POLICY BRIEF

OECD

Economic Survey of United Kingdom, 2005

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Introduction

The stability and resilience of the economy has been impressive and labour and product markets are among the most flexible in the OECD, but structural economic performance judged against a range of indicators can be further improved.

Table 1. **Impressive macroeconomic stability but structural performance can be further improved**

	Period	Ranking among	
		G7 countries	All 30 OECD countries
Macroeconomic performance			
Smallest absolute output gap	Average 1998-2004	1st	1st
Lowest variance of CPI inflation	Average 1998-2004	1st	1st
Structural performance			
Liberal product market regulation	2003	1st	2nd
GDP per capita	2003	3rd	14th
Productivity per hour	2003	5th	15th (out of 27)
Skills, % of adults having more than low skills	2003	5th	17th
R&D intensity	Average 2000-03	6th	14th
Infrastructure, *Global Competitiveness Report*	2004	6th	17th

This in turn explains why in terms of GDP per capita the United Kingdom still only ranks just above the median across all OECD countries. Policies to address the apparent relative underperformance have been in place for some time and are already showing results in some areas. To further improve this situation, policy-makers should address the following key challenges:

- ***Raise the general skill level of the workforce.*** Effective policies will help the economy to absorb innovations and adapt work processes to

This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of United Kingdom. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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take advantage of new technologies and so boost productivity.

- ***Address the apparently mediocre innovation performance.*** Careful consideration needs to be given to how far it can be improved by policy and how much is explained by imperfect indicators and the structure of the economy.
- ***Improve transport infrastructure.*** The consequence of decades of under-investment has been congested roads and an unreliable rail system, which may be holding back productivity.
- ***Increase labour utilisation by helping those claiming incapacity benefit into work.*** An innovative approach providing more customised help and enhanced incentives to work has been piloted with considerable success. It is important that this is rolled out nationally, although this may require some change in health care priorities.
- ***Ensure that public money is spent efficiently to contain the tax burden.*** Increased expenditure on health and education has been accompanied by reforms aiming to ensure that resources are better used, but further improvements can be made. In expanding childcare the framework needs to be carefully considered to avoid a future escalation in costs. Reforms to the pension system should aim to simplify the system as well as enhance incentives to work and save.

Despite a recent slowdown in growth, output remains close to capacity and inflation close to target, leaving the Bank of England well placed to respond flexibly to future developments. It would appear that major instability from the housing market has so far been avoided. Nevertheless, reforms to the housing market, especially with respect to property tax and planning restrictions, should focus on enhancing stability and increasing the responsiveness of housing supply. Fiscal policy has been strongly supportive since the global downturn in 2000, but the fiscal deficit is now around 3% of GDP and if it does not begin to fall in line with official projections then further measures will be required. ■

What are the main challenges?

Over the last decade, macroeconomic performance has been impressive: GDP growth has been robust and cyclical fluctuations in output have proved smaller than for almost any other OECD country, while inflation has remained close to target. This performance is a testament to the strength of the institutional arrangements for setting monetary and fiscal policy as well as to the flexibility of labour and product markets. But fiscal easing, while supporting demand since the global downturn in 2000, has led to a deficit of around 3% of GDP. However, the main challenges relate to long-run structural performance, given that the United Kingdom still only ranks just above the median in terms of GDP per capita among OECD countries and has made little progress in closing the income gap with the best performing countries. Particular priorities, where the government is already taking action, in this respect are:

- Boosting productivity by addressing weaknesses in innovation, skills and infrastructure investment.
- Raising labour utilisation through reforms that help people claiming incapacity benefit back into work.
- Ensuring public money is spent efficiently. ■

What is the short-term macroeconomic outlook?

