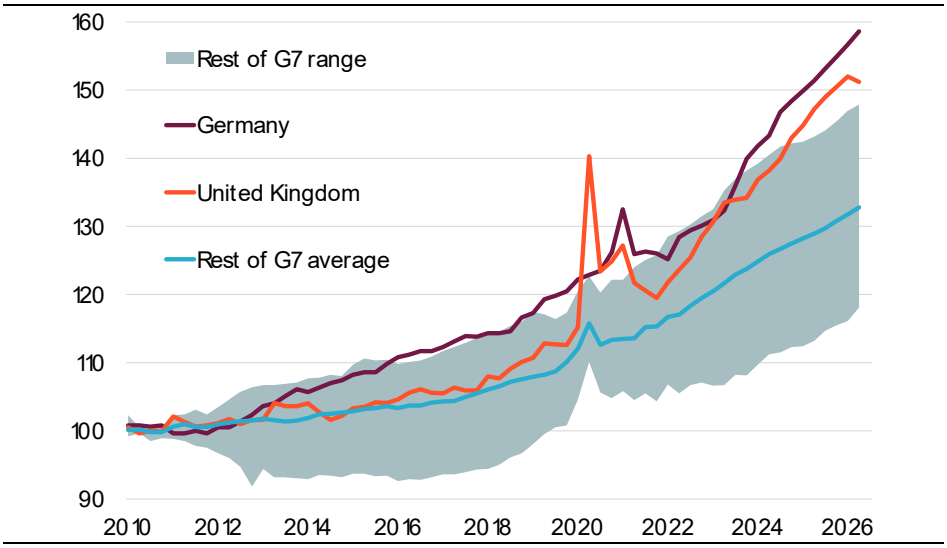
# UK: high-cost island

- **High costs inhibit business activity:** The UK's economic performance over the past 17 years has been disappointing, although not unusual for Europe. Policies designed to alleviate the adverse effect of low growth on voters' finances have tended to make things worse. Attempts to raise wages squeezed profit margins, damaging companies' incentives to produce and sell goods and services. Excessively loose fiscal policy contributed to the surge in interest rates in 2022-23, raising the hurdle rate of return for business investment. Sufficient aggregate demand and advances in technology mean that UK growth can rebound over a two-year horizon. However, whether the UK can outperform on a sustained basis hinges on the country reversing secular and recent increases in business input costs. The risk is that recently appointed Prime Minister Andy Burnham raises the cost of doing business further, compounding Keir Starmer's most significant policy error.
- **World leader in costs:** We compare the costs of the primary factors of production (land, labour and capital) plus energy to those in other advanced economies. Since the turn of the millennium, land has been expensive in Britain. More recently, capital, labour and energy have also become costly. These sharp increases in business costs make the UK less competitive, and risk entrenched underperformance if left unaddressed.
- **Supply-side reform:** The cost of production is a key determinant of the quantity of goods and services companies produce. At its simplest, supply-side reform reduces these costs, increases firms' profit margins, encourages businesses to produce more, and results in greater economic expansion. Raising the supply of land with planning approval, freezing the minimum wage, tightening fiscal policy, encouraging investment in UK equities, and taking a pragmatic approach to energy policy would improve the supply side of the UK economy. This direction is what we will judge the Burnham administration's policies against.

**Chart 1: UK unit labour costs have risen sharply since 2019**




*Indexed to 100 in 2010, nominal unit labour costs. Rest of G7 = Canada, France, Germany, Italy, Japan and the US*

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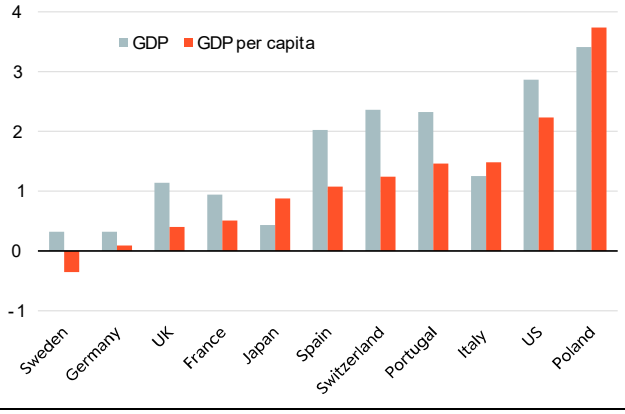
# Poor past performance, poor future returns?

The slowdown in trend economic growth since the financial crisis is a global phenomenon, but particularly severe in the UK. On a per capita basis, GDP has only just avoided outright stagnation since 2019, putting it close to the bottom of the international leaderboard – see Chart 2. Faster population growth, mainly due to high net immigration, explains most of the overall post-COVID expansion. Moreover, much of this expansion occurred immediately after the pandemic, with growth in recent years even more disappointing.

Admittedly, the UK economy has faced a series of growth-sapping shocks. Deficient demand as banks repaired their balance sheets and policymakers ran tight fiscal policies after the global financial crisis (GFC) slowed growth in all affluent countries. The 2022-23 price-wage spiral and the need for much higher interest rates than in the 2010s show that there is no lack of aggregate demand anymore. The yawning growth gap between the US and Europe since 2019 demonstrates that a lack of technological progress is not the limiting constraint either.

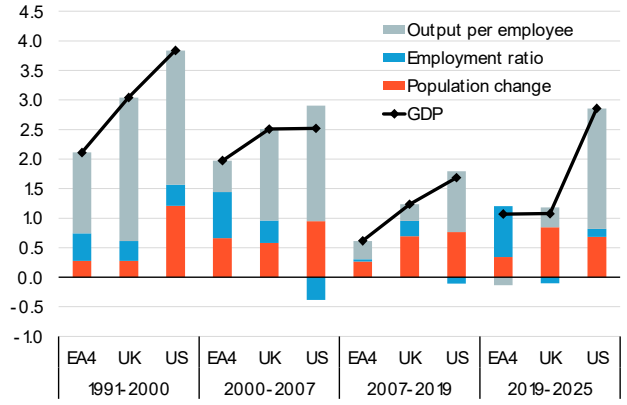
The slowdown in UK growth into line with Germany, France, Italy and Spain, which we dub the "Euro Area four" (EA4), since the pandemic is a new phenomenon – see Chart 3. Brexit, greater sensitivity to US tariffs and energy price shocks are the most common explanations. But this risks retrofitting explanations to the facts. We think that reduction in investment and trade due to Brexit is largely complete. Meanwhile, limited goods exports to the US and lower net imports of energy than most European countries mean that the UK should have been slightly less severely affected by the global shocks of recent years. In this note, we assess whether an underlying deterioration in the supply side of the economy helps explain the malaise.

