission (CQC) (until March 2009, the Healthcare Commission), which registers all health care providers (private and NHS) and monitors the clinical performance of all NHS organisations, including Foundation Trusts. The approach to regulation taken by the Healthcare Commission has been termed “information-led, risk-based regulation”. The aim has been to utilise the vast amount of data already collected in the NHS and to focus on the establishment of

benchmarks and good practice against which practice may vary depending on circumstances, but not fall below certain standards (Kennedy, 2008). A particularly important development has been the publication of annual performance cards by the Commission for all NHS organisations, summarizing overall performance on a four point scale. These have been influential in focusing managerial attention on core NHS targets. Other important regulators include the Audit Commission (which reports on the financial management of all NHS organizations), and Monitor (the regulator of Foundation Trusts, focusing mainly on financial performance). Finally, a new NHS Co-operation and Competition Panel was set up in January 2009. It advises the Department of Health on whether local healthcare markets are operating fairly and efficiently.

## Health system performance

### Population health

Variations in population health are routinely used to judge health system performance, although this practice is subject to much debate. Population health is conventionally measured by various mortality-based indices, such as life expectancy at birth and mortality rates standardised for age and sex. As elsewhere, the UK has experienced rapid improvements in recent years. In 2005, life expectancy was 77.1 years for males, which is close to the OECD average, but the figure for females was 81.1 years, which is well below the OECD average.

The UK mortality rate has been improving rapidly in recent years, but tends to be close to the OECD average or somewhat worse, depending on the indicator used. Standardised mortality rates can also be examined at the disease level. Cancer mortality rates, for instance, have been improving, but remain above the OECD median. Rates for circulatory disease show a faster improvement in all countries, with the UK at about the median.

To adjust for the prevalence of long-standing illness and disability, the World Health Organisation publishes data for health-adjusted life expectancy (HALE), which provides a summary measure for the number of years expected to be lived in “full health”. On this basis, the UK is close to the OECD average. Similarly, amongst 18 OECD countries collecting trends in self-reported health status in 2005, the UK is ranked ninth. The proportion rating their health as “good” is 75%, a figure that has remained stable over several years.

### Clinical outcomes

There has been a long-standing concern that the quality of the clinical outcomes achieved by the NHS is below the OECD average. Table 3.1 suggests that performance is at or slightly below the OECD average.<sup>2</sup> The excellent reported in-hospital results for stroke regrettably have not yet been converted into good total mortality rates from stroke.

Table 3.1. **Indicators of clinical outcomes**

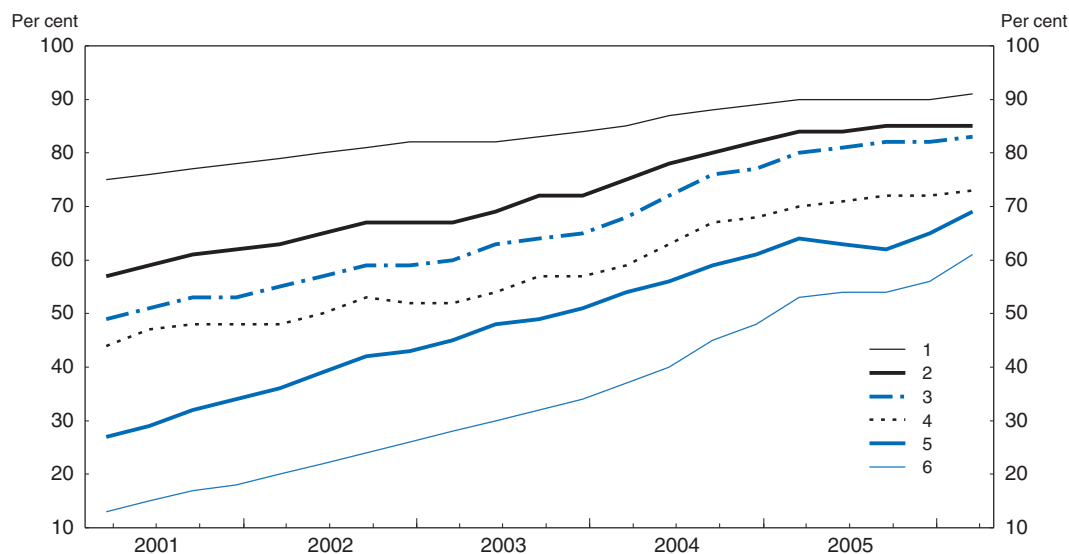
Indicator	OECD sample average	United Kingdom
In-hospital case fatality rates within 30 days after admission for acute myocardial infarction (%)	10.2	11.8
In-hospital case fatality rates following stroke (%)	10.1	5.5
Colorectal cancer five-year relative survival rates, men and women combined (%)	58.9	57.0
Breast cancer five-year relative survival rates (%)	83.6	80.0
Cervical cancer five-year relative survival rates (%)	71.6	72.0

Source: OECD (2007), *Health at a Glance 2007*, Paris: OECD.

The Eurocare project has examined trends in cancer mortality in selected countries, indicating improving trends everywhere, but continued higher rates in the UK. It found for all malignancies a survival rate of 44.8% for men and 52.7% for women, compared with averages of 66.3% and 62.9% across all European registries. There may be reasons other than quality of care for such results, such as variations in the incidence and type of cancers. However, data for a range of individual cancers tend to corroborate evidence that UK cancer outcomes have lagged behind those found in many European counterparts, notably in Scandinavia and central Europe. This could be due to the late stage of diagnosis in the United Kingdom, implying a health system weakness.

Improvements in the quality of GP care have been a notable feature of the health system. Figure 3.2 shows trends in six quality indicators, collected from those practices voluntarily enrolled in the QRESEARCH initiative over a six year period. A major quality improvement initiative, the Quality and Outcomes Framework (QOF) (reviewed below) was implemented in April 2004, in the middle of the period shown. Unfortunately, no baseline data were collected against which to measure the impact of the QOF. However, the QRESEARCH data and other research suggest that the QOF has had only a modest effect on the trends in GP quality, which were in any case already rapidly improving before this initiative.

Figure 3.2. **Selected clinical indicators from the quality and outcomes framework**  
Proportion of eligible patients achieving the indicator



1. HBP4: Blood pressure recorded in last 9 months for patients with hypertension.
2. CHD6: Blood Pressure < 150/90 in last 15 months for patients with CHD.
3. STROKE6: BP < 150/90 in last 15 months for patients with stroke.
4. HBP5: Blood pressure < 150/90 in the last 9 months for patients with hypertension.
5. CHD8: Cholesterol < 5 mmol/l in last 15 months for patients with CHD.
6. STROKE8: Cholesterol < 5 mmol/l in the last 15 months for patients with stroke.

Source: QRESEARCH and the NHS Information Centre.

StatLink  <http://dx.doi.org/10.1787/648028863580>

## Responsiveness

Concerns remain that the NHS is still not sufficiently responsive to patient preferences. The government has recognised this weakness, and in 2004 set a target to “secure sustained annual national improvements in NHS patient experience by 2008, as measured by independently validated surveys, ensuring that individuals are fully involved in decisions about their healthcare, including choice of provider.” Progress has been measured by means of the annual National Patient Survey Programme. Results for the adult inpatient survey are summarised in Table 3.2, which tracks changes in patient-reported scores for five aspects of care. The results indicate a largely static picture, as there is little movement in any of the indicators. Similar results are found for primary care and mental health services (Department of Health, 2008g).

**Table 3.2. Health care quality indicators**

A higher score indicates better quality

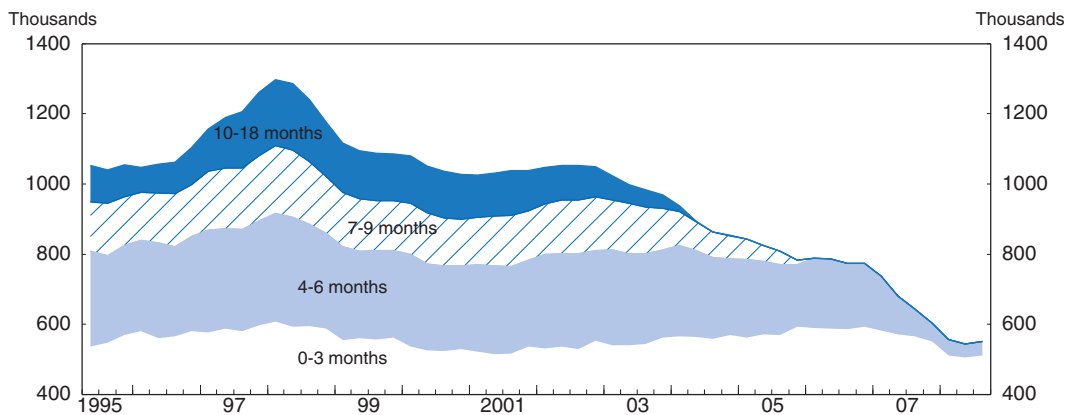
	2001-02	2003-04	2005-06	2006-07	2007-08
Access and waiting	82.1	83.5	84.9	84.8	83.8
Safe, high quality, coordinated care <sup>1</sup>	63.9	65.5	65.1	65.1	64.9
Better information, more choice <sup>1</sup>	67.2	67.9	67.9	67.3	66.7
Building closer relationships <sup>1</sup>	82.6	83.3	83.3	83.1	83.0
Clean, friendly, comfortable place to be	76.7	78.4	78.5	78.4	78.1
Overall	74.9	75.7	76.2	75.7	75.3

1. There were substantial changes in questions between 2001-02 and 2003-04. Scoring was changed to make results comparable across years.


Source: Department of Health (2008), National Patient Survey Programme.

Long waiting times for elective inpatient care have been a feature of the NHS since its formation in 1948. Since 2001 there has been a considerable effort to reduce long waiting times, driven by a strictly enforced system of waiting-time targets for individual hospital trusts. This has resulted in a marked improvement (Figure 3.3). All the very long waits have been eliminated, and recently the absolute numbers waiting have declined. However, this

**Figure 3.3. Inpatient waiting times**



Source: Department of Health.

StatLink  <http://dx.doi.org/10.1787/648032870855>

improvement in long waiting times has not materially affected the satisfaction scores reported above.

There is now a concerted effort to reduce the total wait from initial specialist referral by a GP to eventual treatment to a maximum of 18 weeks (Department of Health, 2008d). In August 2008, 90% of patients admitted to hospital for treatment had waited 18 weeks or less, compared to 56% a year earlier. Without question, NHS policy on long waiting times has been a major success over the period under review. However, as is to be expected with any high profile target-setting process, there have been reports of adverse consequences, including verified incidents of waiting list fraud and less readily verifiable reports of clinical quality being sacrificed in order to meet waiting time targets. Smith (2007) documents many of these adverse effects and the efforts that have been made to overcome them (such as careful external audit of waiting list data). However, gaming will always be a risk associated with such targets.

It is important to note that – whilst patient satisfaction levels have been broadly constant over the period under review – more general satisfaction levels with the NHS amongst the population as a whole have been rising steadily, and are currently at their highest level since 1984 (Appleby and Philips, 2009). The highest satisfaction levels are for GPs and hospital outpatient services. Satisfaction with inpatient services has however fallen markedly, from 74% being “very” or “quite” satisfied in 1983 to 49% in 2008.

### **Inequalities**

Inequalities in health outcomes affecting disadvantaged population groups have been a persistent concern since 1997, yet have proved very resistant to policy interventions. In 2001 the government set targets to reduce health inequalities as part of the Public Services Agreements. The overarching objective, set in 2003, was to reduce inequalities in health outcomes by 10% as measured by infant mortality and life expectancy at birth.

Progress was monitored by an independent reference group. In its final report the Department of Health noted that almost all the departmental actions due for delivery by the end of 2006 had been wholly or substantially achieved (Department of Health, 2008i). The inequality outcomes were however more equivocal. Comparing mortality figures for 2004-06 with those for 2003-05 there had been a further slight narrowing of the infant mortality gap; little change in the gap in male life expectancy; a widening of the gap in female life expectancy; a narrowing of inequalities in absolute terms in cancer and circulatory disease mortality, child road accident casualties and teenage conceptions; and a general reduction in the prevalence of risk factors in other areas, such as smoking, but no narrowing of the gap between social groups.

The inequalities strategy was refreshed in 2008 with the publication of *Health Inequalities: Progress and Next Steps* (Department of Health, 2008b). This reaffirms the commitment to reducing inequalities in health outcomes, and recognises the broader determinants of those inequalities. It sets out a range of actions designed to address the policy problem, but none of these appears to represent a radical departure from previous efforts.

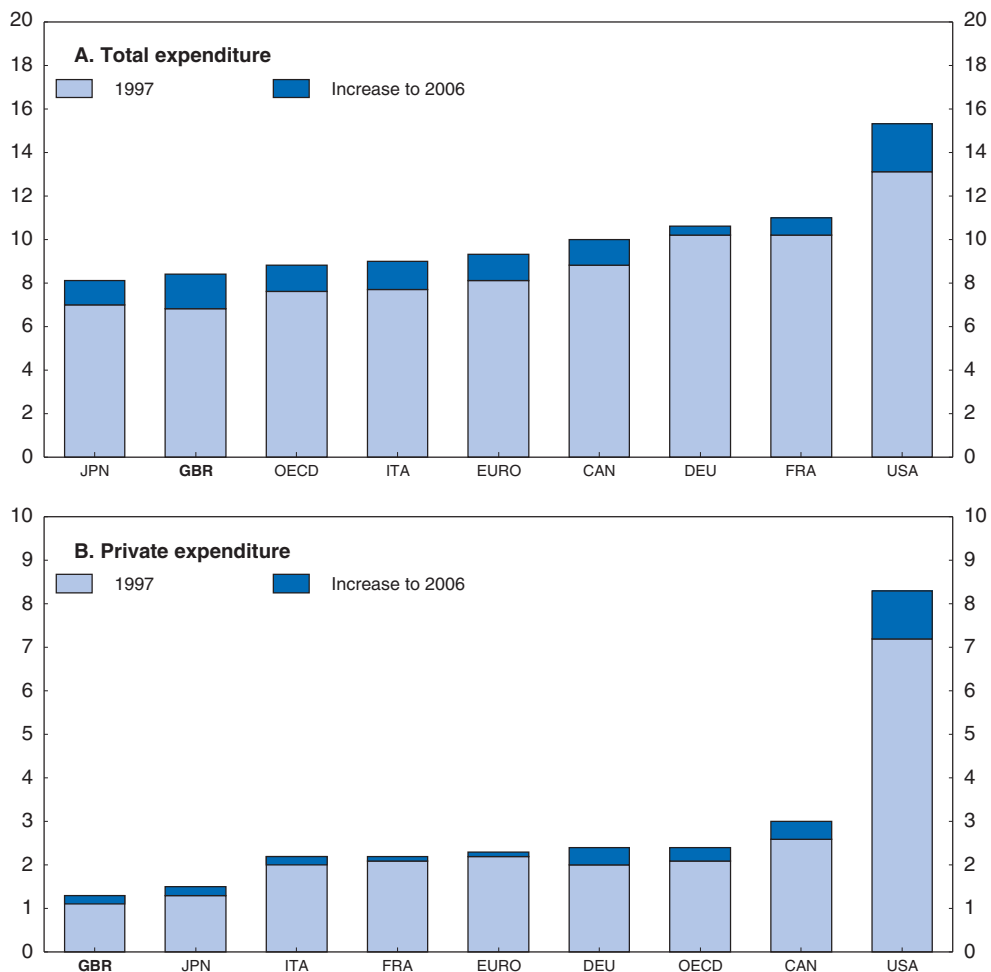
### **Spending and productivity**

Between 1997 and 2006, UK health care spending as a percentage of GDP increased from 6.6% to 8.5%, fuelled mainly by large increases in spending on the NHS (Figure 3.4).<sup>3</sup>

UK spending is now close to the OECD average. According to OECD estimates, until 2050, public health care spending could rise by 3½ per cent of GDP in a cost-pressure scenario and by about half that in a cost-containment scenario. In both scenarios, demographics and relative price changes are the main drivers of health spending (OECD, 2006).

Increases in NHS spending in England have been substantial, with expenditure growth in real terms of approximately 10% per annum between 2000 and 2007. A prime reason for the increase in spending has been the increase in the NHS workforce (Table 3.3). Since 2000, total employment has risen by 19% and that of doctors by 32.5%. Full time equivalent numbers have grown even faster (22% and 34% respectively). Also support staff numbers, such as hospital porters and cleaners, central management and infrastructure support, have risen rapidly. As discussed further below, remuneration of many categories of staff, especially doctors and nurses, has also increased rapidly.

Figure 3.4. **Expenditure on health**  
Percent of GDP, 2006



Source: OECD Health Data 2008.


StatLink  <http://dx.doi.org/10.1787/648064078574>



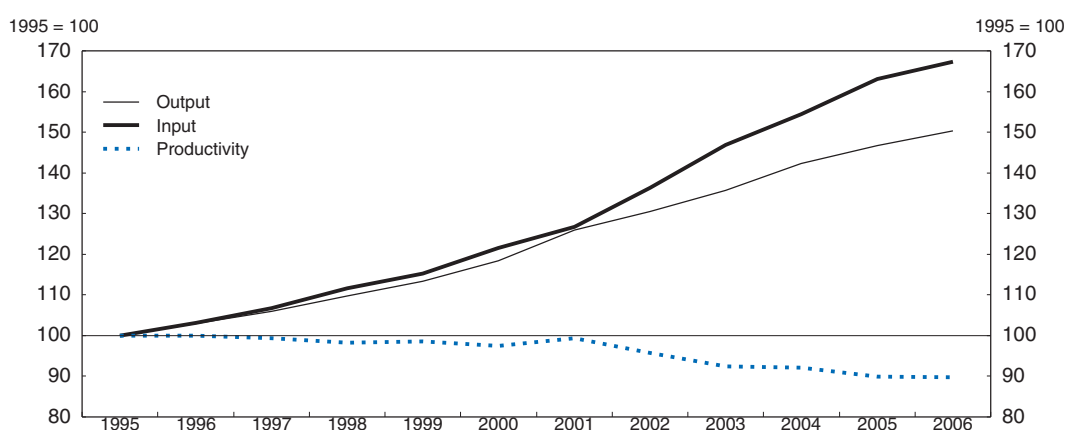
Table 3.3. **Trends in the NHS workforce in England**  
In thousands

	2000	2007	Per cent change 2000-2007
Doctors	96.3	127.6	32.5
Qualified nurses	335.9	399.6	18.9
Other qualified professionals	120.7	154.0	27.6
Support staff	564.9	649.3	14.9
Total	1 117.8	1 330.5	19.0

Source: <http://www.ic.nhs.uk/statistics-and-data-collections/workforce/nhs-staff-numbers>.

The Office for National Statistics (ONS) has produced a series of experimental reports on productivity trends in the NHS. The most recent indicates that – without any adjustment for the quality of care – the quantity of health services grew by about 4% per annum between 2001 and 2005 (Office for National Statistics, 2008). The estimate of outputs is based on a cost-weighted index of activities, such as hospital acute services, community health, GP appointments and GP prescribed drugs. Inputs grew by 6.5% per annum over the same period as this was a period of heavy investment in the NHS, so the ONS estimate of annual productivity change was a decline of 2.5% (Figure 3.5). Taking account of changes in quality of care (mainly in the form of improvements in post-operative mortality) the estimate of the annual decline in productivity is 2.0%. In 2006, the latest available data on these partial measures of output, the decline in measured productivity halts. Making adjustments for quality is inherently difficult. The ONS recognises that that their figures need to be interpreted with caution and alongside other measures to build an accurate picture of NHS efficiency.