Output growth has moderated since mid-2004 from rates clearly above potential growth to rates clearly below it; growth in the year to the second quarter of 2005 was 1.7% compared to potential growth estimates of about 2½ per cent. Some moderation of growth is perhaps not unwelcome given that OECD estimates, as well as survey-based evidence, suggest the economy has been operating at, or slightly above, capacity. Inflation, as measured by the consumer price index (CPI), has picked up from a trough of just over 1% in autumn 2004 to 2.4% in August, above the 2% target. The unemployment rate has remained below 5%, but private sector wage inflation remains consistent with the inflation target. Substantial net immigration, boosted recently by immigration from the new EU countries, has probably been helpful in providing additional labour market flexibility. Responding to the subdued growth in output in the first half of the year, the Monetary Policy Committee (MPC) of the Bank of England voted to cut the repo rate by ¼ of a percentage point in August, following a year in which it had been left unchanged. This move provides some insurance against the downside risks – especially from prolonged weakness in Europe and higher oil prices as well as, domestically, from the housing market – that cloud the short-term growth outlook. However, given that the level of output is currently close to capacity, that inflation has been increasing and is now above target and short-term indicators suggest growth may return to trend, there is not a compelling case for further rate cuts. ■

What is the risk from the housing market?

The marked slowdown in consumption suggests that the housing market continues to have a strong influence on aggregate consumption. The possibility of a much sharper retrenchment in consumption, brought about by a pronounced drop in house prices, remains a risk, although one that has diminished. If a relatively "soft landing" in the housing market has indeed been achieved it owes much to the strategy of gradual pre-emptive monetary tightening, in marked contrast to previous episodes when an abrupt correction in house prices was triggered by sharp interest rate rises. Nevertheless, reforms are needed to make housing supply more elastic to damp future housing market cycles. As highlighted by the Barker review, relaxing planning restrictions to make housing supply more responsive is likely to help and the government is taking steps in this direction.

- Following legislation which has recently been passed, it is important to monitor closely the speed and efficiency of the planning system and progress towards the government's regional housing targets. In response to the recommendations of the Barker Review, the government should reform the planning system to increase its responsiveness to housing demand as well as providing greater incentives for local authorities to meet housing growth targets. The latter could be achieved, for example, by disregarding, for a period, council tax receipts generated by new housing from the calculation of the local authorities grant allocation from central government.
- A reform of the council tax, a tax levied on residential property, to make it more proportional to property values and based on more frequent and up-to-date valuations might also help to dampen future house price cycles.
- The extent of implicit subsidies provided in the government's new scheme to help first-time buyers should be monitored, including any effect on house prices. However, given the scale of the scheme at present, the impact on house prices would be very marginal. ■

Is fiscal policy on track?

The fiscal easing since the global downturn in 2000 has been second only to the United States among all OECD countries. This has pushed the government deficit to around 3% of GDP. The public sector has accounted for about half of all new jobs since 2000. Whether the government has met its "golden rule", that over the course of the cycle the public sector should only borrow to invest, depends on judgements regarding the timing of the cycle. The government's recently revised judgement that the current cycle began two years earlier than they had previously thought will help to meet the golden rule over the current cycle. But given that the margin by which it will, or will not, be met during this cycle is likely to be small, using this criterion to judge whether fiscal policy has been a "success" or "failure" is inappropriate. Clearly, the new fiscal framework has been helpful in restoring credibility to fiscal policy and the economic consequences of slightly missing the golden rule over the current cycle should be regarded as negligible, particularly in the context of relatively low net government debt. A common feature of both official and OECD projections is that under current spending plans an increase in the tax ratio will be required to meet the fiscal rules and significantly reduce the deficit over the coming cycle. In the case of official projections this comes about through a rise in the tax-GDP ratio, reflecting fiscal drag, improved tax compliance and an improvement in corporate profitability, whereas on OECD projections additional measures would be needed.

- If fiscal developments were disappointing beyond what could be explained by weaker-than-expected growth, so that the deficit in cyclically-adjusted terms was worse than projected, then the government would need to take measures to keep fiscal policy on track. ■

How can improvements in public services be sustained as spending slows?

