System failure: UK

James Ferguson
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UK government is a hindrance, not a help

"Governments create nothing and have nothing to give but what they had first taken away." Winston Churchill

"Givers have to set limits, because takers rarely do." Henry Ford

The UK government has been discriminating against the productive private sector for nearly 20 years. The downside to more government, which is a self-serving entity, is higher taxes, more regulation and a higher cost of living. The upsides are more public services, higher minimum wages and more rights for workers and tenants.

Private sector employees, working long hours, earn significantly less per hour after tax than do pampered public sector workers and far less than what in-work welfare beneficiaries are paid for every hour they work.

The rise of government, and the crowding out of the private sector, has systematically destroyed productivity, profits, investment and growth; as well as distorting the property market, wiping out private sector pensions and bankrupting the country through the pursuit of Net Zero.

It is time for a reset, before the decision is taken out of our hands by bond and forex market forces.

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Recommendations

- Long TIPS/linkers
- Short cyclicals & growth
- Long value
- Long Gilts
- Long gold miners
- Long silver

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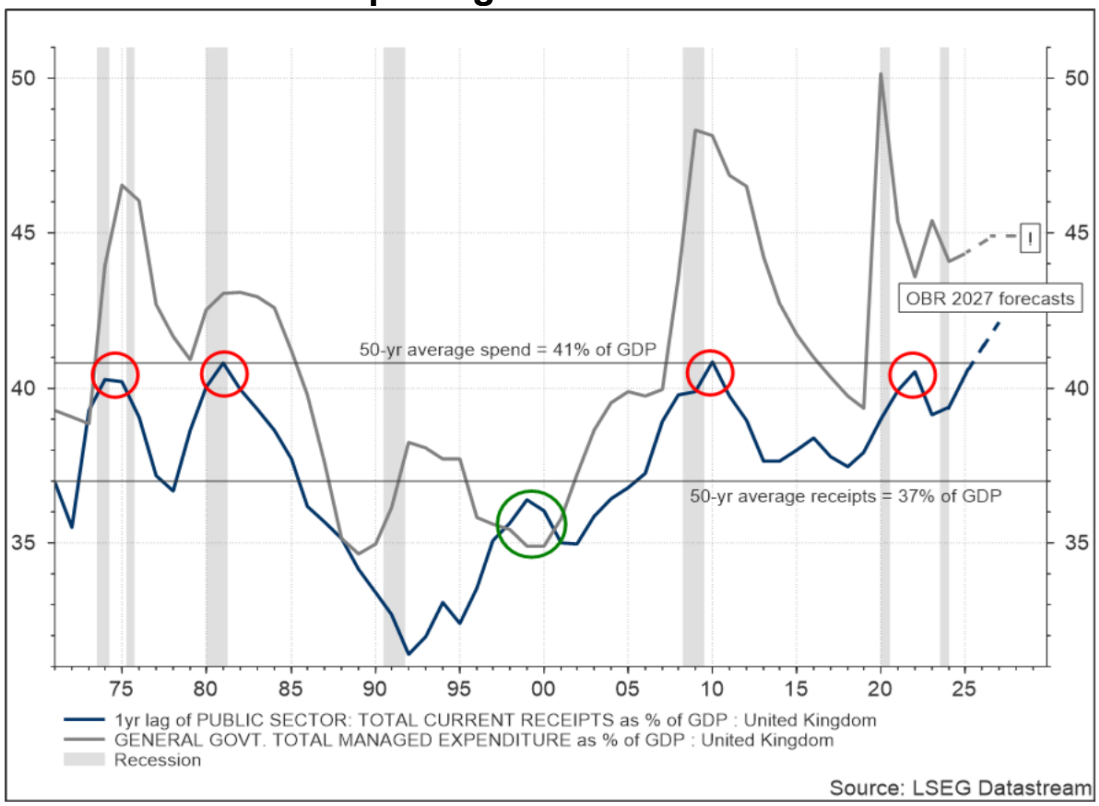
A couple of weeks ago, the BBC Radio 4 flagship politics show, *Any Questions*, came from Belfast. Every political party represented was seemingly pleading for more money, explicitly from Westminster though implicitly from the private sector, to fund their specific constituency. Not one guest spoke on behalf of the givers, just for their competing constituency. The private sector makes up less than a third of the Northern Ireland economy (as is also the case in Wales, Scotland and the North-West of England). So, regional issues are invariably viewed almost entirely through the prism of how much more tax revenue can be squeezed out of the productive centre, but rarely, on how public spending could, or even should, be reined in.