**Chart 2: Close to the bottom of growth leaderboard**




*In % yoy, average annual GDP and GDP per capita growth between Q2 2019 and Q2 2026. Source: Haver, Berenberg calculations.*

**Chart 3: Growth accounting: contributions to growth**




*In ppt, contribution to average yoy GDP growth rate in each period. Sources: European Commission, Haver.*

**Chart 4: Higher costs, lower output**

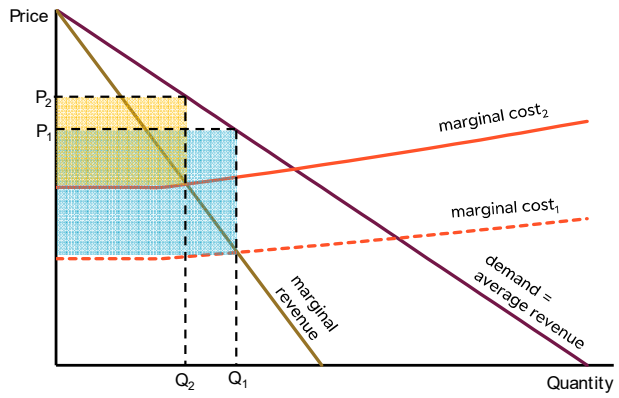



*Illustration of how an increase in marginal costs causes firms operating in imperfectly competitive markets to raise prices and reduce output. The yellow hatch shows larger profits before the cost increase, and the blue hatch lower profits after.*

### Supply-side economics

In the long run, economic output and growth are determined by the quality of the institutions that govern the economy, the availability of the primary factors of production: land, labour and capital, and how efficiently firms can combine them to produce goods and services (i.e. technology).

Companies' individual profit maximisation problems illustrate how the cost of inputs determines the amount of goods and services each company produces. A rise in the cost of producing each unit (marginal cost) increases the price that companies will charge to maximise their profits, and in turn reduces the number of units that they sell – see Chart 4.

The energy price shocks of 2022 and 2026 were examples of supply shocks, in which a drop in the supply of an input to the production process pushed up its price, thereby reducing output and tilting the economy towards stagflation. While the UK government has little control over global commodity prices, its policies do affect the costs of the other inputs to the production process. In this note, we examine how the costs of land, capital, labour and energy compare to those in other economies, and the reasons for the differences.

# Land: the original sin

Over the past 25 years UK house prices have risen by more than those in geographically constrained Singapore and almost as fast as in Hong Kong[1]. A scarcity of land on which the state has granted landowners permission to build explains the surge in house prices over and above that in comparable economies. Very high property prices have crushed aspiration by making it too expensive for UK residents to improve their lot by moving to a new city. They have also caused households to use their savings and borrow to bid up house prices, diverting capital and lending from more productive uses.

*UK house prices have trended up...*

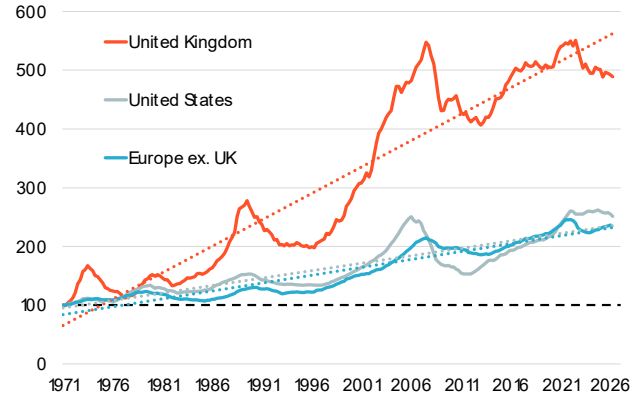
**An exceptional rise in house prices:** Good historical data on land prices is difficult to find, so we base our analysis on the cost of residential property. The same limits on the supply of land with permission for construction raise the cost of real estate development and rent for businesses. Admittedly, part of the rise in real house prices (i.e. over and above inflation) over the past 40 years is common to most developed economies, caused by lower interest rates. Lower rates increased home valuations and enabled buyers to boost their house purchase budgets with larger mortgages. However, the fivefold increase in real house prices in the UK since 1971 was about twice the size of the increase in house prices in the US and continental Europe, as the pace of housebuilding per capita in the UK lagged behind – see Chart 5.

*...since a post-war law change curtailed supply*

Bringing a 2019 European Commission paper on the absolute level of house prices up to date with national house price indices reveals that UK house prices have recently climbed to the highest in the G7 in absolute terms too – see Chart 6. Land prices have risen even faster. The Policy Exchange, a think tank, found that "in the 1930s the cost of land accounted for less than 5% of the cost of houses. In the 1960s the figure was still only about 10%; in the 1970s about 20%; in the late 1990s about 40%", increasing to 55% in the 2010s[2]. As a result, house prices in the UK are double the cost of constructing a home, whereas they are just one third higher in the US[3].

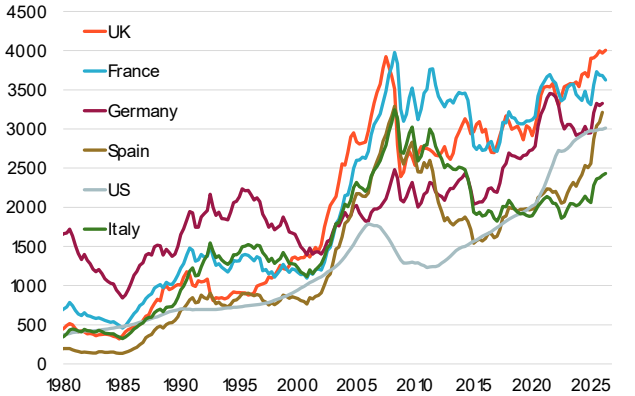
**The root of the problem:** Population growth, rising incomes and past falls in interest rates raised demand for housing across the developed world. In the UK, inelastic supply caused far more of the adjustment to this increase in demand to come through a rise in prices. We trace the lack of a supply response back to changes to the law after WWII. In the late 1930s, landowners could build anything they wanted, subject to a height limit (10 storeys) and some building safety regulations. The system was turned on its head after the war. In the spirit of the planned economy that the war necessitated, the state took control of real estate development through the 1947 Town and Country Planning Act (TCPA). The TCPA abolished property owners' right to build on their land. Whereas prior to the Act councils had to compensate landowners for restricting their development rights, afterwards, landowners were not allowed to build without explicit permission from the state.

**Chart 5: The rise in UK house prices outstrips that elsewhere**




*Indexed to 100 in Q1 1971, real house price indices. Source: Bank of International Settlements (BIS)*

**Chart 6: House prices ($/m2)**




*At current exchange rates. Calculated by Berenberg using European Commission estimates of average house prices per square meter in c2011 and BIS nominal house price indices*

[1]OECD, "Analytical house prices indicators", 2024
[2]Policy Exchange, 'The UK's Broken Housing Market", 2024
[3]Southwood, Hughes and Bowman, 'Foundations'

Chart 7 shows that private housebuilding slowed sharply after the TCPA was introduced. Admittedly, gross housebuilding rebounded in the 1960s and 1970s, but mainly due to large-scale public housebuilding projects to replace homes damaged in the war. Since then, land-use policy has become increasingly restrictive, further reducing build rates. Constrained supply explains much of the lengthy uptrend in house prices that became an accepted feature of the UK economy.