Figure 3.5. **Health care output<sup>1</sup>, inputs and productivity**



1. Excluding quality adjustment.

Source: ONS and Public Service Productivity, Health Care, London.

StatLink  <http://dx.doi.org/10.1787/648083554838>

The NHS has increased the focus on Value for Money. For example the Department of Health has assessed its own progress in achieving efficiency gains mandated through a national public sector efficiency programme, and estimates that it has exceed the £ 6.5 billion savings target set for it between 2004-05 and 2007-08. However, the methods used for measuring efficiency gains have some limitations and therefore the self-

assessments of gains made right across the public sector have to be treated with some caution (National Audit Office 2006b, 2007a).

In 2002 Sir Derek Wanless published a review of NHS “futures” for HM Treasury, in which he projected long-term trends in spending on health care from 2002 to 2022 (Wanless, 2002). He considered three scenarios, depending on future NHS performance and success in public health: (a) “solid progress” (the central estimate); (b) “slow uptake” (a pessimistic scenario); and (c) “fully engaged” (an optimistic scenario). The “fully engaged” scenario includes an ambitious assumption about productivity gains.

In 2007 Wanless prepared a detailed five year progress review (Wanless *et al.*, 2007). He found that, overall, progress has been somewhere between “slow uptake” and “solid progress”, and in particular that rates of change in “lifestyle” had been disappointing. Also, National Service Frameworks were not systematically updated or rolled out, so he could not estimate costs of new treatments, and there are no clear plans or targets for productivity improvements. Spending over the five year period has been in line with his recommendations. If current trends continue, Wanless judged that future resources required will tend towards the “slow uptake” scenario, raising questions about the financial sustainability of the NHS. He concluded that the need to improve prevention and productivity has become even greater. There has indeed subsequently been greater policy attention directed towards prevention of diseases, with an emphasis on the collection and dissemination of evidence on the effectiveness of interventions (*e.g.* the Cochrane Public Health Review Group and the NICE Public Health programme). Implementation of national policies such as the ban on smoking in public places represent progress in addressing lifestyle issues, and there is currently much emphasis on tackling obesity.

International comparisons of health system productivity, as attempted by the WHO in its World Health Report 2000, are fraught with difficulty (World Health Organization, 2000). Historically, relative to OECD comparators, the health care system incurred low spending but secured mediocre outcomes in many domains. More recently, outcomes have improved, but they still on balance tend to lag behind comparators. Likewise expenditure has increased rapidly and is now close to the OECD average. The OECD has recently estimated that the UK health system achieved life expectancy levels in 2003 that were roughly as expected, given spending levels and other national circumstances such as income and educational attainment (Joumard *et al.*, 2008). In other words, after adjusting for external conditions, productivity of the UK health system is close to the OECD average.

## Health care reforms

The Department of Health has, since the NHS Plan was published in 2000, implemented a set of NHS “system reforms” that have sought to modernise all elements of the health care system. The focus has been on improving system outcomes (measured in terms of health gain, responsiveness and reduced inequalities in health outcomes) and productivity (value for money). The fundamental sources of revenue for the NHS (national taxation and low user charges) have remained untouched. However, attempts have been made to reform most other aspects of the health system. The key principles underlying the reforms have been: Improved strategic purchasing (commissioning) of health services; enhanced choice of provider for patients; increased plurality of health care providers, including the development of not-for-profit “Foundation Trusts” and private providers; better alignment of payment mechanisms with work undertaken (diagnosis-related group

(DRG) financing or “Payment by Results”); and changes to employee contracts to raise quality and productivity.

### **Commissioning**

Commissioning involves the strategic purchasing of health care services to secure the best quality care and health outcomes for local populations, within a fixed budget. The introduction of the purchaser/provider separation started in 1991, when purchasing became the responsibility of the health authorities. General practitioners could also voluntarily become GP fundholders, alongside health authority purchasers, having responsibility (in a limited way) for devolved budgets for purchasing elective care and prescribing. There is little evidence that health-authority purchasing secured many material benefits in the 1990s (Le Grand, Mays and Mulligan, 1998). However, evidence suggests that the financial incentives associated with GP fundholding were successful in controlling activity and reducing waiting times (Dusheiko, Gravelle and Jacobs, 2004; Dusheiko *et al.*, 2006).

Since 1991 there have been major changes in the organisation, budgetary arrangements and provider markets for health care commissioners, as well as in the number, size and budgetary responsibilities of commissioners. Commissioning is now the responsibility of the 152 Primary Care Trusts (PCTs). It is at the heart of many of the other system reforms taking place in the NHS, including enhanced patient choice; managing new types of providers; the shift to legal status for healthcare contracts; the use of fixed DRG tariffs; the focus on providing care closer to home; and the need to adhere to the many standards and targets set for quality of care. Thus, through their responsibility for the bulk of NHS expenditure, commissioners face one of the biggest challenges in the NHS.

Attempts have been made to enhance the capabilities and capacity of PCTs to undertake their tasks, culminating in the *World Class Commissioning* initiative (Department of Health, 2007). This sets out the Department of Health’s view of the competencies required of PCTs, with the aim of supporting them where they fall short and giving them greater freedom where they are doing well. PCTs will be held to account for their performance in achieving the desired system outcomes through a national assessment system. A range of (mainly non-financial) penalties and rewards have been designed to incentivise PCTs. Greater intervention by the strategic health authority and potential designation as a “challenged” organisation is the main penalty for under-performance. The requirements of PCT commissioning are now well-understood, and there are signs that the NHS is engaged in the process. However, it is too early to judge the impact of World Class Commissioning on patients and health outcomes.

As part of the commissioning reforms, the Department of Health reintroduced from 2005 a form of GP purchasing known as Practice Based Commissioning (PBC). This follows the principles outlined in the NHS Plan that commissioning should take place as close to the patient as possible. PBC seeks to give indicative budgets to the general practices within a PCT, carved out from the PCT budget. A typical general practice will be responsible for about 10 000 patients. PCTs remain legally responsible for the commissioning process, while GPs are expected to take greater responsibility for the financial consequences of their referral decisions and to commission services that suit their patients, re-designing such services where necessary. PBC is also viewed as a major tool in managing demand through the use of financial incentives to control activity, mirroring the successful approach taken in GP fundholding.

Independent assessment of the early impact of PBC has highlighted a number of potential problems and obstacles to achieving the ultimate aim of improving health for local people. The Audit Commission's first overview of PBC indicated that engagement of GPs with PBC was limited. Its later survey showed some progress had been made but many PCTs were still at an early stage of implementation in 2006-07 (Audit Commission, 2007). In particular, although progress had been made in setting up processes and policies related to the organisation of PBC, many crucial aspects of financial management were still to be developed.

The specific issues identified as crucial to success of PBC included: good quality and timely information for monitoring; provision of robust indicative budgets using a methodology understood and approved by GPs; training and analytical capacity; freedom for GPs to use savings to develop services and support for change; good governance arrangements especially where practices purchase services from themselves; and shared ownership of decisions on strategic objectives between practices and the PCT (Healthcare Commission and Audit Commission, 2008). There are more recent signs of some improvements noted by GPs (Department of Health, 2009).

A persistent theme of the NHS commissioning process throughout its many manifestations has been the apparent inertia in the pattern of commissioned services. Despite two decades of reform, there is little evidence of significant shifts in the nature or provider of commissioned services (Dusheiko *et al.*, 2008). One of the expectations of PBC is that it will finally result in the development of new and innovative services and re-design of services to meet local needs better. Some examples have been documented, such as GPs undertaking minor surgery or the introduction of new patient pathways that reduce waiting times.

It is nevertheless early days to expect to see significant large scale progress in service change and the latest Department of Health survey reports that trends appear to be moving in the right direction. The percentage of practices commissioning new services as a direct result of PBC continues to rise, with 61% stating they had done so in the most recent survey (Department of Health, 2009). The early stages of GP fundholding were dominated by enthusiastic practices that drove forward the reform, whilst others were at first more reluctant to engage. A similar pattern appears to be emerging with PBC. If commissioners eventually do become more active in re-shaping the provider market, they are likely to encounter significant problems associated with the implementation of change in the NHS at local level. In particular, any rationalisation of services through relocation, merger or closure of "failing" services is likely to be perceived locally as detrimental to access. It will, therefore, be politically highly charged and possibly face legal challenges by local communities. If the pressure to avoid such thorny issues inhibits the pursuit of changes that are justified in terms of the overall benefits, then the principles underlying much of the reform process may be undermined. The emerging role of the new Cooperation and Competition Panel may be important in this domain.

Some argue that there are inherent limitations in trying to maintain a division between commissioners and providers in a publicly funded health care system in which providers often have greater market power than purchasers and where the complexity of health care means that the costs of writing contracts and monitoring performance are substantial. However, there are clearly costs associated with ensuring good performance regardless of how the healthcare system is organised and the issue of which approach is

most efficient remains unresolved (Ham, 2008). At least in principle, PBC does seem to offer some promise in making commissioning more sensitive to patient needs whilst containing expenditure. Many challenges nevertheless remain for the future, such as securing better engagement of GPs in PBC; ensuring the probity of the system if GPs move towards providing some secondary care themselves; and measuring and making public the performance of GPs as commissioners.

It is worth noting one final policy development: the possibility of allocating “individual budgets” directly to patients with certain chronic conditions, with which they can purchase care in line with their own preferences. This policy will be tested with some small scale pilot studies. It follows from similar experiments in the social care sector, and takes the principle of devolved decision-making and personalised care to its logical conclusion. Individual budgets raise many issues, however, relating to information for patients, financial control, health outcomes and risk sharing.

### **Patient choice**

The expansion of patient choice has been a major plank of health reform (Department of Health, 2003). There are several strands to the choice policy, including: choice of provider for elective care (Department of Health, 2003); choice of type of antenatal and postnatal maternity care and choice of place of birth (Department of Health and Partnerships for Children, 2007); and choice in care planning and treatment regime for specialist groups or treatments (*e.g.* mental health). However, it is choice of location of service for elective care that has been at the centre of the reforms. Since April 2008, PCTs have been obliged to offer most patients a choice among providers (hospital, not physician) at the time of first referral by a GP, including any NHS hospital in the country and many private sector providers.

There are several stated aims of choice policies, such as enhancing consumer empowerment; stimulating supply side competition, efficiency and diversity; improving quality and responsiveness; and improving access. In particular the national system of case payments (see below) seeks to ensure that money is directed wherever patients choose to go. The intention is to make providers more responsive to patient preferences. Choice is therefore seen as desirable in its own right and as a means to enhancing market efficiency.

Several initiatives have been designed to help patients make effective choices. “NHS Choices” is a website that facilitates comparisons of hospitals by providing information on hospitals, such as waiting times and re-admission rates; it also includes comments and ratings from patients (Department of Health, 2008f). The Department of Health reports this site received over seven million visits in March 2009. The “Choose and Book” system allows people to book electronically or by telephone their first hospital appointment at their chosen hospital, once they have a confirmed referral from their GP (Department of Health, 2008e). The Department of Health reports that almost 10 million patients have been referred through this system since it began in summer 2004. More GP practices are using the system and in July and August 2008, over 80% of practices were participating.

Patients would be better positioned to make choices if they were given better information on outcomes at the procedure, hospital and surgeon level (Department of Health, 2003). However, there are currently few indicators of clinical quality to inform patients’ choices. As a move towards more general performance reporting, from April 2009 patient reported outcome measures (PROMS) will be routinely collected for four

hospital interventions: knee and hip replacement, varicose vein surgery, and hernia repair. This is a significant innovation and England is at the forefront of development in this area. However, the NHS has not been as good in collecting good data on quality beyond information about significant adverse events (readmissions or death) until recently, and it is noteworthy that one of the first initiatives for collating and disseminating performance information for the public was the work of the private sector concern Dr Foster Intelligence ([www.drfooster.co.uk](http://www.drfooster.co.uk)).

Offering choice over the timing of appointments, location of care and treatments is popular with the public. However, it is less clear whether some of the other market consequences of choice, such as closure of under-utilised hospitals, are so readily accepted (Appleby and Philips, 2009). Furthermore, although the proportion of patients reporting that they are aware that they are entitled to choice, and remembered being offered a choice, has increased over time, the most recent increases have been very modest (Department of Health, 2008h). Moreover, it has proved difficult to assess the impact that increased choice has had on health system performance, as distinct from the impact of other policies. A review of the available evidence concluded that there is not yet any convincing evidence that choice has improved quality of services (Robinson and Thorlby, 2008) and this conclusion has been supported by recent qualitative findings. There are also plans to enhance treatment choice for those with long-term conditions and mental health problems and facilitating choice and easier switching of GP. The prospect of allocating personalised budgets to patients with some long-term conditions, if implemented, would give patients even more direct control over healthcare purchasing decisions.

There are some potential conflicts between the choice policy and other strands of the NHS reforms. Most importantly, commissioners are required to commission strategically. To do so, they need to be able to exercise some control, or at least influence, over the treatments patients receive taking account cost/quality and which providers should be used whilst at the same time ensuring choice. Similarly, Practice Based Commissioning provides incentives for GPs to provide certain services that were previously provided elsewhere. This may result in a conflict of interest for GPs in offering independent advice to their patients on what choices are available. However, the General Medical Council issued guidelines in 2006 (titled “Good Medical Practice”) that set out how GPs are expected to behave to ensure probity and transparency when faced with a potential conflict.

However, most of the other reforms seek to facilitate and reinforce improved choice. For example, the increased range of provider has led to the creation of the “Extended Choice Network”, which allows GPs to offer choices to patients from approximately 147 approved independent providers, including independent sector treatment centres. Similarly, the use of the national tariff (Payment by Results) rewards those providers chosen by patients with increased business, thereby, in principle, providing an incentive for increased quality and responsiveness.

### **Plurality in provision**

A common thread running through the system reforms is the diversification of the provider “market”. New types of providers include the independent sector, most notably through Independent Sector Treatment Centres (ISTCs); Foundation Trusts; and the “third sector”, which includes not-for-profit organisations such as social enterprises, voluntary groups and charities. The policy has several aims: encouraging competition and innovation; improving responsiveness; and increasing access and capacity.

ISTCs were envisaged specifically as an instrument to encourage private sector entry into routine elective care, with the objective of reducing waiting times. The NHS Plan emphasised the potential for the private sector to play a bigger role in providing services and allow purchasers to secure gains in efficiency and enhance choice. The ISTCs now cover a range of elective and diagnostic procedures, but activity by ISTCs has been limited, accounting for only 1.8% of total elective activity in 2007-08. Unpublished research suggests that the ISTC programme has had no statistically significant impact on the reduction in waiting times either for those PCTs in which ISTCs are located nor a more general effect across the system.

Foundation Trusts (FTs) were created by the Health and Social Care Act in 2003 and gave NHS hospital trusts the opportunity to become independent not-for-profit public benefit corporations. Whilst remaining in the public sector, they were granted greater autonomy from central control and a range of financial and other freedoms. These include greater financial flexibility (they do not have to break even but must remain financially viable and are allowed to retain surpluses); they can invest in buildings and new services; they manage their own assets; and they can recruit and reward staff with higher salaries, although many of these freedoms have also been extended to NHS Trusts. This reform was part of the general strategy to shift away from a centrally managed system to one managed locally.

Applying for FT status is voluntary but a successful application depends on performance. Only those trusts performing well (gaining three stars, the top rating, in the Healthcare Commission's performance rating system) are allowed to apply. FTs were introduced in a phased manner and in October 2008 there were 107 FTs, of which 31 were mental health trusts. The ultimate aim is for all NHS Trusts to convert to FT status, but progress has not been as fast as originally envisaged.

The quality of care provided by FTs remains subject to the scrutiny of the Care Quality Commission (which undertakes quality and performance regulation for all NHS organisations). FTs also have to satisfy their PCT commissioners in terms of adherence to national targets such as those for waiting times. However, they are free from direct management by the Department of Health. Instead, they are authorised and supervised by Monitor, an independent regulator created to oversee and license FTs.

FT status was intended to bring a range of benefits. The governance structure of FTs involves a bigger role for local communities, a form of "social ownership" in which local people and FT staff have the right to become members and vote for a board of governors. The intention was to make service provision more responsive to local communities and to enhance staff morale. In addition, the financial freedoms enjoyed by FTs are expected to help them improve their financial management, efficiency and performance. In particular, FTs are expected to reinvest surpluses in innovative services and delivery mechanisms.

Monitor reports that FTs are performing well as a group. A recent review reported that all were meeting national core standards and targets, including progress towards the 18 week waiting list target (Monitor, 2008). The main challenge identified was in terms of hospital acquired infection, with several FTs declaring a risk of not reaching their targets. Monitor concluded that six trusts were in "significant breach" of their terms of authorisation, five due to their performance with hospital infection rates, although this problem is widespread amongst NHS hospitals and not confined to FTs. The latest performance assessment by the Healthcare Commission identified FTs as doing very well

as a group when compared to non-FTs – with 38 out of the 42 highest rated trusts having FT status, and just one FT rated “weak” for quality of service (Healthcare Commission, 2008). However, a recent report by the Commission identified serious failings in the quality of emergency care at the Mid Staffordshire NHS Foundation Trust. It found, amongst other things, that the Board’s emphasis was on financial savings and securing Foundation Trust status, and that it lost sight of its responsibilities to deliver acceptable standards of health care (Healthcare Commission, 2009). The report has led to an increased emphasis on cooperation between regulators and on clinical safety being a board level concern.

FTs had been warned by Monitor that they needed to make bigger surpluses if they were to invest in new services and renew their assets. The most recent assessment suggests this is now happening, with FTs as a whole delivering revenues and surpluses in excess of planned amounts. However, detailed analysis of the relative financial performance of early waves of FTs and non-FTs suggests that much of the superior performance of hospitals with FT status existed before their transfer to FT status (Marini *et al.*, 2008). It is therefore not clear that the FT policy itself is responsible for creating strong financial performance.

Similar arguments apply to other aspects of performance, as most comparisons between FTs and non-FTs are undertaken on a crude basis and do not allow for the self-selection of successful FT applicants. For example, the timing of improvements in quality ratings does not seem to be clearly linked to the timing of achieving FT status. Furthermore, there are examples of new services provided by FTs, such as critical care units, networks of radiotherapy services, and “self pay” dermatology services not provided free by the NHS. There is also evidence of speedy resolution of innovative deals, such as a partnership between a charity and FT to deliver mobile chemotherapy services (House of Commons Health Committee, 2008b). But it is not possible to attribute these innovations specifically to the FT regime.

However, financial management methods adopted by FTs appear to represent a marked improvement on former practices. The NHS as a whole is moving towards financial reporting practices adopted by Monitor. Furthermore, many FTs have adopted “service line reporting”, in which budgets are allocated to medical departments. Such improvements in cost accounting are essential if providers are to understand their cost structures and pursue innovation.

