UK FINANCE

MONTHLY ECONOMIC INSIGHT

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The main economic news in November was the government's autumn statement and accompanying forecast update from the Office for Budget Responsibility (OBR) – this month's briefing will dig into the headlines. ICYMI productivity week has just passed, so we'll take a top level look at why it matters.

TAX CUTS

The starting point for the chancellor's autumn statement, as we noted **last month**, was a slightly better picture on the public finances than has been expected in March (and considerably better than ahead of his 2022 autumn statement).

Before we get into specific spending measures, the OBR indicated that the medium-term outlook for the public finances was also looking better, as higher for longer inflation (we'll come to that next) and frozen income tax thresholds would continue to boost revenues over the forecast period. Though higher welfare and debt interest payment would offset that benefit to a degree. Together this meant that borrowing was set to be nearly £27 billion lower in 2027/8 compared with the March forecast.

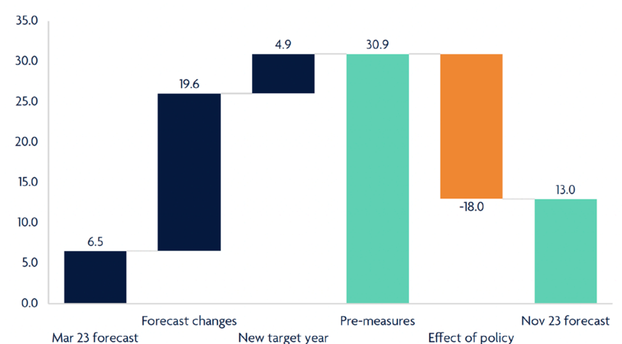
Q. What to do? A. Spend it.

The chancellor unveiled two substantive tax changes – substantive in terms of cost and potential impact. A 2p reduction in the main rate of employee national insurance contributions and 100 per cent capital allowances for qualifying investment, previously a temporary measure, was confirmed as permanent. Together, the OBR estimate these measures will cost around £20 billion by 2027/8.

As is the norm in these statements there were a range of smaller scale announcements, such as changes to the local housing allowance, action to increase labour market participation, tweaks to R&D reliefs and moves to reduce the burden of business rates.

The measures will result in a modest reduction in the tax burden, but even with these policies at the end of the forecast period the tax take will still rise to a post-war high of 38 per cent in the next five years.

Chart 1: Fiscal target, debt headroom



Source: OBR

The upshot for the public finances was a path for borrowing that was little changed from the March forecast and the chancellor, therefore, continuing to meet his fiscal rules on debt falling and net borrowing.

But (there's always a but), the margin by which the debt rule will be met is wafer thin (and the OBR notes less headroom than other chancellors have given themselves) (**chart 1**). The assessment by the OBR is that £13 billion is the difference between debt falling at the end of the end of the forecast period … and not.

There are a couple of factors that mean hitting this target could be a close call – firstly it assumes that departmental spending totals beyond next year will increase by less than one per cent in real terms over the next parliament (the reality of that would likely be a material squeeze on departments outside of health and defence). Indeed, the OBR notes "the outlook for departmental spending is therefore a significant and growing risk to our forecast."

It also assumes that the chancellor will break from the long tradition of fuel duty freezes in the March 2024 budget. If that turns out not to be the case, that alone would reduce the debt rule headroom by two-fifths.

For balance, there are also some upside risks – a much stronger profile for productivity, for example, or higher inflation further raising nominal tax revenues.

In one sense, these numbers are but one forecast scenario. Long before the end of the forecast period we'll have an election and, most probably, a change to the occupant of No. 11 Downing St. But it does give an indication of the constraints the next government will face.

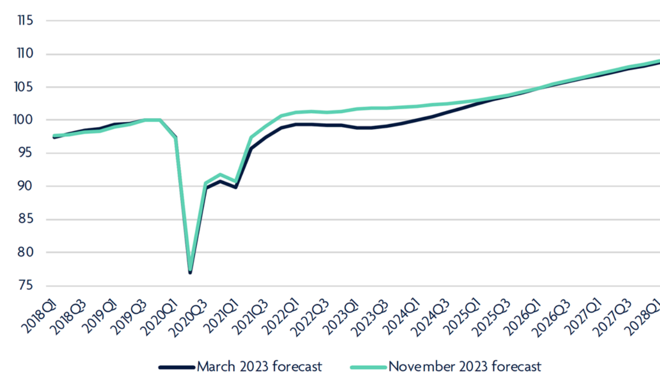
OBR GROWTH FORECASTS

In last month's briefing we also signalled the likelihood of some quite material revisions to the economic outlook in the OBRs forecast update, not least as a result of Blue Book Revisions which gave the OBR a stronger starting point for its forecast than had been assumed in March.