## Adverse consequences

*Tight land supply prevents successful places from growing...*

**Reduced labour mobility:** In the 19th and early 20th centuries, internal migration fuelled economic growth. The places where new industries were taking off expanded by attracting an influx of workers eager to earn higher wages. Glasgow's world-leading shipbuilding industry led to a tenfold increase in its population from 70,000 in 1800 to 700,000 in 1900.

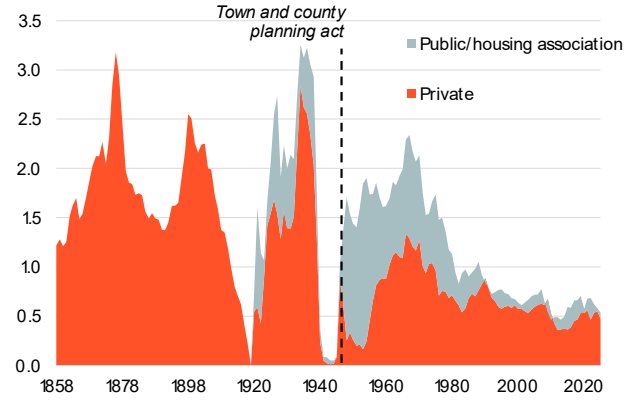
Because successful British cities can no longer allowed to expand much, the main result of economic success today is often an increase in land and house prices that makes it too expensive for all but the most sought-after individuals to work there. Only those who secure one of the highest paid jobs can afford to live nearby, and then must allocate a large share of their new salary towards servicing their mortgage rather than enjoying a much-improved standard of living. Others will spend their time and money on a lengthy commute. Similarly, high land prices make it more expensive for companies to acquire land to expand their sites. The most obvious recent example of this is Cambridge, where a world-leading life sciences cluster has generated an 80% increase in active companies over the past decade, but limited new housing and laboratory space have restricted the increase in the city's population to just 14%.

Reduced economically motivated migration within the UK across the income spectrum helps to explain the outsize disparity in wages between South East England and the rest of the country too. When housing construction responds to demand, labour supply can move to successful places and cap wage growth there. The corresponding drop in labour supply in the places that migrants left prevents wages there from falling far behind.

*...and produces windfalls for landowners when construction is permitted*

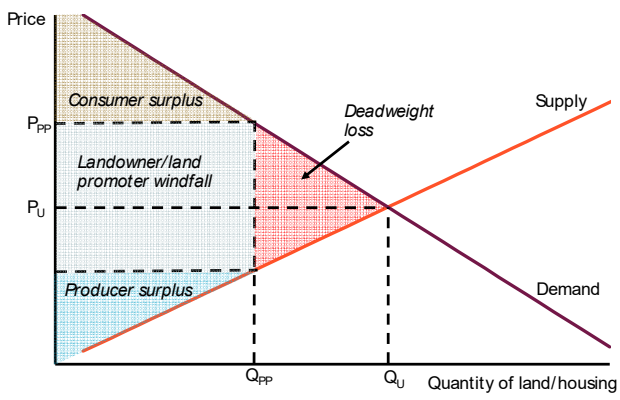
**Distorted incentives and deadweight loss:** Difficulty obtaining planning permission rations the supply of land for development. Chart 8 shows how this constraint on the amount of land available for construction raises its price and generates a large windfall for the landowners and land promoters[4] who successfully secure planning permission. As a result, a good deal of effort is expended on lobbying local governments to grant it. At the same time, higher land prices squeeze profit margins for those who put the land to use. This incentivises entrepreneurs to game the planning system over starting a business that offers new goods and services to society. For consumers, the result is unsatisfied demand for housing and a deadweight loss. Although homeowners may be pleased by the increase in the value of their home, the rise in its price is not due to any improvement in the quantity or quality of accommodation it provides. Instead, it reflects a scarcity of homes. If house prices were lower, homeowners would still enjoy the same standard of accommodation but have more money left over to spend on other things. The supply of, and demand for, non-housing goods and services would be greater if house prices were lower.

**Chart 7: Housing supply (additions as a % of existing stock)**




*Source: Watling, S. and Breach, A. (2023), The Housebuilding Crisis, Centre for Cities.*

**Chart 8: Land values make up a large chunk of UK wealth**




*Diagrammatic representation of how restricting the quantity of land with development rights from $Q_U$ (unrestricted) to $Q_{PP}$ (the quantity with planning permission) raises land prices, and who captures the gain.*

[4] "Land promotion" companies work with landowners to secure planning permission on their land in return for a share of the profits.

**A suboptimal allocation of financial resources:** The UK's national balance sheet shows that land and dwellings account for about three quarters of the nation's non-financial wealth – see Chart 9. That represents a significantly higher share than in other G7 countries for which the data is available. Because land is finite, this is purely an expression of land prices rather than indicating any increase in its quantity or quality.

*Rising house prices have led to an overallocation of resources to house purchases...*

Consistent real land price appreciation has instilled a belief in the public that housing is the best possible investment they can make. This brought forth speculative demand for homes that led to a self-fulfilling boost to buyer demand and house prices. The invention of buy-to-let mortgages in the late 1990s enabled small-scale investors to enter the market more easily. An increase in the share of homes owned and rented out by private landlords followed, from 10% to 20% of the housing stock by the mid-2010s. Many owner-occupiers probably bought larger homes than they needed on the expectation that the price would rise too.

*...that has taken capital away from more productive uses.*

High house prices mean that young adults have had to save for longer than in the past to amass a deposit for a home. Typically, buyers put both their life savings and a large mortgage towards their purchase. The result is a huge transfer of wealth from those who have not owned property for the past 50 years, the period over which real house prices increased fivefold, to those who have.

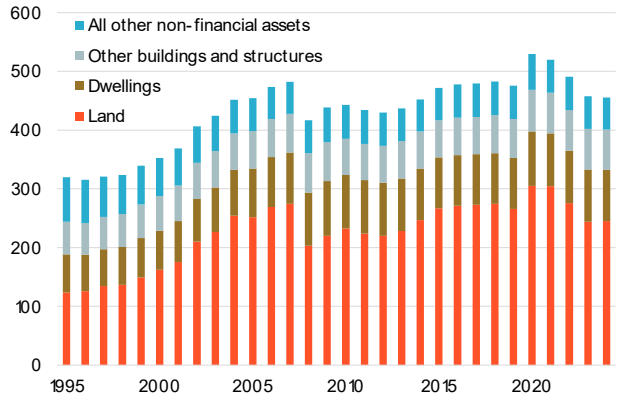
This leaves working-age adults with a smaller pool of capital to invest in financial assets, and possibly less bank lending to businesses too. About 70% of outstanding UK bank lending is made up of mortgages on residential properties. The necessity of channelling savings towards a place to live likely reduces the capital available to firms to invest in machinery, research and development. Whereas bidding up land prices does not produce any more land, business investment increases the capital stock available to firms to use in the production process.

**Lower fertility rate:** Finally, high house prices may also hurt long-run growth potential by reducing population growth. Stretched housing affordability has resulted in young adults living with parents or in shared accommodation for longer (see Chart 10), delaying having children. Fortunately, the UK fertility rate held up close to the replacement ratio of two until the early 2010s. The drop to 1.4 since will begin to weigh on labour supply in the 2030s, later than in many other Northern European countries.