### **Payment by Results**

The introduction of an activity-based funding mechanism for reimbursement of providers for hospital care has been a key element of the NHS reforms (Department of Health, 2002). It is rather misleadingly known as Payment by Results (PbR), since it directly rewards only output activity and not the quality of outcomes. It is based on DRG finance systems used in many other health systems and was designed to support the related policies of patient choice and practice based commissioning. Providers are reimbursed according to a case mix adjusted tariff determined by the Department of Health and based mainly on the average of all hospital costs for that procedure. Patient categorisation is according to a system of Healthcare Resource Groups (HRGs) (similar to DRGs), with separate tariffs for elective and non elective care.

A national tariff is used, with limited scope for local variation apart from an adjustment to account for unavoidable regional cost differences and top-up payments



applicable for a small number of specialised services. In general the tariff seeks to reflect all relevant costs, including most capital expenditure. The policy has been phased in since 2002-03 and there are now over 1 000 HRGs covered by the tariff for acute elective and non-elective activity, outpatient attendance and day cases. Refinement of existing HRGs and expansion of the PbR approach to mental health, ambulance services, long-term conditions and community care are planned (Department of Health, 2007).

One of the difficulties in assessing the impact of PbR is that it is a policy with multiple aims. The objectives for PbR are: increase efficiency; where needed, encourage expansion of activity; support patient choice; increase patient satisfaction; encourage providers to be responsive to patient and commissioner preferences; keep costs under control; introduce fairness and transparency in funding providers; encourage the development of new, cost-effective treatment pathways; and shift patterns of service provision away from historical patterns and improve quality. Some of the objectives are long term, others short term; some are very ambitious and several may conflict with other policy intentions (Miraldo, Goddard and Smith, 2006). For instance, providers are expected to increase activity and this has indeed been the experience in many countries where prospective payment has been introduced. The specific emphasis in England was to tackle waiting lists for elective and outpatient care. However, the payment mechanism also gives providers an incentive to increase activity in any area where the tariff is greater than their marginal costs and this may affect the mix of activity or may inhibit desirable shifts in activity from hospital to community settings. There is a tension therefore between the desire to stimulate activity and the need to promote efficient provision and operate within the fixed NHS budget.

In principle, it may be possible to design a payment system that offers a reduced tariff for activity beyond a target level based on historical activity levels. If the level of payment is not specified in advance, providers have an incentive to stay within target activity levels. This has been tried in Australia (Street and Maynard, 2007). In England, more direct ways of managing activity have been introduced in the form of referral management centres that operate at the interface between GPs who refer patients and the hospital specialists who treat them. The centres can monitor and even block referrals, but they have been controversial and their effectiveness has yet to be evaluated (Davies and Elwyn, 2006).

Experience in other countries indicates that the success in achieving many of the stated aims will depend crucially on the precise nature of the tariff. Currently, the tariff is based on national average costs. One way of rewarding providers who undertake innovative treatments or use treatments that are known to produce health gains may be to introduce higher prices for such treatments. There is also discussion about basing tariffs on the costs of more efficient providers, rather than the national average (Street and Maynard, 2007).

As with the other reforms, identifying the specific contribution of PbR to changes in system behaviour is difficult. Some research has suggested that (at least in the early stages of the policy) PbR has contributed to and reinforced, rather than driven, the observed increases in elective activity and reductions in elective length of stay (Audit Commission, 2008). The experience in England has been compared with that in Scotland, where the tariff system was not adopted. Econometric analysis suggests that where PbR was implemented: (a) unit costs fell more quickly; (b) length of hospital stay fell more quickly; and (c) the proportion of elective cases treated as day cases increased more quickly (Farrar *et al.*, 2007). The volume of inpatient activity also increased but results were less clear for outpatient

treatment. These gains did not appear to be made at the expense of quality as proxied by inpatient mortality rates, 30 day post-surgery mortality or emergency re-admission following hip fracture treatment.

It has also been possible to compare, within England, the 15 HRGs initially subject to the tariff in the early days of the PbR policy, with all other HRGs (Street and Miraldo, 2007). The results suggested that relative unit costs had not been affected by the policy. In addition, although there was a faster rate of growth in elective activity in the subset of 15 HRGs to which PbR applied, this could not necessarily be attributed to PbR because there was already a long-standing upward trend in activity growth for these HRGs. Similar difficulties were experienced in attributing to PbR the reductions in waiting times observed in the 15 HRGs subject to the tariff. It was also associated with a higher rate of growth in day case activity.

### **Workforce contracts**

Since 2004, there have been substantial changes in the contractual arrangements for GPs and for hospital consultants and other NHS staff. Two key policy reforms are the GP contract and the hospital specialist contract.

#### **General practitioner (GP) contracts**

GPs form the backbone of primary care services. They can practice either single-handedly or as groups in GP practices. 85% of GPs are independent contractors, with two thirds of those practising under the national General Medical Services (GMS) contract. In the light of a perceived shortage of GPs, causing access difficulties for patients, the apparently low morale of GPs, and a desire to modernise the primary care services, the government negotiated a new contract with GPs that was implemented in April 2004. Table 3.4 summarises the differences between the old and new GMS contracts (National Audit Office, 2008). The remuneration and terms of employment of salaried GPs generally reflect the contents of the new GMS contract.

Central aims of the new national contract were to stimulate supply of general practitioners and to provide high quality care. There was a general recognition that this would require higher expenditure levels. However, much of the controversy around the initial impact of the new contract has centred on the high costs of implementing the contract, which in the first three years of operation were 9.4% higher than intended. The over-spend was mainly due to an underestimate of the cost of implementing a new quality framework and also to higher than expected costs of the new ways of providing out of hours care.

A fundamental quality tool implemented within the new GMS contract was an ambitious incentive regime known as the Quality and Outcomes Framework (QOF). The QOF consists of a set of about 150 performance indicators measuring aspects of the quality of primary care, within 4 broad domains: clinical, organisational, patient experience and additional services. The level of performance on each indicator yields a score, and a practice's aggregate score determines its quality bonus. Approximately 25% of a practice's income is determined by performance on the QOF.

There has been much debate on what gains have been achieved from the new contract in return for the extra funding. One aim was to increase the number of doctors recruited to and retained in general practice. This has indeed happened, with numbers of GPs

Table 3.4. **The new General Medical Services contract**

Contract held between PCT	Old General Medical Services contract	New General Medical Services contract
	Individual GP	GP Practice
Funding for core service	Individual GP patient list provides a small fee per patient registered and a fee for each item of service provided. There was also a Basic Practice Allowance.	Each practice receives its main funding for the provision of essential services via a "global sum" based on the weighted needs of the practice's pooled patient list. The global sum payment is based on a national allocation formula, calculated according to lists size and adjusted for the age and needs of the local population. This is supplemented by a Minimum Practice Income Guarantee which was negotiated to ensure that practice funding was not reduced in the first few years of the contract.
Service delivery	GPs can claim for a limited range of additional services.	Flexible structure allows practices and Primary Care Trust to opt in to provide a portfolio of enhanced services, which can be innovative or tailored to meet specific patient need.
Out of hours	GPs responsible for out of hours service but many delegated this to other providers.	The new contract defined "core hours" (8am to 6.30pm) as when practices are responsible for providing a full range of primary medical care services. Responsibility for out-of-hours urgent care was removed. Practices can opt to provide out-of-hours urgent care under a separate contract (defined as Monday to Friday 6.30pm to 8am, weekends and bank holidays).
Quality rewards	Some small sums available for quality rewards, for example some payments for cervical cytology. There was also a range of quality schemes in the later years of the old GMS, including "Investing in Primary Care" schemes.	Practices are financially incentivised for delivering measurable levels of quality in-patient care, via the evidence-based Quality and Outcomes Framework (QOF). Between 10-15% of the new money tied to the contract is available to reward practices for providing higher quality services.
Staffing	Funding follows GP, so no incentive to develop other staff.	Encourages development of different skill mix within a practice by linking some funding to activity carried out by nurses and other practice staff (through the Quality and Outcome Framework).

Source: Department of Health, National Audit Office (National Audit Office, 2008).

increasing by 15% since 2002-03 and some reports of better morale (Department of Health, 2008a). Attempts to direct extra GPs into the most "under-doctored" and needy areas have been less successful, and more targeted policies have recently emerged to tackle this issue. The job satisfaction of GPs with their working lives has also improved since the introduction of the contract, despite perceptions of increased workload, and GPs appear positive about the impact of the contract on the quality of care (Whalley, Gravelle and Sibbald, 2008).

A second aim was to increase productivity in the primary care sector and the evidence that this has happened is fairly limited, and open to dispute, because of the difficulties inherent in measuring productivity in the health care sector. GPs have performed very highly on the QOF. The proportion of practices achieving the maximum points available in each year were above 90% since 2004-05 (National Audit Office, 2008). Although there is some scope for manipulation of the QOF by practices seeking to maximise income, preliminary research suggests that this appears to have been limited. Indeed many GPs delivered quality of care at levels in excess of those required merely to maximise their income (Gravelle *et al.*, 2008). However, as indicated above, the quality of primary care was already improving rapidly at the time the QOF was introduced, and it is consequently difficult to ascribe how much of the improvement is due to the QOF incentives. Improvements have been more rapid in certain areas (such as asthma and diabetes) when the QOF was introduced, although even these effects are fairly modest (Campbell *et al.*, 2007). Similarly, health inequalities in terms of the gap between the most and least deprived areas, have also declined for some procedures (*e.g.* blood pressure monitoring)

(Ashworth, Medina and Morgan, 2008). However, concerns remain about the overall impact on equality amongst some groups and on the impact on non-incentivised conditions and procedures.

Other aims of the contract, such as delivering new types of services and reducing the administrative burden on GPs, have been assessed as being only partially achieved to date. Some of the stated aims were so broad that it is difficult to judge whether they have been achieved or the degree to which improvements can be attributed to the new contract rather than to other factors.

The Department of Health has recently completed a consultation exercise on the future development of the QOF, with the intention of improving the evidence base for the QOF and for increasing the transparency by which decisions on the content of the QOF are taken. In particular, NICE is to have a central role in decisions on the QOF indicators from April 2009.

### **Consultant contracts**

Senior hospital specialists in the NHS are known as consultants, and they operate under a national employment contract, which was reformed in 2004. The new contract was intended to align consultants' pay more closely than hitherto to the objectives of the NHS, by providing stronger management control over their activities. Previously, there had been widespread dissatisfaction on the part of both doctors, who faced no limitations on the work expected of them, and managers, who found it difficult to influence the work of consultants or monitor the amount of work they chose to undertake in the private sector. The new contract was expected not only to reward consultants along a fairer and more transparent salary scale, but also to improve productivity and increase the contribution of consultants to the NHS. The contract negotiations were contentious, particularly concerning the amount of private practice to be allowed under the new contract and the degree of managerial control of job plans. The contract eventually agreed involved some substantial concessions by the Department of Health (Maynard and Bloor, 2003).

Independent reviews of the new contract suggest that it has had only a limited impact to date (Williams and Buchan, 2006; National Audit Office, 2007b). The focus on job planning has resulted in greater transparency, which has the potential to enhance consultant productivity. However, this has not yet been achieved in practice to any measurable extent. To a modest degree, the contract has channelled more attention to NHS work, and into research and teaching, with a slight decline in hours spent on private practice. There has also been an increase in the number of consultants recruited and a fall in vacancy rates (at a time when demand for consultants exceeded supply). However, there is no evidence of an increase in the hours spent on direct patient care or any changes in the nature of services provided, such as evening clinics. Furthermore, the costs of implementation in the first three years have been higher than predicted, mainly due to an under-estimate of the baseline activities of consultants and because the contract was implemented in some trusts without due attention to the funding allowances that had been made by PCTs. Nevertheless annual earnings growth for consultants in the five years following implementation of the new contract has been lower than for the previous five years. Earlier evidence suggests that there are substantial variations in activity rates between consultants (Bloor, Maynard and Freemantle, 2004) which may imply a role for tailoring part of the contract to individual activity rates.

## Conclusions and recommendations

Since the publication of the NHS Plan in 2000, the NHS has steadily evolved from a being a conventionally planned, centrally controlled organisation, towards one relying much more on increased local autonomy, with regulation to secure national standards. The extent to which this evolution has been informed by a long-term strategy is a matter of debate. An independent “Capability Review” of the Department of Health in 2007 (Cabinet Office, 2007) noted that “There is currently no single clear articulation of the way forward for the whole of the NHS, health and well-being agenda.” This suggests that – at the very least – the strategy underlying the reforms had not been communicated successfully beyond the Department. However, the emerging model of health system organisation and delivery can be viewed as a coherent package (Stevens, 2004). There are nevertheless areas for further improvement (Box 3.1).

The reform programme since 2000 covered many aspects of the organisation of health care including commissioning, provision and the mechanisms of rewarding NHS staff. Many of the reforms have the potential to improve efficiency, responsiveness and ultimately patient outcomes. Indeed, the English NHS can be seen as a health system “laboratory”. However, evaluation of the impact of specific reforms is very difficult, as they are often inter-related, have multiple aims, and have been implemented universally and simultaneously, with little consideration for the need to evaluate. It is therefore impossible to identify with any confidence which elements of the reforms have been of most value in effecting some of the improvements achieved over the last decade. Major challenges lie ahead if the NHS in its current form is to remain sustainable financially.

### Box 3.1. Recommendations concerning health care reform

The government’s reform programme provides a broad vision for the health system. Most, though not all of the reforms are pulling in the same direction, consistent with the stated objectives of improving outcomes for patients, population health, and value for taxpayers’ money. However, in many domains it remains too early to state with any confidence whether the reforms are delivering improvements. The recommendations therefore relate to addressing weaknesses and contradictions within the emerging system architecture.

- The commissioning process is at the heart of the NHS reform strategy and commissioners face a considerable challenge ahead. PCTs and general practices require practical support and investment in skills and capabilities in order to fulfil their commissioning responsibilities. Urgent attention should be given to remedying any lack of necessary capacity within PCTs and general practices. A recent programme (World Class Commissioning) is seeking to improve PCT’s technical commissioning capability and the health outcomes achieved. Results from the assessment of progress made in the first year (2008/09) show that PCTs have further improvement to make, although the initiative is at an early stage and the full benefits may not be apparent for some time.
- The increased devolution of decision-making implicit in the reforms may result in variations in services, and it is not clear that unelected PCTs have the democratic legitimacy necessary to make coverage decisions on behalf of their populations. PCTs have a statutory duty to involve patients and the public in decision making. It is important that this local engagement is achieved, and progress should be kept under review.

**Box 3.1. Recommendations concerning health care reform (cont.)**

- Many of the reforms imply potentially radical changes to provider markets: new entry by a range of different providers both public and private sector; the re-design of services by commissioners to meet local needs; and the impact of patient choice on the sustainability of existing providers of services. This suggests the need for much clearer policies on the entry, merger and exit of provider organisations. Although some progress has been made in defining processes, reconfigurations on the provider side often give rise to profound local political difficulties, and there is a clear case for improving the level of public debate in this domain. Much greater efforts are needed to improve the consistency and transparency of local service reconfigurations. The work of the new Co-operation and Competition Panel will be central in this domain.
- One of the strengths of the NHS has been the especially high levels of financial protection it offers in times of sickness, with user charges rarely used to any significant extent. However, most OECD countries have modest user charges, mainly to moderate demand rather than act as a significant source of finance. The recent deliberations over “top-up” fees have opened up a debate over the use of private funds that could usefully be extended to a broader discussion of the role of user charges and voluntary health insurance in the NHS of the future.
- There are considerable doubts as to whether the information flows currently available in the health system are adequate to support the model of regulation and choice. For example, there is doubt whether PCTs can make informed decisions about commissioning and whether patients can make informed choices about providers. Attention has been given to reassessing the information needs of the health system and this needs to continue.
- The PbR payment mechanism is a central instrument of the new NHS to which has been attached an enormous range of objectives, some of which are in conflict. The Department of Health needs to ensure that its future development is carefully aligned with all relevant system objectives. In particular, the current reform programme should be used to reflect priority activities and developed to reward higher quality rather than merely reflecting passively costs. Consideration should be given to aligning the remuneration of personnel more closely with activity.
- NICE has made a major contribution to the assessment of new technologies. However, its role and methodologies are coming under increasing scrutiny. For example, there is doubt, whether issuing of mandatory guidance is appropriate in a more decentralised system. The methods of NICE should be kept under review as the nature of the health system evolves.
- The Healthcare Commission has introduced innovative new approaches towards performance assessment. A key issue for its replacement, the Care Quality Commission, will be striking the right balance between assuring minimum standards and promoting quality improvement.
- Population health and health inequalities have been a stated priority of successive governments. However, progress has been modest and there is a dearth of evidence on which to base policies. Greater attention should be given to designing and evaluating public health initiatives so that policies and priorities can become better informed.
- A consistent theme emerging from the discussion above has been the difficulty of evaluation, and the paucity of relevant research. Researchers are now examining the impact of some of the reforms. However, many of the reforms are associated with considerable resource implications, so that future implementation should be undertaken with evaluation in mind. Adequate data should be put in place and research commissioned to monitor and evaluate the impact of all reforms in a timely fashion. Collection of comparable data across the entire UK would be one concrete step towards improved evaluation.

## Notes

1. Increased devolution within the United Kingdom has led to some divergence in the health systems of the four constituent countries. This chapter examines developments only in the English health system, although some data necessarily refer to the whole of the United Kingdom. The English system covers 84% of the total population of the United Kingdom.
2. Comparability is sometimes limited because of different reporting timeframes.
3. Spending as a share of GDP declined marginally to 8.4% in 2007.

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## Chapter 4

# Financial stability: Banking on prudence

*The UK financial market has been severely affected by the financial market crisis. The crisis has exposed weaknesses in the supervisory framework as well as that for crisis management and resolution. This chapter reviews the supervisory and regulatory framework and the many reforms that have already been adopted to remedy these weaknesses. It also provides recommendations for further reforms.*

A well-functioning financial market is essential for sustaining economic growth, both to support activity in the short term and to allocate resources to investment for the longer term (de Serres *et al.*, 2006). The UK financial market is highly developed, dynamic and internationally open. It is an important sector of the UK economy and the City of London is a major international financial centre. Sound regulation and supervision are important in ensuring that financial market institutions, particularly banks, function well and that financial stability is sustained. The regulatory approach developed by the UK authorities has been well-regarded (IMF, 2003) and a number of countries have followed the model of a single supervisor for all financial firms.

UK markets and institutions were deeply involved in the prolonged global credit and asset-price cycle that has developed into a financial crisis with severe effects on the real economy. The house-price boom was very pronounced and UK banks made heavy losses from purchases of asset-backed securities. Since liquidity and funding pressures led to a bank run at Northern Rock, there have been many policy measures to ease stress in financial markets, and a number of major banks have been brought into different forms of public ownership or required recapitalisation. The immediate challenges facing the UK banking system are addressed in Chapter 1. This chapter considers the system of financial regulation and supervision, focusing especially on banks, in the light of recent developments and current reforms. Recent experience points to a range of problems in terms of capital adequacy standards, liquidity and funding arrangements, supervision, crisis management and resolution, and macroprudential regulation. In some areas, reforms have already been made or are under discussion. But more work is required, once the immediate problems have been addressed, to ensure that banking regulation and supervision are adequate.

