

McKinsey & Company, London
McKinsey Global Institute



November 2010

From austerity to prosperity: Seven priorities for the long term



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Kevin Sneader
Charles Roxburgh
Jonathan Dimson
Grey Baker
Karen Croxson
Tim McEvoy
Robert Stillwell
Fraser Thompson
Max Tse
Joycelyn Williams
James Wise

Preface

From austerity to prosperity: Seven priorities for the long term is a joint effort between the London office of McKinsey & Company and the McKinsey Global Institute (MGI), the Firm's economics and business research arm. We have looked at the opportunities for the UK to achieve and sustain robust growth over the longer term. The report is part of a broader ongoing MGI research effort on the topic of growth and renewal.

This project was led by Kevin Sneader, Managing Partner, UK & Ireland, Charles Roxburgh, a Director of MGI, and Jonathan Dimson, a Partner in London. The project team comprised Grey Baker, Karen Croxson, Tim McEvoy, Robert Stillwell, Fraser Thompson, Max Tse, Joycelyn Williams, and James Wise. We are grateful for the advice and input of many McKinsey colleagues, including Michael Barber, Dominic Casserley, Hugh Harper, Nicolaus Henke, Jan Mischke, and Robin Nuttall, as well as several experts acknowledged in specific sections of this document. The team also benefited from the contributions of Tim Dickson, who provided editorial support; Andrea Minton-Beddoes, Ian Gleeson, and John Cheetham on external relations; and Laurence Parc and Georgina Buck, visual graphics specialists.

Distinguished experts outside McKinsey provided invaluable insights and advice. We would particularly like to thank Jonathan Haskel, Professor of Economics at Imperial College and Martin N. Baily, a Senior Adviser to McKinsey and a Senior Fellow at the Brookings Institution. Several other experts in academia, government and industry have offered invaluable guidance, suggestions, and advice.

This report contributes to the debate around the challenges and opportunities facing the UK as we move from recession to what we hope is sustained and balanced growth. As with all MGI research, we would like to emphasise that this work is independent and has not been commissioned or sponsored in any way by any business, government or other institution.

Kevin Sneader
Managing Partner
UK & Ireland

Charles Roxburgh
Director
McKinsey Global Institute

Jonathan Dimson
Partner
London

November 2010

Challenges and opportunities


The UK's GDP per capita growth was the **highest** in the G-7 over 1994–2009

Since 1990, the UK has closed a productivity gap of over **10%** with the EU-15

Manufacturing drove over **25%** of productivity growth between 1995 and 2007

The UK has **50%** of all European headquarters for multinationals

The UK has **19** of the top 100 global universities



Productivity in the UK is
17% lower than
in the US

£350bn of transport
infrastructure investment is
needed over the next 20 years

The share of the British population
considering entrepreneurship
as a career path is **18** percentage
points lower
than in the US

An ageing population is predicted
to reduce economic growth by
0.3 percentage points
per annum in the future

Around **50%** of growth
over the past decade has been
concentrated in Greater London
and its neighbouring regions

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Executive summary

LONG-TERM PROSPERITY DEMANDS A MORE PRODUCTIVE, BROAD-BASED AND RESILIENT ECONOMY

A successful, dynamic economy must be productive, broad-based, and resilient. In these respects, the United Kingdom's recent economic record has been mixed.

Over the last 15 years the UK's productivity growth has been encouraging, matching the strong performance of the United States and closing the productivity gap with the EU-15. Overall productivity levels, however, are still 17 percent below the US and 10 percent lower than those of Germany.

The UK enjoys relatively high rates of labour participation (nearly five percentage points higher than the OECD average) and relatively low unemployment. But regional imbalances remain a concern—around half of economic growth over the past decade was concentrated in Greater London and its neighbouring regions—and too much recent employment growth has been in the public sector (from 1999 to 2009, the public sector workforce grew by 800,000).

The UK, meanwhile, is well-placed to survive and thrive in a modern global economy and should be able to benefit from growing demand from consumers in rising markets like India and Eastern Europe. However, there is a need to build resilience by managing down high public deficits and private debt levels, and taking practical steps to offset the economic effects of our ageing population.

THERE ARE SEVEN PRIORITIES TO DRIVE LONG-TERM GROWTH

Small changes to the long-term growth rate will have a far larger impact over the next two decades than anything that changes the short-term outlook. Specifically, a downward shift in long-term GDP growth from 2.5 percent per annum down to 1.5 percent per annum would reduce aggregated growth in GDP between now and 2030 by nearly 30 percentage points. This could reduce output by as much as £400bn in 2030.

Beyond the downturn, we believe there are seven priority areas that if tackled will allow the UK to achieve sustained growth over the next two decades:

1. **Focus on raising productivity sector by sector to drive overall growth.** To drive overall growth it is “within sector” productivity that matters, not sector mix. Public policy often focuses on innovative niches (e.g., semiconductors) rather than on the largest sectors whose productivity is low by comparison with global best practice. Service sectors (e.g., retail trade, business services) represent around 65 percent of private sector output and account for much of the productivity gap with countries such as the US and Germany. Government can lead efforts to improve productivity by working with sector participants and new entrants to remove barriers to growth (such as regulatory burdens, land use restrictions) and support improvements in managerial quality and employee skills.
2. **Secure the UK's position as the location of choice for multinationals.** Multinationals may account for less than two percent of UK businesses, but they drive

overall economic growth and large-scale innovation, accounting for 80 percent of UK R&D, and growing productivity eight times as fast as smaller firms. Government should work with leading multinationals on a ten-year plan to make the UK the most attractive European location for multinationals, addressing skills, immigration, infrastructure, and tax.

3. **Unlock infrastructure investment.** The UK will need to spend more than £350 billion over the next 20 years merely to maintain its existing transport infrastructure and a further £120 billion – £170 billion to support its energy infrastructure. This level of investment will require greater regulatory certainty and improved economic returns to attract private capital. In energy, for example, agreement is necessary on how the UK's decarbonisation targets will be met. In transport, a priority is to create additional funding streams to fund road investment via, for example, higher fuel duties.
4. **Innovate at scale.** Government efforts to stimulate the growth of clusters have often ended in failure. Past McKinsey research has shown that only half of clusters have grown faster than the overall economy. Achieving success requires concentration of investments in research into large and connected centres, access to global best practice through the recruitment of top talent, and cluster-specific support that builds on existing competitive advantages (e.g., in biosciences).
5. **Unleash the growth potential of education and health.** Education is a huge market—the OECD estimated that in 1980 just over a million students were enrolled at universities and colleges outside their country of origin; that number has now tripled to 3.3 million. This is a significant growth opportunity. For example, educating international students is Australia's third largest export industry. Meanwhile, UK health care could be a £200 billion industry by 2030. The UK needs to think about these sectors as international growth opportunities rather than public sector cost centres. This will require new and existing universities to add capacity and capability to attract international students. In addition, NHS organisations need to be able to restructure and compete for private patients without restrictions, while additional private capital will be needed to meet rising health care demand in the UK.
6. **Pilot devolution to dynamic cities.** Cities have been responsible for 78 percent of the UK's economic growth over the last ten years. Given the urgency of supporting growth across the UK, now is the time to experiment with options and give cities much greater city-wide coordination roles and financial responsibility, including, for example, the flexibility to negotiate regional as opposed to nationally agreed public sector pay and the freedom to strike local financial deals with investors.
7. **Address generational imbalances.** Demographic trends pose two challenges for major developed economies such as the UK. The first is how to maintain growth in the face of a declining working population (estimated to be a 0.3 percentage point annual drag on GDP growth). The second is how to fund long-term health and social care, where demand is set to rise by more than 70 percent in the next 20 years. The UK needs a radical increase in older working, leveraging the practices of innovative firms and ensuring these are spread more widely. Unlocking the £1 trillion of unmortgaged housing wealth owned by those over 60 through equity release would also enable older generations to make a greater contribution to paying for the public services they need.

1. Looking back: How has the UK economy performed?

The UK economy has become more prosperous since 1994 thanks to increased labour productivity and the maintenance of a high level of employment participation. As a result, the UK's GDP per capita has grown faster than other G-7 economies over the past 15 years. However, the UK still lags behind leading European countries and the US in productivity and more needs to be done to remove barriers such as land use regulations and to address the underlying factors that drive productivity such as skills, management quality, and infrastructure. Moreover, despite reasonable overall progress, economic growth has not been sufficiently broad-based and many regions have fallen behind the national average. High levels of private sector debt, a large public deficit, and a disproportionate dependence on financial services and the housing sector for taxation have increased the economy's vulnerability to external shocks. In addition, past reliance on the public sector for job growth and an ageing population raise additional concerns about the economy's future resilience.

To assess the past performance of the UK economy, we need first to define the criteria against which to judge success

A successful, dynamic economy must be productive, broad-based, and resilient. There is little consensus on the most appropriate metrics with which to assess an economy's overall progress. Many have challenged the traditional approach of looking solely at GDP, or GDP per capita, as too narrow to reflect overall well-being. A recent commission established by President Sarkozy has examined whether more comprehensive measures may be more useful.¹

We agree that wider indicators of development and progress need to be considered.² However, many of the things that we value highly, including good health, safe and fast transport, education, parks and recreational facilities, and social inclusion, depend to some extent on economic output. The focus of our analysis is therefore to examine changes in GDP per capita—the value of the final goods and services produced in the economy in a given year, relative to the size of the population. GDP per capita is generally accepted as the best available single metric for economic activity and standard of living. It also has the advantage of being widely available in data records (see box 1, “The limitations of GDP”).

1 The “Commission on the Measurement of Economic Performance and Social Progress” established by the French government in 2008 has examined other measures of well-being (beyond GDP per capita). The Commission, chaired by Professor Joseph E. Stiglitz and including Professor Amartya Sen, distinguishes between an assessment of current well-being and an assessment of sustainability.

2 See for example Newsweek's alternative country ranking (<http://www.newsweek.com/2010/08/16/best-countries-in-the-world.html>)

Box 1. The limitations of GDP

GDP is the value of the final goods and services produced in the economy in one year. It is generally accepted as the best available single metric for economic activity and standard of living; data are widely available; and it correlates with many measures of “welfare”, particularly in less-developed countries. However, it does have several limitations.

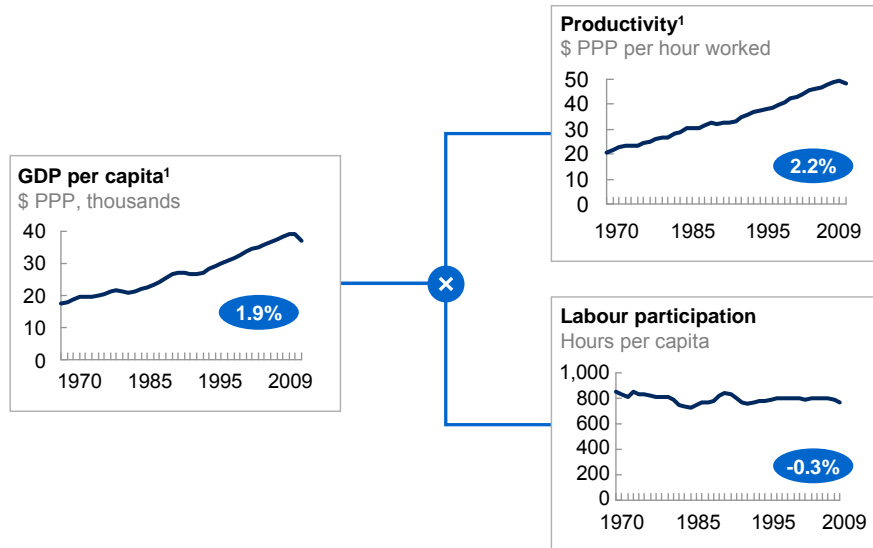
GDP does not include several aspects relevant for “welfare” measurement—consumer surplus (the value customers attribute to products or services beyond the price paid), wealth distribution beyond averages, be it via earnings spreads or transfers, depletion of resources, unpaid activities, environmental costs, depreciation, leisure.

GDP faces other limitations—non-market activities are valued using expenditures, so typically the value of many public sector services is calculated by reference to their cost; imputed values are less reliable than measured values (e.g. imputed rents); inclusion of products that are not a source of utility but are necessary (e.g., prisons, defence).

Moreover, looking at total GDP rather than GDP per capita can, during times of population growth, create a misleading impression of relative economic success. For instance, over the past 15 years, US GDP has grown at a rate of 2.6 percent annually compared to 1.8 percent in the EU-15. However, due to strong population growth in the US, the per capita growth rates are almost identical (1.5 percent in the US versus 1.4 percent in the EU-15). So, the perceived US economic outperformance versus Europe turns out largely to be a factor of its population growth.

Productive. The long-term driver of GDP per capita is productivity—the output per hour of an employed worker. We know from economic theory that productivity drives GDP growth and that the resulting economic surplus can benefit consumers in the form of better products or lower prices, employees in the form of higher salaries, or investors in the form of higher profits. We see this in practice too—past growth in average incomes in the UK and other developed countries is the direct result of strong rises in productivity per hour, offsetting falling hours worked per capita (Exhibit 1). Lagging productivity explains 86 percent of the UK’s income gap with the US.

However, focusing solely on productivity provides a narrow assessment of the performance of an economy. For instance, it neither takes wealth distribution into account nor reflects how the economy is positioned relative to emerging trends such as globalisation and demographic shifts. For these reasons, we also consider two additional factors—the extent to which growth is broad-based and the degree to which it is resilient to shocks.

EXHIBIT 1**Productivity has been the key driver of past UK growth**X.X% CAGR², 1970–2009

1 Expressed in US dollars at 2009 EKS PPPs

2 Compound annual growth rate

SOURCE: The Conference Board; McKinsey Global Institute; IMF; Eurostat

Broad-based. It is critical to consider whether growth is broadly shared across regions and between individuals. This is partly an issue of social equity and partly an issue of stability. If growth is concentrated in a very small subset of the population, there will be political pressures for redistribution (which could slow growth, e.g., by calls for protectionism or higher taxes) and there may also be pressures for the less successful to take on debt in order to match the lifestyles they see others enjoying. Therefore, over the long term, the benefits of economic growth need to flow to all citizens, at least to some extent. Useful pointers to this are the share of the working-age population that participates in the labour force and the extent to which the labour force is employed. In addition, understanding the regional distribution of these labour market characteristics, as well as productivity, can help understand how wealth is shared across the country. Metrics such as growth in income for different deciles of income distribution also provide important insights.

Resilient. The final factor to consider is the extent to which the economy can cope with future shocks. In other words, is growth “future-proofed”? The economy must be on a firm footing to adapt to any potential shocks as well as to long-term trends such as an ageing population and the growth of emerging markets. McKinsey’s “Global Forces” work has highlighted many of these trends (see box 2, “Understanding global forces”).³

Past MGI work has highlighted a number of factors associated with productive, broad-based, and resilient economies (Exhibit 2). Over the course of nearly two decades, MGI has found that competitive intensity within sectors (not sector mix) is critical for driving

3 Bisson, Peter, Elizabeth Stephenson, and S. Patrick Viguier, “Global forces: An introduction,” *McKinsey Quarterly*, June 2010.

sector productivity.⁴ This competitive intensity is driven by factors in the external environment (e.g., planning laws, product market restrictions) that shape the competitive dynamics of a sector. Productivity is also boosted by cross-sectoral factors, many of which are often overlooked by policymakers (e.g., management capabilities). Broad-based growth is supported by well-functioning labour markets and education policies that incentivise participation and ensure basic employability, as well as by empowering regions to develop locally tailored economic strategies. Resilience is driven by ensuring financial stability through sustainable public finances and low systemic risk in financial markets; having diversified sources of growth; and aligning the economy with future trends, such as an ageing population and climate change.

EXHIBIT 2

Framework for long-term growth: Critical drivers

Productive
<ul style="list-style-type: none">▪ Competitive intensity within sectors, not sector mix▪ Growth drivers (e.g., skills, innovation, management capabilities, infrastructure, capital investment)
Broad-based
<ul style="list-style-type: none">▪ Flexible labour markets▪ High participation (women, seniors, youth)▪ Basic skills for employability▪ Empowered cities and regions
Resilient
<ul style="list-style-type: none">▪ Financial stability (sustainable public finances, low systemic risk)▪ Diversified sources of growth▪ Alignment with future trends (e.g., ageing, emerging markets, climate change)

The UK has made significant progress on creating productivity, but growth has not been sufficiently broad-based or resilient

Overall, the performance of the UK economy against this scorecard has been mixed. On productivity, the UK economy has performed well. The UK has almost closed the productivity gap with the EU-15 and tracked the US over a period in which US productivity growth has been strong. However, more remains to be done—productivity per hour is still roughly 17 percent lower than the US.

4 For further detail, see McKinsey Global Institute, *How to compete and grow: A sector guide to policy*, March 2010.

Improvements in productivity and economic growth have also been uneven. The UK has relatively high participation rates (nearly five percentage points higher than the OECD average) and low overall unemployment (during 2004–08, unemployment of those aged 25 and above averaged 3.6 percent versus 6.5 percent in the EU-15 and unemployment rose less in the UK than in the rest of the EU and the US during the crisis). However, high youth unemployment (on average 13.6 percent of the workforce aged below 25 were unemployed during 2004–08) and imbalances in regional incomes remain concerns. Around half of the economic growth over the past decade has been concentrated in Greater London and its neighbouring regions. Many other regions have lagged significantly, for example, growth in the West Midlands has been almost a full percentage point lower than the national average. Employment and participation rates vary markedly between regions, but large productivity differences are most striking. In 2008, gross value added per hour worked was over 50 percent higher in London than in Wales.

The resilience of the UK economy was weakened by high private sector debt and high public deficits. Whilst the UK is potentially well-positioned to benefit from the rise of some emerging markets such as India, the economy is still vulnerable to shocks due to continuing high debt levels and the country's ageing population. Unless retirement patterns change, demographic trends will reduce annual economic growth rates by around 0.3 percentage points to 2030. Current trade patterns are also strongly skewed towards slower growing, more developed markets.

1.1 PRODUCTIVE ECONOMY

The UK has significantly improved its productivity, but there is ground to make up relative to the best performers

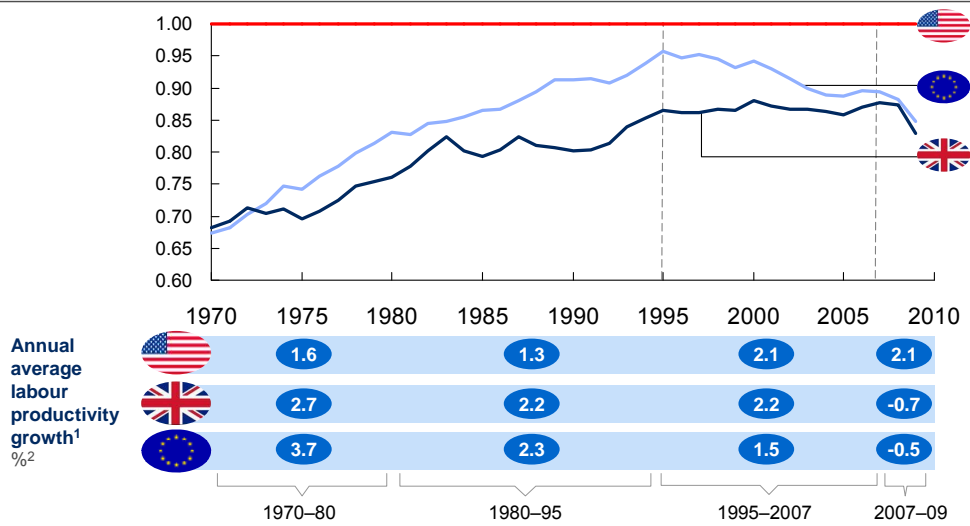
The UK's performance on productivity over the past 15 years has been robust. It narrowed the productivity and output gaps with the US between 1970 and the mid-1990s—tracking strong US productivity growth thereafter—and over the last 40 years has nearly closed the productivity gap with the EU–15 average (Exhibit 3), which had widened during the 1970s.

Despite this progress, UK productivity remains roughly 17 percent lower than that of the US, 14 percent lower than that of France and around 10 percent less than that of Germany (Exhibit 4). The UK's GDP per capita is actually higher than those of both France and Germany due to higher hours worked per capita (reflecting higher participation and employment rates, as well as longer hours worked per employed worker). When estimating productivity per worker (rather than per hour), productivity in the UK is similar to that of France and higher than in Germany because UK workers spend more time at work than their European counterparts. However, the productivity gap with the US is even greater on a per worker basis because of the longer average working hours in the US.

EXHIBIT 3

The UK closed the productivity gap with US up to 1995, after which the gap stabilised until 2007

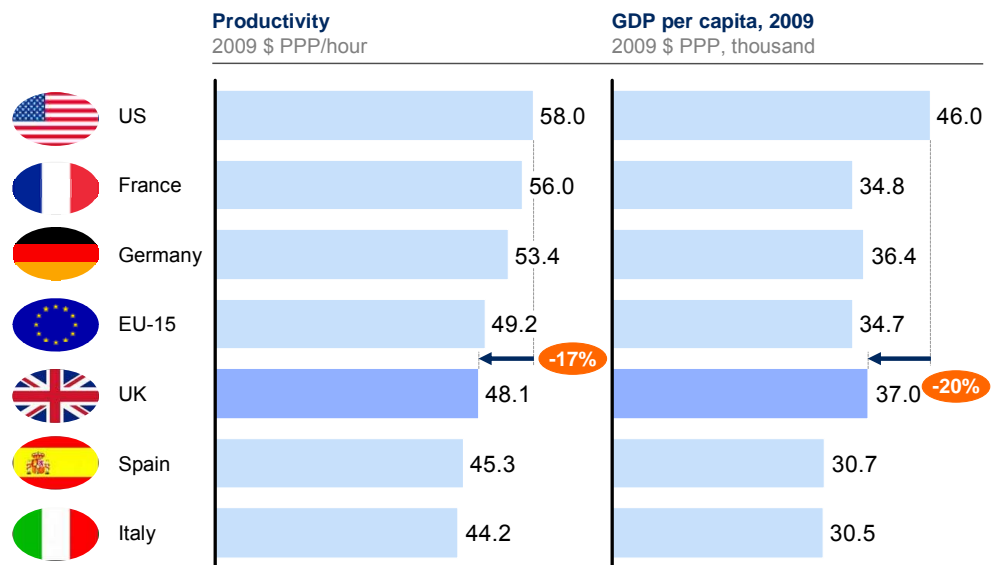
Labour productivity indexed to US = 1



1 Real, expressed in USD at 2009 EKS PPPs; EU is EU-15 and excludes new member countries
 2 Data until 2009 – The 2005–2008 picture is slightly different, with UK at 1.8%, US at 1.2% and EU-15 at 1.0%
 SOURCE: The Conference Board; IMF; Statistics.gov.uk; McKinsey Global Institute

EXHIBIT 4

Labour productivity remains below US and leading European levels



SOURCE: The Conference Board; IMF; McKinsey Global Institute

Past MGI work has identified two broad sets of factors that drive sector performance:

- **Competitive dynamics:** MGI studies over the course of nearly two decades in more than 20 countries and 28 sectors have highlighted how the operational decisions of businesses (product / format mix, scale, capacity utilisation and the like) influence productivity in different sectors; they have also demonstrated that these operational decisions are in turn driven by factors in the external environment (such as zoning laws and product market restrictions) that shape the competitive dynamics of a sector.
- **General enablers:** Beyond competitive dynamics, there are several cross-sector factors that underpin growth. Most important of these are skills, innovation, infrastructure and management quality.

The performance within sectors, not sector mix, has driven this performance

Earlier research by MGI has shown that productivity performance within each sector matters more than an economy's sector mix.⁵ As can be seen in Exhibit 5, the entire productivity gap between the UK and the US, and between the UK and Germany, is due to the productivity performance within individual sectors of the economy. In neither instance does sector mix, i.e., the relative shares of different sectors, explain differences in productivity. Indeed, when compared with the US and Germany, the UK has a higher proportion of activity in sectors that typically have high productivity.

Much of the “within sector” productivity gap with the US is driven by the service sectors

Local services (for example, retail trade), business services (such as advertising) and professional and financial services account for almost two-thirds of the “within sector” productivity gap compared with the US (Exhibit 6).⁶ Productivity growth in many service sectors has been relatively strong; however, continuing barriers to competition and the weakness of critical factors (such as skills and infrastructure) can explain the remaining gaps in best practice, which we will address in further detail in Section 2.

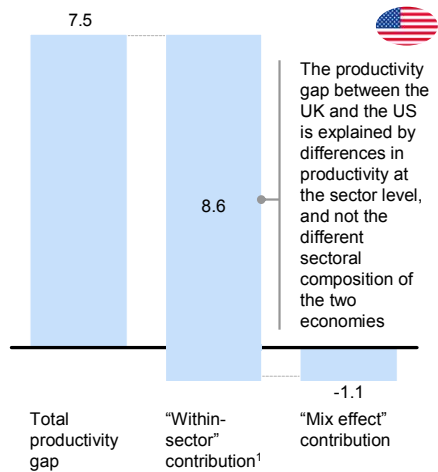
5 There are exceptions to this rule. Our analysis excludes mining due to different endowments of natural resources. It also excludes real estate, health, education, and public services due to measurement and comparability issues. Norway's oil industry alone gives it a US\$11 per hour productivity advantage over the economy in the US—90 percent of Norway's total advantage. For a more detailed discussion see McKinsey Global Institute, *How to compete and grow: A sector guide to policy*, March 2010.