Record tax share

Those whose taxes do the heavy lifting of paying for political largesse are usually working too hard to find time to defend their own cause, let alone see what is being done behind their backs. Yet everything that an economy produces is produced by the private sector and is either paid for out of current taxes, (taxes levied on the public sector are merely recycled private sector earnings) or out of debt which, added to the interest, has to be paid for out of future tax. By the eve of the millennium, the UK was running a surplus. Public spending had fallen back to the 35% of GDP it had last been in the late 1980s (see grey line in Chart 1 below), whilst government receipts (blue line) were 36%. Government debt was a mere 28% of GDP and for five years, annual productivity growth had been growing at +3.3%. What could possibly go wrong?

The private sector workhorse relaxed its vigilance, whilst politicians gleefully leapt on an irresistible opportunity. For the last 25 years, the average deficit has been 4.5% of GDP. Public sector debt is now 101% of GDP (+260%). Although a record peacetime tax take has raised receipts to 40% of GDP, planned to rise to 43% by 2030, this remains far short of current spending which, at 45.5% of GDP, implies a deficit of 5.5%. The perennially over-optimistic OBR thinks spending will soon flatline (sic).

Chart 1: UK tax receipts & government TME as % of GDP



No doubt the Office for Budget Responsibility (OBR) is assuming not only that government can increase already record-high taxes at will, which Arthur Laffer would have something to say about, but also that debt interest costs will stay flat at 4% of GDP, the commitment to raising defence spending to 3% of GDP will be smoothly accommodated, Labour backbenchers will allow out-of-control welfare payments to be cut back and the newly resuscitated idea of slavery-era reparations won't happen. Besides, we are currently in a benevolent economic environment. History shows that the tax take tends to peak (no surprise) just before recessions (see red circles in Chart 1 above), after which the automatic stabilizers kick in sending spending up by more than 5% of GDP, just as the profit and employment crunch reduces the tax take by anything up to 4% of GDP. To absorb such predictably regular shocks, even Keynes advised prudent governments to run a surplus in the good times.

Peak Laffer Curve

The taxation well has pretty much run dry. Government receipts next year will be a post-War record high of over 42% of GDP, as raids on non-doms manifest, but all previous tax takes above about 38% of GDP either triggered or coincided with recessions (see red circles in Chart 1 above). Yet unabated spending is on track to reach 46% of GDP this year, and will only peak next year if you believe the OBR's chronic optimism and the government's genuine intention to make spending cuts from 2028 (when it will be someone else's problem). Borrowing costs already took up 3.6% of GDP last year when gilt yields averaged 4.5%. Now yields are almost 100bps higher and with debt over 100% of GDP, interest expense is clearly heading towards 5% of GDP (+40%), equivalent to 12% of the total tax take. Eventually even Labour politicians will be forced to realize that cutting public expenditure is the only viable option. Until then, fiscal 'stimulus' will continue to act as a drag on growth.

Wes Streeting, the Defence Secretary demonstrated the government's poor grasp of the situation when he told Radio 4 listeners last week that "spending on pensions and disabilities is pretty much the whole welfare budget (11.1% of GDP) right there" and that the only solution (sic) was to get the young NEETs (not in employment, education or training) back to work. Yet a quarter of welfare payments (> £90bn, or 2.8% of GDP) go towards neither pensions nor disability. As for pensions, the Triple Lock has far outgrown its original intentions and > 80% of disability benefits go to working-age households. Many disabilities are 'not visible' and claims are reportedly spiraling out of control, with 1-in-6 new cars sold in the UK now being provided to welfare claimants, for example. There is plenty of fraud and waste to cut if politicians only had the resolve. Ask Millei.

Hard work, tough luck

After 5 years in a dead-end position, one of my son's uni friends just celebrated a great new job which shoots him into the 94th income percentile. Whilst he will now pay £20,939 in tax, because of the 50 hours per week in the job spec, his take-home pay works out at just £20.80/hour; and perhaps less assuming the offer document puts an overly positive spin on the hours actually required. This graduate-qualified, private sector role compares rather unfavorably to a, presumably wholly unqualified, working age welfare beneficiary, doing the minimum required 16 hours (i.e. 2 days) a week that is the gateway to benefit eligibility. On the London minimum wage, earnings are £12,854, with only £77.72 due in tax. Assuming they receive the full benefit cap of £25,323, annual net income works out at £38,177, substantially more than the median full-time worker who keeps £31,629 and equivalent to £45.80 per hour worked, nearly 3x the net hourly full-time rate of £16.57 per hour. Adding insult to injury, the benefit cap is close to the £20,939 the private sector 'good job' earner expects to pay in tax.