### Some background on banking sector developments

The UK banking sector is large, internationally open and highly developed. Total banking assets are over five times GDP, a much higher multiple than in the euro area, even though bank finance is relatively more important there, and a much higher multiple than in the United States (Table 4.1, Panel A). Around 500 000 people are employed in banking with over 1 million in the wider financial sector. The City of London, a major international financial centre, accounts for a large share of global banking activity. Around two-thirds of overall bank assets and liabilities are denominated in foreign currency, much of it not closely connected to domestic non-financial activity. Only around 20% of banking establishments are UK-owned, although many of the foreign-owned banks are small. UK-owned banks account for around 40% of overall banking assets and around 60% of sterling assets, which are most closely related to the domestic economy (Table 4.1, Panel B). The foreign-currency assets and liabilities of UK-owned banks are nevertheless still substantial by comparison with GDP. While the overall concentration of the UK banking system is not especially high, the market concentration of lending and deposits of UK households and

**Table 4.1. UK banking sector overview**

Panel A. Resident banking-sector assets (multiples of GDP)

Country	2007	2008
UK	5.0	5.5
Euro area	3.3	3.5
US	0.9	1.0

Panel B. UK resident banking-sector assets by currency (multiples of GDP)

Bank ownership	£ assets	Foreign currency assets	Total assets
UK	1.40	1.05	2.45
Other European Union	0.47	1.05	1.51
American	0.08	0.44	0.52
Japanese	0.01	0.11	0.12
Other developed	0.16	0.65	0.81
Other	0.01	0.05	0.06
Memo: building societies	0.26	0.02	0.27

Source: Bank of England.

companies is considerable, with 63% accounted for by the top 5 banks prior to 2008 (Bank of England, 2008b).

Many factors have contributed to the development of the financial and banking system in its current form. The prominence of London's international capital markets began in the 1960s. Restrictions on the banking system were eased substantially during the 1970s and quantitative controls largely disappeared with the abolition of the "corset" arrangement on bank balance-sheet growth in 1980. UK banks began to enter investment banking after the 1986 "Big Bang" deregulation of the equity markets. Building societies, mutually-owned savings banks that specialised in residential mortgages, were allowed to demutualise in 1986 and many became banks, undertaking a wider range of activities.

Since the recession of the early 1990s, the UK banking sector enjoyed a prolonged period of expansion and profitability with apparently good credit quality. Indicators of financial soundness were favourable over the boom period, perhaps giving banks and regulators a false sense of security (Table 4.2). An important development during this period was the globally widespread shift towards securitisation of loans. This allowed banks to collect substantial front-end fees for arranging and structuring portfolios of mortgages, without carrying the credit risk on their balance sheet or needing to fund the extension of credit directly. At the same time, banks held large volumes of other banks' structured products on their balance sheets. More generally, the banking sector rapidly

**Table 4.2. Financial soundness indicators for UK banks**

	2003	2004	2005	2006	2007	2008 <sup>1</sup>
Major banks tier 1 capital ratios – median	8.1	8.0	7.9	8.0	7.7	7.9
Bank capital to assets – median	26.7	26.6	30.4	30.8	31.2	34.1
Bank non-performing loans to total loans	2.5	1.9	1.0	0.9	0.9	
Bank provisions to non-performing loans	69.8	61.5	54.0	54.6		
Bank return on assets	0.6	0.7	0.8	0.5	0.4	
Bank return on equity	8.6	10.9	11.8	8.9	6.2	

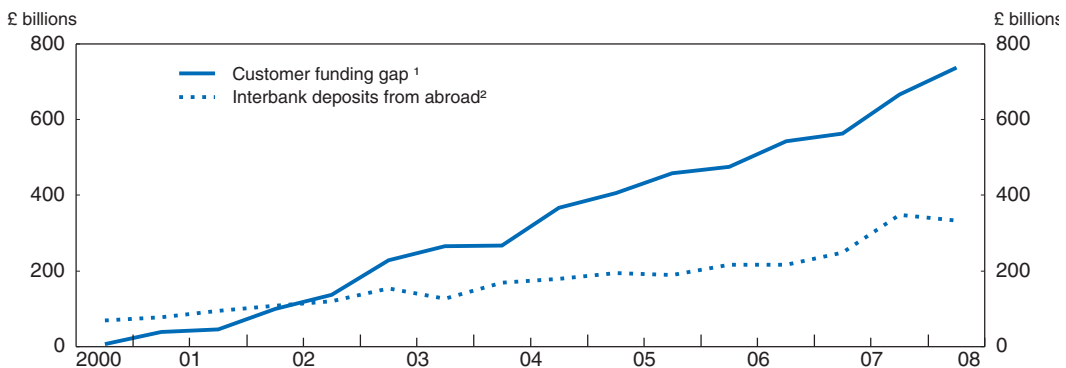
1. June 2008.

Source: IMF (2008) and Bank of England.

increased its lending to the UK corporate and, especially, household sector, fuelling increases in house prices, while also purchasing assets and extending more loans abroad (Chapter 1).


The increasing dependence of banks on wholesale funding from financial markets (other banks, money market funds, corporate treasuries and other non-bank investors), rather than deposits, was another major development. Major UK-owned banks' "customer funding gap", which indicates net dependence on wholesale funding, rose on the Bank of England's definition from zero in 2001 to £ 738 billion in 2008 (around 50% of GDP), of which £ 333 billion was accounted for by net interbank deposits from abroad. The presence of the international banking market in the City of London may have facilitated such borrowing by domestic institutions.

Figure 4.1. **Major UK banks' customer funding gap and foreign interbank deposits**

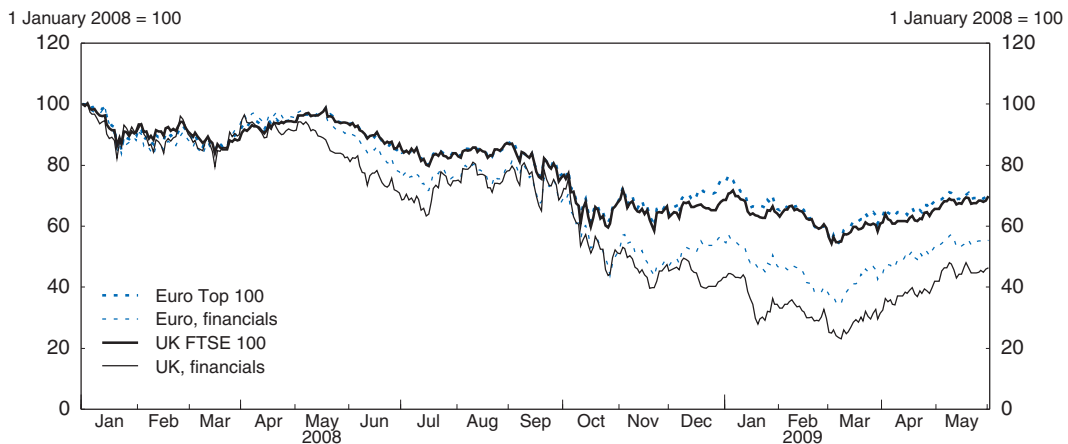


1. Customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors.
2. Data exclude Nationwide.

Source: Bank of England.


StatLink  <http://dx.doi.org/10.1787/648110470367>

The turning of the credit cycle had a severe impact on the UK banking system. Interbank markets have been stressed since August 2007 and almost froze up in autumn 2008, Northern Rock bank faced a customer deposit run, additional measures were implemented to provide liquidity to financial institutions, a number of banks were recapitalised and one bank nationalised. In international comparison, UK-owned banks have been among those most severely affected to date and their share prices have fallen more sharply than the European average, when adjusting for currency movements (Figure 4.2). Initial estimates suggested that large UK-owned banks were heavily represented among institutions making very large write downs from exposures to asset-backed securities, proportionately more so than euro area or Japanese banks (The Banker, 2008). Losses for major UK-owned banks were estimated by the Bank of England in October 2008 at £ 36 billion. Most of these losses were due to US assets, notably asset-based securities linked to the US sub-prime market. With their relatively heavy reliance on wholesale funding, UK banks were more exposed to the difficult conditions in interbank and other wholesale markets and the lack of demand for securitised loans. However, despite UK banks' prior dependence on cross-border funding and on foreign buyers for securitised debt, the link of the crisis to the role of London as a global financial centre should not be exaggerated. Earlier analysis suggested a degree of insulation between the

Figure 4.2. Share price indices<sup>1</sup>

1. All series are denominated in UK £.

Source: Datastream.

StatLink  <http://dx.doi.org/10.1787/648155157582>

domestic and international banking sectors because many wholesale market transactions are between branches of foreign-owned institutions (IMF, 2003).

## Banking regulation

### Why regulate banks?

The need for banking regulation arises from the existence of asymmetric information between lenders and borrowers. Uncertainty about the returns to projects for loans that have been advanced can lead to instability in the financial system, which once set in motion, cannot easily be overcome by private markets alone. In addition, information asymmetries between the authorities and lenders create moral hazard for institutions that are “too big to fail” given the impact they have on the wider economy. Regulation is one way of addressing these problems. There are three central objectives of regulation and supervision (OECD, 2007):

- Prevention of systemic risk: maintaining the stability of, and confidence in, the financial system.
- Consumer/investor protection: protecting investors and borrowers from excessive risk of loss or financial harm arising from failure, fraud, manipulation or other forms of misconduct.
- Conduct of business: ensuring effective, efficient and reliable functioning of financial markets with the proper working of competitive forces.

A key aspect underlying the need for banking regulation arises from the mismatch between short-term funding of banks and the long-term nature of many bank loans such as retail mortgages. In traditional banking, a large share of short-term liabilities took the form of deposits callable on sight or with short terms. This maturity mismatch makes banks fragile as they can normally operate with low levels of liquid assets (cash, short-term government bonds) to invest in higher yielding illiquid assets, while providing “liquidity insurance” to depositors (Diamond and Dybvig, 1983).

There is, however, a risk that an unexpectedly large number of depositors will seek to withdraw their deposits at the same time and there may be “runs” if agents decide to

withdraw their deposits in anticipation of a critical mass of other depositors doing the same. This liquidity problem can lead to insolvency if the bank needs to sell its illiquid assets rapidly and cannot obtain the full value but rather receives “fire sale” prices. The more modern model of banking, applicable to the large domestic UK banks, has greater reliance on funding from wholesale money and bond markets than smaller banks. Although such funds may be provided by well-informed investors in generally well-functioning capital markets, market funding has in the current crisis proved subject to runs just like retail deposits, and the difficulties in the interbank market since August 2007 illustrate the risks of a wider absence of liquidity for banks that need to finance long-term assets. There are important externalities between institutions due to actual or perceived interlinkages that imply that “runs” may spread between institutions. Banks have only a relatively small amount of their own equity capital and liquid assets in relation to their overall liabilities. There is therefore an inherent risk of insolvency if a bank’s loans are not repaid or if assets have lower returns than anticipated.

### **The UK regulatory framework**

The UK financial system is an integral part of the EU single market in financial services. European single-market legislation provides much of the basic framework for regulation, which itself often follows international agreements (OECD, 2009). Individual countries nevertheless retain substantial discretion on how this framework is transposed into national requirements. Bank supervision remains a national responsibility with the national authorities having the primary responsibility in most areas for institutions incorporated in their jurisdiction, but with much less control over the activities of branches of banks based in other EU countries, which may enter the domestic market using the EU banking passport system. Recent initiatives at the EU level aim to improve coordination between the different regulators of large complex cross-border financial institutions by creating colleges of the different national supervisors involved with an institution. These proposals envisage a coordinating role given for the “lead supervisor”, the supervisor that has the responsibility for the consolidated banking group within the colleges.

The UK has relied on a tripartite framework for financial stability: the Financial Services Authority (FSA) is responsible for financial and banking regulation; the Bank of England contributes to the stability of the system through monetary policy, its lender of last resort operations and macroprudential surveillance; and the Treasury is responsible for the overall architecture of the system and aspects affecting the public finances (Box 4.1). The recent crisis has intensified the cooperation between these institutions as all have been required to work together when dealing with failing banks, the recapitalisation of the banking system and other measures to support the supply of credit. As discussed below, significant changes to the Bank of England’s role in financial surveillance are envisaged in the Banking Act 2009.

#### **Box 4.1. The 2006 tripartite agreement**

The Memorandum of Understanding (HM Treasury, 2006) seeks to define clearly the responsibilities of the FSA, the Bank of England and the Treasury based on four guiding principles: clear accountability, transparency, the avoidance of duplication and regular information exchange.



**Box 4.1. The 2006 tripartite agreement (cont.)**

The Bank of England has as a core purpose the maintenance of the stability of the financial system as a whole. This involves the setting of monetary policy and the use of regular market operations to deal with fluctuations in liquidity. The Bank has a lender of last resort function in the case where a problem with an individual institution has a systemic impact on other parts of the financial system. In addition, the Bank has responsibility for oversight of systemically important payment systems and financial infrastructure. The Bank has a wider responsibility for the stability of the financial system, advising on the implications for UK financial stability of developments in the domestic and international markets. The Deputy Governor of the Bank sits on the board of the FSA.

The FSA's powers and responsibilities are set out in the Financial Services and Markets Act 2000. It authorises and supervises: banks, building societies, investment firms, insurance companies and brokers, as well as securities listings and clearing and settlement systems. The FSA sets capital or other regulatory requirements. It also has a crisis management role. For a troubled bank it can facilitate a market solution involving, for example, the injection of new capital by one or more third parties. The FSA also has an advisory role in terms of international and European policy initiatives in the area of regulation.

The Treasury shapes the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EU directives. Moreover, it is responsible to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations. It also has a role with respect to the public finances and public debt management. The Treasury has no operational responsibility for the activities of the FSA and the Bank but it is expected to be closely involved with many aspects of regulation and crisis management.

The Memorandum of Understanding sets out responsibility with respect to information gathering and the need for free information exchange between the FSA and the Bank, the establishment of a tripartite Standing Committee meeting on a monthly basis at deputies (official) level to discuss individual cases of significance and other developments relevant to financial stability with the possibility to meet at principals level (Chancellor/Governor/Chairman) in exceptional circumstances.

**Bank regulation**

The regulation of banks is aimed at achieving stability, both of individual institutions and the system as a whole, and has a number of aspects. Capital adequacy standards influence the overall amount of risk that is taken through the amount of capital held to cover unexpected losses, as well as giving equity holders an incentive to monitor the amount of risk-taking. Restrictions on liquidity and funding practices seek to ensure that institutions have sufficient liquid assets on hand to meet short-term liabilities. Deposit insurance is an important instrument to maintain the stability of banks by reducing the incentive for bank runs. There is a range of other areas of prudential regulation and supervision, such as regulatory oversight of risk management practices. Regulation must be carefully designed to strike a balance between stability and growth, as well as ensuring that possibilities for regulatory arbitrage are minimised (Wehinger, 2008).

### **Capital adequacy standards**

The framework for the capital adequacy standards for UK banks up to the end of 2006 was based on the Basel 1 standards (including the 1988 Capital Accord). These were applied in the United Kingdom through the transposition of the relevant EU directives, which followed the principle of minimum harmonisation, thereby allowing national authorities to impose higher standards over a wide range of areas as necessary. Banks were required to hold a minimum of 8% of capital against risk-weighted assets, where risk weightings were defined in terms of broad categories or “buckets” of assets.<sup>1</sup> In 1996, the Basel framework was supplemented by provisions for the regulation of market risk in trading books. This system had a number of shortcomings: the risk classes were crude;<sup>2</sup> and there was an incentive to maximise risk within the classes. In many countries, the 8% risk-based capital ratio became a target and not a minimum. The UK authorities, however, avoided this practice by setting “individual capital guidance”, a minimum level of capital below which supervisors would engage in enhanced intervention. Minimum capital for individual institutions was effectively set at levels often well in excess of 8%, based on detailed analysis of the risks by the supervisor, and banks usually held capital somewhat in excess of the “trigger” levels. Although differences in accounting standards make international comparisons difficult, the available evidence suggests that prior to the crisis UK banks appeared to be well capitalised (in terms of Pillar 1) and had, on average, capital-adequacy ratios that were above the European average.

The effectiveness of these regulatory capital ratios was, however, weakened as banks used off balance sheet vehicles to hold securitised assets. These assets had a relatively low impact on the calculation of capital adequacy. As a result, risks to banks’ capital were understated, as these vehicles often had claims on banks due to credit risks or back-up liquidity lines. Some EU countries (Denmark, the Netherlands and Spain) required separate capitalisation of subsidiary special investment vehicles (SIVs) and conduits, which effectively removed this problem. Off-balance sheet vehicles also reduce the transparency of a bank’s financial position and, although aware of the exposure of individual UK banks, the FSA was surprised by the scope and size of the overall market for SIVs when the crisis began. The International Accounting Standards Board (IASB) is currently looking at ways to improve consolidation of SIVs in financial statements. However, regulatory treatment of SIVs should be tightened in terms of how capital requirements are set and allowance made for counterparty credit risk, as well as other risks arising from SIVs and any other near-bank subsidiaries that may be devised in the future.

Capital adequacy regulation since 2007 has been based on the Basel 2 approach, updating the earlier arrangements and applying the EU Capital Requirements Directive. There is a standardised approach for small banks based on risk weightings but with more differentiated categories than in the past and with risk ratings generated by credit rating agencies. More complex banks – such as major UK banks – can use internal risk models as a basis for allocating capital. Under the “foundation” approach, the bank estimates the probability of default and supervisors supply other inputs, whereas under the “advanced” approach banks run models using their own parameters and thereby have complete control of the factors determining their capital allocation. The introduction of Basel 2 has also better integrated other developments in financial markets, including the quality of collateral, guarantees, credit derivatives, netting and securitisation. For UK banks, the implementation of the new framework did not on average lead to a reduction in the amount of capital held for regulatory purposes, although for some institutions the

adoption of the “advanced” approach did lead to a reduction. The reliance on both credit rating agencies and internal models for risk assessment may be a weakness in the new framework given the problems revealed by the subprime crisis about rating agency assessments and the short sample of data available for risk modelling. Overoptimistic assumptions on correlations and credit risk, for example, may have been used by rating agencies in the assessment of collateralised debt obligations with an indirect effect on banking institutions holding such assets and the amount of regulatory capital they were required to hold.<sup>3</sup> Although there is a case for excluding ratings from the Basel 2 process entirely (Brunnermeier *et al.*, 2009), at least for securitisation products, bankers and regulators should at a minimum use considerable caution in the use of ratings in the future and they should not be used mechanically as a substitute for their own analysis.

The increasing complexity of commercial banks as they have moved away from traditional activities has made banking regulation and supervision more challenging. Given that it is harder for regulators to monitor how a more complex institution is operating, regulation has shifted to emphasise internal risk management procedures. UK regulators were particularly advanced in the shift from rules-based to principles-based or process-oriented regulation. It is also an important part of Basel 2’s three-pillar framework of capital adequacy, supervisory oversight and market discipline. In this approach, supervisors are less involved in setting rules for determining capital adequacy and focus instead on ensuring that internal risk management procedures are adequate. The FSA has been active in the application of the “Pillar 2” individual assessment of a bank’s own capital position and requiring “capital add-ons” where the “Pillar 1” capital requirements are judged insufficient. The initial “Pillar 2” approach is described in FSA (2007c) and has continued to evolve. Market discipline was also expected to play an enhanced role through greater disclosure (“Pillar 3”).