The growth outlook for next year is summed up as "*squeezed real wages, higher interest rates, and unwinding government support all weigh on economic activity.*" GDP growth will be stronger this year, in part due to greater resilience than expected in the face of price shocks (**chart 2**). And the hit to real household disposable income (RHDI) growth in 2023 wasn't as significant as the OBR had previously forecast (larger boost to incomes from higher interest rates). But living standards are expected to contract again in 2024 as inflation outpaces incomes.

The OBR assumes that inflation will be higher and more persistent than was the case in the Spring – a view in line with the Bank of England's assessment. CPI inflation is now expected to rise by 3.6 per cent next year and hit the 2 per cent target in mid-2025.

Chart 2: GDP growth, 2019 Q4 = 100



Source: OBR

The forecast again exposes the significant pressure households have been under in recent years, with RHDI per person not recovering back to its pre-pandemic levels until 2027/8. Inevitably the translates into a weaker outlook for consumer spending in 2024 and 2025, and together with a weaker near term investment outlook, this has lowered GDP growth projections to 0.7 per cent and 1.4 per cent in the next two years. A still sluggish picture, but a bit more optimistic than the Bank of England and the average of independent forecasters.

The chancellor's big spending announcements are judged to have a positive impact on this outlook. The package provides a modest demand boost in the short-term and a bigger, lasting, supply side impact, primarily from the capital allowances change. In addition, national insurance contributions cuts and welfare changes other will increase the level of employment.

At this point, the author must declare an interest, as a long-term campaigner for capital allowances reform in a previous role. The move to full expensing significantly improves the competitiveness of the UK's tax regime for capital investment, and investment-intensive businesses. Smaller businesses investing in the latest equipment will see a cashflow benefit from the move and it brings the tax treatment of investment more closely in line with investment cycles, compared with the previous regime. All this should be good for productivity (we'll come to that in a minute) and make a positive contribution to the UK's net zero journey.

The OBR estimates that this will take time to have an impact, with business investment falling next year, but generating a net additional £13.9 billion of cumulative real business investment over the forecast period.

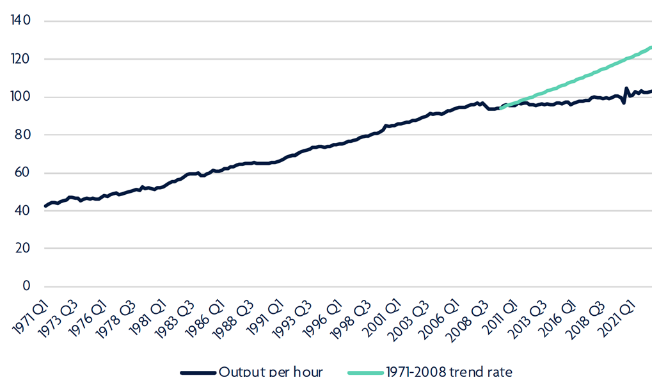
HAPPY PRODUCTIVITY WEEK

The Productivity Institute, an ESRC funded body, which brings together academic institutions to explore what productivity means for businesses, workers and communities, is behind national productivity week. The problem of low productivity in the UK has been a decade and a half in the making (**chart 3**) and has significant implications for the economy and living standards.

Growth in output per hour worked was ticking over an annual rate of over two per cent between 1971 and the financial crisis (GFC) in 2008. While not top of the international leagues (that would be the US), its stellar in the context of the years that followed the GFC (around 0.6 per cent). Also important to note, however, that this post-GFC productivity slowdown was not a solely UK phenomenon – we see similar across developed economies.

