UK – Public finances to feel the strain as weak productivity dampens outlook

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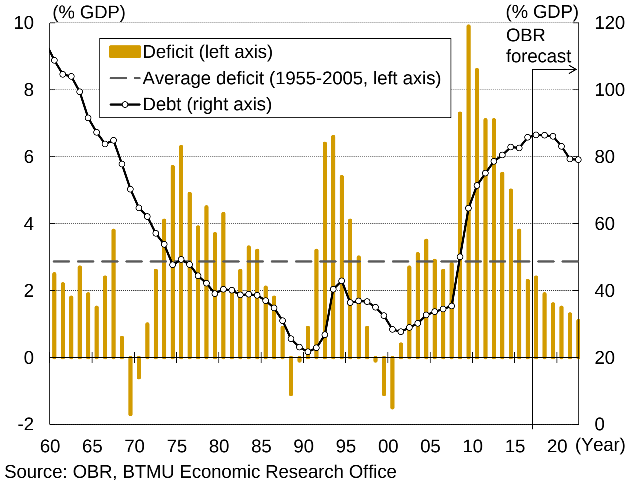
1. Introduction

On 22 November the UK finance minister announced the annual Budget. There was no radical deviation from recent policy. Some modest measures aimed at helping with political pressure points mean slightly higher government borrowing, but the overall fiscal policy mix remains tight. In fact, the policy proposals were overshadowed by downbeat forecasts from the Office for Budget Responsibility (OBR, the independent public finance watchdog which releases forecasts for each Budget). GDP growth forecasts have been dragged down and public finances will come under much more pressure than previously expected over the next five years. It may well be worse; the forecasts are based on neutral assumptions about Brexit.

2. Fiscal consolidation

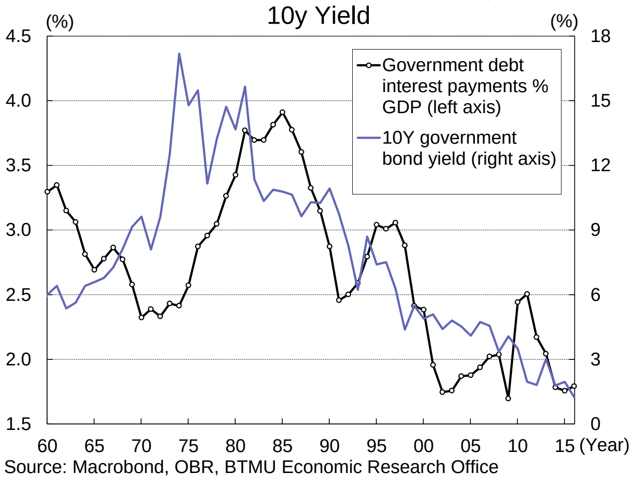
The UK government has maintained tight fiscal policy since 2010. The current target is to reduce the cyclically adjusted budget deficit to 2% of GDP and have falling public debt as a share of GDP by 2020-21. Longer term, the aim is to reach a budget surplus “at the earliest possible date” in the next parliament (the announcement was before the snap election in June so we take this to mean 2020-2025).

Chart 1: UK Public Debt and Deficit



Source: OBR, BTMU Economic Research Office

Chart 2: UK Government Debt Interest Payments and 10y Yield



Source: Macrobond, OBR, BTMU Economic Research Office

The OBR thinks the government will meet all three targets. The cyclically-adjusted budget deficit stood at 2.2% of GDP in 2016-17 but is on course to fall to 1.8% by next financial year, and 1.1% by 2022-23. Public sector net debt will probably peak at around 86.5% of GDP this year then fall to 79.1% by 2022-23.

As chart 1 shows, the (unadjusted) deficit last year dipped below the post-war average. Favourable financing conditions are helping. Very low yields on government bonds mean that government debt interest payments (as % of GDP) are a full percentage point below the long-term average (chart 2). However, we do note a headwind from the post-referendum depreciation in sterling. The latest ONS public finance data show that the government's debt interest payments have risen considerably due to the effect of higher RPI inflation on index-linked gilts.