### ***Market risk and the secondary banking market***

As major banks have moved away from traditional banking activities, market risk has become more important to the stability of the banking system. This trend has been reinforced by the financial and regulatory developments that extended the use of securitisation and holding of securitised loans on banks’ balance sheets. The greater reliance on marketable assets, rather than loans, has extended the use of mark-to-market accounting, where the value of assets is frequently reassessed using financial data. In principle, this approach increases transparency by making it harder for firms to conceal losses. It may, however, lead to problems if market prices create misleading signals. In the upswing, market prices are likely to have understated the risk of many assets. Since the turmoil began, mark-to-market losses on securitised structured products were to a considerable extent a reflection of liquidity risk as well as credit risk, with the former estimated to have accounted for around 40% of mark-to-market losses on structured products (Bank of England, 2008b). There is concern that the use of credit default swap (CDS) prices to aid in asset valuation may have contributed to a downward spiral in asset prices because the loss of liquidity lowered prices for a given expected level of default. Furthermore, the “fire sale” problem, namely that banks facing pressure on liquidity find it hard to realise the full value for assets, is arguably exacerbated by marking to market. However, given that historic cost accounting has significant problems also, marking to market remains appropriate for the trading book but it will be important to use recent

experience about the behaviour of valuations in guiding how regulators and markets use this information in the future.

## **Liquidity and bank funding**

### **Liquidity regulation**

Liquidity regulation is less extensively covered than capital adequacy in both international and EU frameworks. The UK authorities' approach places significant emphasis on firms being expected to survive liquidity stresses through the market funding rather than central bank funding. The current liquidity regime for large UK banks contains both a qualitative and a quantitative component. The qualitative elements require there to be adequate systems and controls with adequate liquidity, stress tests and contingency plans. These are based on the Basel Committee on Banking Supervision's 2000 *Sound Practices for Managing Liquidity in Banking Organisations*. In addition to these requirements, large UK banks are required to meet the Sterling Stock regime. This policy is designed to ensure a bank has sufficient liquidity for the first week of a liquidity crisis without recourse to wholesale funding and assuming an outflow of retail deposits. The regime requires banks to hold government bonds and central bank reserves and not assume central bank eligibility. The holdings of this narrow set of liquid assets have declined as a share of total asset holdings for the UK banking sector over a long period from the 1970s to 1% in 2008, according to a measure by the Bank of England.<sup>4</sup> However, the more internationally comparable ratio of liquid assets to total funding for the large UK banks is on average 12%. Like other quantitative liquidity regimes, the Sterling Stock regime displayed a number of weaknesses during the current crisis. The current regulations do not take into account foreign currency and off balance sheet liabilities. As an immediate response to the crisis, the authorities introduced stringent new reporting requirements and stress tests of liquidity: these must now include an assessment of how a bank would cope if there were no more liquidity available over a "prolonged" period consistent with recent experience.

The FSA has been consulting since December 2008 on a new liquidity regime, which would be more closely linked to the funding needs of each bank and based on more severe assumptions about the stickiness and the chronic nature of liquidity shortages (FSA, 2007b and 2008b). The UK authorities are active members of the appropriate EU and international fora and have publicly stated their desire for a global and European liquidity standard. At the same time, the FSA has been clear that it will have to proceed with the required overhaul of its domestic liquidity regime in the absence of international consensus. The proposals emphasise the responsibility of banks' senior management to adopt sound approaches to liquidity risk management. There are six main elements to the planned changes. First, all regulated entities must have adequate liquidity and must not depend on other parts of their group to survive liquidity stresses, unless permitted to do so by the FSA. Second, there will be a new systems and controls framework based on the recent work by the Basel Committee on Banking Supervision (BCBS) and the Committee of European Banking Supervisors (CEBS). Third, there will be a system of quantitative individual liquidity adequacy standards (ILAS) for each institution based on a firm being able to survive liquidity stresses of varying magnitude and duration. Fourth, a new framework for group-wide and cross-border management of liquidity is to be introduced allowing firms, through waivers and modifications, to deviate from self-sufficiency where this is appropriate and would not result in undue risk to clients. Fifth, a new reporting framework for liquidity is introduced, with the FSA collecting detailed, standardised liquidity data at

an appropriate frequency so the FSA can monitor both firm-specific and market-wide developments in terms of liquidity-risk exposures.<sup>5</sup> Sixth, the proposal includes a significant increase in banks' buffer of liquid assets. The FSA would require banks to hold 6-10% of assets in government bonds compared with an average of 5% for the ten largest banks at present. The FSA calculates that this imply that banks could switch £ 87 to £ 350 billion of their assets into government bonds. The regulator's calculations assumed the shift would cost banks 150 basis points a year in lost revenues, because the government bonds they will be forced to hold will have lower yields than their current fixed-income instruments.<sup>6</sup> Internationally, US commercial banks hold 13% of their assets in US Treasury and Agency securities, while euro area banks hold only around 6% in government securities. The new liquidity proposals would be a marked advance, in particular on the previous, one-size-fits-all quantitative approach to liquidity regulation. These measures would also help to address moral hazard issues resulting from the provision of liquidity during the financial turmoil. The buffer is likely to be particularly important and should aim to raise the proportion of liquid assets held by UK banks. It will be important to ensure that regulatory arbitrage is contained if UK regulations were to be comparatively tight.

### **Deposit insurance**

Deposit insurance systems are designed to protect against financial instability by preventing "runs" on banks. However, especially because the insurance is typically not priced according to risk, it also gives rise to moral hazard, with incentives for protected banks to take greater risks (Schich, 2008). Up to 2007, the ceiling of insured deposits was £ 35 000 with co-insurance: the first £ 2000 was fully covered and the remainder at 90%. The idea was to provide an incentive for depositors to monitor banks to avoid losing money, thereby reducing moral hazard.

The Northern Rock episode showed that this scheme was insufficient to prevent bank runs and the co-insurance element was removed in October 2007. As financial market tensions intensified in October 2008, the ceiling was raised to £ 50 000, which is just above the minimum under new European agreements. This raised the coverage under the pre-2007 arrangements from 96% of eligible retail accounts and 50% of the value of deposits to 98% of accounts and 60% of the value of deposits at present. To avoid runs, it is important that expected deposit insurance payouts should be rapid and predictable. Confusion and possible delay in receiving funds were problems in the case of Northern Rock and the authorities are now planning to introduce a target to pay out within 7 days after closure, as soon as changes to bank systems can be made (target of end 2010). This is closer to the practice in countries such as the United States where the scheme pays almost immediately. The Banking Special Provision Act 2008 (BSPA) and the special resolution regime (SRR) in the UK has also enabled several rapid deposit transfers (e.g. Bradford & Bingley, Dunfermline Building Society).

There is also a need for improved consumer information on the deposit insurance system. Consumers, for example, are unlikely to understand that coverage is per depositor per authorised entity and may not realise that they are only insured once for multiple accounts held with a single entity even if that firm trades under multiple brands. A smooth functioning deposit insurance system can also help winding up failing institutions by ensuring that retail depositors are protected in all eventualities. This aspect appeared to work well with the nationalisation of Bradford and Bingley, where funding provided through the Financial Services Compensation Scheme (FSCS) was an important part of

achieving a smooth transition to a new form of ownership. There are also important challenges arising from the presence of cross-border banking operations; the failure of three Icelandic banks in October 2008 left many UK households and institutions exposed but Iceland appeared unable to reimburse these depositors and the UK government financed repayment of retail deposits.

Deposit insurance is one of the functions of the FSCS, which also has responsibility as the statutory compensation fund for defaults by other financial firms, such as investment firms (including paying compensation for cases of mis-selling and bad advice where the independent Financial Ombudsman Service has determined that compensation is payable). The FSCS is operationally independent of the Treasury and the FSA. Funding remains on the basis of “what could be reasonably expected within a year” and hence the fund has been very modest. The supplementary government funding provided during the last half of 2008 in respect of Bradford & Bingley, the Icelandic banks and London Scottish Bank has meant that the FSCS has accrued substantial loans which were used to fund resolution of those defaults and which will need to be repaid. Since February 2009, under the Banking Act, the FSCS is now able to borrow from the government’s National Loans Fund to provide payouts in the short run and can continue to raise *ex post* levies on the banks to cover the costs it has incurred. However, pre-funding towards a Treasury-determined target level is possible under new legislation (HM Treasury, 2008c). Although existing claims on the fund and the current situation in the banking system preclude a swift transition to a new system of pre-funding, such a reform might add to the credibility of the deposit insurance regime and avoid the pro-cyclical features of the current system by building up funds during booms rather than charging levies in a downturn. Consideration should be given to a system of risk-based insurance premia as used in other OECD countries (Canada, Finland, France, Italy, Portugal, Sweden, and United States), which would more closely align risks being taken by institutions and thereby reduce the probability that it may need deposit insurance. There is a risk that this differentiated system would stigmatise banks that are already in difficulty, although there is little evidence of such destabilising effects in systems where this approach has been taken.

### ***Funding and securitisation***

UK banks were heavily dependent on securitisation to sustain the flow of lending that was being made through their operations: securitisation amounted to 25% of new mortgages in 2007. This proved a structural weakness as much of the funding for securitisations came from other banks or from overseas. The subprime crisis in the United States hit the demand for UK securitisations directly. Suspicions arose about the real level of risk of highly-rated securities as a result of the high rate of default on the loans underlying US sub-prime collateralised debt obligations (CDOs). This led to a “buyers strike” also for UK securitisations, notably by US banks. There could be advantages in creating a more solid basis for UK mortgage securitisations with a stronger base of institutional investors, such as insurance companies and pension funds. The UK authorities passed legislation early in 2008 enabling the issuance of regulated covered bonds compliant with the UCITS Directive, thereby putting the UK at par with some of its European counterparts. This would also provide financial institutions with an expanded number of instruments with which to undertake secured borrowing, while simultaneously providing investors with an additional choice of instruments through which they could obtain the security of direct recourse to the underlying assets. However, after robust levels

of issuance for a number of years, the covered bonds market subsequently followed the dislocation of other secured and unsecured credit markets over the course of 2008, as both primary and secondary trading volumes diminished substantially.

### **Lending standards and “subprime” lending**

Poor lending standards, whereby customers are exposed to excessive levels of risk, can be bad both for borrowers and the soundness of banks. A designated subprime mortgage market did not develop in the United Kingdom and non-deposit taking institutions, which have often been aggressive in lowering lending standards, accounted only for around 1% of the stock of mortgages. Mis-selling of mortgages is likely to have been a relatively minor problem as the sale of mortgage products both by banks and mortgage brokers is closely regulated in terms of suitability for the customer by conduct of business regulations for financial firms.<sup>7</sup> There is nevertheless evidence of risky lending practices in the mortgage market: there was a significant proportion of self-certified loans and a very large market in buy-to-let mortgages, both of which the FSA considers higher risk for the lender, in part because self-certification increases the likelihood of fraud. Strikingly, these two risky categories of lending accounted for one third of the flow of new mortgages in recent years and already accounted for 12-14% of the stock of arrears by September 2008, far above the rate of arrears on conventional mortgages. Some lenders reduced lending standards during the upswing of the credit cycle, increasing lending to risky categories, extending the maturity of mortgages and allowing higher loan-to-value ratios (LTVs) for mortgages. Northern Rock, for example, offered some loans with LTVs up to 125%, which left borrowers and the bank very vulnerable. Had mortgage standards been tighter, some problems may have been avoided. The regulator could limit the use of high LTV loans by raising the capital charge and closer supervisory attention is warranted for particular segments, such as buy-to-let lending. The FSA plans to publish a paper in September of this year on mortgage regulation considering all aspects of regulation. It will also consider moving from general standards of lender behaviour to prescriptive product regulation, including maximum loan-to-value and loan-to-income caps.

### **Remuneration**

Inappropriate remuneration schemes can misalign incentives between banks' management and their shareholders, leading to excessive risk taking. In particular, bonus schemes that reward the short-term performance of an individual can lead managers to increase short-term returns, with the potential of risking greater losses in the future. The Financial Stability Forum (FSF, 2008) has encouraged supervisors to mitigate risks arising from inappropriate incentives. The FSA has considered remuneration packages, as well as aspects of corporate governance, as part of its assessment of risk in financial institutions for some time. However, supervisory information in this area appears to have been limited and no aggregate data on remuneration packages and their components in financial markets are publicly available. In October 2008, the FSA wrote a “Dear CEO” letter to banks for an explanation of their policies in this area and has underlined that remuneration issues could ultimately be reflected in higher capital requirements. The government has also asked banks in receipt of capital assistance to show restraint in paying bonuses. Although it is important to ensure that policy in this area does not lead to a loss of talent towards unregulated entities, the current situation could be considerably improved if bonuses were paid over much longer periods, rather than being tied to quarterly or annual

results, and perhaps also linked to the performance of the firm as a whole rather than individual traders or managers. The FSA's recent draft Code on Remuneration Policies would move in this direction, by providing that firms should not assess performance solely on basis of short-term performance and requiring good procedures to be in place in line with sound risk management (FSA, 2009). A wider review of corporate governance on bank boards is also underway.

## Supervision

The UK authorities have developed their own distinctive framework for prudential supervision with a strong emphasis on risk- or principles-based supervision, rather than relying more heavily on rules and one-size-fits-all quantitative regulations.<sup>8</sup> The FSA has developed the ARROW approach to regulation: this determines what resources should be devoted to supervision of each institution, according to the risk it poses to the system. Such risks to the system reflect in turn both the riskiness of its activities and the impact on the overall financial system if the risks were to materialise. The ARROW 1 approach, adopted in 2001, sought to assess risk for individual firms on the basis of identifying particular areas of risk in accordance with risk categories. The initial "Impact and Probability model" featured a complex mapping of indices of risk against groups of business and control risks. This gave rise to a net probability of risk to the FSA objectives and resulting impact and probability scores. ARROW 2, introduced in 2006, improved on ARROW 1 by being more readily communicable to firms, offering more proportionality and consistency with risks, and giving greater transparency in the relationship between the scores. This approach provides an inherent risk profile, which divides institutional risks into risks linked to the business model (including the banks' customers/products/markets and its business process) and environment risks (the state of capital markets, the economy and legal environment). Supervision under this approach is intended to examine how business risks are mitigated by associated controls within the business and its management, governance and culture. Capital and liquidity are regarded in this framework as "other mitigants". The net probability of a risk event occurring is assessed at major periodic internal FSA meetings of supervisors and managers,<sup>9</sup> and leads to a remedial supervisory programme of greater or less intense prudential supervision. However, as discussed below in the context of Northern Rock, this system appears to have suffered from significant shortcomings in the practical application of the ARROW procedure. Greater disclosure of the assessments resulting from the ARROW process and trigger ratios could improve the market discipline on banks as well as the supervisor. Although care would be needed in communicating the outcomes of the assessments, this would be consistent with the importance accorded to market discipline in the UK's risk-based approach to supervision.

### ***Lessons for supervision from the Northern Rock failure***

The failure of Northern Rock led to an internal FSA report that highlighted a range of serious failings in its supervision (FSA, 2008a). Among high impact firms, those whose failure could generate systemic risks, Northern Rock had one of the longest regulatory periods between formal ARROW assessments (36 months as compared to 18-24 for most other banks), the lowest number of close and continuous regular surveillance meetings and was the only high impact firm without a Risk Mitigation Programme.<sup>10</sup> Supervision had also been hindered by Northern Rock being moved between FSA divisions three times in as many years. Supervisory resources in the years prior to the crisis were diverted by



takeovers, demutualisation and the implementation of Basel 2. The division mainly responsible for Northern Rock had suffered staff cuts. Records of supervisory meetings were often not kept. Even as late as spring 2007, Northern Rock was allowed to pay a large dividend and reduce its capital adequacy target. This was only months before it failed and at a time when the FSA was already concerned about its liquidity (Treasury Committee, 2008a).

Underlying these regulatory difficulties were problems with the application of the FSA's ARROW 1 risk assessment mechanism (FSA, 2008a). Supervisory teams did not have to contribute developed financial analyses under ARROW 1,<sup>11</sup> and hence danger signs such as the high publicly-announced target for asset growth and heavy reliance on wholesale funding were missed. The ARROW panel consequently agreed a long review interval of 36 months, on the basis of "behaviour and quality of management", while it judged risks as being of "low probability".

The FSA is addressing shortcomings in the way banks are supervised, including by raising senior manager engagement with high impact firms; increasing the number of supervisors engaged in high impact firms; increasing the focus on prudential supervision, especially liquidity and stress testing; raising emphasis on assessing the competence of firms' management; and improving the use of information and intelligence. The ARROW 2 process also provides a sounder basis for supervision than ARROW 1. There will be a greater emphasis on in-depth financial and quantitative analysis, and peer-group comparison in the FSA's approach to supervision. A broader issue is whether macroprudential elements are sufficiently noted in the ARROW process and how the priority risks in the FSA's Financial Risk Outlook are "effectively operationalised" (FSA, 2008a). Connecting macro-prudential analysis to the day-to-day supervisory process is a difficult challenge. The FSA has implemented a process of providing supervisory staff tailored guidance derived from such analysis including its own Financial Risk Outlook document.

## Policies for crisis management and resolution

The financial crisis, particularly the failure of Northern Rock, exposed a number of weaknesses in the policy and legal framework for crisis management and resolution. Under the 1997 Memorandum of Understanding, the FSA had regulatory responsibilities in this context with the Bank of England being lender of last resort. However, no instruments to take control of a failing bank existed. General corporate insolvency provisions are unsuitable for banks because of the importance of confidence and the speed of possible bank runs, and there is no provision for continuity of service or for depositors to be treated differently from other creditors.

Under the Banking Act 2009, the Special Resolution Regime was introduced to allow pre-insolvency intervention in UK based deposit takers. The Bank of England is at the core of this mechanism as an independent agency with the relevant technical competence and due to its role with regard to overall financial stability. Unlike the US system of Prompt Corrective Action (PCA), intervention is dependent on both qualitative and quantitative criteria. Under the Banking Act the FSA will trigger the mechanism as the supervisor. Triggering is to be based on the statutory "threshold conditions" against which the FSA already authorises and supervises banks, which include capital and liquidity measures. If a bank is failing or is likely to fail to meet the threshold conditions, the FSA will determine

whether there are any actions – other than resolution – that could be taken by the bank to re-establish its compliance with the threshold conditions. Once an institution is put into the regime, there are three main options for the Bank of England: insolvency (closure and payout), a bridge bank or accelerated transfer to a private sector purchaser. In addition and as a last resort if the other options are inappropriate and a specific and more stringent financial stability threshold has been reached, the Treasury may choose to place a bank (or its UK incorporated holding company) into temporary public ownership. In the case of insolvency, the primary duty of the administrator is to help the FSCS to meet its needs with regards to deposit insurance. The Treasury is expected to be closely involved (as it has in recent initiatives to support the financial system), particularly if there are international law issues or if there are significant sums of public money at stake.