Taxes and public spending have outpaced economic growth so that the public spending-to-GDP ratio reached 44% in 2004 compared with 40% in the late 1990s. Publicly-funded provision of healthcare and education has risen considerably. But flexible product and labour markets have been maintained while benefits and the overall tax pressure have been kept at levels that do not blunt incentives to look for work, helping people and families to support themselves. Maintaining this balance is crucial to ensure the sustainability of the expansion in welfare programmes.

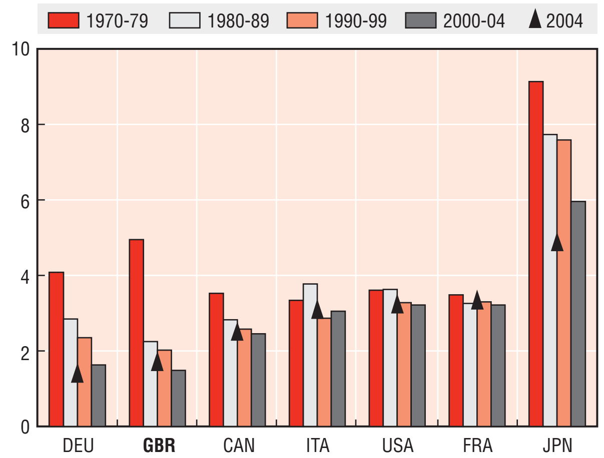
- Efforts need to continue to increase efficiency. While outcomes in health and education have improved recently, improvements are slow to come and much slower than the expansion of inputs. Building on *payment by results*, incentives faced by providers could be further improved, for example by the introduction of incentive pay for hospital doctors, and further involvement of private sector providers may be desirable to ensure contestability.
- Where possible, users should contribute to the costs of service provision. Reinvigorating higher education based on increased fees from 2006, which students can defer and repay as income-contingent contributions once they have graduated, is a good example. But also here policy could be fine-tuned as the planned zero real interest rate implies a subsidy which is not warranted on exclusively economic grounds. Applying instead an interest rate close to government borrowing costs would free substantial government resources. ■

How can improvements in the transport system be achieved?

For decades under-investment in public infrastructure was an easy option for constraining public outlays. The government's first fiscal rule, the so called "golden rule", distinguishes between capital and current spending, and has helped to avoid such short-term expediency. Indeed, the share of government investment in GDP has risen, and there are plans for it to rise further. Nevertheless, even after it rises to just under 2½ per cent of GDP next year, it still remains relatively modest compared with many other OECD countries and may be inadequate to correct years of neglect. The United Kingdom ranks poorly in international comparison both on survey-based measures regarding the quality of transport infrastructure and on measures of congestion, although there have been recent improvements in rail performance. Additional road building will not by itself permanently relieve these pressures, rather it needs to be combined with congestion charging. The success of the London Congestion Charge suggests that there might be growing public acceptance of the principle and growing interest in a nation-wide congestion charging scheme, although this would be costly and not feasible for some years. Nevertheless, it is important in the meantime that all tiers of government undertake research and experimentation on smaller scale projects that build on the experience of the M6 toll road and the London Congestion Charge.

- Investment in transport infrastructure should be maintained to at least levels envisaged in current spending plans over the long term and the reasons for any persistent under-shoot relative to plans should be examined with a view to taking remedial action. The case for further raising expenditure on strategic roads should be considered given that on current plans such outlays in real terms remain well below levels in the first half of the 1990s.
- The Government should monitor incentives for local authorities to pursue local congestion charging schemes. This might be done by making funds from the *Transport Innovation Fund* available sooner. Additionally, future planned increases in funding for

Figure 1. **General government gross fixed investment**
Period averages, in per cent of GDP



Source: OECD Economic Outlook 77 database.

local transport could be made contingent on local plans to tackle congestion.

