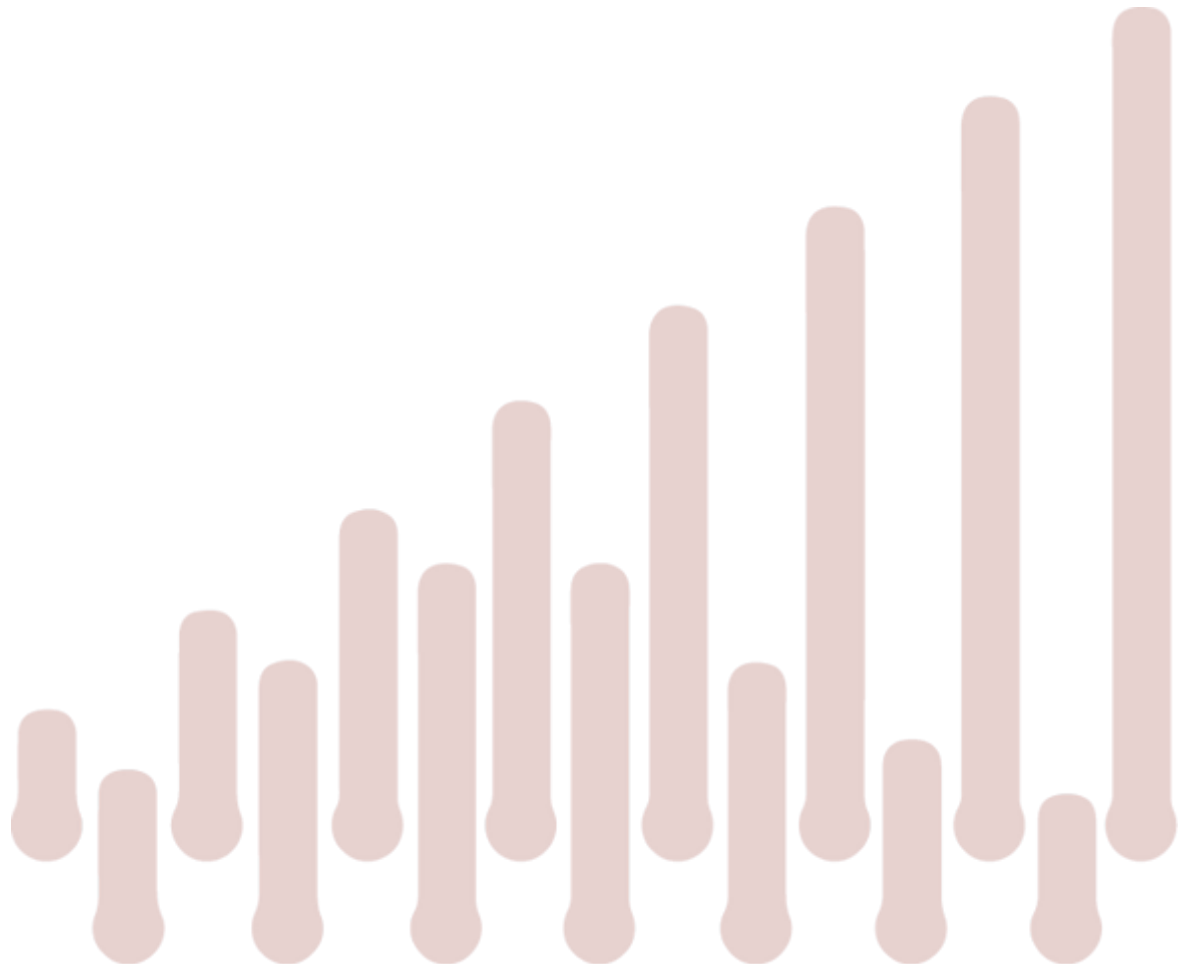


Macroeconomic Context

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NIESR General Election Briefing

May 2024



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OVERVIEW

This briefing focuses on:

- The state of the UK economy since 2019
- The need for supply-side reforms and a new fiscal framework to support growth and living standards.

