



making business sense

ECONOMIC INSIGHT

MONTHLY BRIEFING FROM ICAEW'S
ECONOMIC ADVISERS

SEPTEMBER 2011



WORLD ECONOMY TEETERING ON THE EDGE

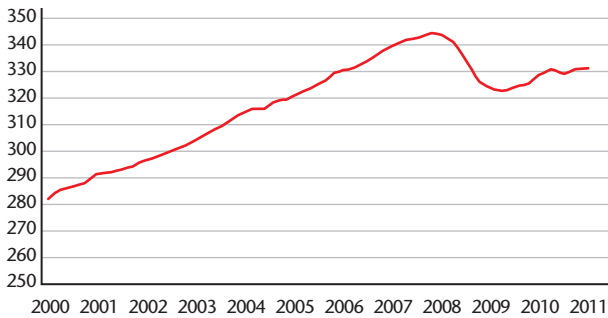
The past month has seen little in the way of good economic news and markets across the globe are on edge, deeply concerned about the risk of another recession in the West. The job market in the US appears to have ground to a halt, the sovereign debt crisis in the eurozone continues and the UK economy has effectively remained stagnant for the past three quarters. Leading indicators show a sharp downturn in business confidence in the West.

Policy-makers, acknowledging that the global economic recovery is far from a done deal, are refocusing on the need to bolster growth and prevent a double-dip recession. President Obama has announced a \$450bn spending package aimed at boosting job creation in the US, while central banks across the developed world are maintaining their loose monetary policy stance. Overall, the West looks set for another rough period.

OBR's forecasts look increasingly unrealistic

The Office for National Statistics' second estimate of Gross Domestic Product (GDP) in the UK for Q2 2011 remained unchanged, with estimated quarter-on-quarter growth of just 0.2%, down from 0.5% growth in the first quarter of the year. Compared with the same quarter a year ago, economic activity rose by just 0.7%. Furthermore, output remains some 3.9% below its pre-recession peak, as shown in Figure 1.

Figure 1: Quarterly level of GDP, £ billions, constant 2006 prices



Source: ONS

The largest contribution to growth in the second quarter came from the business services and finance sector, which grew by 0.8% quarter on quarter. The production industries were a drag on growth, within which the manufacturing sector contracted by 0.5%. This was the first quarterly contraction for the manufacturing sector since Q3 2009. Recent survey evidence for the sector – including the *ICAEW/Grant Thornton Business Confidence Monitor* – has suggested a toughening outlook for manufacturing continuing into the second half of the year.

Overall, the latest data confirms that the UK economy has more or less flatlined over the past three quarters and suggests the Office for Budget Responsibility's (OBR's) forecast of 1.7% growth this year will be missed by quite a wide margin. With the eurozone debt crisis continuing and job creation in the US grinding to a halt, there are clear signs that this period of economic stagnation could go on for a prolonged period of time. While few commentators are calling a double-dip recession, many now acknowledge that it is becoming an increasing possibility.

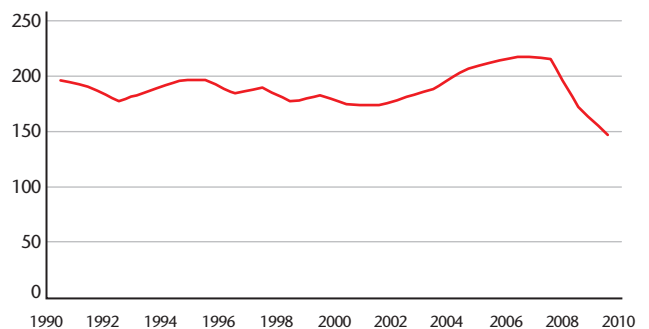
Chronic shortage of housing to blame for high house prices

There has been a great deal of talk over the past few weeks about the government's proposed changes to the planning system, which aims to reduce thousands of pages of planning rules to fewer than 60 pages. While some economists see this as a solution to the nation's housing crisis – a result of a chronic shortage in housing relative to demand – other groups have criticised the likely impact of the proposed changes on the environment and aesthetics of the UK, fearing that they may trigger further urban sprawl, as well as threatening endangered wildlife.

Those in the pro-reform camp note that only about 13% of the UK's land is currently classified as 'urban', and that we could build thousands of new homes on green space without 'paving over the countryside' – something which needs to be considered as rental prices in the South East and London reach exceptionally high levels and home ownership remains out of reach for the average young person.

Those cautious about planning reform broadly acknowledge the housing shortage in the UK, but they tend to argue that, rather than paving over green space, new homes should be built on brownfield sites and more should be done to bring empty homes back into use. Pro-reform groups argue that failing to use greenfield land will result in more ungenerous, frugal new developments which fall short of people's aspirations; newly built homes in the UK currently have the smallest rooms in the EU.

Figure 2: Housebuilding completions per year, thousands



Source: Department for Communities and Local Government

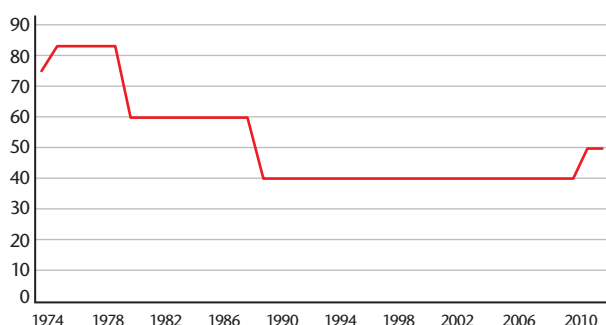
However, while the environmental implications of planning reform are clearly up for debate, most economists agree that a resurgence in housebuilding could be a solution to the current economic malaise gripping the nation. The massive housebuilding boom in the 1930s helped drive the UK recovery during this period and partly explains why the UK fared relatively well compared with other developed nations during the Great Depression. The number of new dwellings built each year averaged over 300,000 during this period – far higher than that shown in recent years, as shown in Figure 2. In 1930 there were about 800,000 workers in the UK building industry, but by 1939 this number had risen to over a million. Policy-makers looking to boost growth could learn some lessons from the 1930s.