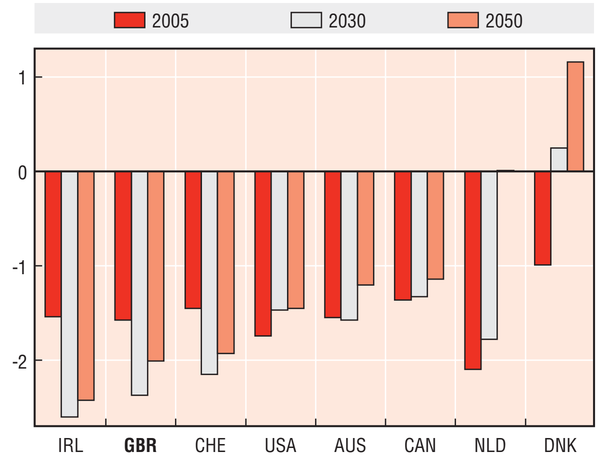
- In assessing the appropriate level of public investment and subsidy for public transport, account should be taken of the criteria used to assess the national road pricing scheme, in particular giving weight to time savings resulting from less road congestion. On this basis, it seems likely that more subsidy should be directed at those railway lines which have greatest potential for relieving road congestion.
- Further measures for closer integration of investment decisions between railway infrastructure and train operations need to be found. The success of recent changes to integrate planning around Network Rail's regional offices need to be monitored. ■

How should the pensions system be reformed?

Current pension arrangements combine one of the lowest state pensions in the OECD with one of the most developed systems of voluntary privately-funded pensions. The main objective of the state system has been the prevention of poverty rather than providing a particular replacement income relative to pre-retirement earnings. Unlike the situation in many OECD countries, future fiscal costs are not projected to rise significantly as the population ages. Instead concerns focus on the declining average public pension relative to the income of those in work; recent estimates suggest that state spending per pensioner is likely to fall by almost one-quarter relative to average earnings over the next four decades if the current indexation conventions are followed. In addition, the level of private pension provision has been declining. The Pensions Commission, set up by the government to review the adequacy of private pensions saving and due to report in November 2005, estimated that 9 million people are currently making inadequate provision for retirement. A related weakness of the current system is that the number of pensioners who will be subject to means-testing is likely to grow substantially which, while keeping fiscal costs down and targeting resources at those with the lowest incomes, will also increase the number of pensioners who will be subject to disincentives to private saving. By 2050 over 60% of all pensioners could face a marginal tax rate of at least 40% on additional savings income. The complexity of the current state system may further reduce incentives to save because it is difficult to understand what the state will provide.

- A considerable simplification could be achieved by reducing excessive reliance on means-testing, particularly its projected growth in the future. This could be achieved by raising the basic state pension and indexing it to future earnings rather than prices. The fiscal costs could be partially covered by gradually raising the state pension age in line with increasing life expectancy, as well as by introducing a cap on tax subsidies to pension savings to better target tax-relief at low and middle-income earners where under-saving is most pronounced.
- Reducing means-testing would also facilitate reforms to promote other sources of income during retirement, such as through mortgage equity release products. There is a large potential for "house rich, cash poor" pensioners to make use of such products, although currently only around 1% do so.
- At a later stage, if there is no significant increase in saving for retirement, imposing some form of mandatory savings could be considered. This would be justified to the extent that individuals are myopic, although it might also force some individuals to save whose circumstances did not warrant it. It is also likely that there would be some offsetting fall in

Figure 2. **The fiscal cost of subsidising private pensions**[1]
In per cent of GDP



1. Base case, no new saving. Only OECD countries with substantial assets in tax-favoured retirement plans are shown.

Source: P. Antolin, *et al.* (2004), "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", *Economics Department Working Papers*, No. 393, OECD, Paris.

voluntary savings. Finally such a step could not be taken if current means-testing arrangements remained in place because it would clearly disadvantage those on low-incomes. In the meantime, a change which would stop short of higher compulsory saving would be to change employee participation in company pension schemes so that the default is that they are contracted in, unless they deliberately take a decision to opt out. Evidence from the United States suggests this should raise employee participation in company pension schemes. ■

What is the economic rationale for public support for childcare?