KEY POINTS

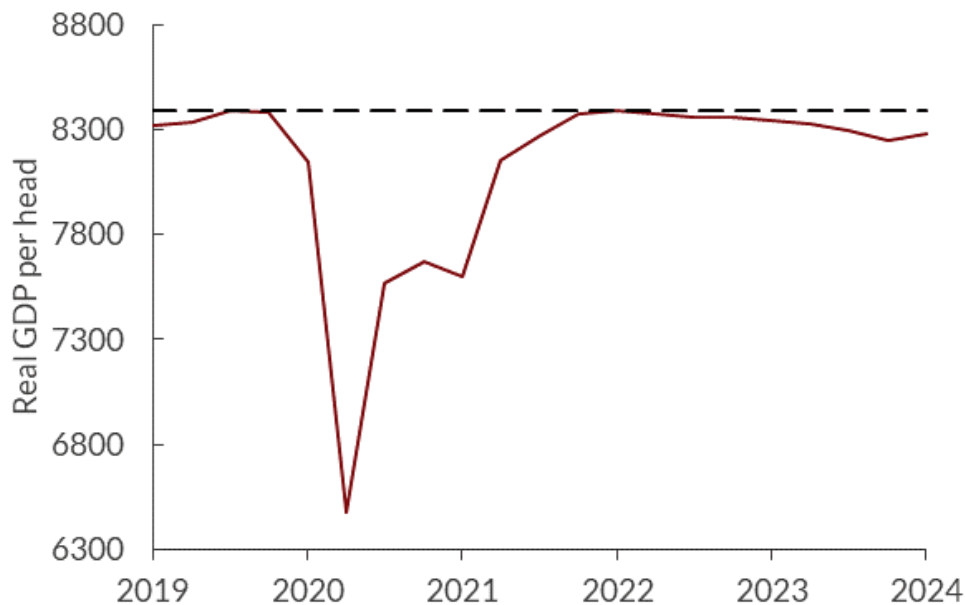
- The United Kingdom's economy has been marred by low growth and flatlining productivity by historical and international standards.
- We project that the growth rate of output and productivity will recover modestly to around 1 per cent per year for remainder of the decade.
- A revised fiscal framework is vital for fostering sustained economic growth.
- Revitalising the UK economy and boosting living standards will depend on supply-side reforms such as raising public investment in key areas like healthcare, infrastructure and housing, as well as helping unlock greater business investment.
- Integrating public sector net worth as a fiscal target can help incentivise higher public investment, which in turn will improve UK growth prospects in the next parliament and beyond.

Current State of the UK Economy

The United Kingdom has experienced low economic growth since the previous election in December 2019. In the second half of 2023, the economy was particularly weak and there has been no substantial growth in economic activity over the past two years.

This low trend growth is illustrated by Figure 1, which shows real GDP per head over past decade, with a line to denote the output level prior to the Covid-19 pandemic.

Figure 1: UK GDP per head (quarterly frequency)

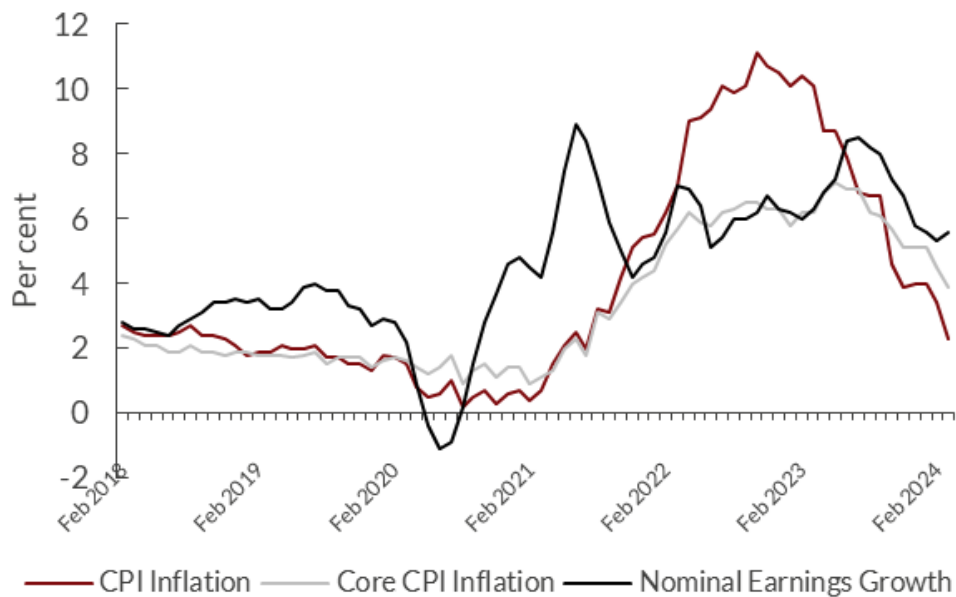


Source: ONS

GDP per head is currently below its fourth quarter of 2019 value. Moreover, NIESR's most recent outlook (Bejarano Carbo et al., 2024) is for GDP per head to increase by 0.1 per cent in 2024 and by a further 0.5 per cent in 2025. For real total economic activity, our projections suggest an increase of 0.9 per cent in 2024.