6 See the Appendix for further detail on the categorisation of sectors in this report.

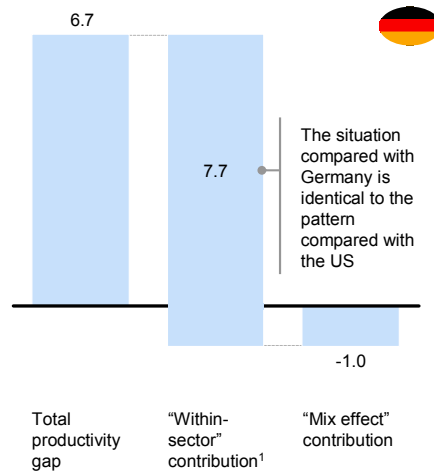
EXHIBIT 5

The productivity gap with the US and Germany is explained by differences in productivity within sectors rather than the sector mix

Labour productivity gap UK vis-a-vis US
 2005 \$ PPP per hour worked



Labour productivity gap UK vis-a-vis Germany
 2005 \$ PPP per hour worked



¹ The "within-sector" contribution is calculated as the gain in the country-wide average productivity that would be achieved if the UK sector mix was kept constant and the productivity of each sector was the same as in the US
 SOURCE: EU-KLEMS; McKinsey Global Institute analysis

EXHIBIT 6

The "within sector" gap with the US is driven by service sectors

2005 productivity levels and gap, 2005 \$ PPP per hour worked

Sector	UK Productivity	US Productivity	Productivity gap %	Contribution to productivity gap 'within effect'
Primary resources	53	54	-1	0
Manufacturing	39	49	-20	-1.2
Infrastructure - utilities	104	99	5	0.1
Infrastructure - construction	28	32	-13	-0.3
Infrastructure - transport	28	35	-20	-0.3
Local services	21	30	-30	-2.5
Business services	20	34	-40	-1.3
Professional and financial services	50	66	-24	-1.6
Public	45	34	33	2.3
Total¹	37	44	-17	-8.6

¹ Total does not represent sum of individual sectors due to exclusion of the real estate sector. Comparisons between real estate data are not very meaningful because of the impact of imputed rent and because value added depends on capital much more than on labour
 SOURCE: EU KLEMS; McKinsey Global Institute analysis

Manufacturing is a strong contributor to recent productivity growth

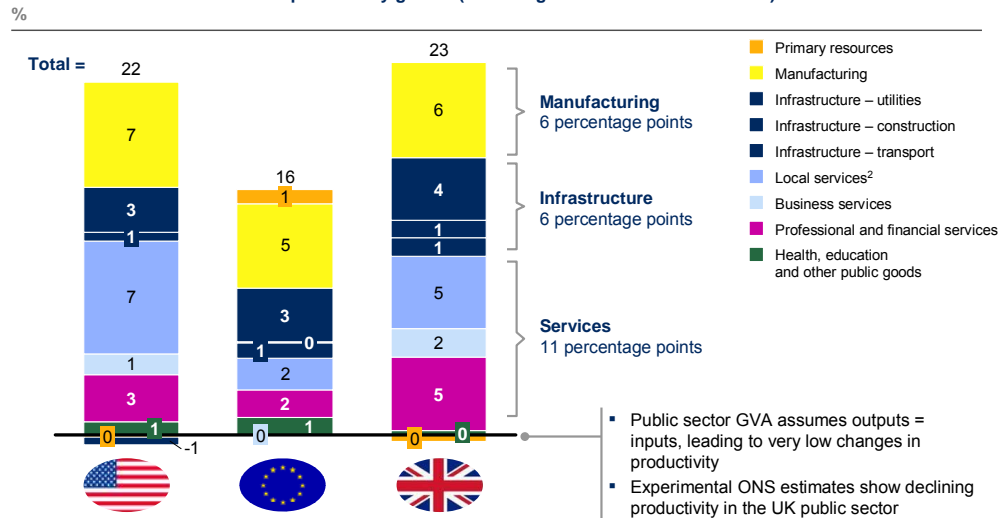
Many commentators continue to argue that the UK is too dependent on financial and professional services, and that manufacturing is suffering from neglect. Whilst financial and professional services represent a higher share of the UK’s overall output and productivity growth than in other countries, the differences are less than many people believe. For example, professional and financial services represented around 15 percent of GDP in 2007, whereas in the EU-15 it was 11 percent and in the US it was 14 percent. The differences in productivity growth are also small (Exhibit 7). Professional and financial services contributed 5 percentage points out of the UK’s total of 23 percentage points of productivity growth from 1995 to 2005, versus two and three percentage points in the EU-15 and US respectively.⁷ Financial and professional services were important contributors to productivity growth, but are only part of the story.

The contribution of manufacturing to productivity growth, meanwhile, has accounted for over a quarter of overall productivity growth since 1995. The contribution of manufacturing to overall productivity growth in the UK has actually been greater than in Europe over the same period (6 versus 5 percentage points), despite manufacturing representing a small share of the overall economy in the UK than in Europe (12 percent of versus 18 percent of GDP in 2007).

EXHIBIT 7

Manufacturing has been a strong contributor to productivity growth

Sector contribution to 1995–2005 productivity growth (excluding real estate and mix effects)¹



¹ Mix effects reduced productivity growth by 3% in each of the US and UK, and 1% in the EU-15; real estate productivity has been excluded due to difficulty of measuring and comparing labour productivity in this area

² Retail, wholesale, hotels and restaurants, renting of machinery and equipment, other community, social and personal services, private households with employed persons

SOURCE: EU KLEMS; McKinsey Global Institute analysis

7 Total productivity growth over this period was 16 percentage points in the EU-15 and 22 percentage points in the US.

Significant numbers of jobs have been lost in UK manufacturing

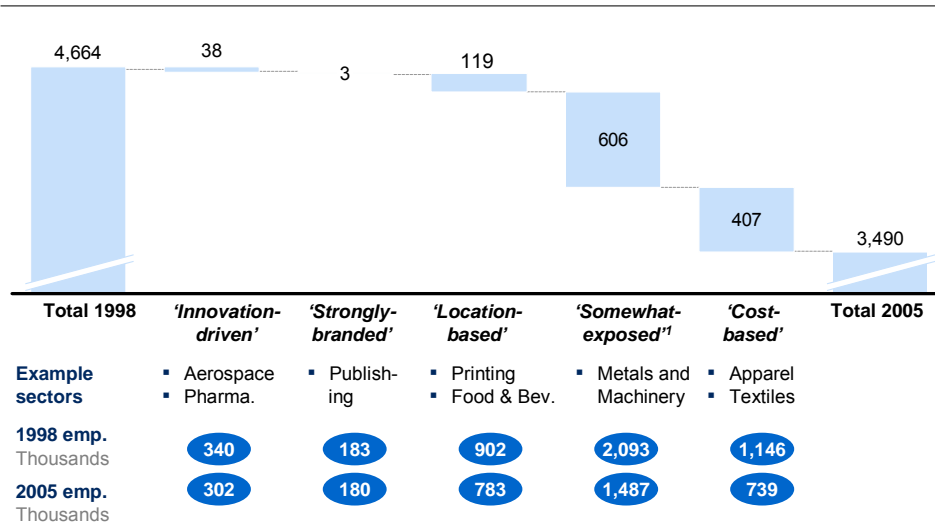
So what has driven this productivity growth in manufacturing? At a high level it is due to significant job losses in the sector since total output grew by only 0.3 percent per annum from 1995 to 2005. However this aggregate picture conceals important differences in the performance of different subsectors within UK manufacturing. Building on a methodology used by MGI in a study of French industry⁸, it is possible to gain a better understanding of the drivers of productivity growth by separating industrial sectors into five groups defined by the nature of their competitiveness challenge:

- **Innovation-driven.** Sectors relying heavily on technology that have long and costly R&D cycles; in which competition is centred heavily on innovation; where a handful of leading companies exert a powerful spillover effect on subcontractors or related sectors. Examples include aircraft and spacecraft, railroad and transport equipment, and pharmaceuticals. These sectors accounted for about nine percent of industrial employment in the UK in 2005.
- **Strongly-branded.** Sectors in which brand image, sustained through continuous innovation in design and conception, is essential; where it is critical to have an in-depth understanding of consumer expectations to respond quickly to market developments, or the ability to shape them (for example, publishing). Combined, these sectors accounted for about five percent of UK industrial employment in 2005.
- **Location-based.** Sectors characterised by a strong need for proximity to market, because of difficult or costly transportation. Examples include food manufacturing and printing. These sectors accounted for about 22 percent of UK industrial employment in 2005.
- **Somewhat-exposed.** Sectors characterised by competition on product quality and innovation as well as strong pressure on prices; and facing a growing competitive threat from emerging countries. Examples include automotive, telecommunications equipment and electrical machinery. These sectors accounted for about 43 percent of UK industrial employment in 2005.
- **Cost-based.** Sectors where competition hinges mainly on price and the cost of transporting products is not a barrier; in which the relative importance of the labour costs of a product gives emerging countries a decisive advantage. Examples include apparel, electrical consumer goods, and small home appliances. Combined, these sectors accounted for about 21 percent of UK industrial employment in 2005.

Much of the employment loss in manufacturing has come from the restructuring of sectors whose UK prospects are particularly challenged by competition from low cost countries. Industrial sectors where competition is largely price-based (i.e., “somewhat-exposed” and “cost-based”) have accounted for around 85 percent of total industrial job losses since 1998 (Exhibit 8).

EXHIBIT 8**Much of the productivity gain in manufacturing has come from necessary restructuring in sectors with limited growth prospects****Change in direct industrial employment, 1998–2005**

Thousand



¹ Defined as sectors where competition is based on a mix of cost and differentiation
 SOURCE: EU KLEMS Database; McKinsey Global Institute analysis

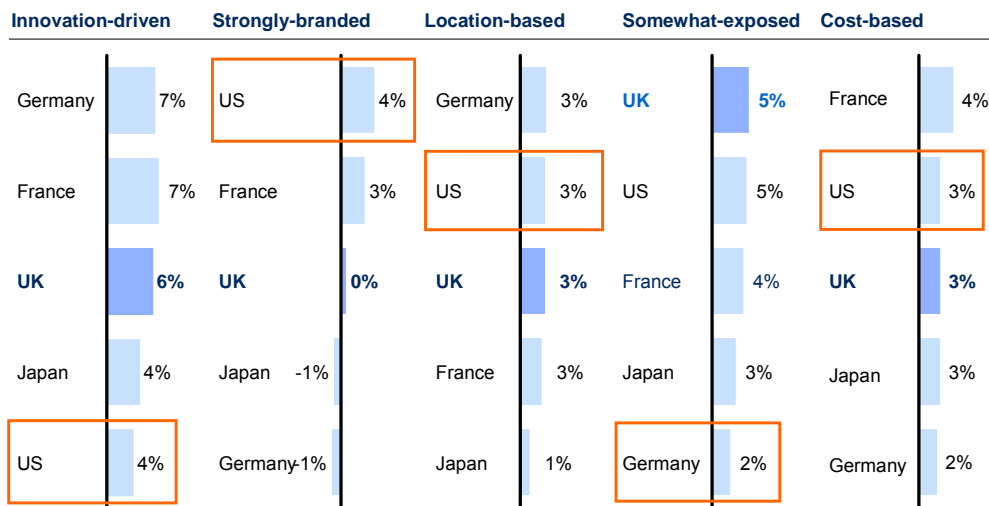
Whilst painful, this restructuring should strengthen the overall UK industrial sector by focusing manufacturing on areas where the UK has the best chance of competing in the long term. The UK cannot—nor should it—aspire to compete in those sectors of manufacturing that are purely cost-based and where it would have to compete with countries where the cost of labour is considerably less than in the UK. The UK's industrial future lies in sectors where competition is based more on innovation and skill. Here the story is more encouraging. Employment has been lost in these more innovative sectors as well, but at a much lower rate than in the more “cost-based” sectors. For example, “innovation-driven” sectors lost 38,000 jobs from 1998 to 2005, equivalent to a fall of 1.7 percent per annum (versus 4.8 percent and 6.1 percent in the “somewhat-exposed” and “cost-based” sectors respectively). Reflecting the competitiveness of many UK companies in these sectors, the productivity growth in the “innovation-driven” sectors was a substantial 6.1 percent annually—higher than the productivity growth of the US in these sectors over the same period (Exhibit 9).

EXHIBIT 9

Restructuring has helped improve competitiveness in manufacturing sectors to some degree

Productivity leader

Labour productivity growth rate in industrial segments, 1998–2005
 Compound annual growth rate, %



Note: Data for Computers and Radio & TV equipment is unavailable
 SOURCE: EU KLEMS database; McKinsey Global Institute analysis

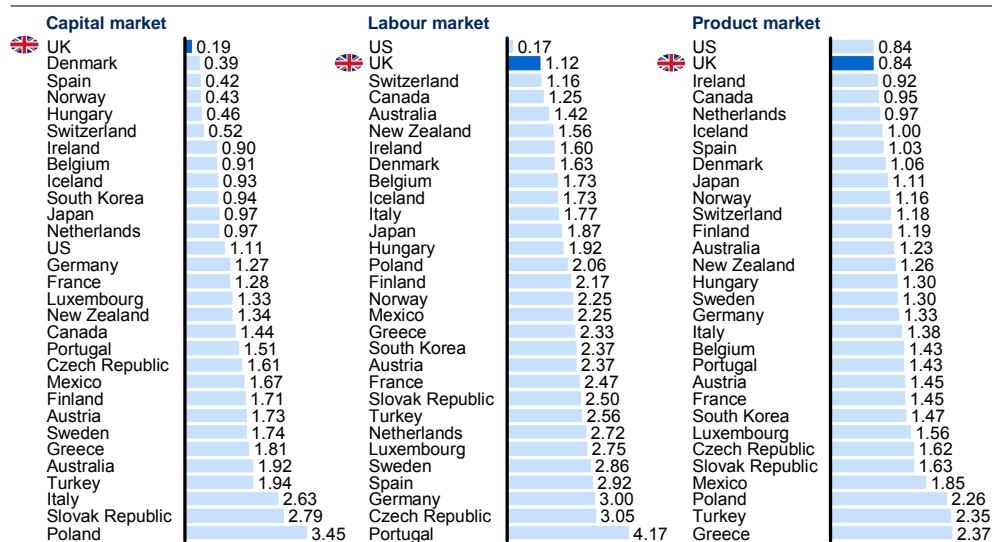
Ensuring a sustainable and vibrant industrial sector in the future will require the UK to focus on innovative areas where it stands the best chance of competing, whilst also addressing critical issues such as skills and management quality.

The UK’s sector performance has been driven by strong market flexibility spurring competition, but some gaps remain in other areas

Strong labour, capital, and product market flexibility—qualities for which the UK is ranked either first or second in the OECD (Exhibit 10)—have spurred competitive dynamics. For example, regulatory changes such as the unbundling of the “local loop” and innovations in mobile telephony encouraged new competition in the telecommunications sector and increased the annual rate of productivity growth by 20 percent.

EXHIBIT 10**Flexible capital, labour and product markets have underpinned recent growth****Restrictiveness of various markets¹, OECD countries 2010**

Indices between 0 and 5, lower being less restrictive



¹ Indices are 'Barriers to foreign direct investment'; 'Protection for regular employment'; and 'Restrictiveness of economy-wide product market regulation'
SOURCE: OECD, 2010

However, gaps still remain in market regulations and more can be done to improve areas such as:

- **Planning.** Planning remains a burden despite several reports and papers addressing the issue, including the Planning Bill (2008). A survey by the Killian Pretty Review of 2008 found that only 3 out of 64 planning applications went ahead without difficulties, while over half encountered substantial problems. According to the National Audit Office, planning laws create the highest regulatory costs of any type of regulation.
- **Skills.** The proportion of the so-called STEM (science, technology, engineering, and mathematics) graduates has fallen in the last ten years, while more people are doing medicine, social sciences or general business degrees. Around 57 percent of senior executives lack confidence in their ability to access high-skilled employees in the future. In the automotive sector for example, 40 percent of firms say that recruiting skilled technical employees is a challenge with 33 percent of qualified engineers due to retire in the next ten years and graduates increasingly choosing to work in the service sectors. Less than 25 percent of engineering graduates went into manufacturing jobs in 2007.
- **Innovation.** Clusters in the UK are smaller and growing more slowly than their US and Asian counterparts, and entrepreneurship is relatively weak. The share of the British population interested in entrepreneurship is 18 percentage points lower than in the US.⁹

⁹ Bosma, Neils, Kent Jones, Erkko Autio and Jonathan Levie, "2007 Executive Report," *Global Entrepreneurship Monitor*, 2008.

- **Management capability.** According to joint McKinsey / London School of Economics research, UK management scores are ten percent lower, on average, than the US, and the UK has a “long tail” of low-performing firms.¹⁰
- **Infrastructure.** The UK does not compare well internationally, being ranked 33rd in a World Economic Forum survey of infrastructure quality. More businesses rate infrastructure as a barrier to growth than they do workforce education and skills.

1.2 BROAD-BASED ECONOMY

The UK has performed relatively well in terms of participation and employment

Unemployment and participation rates in the UK compare relatively favourably to those of similar countries:

- **Participation.** A relatively high proportion of the UK’s working age population participates in the labour force. Overall participation is nearly 79 percent—over five percentage points higher than the OECD average and even higher than that of the US (77.9 percent). Female participation is particularly high (78.5 percent) compared with other countries—almost eight percentage points higher than the OECD average. Part of this seems to be attributable to increasing educational attainment of women in the UK—in 1995, only 46 percent of women aged 25–64 had at least an upper secondary education; by 2008, this had risen to 70 percent. Public expenditure on child care benefits is also fractionally higher than the European average (0.4 percent versus 0.3 percent).
- **Unemployment.** From 2004 to 2008, unemployment of those aged 25 and above averaged 3.6 percent versus 6.5 percent in the EU-15. Whilst unemployment has increased during the financial and economic crisis, UK levels still compare favourably to most OECD countries. From the onset of the crisis in March 2008 to July 2010, unemployment in the UK rose 2.6 percent, lower than in both the EU-15 (2.8 percent) and the US (5.1 percent). However, youth unemployment remains high—on average 13.6 percent of job seekers aged less than 25 were unemployed in the period 2004–08, which is still less than the EU-15 average over the same period (15.6 percent), but considerably more than the average in countries such as the Netherlands (6.8 percent) and Denmark (8 percent).¹¹

However, there are still large variations in regional incomes

While the UK’s GDP growth over the last ten years has been strong, around half of this has been concentrated in Greater London and its neighbouring regions. Many other parts of the economy lagged significantly behind: for example, the West Midlands experienced growth almost a full percentage point lower than the national average between 1997 and 2007, and almost two percentage points lower than Greater London. The average difference in national GDP per capita and GDP per capita in the regions is 29 percent in the UK, versus just 14 percent in Sweden (Exhibit 11). If each of the lagging regions had grown at the same 2.8 percent rate as the country as a whole, the UK would be £38 billion, or 2.7

10 Bloom, Nick, Stephen Dorgan, John Dowdy and John van Reenen, *Management practice & productivity: Why they matter*, McKinsey & Company, November 2007.

11 For a review of how the Netherlands has managed to reduce youth unemployment, see McKinsey Global Institute, *Beyond austerity: A path to economic growth and renewal in Europe*, October 2010.

percent, better off. Future growth at this rate—rather than at the historic trend—would be worth £130 billion in 20 years time, i.e., an additional 7.5 percent on total GDP and an acceleration of 0.4 percentage points per annum in the growth rate.

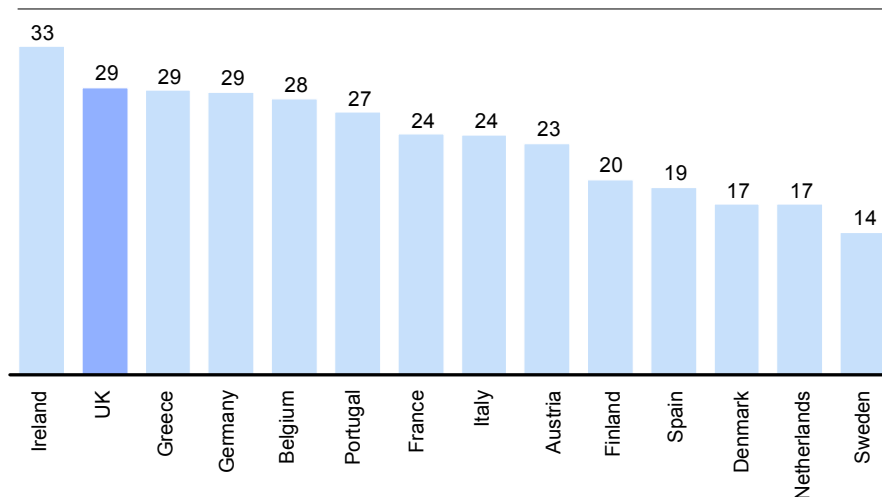
Figures released recently by the Office for National Statistics (ONS) also show that the regional distribution of employment varies widely. For example, in Liverpool, Nottingham, and Glasgow, over 30 percent of households are workless.¹²

EXHIBIT 11

UK regional dispersion is larger than in other countries

Dispersion of regional GDP per capita

Average regional difference from national GDP per capita¹, 2007
%



¹ EU-15 minus Luxembourg. The dispersion of regional GDP (at NUTS level 3) per inhabitant is measured by the sum of the absolute differences between regional and national GDP per inhabitant, weighted with the share of population and expressed in percent of the national GDP per inhabitant. The dispersion of regional GDP is zero when the GDP per inhabitant in all regions of a country is identical, and it rises if there is an increase in the distance between a region's GDP per inhabitant and the country mean.

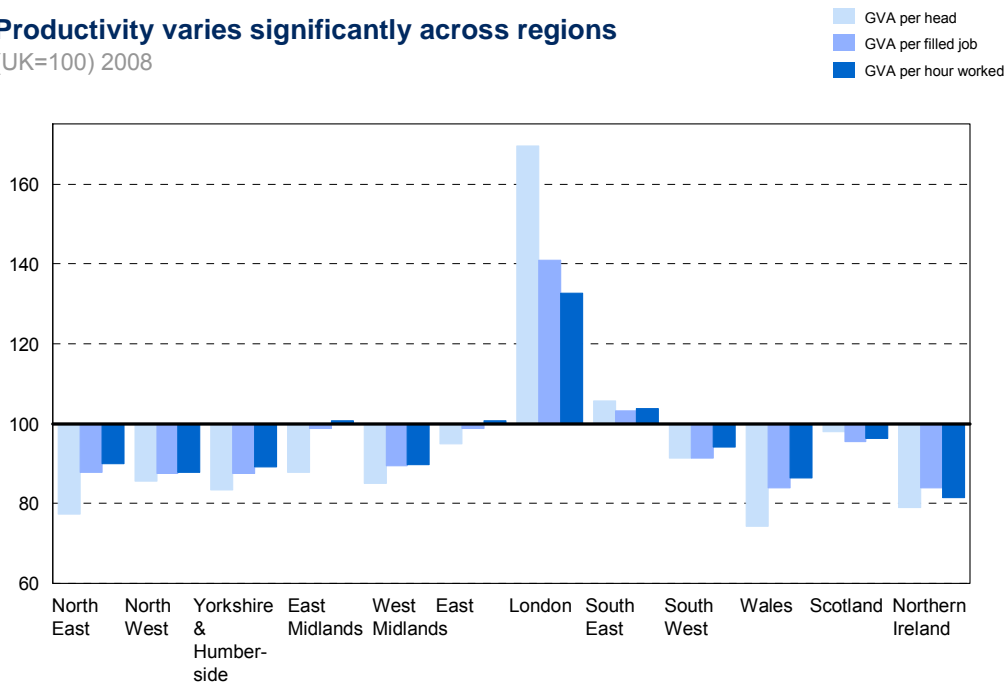
SOURCE: Eurostat

Regional differences can be explained both by labour market dynamics and productivity. For example, there is a 10 percentage point gap in participation rates between the best performing region (South East) and the worst (Northern Ireland). Regional employment levels vary considerably and many regions are overreliant on the public sector (the public sector accounts for 45 percent of employment in some regions). There are also large gaps in productivity. For example, the ONS found that gross value added per hour in 2008 was over 50 percent higher in London than in Wales (Exhibit 12).

EXHIBIT 12

Productivity varies significantly across regions

(UK=100) 2008



SOURCE: Office for National Statistics Regional Economic Indicators

1.3 RESILIENT ECONOMY

Past UK growth became too dependent on high private and public sector debt, which will have a negative impact on future growth

In common with other developed regions around the world, the UK has built up substantial levels of private and public debt as a direct consequence of the first global recession since World War II.

Before the crisis, the UK had the lowest stock of public debt (relative to GDP) of any of the G-7 countries. However, (net) government debt had already begun to rise well before the crisis, from 30 percent of GDP in 2002 to 36 percent in 2007.¹³ Government debt has since ballooned as a result of the bank bailouts, falling tax revenue and public spending aimed at stimulating economic recovery. Net public debt in the UK has already risen above 50 percent and is due, on Office for Budget Responsibility (OBR) projections¹⁴, to peak at around 70 percent by 2014. The OECD expects gross public debt levels in the UK to reach 78 percent of GDP in 2010 (Exhibit 13). European Central Bank researchers have concluded that gross government debt levels above 90–100 percent of GDP are usually

13 Public Sector Net Debt (PSND) records most financial liabilities issued by the public sector less its holdings of liquid financial assets, such as bank deposits. PSND is the main measure used in the UK. The EU's Excessive Deficit Procedure focuses on General Government Gross Debt.