**Policy recommendations**

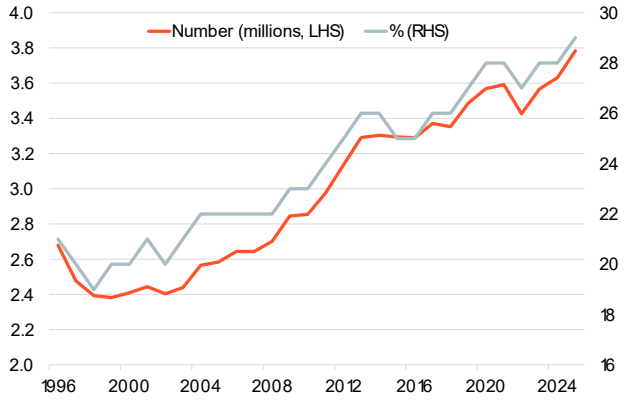
- Restore the right of landowners to build on their land within a predefined set of rules.
- Make it less expensive to move house by abolishing stamp duty.

**Chart 9: Land makes up a large chunk of UK wealth**




*In % of GDP, total UK non-financial assets. Source: ONS*

**Chart 10: Number of 20-34 year olds living with parents**



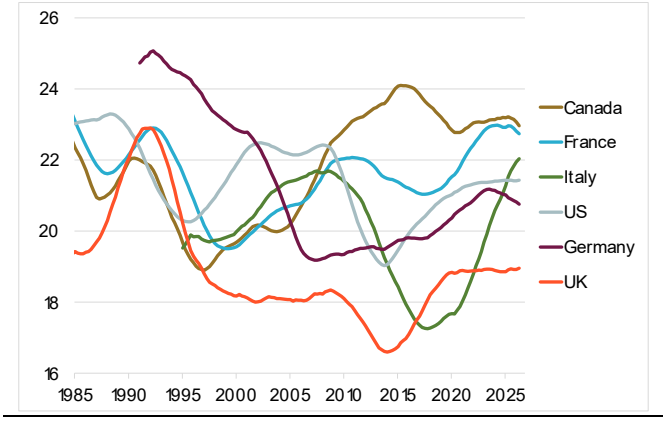

*Source: ONS*

# Capital: crowded out

Capital comprises the stock of man-made physical assets, like machinery, tools and buildings, and intellectual property. Workers employ these to produce goods and services. Relatively low UK business investment since the 1990s indicates that a lack of capital deepening is part of the explanation for disappointing growth – see Chart 11. Admittedly, the services sector that dominates the UK economy (81% of output) requires less fixed capital than industry. But the shift out of capital-intensive industries could be a consequence of low investment itself.

Indeed, UK firms currently face a higher cost of debt (interest rates) and equity capital than companies in other countries. This drives up the hurdle rate of return which investments must deliver to be profitable and worthwhile. Some economists argue that because (in a closed economy) savings equal investment, higher UK investment requires higher saving. A recent rise in the household saving rate means there should now be more capital available to invest. However, as we will see, the more significant problem is that the largest pot of domestic savings is predominantly used to fund investment overseas rather than in the UK.

**Chart 11: Business investment (% GDP)**



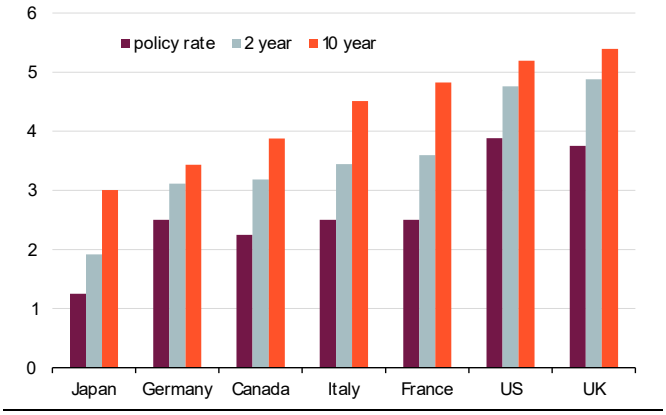

*5-year rolling average. Source: OECD*

## Debt

UK firms face higher long-term interest rates than those in other advanced economies, but if we are right that the Bank of England (BoE) will only hike the policy rate once, this disadvantage should prove temporary.

Corporate bond yields are benchmarked off the 10-year sovereign bond yield. The UK's yield has exceeded the rest of the G7's most of the time since the September 2022 "mini budget". The narrow spread between the two- and ten-year gilt yields now indicates that the reason for the discount has since changed, from concerns about fiscal sustainability to persistent inflation – see Chart 12. Having watched the BoE lose control of inflation in 2022, the market has priced in four 25bp increases in Bank Rate by next summer in response to the Iran war.

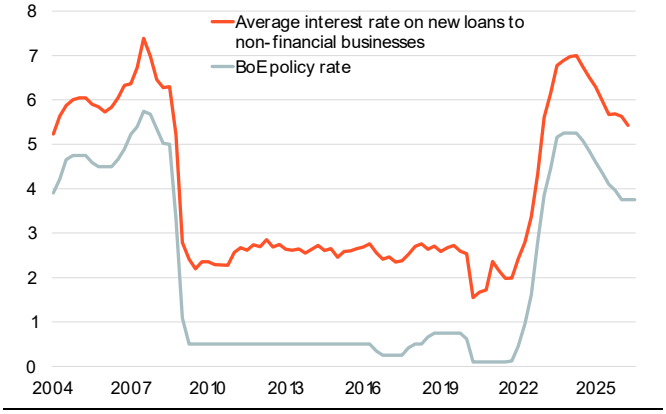
**Chart 12: G7 yield curves**




*% yield to maturity. Source: Bloomberg*

However, policy changes that raised labour costs in April 2025 explain much of the past excess UK inflation. This cost-push inflation has since dissipated. Better calibrated (tighter) policy and labour market slack should prevent another price-wage spiral from forming. We think that the BoE will hike just once on 5 November. If so, a repricing of near-term rate expectations should bring the 10-year gilt yield down below 5% by end-2027 and pull down corporate bond yields. A lower policy rate would also support other business lending – see Chart 13.

**Chart 13: Policy rate and average interest rate on business loans**




*In %. Sources: BoE, Haver.*

Our call rests on the assumption that the government will tighten fiscal policy as planned. Now that interest rates are well above the zero lower bound, there is no need for fiscal stimulus. Instead, the government should continue to tighten fiscal policy until the public finances are sustainable. The BoE can offset the negative demand impulse with lower interest rates that encourage firms to invest. Their initial investment will raise aggregate demand immediately, and the resulting increase in the capital stock will raise the supply capacity of the economy in future.