The new arrangements meet an important need in having a mechanism for crisis management and resolution with a pre-insolvency trigger. This is a useful new instrument to help maintain financial stability, protect taxpayers, obtain continuity of banking facilities and protect depositors' interests. There remain some concerns that the new regime will cut across creditors' and shareholders' rights relative to a normal insolvency and that, under set off and netting arrangements for example,<sup>12</sup> the creditors in a residual bank could be worse off than under the previous arrangements for liquidation. However, the new arrangements include measures to safeguard property rights. These measures ensure that the Treasury can put in place measures to compensate shareholders and creditors for the loss or interference in their property rights when a bank is placed into the special resolution regime. In addition, a number of measures have been put in place via secondary legislation to ensure that set-off and netting arrangements are protected and that creditors of a resolved bank cannot be left worse-off than if a bank had entered into insolvency proceedings. The new system will make it easier for the authorities to resolve failing banks which is important in disciplining private sector incentives in the long run, and retains considerable flexibility in how the authorities react. There is a risk, however, that the arrangements will strain the managerial, legal and accounting resources of the Bank of England, particularly if there are multiple failures. The Bank of England is addressing this risk by creating a new specialist resolution unit that can draw on external specialist resources when required.

Financial stability has been added to the criteria in the Enterprise Act under which mergers can be referred to the Secretary of State for Business, Enterprise and Regulatory Reform to consider whether it is in the overall public interest for the normal competition approval process to apply, although mergers remain subject to the EU rules. In effect, the minister can take a rapid decision, advised by the tripartite committee and the Office of Fair Trading. This change allowed the merger of HBOS and Lloyds TSB to be approved speedily. In this case, however, the merger created a bank with almost one-third of the UK market, which may affect competition in the sector and has created an institution, which is likely to have systemic implications if it were to fail.

## Systemic risk and macroprudential regulation

The role of banks in the prolonged credit and asset-price cycle that has turned so dramatically raises the question of whether policy should be used to “lean against the wind” during the upswing. These system-wide macroprudential concerns go beyond the institution-specific concerns that have been the focus of microprudential regulation. Experience of conducting such policies is limited internationally, although Wadhvani

(2008) argues that the Swedish authorities have been able to undertake them. The system of countercyclical provisioning in Spain may also have helped its institutions, as might setting capital requirements as a function of interest rates as is done in Argentina.

Under the pre-crisis arrangements, the Bank of England had responsibility for contributing to the maintenance of financial stability and this was a core purpose of the Bank, alongside monetary policy. The Bank produced twice-yearly Financial Stability Reports and participated in the tripartite arrangements but had no dedicated instrument with which to target financial stability and did not have direct access to a full set of supervisory information, although the Bank's analysis of financial stability fed into the FSA's ARROW process of risk assessment as well as being sent to the boards of UK banks.

Under the Banking Act 2009, the Bank of England will have a legal objective "to contribute to protecting and enhancing the stability of the financial system of the United Kingdom".<sup>13</sup> The Act will also formalise the Bank's role in supervision of payments systems. A Financial Stability Committee, chaired by the Governor, will be set up as a sub-committee of the Bank's Court of Directors to deal with this objective (HM Treasury, 2008a, b, c). An important innovation under the Act is that the FSA be able to request data from banks that it thinks is or may be relevant for the stability of individual institutions or one or more aspects of the UK financial system. This information can be disclosed to the Bank or HM Treasury in order to provide the basis for a much more detailed understanding of developments in the banking system. In particular, experience in the last years of the credit upswing suggests that a few institutions can have a disproportionate effect on the overall availability of credit. The hope is that the Bank will have the information to signal concerns about this to the FSA, perhaps having sufficient basis to signal this publicly if it is sufficiently concerned. These changes are not expected to change substantially the operation of the tripartite committee which, continuing the practice under the Memorandum of Understanding between the Treasury, Bank and FSA, meets once a month, together with a substratum of cooperation at a lower level (Box 4.1). By giving the Bank more involvement and redefining responsibilities more clearly, it is hoped that the new regime will be better able to deal with macroprudential risks. However, there remain risks of unhelpful conflict between the Bank and the FSA or that, equally, importantly, issues may be perceived as falling between the remit of the two organisations. It may be difficult to reconcile the overall macroprudential objective within a structure of two independent institutions, rather than perhaps linking them more closely institutionally and giving responsibility to a joint board of both institutions.

### ***Understanding of the risks in the credit cycle***

An understanding of the economic and financial cycle is essential to the implementation of macroprudential policy. Timely warnings regarding systemic risks are required as an input to policy decisions, as well as to strategies and market behaviour of financial institutions. Many central banks have sought to develop their macroprudential surveillance, monitoring conjunctural and structural trends to give warning of the approach of financial instability. The Bank of England publishes a semi-annual Financial Stability Report, covering both international and domestic developments, and the FSA has an annual Financial Risk Outlook. These assessments were intended in part to influence the ARROW process, although the FSA Internal Auditors in their report on Northern Rock suggested that priority risks in the Financial Risk Outlook needed to be "effectively operationalised" (FSA, 2008a).

The most recent Financial Stability Report before the crisis concluded that the “UK financial system remains highly resilient”, while noting that macroeconomic stability and competition in the financial sector have “encouraged a further increase in risk taking” and that this “increased the vulnerability of the system as a whole to an abrupt change in conditions” (Bank of England, 2007). Risks were considered to arise from credit markets, which weakened credit risk assessment, impaired risk monitoring and made financial institutions more dependent on market liquidity leading to “warehousing risk” if institutions piled up loans they were unable to securitise. These were held to compound pre-existing risks arising from high asset prices and vulnerabilities in risk premia, high levels of corporate and household debt, dependence on market infrastructure, large financial imbalances among the major economies, as well as from rising systemic importance of large complex financial institutions. There was seen to be a risk of unwinding of low risk premia, triggering a pickup in corporate defaults, an unwinding of leveraged positions in corporate credit markets and consequently lower market liquidity and further falls in asset prices with a generalised retreat from risk-taking and a rise in correlation across markets reducing the scope for diversification against shocks. Such a scenario was seen as calling the “originate and distribute” business model into question. Meanwhile, the FSA (2007a) in its Financial Risk Outlook (FRO), highlighted as “priority risks” that firms should evaluate their responses to extreme situations (stress test) despite current low volatility; they should be aware of valuation problems with illiquid instruments (albeit in the context of conflicts of interest); and they should consider operational and legal risks with derivatives. They were also urged to bear in mind dangers arising from terrorism, crime and, interestingly, the volume of regulatory reform. The FRO also noted that some consumers were at risk from high debt levels. However, the authors felt that “it is highly unlikely that consumer indebtedness problems could lead to a financial stability problem”.<sup>14</sup> While highlighting a number of risks and capturing a number of the mechanisms by which these materialised, Davis and Karim (2008) note that the Bank of England and the FSA, in common with other macroprudential analysts, did not capture the full extent of the crisis. Partly based on the FSA’s view of the remoteness of risks from household debt, no specific action at the level of bank regulation was taken to limit household debt, such as tightening regulations relating to mortgages or increasing capital requirements. Such measures were used to a modest extent, for example, in Estonia and Ireland which faced similar housing booms.<sup>15</sup>

### **Stress testing**

Stress testing at the system-level, rather than for individual institutions, attempts to quantify macroprudential risks. In 2003, the IMF undertook a Financial Sector Assessment Programme (FSAP) that included extensive stress testing. UK banks were found to be very resilient at that time. A problem with stress testing is that shocks have to be realistic but the bank management’s view of realism may be excessively conditioned by current market conditions (“disaster myopia”) or undermined by incentives to maximise returns in the short run. Stress testing of financial innovations is particularly uncertain because there was no experience to show how the market might be tested in a downturn and there is Knightian uncertainty about the full range of the probability distribution. For example, the risks inherent in CDOs were underestimated until they materialised in stressed market conditions, revealing that excessively optimistic assumptions had been made. Such financial innovations need to be assessed for their macroprudential impact by the Bank of

England and not just by the regulators: the Bank should be involved with the details and preparation of regulation generally and this must include the evaluation of financial innovations that could have a systemic impact.

### **Regulation and pro-cyclicality**

There is limited international experience with designing regulatory standards that act against credit and asset-price cycles, for example by increasing minimum capital ratios to dampen lending growth. There is an on-going debate about whether Basel 2 has made the financial system more or less pro-cyclical. Through-the-cycle ratings should tend to dampen the pro-cyclical forces previously at work (Bank of England, 2008a). The requirement for stress testing for a downturn under Pillar 2 should also act against pro-cyclicality by making banks consider the range of risks that can occur during a cycle or even a long period of time. However, the increased use of marking-to-market and banks' own assessment of risk may lead banks hit by falling credit quality to contract balance sheets in downturns since raising capital is difficult in such conditions and thereby exacerbate the underlying weakness (Goodhart, 2005). Tougher liquidity standards introduced since the crisis will help to reduce pro-cyclicality, for example, by reducing the ability for banks to expand balance sheets rapidly using wholesale funding.

The UK authorities are considering explicit countercyclical regulation, although the details are not yet firm (Bank of England, 2008b). These could include an overall leverage ratio of capital to unadjusted (rather than risk-weighted) assets. This would limit the scope under Basel 2 arrangements for banks to assess their own risk by providing a ceiling and may be helpful in making regulation more transparent, although it is essential that the ceiling applies to all relevant assets and does not encourage banks to use off-balance sheet structures to escape the ceiling. It is notable that, prior to the crisis, risk-adjusted capital adequacy ratios were relatively stable, but leverage ratios (asset to capital ratios unadjusted for risk) rose sharply (Table 4.2). This is consistent with UK banks raising their exposure to apparently high quality assets such as AAA-rated CDO tranches, which later generated major losses. Time varying capital requirements related to lending growth are also under consideration, as is the purchase of catastrophe capital insurance (Kashyap et al., 2008). Dynamic provisioning requires banks to build up loss reserves in good times to cope with bad times and has been implemented in Spain. UK banks did not build up extra provisions in the upturn: the non-performing loans/total loan ratio fell from 2.5% in 2003 to 1% in 2006, while the ratio of provisions to non-performing loans fell from 70% to 54.6%. Potential conflicts with tax rules and with accounting standards would need to be addressed if this approach is to be implemented. More specific regulatory interventions could also be considered such as limiting loan to value (LTV) ratios for mortgages or restrictions on income gearing. In general, countercyclical policies based on discretion are likely to be difficult to implement as the authorities can easily share the same excessive optimism as the private sector about future prospects and risks. In addition, authorities may face political pressures if they try to contain the expansionary phase of a credit cycle, particularly from the financial industry. A rules-based approach to pro-cyclicality, although blunter, would have the benefit of being transparent.

## **Strengthening banking regulation and supporting financial stability**

Following a prolonged credit and asset-price cycle, the United Kingdom is facing a serious credit crunch with considerable impairment of its banking system. The actions

being taken to sustain the banking system, reviewed in Chapter 1, are the most immediate challenge facing the authorities. The crisis has, however, revealed a number of weaknesses in the system of micro and macro-prudential surveillance. Policies have already been or are being strengthened in terms of crisis management and resolution with the Special Resolution Regime and changes to the deposit guarantee scheme. In addition, the macroprudential regime should become more effective as the role of the Bank of England is enhanced by the Banking Act 2009. Major changes are also being considered to the regulation of liquidity, where the previous system of regulation imposed very little by way of restrictions on banks' activities. Broader changes will need to be considered and the authorities will need to rebalance an approach that has relied heavily on principles and market information, perhaps in terms of more quantitative restrictions and a greater use of rules.<sup>16</sup> A broader issue is how to link macro-prudential and micro-prudential regulation more effectively (Barrell and Davis, 2008), including the design of a countercyclical regulatory framework. It is vital that regulation of both types becomes more effective in the sense of ensuring that risky activities do not migrate either internationally or to less-regulated financial institutions such as hedge funds (Goodhart, 2008). In all these areas, it is important for the UK authorities to support and engage constructively in the many international and EU initiatives both to ensure a level playing field in terms of competition but also to ensure that the risk of international spillovers is minimised. The recommendations for further reform (Box 4.2) are close to those recently issued by the Turner Review (FSA, 2009).

#### Box 4.2. Recommendations on banking regulation and financial stability

The immediate priority of the authorities should be sustaining the banking system. For the longer term, UK banking regulation should be strengthened in the light of recent developments and weaknesses that have been demonstrated. Many of these reforms can be advanced by the UK authorities acting alone, although their impact would be greater if coordinated with other countries. Constructive engagement with international and European initiatives will be essential to securing the best outcomes in most areas. The ECOFIN Financial Turmoil Roadmap and the Financial Stability Roadmap are important frameworks in this regard, alongside the G20 Global Plan for Recovery and Reform (2009) and the work by the de Larosière Group (2009). The Turner Review makes a number of valuable recommendations for national regulation, as well as the supervision of cross-border institutions.

This chapter's main recommendations are:

##### **Capital adequacy requirements**

- Capital adequacy standards should be strengthened to ensure that banks have a sufficient capital cushion for the risks being undertaken. Banks should be required to hold adequate capital for off-balance sheet risks, so as to counter regulatory arbitrage and reputational risks. Consistent with this, the accounting treatment of off-balance sheet assets should be aligned with the underlying risks.
- External credit ratings should be used with due caution by regulators and supervisors in the assessment of the riskiness of banks' activities and should not substitute for their own analysis.

**Box 4.2. Recommendations on banking regulation and financial stability (cont.)****Liquidity standards and funding**

- The new liquidity proposals for banks would be a marked advance and should be implemented. Consideration should be given to further measures, including the recommendations in the Turner Review.
- Over time, the legal and regulatory framework should be reviewed to ensure that there are no undue barriers to the development of a covered bond market or the well-functioning of the securitisation market.

**Lending standards**

- Lending standards should receive greater regulatory and supervisory attention. Limits on high loan-to-value (LTV) mortgage loans should be introduced or capital requirements for high LTV mortgages raised. Greater scrutiny should be applied to risky and fast-growing activities as these emerge, such as buy-to-let activity lending.

**Bank supervision**

- Banks should be more tightly regulated and supervised, together with other financial institutions. The FSA has been taking steps to make banking supervision more effective by increasing the resources devoted to major institutions, giving more attention from senior management in the FSA and additional information from banks.
- The quality of financial analysis in the ARROW process should be further improved with a greater emphasis on evaluating comparative performance, as well as better understanding overall developments in the credit market. Macro-prudential concerns should have a real impact on the ARROW assessments.
- Trigger ratios and the details of ARROW assessments, as well as future individual liquidity adequacy standards, should be published as appropriate and in line with international best practice to enhance transparency and market discipline.
- Consideration should be given to what lessons can be learnt from the more rules-based approaches to supervision practiced in other OECD countries.

**Risk management**

- The regulation and supervision of remuneration policies should be tightened. The FSA should improve its information gathering. It has already clarified what constitutes appropriate practice. Risky practices should result in regulatory or supervisory intervention, such as raising capital requirements.

**Crisis management and resolution**

- The Special Resolution Regime is an important step forward. Consideration should be given to numerical targets, alongside qualitative judgments, for prompt corrective action. The Bank of England needs to allocate sufficient resources to deal with the possibility of multiple bank failures.

**Deposit insurance**

- The deposit insurance scheme has been strengthened by raising coverage, removing coinsurance and renewed attention to the operational aspects. The system could be prefunded to a greater extent and consideration given to introducing risk-based premia along the lines of schemes used in other countries.



**Box 4.2. Recommendations on banking regulation and financial stability (cont.)****Macroprudential regulation and pro-cyclicality**

- The pro-cyclicality of the financial system should be damped. Consideration should be given to the use of an overall leverage ratio, covering all relevant assets, and dynamic provisioning. The development of other instruments should also be considered. In general, a rules-based framework may be more effective than discretion.
- The Banking Act will provide an improved framework for dealing with risks to overall financial stability. The smooth functioning of the relationship between the Bank of England and the FSA should be monitored and other arrangements introduced if necessary.

The Bank of England and the FSA should work closely together in the detailed evaluation and preparation of regulation covering financial innovations that could have a systemic impact.

**Notes**

1. Capital includes both shareholders' equity (Tier 1) and other quasi equity instruments including subordinated debt (Tier 2).
2. For example, there was a 100% risk-weighting on all non-financial companies, regardless of credit quality.
3. The rating agencies appear to have assumed that US-wide falls in house prices are extremely unlikely, which gave a false view of the overall risk of the instruments.
4. Broad liquidity is defined to comprise cash, Bank of England balances, money at call, eligible bills and gilts. The Bank of England's preferred measure is for sterling liquidity as a proportion of total assets. An alternative measure capturing total liquidity as a proportion of total assets is somewhat higher at around 4%.
5. Apart from reports on systems and controls, all items will be reported at least monthly and in most cases weekly or daily (FSA, 2008b Annex 5).
6. Targets for holdings of government bonds will be phased in gradually to avoid destabilising markets. Banks will be allowed to hold US and European government bonds, as well as UK gilts, depending on the distribution of their assets.
7. Kempson (2008) indeed suggests that UK mortgage regulation has some lessons for the United States.
8. The approach has also been dubbed "light-touch approach".
9. The ARROW assessments for individual banks are not in the public domain.
10. According to FSA (2006) page 20, "Once during every regulatory period we will perform a firm risk assessment. This risk assessment will have a planning, discovery, evaluation and communication phase. During the rest of the regulatory period (until we conduct the next re-assessment), the firm is subject to ongoing monitoring. The results of the risk assessment itself may also lead to further actions during the rest of the regulatory period directed towards specific issues. These actions are known as a Risk Mitigation Programme (RMP)".
11. Such as assessment of the company's projections of profitability and growth, which would be undertaken in a typical credit analysis.
12. These are means to ease operations in markets such as swaps by each partner agreeing to accept net exposures to the transaction in question.
13. An explicit definition of financial stability is not provided in the Act, beyond these words. It could be argued that a definition would be appropriate so as to constrain future interpretations, such as defining systemic risk, financial instability or disorder as entailing heightened risk of a financial crisis "a major collapse of the financial system, entailing inability to provide payments services or to allocate credit to productive investment opportunities" (Davis, 2002).



14. FSA (2007a), page 9.
15. Estonia increased the risk weighting on all loans secured by mortgages on residential property and limited mortgage interest rate deductibility. In Ireland the risk weighting on high LTV mortgages for owner-occupiers was raised, as was that for exposure to let property and to commercial property.
16. As Lord Mandelson, Secretary of State for Business, Enterprise and Regulatory Reform, put it in a speech at the City Trade and Investment dinner at Mansion House (4 March 2009): “We used to talk about light touch; now it's going to be about right touch”.

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## Chapter 5

# Structural policies to promote sustainable long-term growth

*While the immediate imperative is to tackle the financial crisis and to steer the economy through the current downturn, there are also a number of longer-term challenges that need to be addressed to foster a robust and sustainable recovery. In particular assistance for young and low skilled workers needs to be enhanced and the performance of the education sector also needs to be improved.*

The economic performance of the United Kingdom was strong in the years before the financial crisis. GDP per capita increased at a strong pace, spurred by globalisation, and this improved the relative performance of the UK economy among OECD countries (OECD, 2007). Employment increased and labour productivity growth was strong, outpacing the euro area average and close to the US rate. However, performance was weaker in the years since the turn of the century (OECD, 2009). Despite the strong economic performance before the housing market began to weaken and the financial crisis hit, employment and labour productivity growth eased compared with the previous years, so the gap with the United States stopped closing and there remains a substantial gap with the best performing OECD countries in terms of both GDP per capita and labour productivity. That said, productivity growth tends to be procyclical, so an easing of its rate in the latter part of the economic cycle is to be expected. Although employment and participation have been relatively high overall, there have remained areas where labour market performance can be improved such as the outcomes for low-skilled workers and the re-engagement of disabled workers. Furthermore, some of the apparent progress in economic performance over recent years may have been unsustainable. Once the financial crisis is resolved, it will be important to set the economy on a sustainable and strong medium-term growth path to ensure that living standards are raised in the medium term.