Changes in family structures and attitudes with more women wanting to pursue a career make availability of flexible and affordable childcare essential for reconciling work and family life. Male and female employment rates have reached 79% and 70% respectively, but many women work part-time. At the same time, a more polarised family structure has emerged with many jobless households, which reinforces the risk of social deprivation being passed on from one generation to the next. Only a third of lone mothers with children under 5 are employed. Access to childcare is an important element in any package of measures to address this problem, in particular for lone parents. Raising public subsidies for childcare and out-of-school-hours care is warranted because earnings potential often declines when having been out of work for a while, so that low-cost child care can be crucial for making work pay. Universal free preschool also helps children by stimulating their emotional, social and cognitive development. On this basis the government's ambitions as laid down in a "ten-year strategy" are laudable. However, as witnessed in Scandinavian countries, leave and childcare can become a heavy burden on public finances making it important to encourage cost-conscious behaviour.

- Developing support for childcare and nursery education should have priority over extending paid maternity leave. Policies can help to promote family-friendly work-place practices and already today mothers have a right to 12 months job-protected leave with 6 months being paid, rising to 9 months in 2007. Spending time at home is already favoured by the fact that income from work and consumption is taxed, while for natural reasons leisure is not. Prolonged absence from work leads to lower lifetime earnings for mothers and hence foregone tax revenue; the precise implications of slightly longer paid maternity leave are however not clear and there is a pay-off resulting from close contact between the mother and the young child. A prudent approach would be to focus on increasing the choice for parents on how leave is taken including on a part-time and perhaps shared basis, and to evaluate the effects of the 9 months paid leave before committing to the extension of paid leave to a full year.
- The quality and flexibility of the supply of childcare services should be developed including by allowing innovation and seamless integration of public and private services. Administrative systems underpinning the childcare element of the working tax credit, should be strengthened and alternative formulas considered. For example, shifting from reimbursement of 80% of costs to a combination of a fixed-value voucher and a 60% coverage of costs above the voucher value would give parents incentives to buy quality care but ensure cost consciousness about spending going beyond the voucher value. The government's intention to extend free preschool provision is welcome. In doing so, it will be important to integrate it with other care provisions so as to avoid complex logistical problems for families and to maintain a level playing field for public and private providers so that contestability drives innovation in how childcare is provided. ■

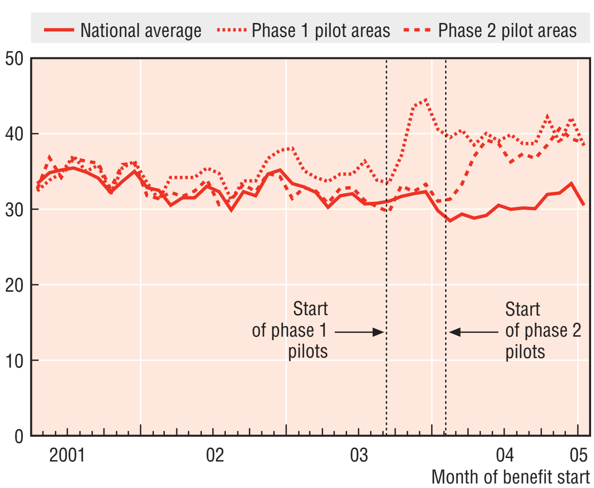
How successful has the new approach to disability benefit been?

While the unemployment rate is very low*,* the working age inactivity rate has remained stubbornly above 21% since the early 1990s recession. As many as 7% of 25-54-year-old men are inactive, compared with 1% three decades ago when the unemployment rate was at a similar level as now. This is partly a symptom of the general lack of skills, as inactivity has risen most for the least skilled. Yet, many end up claiming disability-related benefits, where the number of recipients, particularly prime-age men, has grown faster than in most other countries, with most of this growth occurring in the 1980s and early 1990s. They have recently started to decline. It is encouraging that many of the 2.6 million receiving incapacity benefits do not consider themselves as disabled, and many say they would like to work. At the same time, many people with disabilities are in work, not claiming benefits. This suggests that there is significant scope for helping people on incapacity benefits to return to work.