## Equity

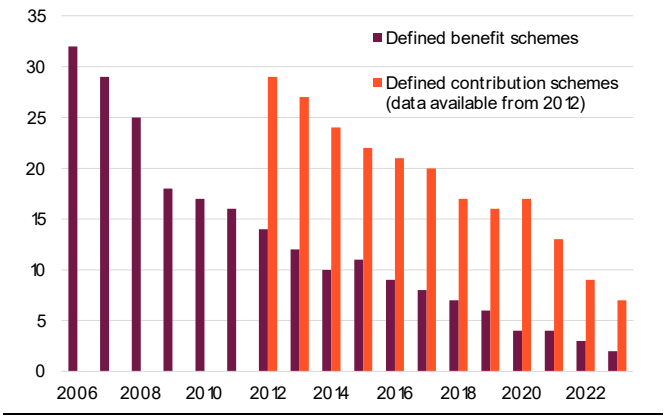
Debt is an unsuitable way to finance high-risk, high-reward investments because companies with uncertain prospects cannot guarantee repayment as creditors demand. Conversely, equity investors are willing to accept some risk of failure because their reward, a share of the profits, will outstrip debt interest many times over if the business succeeds. Companies that innovate to provide new products to society and scale up are the underlying engine of economic growth. A well-functioning equity market is critical to supplying these firms with the capital that they need to grow.

Whereas UK firms have only faced uncompetitively high interest rates on debt for a few years, the dearth of equity capital is a structural problem. In their pensions, UK households own one of the largest pools of financial assets in the world, but the share that finds its way to UK businesses has dwindled. Defined Benefit (DB) pensions hold about £1.7trn of assets and newer Defined Contribution (DC) schemes £1.2trn[5]. The share of DB assets in UK equities dropped from a third in 2006 to 2% in 2023. Similarly, the share of DC capital allocated to UK equities declined from 30% in 2012 to 7%[6] - see Chart 14. The argument that higher UK saving will boost UK investment does not stack up when capital heads overseas.

The drop in investor demand for UK equities has resulted in an increase in the cost of equity capital and a shrinking stock market. The UK equity market trades at a discount to those overseas, as shown by a lower price-to-earnings ratio and higher earnings yield – see Chart 15. The earnings yield (annual earnings divided by the market value of the company) is a rough proxy for the hurdle rate of return that justifies raising capital on the stock market to make an acquisition or undertake an investment project. Not only does this rule out acquisitions and investments that UK companies would otherwise make, but it has also caused the UK stock market to shrink.

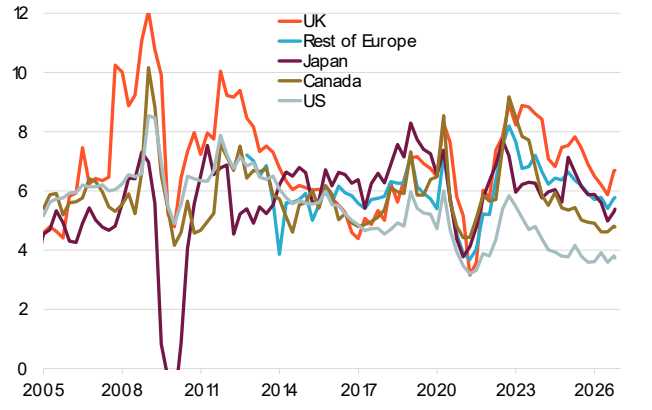
High earnings yields make publicly listed companies attractive takeover targets – they are worth more to private equity investors and overseas rivals who face a lower cost of capital than their value on the London Stock Exchange. The result has been a structural decline in the number of UK-listed businesses – see Chart 16. The drop in capital invested in UK equities has caused a negative supply response. Declining investor demand, an uncompetitive cost of capital, and worsening liquidity have formed a self-reinforcing circle that not only reduces business investment, but also damages one of the crown jewels of the UK economy: London's financial services hub.

**Chart 14: UK pension fund average allocation to UK equities (%)**



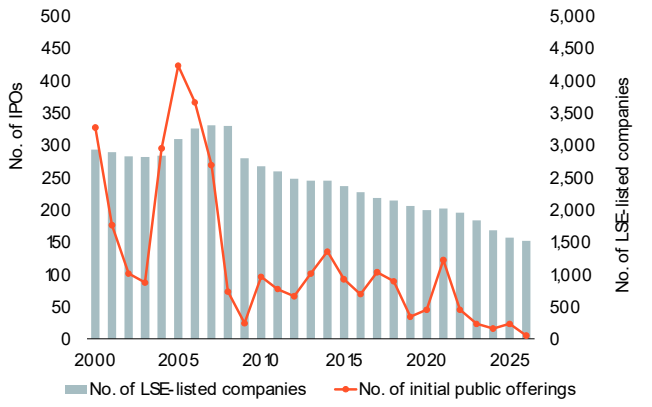

*Source: gov.uk, "Pension fund investment and the UK economy"*

**Chart 15: Earnings yields (%)**




*Based on 12m trailing earnings. Large- and mid-cap country indices representing c90% of the index. Source: Bloomberg*

**Chart 16: Number of listed companies**




*Source: Autumn 2026 Berenberg investor barometer.*

[5] Pensions Policy Institute, "Pension scheme assets – how is asset allocation changing and why?", 2025).
[6] gov.uk, "Pension fund investment and the UK economy"

The initial trigger for this unfortunate chain of events was the 1991 Mirror newspaper pension scandal, in which proprietor Robert Maxwell embezzled £453m (£1.1bn in 2026 prices) from his staff's occupational pension schemes[7]. This led to a series of changes that made it difficult for DB pensions to invest in equities. The 1995 Pensions Bill mandated that pensions should hold sufficient assets to meet their liabilities at all times, in case they were wound up. Subsequently, the introduction of Financial Reporting Standard 17 rules from 2000 moved pensions onto company balance sheets. To avoid being judged on fluctuations in the value of their occupational pension fund rather than company trading, executives shut DB schemes to new entrants and shifted assets out of equities into bonds, to match the schemes' liabilities. Chart 17 shows that, as a result, the divestment of UK domestic capital from UK equities began in the mid-1990s.

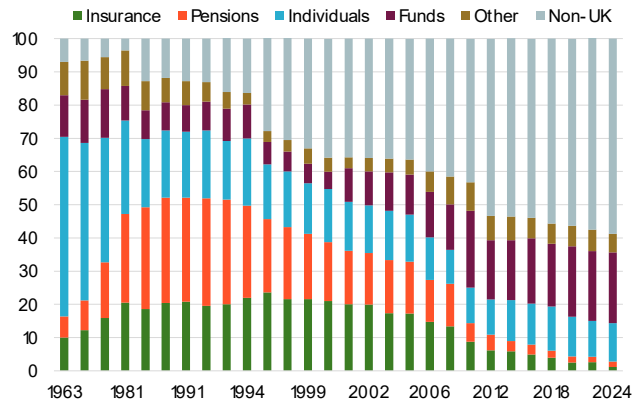
*A well-intentioned policy change had major unanticipated adverse consequences*

The shift to DC pensions and the recent increase in the household savings ratio create an opportunity to incentivise pension funds and households to invest a larger share of domestic savings in UK businesses – see Chart 18. A large proportion of DC pension capital is allocated to equities, but very little is directed to UK shares. Other countries that use tax breaks to incentivise domestic investment, such as Australia and New Zealand, enjoy much larger allocations to investments at home.