So, not only is our high earner effectively paying to bring up someone else's family (as well as his own), he is also working more than three times as long as they do for the privilege.

In-work benefits

A quarter of UK workers work part-time and, because the gateway to benefits is 16 hours a week, average hours worked by part-timers are 16.5 and the median is even closer to 16. In the example above, a London-based part-time worker might earn £122.85 a day after tax for the two days of work required to qualify for benefits, but 'earns' £162.33 per day equivalent in benefits for the remaining three days a week, making the marginal tax impact of working a minute more than the minimum 16 hours wholly prohibitive. The UK 'low pay' benefits system, by not adjusting for hours worked, is not only unfair to full-time workers, but effectively traps in-work welfare recipients in permanent state dependency. Any honest and useful measure of income inequality should be neither blind to net income, nor to hours worked. When some academics talk about income inequality, they often 'neglect' to adjust for the effect of taxes and benefits (eg. Pikkety, Saez, Zucman, et al. to name but three), but never do they adjust income inequality for hours worked. This is the secret sauce at the heart of the equality of outcome socialist agenda.

Public sector workers

Of course, the state is always and everywhere inefficient, so it is not just welfare beneficiaries that are a drain on productivity. Another young grad we know, for example, works for the civil service for only 60% of the 'high earner's' base salary (i.e. £45k). Yet, net of tax, his contracted 35 hours per week earn him almost the same per hour (£19.74) as his mate with the 'great job', with the added benefit that in the public sector, for any extra hours worked, he gets an equal amount of time off in lieu. He usually opts for working 9-6 for four days a week (sometimes from home) and takes every Friday afternoon off. Additionally, there is the extremely generous, non-contributory, tax-free 29% of salary, defined benefit pension contribution, worth just over £13,000 a year, which effectively raises his post-tax hourly public sector wage to £26.90/hour. Not content with this, the Public and Commercial Services (PCS) Union is now threatening strike action if its demand for a 28-hour (4-day) week combined with a 10% pay rise is not met. How public service attitudes have changed. His wartime bodyguard reported that Winston Churchill often worked a 120-hour week.

Employers' costs

Although the minimum wage is two thirds of the median wage (up from less than half when Tony Blair introduced it in 1999), additional government regulations and taxes have raised full-time, entry-level worker costs to £28,308.50 more than £4,000 (+18%) higher than just three years ago. If young, uneducated, unskilled, inexperienced workers, doing undemanding jobs poorly, perhaps with non-monetary perks, like room-and-board (eg. au pairs), are now getting paid almost the same as family breadwinners, because of government intervention, no matter how well intentioned, then the system is broken.

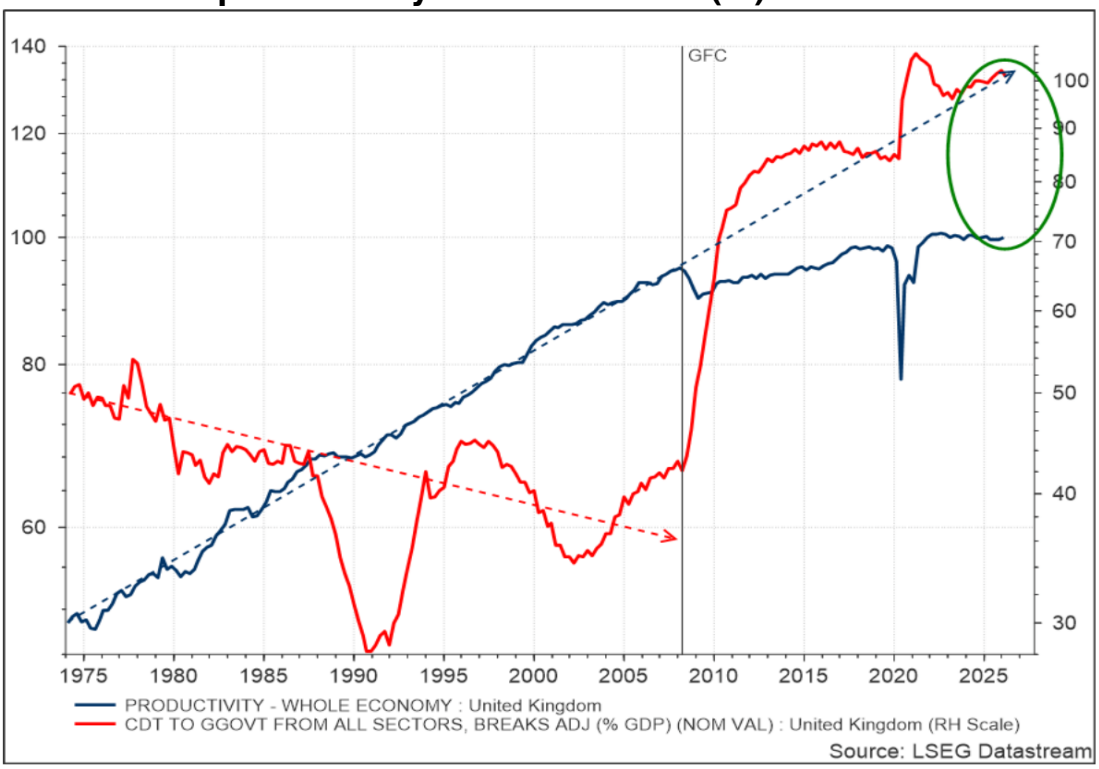
The issue is not, therefore, as it is usually presented: income inequality per se, it's the inequality of the rewards accruing to education, productive effort and hard work. If the PCS strike threat proves successful (Labour usually caves in to the unions), this public sector package would raise the civil servant's hourly net to £35.86, including pension. When the young private sector cohort find out about the extent of this widespread inequity, might we finally see a sea change in the pro-woke consensus? Equivalizing

