Section 2 Commentary

Chapter 1

Economic prospects and public expenditure

The performance of the UK economy weakened in 2017, with growth lower than had been expected. The principal cause of the slowing of the economy was the squeeze on incomes arising from the rise in inflation that followed the currency devaluation, itself precipitated by the Brexit vote in June 2016. The Office for Budgetary Responsibility points to the continued divergence between stronger than expected employment growth and weaker than expected productivity growth, which has also squeezed household incomes.

Figure 2.1.1 demonstrates how seemingly small differences in growth rates accumulate even over a short period. It shows what the growth of the economy would have been like had it returned to the pre-crisis long-term trend growth rate of two per cent, and compares this with the OBR's March and November forecasts. The graph implies that the economy would be about one per cent smaller in 2021 than if the pre-crisis trend rate had prevailed on the basis of the March forecast, but 3.2 per cent smaller according to the November forecast. This rises to a gap of 3.7 per cent in 2022.

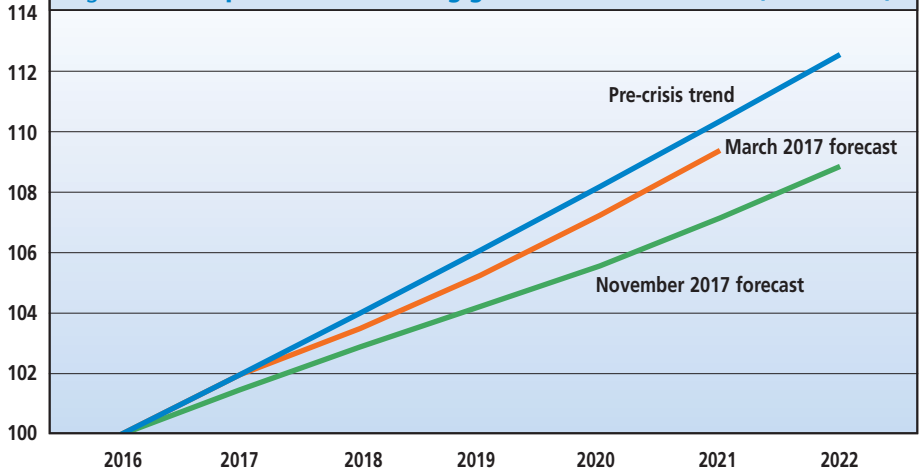
The UK is now one of the poorer-performing advanced economies in terms of growth. The absolute and relative decline in growth is illustrated in Figure 2.1.2.

Having grown more strongly than the eurozone and marginally below the OECD in 2015, since 2016 a sizeable gap has opened up, leaving forecast UK growth at half the OECD average level in 2019. It might be added that the performance of advanced economies generally is modest by historic standards.

As indicated earlier, the UK labour market remains robust in terms of employment. The number of people in employment is expected to grow by one million from 31.7 million in 2016 to 32.7 million in 2022, which is slightly more than was expected by the OBR in its March forecast. However, earnings growth is expected to remain subdued, and has been revised downwards since the March forecast. Real earnings are expected to fall in 2017 and 2018. Unemployment (as measured by the Labour Force Survey) is expected to remain below five per cent in the period up to 2022.

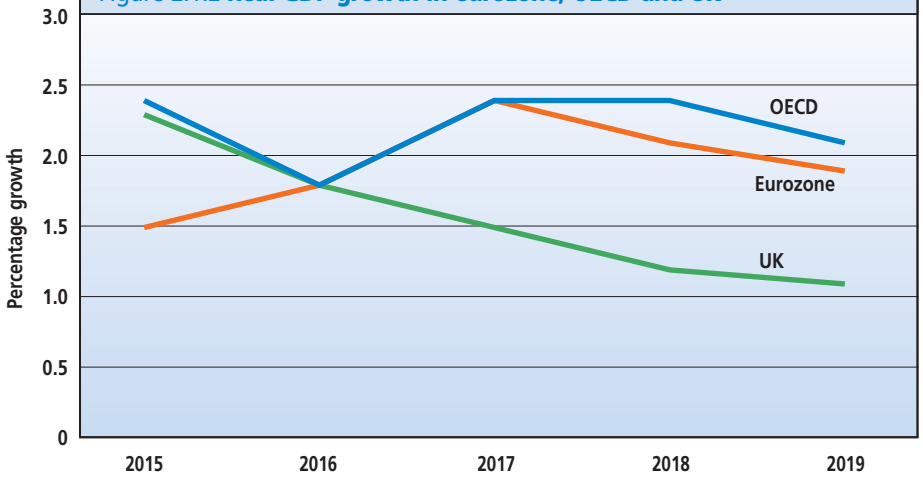
The devaluation of sterling following the Brexit referendum in 2016 has fed through into higher import prices and is causing CPI inflation to rise from 0.7 per cent in 2017 to 2.7 per cent in 2017. However, the OBR forecasts that inflation will fall after 2017 and return to the two per cent target in 2020.