**Policy recommendations:**

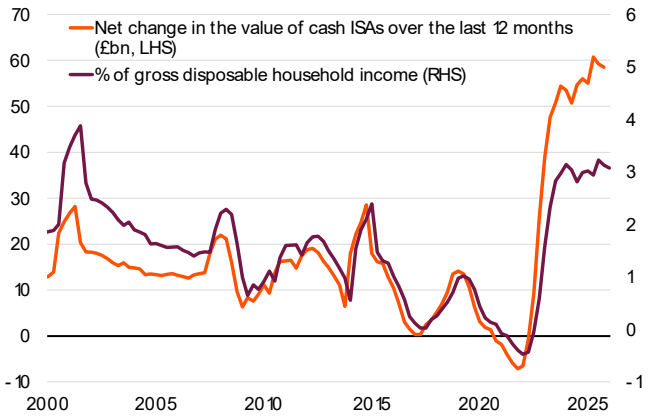
- Take advantage of the newfound space for the BoE to lower interest rates to tighten fiscal policy and put the public finances on a sustainable trajectory. The BoE can offset the negative demand impulse from the narrowing in the fiscal deficit by setting interest rates at a lower level to encourage private sector consumption and investment to fill the gap.
- Scrap stamp duty on purchases of UK shares for domestic investors. As it is not due on purchases of foreign shares, the current 0.5% charge creates an active deterrent to investing in UK shares for domestic investors.
- Exempt UK equities in DC pension pots from inheritance tax when they fall into the scope of the charge from April 2027.
- Limit existing ISA investment tax breaks for retail investors to UK assets.

**Chart 17: Ownership of UK shares (% of total)**




*Note that data points are infrequent before 1991. Source: ONS*

**Chart 18: Household saving is up, but mainly in cash**




*Sources: BoE, Haver, Berenberg calculations.*

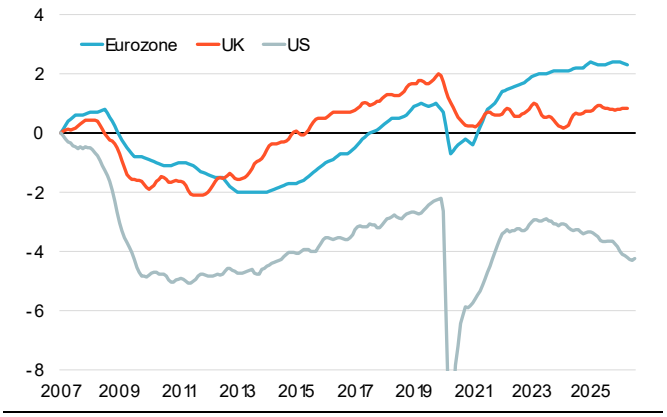
[7] House of Commons Library Research Paper, "The Pensions Bill (HL): Pension Fund Regulation", 1995

# Labour: from strength to fallibility

## Prior strength

Following the GFC, the UK's rapid employment recovery relative to the Eurozone and US highlighted its labour-market flexibility. Employment began to rise in 2011, before similar upward trends emerged elsewhere – see Chart 19. Memorably, BoE Governor Mark Carney was dubbed the "unreliable boyfriend" after his 2013 pledge not to raise Bank Rate from 0.5% until the unemployment rate fell below 7%. It promptly fell through that threshold within six months and hit 4.1% before the BoE next raised interest rates five years later. The counterpart to sluggish real wage growth in the 2010s was low enough labour costs for companies to respond early to the economic recovery by hiring. A series of policy decisions since has undermined both the competitiveness of UK labour costs and the ease with which companies can hire and fire staff.

**Chart 19: Change in the employment ratio since Q1 2007**




*In ppt, change in the 15/16/17+ employment-to-population ratio since Q1 2007. Data vary by country. Source: Haver.*

## First mistake – minimum wage

The minimum wage was first brought in in 1999, and for most of the policy's life it did no harm. However, the Conservative government's 2015 decision to increase it from just over half of median hourly earnings to 60% and then in 2019 to go even further, to two-thirds, has resulted in major distortions to the labour market. The current Labour administration recently delivered its predecessor's ambitions, and in doing so set the minimum wage well above international norms – see Chart 20. Moreover, whereas the minimum wage initially only applied to workers aged over 25, since 2020 its coverage has been gradually expanded to include all staff over 21.

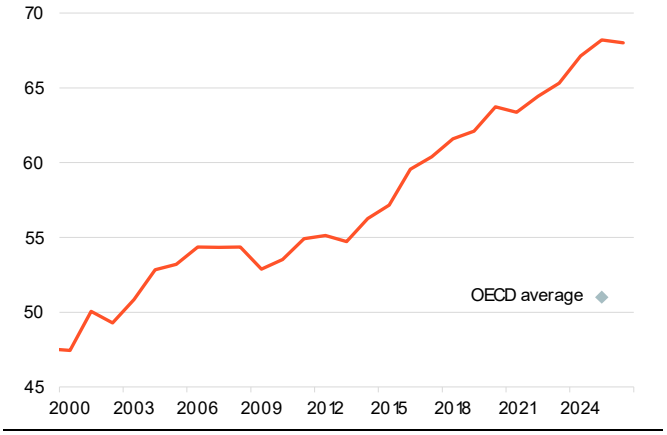
Since 2023, increases in the wage floor have clearly distorted the labour market. We do not get regular detailed hourly wage data, but the monthly wage data from the employee tax system show an unprecedented divergence between the pace of pay growth at the bottom and top of the pay distribution.

Chart 21 shows that pay growth at the 25th percentile of the pay distribution, equivalent to £19,000 per annum and 29 hours per week on the minimum wage, grew by about 8% yoy in 2023-2025 despite weakening demand for staff. Meanwhile, pay at the top of the pay distribution slumped in a more accurate reflection of labour market conditions.

The result has been a major compression of the lower half of the pay distribution from the bottom up. In lower pay sectors, the premium of the median hourly wage in the industry over the minimum wage has narrowed from 36% in 2015 to just 14% now. On top of the higher cost of the most inexperienced staff, this squeezes employees' incentives to progress. Why go for promotion when the increase in responsibility outweighs the pay rise?

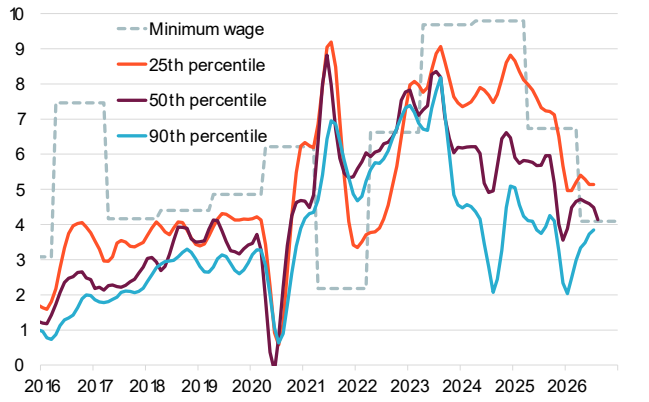
In summary, the UK's exceptionally aggressive minimum wage policy has both raised the cost of employing lower-paid staff significantly, and made it difficult to incentivise staff to progress.

