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MACRO MORNING BRIEFING

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Participation, Remuneration And Taxation

Central Banks Face Up to Public Sector Labour Distortions

- High levels of public-sector employment to support wages
- Welfare debate aside, taxation affects labour incentives
- Bond markets to target fiscal credibility in electoral manifestos

Governments pull up wages, pushing down participation

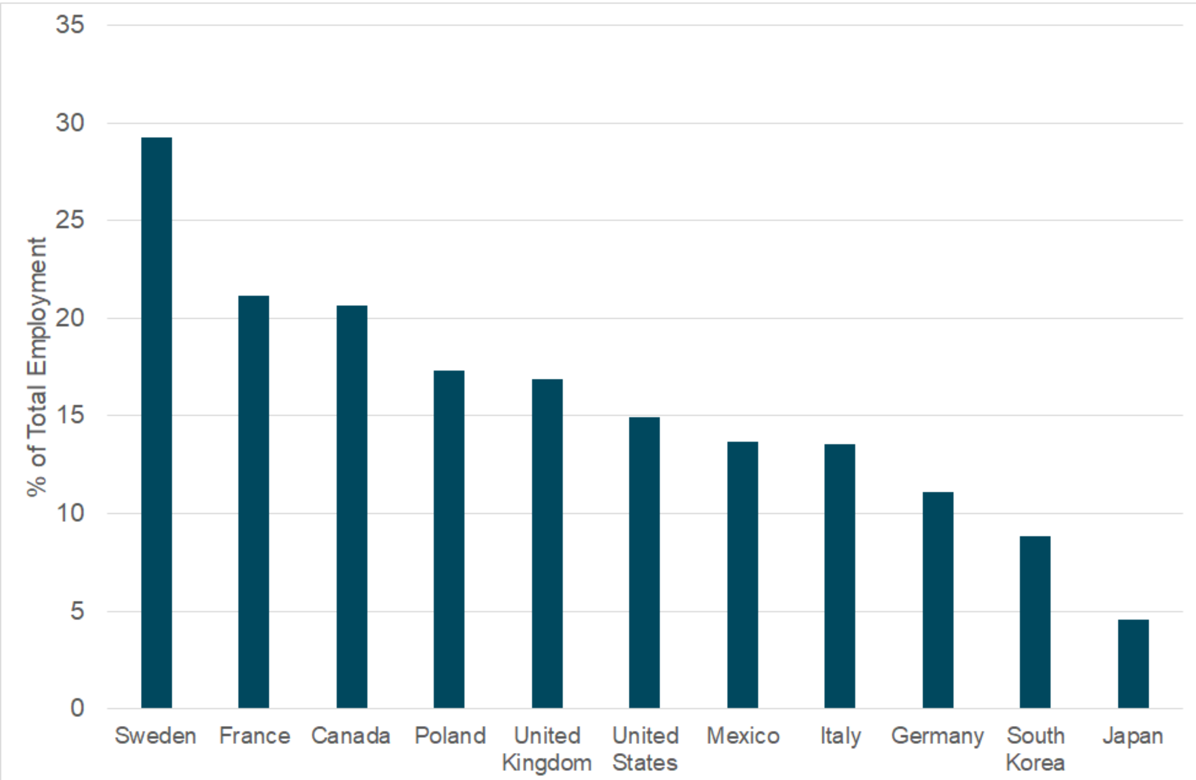
February has not been kind to expectations for falling inflation, especially in the US. Even though growth expectations continue to decline and there are clear indications globally that general activity levels continue to weaken, central banks' proverbial hands are being forced: aside from Federal Reserve officials, key policymakers in Europe such as European Central Bank President Christine Lagarde and Bank of England Chief Economist Huw Pill have also sought to dampen expectations for an earlier rate move.

Such reactions by data-dependent central banks are natural. But what separates the Fed from its European peers is that the US is clearly starting to pull away in growth. Germany has only registered one fully positive quarter of real GDP growth in the last five, and even that was only a paltry 0.1% q/q. The UK has also confirmed entry into a technical recession. US exceptionalism is a dominant theme, but markets continue to struggle with the reasons behind it, and often fall back on the usual factors such as demographics and other structural factors which tend to generate higher total factor productivity.

Although European policymakers continue to worry about new supply shocks – against which the US has far stronger resilience, especially in energy – inflation risk globally remains concentrated in labour markets. This is another area where the US is clearly outperforming, but it could potentially have better productivity to compensate. In the post-pandemic environment, much of the labour demand was attributed to government largesse. Income support during the pandemic boosted savings and spending power, but it is difficult to extend this view into 2024 with savings rates having largely normalised.