*Going for Growth* (2009) identified a number of structural reform challenges that need to be tackled if the country is to resume its catch up with the leading OECD countries once the current downturn has ended. The priority areas include reforms to the disability benefit schemes, the school system, infrastructure, especially for transport, public sector services and land use planning:

- While the government has made a number of reforms to reduce numbers on disability benefits schemes, levels still remain high by OECD standards. The Pathways to Work programme was successfully trailed and is now being rolled out across the country. The reforms include a Work Capability Assessment, which focuses on the claimant's capacity to participate in the workforce and from 2010 will begin to be applied to existing disability benefits claimants, not just new claimants.
- Improving the educational attainment of young people is another important challenge if the United Kingdom is to improve living standards in the longer term, particularly in a globalised world with rapid technical change requiring an adaptable and well-educated workforce. Moreover, a more even performance across the student population will assist in addressing the trend of increasing inequality. International standardised tests show that the United Kingdom lags the better performing countries significantly, suggesting that considerably more needs to be done both in terms of overall performance and assisting the poorer performers. This issue is discussed in further detail below.
- The adequate provision of public infrastructure should be a priority, particularly in transport where road and airport congestion, and problems in the rail system impede business and constrain productivity. The government has already announced the

bringing forward of planned public investment projects and has gone some way in adopting the recommendations of the Eddington Report on transport infrastructure. However, while the fiscal arrangements have lifted public investment, more will need to be done to meet the government's 2000 Ten Year Plan targets. The financial crisis poses a problem with the ongoing viability of Private Finance Initiative (PFI) funding of infrastructure projects. In March 2009 the government took steps to forestall these problems by offering to lend to PFI projects that were having difficulties accessing sufficient debt finance on acceptable terms.

- Like many OECD countries, the United Kingdom also faces the challenge of coping with an ageing population. Given the large role played by the government in the provision of health and other social services, ageing is a medium to long-term fiscal challenge. Part of the answer lies in improving the efficiency of the public sector, particularly the efficiency of the public provision of health services (Chapter 3).

Shortages of land for residential and commercial development have been one reason for the large price fluctuations seen in the house and commercial property market in the United Kingdom over the past few decades. The government has embarked on an ambitious programme of planning reform following publication of the planning White Paper in 2007 in response to the recommendations of the Barker Review of Land Use Planning (2006). The government has since passed the Planning Act 2008 which will set up a new Infrastructure Planning Commission, to be in place later this year, which will put in place a faster, more certain and transparent process for planning for major national infrastructure projects – the aim is to cut the time taken from application to decision to less than one year. In addition, the Planning Act will continue to introduce further reforms of the town and country planning system with the aim of making it more responsive and efficient. The government is also consulting on a new planning policy statement for economic development, with a view to making the planning system more responsive to market signals and demands in allocating land for development. The government also commissioned the Killian Pretty Review of Planning (2008) to investigate the opportunities for improving the planning application process for the benefit of all involved. The government's response to the review was published in March 2009. A responsive and effective planning system is essential to supporting the government's wider long-term goals of increasing housing supply and providing the infrastructure that supports it. The Barker Review also made numerous recommendations aimed at freeing up land for development. To this end the government has made some changes to the tax treatment of vacant and unused land, including the passage of the Rating (Empty Properties) Act 2007 which changes the relief from business rates in respect of empty property, but more radical measures could be considered including the introduction of a broader land-use tax and the freeing up of green belt land, much of which is of little ecological or recreational value, for housing and commercial development.<sup>1</sup>

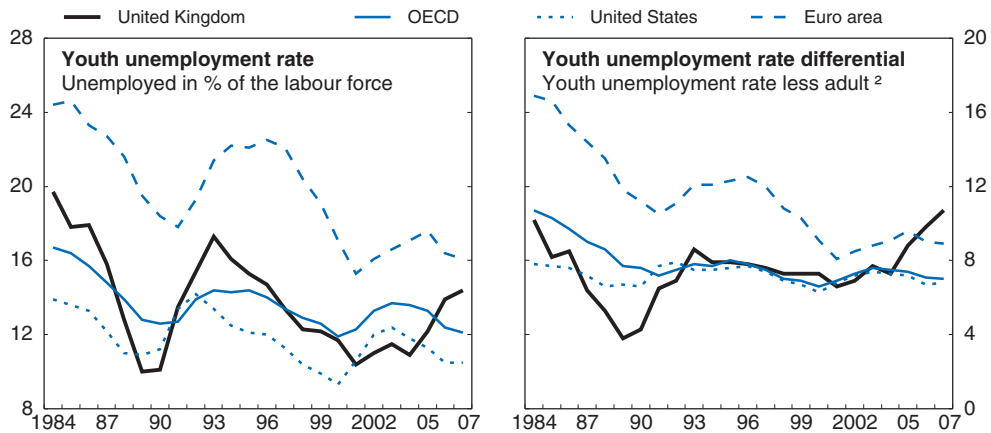
### ***Work prospects for the least skilled need to be enhanced***

Coming into the current downturn, the unemployment rate in the United Kingdom was below the OECD average, and participation rates have continued to rise, particularly among older people and women. For the young, however, some more worrying indicators have begun to emerge. Whereas labour market improvements over the 1990s had brought the youth unemployment rate to below the OECD average by the start of the millennium, in recent years this trend has reversed and recent increases pushed the youth

unemployment rate up to 14.4% in 2007, significantly above the OECD average and close to the euro area average (Figure 5.1, left panel). Relative to adult unemployment rates, youth unemployment rates have been trending up significantly, much more so than in other countries (right panel).


Figure 5.1. **Youth unemployment indicators**<sup>1</sup>

Per cent



1. The OECD and euro area (12 countries) aggregates are unweighted averages. Preliminary data for 2007. Youth covers the age range 15 or 16 to 24 depending on the country.
2. Unemployment rate of youth minus the unemployment rate of adults (age 25-54).

Source: OECD (2008), OECD Employment and Labour Market Statistics – online database.

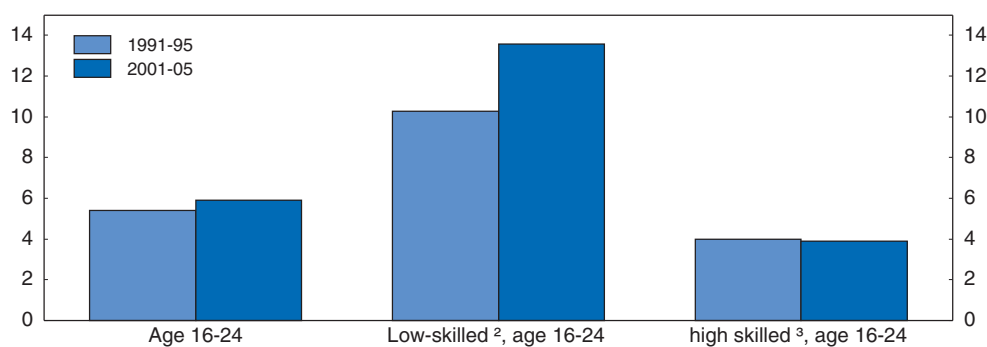
StatLink  <http://dx.doi.org/10.1787/648200584400>

More positively, the incidence of long-term unemployment among youth has decreased by over 7 percentage points over the past decade. This decline has been assisted by the introduction of the New Deal for Young People (NDYP) scheme in 1998. It is a compulsory active labour market programme for youth, which allocates youth to employment or training options after 6 months into the unemployment spell. New Deal has limited the duration of unemployment for young people, which has considerable benefits. The total youth unemployment rate has, however, risen over the last few years, as has the number of young people who are neither in employment nor in education or training (NEET). In 2004 the government set a target of reducing the share of 16 to 18-year old youth who are NEET by 2 percentage points by 2010. There has been recent good progress against this target, with rates dropping from a peak of 10.6% in 2005 to 10.4% in 2006 and 9.4% in 2007. To meet the target rates need to hit 7.6% by end 2010. Clearly, the economic downturn poses challenges, but the government has articulated a NEET action plan and has funded additional places for 16-19-year olds in education and training. The government has also recently announced a new guarantee of 6 months of work or training for all 18-24-year olds unemployed for 12 months.

Within the youth cohort, it is low-skilled youth who have experienced the greatest labour market deterioration. A recent OECD study on Jobs for Youth in the United Kingdom (OECD, 2008a) used data from the British Household Panel Survey to obtain a measure of persistence of non-employment for youth aged 16-24 who have left education. This shows that the percentage of all 16 to 24-year olds not in education who were continuously non-employed has been roughly unchanged at around 6% since the first half of the 1990s.

However, this stability masks divergent trends between skilled and low-skilled youth. Whereas youth with qualifications have experienced improved employment outcomes, low-skilled youth not in education have become even more likely to experience persistence in their non-employment status (Figure 5.2). Low-skilled youth are now more than five times more likely to be unemployed than their more skilled counterparts, a situation that has worsened over the past decade. The low-to-high-skilled youth unemployment ratio is now one of the highest in the OECD (OECD, 2008a).

Figure 5.2. **Persistence of non-employment status in the United Kingdom**  
Percentage of individuals not in education who are non-employed throughout each five-year period<sup>1</sup>



1. OECD estimations based on the British Household Panel Survey, waves 1 to 15.
2. Less than International Classification of Education (ISCED) 3 – not holding upper secondary education.
3. Greater than ISCED 3 – at least high school graduates.

Source: OECD (2008), *Jobs for Youth: United Kingdom*, OECD Publishing.

StatLink  <http://dx.doi.org/10.1787/648214220056>

Two potential explanations for the worsening labour market outcomes for low-skilled youth are the opening up of the labour market to migration from most of the new EU member countries and the introduction of the minimum wage.

Since 2004 there has been a considerable increase in inflows of work-related migrants, with free access to the UK labour market being granted to EU citizens from the A8 countries – most notably from Poland, Lithuania, the Slovak Republic, the Czech Republic and Hungary (in decreasing order of numbers). With the accession of Romania and Bulgaria (A2) to the European Union in January 2007, restrictions were placed on worker inflows from those countries which, as a result, have remained modest to date. Part of the motivation for putting these restrictions in place was a concern about possible negative impacts on the labour market. Indeed, while work-related immigration to the United Kingdom has undoubtedly brought benefits with foreign workers filling skill gaps, allowing closer matching of job vacancies and skills, and bringing in skills that complement those of native-born workers, there have been concerns that they have displaced native workers and may have reduced wages, particularly of young and low-skilled native workers. However research to date finds little evidence of any negative impact on the work prospects of young and low-skilled native workers (Blanchflower *et al.*, 2007) despite A8 and A2 workers generally being young but on average better educated than natives of a similar age.

A minimum wage was reintroduced in 1999 and currently there are three rates: an adult rate, a development rate (for workers aged 18-21), and a rate for 16-17-year olds

(introduced in 2004; younger than 18-year olds were exempt prior to 2004). The minimum wage is set annually on the recommendation of the Low Pay Commission (LPC). Currently the development and 16-17-year old rates are around 80% and 60% of the adult rate respectively, and the rates have increased at an average of around 5.1% per annum since being introduced. This is significantly higher than the rate of increase of average economy-wide earnings. Young inexperienced workers' chances in the labour market are particularly sensitive to wages, as implicitly acknowledged in providing a lower rate for younger workers. Setting the rate too high could damage work prospects (Neumark and Wascher, 2003; Neumark and Wascher, 2006). While some of the decline in income inequality and poverty in the United Kingdom in recent years may be attributable to the introduction of the minimum wage, a trade-off exists, particularly in terms of employment prospects for young and low-skilled workers. The minimum wage should be increased at or below the rate of increase in the median wage.

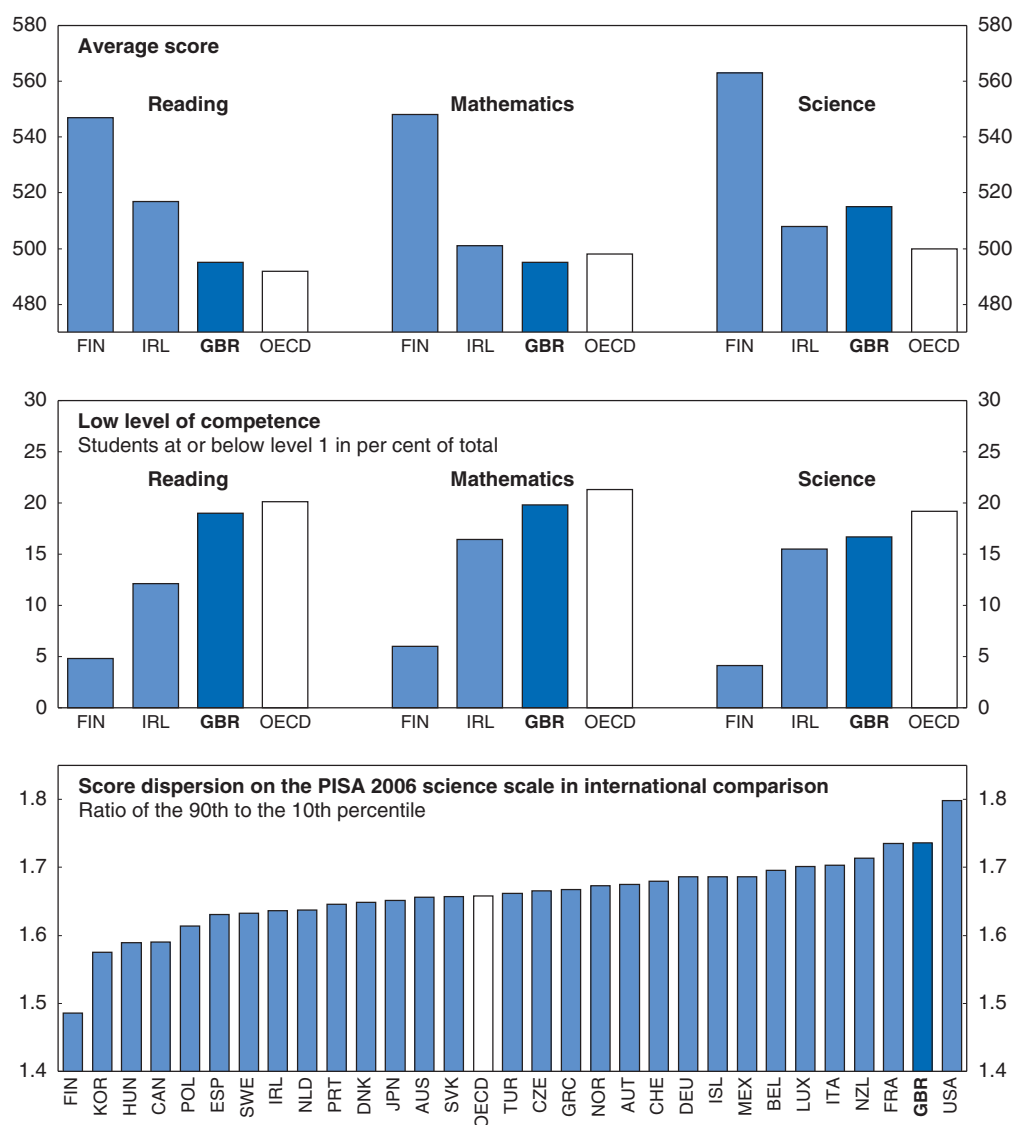
### **Better education achievement would help to narrow socio-economic gaps**

Globalisation, together with skill-biased technical change, is changing the composition of jobs in advanced economies and raising the level of skills required to do them. Moreover, the current downturn is likely to accelerate the rate of structural change. This has increased the importance of educating a large proportion of the population to much higher standards than in the past. The government has acknowledged the importance of education for facilitating individual success in the labour market and has responded to this challenge by raising education spending, expanding the capacity of the education system in pre-primary education, encouraging young people to stay at school for longer, and developing new qualifications for 14 to 19-year olds.

Some successes have been achieved, such as an increase in the percentage of 16 and 17-year olds in full-time education. Nonetheless, the focus on raising the school leaving age and meeting performance targets in education may still be distracting attention from the more important goal of raising core literacy and numeracy achievement. Although education performance has been recorded as increasing on the basis of national examination results, there is some concern that these measures may have been biased by the presence of targets (Brook, 2008). Indeed, national examination results contrast with the results of international tests such as PISA and PIRLS, which suggest that the performance of young people in the United Kingdom remains close to the OECD average. For example, the PISA 2006 study suggested that 15-year olds in the United Kingdom perform significantly below the level of the best-performing countries, although they do perform above the OECD average in science (Figure 5.3, top panel). According to this study, almost 20% of young people performed at the lowest level of competence, versus only around 5% in Finland, the top performer (middle panel). Moreover, when compared with the PISA results from previous years, there may have been some deterioration over time.<sup>2</sup> Dispersion in performance is also more marked than in all other OECD countries except the United States (bottom panel).

The performance of the UK's top students is good. Table 5.1, which compares the distribution of the UK's PISA scores with those of the top 7 countries, shows that UK pupils at the very top do relatively well (a gap relative to the top 7 countries of 15 to 18 points at the 95th and 90th percentiles), whereas the gap is wider further down the distribution (peaking at 35 points at the 10th percentile). The results illustrate that the UK education system is poor at ensuring good performance of pupils in the middle to bottom half of the



Figure 5.3. Students performance based on PISA 2006<sup>1</sup>

1. The OECD aggregate is an unweighted average.

Source: OECD (2007), PISA 2006: Science Competencies for Tomorrow's World, OECD Publishing.


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Table 5.1. Average PISA scores by percentile ranking: Top seven performers versus the United Kingdom<sup>1</sup>

	5th	10th	25th	Mean	75th	90th	95th
Average PISA score top 7 countries	370	407	468	530	595	646	675
United Kingdom	335	372	435	502	571	628	660
Gap: Top 7 – United Kingdom	34	35	32	28	24	18	15

1. Measured by the unweighted average of the various percentile scores for mathematics, reading and science. The top seven performers are Finland, Korea, Canada, New Zealand, Netherlands, Australia and Japan.

Source: OECD (2007), PISA 2006: Science Competencies for Tomorrow's World, OECD Publishing.

education performance distribution. In order to achieve a higher overall performance students in the middle and bottom half of the distribution need to perform better.

Similar conclusions emerge from results of the PIRLS International 2006 survey of achievement in reading among children aged about 10-year olds. This study showed that England's performance had deteriorated relative to its performance in 2001.<sup>3</sup> Moreover, data on the distribution of the PIRLS results suggest that children in the middle and bottom half of the distribution are already falling behind those in the top performing countries even before they complete primary school. Consistent with the PISA results (shown in Table 5.1), Table 5.2 shows that reading performance among the most advanced English children was not much below that of the most advanced children in the top 7 countries (a gap of only 2 percentage points). Some positive reflection of policies to assist the poorest performers is evident in the fact that the biggest gap was not among the lowest performers. However, a much wider gap is evident among children in the middle and lower part of the distribution.