Beyond this year, we anticipate annual growth rates of only around 1 per cent. This represents a trend rate of growth for the United Kingdom that is much lower than in the past.

Figure 2: UK inflation rates and wage growth



Source: ONS

In the aftermath of the Covid-19 pandemic, the UK economy faced several significant inflationary shocks. The large-scale accumulation of household savings during the first lockdown created pent up demand for consumer goods which then materialised after restrictions were eased. Meanwhile, there was significant supply chain disruption and the economy was not well adjusted to cope with the sudden shift in consumer demand.

In the wake of lifting all restrictions, an energy price shock transpired following Russia's full-scale invasion of Ukraine. This layered a further price push shock on top of already damaged supply chains, leading to a rapid increase in the headline rate of inflation.

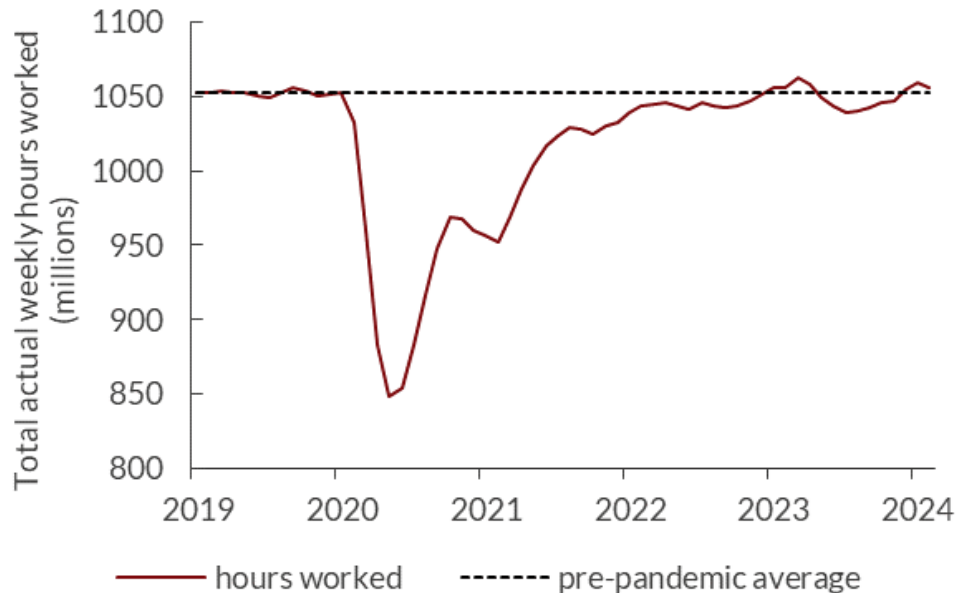
The Bank of England responded accordingly and started to raise rates gradually in late 2021 and then more rapidly from mid-2022. While inflation peaked in October 2022 at 11.1 per cent, the headline rate has fallen substantially over the past year. This can be seen in Figure 2 which displays the headline rate of inflation, core inflation and wage growth.

This suggests that the persistent components of inflation are abating, and the headline rate is on course to meet with its 2 per cent target by the end of 2024. With the Bank of England now having inflation broadly under control, we anticipate two rate cuts of 0.25 percent this year as inflationary pressure continues to ease. As interest rates begin to fall, we expect them to settle at around 3.25 percent by 2026. This cautious approach to rate cutting also gives the Bank of England breathing space should any of the upside risks stemming from geopolitical uncertainty materialise.

Turning to the labour market, the vacancy to unemployment ratio has returned to levels in line with its pre-pandemic norm. However, working age labour force participation has remained relatively flat and is not expected to return to pre-pandemic levels until the end of this decade (Bejarano Carbo et al., 2024). Moreover, total hours worked remain

unchanged relative to 2019 figures despite a higher population. As shown in Figure 3, actual total weekly hours worked (inclusive of experimental ONS data) indicate that hours are still around where they were before Covid-19. This has resulted mainly from the large increase in long-term sickness observed over the past few years, with 750,000 additional working-age individuals have left the labour force since the pandemic.