This is not to say that governments have been engaged in massive fiscal contraction, either. We have previously highlighted Lagarde's comments around wage gains in Eurozone public-sector employment, and this is not a uniquely European phenomenon. As Exhibit 1 below indicates, while French public-sector employment is above 20% of total employment, Canada is not far behind. Perhaps somewhat surprisingly, public-sector employment by this measure in Italy and Germany is lower than in the US and UK. There is no clear number beyond which the public sector's role in labour markets is so strong that the government becomes the marginal 'wage-setter'. Even so, the prevalence of stagflation risk in Europe and Canada also means that having public-sector employment assert greater dominance also comes with risks, especially if it results in a more general productivity drag – a risk which Lagarde has warned about openly in relation to Eurozone inflation.

Exhibit #1: Public-Sector Employment

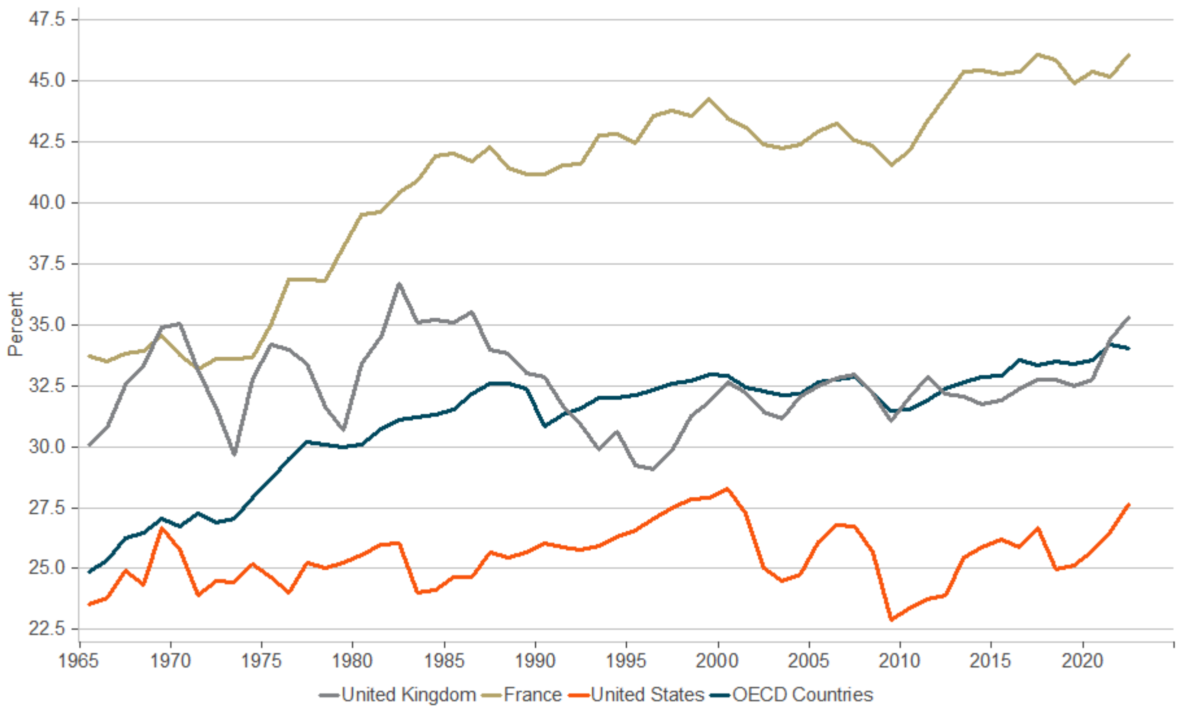


Source: Macrobond, BNY Mellon

Government spending per se need not be negative for productivity, especially if there is a more comprehensive industrial policy in which subsidies aim to boost private-sector innovation. The potential for public-sector investment to 'stop-in' the private sector is strong, but such investment is not congruent to expanding public-sector employment. Furthermore, the notion of fiscal dominance could also return as investors chase real rates, rather than nominal. Without commensurate productivity growth, markets will question whether revenue can keep up with any form of expansion. Tolerance will likely be lowest for economies with high tax intake but lower output; such a result means productivity is not keeping up.