**Chart 20: Relentless – minimum wage as a share of median pay**




*%, minimum wage/the National Living Wage as a share of median hourly earnings. Berenberg calculation for 2026 median earnings based on average weekly earnings growth since the last median pay data. Sources: House of Commons Library, ONS, Berenberg.*

**Chart 21: Minimum wage bites**



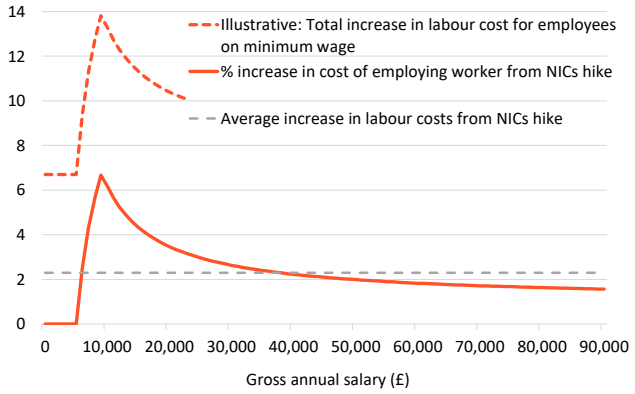

*% yoy, gross pay at selected percentiles of the pay distribution and the minimum wage.*

## The compounding error – payroll tax

The government exacerbated the increase in the cost of employment due to the minimum wage with a major payroll tax hike. In the first budget after Labour's 2024 election victory, Chancellor Rachel Reeves announced a hike in the rate of employer National Insurance Contributions (NICs) on employee gross pay from 13.8% to 15% and dropped the threshold from which it applies from £9,100 to £5,000. The reduction in the threshold made the change particularly taxing for firms employing lower paid staff – see Chart 22. Taken together, the minimum wage and NICs increases raised the cost of employing someone on the minimum wage for 15 hours a week by almost 14% on 1 April 2025.

On top of these increases in labour costs, the government also inserted more rigidity into the labour market with its Employment Rights Bill. By lowering the bar to strike action and reducing the qualifying period for unfair dismissal from 2 years to 6 months, the bill increased employers' risks too.

**Chart 22: Policy raised cost of low-wage employment most**

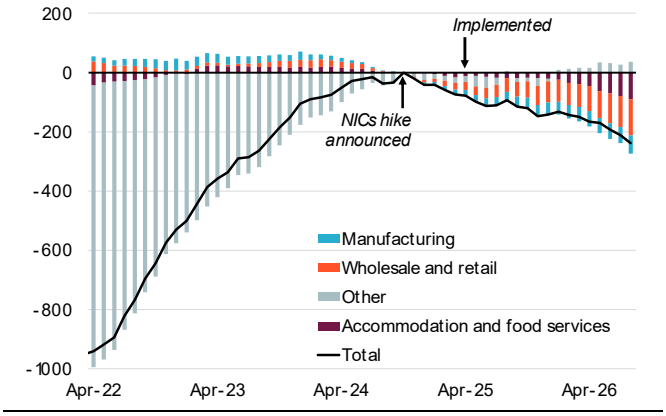



*% change in the cost of employing staff on 1 April 2025 due to policy changes. Sources: gov.uk, Berenberg*

## Predictable consequences

We set out the likely consequences for employment and inflation in our 3 December 2024 note "UK: Labour costs bite". The evidence suggests that the policies were a little more damaging than we anticipated. The steep rise in the cost of employment both raised UK services price inflation above that in other countries and put a handbrake on employment despite resilient economic growth. UK purchasing managers reported that they would reduce headcount from the moment the payroll tax hike was announced, and payroll employment has steadily declined since – see Chart 23. Unsurprisingly, job losses have been concentrated in the low-wage sectors which bore the largest increase in costs, and among younger people due to a reduction in the number of first job opportunities. The UK's youth unemployment rate has increased from 11% in 2019 to 16.4% and now eclipses that in the Eurozone. The UK has lost its labour market advantage.

**Chart 23: Change in payroll employment by sector**



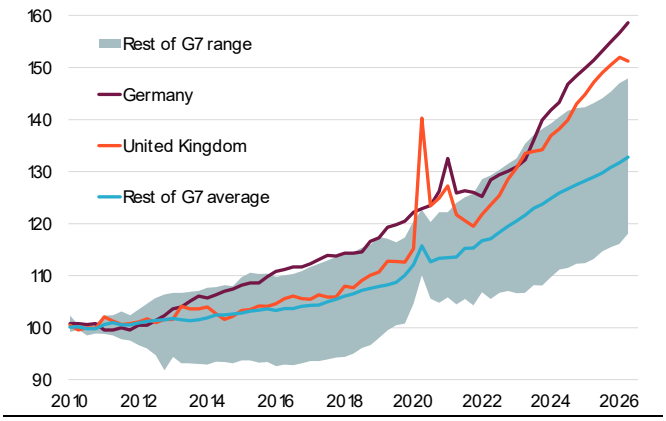

*000s of employees, difference from October 2024 level.*

## Big picture

The hike in labour costs raised the labour and tax shares of national income at the expense of a 2ppt drop in the profit share, which helps explain poor UK corporate earnings growth in 2024 and 2025. The good news is that the government has now achieved its goal of lifting the minimum wage to two-thirds of median hourly pay, so the policy should not ratchet up labour costs any further. The effect of the NICs hike is also dissipating, reflected by a slowdown in services price inflation.

Nonetheless, cumulatively the last decade of labour market policy has made the UK a far less attractive place for global businesses to locate employment. Unit labour costs adjust wages for employees' productivity, to give the cost of staff per unit of output. On this measure, UK labour costs have increased by more than in any other G7 country except Germany since 2010 – see Chart 24. The government should pare back the minimum wage to 60% of median hourly earnings and, when fiscal circumstances allow, reverse the hike in payroll taxes to end this trend.

**Chart 24: UK unit labour costs have surged**




*Indexed to 100 in 2010, nominal unit labour costs. Rest of G7 = Canada, France, Italy, Japan, US.*

# Power: tunnel vision

The 2008 Climate Change Act created a legal obligation for the UK to reduce greenhouse gas emissions by 80% by 2050. Over time governments have made the targets more ambitious, committing to net zero by 2050 and fully decarbonising the electricity grid by 2030. Unfortunately, the goal of fully decarbonising electricity generation on such a short timeline and the policies the government has pursued to achieve it have incurred huge, fixed system costs that billpayers have picked up the tab for. As a result, electricity prices for non-domestic use are higher in the UK than anywhere else in the world – see Chart 25.