14 These projections were made as part of the June 2010 budget.

associated with lower long-term growth rates, and that the negative impact may even start from around 70–80 percent.¹⁵

The UK government is now committed to a period of austerity that will return the public finances to a sustainable level. Macroeconomists can debate whether the size or timing of the cuts were appropriate. What is already clear is that the public sector will no longer be a driver of growth in the way that it was in the past.

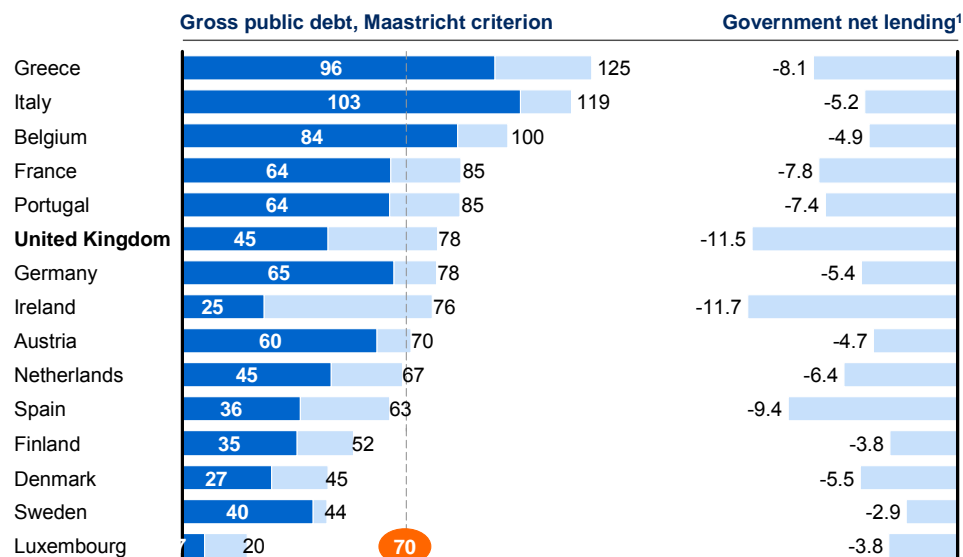
The public sector has been a major contributor to job growth (adding, for example, an additional 800,000 employees from 1999 to 2009) but the OBR now expects 610,000 job losses in the public sector by 2016.

EXHIBIT 13

As in other European countries, public debt in the UK has risen above 70 percent of GDP

% of GDP, 2010 projection

■ 2007 level



1 Differs from the Maastricht definition in that it does not include streams of payments and receipts from swap agreements and forward rate agreements.
SOURCE: OECD Economic Outlook Database, 2010

At the same time, households are likely to reduce spending in order to wind down existing levels of debt. In 2007, before the onset of the global financial crisis, the UK's household debt to disposable income level was 22 percent higher than in the US. Recent MGI research has demonstrated that deleveraging has followed nearly every major financial crisis since World War II and that this is usually a long and difficult process.¹⁶ Although there are instances of economies deleveraging through default, high inflation or by simply growing out of debt, the most common type of post-crisis deleveraging is belt-tightening.

15 Checherita, Cristina and Philipp Rother, *The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation for the Euro Area*, European Central Bank Working Paper Series Number 1237, August 2010. See also Reinhart, Carmen M., and Kenneth S. Rogoff, "Growth in a Time of Debt," *American Economic Review*, May 2010, Volume 100, Number 2.

16 McKinsey Global Institute, *Debt and deleveraging: The global credit bubble and its economic consequences*, January 2010.

MGI analysis shows that such efforts have lasted an average of six to seven years and reduced total debt to GDP by about 25 percentage points. In nearly every episode MGI examined, GDP growth declined in the first one to two years of the deleveraging process but then rebounded, even while deleveraging continued. Deleveraging may prove even more painful this time. In the past, such episodes involved one economy or a few relatively small economies, but today's crisis is global in scale.

The UK is well-positioned to benefit from some emerging trends

Despite the near-term challenges of deleveraging, the UK is well-placed to benefit from longer-term structural trends in the world economy (see box 2, "Understanding global forces). By 2020, 40 percent of the world's population will be middle-income, up from 20 percent today, and India, where the UK has strong historical links, will be a key driver of this growth—91 million urban households in India will be middle-income by 2030 according to McKinsey estimates, up from 22 million today.¹⁷

The UK is also well-positioned to take advantage of a gathering shift towards greater resource productivity. Natural resources underpin ten percent of global GDP, and demand for oil, coal, iron ore, and other natural resources will rise by at least a third over the next decade. Whilst this potentially puts a brake on growth, it also represents an opportunity. For example, it is expected that \$2 trillion will be invested in clean-energy capacity globally over the next ten years, providing significant opportunities for UK sectors such as advanced manufacturing. In addition, rapid advances in biosciences are likely to propel a new wave of innovation and economic growth, on a scale potentially equal to the Information and Communications Technology (ICT) revolution. The UK is already well placed in biosciences (e.g., with two of the world's five leading pharmaceutical companies headquartered in the UK) and could, with the right policies, be a major beneficiary from these developments. Finally, English language skills are likely to remain an enduring competitive advantage for the UK in a world in which English increasingly is becoming the international language of business.

¹⁷ For more detail on India's urbanisation and growth trends, see McKinsey Global Institute, *India's urban awakening: Building inclusive cities, sustaining economic growth*, April 2010.

Box 2. Understanding global forces¹⁸

“I never think of the future,” Albert Einstein once observed. “It comes soon enough.” Most business managers and policymakers, confronted with the global forces shaping the business and economic landscape, also assume that their ability to sculpt the future is minimal. They are right that they can do little to change a demographic trend or a widespread shift in consumer consciousness, but they can react to such forces or, even better anticipate them to their own advantage. Above all, they ignore these forces at their peril. McKinsey has analysed key global trends that will define the coming era. We have identified five forces, or crucibles, where the stress and tension will be greatest and which thus offer the richest opportunities for companies to innovate and change:

The great rebalancing. This decade will mark the tipping point in a fundamental long-term economic rebalancing that will likely leave traditional Western economies with a lower share of global GDP in 2050 than they had in 1700. By 2020, more than half the world’s GDP will be generated in developing countries. This growth will not only create a wave of new middle-income consumers but also drive profound innovations in product design, market infrastructure, and value chains.

The productivity imperative. Developed world economies, particularly those with ageing populations, will need to generate pronounced gains in productivity to power continued economic growth. In many cases, all of a country’s future growth will need to be driven by productivity improvements. For instance, Europe needs to accelerate its rate of productivity growth by 30 percent simply in order to match its past rate of GDP per capita growth. Sustaining necessary improvements in productivity will require a step change in investment in infrastructure in the developed world, on top of continued investment in new infrastructure in emerging markets.

The global grid. The global economy is growing ever more connected. Since 1990, trade flows have grown 1.5 times faster than global GDP. Cross-border capital flows have expanded at three times the GDP growth rate. Information flows have increased exponentially. Complex flows of capital, goods, information, and people are creating an interlinked network that spans geographies, social groups, and economies in ways that permit large-scale interactions at any moment.

Pricing the planet. Natural resources and commodities account for roughly ten percent of global GDP and underpin every single sector in the economy. Rising demand for resources, constrained supplies, and changing social attitudes towards environmental protection are in collision. The next decade will see an increased focus on resource productivity, the emergence of substantial clean-tech industries and regulatory initiatives.

The market state. The often contradictory demands of driving economic growth and providing the necessary safety nets to maintain social stability have put governments under extraordinary pressure. The state, far from withering away, is likely to play an ever-larger role over the next decade. Debt levels in OECD countries are likely, on average, to rise to 120 percent by 2014—up from less than 80 percent today. And over the next 20 years, governments will need to face up to their off-balance liabilities for pensions and health care. This will force radical reconsideration of the role of the state in many developed economies.

18 Bisson, Peter, Elizabeth Stephenson, and S. Patrick Viguerie, “Global forces: An introduction,” *McKinsey Quarterly*, June 2010.

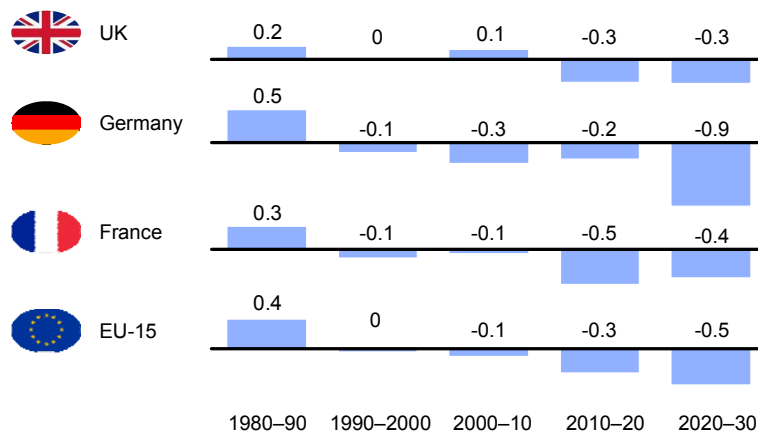
However an ageing population will pose a sizeable challenge to growth

Assuming no changes in patterns of work, the falling share of the working population relative to the UK’s total population will hinder GDP growth in the future. Over the past 30 years, the working population has grown relative to the total population, adding about 3 percent to total GDP per capita. However, between 2008 and 2050, the proportion of people aged 65 and over is projected to increase from 16 percent to 24 percent. Unless retirement patterns change, these demographic trends could result in a drag on growth of 0.3 percentage points every year (Exhibit 14). The UK is in a better position than the rest of Europe, but the impact still amounts to 6 percent of GDP in total over the next 20 years. A long-term growth strategy needs to be able to tackle these inter-generational issues, to avoid creating unsustainable imbalances and placing unmanageable obligations upon younger generations in the UK.

EXHIBIT 14

Effect of changing age mix will hamper GDP growth in the next decades

Contribution of share of working-age population growth to yearly GDP per capita growth¹
 Percentage points



¹ Under ceteris paribus assumptions on labour utilisation and productivity.
 SOURCE: United Nations Population Division

2. Going forward: Seven priorities for long-term growth

This report takes a long-term horizon and considers priorities for the UK to sustain growth over the next 20 years. Now is the time to move on from recent discussions about the UK’s short-term fiscal position and outlook and to think about what will drive growth in the long term.

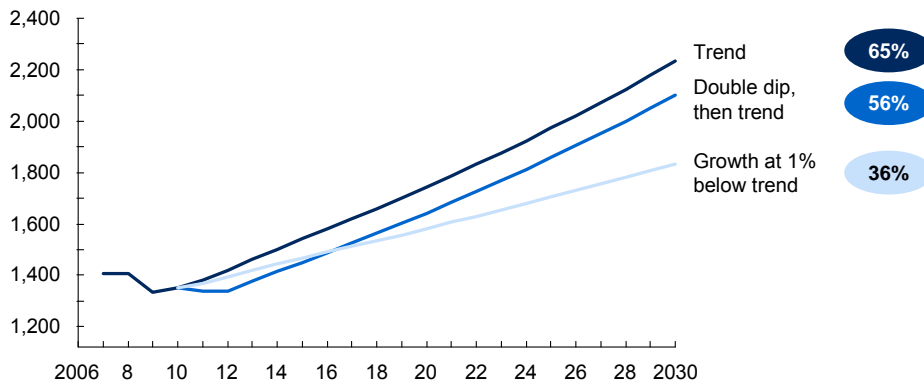
Small changes to the long-term growth rate will have a far larger impact by 2030 than anything that changes the short-term outlook. Exhibit 15 illustrates this point. A double dip in the short term would reduce the cumulative increase in output over the next 20 years from 65 percent to 56 percent, assuming trend growth of 2.5 percent per annum. A one percentage point reduction in that trend growth rate would cut total growth to 36 percent—a far more significant reduction. This could reduce output by as much as £400 billion in 2030.

EXHIBIT 15

Weak long-term growth hurts the UK far more than a double dip ILLUSTRATIVE

UK GDP to 2030 under various scenarios
2007 £, billion

Total increase



Note: Baseline trend on OBR data to 2015 and then UK historic growth rate of approximately 2.5%
 Double dip projected as 1% decline in 2011, stagnation in 2012, and then return to trend growth
 Low growth projected at one point below trend from 2011 onwards
 SOURCE: Office for Budget Responsibility; McKinsey Global Institute analysis

We believe that there are seven priority areas that, if tackled, will allow the UK to achieve sustained growth over the next two decades. Addressing them will deliver the objective of a dynamic and prosperous economy by improving productivity, supporting a broad base of sectoral and regional employment and opportunities, and creating resilience against external shocks and long-term trends.

The first question to address is how best to drive productivity growth in the private sector, particularly given that any strategy risks developing into a policy of actively "picking winners."

Sections 2.1 to 2.4 set out steps that can be taken and where policy has an active role to play: to focus on sector-level actions to remove barriers to growth and improve skills; to ensure that the UK is attractive to companies that drive up competitive intensity and productivity; to stimulate investment in infrastructure and; to support innovative activities in ways that capture the benefits of concentration in clusters but leave room for individual experimentation and competition. Section 2.5 looks at the role of health and education, sectors which have largely been publicly funded and provided. While the importance of productivity improvements in this sector are well recognised, this section considers how the UK could rethink its approach to health and education to unleash further productivity gains and economic growth.

Steps to increase productivity and remove barriers to growth will help to create a more broad-based and resilient economy, but more also needs to be done. The importance of social and economic inclusion is well recognised, as is the role of basic skill development and education, but in this report we consider two areas where we believe there are particular opportunities that have not yet been fully explored. Sections 2.6 and 2.7 look at two elements of supporting broad-based growth and building future resilience – devolving power to dynamic cities and addressing the effects of an ageing population.

2.1 FOCUS ON RAISING PRODUCTIVITY SECTOR BY SECTOR TO DRIVE OVERALL GROWTH

Sector productivity is what matters. This can be achieved through sector-specific efforts to remove barriers to growth, supporting economy-wide improvements to inputs (particularly skills and management capabilities) and increasing real and perceived competition.

Sector-specific analysis is needed to identify the barriers to productivity and growth

As shown in our analysis of the UK's past growth, it is productivity within sectors—not sector mix—that is the key to increasing overall UK productivity.¹⁹ Over the course of nearly two decades, MGI has used sector-level research in multiple countries and sectors, employing insights from microeconomic analysis to build a picture of macroeconomic outcomes. We believe that this micro-to-macro approach is the key to identifying drivers of better productivity.

MGI has previously highlighted how the operational decisions of businesses (e.g., product or format mix, scale, capacity utilisation) influence productivity in different sectors; it has also demonstrated that these operational decisions are in turn driven by factors in the external environment (e.g., planning laws, product market restrictions) that shape the competitive dynamics of a sector.²⁰ Competition can increase productivity in three main ways. First, competition encourages managers to reduce inefficiencies.²¹ For example, research by McKinsey and the London School of Economics has shown a strong correlation between the level of perceived competition and management quality, which in

19 See the Appendix for further detail on the categorisation of sectors in this report.

20 For further detail, see McKinsey Global Institute, *How to compete and grow: A sector guide to policy*, March 2010.

21 See Meyer, Meg A. and John Vickers. "Performance Comparisons and Dynamic Incentives," *Journal of Political Economy*, 1997, Volume 105, Number 3; Schmidt, Klaus. "Managerial Incentives and Product Market Competition," *Review of Economic Studies*, 1997, Volume 64, Number 2.

turn is linked closely to productivity growth in firms. Second, through changes in market share and entry/exit rates, competition reallocates resources towards the most productive firms (improving allocative efficiency).²² Finally, competition exposes firms to new ideas and provides an incentive for firms to innovate.

Service sectors are often overlooked but have large potential for impact if barriers to competition and growth are removed

Public policy tends to focus on innovative sectors (e.g., semiconductors, solar energy), which are generally too small to create economy-wide impact. Service sectors, meanwhile, are the largest drivers of job growth in the UK but tend to be overlooked. Service sectors (e.g., local services such as retail trade, business services) represent around 65 percent of private sector output and account for much of the productivity gap between the UK and US, and between the UK and Germany. Improving service sector productivity also has large spillovers to other sectors—by allowing companies to reduce their costs and boost competitiveness; by creating incentives for globally competitive businesses to increase their own productivity²³; and by releasing employment to support the growth of other sectors.

In retail, for example, the UK has made progress on the productivity front, but still lags behind the US, France and Germany. MGI examined the retail trade in its 1998 report on the UK economy.²⁴ At the time, labour productivity in the food retail sector in the UK was at three-quarters of US levels, held back in part by land use restrictions that inhibited retail expansion and prevented retailers from enjoying the full benefits of scale. Since 1998, the sector has performed relatively strongly, with labour productivity growth faster than in other G-7 countries. Market leaders such as Tesco have opened a large number of highly productive stores, gaining share at the expense of low-productivity food specialists and raising average productivity in the sector. The average Tesco Express is almost three times as productive as an independent food specialist (in terms of sales per square foot); the number of Tesco Express stores has grown by 50 percent annually from 2002 to 2007, whilst other food specialist stores have shrunk by 4 percent (Exhibit 16).

However, despite this encouraging performance, productivity in the UK retail sector still lags behind the US level by more than 20 percent and also remains lower than in Germany and France. There are two important reasons for this. First, there is a limited number of high-productivity, large-format stores—which are five times as productive as traditional stores—due largely to restrictive planning regulations (Exhibit 17).

22 Resources at the industry level were allocated less efficiently across firms in countries where service regulations are less market friendly. For further detail, see Arnold, Jean, Giuseppe Nicoletti, and Stefano Scarpetta, *Regulation, Allocative Efficiency and Productivity in OECD Countries: Industry and Firm-Level Evidence*, OECD Economics Department Working Paper Number 616, OECD Publishing, 2008.

23 The exact relationship between competition and innovation is disputed. There is evidence of a positive relationship between competition and innovative activity at the industry level, e.g., Nickell, Stephen, "Competition and Corporate Performance," *Journal of Political Economy*, August 1996, Volume 104, Number 4, 724–746 and Blundell, Richard, Rachel Griffith, and John Van Reenen, "Market Share, Market Value and Innovation in a Panel of British Manufacturing Firms," *Review of Economic Studies*, July 1999, Volume 66, Number 3, 529–554. Others find that the impact of competition on innovation depends on specific industry characteristics, e.g., Aghion, Philippe, Nick Bloom, Richard Blundell, Rachel Griffith, and Peter Howitt, "Competition and Innovation: An Inverted U Relationship," *Quarterly Journal of Economics*, 2005, Volume 120, Number 2, 701–728. See Nicoletti, Giuseppe and Stefano Scarpetta, "Regulation, Productivity and Growth: OECD Evidence," *Economic Policy*, CEPR, 2003, Volume 18, Number 36, 9–72, for evidence that competition has the greatest positive effect on productivity in sectors behind the technology frontier.

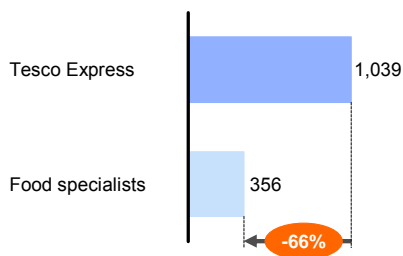
24 McKinsey Global Institute, *Driving productivity and growth in the U.K. economy*, October 1998.

EXHIBIT 16

The opening of high-productivity local stores by market leaders led to share gain from smaller stores and increased average productivity

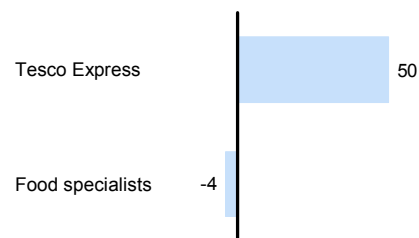
The average Tesco Express is nearly three times as productive as a food specialist ...

Sales density by store type
 £ per sq foot



... and strong growth in Tesco Express stores has been crowding out traditional stores

Growth rate in number of stores by store type 2002-07
 Compound annual growth rate, %



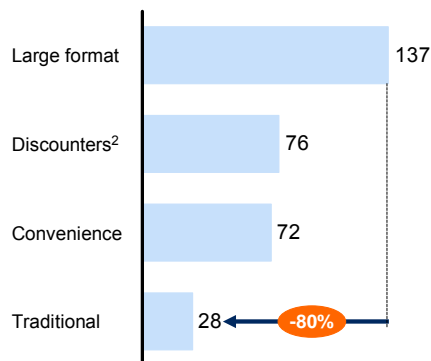
SOURCE: IGD; Verdict; McKinsey Global Institute analysis

EXHIBIT 17

In retail, there is variable performance among different formats, and the UK has a large number of small, low-productivity stores

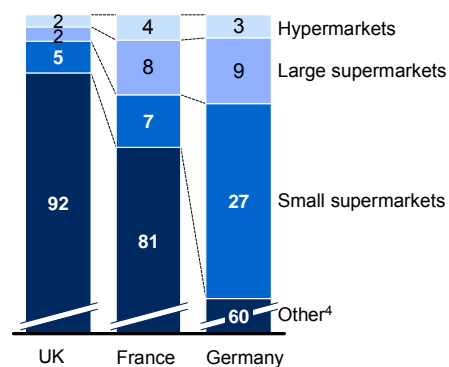
There is a high variability in performance among different store formats ...

UK productivity¹ by format, 2008
 Indexed to UK grocery sector = 100



... and the UK has a large number of small-format stores compared to peers

Number of stores by format³, 2006
 % of total stores



1 Calculated as turnover per square foot.
 2 Discounters operate large-format stores but have been separated out from other large-format retailers.
 3 Hypermarkets = Grocery stores greater than 2500 sq metres; Supermarkets = Grocery stores between 1,000 and 2,500 sq metres;
 Small supermarkets = Grocery stores between 300 and 1000 sq metres; Other = Grocery stores that are smaller than 300 sq metres.
 4 Other = Traditionals such as butchers, bakers, greengrocers, fishmongers, and other food specialists.
 SOURCE: IGD; Nielsen

Second, infrastructure is a critical driver of productivity in retail. The UK's high dependence on motorways for freight, along with one of the lowest motorway densities amongst developed countries, high road utilisation, and chronic congestion, adds an estimated £10 billion a year to the freight costs of business. Closing the remaining productivity gaps in retail trade will require lifting these barriers.

Sector-specific initiatives must be supported by efforts to better align skills with sector needs and to boost management quality and competitive intensity

Employers complain about gaps in management and technical skills in the best systems, but the extent of concerns in the UK suggests that the workforce often is ill-equipped for industry. The proportion of so-called STEM (science, technology, engineering, and mathematics) graduates has fallen in the last ten years, while more people are doing medicine, social sciences, or general business degrees. Many of the STEM graduates and the majority of postgraduates are non-UK residents, who may or may not be willing (or able) to stay in the UK for the long term. Some 57 percent of senior executives lack confidence in their ability to access high-skilled employees in the future. In the automotive sector, for example, 40 percent of firms say that recruiting skilled technical employees is a challenge, with 33 percent of qualified engineers due to retire in the next ten years and graduates increasingly choosing to work in service sectors. Less than 25 percent of engineering graduates went into manufacturing jobs in 2007.

One way to improve productivity and skills is to find ways of better matching the needs of employers with the incentives of those who provide education and also the choices made by students. Measures of university performance place little weight on employability factors, and one of the leading league tables of university rankings gives them no weight.²⁵ Recent proposals on higher education funding should increase pressure to align supply with demand and employability.

Management quality is also a concern. McKinsey, together with the Centre for Economic Performance at the London School of Economics, has examined the relationship between management quality and firm performance. Over the years, we have conducted interviews with more than 6,000 manufacturing companies across 19 countries in North and South America, Europe, Asia, and Australasia, focusing on 18 dimensions in three major areas: (1) lean operations; (2) performance management; and (3) talent management.

Management quality has been found to have a strong impact on productivity and output. For example, an improvement of one point on a scale of one to five in the quality of management practices is correlated with an improvement of six percentage points in total factor productivity. A single point improvement in management practice score is associated with the same increase in output as a 25 percent increase in the labour force or a 65 percent increase in invested capital.

There is significant variation in management performance in the UK, with a large proportion of low-performing firms. UK management scores are ten percent lower than the US on average, with a long tail of low-performing firms (Exhibit 18). For example, 7 percent of UK firms were assessed as "poor" on management quality, versus less than 2 percent in the US. A number of factors are associated with poor management practice scores.

- First, competitive intensity is highly correlated with better management. Managers who report fewer perceived competitors tend to have lower management practice scores, and

25 Times Higher Education's 2010–2011 World University Rankings. Methodology available at: <http://www.timeshighereducation.co.uk/world-university-rankings/2010-2011/analysis-methodology.html>.