to the working age welfare cap beneficiary, who receives an income of £45.80/hour worked, a civil servant might soon receive £35.86 per hour worked, the 'good job' takes home £20.80/hour, whilst the median private sector fulltime employee works 36.7 hours per week, earns £39,039 gross and takes home only £16.57 per hour worked.

Working v shirking

From an economy-wide point-of-view, the explosion in unproductive government policies, as measured by the surge in debt-to-GDP (see red line, RHS in Chart 2 below) has crowded out the private sector and chronically damaged productivity (blue line). The lost productivity, compared to the pre-GFC trend (dotted blue arrow), is equivalent to £1trn a year, or one third of today's GDP (see green ellipse). The fact that politicians are unable, or at the very least unwilling, to admit that the collapse of economic growth is the natural consequence of their policies: chronic deficits, crowding out and, since the GFC, the reversal of post-War government deleveraging (dotted red arrow), suggests that it is a prerequisite that this self-serving political blind spot be recognized and reversed before it is too late and more drastic fiscal measures are called for.

Chart 2: UK productivity & debt-to-GDP (%)

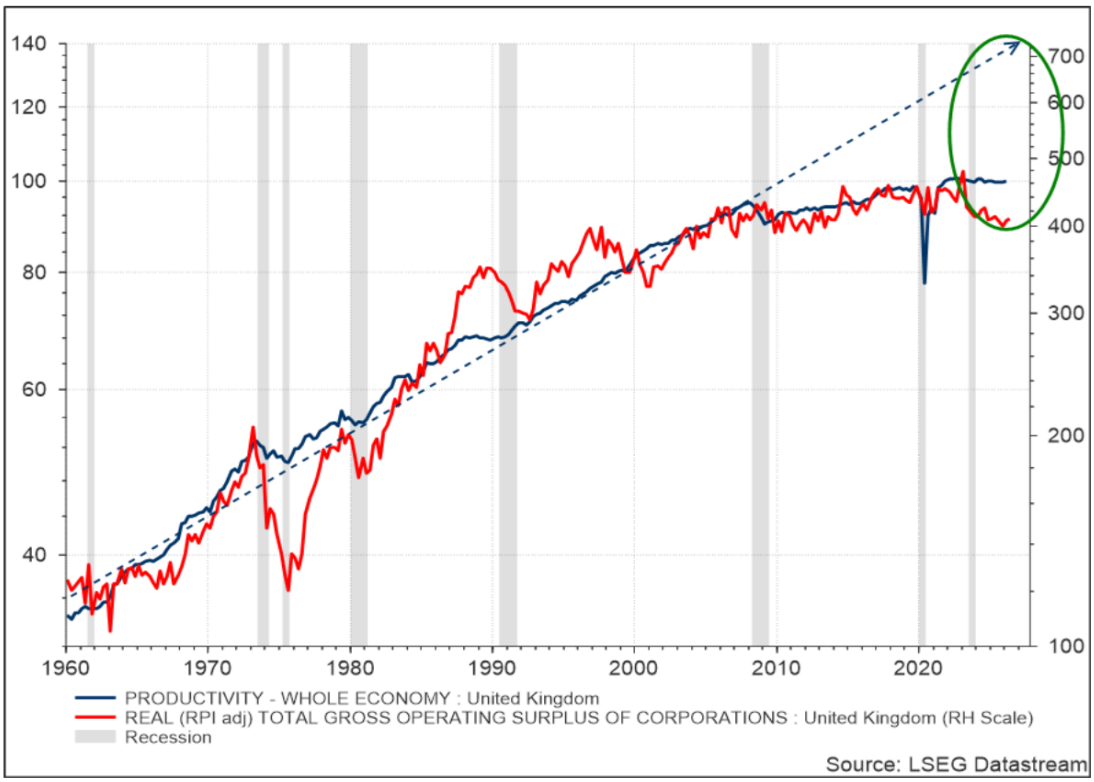


The Argentinians have recently come to their senses. Since the euro-crisis, the Greeks, Spanish and Irish had also been forced to do so and in the slightly more distant past so did the Swedish and the Canadians under Jean Chretien. When something cannot continue, it won't. In the US, where blue states are the ones imposing more tax, more regulation and a higher cost of living, there is an exodus of corporate HQs and middle-class families to new homes in southern red states. Yes, the public sector provides fewer services and workers have fewer rights, but that translates into consumers having a lower cost of living. Sunnier weather and zero state income taxes in the likes of Texas, Tennessee, Nevada and Florida also help ease the transition.