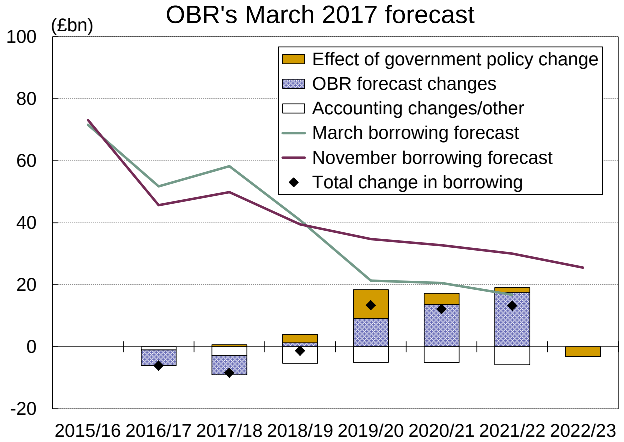
3. Some slight easing in the short term but no departure from austerity

Against this background, there was no meaningful departure from austerity in the 2017 Budget. Instead there was some very moderate fiscal easing. This came in the form of relatively small-scale policies aimed at easing political pressure on the Brexit process, public services and housing:

- An extra £3bn was allocated to government departments to help prepare for Brexit over the next two years. This includes "funding to prepare the border, the future immigration system and new trade relationships".
- £6.3bn of new funding for the National Health Service.
- Stamp duty (a property transaction tax) was cut for most first-time house buyers. The change will save purchasers up to £5,000 in upfront costs at an estimated £3.2bn cost to the government over the five-year forecast period.
- Fuel duty per litre will be frozen again in nominal terms. This, combined with the stamp duty move, means the resulting overall policy mix is a net cut in taxes next year.
- The government will support housebuilding with £15.3bn of new funding and the creation of five new towns.

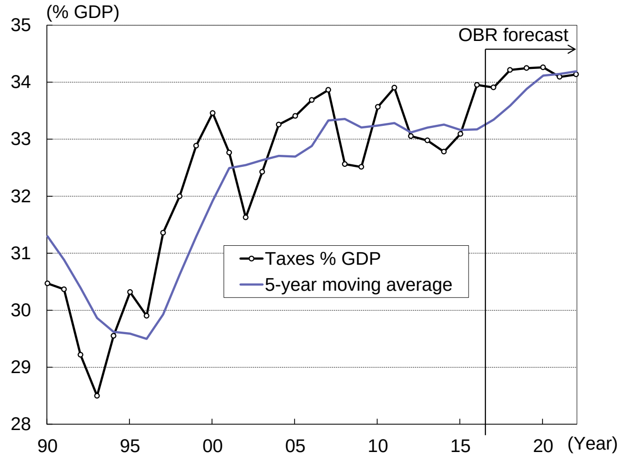
These measures, along with other policy changes and a reduction in the pace of planned future cuts will add £2.7bn to government borrowing in 2018-19. This increases to £9.2bn (0.4% of GDP) in 2019-20, according to the OBR (chart 3). After this, temporary boosts for Brexit and the health service will fade and the government plans tighter fiscal policy. The Institute for Fiscal Studies (IFS) estimates that the Budget will lead to a net cut to welfare of £11.5bn by 2021-22 and net tax rises of £4bn. As chart 4 shows, the UK tax burden (as a share of GDP) has been trending upwards since the mid-1990s and is expected to increase further.

Chart 3: Public Sector Net Borrowing: Changes to the OBR's March 2017 forecast



Source: OBR, BTMU Economic Research Office

Chart 4: UK Tax Burden



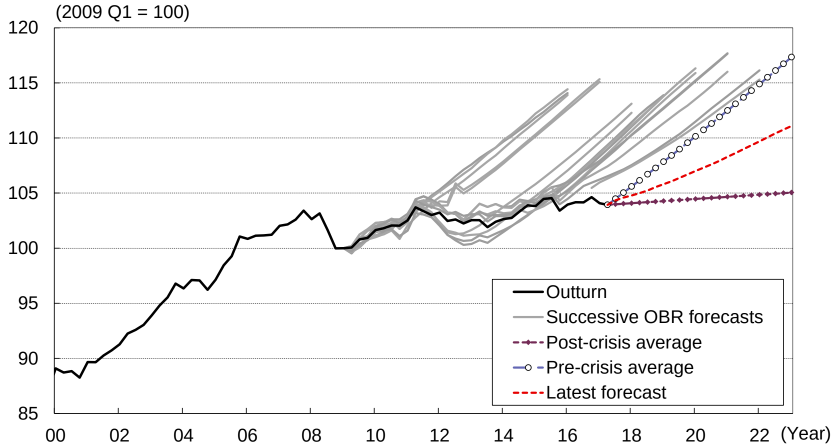
Source: ONS, BTMU Economic Research Office

It is also worth noting that the government was fortunate to have increased breathing space. An accounting change – housing associations will now be treated as private sector entities – led the OBR to reduce both its borrowing and debt forecasts, giving the finance minister a little more leeway. The announcement of new sales of the government's £24bn RBS stake will also help reduce net debt (but will probably represent a significant loss to the taxpayer).