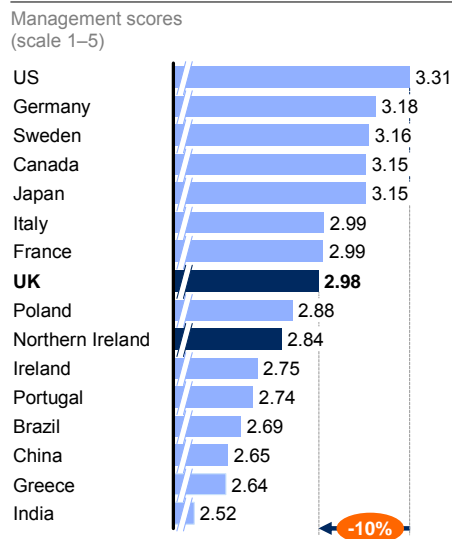
UK managers report a lower number of perceived competitors than many benchmark countries (e.g., US, Canada). The UK should continue to drive up competitive intensity through market flexibility, while ensuring that proposed changes to the organisation of competition authorities help create a world-class competition regime.

- Second, many poor-performing firms are family-run businesses—on average, family-run businesses have significantly lower management scores than other ownership types.²⁶ However, family-owned but externally run businesses perform significantly better. The mandate for family-owned companies is simple—ensure a competitive selection process for successful succession planning.
- Finally, the level of skills, as measured by the percentage of managers with degrees, is associated with better management scores.

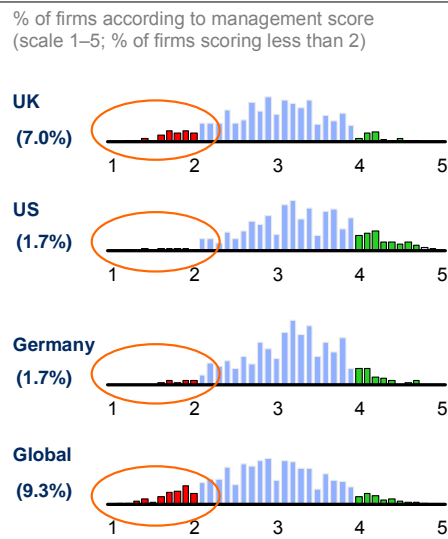
EXHIBIT 18

There are weaknesses in management quality in UK medium-sized businesses

The UK significantly lags behind the US in manufacturing management practice scores ...



... with a larger share of underperforming managers compared with other countries



SOURCE: McKinsey, Management Matters, 2008

26 Similarly, past McKinsey work has found that family-owned businesses that select the CEO from among all family members are no worse managed than other companies. Control of family-owned business is often handed down to generations within a family, and current tax policy supports this historical arrangement in the UK. A typical medium-sized family-owned business receives an inheritance tax exemption of 100 percent in the United Kingdom, versus 50 percent in Germany and zero in the US. See, on this point, Bloom, Nick, and John Van Reenen, *Measuring and Explaining Management Practices Across Firms and Countries*, CEP Discussion Paper Number 716, Centre for Economic Performance, March 2006, 8.

Improving sector productivity requires addressing sector-specific concerns as well as better aligning skills to sector needs

In order to improve sector-level competitiveness, sector-specific barriers to competition must be removed, and there must be better alignment of inputs (such as skills and management quality) with sector needs:

- **Conduct sector-level studies with business.** The government in partnership with sector participants should conduct in-depth studies of sectors (particularly local services) to identify and remove barriers to competition, productivity, and growth.
- **Improve transparency about the earnings potential of graduates.** Currently, information on lifetime earnings and starting salaries for different courses is available, but it is difficult to access. With a greater emphasis on student-funded tertiary education, demand is likely to increase for easily comparable information on returns on an investment in a university education.
- **Match funding or accreditation of courses to industry needs.** One radical solution would be to give employers a commissioning role in university funding. The model might be similar to law firms' acceptance of LPC qualifications or the government's regulation of PGCE qualifications, with industry bodies allocated funding to pay for courses. In the Netherlands, for example, sector advisory bodies are responsible for determining whether courses meet the needs of industry and whether a course is accredited.²⁷
- **Strengthen transparency and incentives to improve management skills.** The McKinsey/LSE research has drawn attention to the scope for boosting UK productivity through improved management capacity, particularly in SMEs. Finding the answer in a dispersed economy is not straightforward. But more can be done to encourage innovative approaches, such as improving transparency of management quality (as research has shown managers are generally poor at assessing their own management quality); addressing barriers to sector competition; providing incentives for executive education for owners of small businesses; and working with family-owned businesses to improve succession planning.

²⁷ Alternatively, there could be involvement of industry in the design of curricula in secondary and tertiary education.

2.2 SECURE THE UK'S POSITION AS THE LOCATION OF CHOICE FOR MULTINATIONALS

The UK should make sure that the conditions for business are attractive, recognising the important role played by large and multinational companies. This means working with businesses to improve skills and infrastructure and keeping regulation and tax regimes competitive.

Multinationals are a critical part of the UK economy, but in recent years, many multinationals have moved to other locations

Multinationals may account for less than 2 percent of UK businesses, but they drive overall economic growth and account for a disproportionate share of UK productivity, employment, and innovation:

- **Productivity.** The productivity of large firms has, on average, grown by 3.3 percent per year from 2000 to 2008—roughly eight times as fast as smaller enterprises over the same period (Exhibit 19). Many of the jobs created by international firms in the UK are highly skilled positions that pay above-average wages.²⁸
- **Superior management practices.** Multinationals tend to adopt superior management practices, which in turn spur productivity. Recent research of management practices by McKinsey and the London School of Economics shows that multinationals lead the field, regardless of where they operate (Exhibit 20).²⁹ When managers who were trained at multinationals leave, they may go on to raise management standards in smaller, entrepreneurial firms.
- **Employment.** Multinationals account for 23 percent of service sector employment and 38 percent of industrial employment.
- **Innovation.** Almost 80 percent of R&D expenditure is attributable to multinationals.³⁰ Multinationals are also an important channel for diffusing new approaches across countries.
- **Knowledge spillover.** Multinationals can “listen in” on new ideas by locating their R&D labs in leading knowledge hot spots around the world. This “technology sourcing” allows insights captured overseas to drive productivity improvements in the UK. Furthermore, domestic firms can learn from foreign multinationals with a presence in the UK.

28 Edwards, Paul, Tony Edwards, Anthony Ferner, Paul Marginson, Olga Tregaskis, David Adam, and Michael Meyer, *Employment Practices of MNCs in Organisational Context: A Large-Scale Survey*, Leicester Business School, 2007.

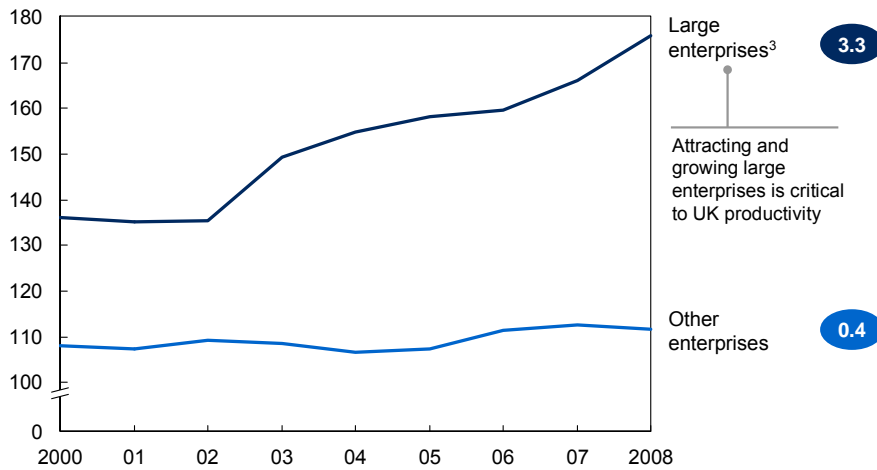
29 Bloom, Nick, Stephen Dorgan, John Dowdy, and John Van Reenen, *Management practice & productivity: Why they matter*, McKinsey & Company, November 2007. Other studies have found that non-multinationals produce a GVA per employee of £28,000 annually for 1996–2000, compared with £37,000 for UK multinationals and £47,000 for US multinationals, e.g., Criscuolo, Chiara and Ralf Martin, *Multinationals and US Productivity Leadership: Evidence from Great Britain*, CEP Discussion Paper 672, Centre for Economic Performance, January 2005.

30 McKinsey estimate based on data and analysis in Griffith, Rachel, Rupert Harrison, and John Van Reenen, “How Special is the Special Relationship? Using the Impact of R&D Spillovers on UK Firms as a Test of Technology Sourcing,” *American Economic Review*, 2006, Volume 96, Number 5, 1859–1875.

EXHIBIT 19

Large enterprises in the UK have increased productivity more than eight times as fast as those in the rest of the private sector

UK real labour productivity by enterprise size¹ – turnover per worker
 2008 £, thousand CAGR,² 2000–08 %

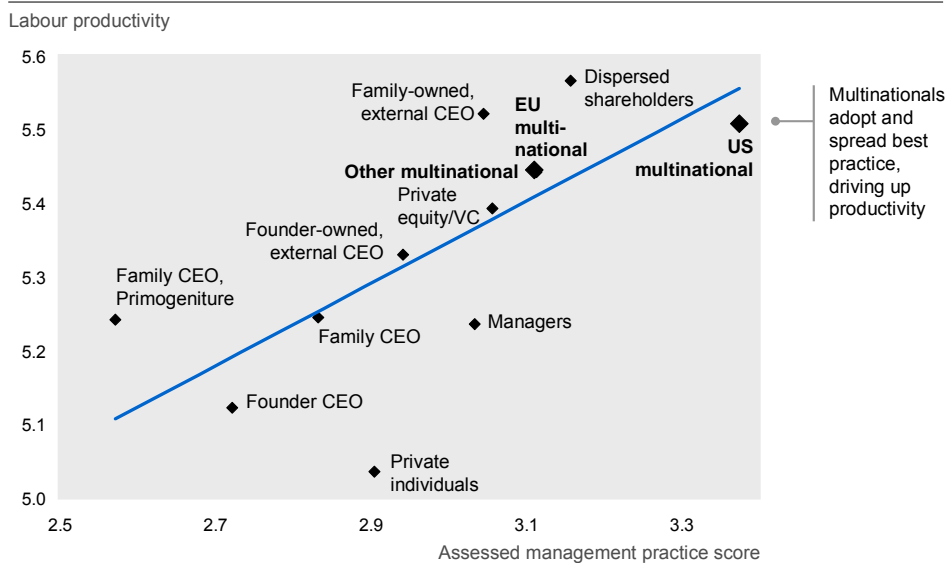


1 Includes private sector enterprises, public corporations, and nationalised bodies; Financial firms excluded due to lack of comparable turnover numbers.
 2 Compound annual growth rate.
 3 Large enterprises are classed as those with 250 or more employees.
 SOURCE: Department for Business, Innovation and Skills; HM Treasury; McKinsey Global Institute analysis

EXHIBIT 20

Multinationals have superior management practices and higher labour productivity

Correlation between management practice and company type



SOURCE: CEP and McKinsey (2007)

The flip side of this strength and dynamism is that multinational firms are relatively “footloose”—they are more likely than domestic firms to respond to changing business environments and to leave countries when the conditions for doing business there become less attractive.³¹ A number of UK companies have already re-domiciled outside the UK (see box 3, “Multinationals—the importance of competitiveness”). The loss of further large firms across a range of industries would be extremely costly for the UK, lowering income directly and reducing government tax income that funds public services and social payments. While the short-term impact of losing a multinational headquarters may affect only a relatively small number of people, the long-term impact can be significant as the UK becomes relatively less attractive for senior company talent and high-value support services.

Box 3. Multinationals—the importance of competitiveness

A number of large multinationals have relocated their activities abroad in response to the UK’s loss of tax competitiveness. Shire, the UK’s third-biggest pharmaceutical company, and WPP, a marketing and advertising services firm, have moved corporate headquarters to the Republic of Ireland. Wolseley, the world’s biggest distributor of heating and plumbing products, has decided to relocate its tax residency to Switzerland.³²

While these departures cut across a number of industries, the potential impact on the UK’s international leadership in financial services is of particular concern. Around 1.3 million people work in financial services in the UK, and the sector contributes 11 percent to the UK’s total income tax and 15 percent to its corporation tax, approximately £42 billion in 2007–08.

Nine of the top ten operators in the specialist London Market Insurance business, where UK companies historically have led the world, have re-domiciled or shifted their tax residency in the past decade. The majority have moved, leaving only nine out of more than 50 Lloyd’s managing agents domiciled in the UK as of July 2010. This has reduced the UK’s tax base by more than £1 billion. These companies’ actions also threaten domestic employment in this industry as the companies build up capacity abroad to demonstrate that key business decisions are taken outside the UK.

Meanwhile, a number of London-based hedge funds have recently decided to relocate to Switzerland, attracted by lower taxes,³³ and the UK’s three largest privately capitalised banks have all said publicly that they may have to reconsider their UK domicile in light of potential UK-specific changes in regulation, continued high taxes and levies, and restrictions on their ability to pay market competitive salaries to retain top talent. Losing any, or potentially all three headquarters, would be a significant blow to London’s status as a global financial centre.

31 Empirical studies have confirmed this tendency. For evidence that in the UK both UK multinationals and foreign-owned multinationals are more likely to close down plants than domestic firms, see Fabbri, Francesca, Jonathan E. Haskel, and Matthew J. Slaughter, “Do Multinational Firms Have More-Elastic Labor Demands?” *Journal of the European Economic Association*, 2003, Volume 1, Issue 2-3, 698–707. For studies that have found similar results for Ireland and the US respectively, see Görg, Holger and Eric Strobl, “Footloose’ Multinationals?” *The Manchester School*, Volume 71, Number 1, 2002, and Bernard, Andrew B. and J. Bradford Jensen, *The Death of Manufacturing Plants*, National Bureau of Economic Research Working Paper Number 9026, June 2002.

32 See, for instance, “Why Britain Could Lose Out in a Global Game of Chance,” *The Sunday Times*, 2 June 2008, available at: <http://business.timesonline.co.uk/tol/business/law/article4045132.ece>.

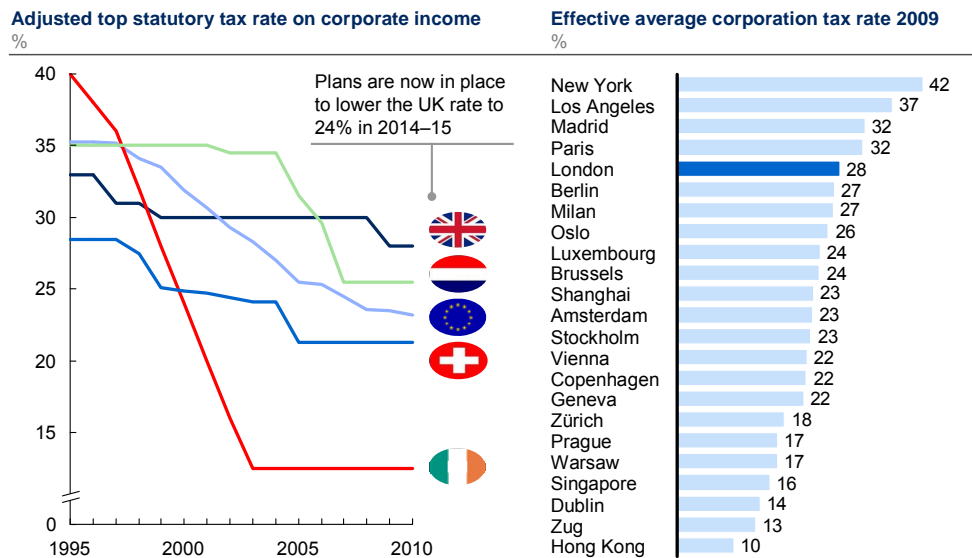
33 For example, in September 2008, the £453m hedge fund, Krom River, announced it was moving its operations to Switzerland, available at: <http://www.efinancialnews.com/story/2008-09-26/switzerland-ups-the-ante-in-battle-for-hedge-funds>.

The UK is improving the business environment, but more needs to be done

UK tax rates have become less competitive since 1995. Exhibit 21 shows how some major economies have reduced corporation tax headline rates to levels well below the UK's and how the UK's effective average corporation tax rate affects London relative to other major cities and jurisdictions. Recent proposals by the UK government will make the UK significantly more attractive, with a reduction in the headline rate of corporation tax from 28 percent to 24 percent in 2014–15 and a review of the regulatory burden faced by businesses.

EXHIBIT 21

UK corporation tax has become less competitive internationally



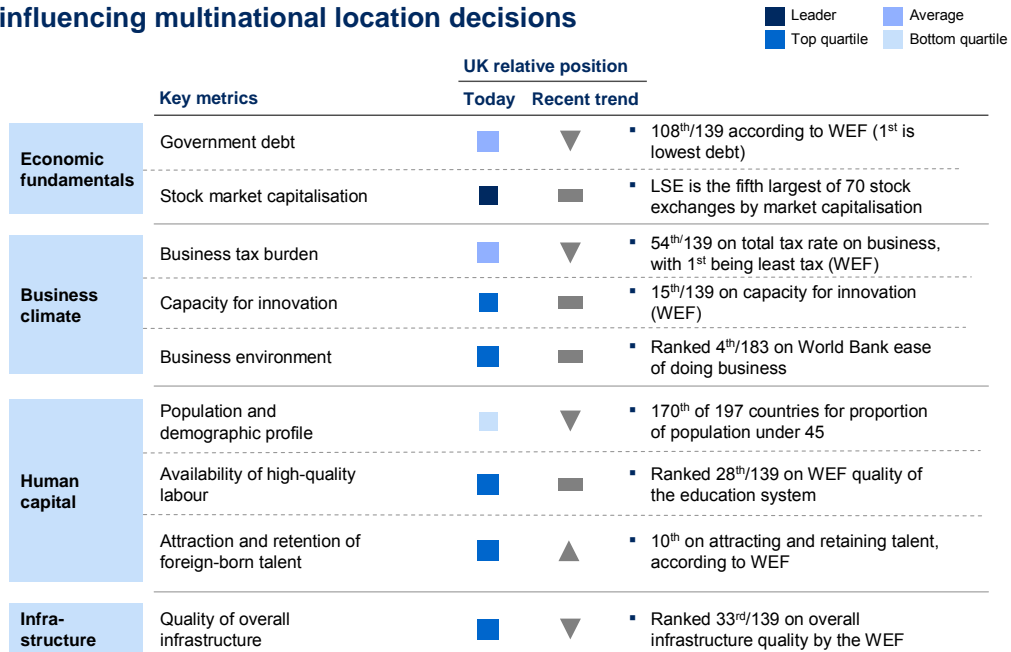
1 Corresponds to the most expensive Swiss canton (Geneva)
 SOURCE: Eurostat, UK Treasury; BAK Taxation Index 2009

However, the UK must go further if it is to maintain its position as a strong centre for multinational companies. The UK's standing has slipped against international peers with regard to several of the factors that influence the location decisions of globally mobile firms. In a recent CBI survey, 86 percent of respondents believed that the personal tax regime made the UK a less attractive place to invest now than it was ten years ago. And this is not just about tax—38 percent said that the UK's infrastructure made the country less attractive.³⁴ According to the World Economic Forum, the UK now ranks 33rd on overall infrastructure quality (Exhibit 22)—lower than developed countries such as France, Germany, Japan, and the US, as well as several emerging countries such as Chile, Malaysia, and Saudi Arabia.

34 Confederation of British Industry, *CBI Annual Conference Survey 2010: UK as a Place to Invest*, 2010.

EXHIBIT 22

The UK has become less attractive on some dimensions influencing multinational location decisions



SOURCE: McKinsey Global Institute synthesis of data from numerous sources; World Economic Forum Global Competitiveness Report; World Bank Doing Business; World Federation of Exchanges; UN Population Division

Government should work with private sector leaders to implement a ten-year plan for making the UK the most attractive European location for multinationals

Several factors influence multinational corporations seeking the best location, including workforce skills, infrastructure, the nature of regulation, and the tax regime.³⁵ The competitiveness of the UK can be eroded quickly, as demonstrated by the case of corporation tax over the past 20 years. We therefore recommend working closely with major multinational businesses to understand what is required to bring companies back to the UK and to implement a ten-year plan to make the UK the most attractive location for multinationals. This would:

- **Ensure access to international skills through open immigration.** A major factor in multinational corporations' choice of location is the availability of a labour force that has strong basic skills, good management capabilities, and technical expertise. While the UK faces difficult trade-offs on immigration, the impact of tier 1 and tier 2 visa restrictions threatens to undermine the vital skill base. To attract and retain international business, it is critical to secure the free movement of skilled labour. However, it is also essential to protect the skill base more broadly, attract foreign students to the UK, and align education with the needs of both domestic and multinational industries.

35 Many of these factors affect productivity and competitiveness broadly, beyond global multinational corporations, and are treated in more detail later in this section. Here we highlight some of the areas on which the UK should focus to ensure that it remains an attractive destination for multinationals.

- **Improve physical and social infrastructure to support business.** Multinational companies depend both on local and national infrastructure. The UK should work with industry representatives to identify any deficiencies that act as disincentives to locate business in the UK. Infrastructure is not just about roads, rail, and energy, but also about communications infrastructure and broadband, as well as the shared public infrastructure such as education, health care, and the legal system. Nor do all infrastructure improvements necessarily involve great cost. Creating greater regulatory certainty for private sector infrastructure investments is costless to the public purse. Reforms to the planning regime need not be costly. And speeding up legal processes could also be achieved without large-scale public funding. The simple introduction of a clerkship scheme to support the judiciary could benefit the UK legal sector, by expediting court processes and expanding capacity at minimal cost (see box 4, “The UK legal sector”).
- **Reduce regulatory burdens through sector by sector reviews.** The regulatory and legal environment can be a major factor in the location of international business. As mentioned above, almost two-thirds of those who responded to the CBI’s 2010 annual conference survey believed that the nature and level of UK regulation is less attractive than it was ten years ago. The current government’s review of the regulatory burden on business is a welcome step towards reversing this trend. The sector-by-sector reviews recommended earlier will offer important insights into those regulations that most constrain productivity and growth in each sector.
- **Create certainty on future tax and regulation.** While the level of corporation or personal taxation will always be a matter of public debate, the uncertainty surrounding future taxes has become a growing concern. Greater certainty could be encouraged by setting out a long-term plan for corporation tax in the UK that would be supportive of long-term growth. This could include ideas such as:

 - Building on current plans to reduce corporation tax by explicitly declaring an intention to remain competitive with other major developed economies (e.g., always being among the 20 percent of major advanced economies with the lowest rate).³⁶
 - Exploring opportunities to establish periods of fixed corporation taxes. Unlike several other jurisdictions, the UK does not offer companies the option to lock in tax rates for longer periods.
 - Establishing an independent body to set or advise on target corporation tax rates, and to monitor and advise on the UK’s competitiveness. This work will need to be complemented by efforts to show the UK public and media that low corporation taxation creates UK jobs.
- **Reduce corporation tax rates by broadening the tax base.** Lowering corporation tax to reverse the recent decline in UK tax competitiveness will attract new multinationals and reduce the outflow of existing companies located in the UK. However, this will require finding offsetting sources of tax revenue, particularly in the strained fiscal environment expected over the next few years. Tough choices will have to be made to broaden the tax base and remove tax breaks for specific sectors. The Office of Tax Simplification is conducting a review of all tax reliefs, allowances, and exemptions, for businesses and individuals in order to identify reliefs that should be simplified or

36 For example, major economies could include the IMF list of 33 advanced economies.

repealed. This could provide an opportunity to lower corporation tax and broaden the tax base. Concretely, the following changes could be considered:

- Removing tax deductibility of interest or introducing other changes so as to equalise incentives for equity and debt finance, e.g., through a Comprehensive Business Investment Tax (CBIT) or Allowance for Corporate Equity (ACE). Research suggests that corporation tax rates below 20 percent would be revenue neutral if tax shields were removed.³⁷ This would make the UK attractive to companies with low leverage and also improve financial stability. There are huge technical and issues to resolve, and it would require a substantial transition period. But we believe it is worth a reconsideration of this idea, both as a spur to economic growth and as a way to improve long-term resilience in the economy.
- Reducing or modifying tax incentives that favour specific industries or that reward past behaviour without incentivising future behaviour. For example, R&D tax credits in the US are based on incremental investment over a baseline, rather than on total investment as in the UK. This is both less costly and creates stronger incentives to increase investment at the margin.

Box 4. The UK legal sector

The legal services sector is a multinational industry that has enjoyed strong growth in the UK, building on the bold initiatives of several leading law firms to build global practices and benefitting from the success of London as a financial centre. The legal sector is an example of how a sector can flourish if the conditions for growth are right, including:

- **An experienced talent pool leading the way in complex cross-border work.** The growth of complex cross-border work has inspired a virtuous cycle of improving capabilities and experience, with the UK now the leading European legal centre and both domestic and international firms increasing their activity. However, as the industry faces new challenges, such as increased competition from US-based international law firms, accessing the necessary skills will be vital.
- **Working closely with major stakeholders to improve facilities.** The legal sector has worked closely with the judiciary to adapt to such modern practices as e-disclosure. Future success will continue to hinge on the current infrastructure meeting the growing needs of transactional and arbitration work. Infrastructure is not only physical networks and energy, but also shared systems and processes. The introduction of a clerkship system for commercial courts would reduce the workload of the judiciary and allow for faster and more effective operations. Costs would be modest (a few million pounds) and could be funded through industry contributions, though for the sake of independence would need to be handled by the state and judiciary and not by a private body.
- **A legal system that adapts well to the needs of modern multinational business.** English law's greater flexibility and ability to integrate complex multinational work has given law firms a much needed boost in recent years. For example, Centre of Main Interest (COMI) rules allow a large amount of European restructuring activity to take place in the UK, simplifying the process for companies operating across countries.