To quote the head of the Productivity Institute, Prof. Bart van Ark this matters because "*nearly two decades of anaemic productivity growth reflect a lack of economic dynamism and missed opportunities for investment, innovation, and improvement in living standards. Lower productivity has made the UK economy less resilient in difficult times.*"

Chart 3: Output per hour worked, 2019 = 100



Source: : ONS and UK Finance calculations

The Institute (and many other bodies) have published an extensive body of analysis on the root of the problem and some of the action that could be taken to push the UK onto a higher productivity path. **A recent blog** for NIESR by Dr Paul Fisher neatly sums up some of the areas where we need to prioritise investment – in equipment and technology, intangibles and skills, digital networks and infrastructure.

In many respects, these are not new recommendations and there is, of course, a great deal more detail on how this is deployed in practice across regions and industries. The new idea put forward by the Institute is the creation of a statutory body with a long-term focus on productivity.

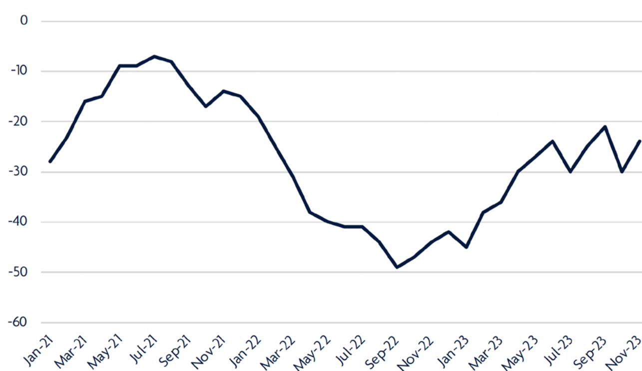
The rationale being that while we know what many of the solutions should be, high levels of policy churn means that plans and strategies that are put in place are not in effect long enough to have real impact. A body that supported more long term thinking, and monitoring and evaluation of implementation (a not dissimilar approach to that taken by the OBR) would seem a sensible addition to the UK's policy making framework and help address fragmentation in policy making.

HOW ARE CONSUMERS FEELING?

Seems the answer to this depends on when you ask. The GfK consumer confidence barometer has been bouncing around since the summer, after mounting a pretty steady recovery following the market turmoil of last autumn, though still not to pre-pandemic levels.

The volatility in recent months highlights the fragile nature of consumer sentiment, with confidence being buffeted by nuggets of news that could impact on household finances – the fall in June was prompted by sharp movements **in swap markets and concerns about rising mortgage rates**; September brought news of a bigger than expected fall in inflation, while the backdrop to the October fall was the conflict in the Middle East.

Chart 4: Consumer confidence index



Source: GfK

November brought news that CPI inflation fell to 4.6 per cent and the announcement of a modest rise in the energy price cap from next January. The headline confidence index rebounded by six points to -24. All components of the index showed improvement – there was a six point gain in expectations for the general economic situation in the next 12 months, and a five point rise in households' expectations for their own finances in the year ahead. And what will be seen as good news for retailers ahead of the key Christmas period, there was a 10-point improvement in the major purchase component. Note the survey was conducted before the autumn statement.

While the improvement is a positive development, the ups and downs of recent months reinforce the fragility of confidence and the ease with which recovery can be knocked off course with a bit of negative news.

ROUND UP

We have one more MPC meeting of 2023. Bank Rate has been held at 5.25 per cent at the MPC's previous two meetings, though that decision was not a unanimous one on either occasion.

Q3 GDP was in line with the Bank's expectation of zero growth, inflation also fell in line with the Bank forecast. There remains a degree of uncertainty about exactly what is happening in the labour market, while the ONS makes some significant changes to its labour force survey, but earnings growth, while still high, was moving in the right direction in October's data.

Statements from MPC members since the last meeting have been keen to point to the continued presence of upside risks to inflation, with higher food and/or energy prices having the potential to slow the fall in CPI back to target. Expectations are, therefore, that Bank Rate will continue to be held at current levels, but we still won't hear any talk of cuts.

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q3 2023	0.0%	↓	0.5%
CPI inflation	Oct 2023	4.6%	↓	6.1%
Unemployment rate*	Sep 2023	4.2%	↔	4.3%
Average earnings	Sep 2023	7.9%	↓	6.4%
Brent crude	Oct 2023	$90.60	↓	-
$ Exchange rate	Oct 2023	$1.22	↓	-
PSNB	Sep 2023	£14.9 bn	↑	£127.6bn

Source: ONS, HM Treasury, Bank of England, EIA

** New ONS experimental series*