4. Gloomy outlook for productivity drags on growth forecasts

The OBR's downgrade to its accompanying economic forecasts was much more significant to the government's fiscal leeway going forward than the policy measures mentioned above. After years of overoptimistic forecasts for productivity growth the OBR relented and stopped assuming that output per hour would revert to the pre-crisis norm (chart 5). The new productivity growth forecasts sit in between the pre-crisis trend and the (almost horizontal) post-crisis trend, decreasing from an average of 1.6% to 0.9% a year.

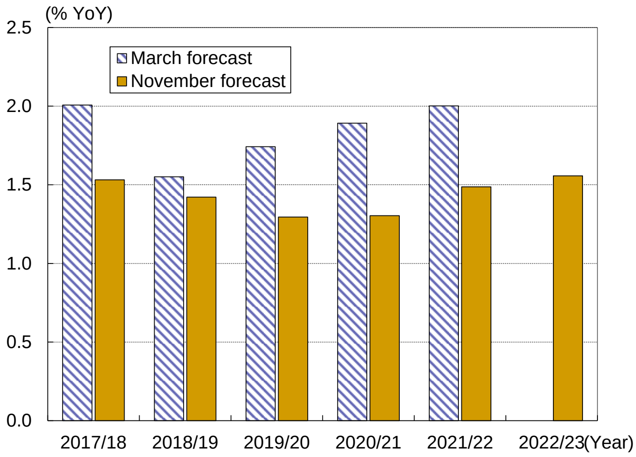
Chart 5: The OBR's UK Productivity Forecasts



Source: OBR, BTMU Economic Research Office

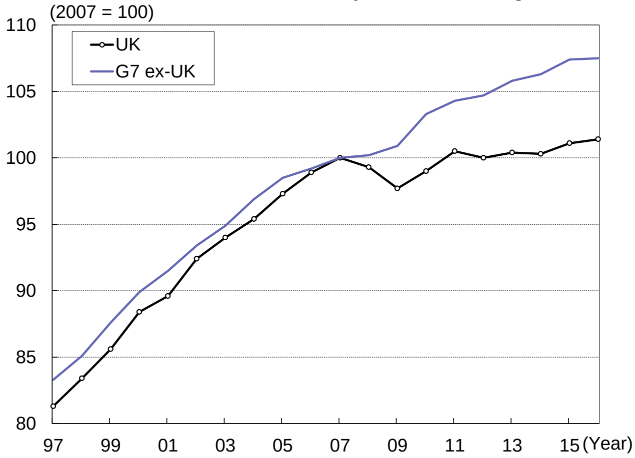
This was not a shock – the change to productivity forecasts was well-signalled in the OBR's October annual forecast evaluation report – but it has important repercussions. Now, annual GDP growth never reaches 2% across the OBR's five-year forecast horizon (chart 6). This means the OBR expects a significant increase in public sector net borrowing between 2019-20 and 2021-22 as chart 3 shows.

Chart 6: The OBR's UK GDP Growth Forecasts



Source: OBR, BTMU Economic Research Office

Chart 7: UK Productivity vs G7 Average



Source: ONS, BTMU Economic Research Office

Importantly, the OBR took a "fiscally neutral" approach in the absence of any "meaningful" information on the likely outcome of the Brexit negotiations. The assumptions are unchanged on the previous OBR forecasts from a year ago (namely, a £15bn hit to public finances each year post-Brexit, and no allowance for a divorce bill). This means that the lower forecasts are separate to any change in the UK's withdrawal from the EU.

We note that poor productivity growth has been a common theme in developed economies since the financial crisis and poses a puzzle for academics, central bankers and private sector economists alike. But as chart 7 shows, the UK is suffering more than most (which added pressure on the OBR to change its numbers).[1]

[1] For a useful summary of theories about the UK's particular woes we recommend a speech from Andrew Haldane, the Bank of England's Chief Economist, entitled "Productivity Puzzles" (March 2017).

5. Reasons for optimism

To our minds, the OBR's numbers for both productivity and GDP growth appear a little pessimistic given their neutral Brexit assumptions. The economic growth projections are below both our expectations and those of most independent forecasters.

(1) Productivity

We suspect the productivity crisis may be exaggerated. The UK economy is orientated towards services and productivity is notoriously hard to measure in this sector. Moreover, historical examples suggest that technological advances can take decades to be reflected in productivity figures and there may be an initial lag before any benefit is shown at all.[2]

[2] See, e.g. 'The Dynamo and the Computer: An Historical Perspective on the Modern Productivity Paradox' (David, 1990).

If the current numbers are accurate, one likely explanation is that firms are substituting labour for capital to increase output. The figures lend support to this idea. Business investment has not contributed more than 0.1pp to quarterly growth since Q1 2015 – during which time the employment rate has increased from 73.4% to a record high of 75%. With unemployment at

4.3%, post-Brexit Britain perhaps becoming less attractive for immigration and new government measures such as pension auto-enrolment, labour is likely to become more expensive. Firms could respond with productivity boosting capex spending (which may also get a boost once we have further clarity about the UK's future relationship with the EU).