The government has taken a number of policy initiatives to address these problems. Under the *Pathways to Work* scheme, being piloted in 10% of the country at the beginning of 2005, most new incapacity benefit claimants are required to attend six, monthly, work-focused interviews soon after their move to incapacity benefit. This provides the potential for developing customised support to overcome the range of barriers which different individuals face in returning to work. New claimants are offered specialist employment advice, new programmes to help manage their conditions, access to a range of tailored support, plus £40 per week as a return to work credit. The pilots have been successful, showing a large increase in participation in reintegration programmes and a marked increase in exits from incapacity benefit Building on this, the government intends to require all except the most severely disabled to participate in activities that support a return to work and to restructure the incapacity benefit into a basic rate plus a supplement conditional on this activity. This represents a welcome

Figure 3. **"Pathways to work" increases the off-flow from incapacity benefit**

Six-month off-flow rate, per cent



Source: Department of Work and Pensions, September 2005.

change from the current situation whereby incapacity benefit is paid at a higher rate if received for more than a year, rewarding those remaining on benefit.

- The *Pathways to Work* programme will be extended to a larger part of the country from October 2005 to cover approximately a third of recipients by October 2006. The programme should continue to be rolled out nationally. The compulsory interviews have also recently been extended to some existing claimants with more manageable conditions in addition to new claimants. When there is sufficient capacity, it should be extended to a wider range of existing claimants.
- An issue of concern is the almost automatic transfer to incapacity benefit when statutory sick pay ends or when an individual becomes sick or disabled while claiming another benefit. General practitioners are the initial gatekeepers, with a more rigorous personal capability assessment taking place later on. Experience from other OECD countries indicates that leaving the decision to an "anonymous" team rather than general practitioners results in more rational decisions. It could therefore be considered to involve specialised occupational health teams earlier in the process of eligibility assessment and so make the transfer to incapacity benefit less automatic.
- The growing number of incapacity benefit recipients suffering from mental and behavioural disorders, which are now the largest group by medical condition, raises the question as to whether the recent rapid expansion of health care has been appropriately prioritised. Today, patients still have to wait for six to nine months to access psychotherapy while conditions often become more entrenched. With adequate treatment and rehabilitation many of those with mental health conditions may be able to get back to work, and providing some meaningful activity may further help such conditions. Shifting health care resources towards mental health would help both labour market performance and human happiness. ■

How can innovation performance be improved?

Across a range of conventional indicators, innovation performance is mediocre in comparison with the best performing OECD countries. Nevertheless, strengths in services, where innovation is less likely to be picked up by such indicators, probably mean that they under-state aggregate performance. For example: much of the R&D intensity gap with many of the top performing countries can be explained by industry mix effects; while patenting performance is mediocre there has been extremely rapid growth in other forms of intellectual property protection, such as the use of trademarks that are more prevalent in services; finally, while the share of researchers in total employment is unexceptional, this is not because of a shortage in PhD graduates in science and technology subjects. These considerations suggest a degree of caution is warranted in pursuing the government's targets specified in its recently announced "10-year Plan for Science and Innovation". At the same time the cross-country evidence linking innovation with aggregate growth performance implies that this should be a policy area under constant review, and there is a growing body of evidence which, while far from conclusive, is at least suggestive regarding which policies are most helpful in promoting innovation.

Recent OECD empirical work has confirmed that innovation performance depends both on framework conditions and specific policies regarding science and innovation. The study found the United Kingdom close to best practice in terms of framework conditions, but suggested scope for improving specific policies directed at science and innovation.