**Table 5.2. Percentages of students reaching the PIRLS 2006 reading benchmark**  
Top seven performers versus the United Kingdom

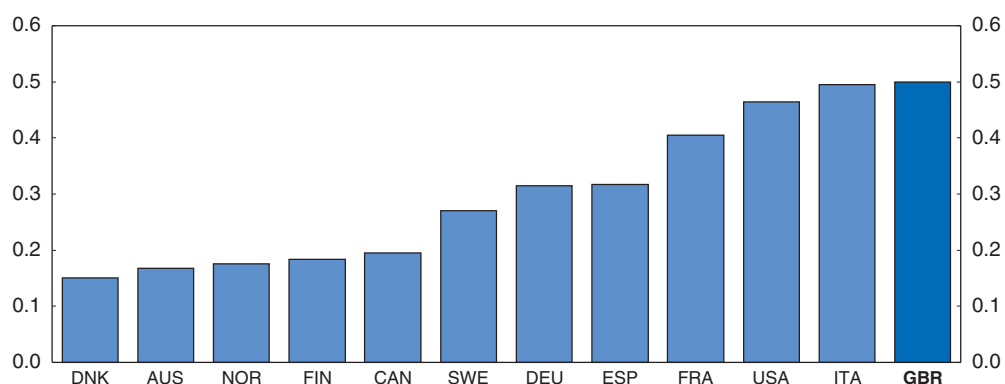
	International Benchmark			
	Advanced	High	Intermediate	Low
Average percentage reaching benchmark in top 7 countries <sup>1</sup>	17	57	88	98
Percentage reaching benchmark in England	15	48	78	93
Gap: Top 7 – United Kingdom	2	9	10	5

1. Measured by the unweighted average of the percentage of pupils reaching each international benchmark. The top seven performers were Singapore; the Russian Federation; Canada, Alberta; Bulgaria; Canada, British Columbia; Canada, Ontario; Luxembourg and Hong Kong SAR.

Source: International Association for the Evaluation of Educational Achievement (2007), *PIRLS 2006 International Report*.

As long as the United Kingdom struggles to improve education achievement among the poorest performers, intergenerational social mobility is likely to remain lower than in many other OECD countries. A common measure of intergenerational income mobility is the fraction of relative income differences between fathers that are transmitted to their sons: the higher this elasticity, the lower is intergenerational income mobility. While this elasticity measure suggests relatively high social mobility in the Nordic countries, Australia and Canada, it shows the lowest degree of mobility for the United Kingdom (Figure 5.4).

In recognition of these issues, the government has introduced a number of policies to lessen poverty, and improve equality of opportunity. These policies have included the introduction of a minimum wage, the working and child tax credits, and pension credit. Some progress is reflected in the fact that compared with the year 2000, there is now a smaller proportion of households that are very poor, and poverty rates have fallen for vulnerable groups including children and pensioners. But at the same time, there has been a further shift in the spatial segregation of the population, with increasing geographical income polarisation in recent years (Dorling *et al.*, 2007). An important channel for improving intergenerational social mobility will be raising the proportion of students from low socio-economic backgrounds who obtain a sufficiently high-quality compulsory education to continue to university study.<sup>4</sup> Given the large variance in educational

Figure 5.4. **Intergenerational earnings elasticity – estimates from various studies**<sup>1</sup>

1. The higher the parameter, the higher is the persistence of earnings across generations and thus the lower is mobility.

Source: d'Addio, A.C. (2007), "Intergenerational Transmission of Disadvantage", *OECD Social, Employment and Migration Working Papers*, No. 52.

StatLink  <http://dx.doi.org/10.1787/648252575451>

outcomes in United Kingdom, continuing to improve access to pre-primary education, which has been shown to increase future education attainments particular for children from disadvantage backgrounds, would be helpful (d'Addio, 2007).

A number of recommendations for raising education achievement and breaking the cycle of inequality were outlined in the previous *Survey*. In particular, it was concluded that policy makers should consider reducing the current focus on tests and targets and introduce changes to the way funds are allocated to schools, in order to raise the relative performance of pupils in the middle and lower half of the distribution. Progress in implementing these, as well as other reforms suggested in the previous *Survey*, is summarised in Table 5.A1.

#### Box 5.1. Recommendations to address longer-term structural issues

- Progress toward reducing numbers on disability benefits should continue, including the extension the Pathways to Work programme to the stock of recipients.
- Improvements in public infrastructure are required to boost productivity, particularly in transport. More will need to be done, particularly to meet the government's 2000 Ten Year Plan target.
- The improvement in the land use planning procedures should be continued to ensure that future demand for land is met, especially for housing purposes.
- Raising training and education levels remains a priority to lift productivity, assist the low-skilled, help to narrow socio-economic gaps and promote social mobility. Given the large variance in educational outcomes, continuing to improve access to pre-primary education, which has been shown to increase future education attainments particularly for children from disadvantage backgrounds, would be helpful.

## Notes

1. The recent “Facing the housing challenge” (DCLG, 2008) report announced a number of measures aimed at increasing the supply of housing including assisting first-home buyers, funding for local councils that are facilitating the supply of housing, and funding to purchase unsold stock from house builders for affordable homes.
2. Average scores in the 2006 PISA study were below those in the 2000 and 2003 studies. However, because of a low response rate in the previous years (see Micklewright and Schnepf [2006] for details), the 2000 and 2003 results are generally excluded from international and across-time comparisons. Thus, it is only possible to say with confidence that the UK’s sample results in the 2006 study reliably reflect those for the national population with the level of accuracy required by the PISA study.
3. In the 2001 study England ranked 3rd and Scotland 14th out of a total sample of 35 participants. In the 2006 study England ranked 19th and Scotland 26th out of a total sample of 45 participants. Similarly, in the 2003 TIMSS study of mathematics skills among 9-10-year olds, England ranked tenth and Scotland 18th out of a total sample of 25 participants. Note that in both the PIRLS and the TIMSS studies the participant samples included developing as well as more advanced countries.
4. Between 1981 and the late 1990s, young people from the poorest 20% of families increased their university graduation rate by just 3 percentage points, compared with a rise in graduation rates of 26 percentage points for those born to the richest 20% of parents (Blanden and Machin, 2004). To date, the academic A-level track at secondary school has been the main conduit to university, but students from low socio-economic backgrounds are less likely to have the grades to enter this track. With the introduction of the new Diplomas, care should be taken to ensure that socio-economic segregation does not increase between A-level and less academic tracks.

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## ANNEX 5.A1

*Progress in structural reform*

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

Recommendations	Action taken since the previous Survey (September 2007)
<b>Education</b>	
Continue to promote a focus on the acquisition of core skills for pupils at all age levels and ensure that this focus is not compromised by the goal of expanding the average number of years of schooling.	Basic functional skill requirements to be imposed from 2010.
Design all education targets in a way that limits the potential for gaming, by ensuring an interactive performance management system that captures the complexity of the education process.	Through the achievement and attainment tables and Ofsted reports, many aspects of schools' performance are already made public. The government is consulting on proposals for a new school report card that will strengthen accountability to parents and local communities by making broader information about schools' performance and achievements more readily available to parents in a simpler, easily understood format.
Encourage the highest quality teachers to move to the most disadvantaged schools.	All eligible schools can offer benefits to teachers taking up posts from September 2009: A golden handcuff of £ 10 000 in return for staying in the school for three years for newly recruited teachers; Access to the new Masters in Teaching and Learning qualification for newly-qualified teachers; Access to a government-funded network of teachers which will offer experience sharing, discussion groups and subject specific activities
Promote the transition to a better allocation of funds by taking deprivation-targeted funding out of the formula used to determine the Minimum Funding Guarantee. Permit smoothed transitions to the improved formulas.	The Department for Children, Schools and Families (DCSF) is conducting a review of the formula for distributing the main school grant – the Dedicated Schools Grant (DSG). It will consult on options for changing the formula in the summer of 2009 with the intention of bringing in changes from the next Spending Review period. Transition arrangements form an important work stream in the review.
Evaluate the pros and cons of introducing a differentiated voucher system of funding (as in Chile) where pupils from poorer families receive vouchers that are valued more highly than those for the general population.	The government is reviewing the formula for distributing the DSG. The aim is to develop a single, transparent formula that will be available for use in distributing the DSG to local authorities. The Review will consider additional educational needs: which pupils are affected; what indicators are best used to distribute money for these pupils; whether in the context of the personalisation agenda it is possible to attach money more directly to deprived pupils, for example, as they move round the system.

Recommendations	Action taken since the previous Survey (September 2007)
<b>Labour market</b>	
Consider modifications to the tax and benefit system that would reduce the marginal effective tax rate faced by lone parents and one-earner couples when extending their hours or when progressing in work.	The Working Tax Credit (WTC) income threshold was increased by £ 1 200 in April 2008, balanced by a small decrease in the tax credits withdrawal rate from 37 to 29%, further enhancing participation incentives for low income families. The number of families facing the highest effective tax rates (above 70%) remains less than half its level in 1998. Since November 2008 lone parents claiming benefit, whose youngest child is aged 12 and over, can no longer receive Income Support solely on the basis of being a lone parent. They can claim Jobseeker's Allowance or another benefit if appropriate which require being actively preparing for or searching for work. This is being rolled out to stock claimants from March 2009.
Improve incentives for labour force participation by second earners by reducing the high implicit taxes on returning to work caused by high child-care cost.	Implicit taxes on work for second earners are significantly reduced, particularly for low earners, through the childcare element of the Working Tax Credit. It provides support for up to 80% of childcare costs up to limits of £ 175-300 per week for families with one/two or more children. The percentage of eligible childcare costs covered rose to 80% in April 2006.
Improve incentives to up-skill by making the child-care element of the Working Tax Credit available to low-skilled people undertaking approved courses of study, as well as those who are working.	The new Free Childcare for Training and Learning for Work scheme offers free childcare to potential second earners entering training. The Sixth Form College Childcare Scheme will pay up to £ 175 per week in childcare support for parents on approved training courses. The Childcare Grant can pay up to 85% of a higher education student's childcare costs.
Extend the Pathways to Work scheme on a mandatory basis to the stock of existing claimants.	The government has rolled out Pathways to Work to cover the remaining 60% of the country. The Welfare Reform Green Paper (2008) set out plans to widen mandatory participation in Pathways, so that all those under 50 who fall in the "Work Focussed Group" of claimants of Employment Support Allowance (ESA) will have to participate in Pathways. The most severely disabled, the Support Group, will be able to participate in Pathways on a voluntary basis.
Improve the monitoring of the health status of people reaching the end of their entitlement to sickness pay and benefits and make the medical assessment of benefit claims earlier.	Incapacity Benefit has been replaced by ESA for new claimants (from October 2008). In parallel with the introduction of ESA, a new eligibility test conducted at the start of a claim will be introduced (the Work Capability Assessment (WCA)). A 10% reduction in those claiming ESA as a result of the WCA is expected. The WCA will be applied to the stock of claimants over the next five years.
Pay more attention to the early sickness stage of the large number of people claiming incapacity benefit from a non-employment status.	The new WCA focuses on what an individual can do. This information is available for advisors to work with claimants at their Work Focussed Interviews, where the advisor and claimant can discuss and agree what kind of steps could be taken to help the claimant back into work.
Consider rolling out the City Strategy "pathfinders" programmes on a wider basis. Also since programmes tend to become less effective over a period of successful implementation, new approaches should be developed and evaluated.	The fifteen pathfinder pilots have been extended for a further two years, to end in 2011. With the introduction of the Flexible New Deal in October 2009, increased flexibility at the local and sub-regional levels will be explored: from consulting local partners on how programmes are commissioned (level one); integrating innovative services to local proposals or a sub-regional approach (level two); potentially extending devolution to give local areas a role in letting contracts (level three).
Improve statistical monitoring of the stock of migrant labour by "cross-checking" registered workers on the Worker Registration Scheme against other databases (e.g. taxpayers).	The Office for National Statistics is currently engaged in a substantial programme that includes taking forward the recommendations of the 2006 Interdepartmental Task Force on Migration Statistics and the more recent Treasury Select Committee report "Counting the Population". The programme is expected to lead to significant improvements in both quality and timeliness of data on migration and the population more generally.

Recommendations	Action taken since the previous Survey (September 2007)
<b>Productivity</b>	
Facilitate the entry of new businesses by reforming planning regulations, especially in the area of retail trade, and abolish the "needs test" for market demand. Put more weight on economic issues in the planning process.	The government is considering proposals to maintain the "town centre first" approach, while improving its effectiveness by removing the current need test and replacing the existing impact assessment with a new test, a key feature of which is a broader focus with emphasis on economic, social, environmental and strategic planning impacts and their impact on car use, traffic and congestion.
Free-up land for development by reconsidering the boundaries of the "green belts" in fast-growing areas.	Planning authorities review green belt boundaries when implementing planning policy. The government is currently reviewing Regional Spatial Strategies (RSSs) for the South East, South West and East Midlands all of which contain green belt review recommendations.
Consider further incentives for land development particularly those with the potential to contribute to the funding of local infrastructure.	The Planning Act 2008 provides powers to establish a new local charge (the Community Infrastructure Levy) which local authorities will be able to apply to new development. Receipts from the new charge must be applied to the provision of infrastructure needed to support growth.
Ensure that infrastructure investment does not fall short of that envisaged in the government's Ten Year Plan for Transport. Consider ways to improve the predictability of transport funding. Follow through with targeted spending in key strategic growth areas.	The government will implement five year transport plans to provide greater certainty. This follows the example of the "control periods" for rail. Targeted spending in key areas was announced in January 2009: for example detailing a National Roads Programme of up to £ 6 billion to increase capacity and reduce congestion in the worst affected areas.
Continue to examine the options for addressing road congestion and environmental impacts including the implementation of a road-pricing system on a national scale.	A demonstration project to trial the technology and processes that could underpin more sophisticated road charging systems will be underway by spring 2009. In addition, the government is bringing forward schemes where capacity can be increased at peak times through the opening of the hard shoulder.
Raise the skill level of the workforce by focusing adult training on the most disadvantaged groups. When evaluating progress, focus more on broader measures. This encompasses improving the quality and volume of qualifications, as well as the employment outcomes from acquiring skills and qualifications, and international measures of adult cognitive skills.	Subsidy rates for publicly funded training – basic skills and first level 2 qualifications are fully funded and level 3 is part funded (50% by 2011). Information is collected regarding attainment, volumes and quality of the various skills programs. The method for measuring overall progress is the agreed PSAs indicators for 2011 and the Leitch 2020 vision. In terms of employment outcome measurements considerable work is underway to enable this to occur in the Integrating Employment and Skills trails and once data sharing legislation is approved (July 2009) measures of employment outcomes from acquiring skills and qualifications and progression measures will be able to be put in place.
Assess the efficiency of fiscal support to R&D, such as the R&D tax credit, over the longer term.	An independent study in 2006, commissioned by the UK government, concluded that a sufficiently long time series of data was not yet available to support robust estimates of the effect of R&D tax credits. The government remains committed to undertake a full evaluation of the schemes as soon as sufficient data becomes available.
<b>Tax competition</b>	
Continue to cut the statutory corporate tax rate and broaden the base.	Reforms to corporation tax announced in March 2007 included a two percentage point reduction in the main rate to 28%, along with a reduction in the rate of capital allowances to 20%, the phasing out of some other capital allowances and the introduction of an Annual Investment Allowance of £ 50 000.
Look into the merit of moving to a dividend exemption system.	The Finance Bill 2009 proposes an exemption from tax for most foreign dividends received and a Targeted Anti-Avoidance Rule will apply to protect against avoidance activity.
Reduce the complexity of the tax code.	Since 2007, four reviews to simplify specific areas of tax policy were conducted and more than 50 measures to simplify the tax system for business brought forward. The government is reducing the administrative burden of the tax system.



Recommendations	Action taken since the previous Survey (September 2007)
<b>Miscellaneous</b>	
<p>Monitor closely the speed and efficiency of the planning system and progress towards the government's regional housing targets.</p>	<p>The Planning Act 2008 will set up a new Infrastructure Planning Commission. It will plan major national infrastructure projects and aims to cut the time taken from application to decision to less than one year. In addition, a new planning policy for housing has been adopted aimed at ensuring more land is brought forward to respond to housing demand.</p>
<p>Consider imposition of some form of mandatory pension savings in the medium term.</p>	<p>In 2008 the UK enacted a programme of pension reform, following recommendations made by the Pension Commission. These comprise: a statutory duty on employers to automatically enrol eligible workers into workplace pension schemes which must meet minimum qualifying requirements; and the public provision of a trust based multi-employer pension scheme for those otherwise without access to a qualifying scheme. The introduction of the employer duty to auto-enrol eligible workers is planned for 2012.</p>



## Glossary

<b>ALMP</b>	Active Labour Market Policy
<b>AME</b>	Annually Managed Expenditure
<b>APS</b>	Asset Protection Scheme
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>CDOs</b>	Collateralised Debt Obligations
<b>CDS</b>	Credit default swap
<b>CEBS</b>	Committee of European Banking Supervisors
<b>CGS</b>	Credit Guarantee Scheme
<b>CQC</b>	Care Quality Commission
<b>DELs</b>	Departmental Expenditure Limits
<b>DRG</b>	Diagnosis-related Group
<b>ECB</b>	European Central Bank
<b>FCI</b>	Financial Conditions Index
<b>FPC</b>	Fiscal Policy Council
<b>FRO</b>	Financial Risk Outlook
<b>FSA</b>	Financial Services Authority
<b>FSAP</b>	Financial Sector Assessment Programme
<b>FSCS</b>	Financial Services Compensation Scheme
<b>FSF</b>	Financial Stability Forum
<b>FTs</b>	Foundation Trusts
<b>GDP</b>	Gross Domestic Product
<b>GMS</b>	General Medical Services
<b>GP</b>	General practitioner
<b>HALE</b>	Health-adjusted Life Expectancy
<b>HMRC</b>	HM Revenue & Customs
<b>HRGs</b>	Healthcare Resource Groups
<b>IASB</b>	International Accounting Standards Board
<b>IMF</b>	International Monetary Fund
<b>ISTCs</b>	Independent Sector Treatment Centres
<b>LPC</b>	Low Pay Commission
<b>LTVs</b>	Loan-to-Value ratios
<b>NEET</b>	Neither in employment nor in education or training
<b>NHS</b>	National Health Service
<b>PBC</b>	Practice Based Commissioning
<b>PBR</b>	Pre-Budget Report
<b>PbR</b>	Payment by Results
<b>PCA</b>	Prompt Corrective Action
<b>PCTs</b>	Primary Care Trusts

<b>PFI</b>	Private Finance Initiative
<b>PROMS</b>	Patient Reported Outcome Measures
<b>PSA</b>	Public Service Agreement
<b>QOF</b>	Quality and Outcomes Framework
<b>ONS</b>	Office for National Statistics
<b>SGP</b>	Stability and Growth Pact
<b>SHAs</b>	Strategic Health Authorities
<b>SIVs</b>	Special Investment Vehicles
<b>UK</b>	United Kingdom
<b>VAT</b>	Value-added Tax
<b>WHO</b>	World Health Organisation

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