Somnambulism

When productivity levels off, so does profitability (see red line in Chart 3 below). UK real profits (red line) are only about half the level we might have expected if we extrapolated the old pre-GFC, pre-government debt eruption trend (see green ellipse). Without productivity there are no profits, without profits no investment and without investment, no growth. This is not some hazily unreliable prediction, but merely an observation of what has already occurred over the last 15 years.

Chart 3: UK productivity & real economy-wide profits



Not so different

The UK is still in denial about its impending predicament, but it may already be too late for France, where the differences are not so much stark, as hard to make out. France's debt is 121% of GDP, marginally worse than the UK's 101%, whilst it famously hasn't managed to run a primary surplus since the mid-1970s. Yet if it hadn't been for a couple of years in the late 1990s (see green circle in Chart 1 above), you could say exactly the same about the UK. Admittedly, the French state accounts for 57% of GDP, compared to the UK where it is 'only' 46% and French taxes are 45% of GDP, compared to the UK where the squeeze is 42%, but frankly these differences are semantic. The yield on French OATs has recently surged +100bps to 5%, capturing the headlines, but the UK pays 30bps more for its debt and, whilst France will probably run a 5.4% deficit this year, the UK deficit, which was 5% last year, will almost certainly match it.

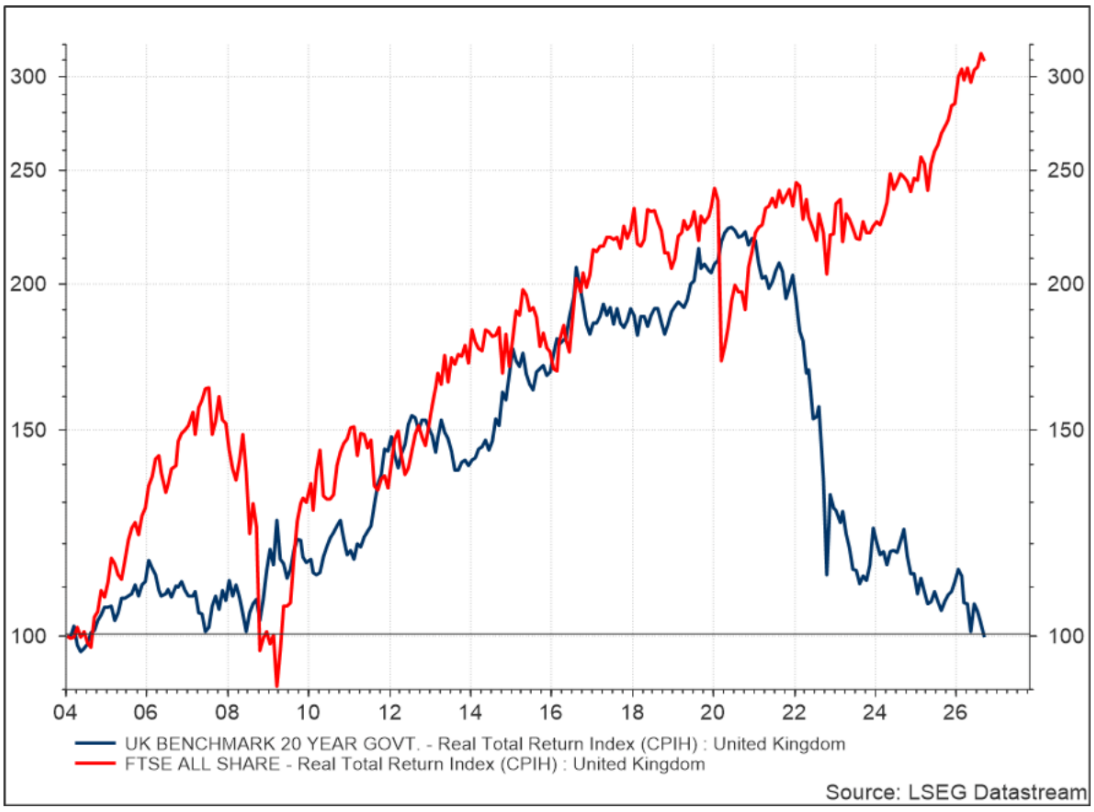
Meanwhile, the Labour party (though the previous Conservative administration were equally culpable), continues to tax productivity and busily transfer as much to its own public sector and dependent constituency at the private sector's expense as it can manage. From April next year, 'unused' pension savings will be subject to Inheritance Tax (IHT) at 40%, though with a marginal income tax rate of 67% on drawdowns, tax efficient options are now severely limited. Note that these tax changes only impact