37 See de Mooij, Ruud, and Michael P. Devereux, *Alternative Systems of Business Tax in Europe: An Applied Analysis of ACE and CBIT Reforms*, Taxation Papers, Directorate General Taxation and Customs Union, European Commission, Working Paper Number 17, 2009.

2.3 UNLOCK INFRASTRUCTURE INVESTMENT

To develop and maintain the transport infrastructure the UK needs, and to make sure the country remains an attractive place for business and investment, the UK will need to continue to reduce construction costs and raise more revenue from infrastructure users.³⁸ Simultaneously, action will be required to stimulate private investment in the UK's ageing energy infrastructure by removing barriers created by planning restrictions and uncertainty, and by increasing returns.

2.3.1 Transport

Transport infrastructure investment needs are large over the next 20 years

Transport infrastructure is an important determinant of productivity and affects the distribution of output and growth across regions.³⁹ Over the last 40 years, UK investment in roads, railways, and airports ebbed and flowed. For example, the country now spends around 75 percent of its 1975 level of investment on roads—up from 50 percent in 2000. Meanwhile, expenditure on the nation's railways declined sharply after the early 1970s, falling by three-quarters in the early 1980s. Since the Hatfield crash, however, spending has been at least twice as high as at any point in the previous 40 years. Today, the average business rates inadequate infrastructure as a greater barrier to performance than insufficient workforce education and skills.

McKinsey's upcoming report "Building the transport infrastructure that the UK needs" estimates that the UK will need to spend £350 billion over the next 20 years to renew its strategic road network, railways, and airports and expand capacity where most needed (Exhibit 23). This is the minimum level of expenditure required if economic growth is not to be hindered.⁴⁰ Funding this investment will require an increase of 45 percent above the average amount spent from 2000 to 2009—for the most part, a period of unprecedented boom. Because 80 percent of transport infrastructure funding over this period came from central government, and because public sector finances are now under pressure, we estimate that there could be a funding gap of at least £100 billion cumulatively over the next 20 years.

38 We would like to thank experts in the McKinsey Infrastructure, Transport and Energy Practices for their input, in particular Quentin Woodley, Stuart Shilson, Julian Mills, Alice Woodwark, Venkie Shantaram, and Eric Beinhocker.

39 Organisation for Economic Co-operation and Development, *Going for Growth*, 2009.

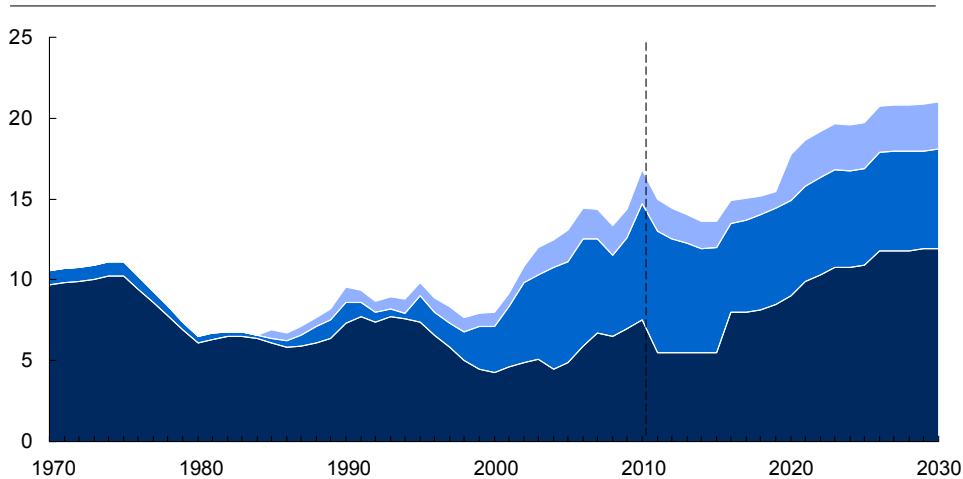
40 The exhibit shows a scenario in which perceived road congestion stays at the same level as today, critical choke points on the UK's railways are addressed, and sufficient airport capacity is built to meet expected demand.

EXHIBIT 23

The UK needs to spend over £350 billion on road, rail, and air infrastructure over the next 20 years to meet expected demand



Annual transport funding requirement by mode
 £, billion



¹ Data for Air not available before 1985
 SOURCE: McKinsey Transport Infrastructure Model, August 2010

The National Infrastructure Plan (NIP) rightly emphasises the need to improve value for money

The NIP, which sets out spending up to 2014–15, is clear about investment priorities, for example, in high-speed rail. At a time of public expenditure constraints, the NIP also states that it is important not to cut investment in infrastructure too sharply. The renewed emphasis on value for money (for example, in construction costs) is encouraging.⁴¹

However, there is still a large need for investment that is unlikely to be met by private funding, particularly for roads. The involvement of the private sector can help reduce maintenance and construction costs and there is a financing role for private capital in cases where the government does not want to provide capital up front.⁴² But private investors expect regular cash flows either from the government (in the form of availability payments) or from tolls. Given constrained public finances, the government is unlikely to be able to fund availability payments out of existing revenue. Meanwhile, road tolling, which is already unpopular in the UK, appears to be a relatively inefficient way to raise revenue from road users.

41 Several commentators have identified specific infrastructure projects that are important for growth and productivity (e.g., the CBI's submission to the 2010 Comprehensive Spending Review). The focus of our report is not on specific project recommendations, but rather on how to ensure sufficient funding in the long term.

42 Given that the UK has attracted more than 25 percent of European investment in transport infrastructure since 2005, it should have no difficulty attracting investors for future projects.

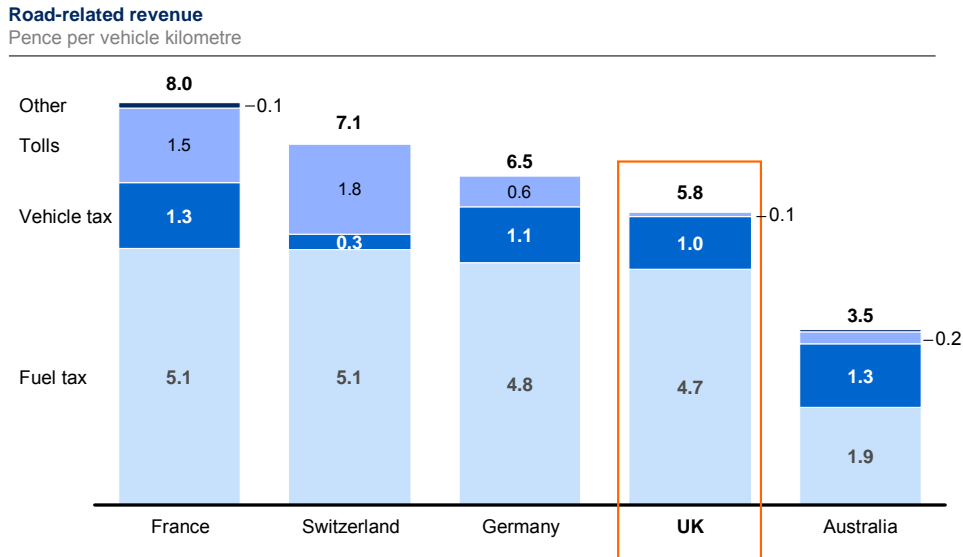
The UK needs to continue to reduce construction costs and raise more revenue from infrastructure users

To close the £100 billion funding gap and deliver the infrastructure the country is likely to need, the UK should consider ways to improve construction efficiency and raise new revenue from infrastructure users, possibly through increased fuel or vehicle levies. Specifically, the UK should consider how to:

- **Continue to improve construction efficiency and reduce costs.** The costs of infrastructure construction and management vary considerably. For example, the Office of Rail Regulation (ORR) has estimated that, notwithstanding improvements, the UK's rail infrastructure is 40 percent less cost efficient than the best quartile of its European peers. Our research estimates that almost £50 billion of the shortfall can be delivered by improving the efficiency of construction—on top of the savings targets set for Network Rail by the Office of Rail Regulation. Our experience working with infrastructure owners around the world suggests that materials expenditure can almost certainly be reduced by 12–14 percent while frontline labour can often be reduced by around 20 percent.
- **Raise more revenue from infrastructure users.** The remaining £50 billion funding gap, which is likely to be concentrated on the road network, can be eliminated by increasing revenue from drivers. Our research suggests that road usage is, on average, considerably cheaper in the UK than elsewhere in Continental Europe (Exhibit 24). To close the funding gap, the UK would need to raise an additional 0.5 pence per vehicle kilometre, making the cost of motoring similar to that in Germany. If the UK were to raise this cash via hypothecated tax increases, it would need to increase fuel duty by 11 percent or vehicle tax by 50 percent. By comparison, road tolling would almost certainly require higher driver charges as the cost of installing and administering a scheme would probably account for 10–50 percent of revenue, depending on the technology used. Although road pricing may be a less efficient way of closing the UK's funding gap, it remains the best way of allocating scarce capacity in urban areas or at pinch points to the drivers who value it most. Road pricing is, therefore, likely to have some role to play, particularly on a local level.

EXHIBIT 24

How road-related revenue compares internationally



SOURCE: Department for Transport – Transport Statistics for Great Britain, 2009

2.3.2 Energy

Significant private investment is needed to fund replacement of ageing generation infrastructure

The UK faces a sizeable energy challenge. Significant amounts of capital—£120 billion to £170 billion, according to the CBI⁴³—will have to be invested in energy infrastructure over the next 20 years as generation capacity reaches the end of its working life and demands for energy sustainability and energy security intensify (Exhibit 25). Existing coal generation will be retired, and renewable, Carbon Capture and Storage (CCS), and nuclear capacity will be needed to meet the shortfall. The UK has set itself the target of deriving 15 percent of energy from renewables by 2020. With long lead times to build new energy generation capability or develop smart grid improvements, the challenge for the UK is to move quickly.

There are also significant opportunities. By making the future energy mix more resilient to supply shocks, the UK can reduce energy price volatility⁴⁴, achieve carbon reduction commitments, and support the UK clean-energy industry through increased domestic demand. At the same time, policies to improve energy efficiency will help to keep down energy demand, easing the need for infrastructure investment, and also potentially creating a large number of green jobs (see box 5, “Green jobs and the construction sector”).

43 Confederation of British Industry, *Decision time: Driving the UK Towards a Sustainable Energy Future*, July 2009.

44 Lower price volatility has also been found to be an important determinant of economic growth; see Nakov, Anton and Andrea Pescatori, *Oil and the Great Moderation*, Banco de España Working Paper 0735, Banco de España, 2007.

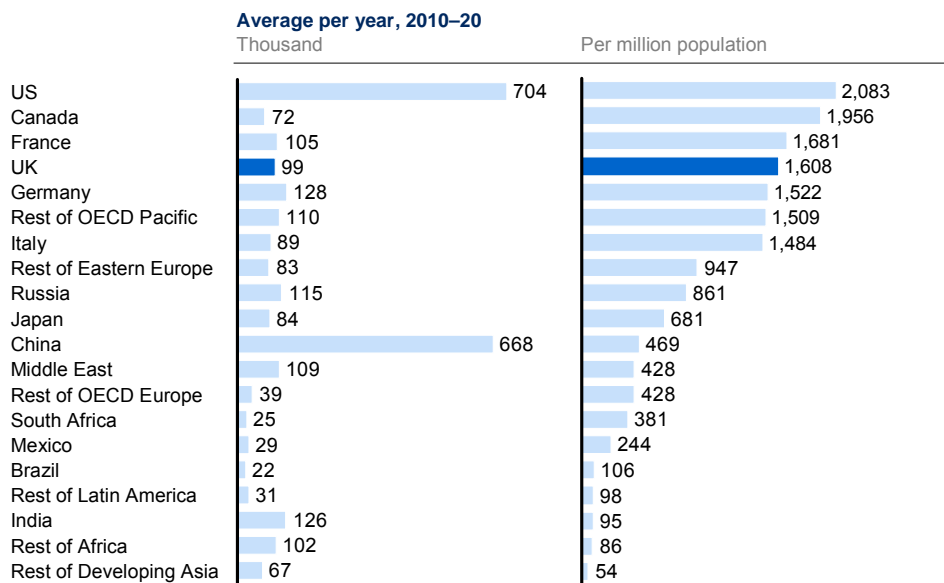
Box 5. Green jobs and the construction sector

Policies to reduce carbon emissions may also have a significant employment impact, as homes and businesses make modifications to improve energy efficiency. For example, the UK government has proposed a new Green Deal that will allow households to finance upfront insulation and energy-efficiency improvements out of future energy savings. The UK government estimates that if all 26 million households in the UK were to take up the Green Deal, employment in the construction and insulation sectors could increase by more than 200,000 people for the next 20 years.

International comparisons based on the McKinsey Global Greenhouse Gas Abatement Cost Curve 2.1 show that the job potential is significant. Taking high-level estimates based on the potential investment in energy efficiency, the UK could expand the buildings sector by on average of 100,000 green jobs each year over the next decade. The methodology is somewhat more conservative than that used in calculations by the UK government. But the overall message from both analyses is clear: implementing measures to improve energy efficiency could create at least 100,000 jobs per year for a decade or more.

Estimated green job potential in buildings sector

HIGH LEVEL ESTIMATES



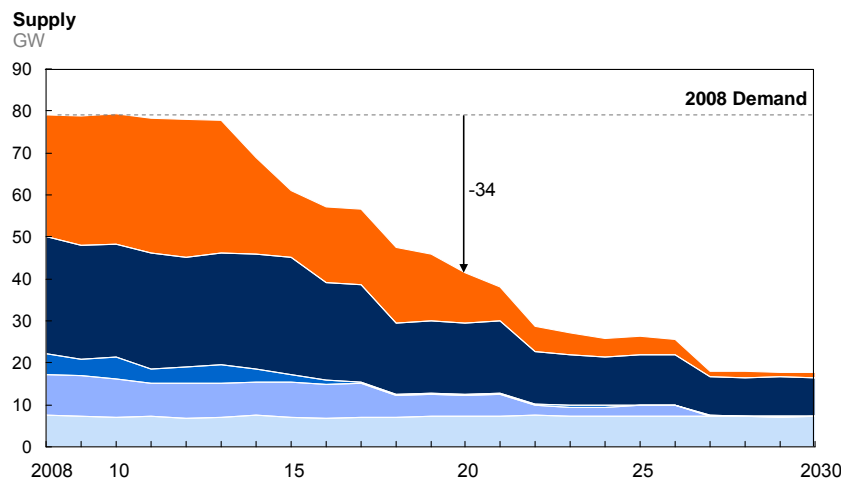
SOURCE: Indicative estimates based on \$70,000 capex per job assumption; Capex estimates from McKinsey Global GHG Abatement Cost Curve 2.1

EXHIBIT 25

Large investments will be required in energy infrastructure over the coming years



Cumulative existing power station retirements



SOURCE: Confederation of British Industry and McKinsey analysis, "Decision time: Driving the UK towards a sustainable energy future," July 2009

The NIP and other plans set out public energy investment and identify some levers to increase investment from the private sector

The UK has made considerable progress in the development of a framework for future energy infrastructure with input from the CBI in 2009⁴⁵, revised National Policy Statements (NPS) on energy, the DECC 2050 Pathways Analysis, and the NIP 2010. Combined with recent statements by major generation companies (on, say, planned nuclear capacity), it looks like the path towards a diverse, low-carbon, and secure energy supply is becoming clearer. Other initiatives include the local incentives for renewable energy through business rates highlighted in the Local Growth White Paper.⁴⁶

However, further clarity is crucial if policy and intent are to translate into committed investment and built infrastructure. While detailed policies such as the level of the Climate Change Levy are still being determined, investors remain uncertain about likely returns, incentives, and barriers to development.⁴⁷ Other policies may also affect future investment and the ability to build a strong skills base to support development.

45 Confederation of British Industry, *Decision Time: Driving the UK Towards a Sustainable Energy Future*, July 2009.

46 Department for Business, Innovation and Skills, *Local Growth: Realising Every Place's Potential*, October 2010.

47 For example, one issue that has been highlighted recently is the risk that leases for offshore wind projects could be revoked in favour of offshore drilling.

Attracting private capital requires greater certainty around future energy mix and policy and effective implementation of fast-track decisions

Energy policy remains an area of current discussion with a number of proposals still to be developed (for example, under the Electricity Market Reform project). Economists such as Dieter Helm have argued for reforms to utility regulation that improve incentives to invest.⁴⁸ In this context, we welcome moves not only to increase certainty but also to align incentives and speed up planning decisions. We recommend that government considers further steps in a number of areas to encourage investment in energy infrastructure, including how to:

- **Identify the preferred or intended pathway towards decarbonisation targets.** Recent policy statements suggest that future energy generation will depend on a range of sources (renewables, nuclear, CCS, for instance), with an emphasis on letting the market determine the precise energy mix.⁴⁹ However, a number of the mechanisms being introduced (for example, the Climate Change Levy and feed-in tariffs) affect the economics of different energy sources in different ways. Investors in long-term energy projects need to have a better idea of the likely long-term energy mix, or at least of the long-term level of support provided through different mechanisms. The DECC 2050 Pathways require urgent refinement to create a single path that will define incentives and regulations and create the basis for private sector investment.
- **Ensure rigorous implementation of fast-track planning decisions.** As further applications for major infrastructure projects are submitted, investors will be looking for fast and effective decisions to match the rhetoric of the NPS. For the first wave of new nuclear generation to be ready by 2018, as currently intended, the planning stages will need to be completed rapidly.
- **Expand incentives for local development.** The retention by local authorities of business rates from renewable energy projects—as outlined in the Local Growth White Paper—will increase local planning incentives. However, these incentives could be taken further through “social contracts” that compensate local areas for energy developments that benefit the country as a whole. We recommend that regulators and government regularly monitor the impact of current proposals on local development to assess whether further incentives are needed and whether barriers are preventing separate agreements between investors and local communities.

2.4 INNOVATE AT SCALE

The public and private sectors have a critical role in supporting innovation.⁵⁰ Globally, government efforts to stimulate the growth of clusters have often ended in failure—past McKinsey research on emerging markets has shown that only half of clusters have grown

48 For a discussion of options for reform in the energy market, see Helm, Dieter, *Market Reform: Rationale, Options and Implementation*, Policy Paper, University of Oxford, 8 October 2010. For recommendations of reforms to utility regulation to improve incentives to invest when returns are determined under a Regulated Asset Base (RAB) framework, see Helm, Dieter, *Utility Regulation, the RAB and the Cost of Capital*, University of Oxford, 6 May 2009.

49 See, for example, Department of Energy and Climate Change, *Revised Draft Overarching National Policy Statement for Energy (EN-1)*, October 2010, 1.6.2.

50 We would like to thank Nicolaus Henke and colleagues in the McKinsey Health and Advanced Industries practices for input on this section.

faster than the overall economy.⁵¹ Achieving success requires scale, building on existing strengths, cluster-specific support and the development of the broader innovation ecosystem in the economy, addressing factors such as entrepreneurial mind-sets, regulatory barriers, skills, and incentives.

The UK has several examples of emerging clusters and new government initiatives to support their development. For example, measures are being introduced to support the growth of high-tech companies in East London, including immigration rules for entrepreneurs, the intellectual property framework and flexible space for development as part of the Olympic legacy.⁵²

In this section, we highlight the example of innovation in the biosciences sector.⁵³ A richer, older world is devoting an ever-increasing share of its wealth to living longer and healthier lives—McKinsey research suggest that the cost of health care in developed countries will rise from 10 percent of GDP today to around 15 percent by 2030. In emerging countries, health care expenditure will grow even faster in relative terms as economies grow and lifestyles change. In China and India, for example, health care spending has been doubling every five years over the past two decades. Consumers of health care are demanding more choices and easier access—creating significant opportunities for bioscience companies that are able to rise to the challenge. This growth is not without its obstacles for the biosciences sector. Rising costs may result in increased regulatory pressure on pharmaceutical companies as governments look for ways to mitigate rising health expenditure (e.g., via quicker licensing of generics, price caps). Access to talent is also becoming increasingly difficult and R&D costs have risen significantly.

The biosciences are particularly dependent on a supportive public sector, e.g., through the quality of university research and education, and on the NHS as a major potential customer and research and development partner. The UK's potential in this high-growth sector of the world economy will be realised only if private and public sector initiatives are aligned and there is a critical mass of innovation.

The UK has a strong research base, but its biosciences cluster faces real threats

The UK has a strong base on which to build a cluster of industries in global biosciences (comprising pharmaceuticals, medical biotechnology, and medical technology), building on existing centres of excellence, primarily in the triangle formed by London, Cambridge, and Oxford.⁵⁴

- The pharmaceutical sector is a leading sector for innovation in the UK, representing over a quarter of all UK business investment in R&D. Two of the world's five leading pharmaceutical companies are headquartered in the UK, and the sector spends more than £4 billion on R&D annually.
- The UK medical biotechnology sector leads Europe in the number of drugs in all stages of clinical development.

51 This suggests limited impact of government support, since assuming a fairly standard distribution one might expect around half to grow faster than GDP, even without support.

52 Speech given by the Prime Minister in East London on 4 November 2010.

53 There are many other possible clusters, including recent proposals to support the developing technology centre in East London.

54 Office for Life Sciences, *Life Sciences Blueprint*, July 2009.

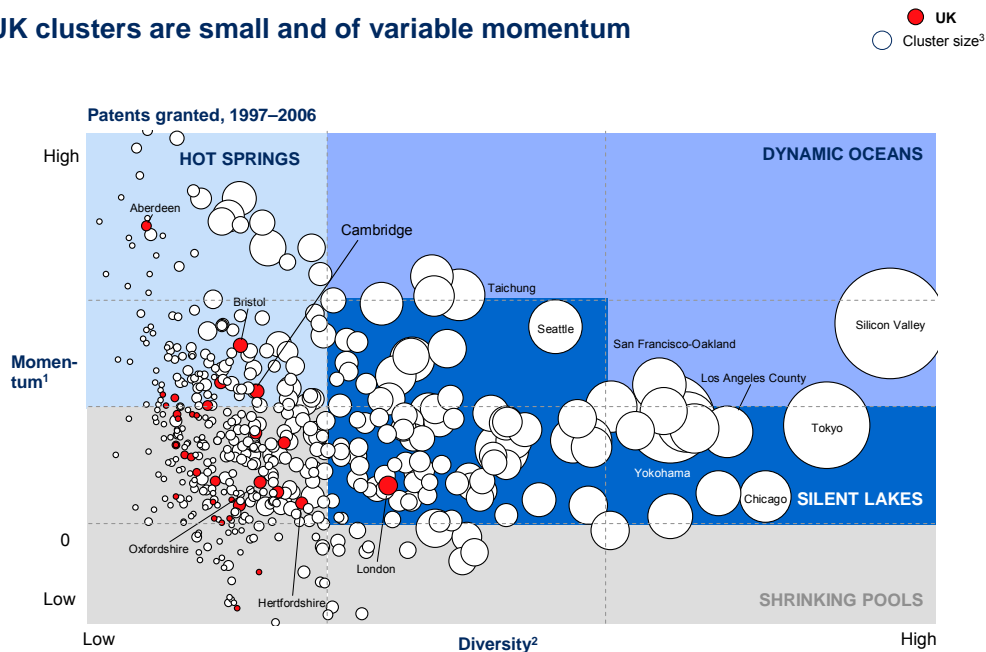
- The medical technology sector has just over 2,000 companies and collectively employs almost 50,000 people across the UK, making the UK the largest player in Europe.
- The UK has strong centres of excellence (e.g., London, Oxford, Cambridge), which have many of the necessary attributes to compete as a biomedical hub on the global stage, boasting world-class institutions, a history of medical innovation, and specialist care and clinical training.
- Collaboration across institutions to support innovation is encouraging, for example, between the UK Centre for Medical Research and Innovation (UKCMRI) and the London BioScience Innovation Centre (LBIC).

However, despite major efforts such as Global Medical Excellence Cluster (GMEC), the UK in recent years has lagged behind others and is facing significant competition on the world stage. The UK was second only to the US in the biosciences sector in terms of both productivity and share of products in the pipeline in 2002. Since then, this position has been weakened, with the UK's share of bioscience products in Europe falling from around 50 percent to about 26 percent in 2007, and no UK-based IPOs for a bioscience company. Other major bioscience hubs can be found mainly in North America, but strong new entrants elsewhere (e.g., Singapore, Shanghai) are also threatening to eclipse the UK's international position.

Across different sectors we see the same trend, with UK clusters, like their European counterparts, much smaller than in the US. Exhibit 26 maps the scale of patent generation and hot spots of innovation globally across a range of sectors, not only biosciences, in relation to patent growth and cluster diversity.