Figure 2.1.1 **Impact of deteriorating growth forecasts on GDP (2016 = 100)**



Source: Calculated from OBR Economic and Fiscal Outlook, Table 1.1.

Figure 2.1.2 **Real GDP growth in eurozone, OECD and UK**



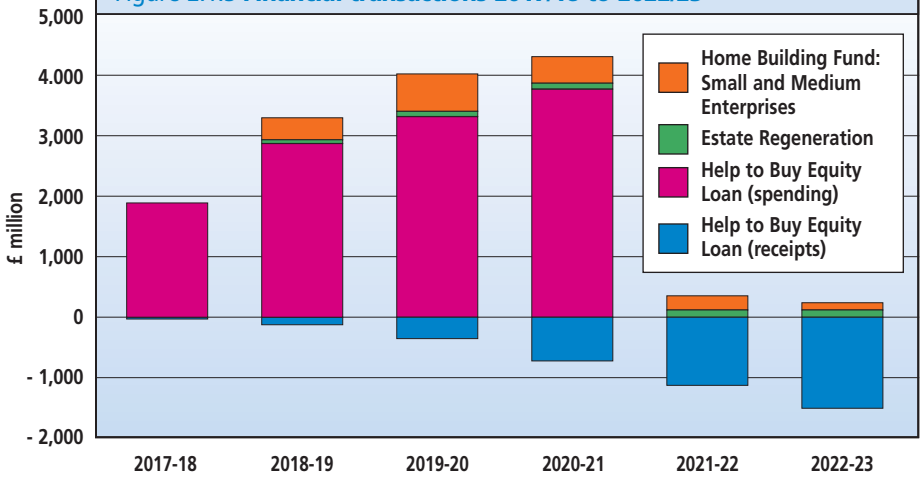
Source: OECD, Economic Outlook, 2017.

Fiscal policy and public expenditure

In terms of public spending, fiscal policy allows some temporary increases up to 2022/23, before current expenditure is frozen in real terms and capital spending rises in line with GDP. Before then capital expenditure for the NHS and housing are increased, certain taxes loosened (notably the exemption of first-time buyers from stamp duty on homes less than £300,000, or on the first £300,000 up to £500,000 in London) whilst increasing current spending for Brexit preparations and the NHS. The OBR notes that the Autumn Budget follows a pattern established since 2010 whereby a net giveaway is provided in the short run, but with tightening later in the period. The effect is that the role of state spending is planned to gradually reduce over the next five years, with the Autumn Budget showing that Total Managed Expenditure will fall from 38.9 per cent of GDP in 2017/18 to 37.7 per cent in 2022/23. It had been as high as 44.8 per cent during the economic crisis in 2010/11, but the Treasury notes that the current level is the same as in 2003/04.

Capital expenditure is planned to increase in line with GDP. Housing receives some priority (see below) and the additional £2 billion for affordable housing (first announced in October) was confirmed in the Autumn Budget. This is expected to provide 'at least' 25,000 additional homes, which represents a rather modest addition to the stock (see Commentary Chapter 4).

Figure 2.1.3 **Financial transactions 2017/18 to 2022/23**



Source: HM Treasury, Autumn Budget 2017, Table 1.9.

Help to Buy Equity Loans are recorded as 'financial transactions' rather than expenditure, and their value is expected to increase every year to 2020/21 when it will reach £3.78 billion (see Figure 2.1.3 for these and some other housing-related financial transactions). This will be counterbalanced by repayments which are expected to rise from just £30 million in 2017/18 to £1.5 billion in 2022/23. With the scheme extended only until 2020/21, its sudden withdrawal might be difficult to manage (see Commentary Chapter 3).[1]

Public Sector Net Debt will be reduced by between 3.2 and 3.4 per cent of GDP as English housing associations are once again removed from the public sector following regulatory changes. This difference now means that PSND is forecast to fall from a peak of 86.5 per cent of GDP in 2017/18 (i.e. with housing associations removed) to 79.3 per cent in 2021/22. A further minor adjustment will occur when changes in housing association classification occur elsewhere in the UK.

The artifice of the classificatory change to housing associations is highlighted by the OBR:[2]

> *This [reclassification] followed the passage of new regulations of which the Government stated: "The only reason these regulations have been introduced is to seek ONS to reclassify housing associations to the private sector. In preparing [them], we have ensured that these only go as far as we have to, to reclassify housing associations." It is hard to argue that the change in statistical treatment reduces the de facto exposure of the Government to these organisations, were they to fall into financial difficulty, nor does it alter their use as vehicles to deliver the Government's social housing policies.*

These are points that the *Review* has been making for two decades.