private sector savers in defined contribution schemes (now that defined benefit schemes have already been taxed out of existence. This is coincident with a recommendation from the Pensions Commission to raise the private sector minimum employee and employer contributions from 5% and 3% respectively, to 6% from each. For firms, this is another tax on jobs, whilst for individuals, it increases the likely future IHT raid on 'unused' pension savings if they die young.

IHT thresholds have been frozen for almost two decades, which had already brought an estimated 40,000 households annually into the net before the inclusion of pension savings, which will take the catchment above 50,000 in 2027. However, the Institute for Fiscal Studies (IFS) estimates that even the median inheritance for those born in the 1980s will be around £136,000 which, given the average of nearly two children per couple, implies that many more will soon be paying IHT. Since Gordon Brown abolished pension fund tax credits 30 years ago, new defined benefit pensions have disappeared from the private sector, which has been forced into defined contribution schemes, now to be subject to IHT. Not so the public sector, whose generous, taxpayer funded non-contributory pension entitlements not only retain defined benefits, but have no 'pot' and so are also ringfenced from IHT.

The rank unfairness extends beyond private sector individuals to their institutions too. From the 2004 Pensions Act onwards, the UK government has embarked on a relentless program of taxation and regulation to coerce institutions into eschewing equity investments in favour of lending to it by buying gilts. In 2004, UK government debt was only 36.6% of GDP; today public debt is more than 100% of GDP. The only way a run of such massive, chronic deficits could have been facilitated was by enforced coercion; a sort of fiscal dominance, but not over monetary policy, over private sector institutions, on whom the impact has been debilitating.

Chart 4: Real UK gilt & FTSE total return indices (base 100)