EXHIBIT 26

UK clusters are small and of variable momentum



1 Growth of patents in a cluster per year, 1997–2006.

2 Patents' industry and firm diversity in a cluster in 2006.

3 Patents granted in 2006.

SOURCE: Juan Alcacer, Harvard University; McKinsey Innovation Practice

Many of the conditions for a successful biosciences cluster are in place, but progress has been limited by several sector-specific barriers

The UK performs well on a number of innovation performance indicators reflecting its strong academic base and openness to foreign investment. For example, the UK ranks second only to the US in research quality measured by citations, producing 12 percent of the world's academic citations, with only 1 percent of the world's population.⁵⁵ The UK ranks first amongst OECD countries in business enterprise expenditure on R&D funded from abroad.⁵⁶ However in biosciences, a number of specific constraints are limiting cluster development:

- **Weaknesses in clinical trials.** Clinical trials are still growing, but other locations (e.g., Australia, Canada, and developing countries such as India and Russia) are overtaking the UK. The UK's participation in global clinical trials dropped from six percent in 2002 to two percent in 2006. Clinical research organisations point to difficulties in accessing patients and the bureaucracy associated with study approval and start up.⁵⁷
- **Gaps in R&D funding.** Proposed changes to R&D and NHS funding streams threaten the financial sustainability of the UK's leading medical research institutions, while new higher education funding proposals may create short-term uncertainty.
- **Lack of access to finance.** Since 2002, the percentage of companies with a market capitalisation of less than £25 million has risen from 20 percent to above 60 percent, and many of these firms struggle with raising finance.
- **Commercialisation of technology.** The UK lags behind the major US hubs in the commercialisation of basic research, producing fewer patents, attracting less venture capital investment and developing fewer biotechnology companies. Part of this seems to be explained by regulatory constraints—the UK patenting process can take 50 percent longer than the process in the US.⁵⁸

Supporting the development of a global leading biosciences cluster requires several specific actions

Achieving success in biosciences will require a coordinated response. Key players, including academic institutions and hospitals, the NHS, venture capital investors, government and industry, must come together urgently to agree to a shared vision of how the UK can continue to play on the global stage. Specific ideas for action include:

- **Create a single biosciences cluster to compete on a global scale.** Rather than spreading funding thinly throughout different biomedical clusters, the UK should focus on creating a cluster with the potential to become a leading global player. This will require the UK to coordinate across Academic Health Science Centres (AHSC) and create specialist centres with deep expertise rather than each AHSC competing in all aspects of research. There then needs to be a clear strategy for growth.⁵⁹ In particular:

55 Department for Business Innovation and Skills, *2009 Annual Innovation Report*, November 2009.

56 Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Outlook 2008*, October 2008.

57 Bioindustry Association, *The Review and Refresh of Bioscience 2015*, 2009.

58 This is based on data from the Centre for the Study of Drug Development, Tufts University.

59 The UK Centre for Medical Research and Innovation (UKCMRI) is an example of how multiple institutions can collaborate to establish scale.

- “One-stop” AHSCs should have a mandate to join R&D, clinical services, and supporting health IT for the benefit of their large local populations. This requires coordination across services, including primary care.
 - AHSCs should be encouraged to compete globally with a joint approach to funding and delivery across research, education, and service innovation. Cluster funding and development could be prioritised based on potential impact and developed through a nationwide competitive process. Firms could collaborate with specific AHSCs that specialise in a relevant clinical area, and applications could explicitly include degree of collaboration with local research institutions, extent of government support required, fast track approvals for planning permission, and knowledge sharing initiatives.⁶⁰
- **Help innovative bioscience companies to start and grow.** Bioscience firms usually start up close to academic institutions, with aspiring scientific entrepreneurs reliant on academic support. The UK should build infrastructure including office and lab space around its main academic assets, and provide the necessary infrastructure to support clinical trials. In addition:
- Attracting and retaining talent. The UK must focus on building its talent base, as bioscience firms rely on the combination of entrepreneurial people, academic support, and business and finance infrastructure. The UK should attract and retain PhD students. US and, increasingly, Asian institutions are a major threat. The UK will need to expand the number of funded PhD programmes as well as ensure that immigration processes provide flexibility to attract and retain top overseas talent.
 - Improving funding for SMEs. The UK should adopt recommendations on improving venture capital funding for SMEs, as outlined in the Cooksey review on biosciences.⁶¹
 - Developing and supporting new business models. The UK has lost significant later-stage research and pharmaceutical trials to lower-cost countries and larger markets. One option is to innovate (with NICE and other bodies) to support niche drug development where phase 3 trials are replaced with long-term “in market” testing, where patients opt in to trials recognising that drug efficacy is still being tested. This would dramatically lower drug development costs while supporting UK innovation.
- **Set up a delivery team to drive innovation.** Implementing a targeted and effective policy to support innovation in UK biosciences will require the collaboration of several bodies. We recommend establishing and funding a senior steering group with responsibility for implementation. This group should comprise representatives from relevant government departments (such as the Department of Health or Department for Business, Innovation and Skills), bioscience entrepreneurs and executives, the National Institute for Health Research, and relevant local stakeholders (for example, the mayor of London).

60 For example, France has established a €1 billion government fund with the explicit aim of directing financing to growth sectors such as high-tech industries and services, through a competitive bidding process. The initiative has created 71 new clusters (only a few of which were defined “global clusters”), and a second phase has been approved with €1.5 billion funding for the 2009–12 period.

61 BioIndustry Association, *The Review and Refresh of Bioscience 2015*, 2009.

The broader innovation ecosystem must also be supported by encouraging more entrepreneurial mind-sets and improving incentives

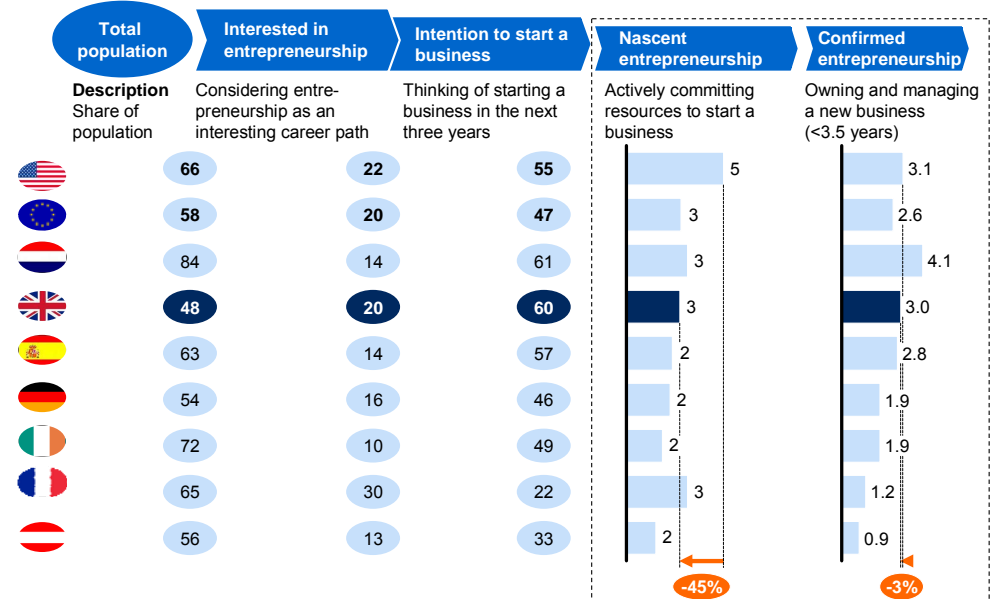
Addressing cluster-specific barriers is necessary, but not sufficient, to create economy-wide impact. Cluster reforms must be supported by tackling broader issues such as how to:

- **Encourage a culture of entrepreneurship and competition.** By comparison with the US, the British (like their European neighbours) are not particularly entrepreneurial. The share of the British population interested in entrepreneurship is 18 percentage points lower than in the US (Exhibit 27).⁶² In particular, the focus and breadth of entrepreneurship training is in need of change. There should be more emphasis on exposing students to the workplace, rather than training in the classroom.⁶³ Ireland, for example, has embedded activities based on “learning by doing” (e.g., students running mini-companies) in state education. More widely, the UK needs to foster a culture of innovation, encouraging young people to seek out opportunities to drive up productivity.

EXHIBIT 27

Fewer people in the UK are interested in entrepreneurship than in other countries

Entrepreneurship funnel, 2009
 % of adult population



62 The UK has already taken steps to address this. 90 percent of secondary schools now provide enterprise education for all pupils at Key Stage 4, and many are also providing it at Key Stage 3. In addition, four “University Enterprise Networks”, comprising a partnership between one or more private sector organisations and the universities within a region, have been established. In a 2009 survey Global Entrepreneurship Monitor found the UK ranked below the US, Germany, and other “innovation-driven” countries in the quality of entrepreneurship training. For further details, see Levie, Jonathan and Mark Hart, “United Kingdom 2009 Monitoring Report,” *Global Entrepreneurship Monitor*, 2009.

63 See Levie, Jonathan, Mark Hart, and Michael Anyadike-Danes, “The Effect of Business or Enterprise Training on Opportunity Recognition and Entrepreneurial Skills of Graduates and Non-Graduates in the UK,” *Frontiers of Entrepreneurship Research*, 2009, Volume 29, Number 23. The authors show that in the UK, work placement programs have a significant effect on both entrepreneurial opportunity perception and skills self-perception (more so than classroom-based training).

- **Rebalance incentives to support Intangible investment.** The tax system in the UK, similar to those in most other OECD countries, currently disadvantages intangible investments such as process improvements, creative ideas, skills, and IT. Relatively generous incentives are in place for R&D expenditures, but other types of intellectual assets receive no tax benefits.⁶⁴ However, the potential for intangible investment to drive innovation is clear—for example, the UK has achieved considerable success in the creative industries, including activities ranging from software development to films.⁶⁵ Creating a more neutral tax system would remove this bias in the current tax code.

2.5 UNLEASH THE GROWTH POTENTIAL OF EDUCATION AND HEALTH

Higher education and health care services should be seen as high-growth industries with large and growing export potential, rather than as public sector cost centres. Both health and education are fast-growing sectors where the UK has strong advantages and opportunities to derive the multiple benefits of economic growth, fiscal balance, and improved public services.

2.5.1 Higher education

Higher education is a fast-growing global market where the UK has strong position and market share

Traditional debates about education have focused on its crucial role as a public service, increasing skills and ensuring fair opportunity for the population.⁶⁶ Overseas students have been viewed primarily as a way to fill funding gaps, or as an important way to increase research talent. But if we view education through a different lens—that of an industry—then the UK education sector has many of the characteristics of a very promising growth opportunity (Exhibit 28).⁶⁷

- **High-growth sector and a strong generator of export earnings.** Education is a huge market: the OECD estimated that in 1980, more than a million students were enrolled at universities and colleges outside their country of origin; that number has now tripled to 3.3 million. More recently, growth has been even faster at 7 percent per year. Educating international students is Australia's third-largest export industry, while Canada's revenue from international students exceeds its coal and lumber exports.

64 For example, 19 OECD countries (including the UK) had specific R&D tax incentives in place in 2005, up from only 12 in 1996. However, only six countries offered tax incentives for corporate training and only one country (Japan) provides a tax incentive for investments in information and communication technology. The UK offers neither.

65 Office for National Statistics, *UK Innovation Survey 2009*, 2009. The Office for National Statistics found that UK firms engage in a wide variety of investments in intangible assets, ranging from computer software to training and advertising. For further reference, see Marrano, Mauro Giorgio, Jonathan Haskel, and Gavin Wallis, "What Happened to the Knowledge Economy? ICT, Intangible Investment and Britain's Productivity Record Revisited," *Review of Income and Wealth*, 2009, Volume 55, 686–716

66 We would like to thank Michael Clark and colleagues in the McKinsey Education and Health practices for input on this section.

67 While this section focuses on higher education, we recognise that there is also a significant opportunity in secondary education.

- **Strong competitive advantages, with global leading brands.** The UK has many outstanding universities—19 of the top 100, according to the QS ranking.⁶⁸ The UK can claim the second-largest share of overseas students of any country (behind the US). It also largely held share in the international market between 2000 and 2008.
- **Opportunity to strengthen the UK’s competitive position.** US immigration policy has reduced the attractiveness of the UK’s main competitor, with the US share of the international market declining from 24 percent in 2000 to 19 percent in 2008.
- **Builds on centres of production distributed throughout the UK, mainly outside London.** Education is a sector with many strong centres of excellence distributed widely across the UK, with great universities located throughout the regions of England, Scotland, Wales, and Northern Ireland.

EXHIBIT 28

Attractiveness of higher education as a growth industry

An attractive growth industry for the UK would be one where ...

... there is a large high growth market		<ul style="list-style-type: none"> ■ 7% market growth ■ 100 million students worldwide
... the UK has market leading brands		<div style="display: flex; justify-content: space-around; align-items: center;">    </div>
... there is a competitive opportunity		<ul style="list-style-type: none"> ■ Market leader losing share ■ The US has declined from 24% of total international students in 2000 to 19% in 2008
... it delivers benefits to all regions		<div style="display: flex; flex-direction: column; align-items: center;"> <div style="display: flex; justify-content: space-around; width: 100%;">    </div> <div style="display: flex; justify-content: space-around; width: 100%; margin-top: 10px;">    </div> </div>

Over the long term, the opportunity is significant. If the UK is able to hold market share—as it has done recently—in a global market growing by nearly 7 percent per year, by 2030 there could be more than 1 million additional international students in the UK, equivalent to 40 new large universities. Capturing even half of this opportunity would more than double current international student numbers. Each international student pays almost £9,000 in tuition costs, in addition to significant income spent on housing and living expenses. By 2030, the additional tuition fees alone from over half a million additional students could be

68 QS is a company specializing in education and study abroad. The overall rankings are compiled based on six distinct indicators: (1) Academic peer review; (2) Employer review; (3) Student faculty ratio; (4) Citations per faculty; (5) International faculty; and (6) International students.

worth £5 billion to the UK economy, creating more than 35,000 jobs for faculty members, and 45,000 for support staff.

Recent developments in education policy are encouraging, but more can be done to capture the opportunity

The structure of higher education funding is changing, and this will result in greater pressure to raise standards and innovate more within the sector. For example, the coalition government's decision to raise the fee cap to £9,000 per annum from around £3,300 currently, should create a greater incentive for universities to innovate and compete to attract students.

To capture this opportunity, though, will require current attitudes to change. The UK needs to address issues that make it less competitive in this market, particularly the risk that the points-based system and immigration restrictions will deter international students and top-flight academics from choosing to study and conduct research in the UK. It will be important to expand capacity so that universities do not turn away international students. And it is necessary to be much bolder about bringing in private capital—both expanding current universities and creating new privately funded universities.

The UK should recognise the opportunity in education, remove barriers to expansion, and align incentives

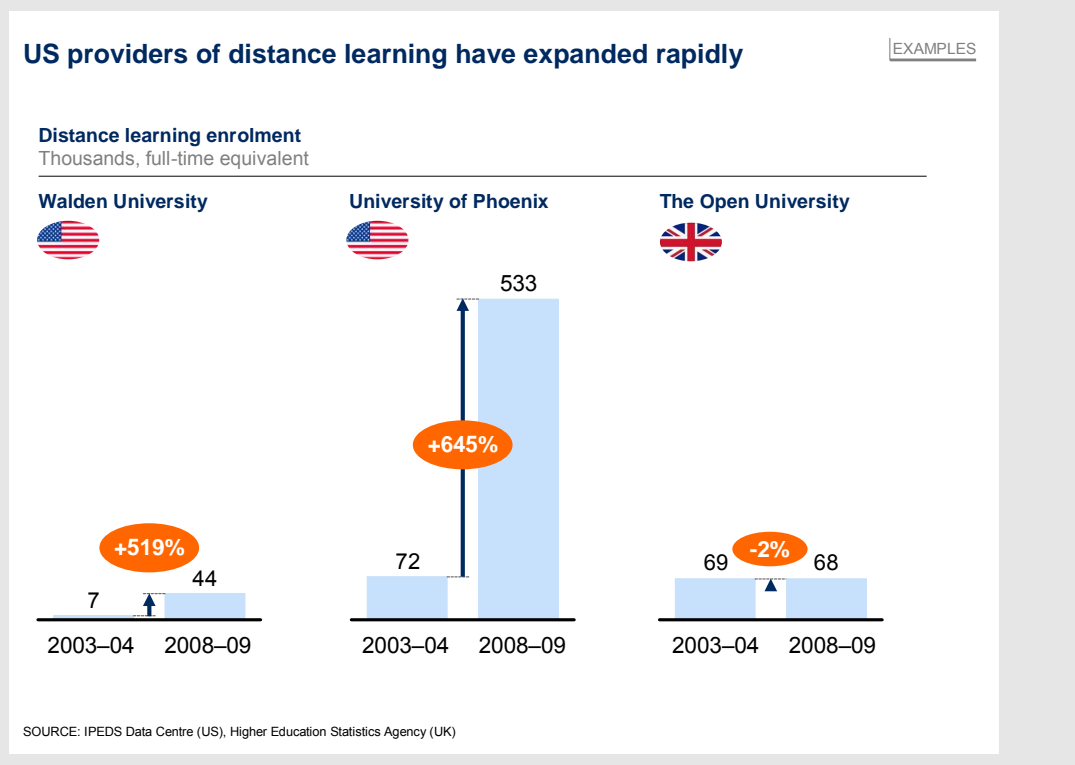
A significant mind-set change is required in the UK's approach to education—it is not only an essential public service but also a large and promising economic growth opportunity for the UK. Proposed reforms to funding are critical, but the focus must now turn to removing any barriers to capturing this opportunity. The government should consider how to:

- **Promote education as an economic growth opportunity.** We recommend working closely with higher education providers to understand how to create a vibrant market for international students—both EU and non-EU. Incentives for expansion should be aligned with other objectives (e.g., ensuring access). Other options may include increasing overseas promotion (e.g., through UKTI and the British Council).
- **Ensure simple and fair immigration for faculty and students.** The government needs to address issues that make the UK less competitive in this market, particularly the risk that the points-based system and immigration restrictions will deter international students and top-flight academics from choosing the UK. We recommend that any reforms to tier 4 student visas do not discourage legitimate immigration for higher education and are excluded from any caps.
- **Remove barriers to capacity expansion.** If the UK were to maintain global share of international students, capacity would need to increase significantly. We recommend working with higher education institutions to identify barriers to expansion, either external (e.g., regulation, funding) or internal (e.g., management resources, governance).
- **Attract private capital and management experience.** To sustain its position in an increasingly competitive global market, the UK will need to attract private capital, and expertise into the sector. This could involve allowing several new private degree-granting institutions—BPP is only the second private university since the founding of the University of Buckingham in 1976. The rapid growth of distance learning through the likes of London School of Business and Finance or the University of Phoenix in the US, show that the size of the opportunity for innovative organisations is large (see box 6, “Growth of major distance learning providers”). The UK should consider how to inject private capital and expertise to build on valuable assets like the Open University.

Box 6. Growth of major distance learning providers

As demand and prices rise in higher education, consumers are increasingly looking towards more flexible models. The growth of distance learning has been particularly strong—demand for degree programmes, professional education, and workplace training has grown by around 10 percent per annum in several developed economies, compared to 2 to 5 percent growth for more orthodox methods.

While the UK has some examples of new, fast-growing providers (such as the London School of Business and Finance), several international institutions have grown much faster than large UK providers like the Open University (OU). Although the quantity of students is not the only measure of success, there are clearly significant opportunities for expansion. In six years, the University of Phoenix in the US has moved from having the same enrolment as the OU to having eight times as many students.



2.5.2 Health care services

Health care demand will continue to grow and put pressure on public funding

For the past 40 years, health care demand has grown at the rate of two percentage points above GDP growth across all OECD countries.⁶⁹ At the same time, it is becoming clear that public spending is likely to face pressure for many years. This is likely to result in a widening gap between what the state is able to pay for and what is demanded.

69 In most markets, health care inflation tends to exceed broader inflation indices so even if health care spend stays constant in real terms, more money or savings need to be raised.

In 2008, total UK spending on health care was around £100 billion (in 2005 prices).⁷⁰ Let's assume it will naturally continue to grow ahead of GDP by just one percentage point (a very conservative assumption given the ageing population and the prevalence of more chronic conditions and advances in technology that expand the range of treatments) and assume that GDP grows at 2 percent per annum in real terms. Roll forward to 2030, and health care is an industry with over £190 billion of spending (in 2005 prices). Now apply current funding plans for the next five years (no cuts in real terms, but no increases either) and then assume that health care spending grows thereafter at 2 percent per annum in real terms. Even on these modest assumptions, a large gap opens up, which needs to be paid for either by private payments or through sustained efficiency savings from improved productivity (Exhibit 29).

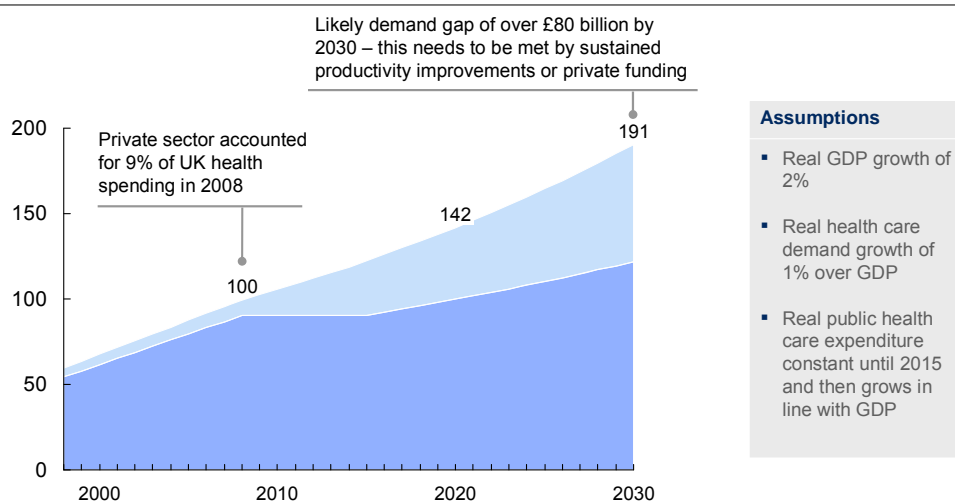
EXHIBIT 29

Productivity improvements and private funding will be needed to help fill the gap in health spending

■ Private health care funding or productivity and cost savings
■ Public expenditure

Real growth in public and private expenditure in health care in the UK

2005 £, billion



Note: Historic private sector share based on share of acute, primary and dental spending. ONS total health care expenditure estimates adjusted to remove social care. SOURCE: UK Office of National Statistics, Expenditure on healthcare in the UK 1997–2008, Laing & Buisson database, 2008 data; McKinsey Global Institute

Given that health care productivity is unlikely to cover the entire gap, it is time for a thoughtful debate about the set of services that the NHS will provide free at the point of delivery to all, which ones will be funded by co-payments (such as some prescriptions today, but potentially a wider range of services), which ones will require top-up fees (such as dentistry or more luxurious hospital accommodation), and which ones will be viewed as private goods for which people should pay the full cost (such as cosmetic surgery).

⁷⁰ Total UK health care expenditure was estimated by the ONS to be £125.4 billion in 2008, representing 8.7 percent of GDP. Our analysis adjusts this figure to remove independent sector expenditure on social care by subtracting estimates from Laing and Buisson for the long-term social care of the elderly and physically disabled (£13.8 billion), the mentally ill (£0.7 billion), and people with learning disabilities (£2.2 billion). Making these adjustments, total health care spending was £108.8 billion in 2008, approximately 7.5 percent of GDP (this £108.8 billion spend is equivalent to £99.5 billion in 2005 prices).

The level of co-payment for services in the UK remains low compared with many other countries, even where the state provides extensive coverage. Countries vary widely in the way that they fund health care. Models include that of Singapore, where two-thirds is privately funded but 80 percent is publicly provided, and the Netherlands, where the government expenditure is complemented by compulsory insurance with private insurers, contributions from employers, and out-of-pocket expenses by patients. The Dutch system is structured in such a way that basic health insurance is guaranteed for the entire population, with the government subsidising contributions for the poor and redistributing the risks equally among insurers. The evidence from the Netherlands also suggests that such a system is compatible with strong health outcomes.

There is also variation in funding methods by service. Over the longer term, the government will need to define how different services are funded in the UK, to ensure clarity and to protect the principle of free care at the point of delivery for an essential core of health care services.

Health reforms start to remove constraints on public providers

The July 2010 White Paper “Equity and Excellence: Liberating the NHS” proposes removing controls on hospitals (specifically those that are Foundation Trusts) that limit their private sector earnings to a fixed percentage of NHS income. To date, caps on earnings from private patients have tilted the playing field against NHS providers and towards private providers, restricting the market and limiting NHS employment.

Removing this cap enables NHS hospitals to use their strong brands to compete in the UK for private services as well as for internationally mobile patients.