The government now has a complex array of fiscal targets under the *Charter for Budget Responsibility*, and these are subject to amendment, so weakening their credibility. This, or the ability of government to (re)interpret the targets, has been a problem since they were first employed in the UK by Gordon Brown. Giving the OBR responsibility to decide whether government has met (or is likely to meet) these targets was intended to improve their credibility; however, it is still sometimes unclear how they should be interpreted.

So, the commitment to 'return the public finances to balance at the earliest possible date in the next Parliament' clearly meant during the anticipated 2020-2025 parliament. However, because the Fixed Term Parliament Act was subverted to allow an early election in 2017, does this mean that the timescale applies to the 2017-22 parliament?

The OBR believes that this target would be missed if the 2022 date is applied, but in reality it matters little. The current (annual) deficit has fallen to within what can be regarded as 'normal' levels: the structural deficit is expected to be 2.3 per cent of GDP in 2017/18, falling to 1.3 per cent in 2020/21.

Monetary policy

As noted above, CPI inflation rose to 3.1 per cent in November 2017, the highest it has been since March 2012 – more than five years ago.[3] The Bank of England Monetary Policy Committee, which cut the Bank Rate from 0.5 per cent to 0.25 per cent immediately after the Brexit referendum, responded to the upswing in inflation by voting 7-2 at its November meeting to restore the Bank Rate to 0.5 per cent. This marked the first tightening of interest rates since July 2007 when the rate rose to 5.75 per cent. The increase brings the Bank Rate to the same level to which it was cut in March 2009, so it remains very low by historic standards, and in this sense economic policy is still far from a return to 'normality'.

The inflationary upturn caused by devaluation appears to be working its way through. It therefore seems likely that any interest rate rises over the next few years will be gradual and modest.

Housing and the 'productivity puzzle'

The analysis above represents a pattern that will have become familiar to readers of the *Review* in recent years. The UK's surprisingly strong employment performance has been accompanied by weak to non-existent real earnings growth. This has been attributed to the so-called 'productivity puzzle' which we referred to in the last *UKHR Briefing Paper*, and explore in greater depth here.

The productivity puzzle refers to the departure from the historic tendency for productivity across the economy to improve over time, and this in turn facilitates real wage growth. Since the global financial crisis, productivity growth has stalled, and with it real wage growth. In turn, this raises concerns that, for the first time since the industrial revolution, living standards of one generation will be no higher, or may even be lower, than those of the previous one. Historically, each generation could expect to enjoy real material living standards about one-quarter above that of their parents.

Consequently:[4]

> *For the past decade, average productivity growth has been negative. This is unusual, if not unique, historically. You would have to go right back to the 18th century to see a similarly lengthy period of stagnant productivity.*

Some commentators suggest that the slowing of productivity growth can be traced back to the 1970s, although the problem appears to have worsened suddenly after 2008. Moreover, it also appears to be a global problem – at least among the advanced economies.

There are many theories as to why productivity growth should have stalled in this way. In the speech from which the above is a quote, the Bank of England's Chief Economist Andrew Haldane discusses some of these theories. He rejects the idea that the productivity puzzle is an illusion caused by a failure to measure productivity growth effectively in new sectors of the economy. The global financial crisis itself may have had a temporary impact through the temporary reduction in availability of capital from the banking sector, and the reduced collateral afforded

by residential properties for small businesses. Further, forbearance by banks and the ultra-loose monetary policy pursued since the start of the crisis undoubtedly saved jobs, but also kept some relatively inefficient businesses going. As Haldane asks (rhetorically) 'Should monetary policymakers have sacrificed 1½ million jobs for the sake of an extra 1 per cent or 2 per cent of productivity?'. The National Institute for Economic and Social Research's Jagjit Chadha adopts this analysis to conclude that '...we have stumbled on a low wage-low productivity-high employment outcome (equilibrium)'.[5]

Haldane points to some structural changes that might provide a longer-term explanation for poor productivity. There is no consensus as to whether technological innovations are ceasing to boost productivity as they did in the past or whether they are on the cusp of generating a new boost to productivity. However, it does seem that the diffusion of technology and ideas has slowed as mobility between companies has fallen, causing those firms that are innovating to be counterbalanced by a long tail of less productive firms.