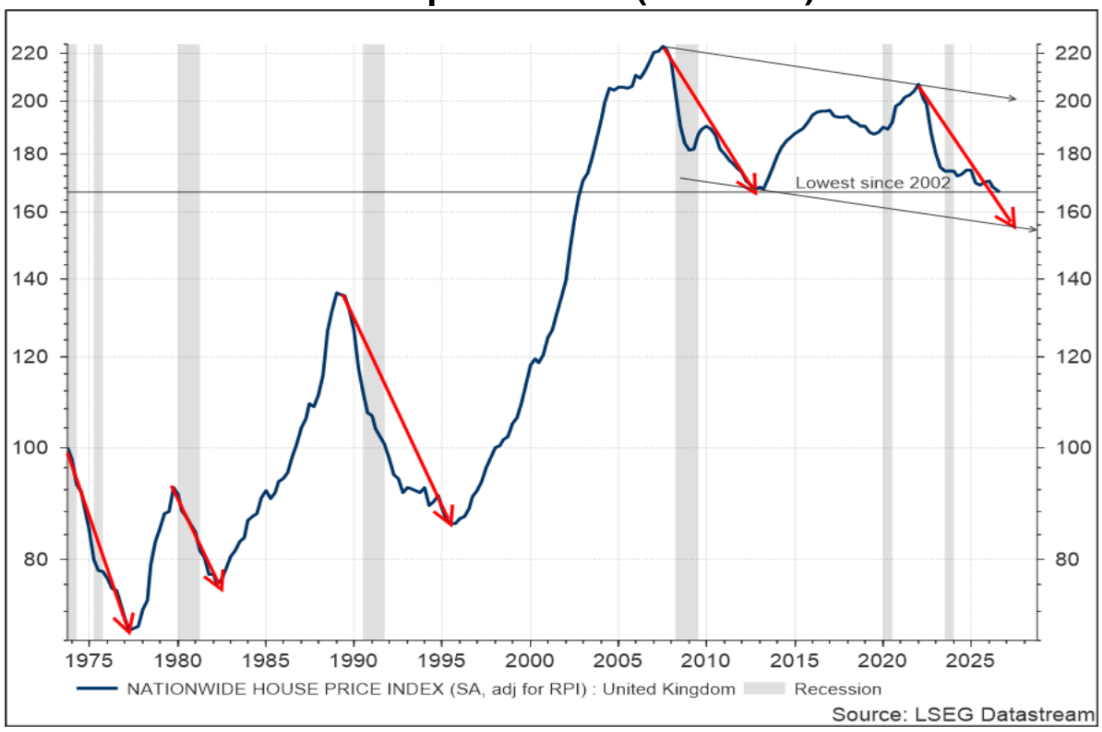


The inflation-adjusted total return from long-dated gilts since 2004 has been precisely zero (see blue line in Chart 4 above). On the other hand, even the underwhelming FTSE All Share, heavy with old economy stocks, but paying a dividend yield that has compounded at 3.5%, has enjoyed an annual total return of over 6% (red line). The regulators' misdeeds continued in the wake of the GFC, which provided top cover for politicians' desire to make government borrowing easier via the expedient of demanding that pension funds and insurance companies duration-matched their liabilities, almost entirely pushing both out of equities and into gilts. At first, the initial result of this enforced portfolio rotation was a gilt bull market that peaked in 2020, but the ultimate consequences once the rebalancing was complete have been beyond dire. If Covid proved that you should never take epidemiological advice from politicians, the self-serving 'de-risking' of the UK pension and insurance industries proves you should take their financial advice at your peril too. Repeatedly, government proves that it is the problem, not the solution.

Safe as houses

Another arena where government intervention has completely distorted household wealth is housing. After the early 1990s recession had sent real house pieces back below where they had been before the Oil Crisis in 1973 (see blue line in Chart 5 below), the launch of new 'buy-to-let' mortgages (1996) combined with assured short-term tenancies lit a fire under UK house prices. As mortgage rates fell, landlords were increasingly able to undercut owner-occupiers, because investors didn't need to fund repayment. In 1998, when mortgage rates were 9.5%, a 90%, 25-year annual repayment cost 10.5%, only 10% more than the interest-only rate. However, by 2003 when mortgage rates had come down to 5.5%, the owner-occupier was paying 7.4%; a 35% monthly premium to interest-only landlords, who effortlessly outbid homebuyers, effectively forcing them to become their tenants. From the artificial pre-GFC peak, UK house prices have declined by a quarter in real terms and are now back at 2002 levels. Estate agent Savills, says non-dom vacated Prime Central London has fared even worse, with real house prices down almost -50% from peak.

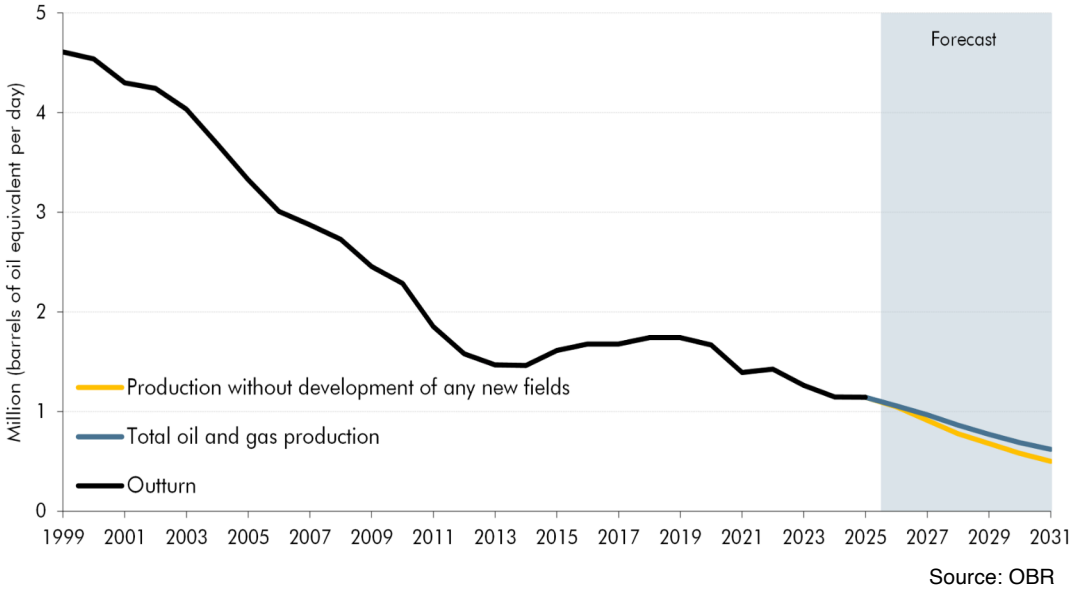
Chart 5: Real UK house price index (base 100)



Intended consequences

The UK government's suicidal program of self-harm could not be better illustrated than with Net Zero which, even if successful from a carbon mitigation point-of-view will do absolutely nothing for the planet. The politicians argue that the decline of North Sea oil (see Chart 6 below) is not due to their draconian 75% 'windfall tax', nor their refusal to issue new licenses, but rather to the fields becoming exhausted. There is only one problem with that argument: Norway.