The UK can support long-term growth by clarifying the long-term scope of public funding and freeing all providers to compete

Bridging the gap between growing demand and finite public resources will require not only significant productivity savings but also tough choices about how to fund ongoing services in health care. Several options should be included:

- **Establish a review on how to fund different services over the long term.** Clear guidance is required on which services are funded by co-payments, which ones require top-up fees, and which ones are viewed as private goods for which people should pay the full cost.
- **Unleash public providers and create opportunities for more public-private collaboration.** Introducing opportunities for public providers to increase private services will create pressure for change across both the public and private sectors, allowing adoption of best practice. Our research with the Centre for Economic Performance at the LSE shows that private hospitals, on average, have better management practices and better health outcomes (measured by mortality related to AMI). Unleashing public providers will also allow more competition with private providers and greater exposure to best practice (Exhibit 30).
- **Consider reform of pension provisions for transfers under TUPE.** The UK has protections for workers’ rights, known as TUPE (Transfer of Undertakings – Protection of Employment regulations 2006), that protect workers when services, functions, or entire organisations are transferred from the public sector to the private sector. However, many transfer contracts include non-statutory Fair Deal provisions that ensure that workers receive broadly comparable pensions, often higher and more complex than the minimum requirements specified in the TUPE regulations. While contracts allowing pass-through of

pension liabilities back to the public sector are often used, current arrangements can limit flexibility and create uncertainty for organisations (for example, in the third sector) that are considering taking on public sector activities. The CSR 2010 has stated that Fair Deal will be the subject of a review to report in summer of 2011. We recommend that several reforms be considered to improve flexibility including:⁷¹

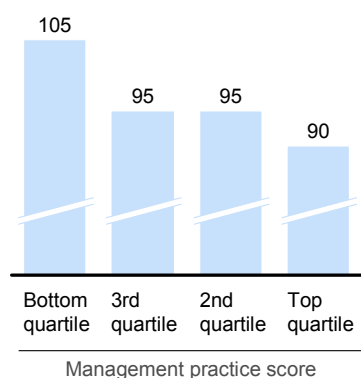
- Altering Fair Deal provisions. While Fair Deal has been critical in protecting workers' rights in the past, since 2006 TUPE regulations provide for minimum pension rights. Fair Deal provisions could be made optional for transfer contracts, or they could be modified.
- Allowing defined contribution alternatives to defined benefit schemes under Fair Deal. Even if Fair Deal is retained in some form, employers would gain greater certainty and reduce administrative cost if generous DC schemes could replace DB schemes (which is not currently permitted).
- Redefining “two-tier workforce” provisions. Currently employers under TUPE who hire additional “non-transfer” workers are required to offer the new workers comparable packages, raising the cost of providing the service to the state.

EXHIBIT 30

Unleashing the health sector could lead to improved management and health outcomes

There is a strong relationship between management practices and health outcomes

UK – Management Practice score and Heart Attack Mortality rates¹



Five factors are closely associated with higher management scores

Competition. Managerial standards are higher when there is more competition

Skills. Clinical qualification of managers is associated with better management

Autonomy. Scores are higher when managers have decision-making authority and accountability to front line

Size and scale. Larger hospitals are better managed

Ownership. Private and not-for-profit hospitals have higher scores

¹ 30 days risk adjusted AMI Mortality rate (relative to national average)

SOURCE: McKinsey and CEP, Management in Healthcare: Why good practice really matters, October 2010; interviews, Dr. Foster quality accounts

71 All reforms would, of course, need to be consistent with EU directives and subsequent rulings. For example, Beckman v Dynamco Whicheloe Macfarlane Ltd. (ECJ, 2002) implies that transfers under TUPE must preserve generous early retirement and redundancy terms.

2.6 PILOT DEVOLUTION TO DYNAMIC CITIES

There is a longstanding regional development problem in the UK—and cities are key to resolving this problem

The UK has many dynamic cities, and cities drive economic growth. Cities were responsible for 78 percent of the UK's economic growth over the last ten years—and almost three-quarters of the population live in them. They also support large rural hinterlands, despite the belief held by some that urban growth undermines the development of surrounding areas.

However, historically, cities have been constrained in their ability to develop, with central government controlling most regional spending through nationally set allocations and allowing only limited flexibility at local level. Public spending is highly centralised in the UK, and local government, where it is responsible for spending, must satisfy many central targets. The Local Government Association estimated in 2006 that more than 80 percent of central targets were concerned with local government. For the most part, local authorities are sub-scale to influence city direction and are denied the chance to vary their approach to economic development according to local comparative advantage and citizen preferences. Recent coalition government policies are removing some of these local burdens.

Furthermore, powers have not always been held at the right level. Cities may be the natural economic zones, but they normally span multiple local authorities (ten in the case of Greater Manchester), which inevitably raises coordination challenges and hinders growth. Academic research, indeed, confirms this intuition; international studies show that localising decision making to an economically relevant level is beneficial.⁷² Moves to allow Local enterprise partnerships (LEPs) may address many of these concerns, despite initial teething problems with the implementation of this policy.

Cities and local authorities also face barriers to local development and investment in the shape of inflexible planning restrictions and limited incentives. The current planning system often inhibits high-growth areas from attracting workers, thanks to limits on house building and new infrastructure. For example, Brighton, with real GVA growth of 3.8 percent between 1998 and 2007, achieved the distinction of being one of the UK's most economically successful cities, but its house building rate is 55 percent below the national average.⁷³ In 2004, office occupation costs were 44 percent higher in Birmingham than in Manhattan.⁷⁴

Regional development has been a well recognised dilemma in the UK for some time, with growth outside the South East consistently slower than the national average. Outside London, GDP per capita is 47 percent below what it is in London, a gap that could widen to 56 percent if the trend of the last 20 years continues for the next 20 years. The public sector has often been used to create jobs in the regions—in some areas such as the North East, the public sector provides over 25 percent of employment. The risk is that regions

72 Cheshire, Paul and Stefano Magrini, "Counteracting the Counterfactual: New Evidence on the Impact of Local Policy from the Residuals", in *Regional Policies and Comparative Advantage*, Borje Johansson, Charlie Karlsson, and Roger Stough (editors), Edward Elgar Publishing, 2002.

73 For further examples, see Centre for Cities, *Arrested Development: Are We Building Houses in the Right Places?* March 2010.

74 Cheshire, Paul and Christian A. L. Hilber, "Office Space Supply Restrictions in Britain: The Political Economy of Market Revenge," *Economic Journal*, 2008, Volume 529, Number 6, 185–221.

outside London become increasingly marginalised and that the country as a whole misses out on a huge opportunity to boost economic growth.

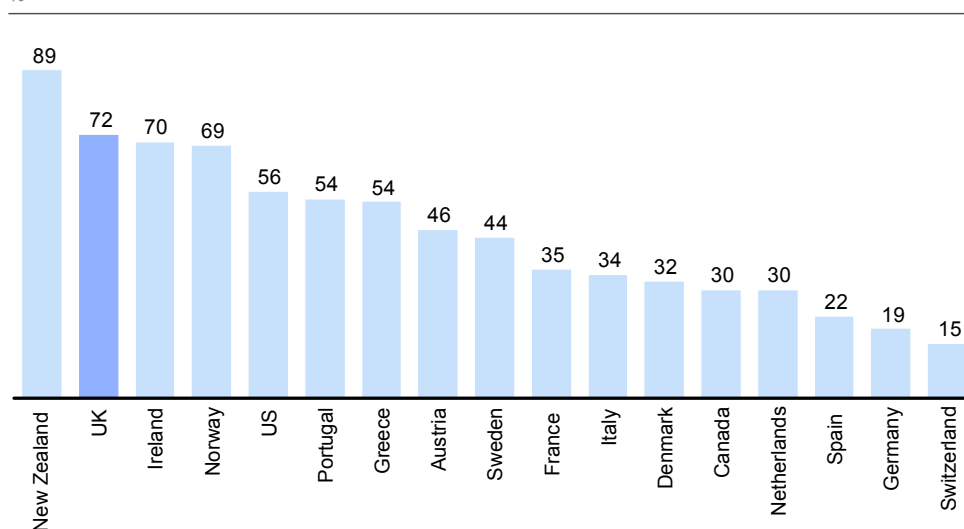
Some steps to increase local control and ease planning difficulties are being tackled—but the present measures do not go far enough

A key impediment to the growth of the UK's leading cities has been a lack of sufficient control at the local level. Public spending is highly centralised. Out of a sample of 17 advanced OECD countries, the UK has the highest percentage of government spending than in any other country except New Zealand, a nation with a population just over half the size of London's (Exhibit 31).⁷⁵

EXHIBIT 31

UK government spending is highly centralised

Government expenditure by central government,¹ 2006
%



¹ Excluding separated social security funds
SOURCE: OECD Governance at a Glance 2009

The central government is taking constructive steps to decentralise, moving towards empowering communities to pursue their own development and growth. The 2010 White Paper, “Local growth: realising every place’s potential”, addresses a number of issues related to the governance and autonomy of localities, the need to focus on economically meaningful areas and the need to realign local incentives for economic development. It also sets out measures to help those regions hardest hit by public sector cuts to rebalance by developing their private sectors.

- **Governance and autonomy.** Local authorities will have greater control over “community” budgets with reduced ring-fencing and targeting. The government is

⁷⁵ Note that this is central government spending as defined by the OECD and excludes separated social security funds. Excluded from this comparison, for reasons of data availability, are Chile, Israel, Slovenia, Mexico, Turkey, and Australia.

introducing community budgets for 16 areas to give greater flexibility in the allocation of resources to social projects.

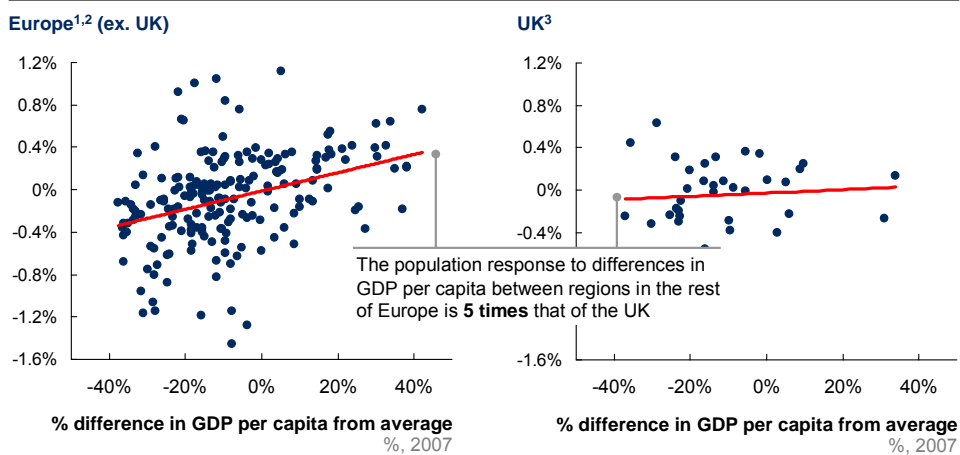
- **Shifting the focus to “natural economic areas”.** The government has invited businesses and councils to come together to apply to form local enterprise partnerships (LEPs). Each LEP is expected to provide vision and leadership on the development of private sector growth and job creation in a natural economic area. They will replace Regional Development Agencies (RDAs), which were based on administratively defined regions.
- **Planning.** Local area incentives for both housing and commercial development will be improved with Right-to-Build powers, facilitating small-scale development without planning approval, a new homes bonus, and the ability to fund local infrastructure through tax increment financing (based on business rates). Government is also considering ways to allow local authorities to retain locally raised business rates.
- **Regional growth funding.** Although regional funding through RDAs is being removed, the regional growth fund will award £1.4 billion over three years to areas hardest hit by public sector cuts to stimulate private sector development. The government’s NIP also commits to public investment in regional transport infrastructure.

The thrust of this agenda is promising, though critical details of how the new system will work have still to be clarified. The final mechanisms will determine the possible impact of reforms. In the meantime, UK cities remain highly constrained (Exhibit 32). Our analysis shows that, unlike in Europe, the populations of the UK’s more economically successful cities do not expand faster than the national average. This suggests that their growth rates are constrained and that these cities are not reaching their full potential.

EXHIBIT 32

Cities in the UK are constrained from expanding

Population change premium over country average, 1998–2008
 Percentage points



1 Some countries excluded due to size or lack of data. Contains Austria, Belgium, Bulgaria, Czech Republic, Finland, France, Germany, Greece, Hungary, Italy, Netherlands, Poland, Portugal, Spain and Sweden
 2 Outliers removed (Prague, Brussels, Hamburg, Ile de France, Flevoland and Illes Balears)
 3 Outlier removed (Inner London)
 SOURCE: Eurostat; McKinsey Global Institute analysis

We recommend exploring a wider range of options

We believe that bolder action is necessary, with a controlled multiyear experiment involving devolution in two to three “pilot” cities, by supporting city governance, increasing financial autonomy, relaxing planning restrictions, and improving the incentives for local development.

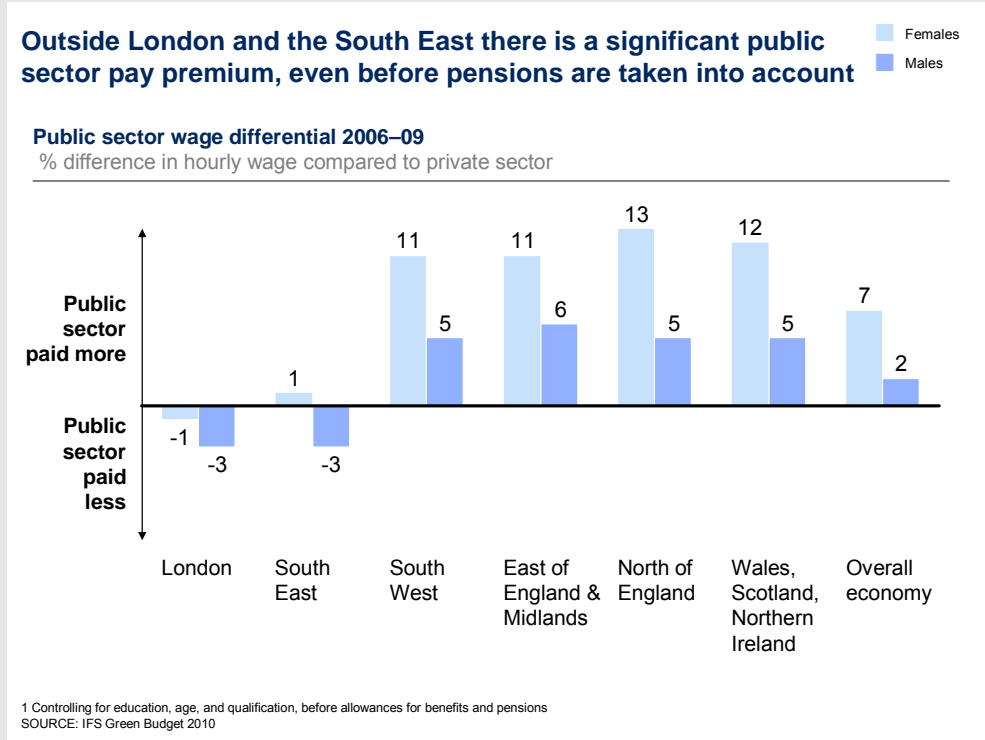
- **Establish multiyear city devolution pilots.** We recommend establishing pilots in two or three of the UK’s major cities with extended planning and funding flexibility and thus creating opportunities for forward-looking mayors and their communities to reshape public spending and experiment with new ways to drive growth. These cities should be encouraged to compete for both public and private investment and to maximise economic value. One radical solution would be to give local areas the power to negotiate regional or even individual pay deals in the public sector. National agreements have long distorted labour markets, potentially crowding out the private sector. Allowing more deprived areas to be flexible on wages and provide a more competitive offer, could boost regional employment (see box 7, “Public sector pay”).
- **Reduce restrictions on land use, zoning, and planning.** The UK’s greenbelt policy is designed to stop cities from growing. It may be advisable to reconsider this policy, given that cities account for nearly 80 percent of economic growth. Public misperceptions on the issue are often quite striking (see box 8, “Planning perceptions in the UK”). Land use restrictions should be reconsidered and relaxed to avoid being an unnecessary drag on development. The government might also consider reviewing height restrictions on building as this would allow expansions without encroaching on greenbelts. Local communities should be allowed to build more densely on developed land where they feel doing so would best meet their development objectives.
- **Bolster local incentives for development.** This can be done in several ways, but at heart, local communities must receive benefits from development that are both sufficiently large and timely to offset the additional costs. Possible options include:
 - **Allocating a greater share of business rates to local authorities.** Under the present system, a large proportion of these rates are collected centrally, and while some are subsequently used for local services, the link with development is broken. Local authorities should keep a large share of locally raised revenue without national involvement.
 - **Bolstering the new Communities Infrastructure Levy (CIL).** The CIL requires developers to pay an additional tax on each development to offset its negative impact. It is not clear, though, that this system will deliver the necessary incentives, and it is complex to administer when combined with other rules on development such as section 106 payments. Pilot cities could experiment with simpler and more transparent payments from developers direct to councils (to help limit council tax bills) in place of the current complex and opaque processes.
 - **Introducing land auctions.** A more radical solution would be to use land-designation auctions to determine where new developments are built.⁷⁶ These schemes could be applied first to the redesignation of brownfield sites to residential land.

⁷⁶ Leunig, Tim, *In My Backyard: Unlocking the Planning System*, CentreForum, March 2007.

Box 7. Public sector pay

Wage comparison between public and private sectors is a difficult topic, given differences in qualifications, age, and educational requirements. After controlling for these variables and even before adjusting for pensions and other benefits,⁷⁷ the public sector wage premium is still significant outside London and the South East. When public sector pensions are taken into account, the premium over the private sector amounts to an additional 12 percent of earnings.

Pay regulation has been found to undermine the effectiveness of public services⁷⁸, and reform of the system is not without precedent; Alison Wolf argues that Sweden moved to a more decentralised system of pay bargaining in the early 1990s. A range of alternative options has been put forward in the UK, including a regional wage bargaining scheme suggested by the Chartered Institute of Personnel Development. While pay levels would be set nationally, regional variations could reflect cost of living and recruitment rates.⁷⁹



77 Bozio, Antoine and Paul Johnson, “Public Sector Pay and Pensions” in Chote, Robert, Carl Emmerson and Jonathan Shaw (editors), *IFS Green Budget 2010*, Institute of Fiscal Studies, February 2010.

78 For evidence that pay regulation in the public sector adversely affects the provision of services, see Hall, Emma, Carol Propper, and John Van Reenen, *Can Pay Kill Regulation? Panel Data Evidence on the effects of Labour Markets on Hospital Performance*, CEP Discussion Paper 843, Centre for Economic Performance, January 2008. In a study of hospital outcomes, the authors find that areas with strong labour demand and pay regulation experience higher AMI mortality rates.

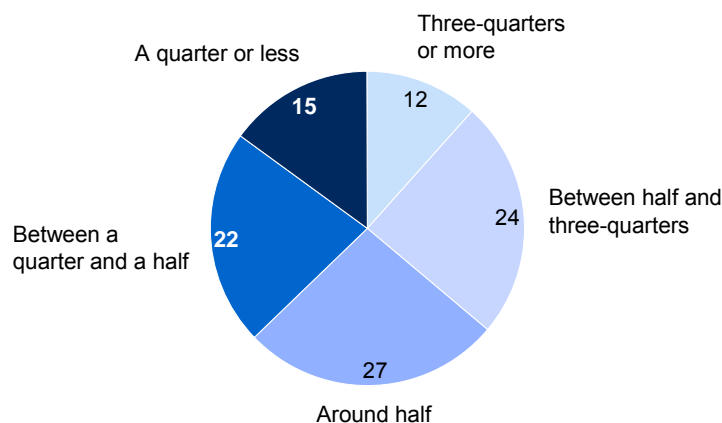
79 Wolf, Alison, *More Than We Bargained For: The Social and Economic Costs of National Wage Bargaining*, CentreForum, 2010.

Box 8. Planning perceptions in the UK

A major barrier to planning rule reforms in the UK is the level of misperception among the public. Conventional wisdom suggests that the UK is a small and crowded island and that planning rules prevent overbuilding and destruction of valuable natural areas. While there are many important considerations in planning, it is clear that conventional wisdom suffers from several misperceptions.

Perceptions of development in England

What proportion of land in England do you think is developed?



Note: Excludes "Don't know" responses
SOURCE: Barker Review 2006

- The UK is far less developed than commonly believed. According to the Barker Review, over 60 percent of UK residents think that half or more of England's land is already developed. The reality is that only 10 percent of England is developed, and much of the developed land is made up of gardens. This holds true even for the South East (outside London), where only 12 percent of land is developed.
- Protections cover a huge proportion of the land, with over 30 percent under some form of protection, including the 13 percent of English land that is designated as green belt. So more land in England is designated as green belt than is developed.
- Very little (only 17 percent) of the green belt is designated as an area of outstanding natural beauty or of particular environmental interest.
- Increasing the size of London by 10 percent would encroach on only 3 percent of the surrounding green belt.

2.7 ADDRESS GENERATIONAL IMBALANCES

Demographic trends pose two challenges for major developed economies such as the UK.⁸⁰ The first is how to maintain growth in the face of a declining working population. The second is how to fund long-term care and rising health care costs.

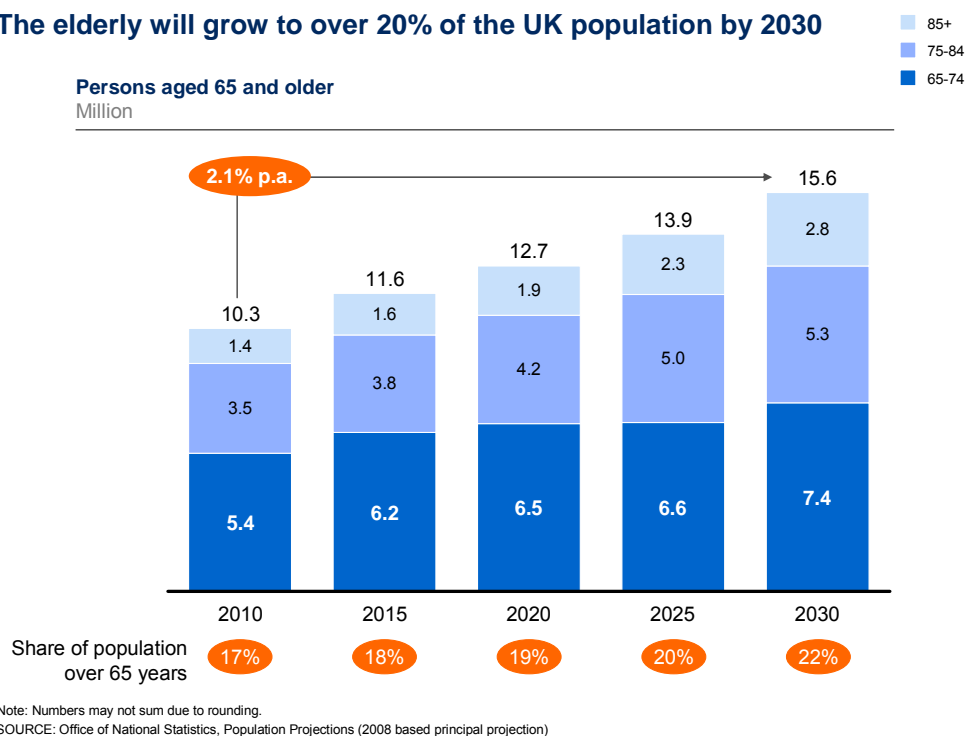
2.7.1 Accelerate the adoption of best practices for the older working population

Demographic trends could place a drag on growth in GDP per capita

In the absence of any change in future patterns of work, the falling share of the working population relative to total population will restrain the UK's GDP per capita. The share of the population aged 65 and older is expected to grow to exceed 20 percent by 2030 (Exhibit 33).

EXHIBIT 33

The elderly will grow to over 20% of the UK population by 2030



As discussed in Section 1.3, over the past 30 years, increases in the working population relative to total population have added about 3 percent to total GDP per capita in the UK.⁸¹ Looking ahead, unless retirement patterns change, the new demographic trends could

80 We would like to thank Gioia Ghezzi, Kara Carter, and colleagues in the McKinsey Health and Insurance practices for input on this section.

81 Overall hours per capita have fallen slightly as reduced hours per employee (e.g., through greater part-time working) have offset increased participation.

represent a 0.3 percentage point drag on growth every year. The UK is in a better position than the rest of Europe, but the overall impact is nevertheless up to 6 percent of GDP between now and 2030, approximately equal to the onetime loss of output resulting from the recent financial crisis.

Ageing will also impose an increasing fiscal burden on the government. Even after taking into account reduced public expenditure on education or unemployment benefits (reflecting the declining population in the relevant age bands), the European Commission projects that spending on pensions, health care, and long-term care will impose an additional “off-balance-sheet commitment” for the UK government of 2.8 percent of GDP annually from 2007 to 2035.⁸²

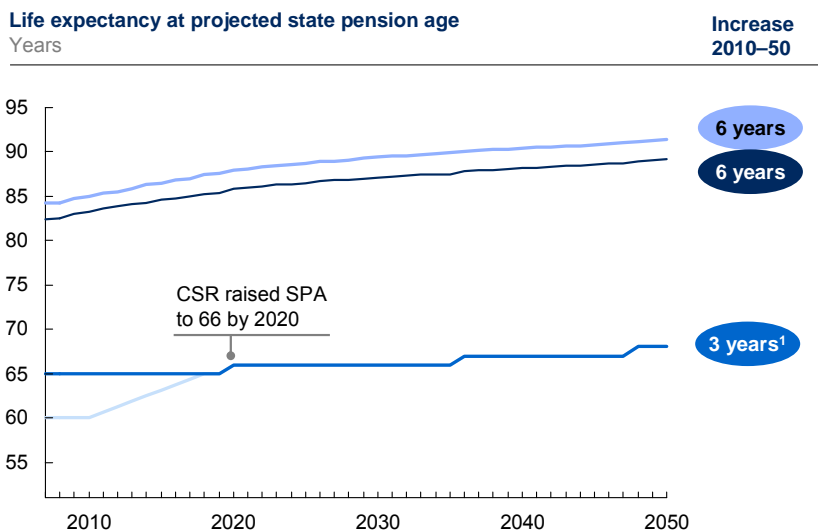
Recent policy measures have been constructive, but have not yet translated older (often part-time) working into practice

The UK is leading the way in Europe when it comes to tackling the implications of changing demographics and retirement patterns. The current and the previous governments have both acted on this issue, equalising retirement ages for men and women, consulting on further increases in the state pension age, introducing reforms to pension systems, and removing default retirement age provisions. The recent Spending Review brought forward plans to raise the state pension age to 66, and that is now scheduled to happen by 2020 instead of 2026. Despite these changes, the increase in longevity over the coming decades is still expected to outstrip rises in the pension age (Exhibit 34).