The government will also be hoping that supply-side measures aimed at improving the economy's productive capacity will help. A 'modern industrial strategy' with targeted public funding and improved incentives for private investment was announced in the Budget, and a White Paper on the government's industrial strategy has already been published. There have been similar initiatives over the last few years with little discernible effect, though. Nonetheless, the OBR's downgrade has brought the issue into sharper focus and may spur further government action, and some of the already-announced measures may also lend support. A key theme of the recent Budget was the inaccessibility of the property market to prospective buyers. A significant increase in housing supply and a decrease in prices could help to increase productivity. (Less capital would be funnelled into housing and could be spent more productively, and commuter journey times would be reduced).

(2) Economic growth

While the government's measures were very mild, the budget did constitute a very gentle easing of policy. It is not until the end of the five-year forecast period that net giveaway measures become net takeaways. Recent history suggests that the government is likely to continue to delay these tighter measures (for example, fuel duty has been frozen in nominal terms since 2010, despite regular guidance that it would rise the following year). This would be welcome. An easier fiscal stance will help cushion the UK through the Brexit process. Based on volatility around the most recent Budget, we think bond markets would shrug off a moderate increase in government borrowing and yields would remain low.

There are also signs that the weakness in sterling is helping trade. It is not as much as may be hoped though, and it is hard to disentangle from the boost that would otherwise exist from the global upswing (net trade contributed half of the 0.8% QoQ growth in Germany in Q3, despite the strong euro). Nonetheless, in the UK, the OBR expects that net trade will contribute 0.1pp to its forecast of 0.3% QoQ average GDP growth in 2018.

6. Still waiting for a Brexit shock

There may be good reason to think that their forecasts look too pessimistic in isolation, but the UK's withdrawal from the EU could yet further erode productivity growth. As mentioned, the OBR takes a neutral approach to its estimates of the impact of Brexit. There are clear downside risks, especially if the withdrawal process is disorderly. Businesses, particularly in areas such as car production, are reluctant to increase capex spending amid uncertainty over the future relationship between the EU and the UK. Foreign firms are more likely to be footloose and may increasingly decide to move operations to EU-27 countries. This would be a blow. Recent research by the ONS suggests that foreign firms operating in the UK are around 75% more productive than domestic firms.[3] A reduction in capex and a decrease in productive foreign-owned firms may mean that the OBR's forecasts will be close to reality.

[3] See 'Foreign direct investment and labour productivity, a micro-data perspective: 2012 to 2015' (ONS, 6 October 2017)

Given the private sector's reluctance to spend on capex due to uncertainty about the final Brexit deal, it was disappointing not to see more government investment in the Budget. The economy has been relatively immune to the referendum result so far (household spending has held up despite higher inflation) but it is likely that there will be a shock at some point. Government spending on infrastructure and education before it arrives could help to both ease the pain and address productivity concerns.

7. Conclusion

There were no radical policies in the UK government's Budget, but it amounted to a small easing of fiscal conditions over the near-term. This was almost entirely overshadowed by the OBR's lower growth forecasts. According to the fiscal watchdog, annual GDP growth will average just 1.4% over the next five years after a large downward revision to its productivity growth estimates. We find some reasons for optimism but note that Brexit effects may yet mean that the OBR's dire forecasts end up being close to the mark.

The idea that the UK economy has little slack, despite relatively low growth rates, echoes the Bank of England's rationale to hike interest rates. With annual potential GDP growth now around just 1.5%, and lingering uncertainty as to the shape of the final Brexit deal, it may well be the case that this is as good as it gets for the economy over the medium term. Any further fiscal consolidation would be very unwelcome in this regard. Taking a wider view, the outlook seems particularly gloomy at a time when the UK's main trading partners are recording firm economic activity.

Box 1: The OBR's long-term projects suggest further pain to come

Looking further ahead, a combination of the downward trend in productivity and demographic change will present serious challenges to the Treasury. In the January Financial Sustainability Report, which projects ahead over a 50-year horizon, the OBR wrote 'the fiscal position is unsustainable' – and this was before the November downgrade in productivity assumptions. Long-term projections for population structure and growth trends make broad assumptions and have to be taken with a pinch of salt. But the main theme of an ageing population, expected in many developed economies over the coming decades, is not a controversial one. The OBR expects public debt as a percent of GDP to fall through the 2020s but then rise steadily to over 225% by 2060 as an ageing population puts pressure on public finances. Under this scenario, debt repayments would account for an ever larger share of government spending. This suggests that the UK government will be forced to continue with tight fiscal policy for decades to come.