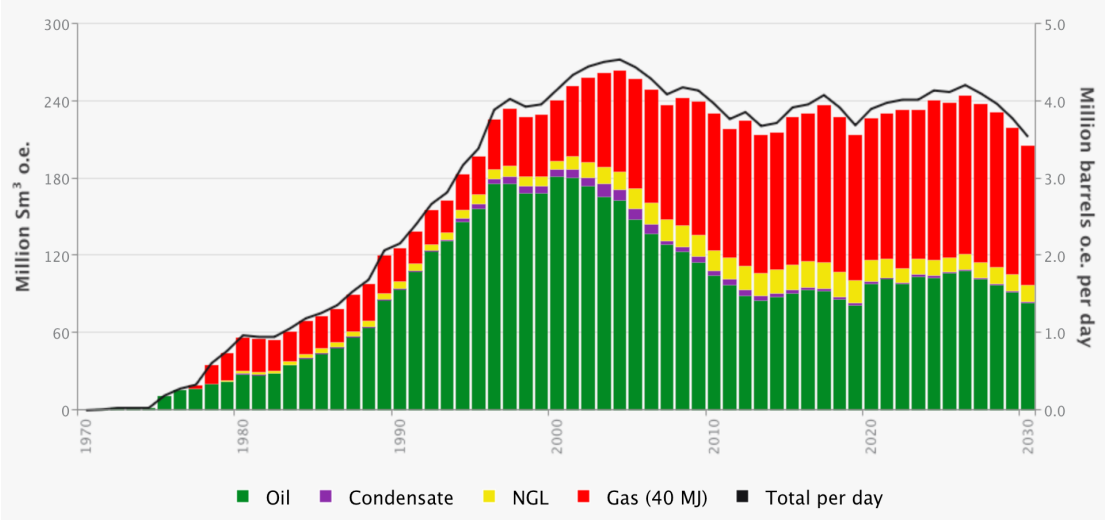
Chart 6: UK oil & gas production (million boed)



Source: OBR

Norway shares the same North Sea field as the UK. Norway's oil and gas production peaked around the same time as the UK and at almost exactly the same level of 4.5 million barrels of oil equivalent per day (boed). Yet unlike the UK where production is now barely 1 million boed, in Norway it is still up above 4 million boed. Gas now plays an increasingly dominant role. According to Norsk Petroleum "in 2025, Norway exported a gas volume equivalent to more than 30 per cent of the ***total gas consumption in the EU and the United Kingdom***" (my bold). The North Sea is not exhausted, it is the government's Net Zero agenda that is to blame.

Chart 7: Norway UK oil & gas production (million boed)



Source: Norsk Petroleum

Conclusion

Defence and the rule of law are necessary prerequisites for civilization and welfare transfers may be desirable for all sorts of reasons, but government spending is inherently unproductive because it is not subject to the profit constraint. Therefore, productivity is a characteristic solely of the private sector and without productivity there can be no profits and without profits, no investment and without investment, no growth. The whole idea, therefore, of government 'stimulus' is a political fantasy. More government means more tax, more regulation and a higher cost of living (because workers' rights are the ying to the yang of consumers' costs of living – just ask the soviets).

UK productivity has been suppressed by chronic government deficits since at least 2008, the date runaway government debt exceeded 40% of GDP. During that time, government has taxed productivity growth almost to extinction, annihilated private sector pension savings, warped the housing market, indebted the country and generally waged war on the private sector to the outsized benefit of its own constituency. There is a way out of the low growth-high debt trap that the UK, and others like France, Japan and possibly even the US are staring into, but it requires an aggressively radical pivot away from the existing government narrative. The politicians will never offer a solution because turkeys don't vote for Christmas. That leaves a couple of very unpleasant alternatives: either the bond market vigilantes demand a far higher cost of debt, or the foreign exchange markets devalue sterling sufficiently radically to make it competitive again. Either way, it will be both nasty and a wholly self-inflicted wound.

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