Given the current politically polarised environment and crowded electoral calendar, calls for tax rises to fund expansion and stave off bond market pressures is also a risk. Each country will likely seek to chart its own “Laffer Curve”, but starting points are very different and reflective of individual economic characteristics. As shown in exhibit 2, despite the US’s consistent deficits over the past few decades, its total tax intake as a share of GDP is well below the OECD average and still remains below the highs at the turn of the millennium. On the one hand, this suggests that the current fiscal course for the US is not sustainable and, by extension, that any inflation risk is generated by government demand. On the other, the UK and France have tax intakes above the OECD average, but both appear to be hardly generating the GDP growth to fund current and contingent liabilities on a sustainable basis.

Exhibit #2: Total Tax Intake, Share Of GDP



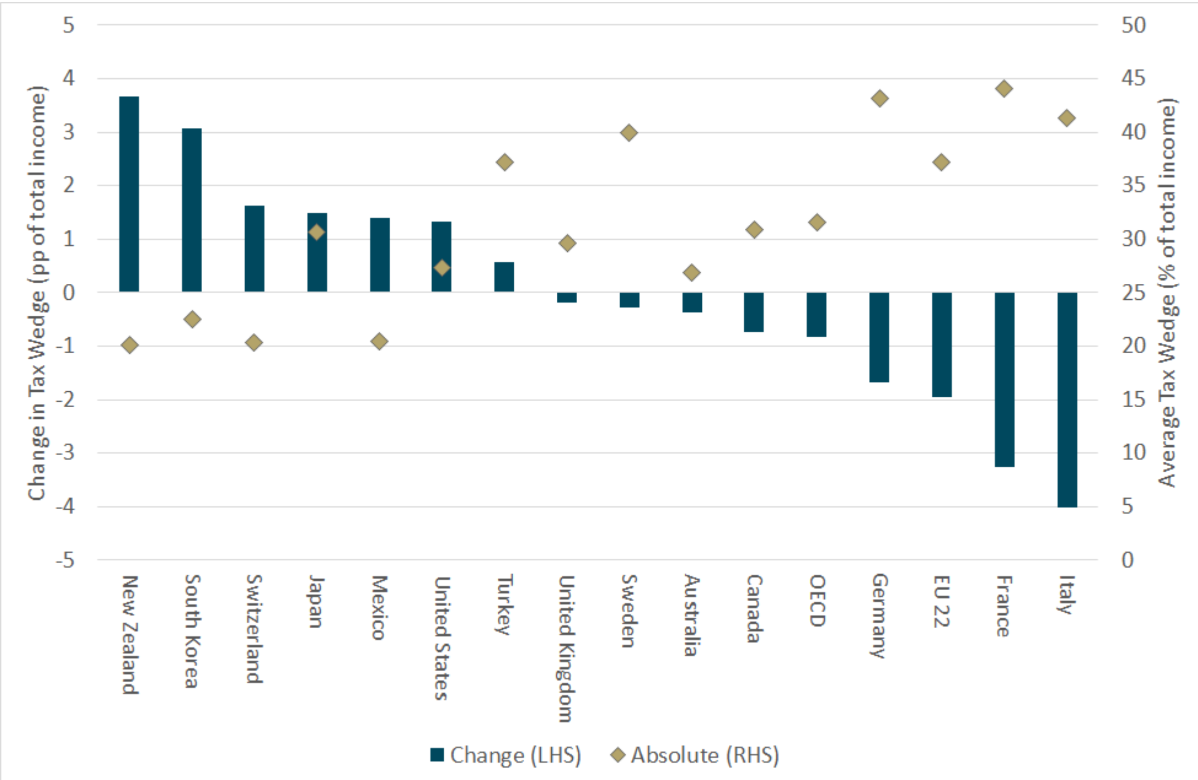
Source: Macrobond, BNY Mellon

Even if fiscal contraction across developed markets is inevitable, it will likely come too late for the current policy cycle. In our view, central banks need to fully assess the impact of fiscal policy on all facets of the labour market and, crucially, whether any residual inflation impact can be remedied by monetary policy. Otherwise, the risk of policy error will likely be high, especially if the private sector requires significant loosening in financial conditions.

The UK is a good case in point at present: participation rates in the economy have fallen sharply to the extent that even though the economy is in a technical recession, labour markets remain very tight. Revised labour force statistics confirm this view. Participation rates around the world have been impacted by the pandemic, but there has been precious little policy debate regarding boosting participation rates until recently, mostly likely because of the urgency of generating productivity growth.