EXHIBIT 34

State pension age is projected to increase, but not keep pace with the rise in longevity

- state pension age (female)
- state pension age (male)
- Life expectancy at pension age (female)
- Life expectancy at pension age (male)



1 Calculation based on male SPA. Female SPA, currently 60, is due to be equalised with male SPA by 2018. It is due to increase by eight years over the period 2010–50. SOURCE: SPA estimates based on Department for Work and Pensions 2007 projections, updated to reflect CSR announcements. Linear interpolation used to estimate the rise in female SPA from 60 in 2010 to 65 in 2018. Life expectancy based on ONS projections.

82 European Commission, *2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2007–2060)*, European Commission, 2009.

Recent efforts to encourage older workers in the UK have produced positive results. Whereas 70 percent of men aged 50–64 were employed in 1996, the figure had increased to 73 percent by 2008; for women aged 50–59, it rose from 61 percent to 70 percent.⁸³ As the state pension ages are equalised and female participation increases, this trend is likely to continue.⁸⁴

Nevertheless, further progress is needed. In 2008–09, only around a fifth of men aged 65–69 continued to work past the state pension age (currently 65 for men, 60 for women). This dropped to around 10 percent for males aged 70–74. For women, the equivalent figures were 35 percent for those aged 60–64, falling to around 5 percent for those in the 70–74 age band.⁸⁵ However, survey evidence suggests that 80 percent of the economically active population would consider some form of paid or unpaid work after formal retirement. Most would prefer any continued working to be on a part-time or flexible basis.⁸⁶

Having a greater number of older workers in the labour market does more than just reduce the dependency ratio. Research suggests that the retention of older people in the workforce can deliver physical, mental, health, and social benefits, as well as being commercially compelling. A recent study of age diversity at 400 McDonald's restaurants across the UK found that older workers boost performance by raising standards of customer service and helping to mentor younger colleagues. Levels of customer satisfaction were on average 20 percent higher in restaurants that employ staff aged 60 and over (around 40 percent of restaurants), compared with those lacking older workers.⁸⁷

Some UK employers have developed progressive policies that increase the attractions of older working, including initiatives to promote health and well-being, training and career development programmes to maintain the skills of older employees, and schemes to offer flexible hours and home working. (See box 9, "Best practice towards older working populations," for further details.) However, adoption of such measures is far from uniform across employers.

83 Office for National Statistics, *Economic & Labour Market Review*, March 2009.

84 Some 13 percent of the UK's population provides some form of informal care—and 4 percent devote as much as 20 hours per week—but almost a quarter of those over 60 act as informal carers.

85 The Institute for Fiscal Studies, "Financial Circumstances, Health and Well-Being of the Older Population," *The 2008 English Longitudinal Study of Ageing (Wave 4)*, October 2010.

86 McNair, S., "How Different is the Older Labour Market? Attitudes to Work and Retirement among Older People in Britain," *Social Policy and Society*, 2004, Volume 5, Number 4, 485-494.

87 The investigation into the link between older working populations and performance at McDonald's restaurants was carried out by The Centre for Performance-Led HR at Lancaster University and led by Professor Paul Sparrow. The research team compared the performance data of 178 company-owned McDonald's restaurants where one or more members of staff aged over 60 years of age is employed with the performance data of 239 company-owned McDonald's restaurants where nobody over 50 is employed. The survey of restaurant managers involved 148 managers and was completed in July 2009. For further details, see http://www.efa.org.uk/data/files/news/mcdonalds_later_life_workers_press_release.pdf.

Box 9. Best practice towards older working populations

Several UK employers have already introduced progressive policies to support and encourage flexible older working populations, supported by networks and organisations such as the Employers Forum on Age (EFA), the Institute for Ageing and Health (IAH) in Newcastle, and Age UK. Examples of effective practices include:

Reducing the impact of ageing through targeted health and well-being programmes.

ScotRail has introduced a strategy to promote the health and well-being of its ageing, mainly male workforce (through initiatives such as smoking cessation advice and in-house physiotherapy). The company has noticed a fall in absenteeism and a marked reduction in musculoskeletal and mental health complaints.

Maintaining the skills of older workers through training and career development.

British Gas has removed age limits on training and apprenticeships. The average age of apprentices has risen. Older trainees often act as mentors to younger members of the group.

Offering flexibility in hours and home working. Both approaches can allow older workers to postpone retirement and adapt their work lives to their own health issues or to the care of other family members. B&Q and Asda both offer flexible work schedules to suit the needs of workers at different life stages, including part-time contracts for grandparents helping with the care of grandchildren. Centrica has saved £10 million on office space by encouraging more home working regardless of employee tenure and position.

We recommend that government and major employers work together to develop a long-term strategy to promote more flexible, extended working lives

The UK should develop a plan that removes barriers and disincentives to older working populations, promotes adoption by employers of best practices towards older working populations, and raises awareness among employees about options for working longer.

There are several ideas for action:

- **Ensure the formal pension framework accommodates and incentivises older (often part-time) working.** This can be achieved through targeted policy adjustments. First, the government should either introduce a more automatic mechanism for raising the state pension age in line with life expectancy or accelerate the existing timetable of proposed increases to the state pension age. This will ensure that participation and the costs of retirement reflect continuing demographic trends. Second, pension rules should be reformed to allow people to take part of their pension entitlements incrementally while continuing to work. Although incentives to defer state pensions currently exist, it is not possible to take part of a pension or to defer the basic state pension without also deferring the state second pension.

- **Establish a national task force to promote best practices in older working among employers and raise awareness about options.** A national task force should bring together policy makers, key stakeholders and researchers to address the issue of older working populations. Participants might include representatives from the Department for Business and Skills, the Employers Forum on Age, the Institute for Ageing and Health, and regional initiatives such as the “Opportunities for Older Workers” programme run by the South East England Development Agency (SEEDA). The task force could develop and maintain a body of evidence to demonstrate the benefits and challenges of older working. It could monitor, publicise, and encourage adoption of best practices among firms, such as initiatives to reduce the impact of ageing, programmes to maintain skills, and policies to meet the changing needs of ageing workers through flexible hours and home working. The task force could also review the use of “right to ask” provisions for flexible working and recommend policies to increase take-up. One effect of the Default Retirement Age (DRA) was to allow older workers the opportunity to request continued working and changes to working practices.⁸⁸ The right to request flexible working continues, but its take-up is limited at many employers.
- **Create systematic career reviews to trigger a shift to older working.** The government could promote initiatives to raise awareness of older working opportunities. As part of this, it might work towards an agreement to introduce systematic career counselling at ages 45, 55, and 60. This would help to bring forward planning for continued or flexible working, identify opportunities for retraining and match career plans to skills. For example, Aviva France offers all workers a career review and training from the age of 50.

2.7.2 Unlocking wealth to fund long-term care

Demand for long-term care is set to grow significantly, but uncertainty surrounds funding

As the UK addresses the challenge of what to do about an ageing population, demand for long-term care is projected to grow significantly. If care provision remains at the same level, demand for long-term care is set to rise by more than 70 percent in the next 20 years (Exhibit 35). This trend will put a burden on the public budget without significant and sustained rises in taxation. Extensive sources of private funding will be required.

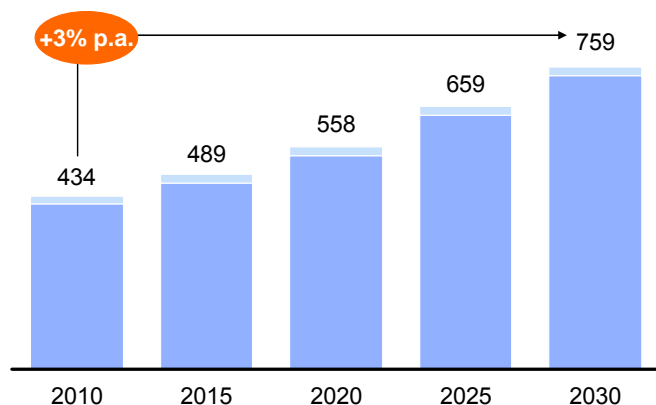
88 The requirement to have a meeting pre-retirement under the DRA rules meant that there was an opportunity to discuss options with employers.

EXHIBIT 35**Demand for care is likely to grow significantly over the next 20 years**

Rest of population
Over 65

Projected¹ numbers of elderly, chronically ill and physically disabled people living in residential settings in the UK, all sectors²

Thousand



¹ Calculated by applying 2007 age-specific risks of living in a residential setting to official population projections, includes all ages

² Aggregate of all sectors – private, voluntary and public

SOURCE: Care of Elderly People UK Market Survey 2008, Laing & Buisson; ONS population projections

However, current funding arrangements for care are poorly understood and are uncertain. Many people are confused about the costs of meeting care needs, who is responsible for funding, and where to get advice. A recent survey by GfK NOP found that people tend to underestimate the duration and costs of their long-term care and that only 11 percent would contact their local authority for advice and information. Only 4 percent would approach a financial adviser, and a quarter had no idea about whom to contact.⁸⁹

Older generations in the UK have the bulk of their wealth locked into valuable housing assets yet have little income. In recent decades, rising house prices and generous pensions have benefited older generations. The majority of the UK's personal wealth is now held by the over-55s, and a substantial portion of this comprises unmortgaged housing assets (Exhibit 36). Unmortgaged home equity owned by older generations was estimated to be worth £1 trillion in 2006.⁹⁰

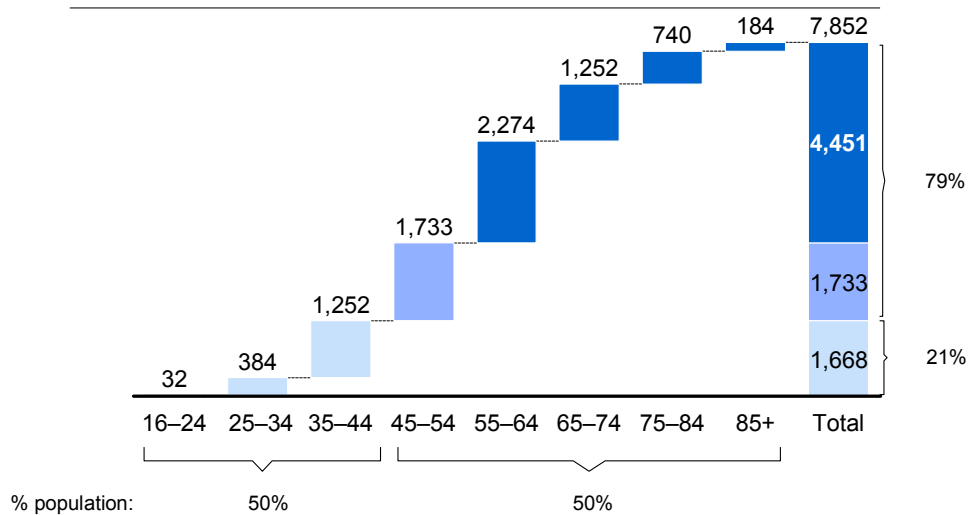
89 GfK NOP interviewed 467 adults aged over 50 across the UK by telephone on 26-28 March 2010. Weights were applied to the data to bring it in line with national profiles. A summary of the survey is available at <http://www.partnership.co.uk/press/2010/June/Press-Release-7-June-20101/>

90 Reifner, Udo, Sebastien Clerc-Renaud, Elena F. Pérez-Carrillo, Achim Tiffe, and Michael Knobloch, *Study on Equity Release Schemes in the EU, Part II: Country Reports*, Institut fuer Finanzdienstleistungen e. V., January 2009.

EXHIBIT 36

A high proportion of wealth is held by older people

Distribution of personal wealth by age group, 2006–08
 £, billion



SOURCE: Wealth and Assets Survey, ONS; Mid-year population estimates, ONS; Labour Force Survey, ONS

The government is reviewing long-term care, and bold ideas are needed

The UK has appointed a commission to consider the best way to meet care and support costs. The Commission on the Funding of Care and Support, chaired by Andrew Dilnot, is due to report in July 2011.

There are many possible approaches to resolve care financing, one among them is expansion of the use of insurance. Only a few countries have compulsory long-term care insurance, and the UK is not one of them. Nor do UK individuals typically take out voluntary insurance for their long-term care needs (Exhibit 37). We believe that one solution that has potential and that has not been explored sufficiently in policy or public debates is home equity release.

Equity release products, also known as reverse mortgages, offer a way to borrow against the value of the home whilst living on in the property.⁹¹ But participation in such schemes has been very limited. The approximately 122,000 lifetime mortgages⁹² outstanding at the end of 2006, valued at around £6.5 billion, represented less than 1 percent of pensioners' net housing wealth. Previous mis-selling scandals have tarnished the public perception of equity release schemes: according to a recent survey, 39 percent of people consider them a good idea in theory, but 60 percent do not trust providers of equity release schemes and

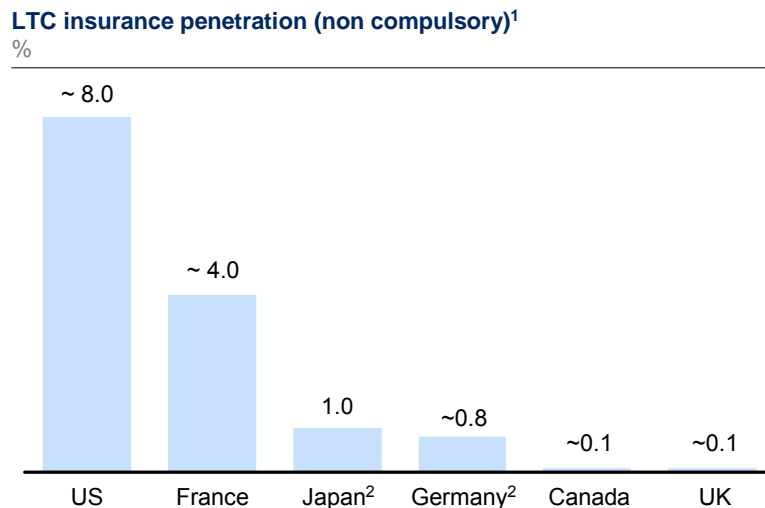
91 According to the Commission for Social Care Inspection, the elderly see selling property to fund care as a last resort—most say they would prefer to be cared for at home.

92 Lifetime mortgages are the dominant form of equity release product for older people in the UK.

50 percent do not believe their products represent value for money.⁹³ In addition to negative customer perceptions, increased regulatory requirements and associated costs caused the leading UK insurance firms to de-prioritise equity release and exit the market.

EXHIBIT 37

Individuals do not insure voluntarily for their long-term care needs ESTIMATES



1 – i.e., percent of total population holding an LTC insurance contract
2 Supplementary private LTC insurance in addition to mandatory public insurance
SOURCE: McKinsey Global Institute analysis

The UK should encourage growth in long-term care insurance and catalyse the equity release market

We recommend the expansion of funding for long-term health and social care by looking at ways to grow both insurance and equity release markets, by considering, for example, how to:

- **Increase awareness of long-term care costs and reduce uncertainty surrounding funding.** In addition to clarifying policy on social care funding, the government should work with providers of care products and care funding to educate the general public about likely care needs, their cost, the share they are expected to meet, and the investment products available to finance personal contributions. More Independent Financial Advisors (IFAs) qualified to provide advice in this area would also help to raise awareness.
- **Stimulate long-term care insurance through default savings.** The government should consider establishing an auto-enrolment savings scheme for long-term care insurance.

⁹³ Rowlingson, Karen and Stephen McKay, *Attitudes to Inheritance in Britain*, Joseph Rowntree Foundation, July 2005.

One idea would be to operate this through “opt-out” payroll deductions, in a similar fashion to the proposed auto-enrolment pensions scheme.⁹⁴

- **Relaunch the equity release market.** This could be achieved by addressing reputational concerns, reducing regulatory costs, introducing government guarantees for a secondary market, and removing disincentives to equity release created by the tax and benefit system.⁹⁵
 - **Countering reputational concerns and encouraging product innovation.** Consumers and many advisers lack confidence in these products as a result of previous mis-selling. Additionally, the regulatory environment and costs dissuade the leading UK financial services players from entering the market. Furthermore, products need refinement to help potential customers leave some portion of their housing wealth to their children.⁹⁶ The government could address these issues in several ways. First, it could encourage well-known brands, such as high street banks, to enter the market or offer access to providers. Second, it could work with industry to simplify and standardise product comparisons, and it could consider standardising underwriting terms and contract details to reduce regulatory costs. Third, it could encourage the development of more flexible equity release schemes that allow customers to release some of their home equity but protect a specified portion of the remaining equity. Finally, it could introduce regulator-led consumer education of equity release products, so that products are better understood.⁹⁷
 - **Introducing government support and guarantees for equity release.** The government could introduce a mortgage-backed security insured by the state. The creation of a robust secondary market in reverse mortgages could drive liquidity in the primary markets, ultimately lowering costs for the elderly borrower. The long-term nature of the reverse mortgage product has tended to be unattractive for lenders, who must tie up capital for a long time without payback. Prudential and several other lenders have exited the UK equity release market recently, citing this feature of the product and the need to deploy capital more effectively.⁹⁸ Access to a liquid state-backed secondary market could change the economics for providers, stimulating re-entry. (See box 10, “Government-insured reverse mortgage securities in the US,” for detail on the state-guaranteed securitisation of reverse mortgages for older citizens in the US.)
 - **Removing disincentives to equity release created by the tax and benefit system.** Although equity release can ease inheritance tax obligations, those who take out policies face the risk of losing benefits because they exceed income or capital

94 The UK government has specified that all employees over 22 will automatically be enrolled in a workplace pension from 2012 (provided that they earn above the annual earnings threshold). Minimum contributions apply, and employees will be entitled to opt out.

95 Equity release products have an advantage that as assets they match the liabilities that many insurance companies face due to ageing.

96 See, for instance, Rowlingson, Karen and Stephen McKay, *Attitudes to Inheritance in Britain*, Joseph Rowntree Foundation, July 2005.

97 One particular barrier is that the size of mortgage sums appears small in relation to the likely repayment. A considerable shift is needed for customers to understand the true costs to providers once accumulated interest is taken into account in the absence of ongoing payments (i.e., unlike a regular mortgage).

98 See, for instance, Welling, D., “Prudential Pulls out of Equity Release,” FT Adviser, *Financial Times*, 23 November 2009.

rules. If they convert drawdowns to income, they may also incur income tax charges. Exempting home equity withdrawal from tax and benefit calculations could encourage the market to develop.

Box 10. Government-insured reverse mortgage securities in the US

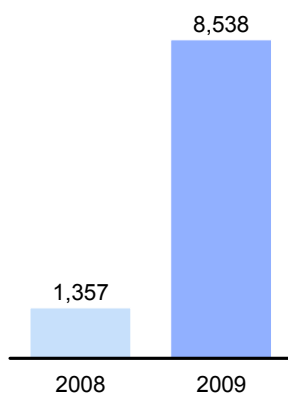
A significant development took place in the US reverse mortgage market in 2007: the Government National Mortgage Association (Ginnie Mae) became the guarantor of a new mortgage-backed security. The Home Equity Conversion Mortgage (HECM) is a reverse mortgage available to American homeowners over the age of 62. Under the scheme, private lending institutions approved by Ginnie Mae originate eligible reverse mortgage loans, pool these into securities, and issue Ginnie Mae mortgage-backed securities. The full faith and credit guarantee of the US government then guarantees the timely payment of principal and interest on these reverse mortgage-backed securities to institutional investors worldwide.

By providing these guarantees, the US government's intention has been to facilitate the creation of a robust secondary market in reverse mortgages that will drive liquidity and ultimately bring down costs for elderly borrowers. Growth in this secondary market appears to have been rapid since its launch in 2007.

The US government-backed secondary market for reverse mortgage securities has grown rapidly since its launch

Growth in US reverse mortgage securities 

Ginnie Mae HMBS annual volume
\$ million



“

Ginnie Mae's full faith and credit backing of the HMBS, coupled with a standardized securitization structure, will expand our ability to provide consumers with safe, reliable reverse mortgage products.

”

– Michelle Minier, chief executive officer of Financial Freedom

“

This is an important milestone in the developing reverse mortgage market. We believe that the HMBS [...] will spur secondary market growth and increase liquidity. This will drive down the cost of borrowing for older Americans.”

”

– Thomas R. Weakland, Acting Executive Vice President of Ginnie Mae

SOURCE: ginniemae.gov, reversmortgagedaily.com

Conclusion

The short-term outlook for the UK is challenging and has spurred significant changes in government policy and vigorous public debate. Now is the time to look forward and take a long-term view on the future sources of growth. This report is intended to challenge existing orthodoxies and bring a fact-based perspective to the debate around what it will take to secure long-term growth.

Indeed, based on our work, we are optimistic that tackling the seven priorities we have identified will enable the UK to achieve robust long-term growth leading to an economy in 2030 that is productive, broad-based, and resilient.

The ultimate goal is an economy that is built on sustained long-term productivity gains. Continued high levels of employment are important—especially in the face of the demographic trends that confront the UK—but productivity is the key. And achieving productivity growth means taking a sector-by-sector approach that removes barriers to best practice, secures the UK as the location of choice for multinationals, unlocks infrastructure investment, supports innovation at scale, and unleashes the growth potential of education and health.

Ensuring broad-based growth also means taking steps to grow the cities that were responsible for 78 percent of UK economic growth over the past decade and in doing so ensure much greater city-wide coordination and financial responsibility.

Additionally, a resilient economy must have in place conditions favourable to continued growth in the face of global trends. Critical in the context of these trends is the need to support a radical increase in older working and to unlock the £1 trillion of unmortgaged housing wealth owned by those over 60. This could include equity release to enable older generations to make a greater contribution to paying for the public services they need without imposing a greater burden on younger generations that will act as a drag on long-term growth.

The UK economy has many advantages on which to build and a record of productivity gains that bode well for the future. The challenge now is to emerge from the downturn with a commitment to productivity growth that embraces the seven priorities for action outlined in this report. When implemented, the result should be a country well-equipped to move from austerity to growth, anchored in a broader, more productive, and more resilient economy.

Appendix: Sector clusters

Economic sectors exhibit a variety of profiles in terms of their productivity and productivity growth. Data used for sectoral analysis are drawn from the EU KLEMS database. Using EU KLEMS sectors, MGI defines ten sector groups based on the type of activity performed and tradability of the output (Exhibit A1).⁹⁹

EXHIBIT A1

Groups of sectors have been chosen on the basis of characteristics, trends and sizes of industry sectors

Primary resources	<ul style="list-style-type: none"> Agriculture Mining (energy) Mining (non-energy) 	Infrastructure – Construction	<ul style="list-style-type: none"> Construction
Manufacturing	<ul style="list-style-type: none"> Automotive Basic metals Chemicals Computing machinery Electrical machinery Food and beverages Machinery Manufacturing Medical, precision and optical instruments Minerals Printing Pulp & Paper Radio/TV/communication equipment Refining Rubber Textiles Tobacco Transport equipment Wood 	Infrastructure – Transport	<ul style="list-style-type: none"> Air transport Land transport Water transport Other transport
		Local services	<ul style="list-style-type: none"> Automotive retail Hotels Leasing Private Retail Wholesale Other social
		Business services	<ul style="list-style-type: none"> IT services Professional services – Other Research
		Professional and financial services	<ul style="list-style-type: none"> Banking Insurance Other finance Professional services – Legal, technical and advertising
		Health, education, and other public goods	<ul style="list-style-type: none"> Education Health & Social Public
Infrastructure – Utilities	<ul style="list-style-type: none"> Post & Telecoms Utilities 	Real estate	<ul style="list-style-type: none"> Real estate

SOURCE: EU KLEMS; McKinsey Global Institute analysis

- Primary resources includes all extractive industries.
- Manufacturing includes all goods manufacturing industries.
- Infrastructure/utilities groups network industries such as electricity, gas, water, post, and telecoms.
- Infrastructure/construction includes all activities related to construction and the maintenance of buildings.
- Infrastructure/transport includes freight and passenger transport as well as storage activities (it does not include road or railway building, which belongs to the construction group, nor train or aircraft manufacturing, which belongs to the manufacturing group).

99 MGI uses the NACE 1.1 classification used by EU KLEMS to define these sectors.

- Local services groups activities that are local by nature such as hotels, restaurants, retail and wholesale trade, and personal services (e.g., leisure, private household personnel, and media).
- Business services groups all services that are provided to other companies, with the exception of financial services (see next item).
- Professional and financial services groups activities related to financial services. This group also includes professional services, as these sectors show similar productivity levels and include finance-related activities such as accounting, auditing, and tax. Technical and advertising should be classified as business services, but granular data is not available for these activities.
- Health, education, and other public goods groups all activities that are usually provided or (partly) funded by governments such as education, health, public administration, defence, and public services (e.g., police, fire services, and justice).
- Real estate includes real estate activities. The accounting of real estate value added includes imputed rent (i.e., imputing a value added to buildings used by their owner equivalent to the value added they would generate if they were leased). This leads to sector productivity numbers that are difficult to interpret.

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