Is the 50% income tax rate curbing growth?

The issue of the 50% top rate of income tax in the UK has risen up the agenda after 20 high-profile economists signed a letter to the *Financial Times* urging the government to drop the top rate, claiming that it is curbing growth and stifling entrepreneurship.

While the top rate is higher than in recent years, as Figure 3 shows, there have been much higher top rates of income tax in the past. For much of the 1970s, the top rate of income tax was 83%. A 15% surcharge on 'unearned' income meant that some individuals were paying a marginal income tax rate of 98%.

Figure 3: Top income tax rates in the UK over time, %



Source: HM Revenue and Customs

In this context, some commentators have argued that the 50% rate of income tax is fair – in the sense that the wealthiest should pay a higher proportion of their income in tax – and still modest compared with the past. However, others point out that the globalisation of the world economy means that high rates of taxation are much less feasible than in the past – nowadays, high-end taxpayers are much more likely to shift tax regimes, moving to parts of the world with more favourable rates of income tax. Similarly, foreign entrepreneurs looking to set up in the UK may be put off because of the relatively high rate of tax. Given this, the 50% rate of income tax may in fact be leading to a loss of tax revenue in the UK.

Whatever the economic cases for and against scrapping the 50% rate, the political process places a significant constraint on change anytime soon. Although the Chancellor has described the top rate of income tax as a 'temporary measure', the political costs of scrapping the rate at a time of austerity would be significant, with the Conservative Party being painted as a 'party for the rich' and possibly leading to a decline in popularity. Within the coalition, the Liberal Democrats would almost certainly demand a tax on wealth (a 'mansion tax') as the price for scrapping the 50% rate of income tax. But it is likely that many Conservative MPs would rebel against such measures. The constraints imposed by the political process mean that – economically rational or irrational – the 50p tax rate is likely to be with us for some time.

Abysmal US jobs data reignites concerns about the global economy

Data released by the US Bureau of Labor Statistics (BLS) showed non-farm payroll employment in the US was unchanged in August compared with July, suggesting that the labour market recovery in the world's largest economy has ground to a halt. The unemployment rate stood at 9.1%, largely unchanged from the previous month. Moreover, the monthly change in non-farm payroll employment for June was revised down from +46,000 to +20,000, and the change for July was revised down from +117,000 to +85,000.

The US has yet to generate sustained private sector job creation to offset job shedding in the public sector, as the US addresses its monumental level of government debt – currently standing at over \$14 trillion. The non-farm payroll data continues to show a trend downward movement in the number of government employees, which fell by 17,000 in August. Local government has lost some 550,000 jobs since employment in the sector peaked in September 2008.

President Obama, commenting on the jobs market a few weeks ago, said he wanted 'to be judged in a year from now on whether or not things have continued to get better'. The President has unveiled a \$450bn package of tax cuts and spending plans aimed at creating new jobs in the US, including \$50bn in spend on infrastructure projects. However, it remains unclear whether the spending package would be a long-term solution to the economic woes in the US or if it is merely a temporary measure aimed at boosting Obama's popularity ahead of the 2012 presidential elections.

Looking at monetary policy, the weakness in the US recovery suggests that a third round of quantitative easing ('QE3') looks increasingly likely.

Figure 4: Monthly change in US non-farm payrolls, thousands



Source: US Bureau of Labor Statistics

Plan to kick-start growth in the UK desperately needed

The torrent of poor economic data across the globe has placed pressure on policy-makers around the world to do something to kick-start growth. With President Obama announcing a new stimulus package to bolster job creation, George Osborne is likely to come under increasing pressure to introduce further measures that will kick-start growth in the UK.

However, this is unlikely to materialise in the form of reduced government spending cuts. The Chancellor has stated that there can be no 'Plan B' for the deficit reduction strategy of spending cuts and tax rises –

changing course could be politically disastrous for the coalition. Moreover, such a strategy could prove risky, with markets across the globe concerned about sovereign debt. Consequently, a renewed growth agenda in the autumn is likely to focus on reducing business red tape and making it easier for businesses to hire and fire new workers. That is, the UK growth agenda is likely to focus on recharging the private sector rather than scaling back public sector reforms.

Key dates for the month ahead:

DATE	EVENT / RELEASE	PREDICTION
21 September	Minutes of September MPC meeting	Unanimous vote in favour of keeping interest rates on hold
29 September	Lending to Individuals	Still weak
05 October	Q2 GDP final estimate	Unchanged from second estimate

Economic Insight Register for updates >>



ICAEW

ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

Because of us, people can do business with confidence.



Cebr

Centre for economics and business research Ltd is an independent consultancy with a reputation for sound business advice based on thorough and insightful research. Since 1992, Cebr has been at the forefront of business and public interest research. They provide analysis, forecasts and strategic advice to major UK and multinational companies, financial institutions, government departments and agencies and trade bodies.

ICAEW
Chartered Accountants' Hall
Moorgate Place London
EC2R 6EA UK
icaew.com