Figure 3. UK actual weekly hours worked



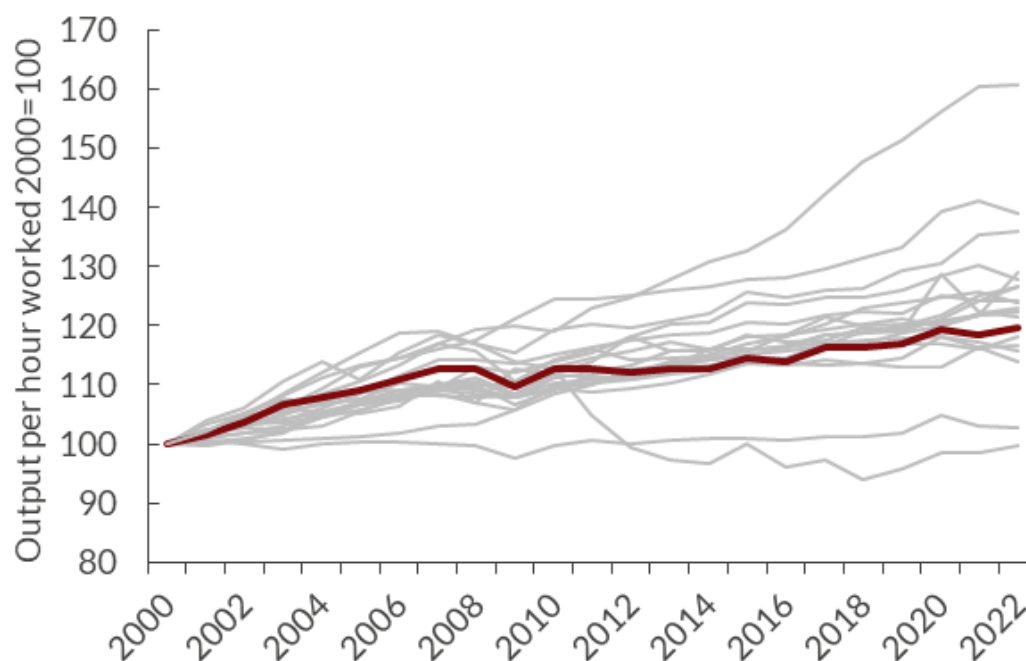
Source: ONS

To summarise, the post-Covid economic landscape remains fragile. The remainder of this briefing will therefore focus on the UK productivity problem and its causes and then assess the case for supply-side reforms and a new fiscal framework to address these structural problems.

The United Kingdom's Poor Productivity Performance

Our ability to improve standards of living depends crucially on productivity growth. The United Kingdom has performed poorly since the turn of the century, relative to comparable economies, in terms of productivity growth. Figure 4 illustrates growth in output per hour worked for the 20 largest OECD economies. The United Kingdom's performance is highlighted in red and falls within the bottom third (the other 19 economies are greyed out). This gives a sense of where the country falls in the pack in terms of its relative performance.

Figure 4. UK and OECD output per hour worked



Source: OECD database

Taking average annual labour productivity growth rates since the year 2000, we find that among the largest 20 OECD economies, the United Kingdom ranks 14th in terms of productivity growth.

Table 1. OECD average labour productivity growth (2000-2022)

1	Korea	2.19%
2	United States	1.51%
3	Sweden	1.42%
4	Portugal	1.18%
5	Australia	1.13%
6	Switzerland	1.08%
7	Austria	1.08%
8	New Zealand	1.01%
9	Denmark	0.99%
10	Japan	0.95%
11	Finland	0.93%
12	Germany	0.92%
13	Canada	0.91%
14	United Kingdom	0.82%
15	Spain	0.76%
16	Netherlands	0.71%
17	Belgium	0.67%
18	France	0.60%
19	Italy	0.13%
20	Greece	0.05%

Source: NiGEM database

Poor performance in productivity puts the United Kingdom ahead of only Greece, Italy, France, Belgium, Spain and the Netherlands. Moreover, it is well-established that the country also has low rates of business and public investment relative to comparable OECD countries. In the next section we explore business investment further in the context of the country's poor economic performance.