Exhibit 3 shows the level of tax wedges across the OECD, which reflects the "ratio between the amount of taxes paid by a single person at 100% of average earnings and the corresponding total labour cost for the employer". The higher the tax wedge, the greater the "extent to which tax on labour income discourages employment". In absolute terms, we can see that the highest tax wedges remain in the European Union, even though the levels have fallen significantly over the past decade. The implication for labour markets seems clear: current income tax rates in Europe likely discourage returnees to the labour force. Consequently, the existing labour force will likely remain tight and existing workers have wage-setting powers. Already a productivity drag, this is compounded by the bulk of new labour demand also coming from the public sector. The US tax wedge is below the OECD average though not low enough either to suggest that personal income tax policy is strongly supportive of higher participation and general labour market productivity growth.

Exhibit #3: OECD Tax Wedges

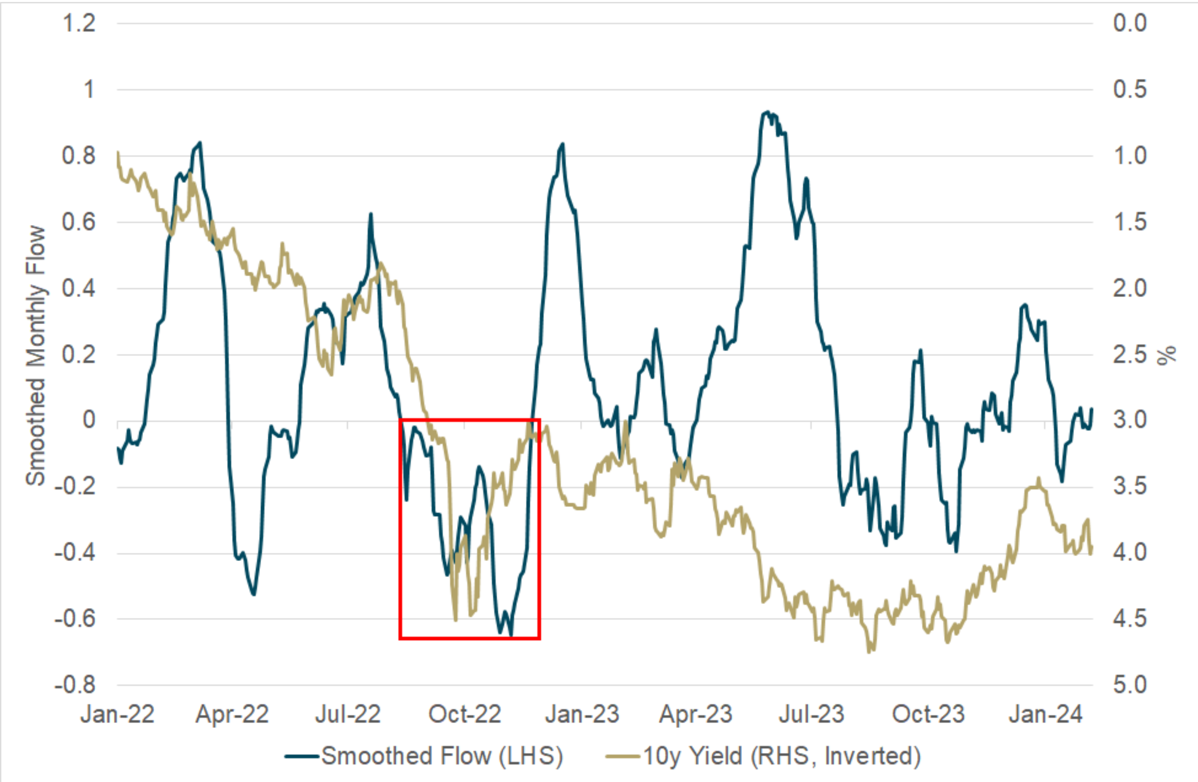


Source: Macrobond, BNY Mellon; Change reflects 2012-2022 difference.

It has been well established that current fiscal policy is sub-optimal across much of the developed world and OECD. Growth is top of the agenda for governments, but views differ on how to achieve this considering the structural issues in place. It is plausible that in the near term, tweaking income tax codes to boost participation is probably the lowest-hanging fruit to boost productivity. However, we think this must be done credibly.

The UK's "mini-budget" episode in 2022 is a stark reminder of how shock-therapy seeking to reduce tax revenue and the tax wedge was viewed. Exhibit 4 (iFlow data) shows that realised flow out of the UK Gilt market then remains the strongest in recent years.

Exhibit #4: The UK Mini-Budget In 2022



Source: BNY Mellon

As central banks continue to grapple with sub-optimal labour markets generating sticky inflation, governments (incumbent or incoming) calling for lower interest rates must acknowledge their role in its causation. As ever, however, the remedy ought not be worse than the disease, and especially now with bond markets back on edge.

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