- The recent shift in emphasis away from grants towards tax incentives is likely to be beneficial in boosting R&D spending, although it is too early to judge the results. Given this lack of results, there is not yet a clear case for further extending the generosity of R&D tax incentives. Tax incentives should continue to be market based, and it is important to ensure that they are well understood by businesses and provide certainty that they will be maintained at existing levels.
- Despite a recent streamlining of fiscal measures to support R&D, there is still potential overlap between R&D tax incentives and remaining grant schemes. There is a need for improved evaluation of fiscal measures to support R&D as officially acknowledged. Future evaluations of all fiscal measures should also address the extent of overlap between different policy instruments, whether there are barriers to take-up in the services sector; whether measures encourage firms to become innovative (rather than increasing the extent of innovation already taking place within a firm). In addition, the balance of direct funding for R&D between SMEs and larger companies who receive most current support might need to be reconsidered.

There is scope to exploit the strength of the science base through further promoting university-business collaboration. The emphasis of current university funding on research excellence will help to foster elite universities which should attract increasingly mobile multinational companies. However, to compete with the best universities worldwide further changes will be required, including a streamlining of university governance procedures and clearer guidelines concerning intellectual property rights. Eventually, a higher cap on university fees may also be required to provide additional financial resources to attract and retain the best academic talent. In line with the recommendations of the *Lambert Review*, consideration should also be given to increasing the funding for those universities that have shown a track record of successful collaboration with businesses, which are not always the same universities that appear at the top of

Table 2. **The industrial structure and cross-country differences in R&D intensity**
Relative to the United Kingdom, percentage points, 2002[1]

	France	Germany	United States	Japan	Finland	Sweden
R&D intensity gap	**0.20**	**0.53**	**0.63**	**0.88**	**1.36**	**2.08**
Due to "within industry intensity"	0.04	0.14	0.68	0.35	0.61	1.51
Due to "industry mix"	0.16	0.39	–0.05	0.53	0.75	0.57
% of R&D intensity gap accounted for by:						
Within industry effect	20	27	107	39	45	73
Industry mix effect	80	73	–7	61	55	27

1. 2000 for Sweden and 2001 for the United States.
Source: OECD calculations based on the STAN and ANBERD databases, July 2005.

the academic rankings determining the bulk of university funding. ■

What effect do skills shortages have on innovation performance?

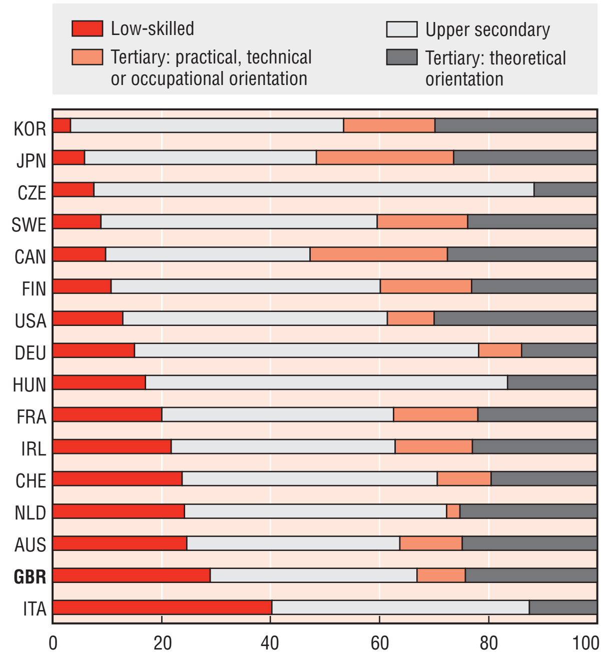
Recent OECD empirical work highlighted "absorptive capacity" as a particular weakness compared with other countries and the *Roberts Review* has drawn attention to falling numbers of graduates in science, engineering and technology (SET) subjects. Where the government has a direct responsibility, for example in the provision of science and mathematics teaching at secondary level or in the level of stipends paid to PhD researchers, it has responded to weaknesses identified in the *Roberts Review.* But given the relatively high number of SET graduates and success in some science-based industries, such as pharmaceuticals, it is difficult to argue that a shortage of researchers is a binding constraint.