Business Investment and Policy Churn in the United Kingdom

Chronically low business investment has plagued the United Kingdom for most of the last two decades. This is demonstrated in Table 2, which illustrates the share of business investment in GDP for the same set of OECD economies as in Table 1. Once again, the United Kingdom's performance is highlighted in red and falls within the bottom third (ahead of only Greece).

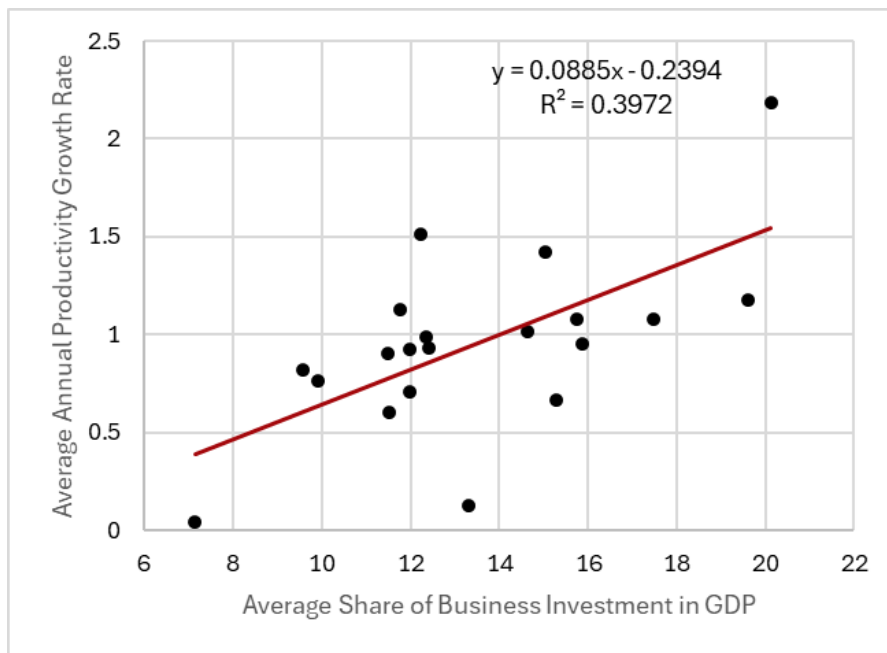
Table 2. OECD average business investment share of GDP (2000-2022)

1	Korea	20.13%
2	Portugal	19.60%
3	Switzerland	17.47%
4	Japan	15.86%
5	Austria	15.74%
6	Belgium	15.27%
7	Sweden	15.05%
8	New Zealand	14.63%
9	France	13.30%
10	Finland	12.43%
11	Denmark	12.37%
12	United States	12.24%
13	Netherlands	12.00%
14	Germany	11.98%
15	Austria	11.77%
16	Italy	11.51%
17	Canada	11.48%
18	Spain	9.92%
19	United Kingdom	9.56%
20	Greece	7.15%

Source: NiGEM database, author's calculations

While productivity growth is multifaceted and has many economic and institutional factors, we can examine the correlation of the average share of business investment in GDP against the average growth rate of labour productivity. The scatter plot indicates a clear positive relation which suggests a positive association of higher business investment with higher productivity growth. Specifically, among OECD economies, a 1 percentage point sustained increase in business investment as a share of GDP is associated with almost a 0.1 percentage point increase in average productivity growth.

Figure 5. Average business investment and productivity growth correlation (2000-2022)