Governments are, of course, aware of the problem. A Productivity Plan was launched by the then chancellor, George Osborne, in 2015. This included providing tax incentives to businesses to invest, improving workforce skills and human capital through measures such as the apprenticeship levy, support for transport, research and digital infrastructure, increasing child care, and also City Deals and Devolution Deals for cities and city regions across the UK. The Autumn Budget returned to the issue, noting that although the productivity puzzle is experienced in other countries, UK productivity growth still lags behind, and is therefore identified as a major impediment to rising living standards.

Investment in productive infrastructure and human capital have long been favoured as means of driving regional development. These are, after all, what the European Structural Funds have been doing for decades, with the Regional Development Funds being directed at improving productive infrastructure and the Social Fund at enhancing human capital. But the government's approach is broader and includes what is sometimes called 'social' infrastructure, which extends to housing.

How housing fits into the productivity puzzle is something that should concern readers of the *Review*. The economist Paul Krugman argues that high housing costs in highly productive cities such as San Francisco drive people to take lower-productivity jobs in cheaper housing market areas.[6] In a UK context, Sam Bowman argued that:[7]

> *This [expensive housing] is not just a problem because it raises people's cost of living. It affects productivity because high housing costs stop people from moving [where] they can work most productively, and to such a high degree that the entirety of foregone productivity growth since 2007 might be achievable just by fixing the supply side.*

A deeper analysis is presented by a team led by Duncan Maclennan for the Australian Housing and Urban Research Institute.[8] They argue that macroeconomic and regional growth studies have focussed on human and productive capital to the exclusion of land, which is treated as being a residual. They argue for greater emphasis to be placed on 'homes, place and space' since,

> *...housing price and cost outcomes have the potential to distort locational patterns within a state or nation in ways that drive firms and households to less than optimal productivity locations. For example, poor housing system outcomes can frustrate the potential for agglomeration economies to foster growth.*

A similar rationale is followed by the UK Treasury:[9]

> *An effective land and housing market promotes productivity by enabling the economy to adapt to change, helping firms to locate where they can be most efficient and create jobs, and enabling people to live and own homes close to where they work.*

The recommended reforms include deregulating and speeding up the planning system, and these were reiterated in the Autumn Budget 2017, which said that 'Evidence suggests the UK should prioritise upgrading infrastructure, improving skills, helping businesses to invest, and reforming the housing and planning systems.' It is important that the government's £44 billion quoted 'support' for housing to raise the building of new homes to 300,000 units per annum by the

mid-2020s is understood in this context (but see Table 2.4.1 for a wider assessment of the extent of government housing support). The housing components within the National Productivity Fund are due to rise from £645 million in 2017/18 to a peak of £3.42 billion in 2020/21, representing half of the total in that year.

Other aspects of the housing question raised by Maclennan's team are how housing and neighbourhood conditions can spill over into children's education and transition to work, and the role that housing plays in providing collateral for small businesses. These kinds of issues are reflected in the work of the Greater Sydney Commission. This was established in 2016 to better integrate planning across the region, and it has placed emphasis on connectivity between housing, public transport and workplaces.[10]

The so-called 'infrastructure turn' seen in many countries in recent years in response to the productivity puzzle and city competitiveness also requires resourcing. Given the climate of fiscal constraint and the erosion of corporate tax bases, new ways of paying for infrastructure are likely to be required in the long run. Governments are unlikely to be willing to sustain indefinitely the increases in their budgets. This in part explains the upsurge in interest in mechanisms for land value capture and land taxation.

Notes and references

1 See HM Treasury (2017) *Autumn Budget 2017*, Cm 587. London: HMT; data taken from Tables 1.6 and 1.9.

2 Office for Budgetary Responsibility (2017) *Economic and fiscal outlook*, Cm 9530, para. 1.43. London: OBR.

3 Bank of England (2017) *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 1 November 2017*. London: BoE.

4 Haldane, A. G. (2017) *Productivity puzzles*. Lecture given at London School of Economics, 20 February. London: Bank of England.

5 Chadha, J. S. (2017) *The UK's Productivity Puzzle: Labour, Investment and Finance*. London: National Institute for Economic and Social Research.

6 Krugman, P. (2014) 'Wrong Way Nation', in *New York Times* (24 August).

7 Bowman, S. (2017) *It's the productivity, stupid*. London: Adam Smith Institute (see www.adamsmith.org/blog/its-the-productivity-stupid).

8 Maclennan, D., Ong, R. & Wood, G. (2015) *Making the Connections: housing, productivity and economic development*, AHURI Final Report No 251. Melbourne: Australian Housing and Urban Research Institute.

9 HM Treasury (2015) *Fixing the Foundations: creating a more prosperous nation*, Cm 9098. London; HMT.

10 Greater Sydney Commission (2017) *Draft Greater Sydney Region Plan and draft District Plans*. Sydney: Greater Sydney Commission.