To raise absorptive capacity policy should continue to focus on raising the low *general* skill level of the labour force. A relative lack of intermediate and vocational skills appears to be an important impediment to the economy's capacity to absorb innovations, explaining the comparatively low proportion of UK firms engaged in successful innovations. Indeed, while the number of persons having university and advanced research degrees (PhDs) is not much different from that in comparable countries, the United Kingdom has a large share of pupils leaving school before completion of the upper secondary level and without an education giving specific competence in a professional field. The government's broad aim that all young people continue in learning until at least the age of 18 and its more specific target for educational participation at age 17 to rise from the current 75% to 90% over the next ten years are therefore welcome.

- Although schools have improved a lot during the 1990s, more could still be done to improve basic literacy and numeracy, thus providing a stronger foundation for continued learning. Tackling school truancy and raising the aspirations of children from a less advantaged background is equally important.
- Continuously improving the relevance and quality of vocational programmes is as important as it is to expand their provision. A key factor determining the success of such an expansion will be that the vocational route gains esteem *vis-à-vis* academically-oriented secondary education – something that appears to be lacking more in the United Kingdom than elsewhere. The government's initiative to establish city academies in disadvantaged neighbourhoods with intensive involvement of businesses should help in this respect, but teething problems have to be resolved.

Figure 4. **Educational attainment of the population aged 25-34 years**[1]

2003



1. "Low-skilled" comprises persons having primary school, lower secondary school or ISCED 3C short programmes as their only formal qualification. Upper secondary includes post secondary non-tertiary programmes. Tertiary type A includes type B for Czech Republic, Hungary and Italy.

Source: OECD (2005), *Education at a Glance*.

- Unifying the current array of vocational programmes and diplomas into a limited number is important to make them more attractive for students as well as employers. Although the government's white paper on the educational offer for 14-19-year-olds did not take the full step recommended by the *Tomlinson Review* to unify all vocationally and academically-oriented programmes into one type of diploma, it does imply a significant step towards simpler and more up-to-date vocational diplomas giving students better pathways later on. It is now essential to work with universities to ensure that the new diplomas give sufficient pathways to continued education including with foundation degrees.

- For adults, workplace-based training should be expanded nationally as planned from 2006-07 following a pilot introduced in 2002. The programme is focused on the least skilled with public funding of the full cost of brokers and training. In return, employers offer time off for participating employees, although about half of all training hours have been covered by publicly funded wage compensation during the pilot phase, with small and medium-sized enterprises typically receiving complete wage compensation. When implementing the programme from 2006-07, wage compensation should be used only sparingly as an "ice breaker" to create a culture of learning within the hardest-to-reach firms. ■

Do taxes and benefits weaken incentives to aquire skills?

Whether efforts to expand and improve the offer of education and training will be fully effective, may also depend on financial incentives to acquire human capital. While in-work tax credits help to boost labour force participation, their means-tested withdrawal leads to high marginal effective tax rates which reach 70% for families with children at below-average income. This attenuates market signals for intermediate skills, because even though *gross* earnings are considerably higher for people with intermediate skills than for the low-skilled, *net* earnings are not very different for households with children. However, for those adults who are functionally illiterate and for school-tired teenagers with problems of truancy, incentives related to future earnings are *not* likely to matter much since more fundamental factors keep them from acquiring intermediate skills. But for others it may be an impediment. While the tax credit reforms over recent years have successfully reduced child poverty while maintaining incentives to work and removing the worst peaks of high marginal effective tax rates, the effect for the average person in a couple with children has been to push up marginal effective tax rates by 5 percentage points. It would therefore be useful to better understand how much taxation of subsequent earnings matters for the propensity of teenagers and adults to make use of the improved education and training on offer. There are also specific issues relating to the short-term incentives for young persons. Paying teenagers who continue in education such as with the Education Maintenance Allowance pilots appears to boost engagement in continued learning. An alternative or additional option is to increase the very light taxation faced by teenagers taking a job at 16 rather than continuing in education. ■

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