Source: NiGEM database, author's calculations

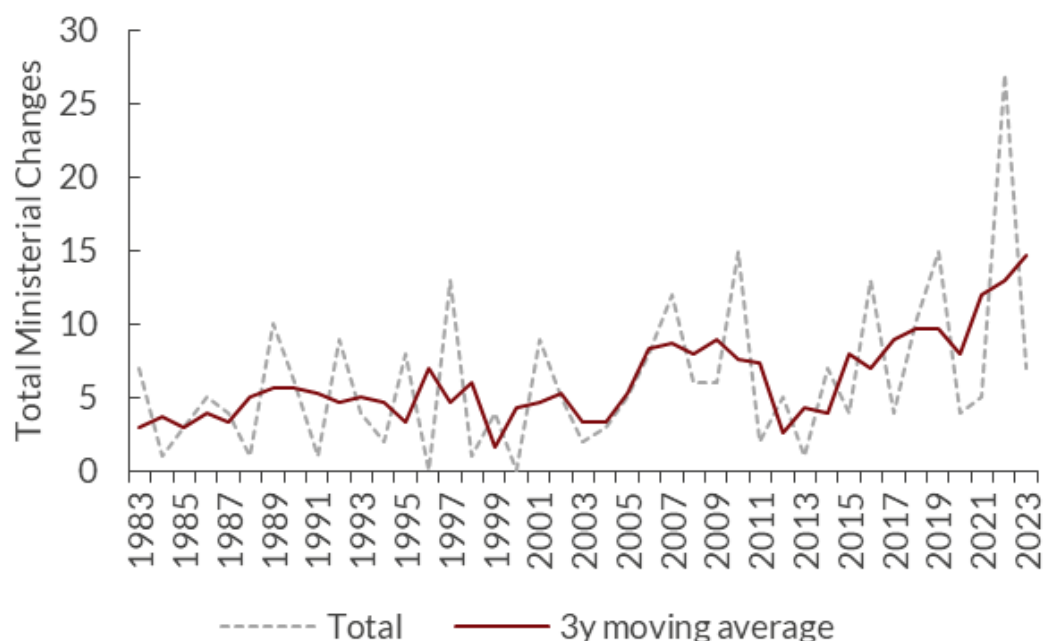
Moreover, it is arguable that the United Kingdom has faced significant policy churn, which has engendered an environment of caution among businesses that has subsequently contributed to low business investment. This has been particularly acute with regards to industrial strategy, which has experienced several significant policy overhauls as well as notable ministerial churn (Pabst and Westwood, 2021).

Concrete examples of policy churn over the last year include the postponement of phasing out new sales of petrol and diesel vehicles, the scrapping the northern leg of HS2 and multiple postponements of checks on agricultural goods entering the United Kingdom from the European Union.

Inconsistent policy announcements affect certain sectors, but they can also contribute to a wider environment of economic uncertainty. This can dampen business investment prospects and generate a mentality of short-termism which keeps business investment low relative to comparable OECD economies.

While policy churn itself remains a nebulous concept, we can construct proxies to measure it. For example, one proxy could be the number of ministerial appointments/dismissals each year. Elevated ministerial churn is likely to be indicative of a lack of long-term commitment to a given set of policies. Figure 6 plots the total number of ministerial changes in the cabinet in each year over the past four decades. As can be seen, starting around a decade ago, we can see a notable increase in ministerial churn. This is indicative of a more uncertain policy environment.

Figure 6. Annual appointments/dismissals of cabinet ministers



Note: The grey dashed line represents the total number of appointments/dismissals in a year, and the red solid line represents a three-year moving average.

Source: Author's calculations

Supply-side Reforms

An important aim of supply-side reforms is to boost investment. Reform of the fiscal framework can help create an incentive structure that will promote public investment, which can be understood as a broader policy intervention in the supply side of the economy if directed towards infrastructure, housing, education and healthcare.

For example, by increasing the NHS budget, the next government could begin to focus on shortening waiting times for health care treatment. Median waiting times according to the have doubled relative to their pre-pandemic level (British Medical Association, 2024). Reducing waiting times could potentially start to deal with the large rise in labour market inactivity due to long-term sickness that has materialised since Covid. Long-term sickness is currently at record levels, with the Office for National Statistics estimating an additional 750,000 of working age have left the labour force since 2019. The conjunction of these factors suggests that a lack of investment in health care is associated with inactivity (see Box B – Bejarano Carbo et al., 2024).

As part of supply-side reforms, healthcare spending should be reframed as an investment in human capital that would contribute in the medium to long run to a more dynamic labour market. A larger pool of workers to draw from in the labour force increases the labour supply and economic growth.

More generally, the United Kingdom still needs a credible long-term plan for public investment to address shortfalls in infrastructure and housing. In particular, the lack of housing supply is captured by the increase in the ratio of average full-time earnings to house prices from 5.12 at the turn of the century to around 8.3 in 2023, according to Office for National Statistics figures.

Public investment can also provide the foundation and subsequent motivation for increases in business investment. If the private sector sees a credible long-term strategy for investment in infrastructure, the improvement in sentiment should lead to an increase in business investment as the two are complementary.

However, investor sentiments alone are not enough to boost business investment. Corporation tax reform in the UK can also play an important role. For example, the permanent extension to full expensing announced in October 2023 has been a welcome measure in offsetting the increase in corporation tax from 19 per cent to 25 per cent in April 2023.

However, to fully leverage changes to corporation tax as a tool for boosting business investment, considerations should be made with regards to balancing incentives for investment in tangible asset and intangible assets – such as software, research and development, and workforce training.

Currently, investment in intangible assets is not covered by full expensing as they do not fall under the category of plants and machinery. Therefore, striking a balance between incentives for different types of business investment is key for cultivating innovation and upskilling, which are ultimately needed for sustained productivity growth.

A New Fiscal Framework

UK monetary policy is set independently by the Monetary Policy Committee (MPC) of the Bank of England in line with their mandate of maintaining inflation at 2 per cent to ensure economic and monetary stability. Any new fiscal framework should be forged such that it works in accordance with monetary policy and not against it.

The UK fiscal framework was set up with the aim of public debt sustainability. Specifically, the current framework entails that the debt-to-GDP ratio should be falling over the OBR's five-year forecast horizon, and that net government borrowing should not exceed 3 per cent of GDP.

However, whether public debt is sustainable depends crucially on the belief whether debt will grow without bounds. This is governed by the credibility of long-run revenue and spending paths and the attitude of financial markets to the underlying health of the economy – not by arbitrary deficit and debt targets.

The current fiscal framework impedes potentially sensible and fully costed fiscal expenditure which does not result in a falling debt-to-GDP ratio within five years.

However, plenty of long-term public investment projects, which boost long-run aggregate supply, have a payoff which does not fall within a five-year horizon.

This discourages public investment by excluding the impact of projects that would lower the debt-to-GDP ratio beyond this five-year window. Subsequently, during economic downturns, these rules disproportionately favour reductions in investment expenditure as they demand improvements in the debt-to-GDP ratio within a relatively short timeframe.

This can limit potential long-run growth by generating an incentive structure which limits public investment. This is corroborated by a low public investment to GDP ratio in the United Kingdom relative to comparable OECD economies (as shown in Table 3).

Table 3. OECD average public investment share of GDP (2000-2022)

1	Japan	5.78%
2	Australia	4.56%
3	Sweden	4.47%
4	Greece	4.26%
5	France	3.91%
6	Netherlands	3.82%
7	Canada	3.75%
8	United States	3.61%
9	Spain	3.39%
10	Denmark	3.23%
11	Portugal	3.20%
	United	
12	Kingdom	3.09%
13	Austria	2.99%
14	Italy	2.79%
15	Belgium	2.30%
16	Germany	2.24%

As strongly argued in Chadha et al. (2021), the United Kingdom is in urgent need of a new fiscal framework. A revised set of fiscal rules would better serve the UK economy by incorporating medium to long-term economic objectives. For example, the UK is legally obligated to reach net zero by 2050. This target will only be met if supported through well-judged public investment in green infrastructure. Such investments could be made exempt from measures within the existing targets.

In addition, a revised fiscal framework could incorporate public sector net worth as a target. This provides a broader measure of public debt sustainability inclusive of what the government owns and what it owes. As domestic public sector net worth is relatively low by comparable international standards, the inclusion of this as a fiscal target could help incentivise sustained public investment and economic growth.

Moreover, a framework which limits potential growth prospects could put additional pressure on monetary policy to control inflation if there is a mismatch between aggregate supply and demand. If there is upward pressure on prices due to global shocks

and there is not sufficient capacity for the economy to grow in the medium and long run, then monetary policy must bring aggregate demand back in line to curb inflation.

And, if fiscal rules demand reductions in current government expenditures, then the role of fiscal policy aimed at managing economic shocks and smoothing government consumption is limited and this places an additional burden on monetary policy (Chadha, 2023). For example, in the period after the Global Financial Crisis (GFC) fiscal contractions required a loose monetary policy, which ultimately resulted in several rounds of quantitative easing due to the zero lower bound. Although this period of quantitative easing is now being wound down, the current fiscal rules remain arbitrary and constrain the government from making prudent financial decision which could work in tandem with monetary policy.

Therefore, an improved fiscal framework reform would create an incentive structure that would boost public investment and create greater bandwidth for fiscal-monetary complementarity.

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