Government subsidies for renewable power generation have locked in expensive electricity prices for years to come. Because renewable power generation is intermittent, the government has entered into agreements to pay for far more capacity than it needs when the sun is shining and the wind is blowing, in the hope that it can meet electricity demand when much of the system is not generating power. Today the UK has 125GW of generation capacity to meet 58GW of peak demand. From 2002 to 2017 the "Renewables Obligation" scheme provided 20-year subsidies for renewable power generation averaging £104/MWh, which cost £7.8bn last year. Since 2014, Contracts for Difference (CfDs) have become the primary method of securing renewable generation. The energy producer is guaranteed the CfD strike price. When the wholesale electricity price is lower, the government tops it up, and when the wholesale price is higher, the energy producer pays the government the difference. These contracts had a net cost of £2.3bn in 2024-25.

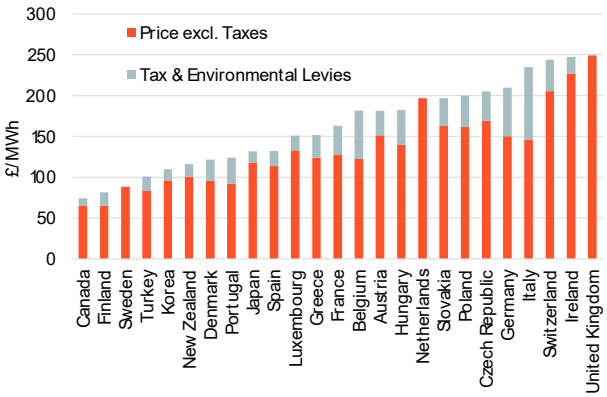
Intermittent renewable generation also makes the electricity system more expensive to administer. To ensure sufficient power, the administrator makes "capacity market" payments to gas and nuclear operators to keep back-up capacity online. The grid must be upgraded to transport power from where it is produced to where it is needed. Furthermore, sometimes the administrator must pay generators to turn their plants off when a glut of supply risks overwhelming the grid. The result is a growing wedge between the wholesale price of electricity and the price industrial firms face – see Chart 26. The sharp rise in energy prices since 2019 has caused many energy-intensive industries to close – see Chart 27.

To reverse this trend, we make three **policy proposals.** First, to prevent the loss of energy-intensive industry, such users should be charged the marginal price of electricity, plus a small contribution to the fixed cost of the system.

Second, future energy auctions should be conducted on an "equivalent firm power" basis, where the government judges bids based on their contribution to reliable supply. This would force intermittent generators to consider how to make their output more consistent and avoid huge increases in system costs.

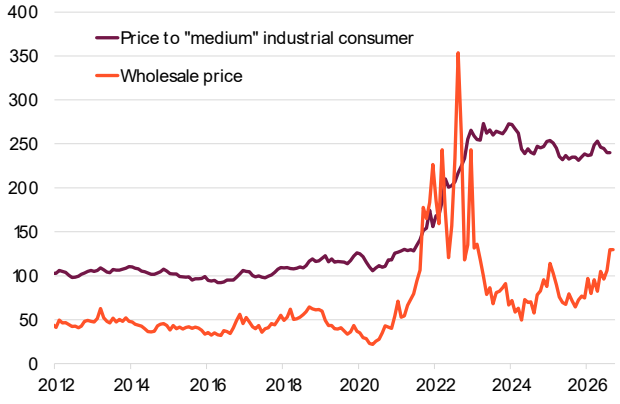
Third, the government should permit more extraction of natural gas from the North Sea. The spot gas price is set by the global market, but gas-fired power stations could stabilise and limit energy costs through long-term fixed price contracts with drillers.

**Chart 25: Industrial electricity prices**



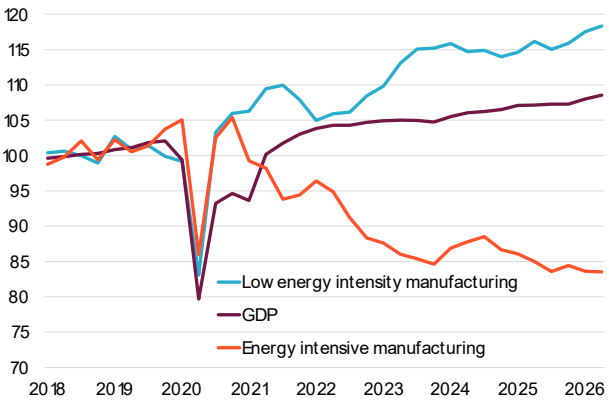

*In ppt, change in the 15/16/17+ employment to population ratio since Q1 2007. Source: Haver.*

**Chart 26: Wholesale and industrial electricity prices**




*In £/MWh. Sources: Bloomberg, DESNZ, ONS, Berenberg calculations.*

**Chart 27: Energy-intensive manufacturing in decline**




*Indexed to 100 in 2018, real GDP and manufacturing output. High energy intensity = manufacture of refined petroleum products, chemicals, metals, rubber, plastics and wood and paper products. Low = everything else. Sources: ONS, Berenberg calculations.*

## Conclusions

*Policymakers have neglected growth*

In this report, we have sought to understand why the primary factors of production and energy are costly in the UK. In each case, we trace the problem back to a policy decision that prioritised other aims over growth. Successive governments have at best subordinated economic growth to other policy aims and often failed to consider long-term economic effects altogether.

This started with the Town and Country Planning Act in 1947, which set land prices on an upward trajectory. In recent decades, the frequency of wrong turns increased. The 1995 Pensions Bill, the 2008 Climate Change Act, and the increase in the minimum wage since 2015 each contributed to an across-the-board increase in the cost of doing business in Britain. In 2025, the current Labour administration compounded the problem with a major payroll tax hike.

*While parts of the UK economy have thrived regardless...*

Despite these headwinds, parts of the UK economy continue to thrive. London and the surrounding South East region host innovative high-productivity businesses which have agglomerated there due to world-leading academic research, human capital, institutional quality (rule of law), and the timeless benefits of the time zone and English language. These same services sectors are well placed to realise further productivity gains by adopting AI. At the margin, the cost of financing, building and running data centres will limit how much of the AI windfall the UK can capture.

*...broad-based growth requires the government to address business costs.*

In the rest of the country, where very high-productivity activity is less prevalent, high input costs are a more severe impediment. Admittedly, land prices are less of a restraint outside South East England. But wherever they are based, businesses are held back by the high costs of capital, labour, and energy.

A key benefit of many of the solutions to these competitiveness issues is that none of them require public expenditure to rectify. They will not butt up against borrowing constraints. In fact, at this juncture, we think that fiscal consolidation is a pro-growth policy due to the lower financing costs and the increase in private-sector investment that would likely result. Instead, lowering the cost of the factors of production requires taking on vested interests and arguing for what works, rather than focusing on short-term treatment of the symptoms.

*We don't expect the Burnham administration to make things worse...*

In the knowledge of the policy mistakes outlined in this note, Andy Burnham's new cabinet must take the Hippocratic oath: first do no harm. The early evidence is encouraging. The government has watered down its spending ambitions to avoid another distortive tax hike and achieve fiscal consolidation. The minimum wage has finally reached the government's lofty ambition, which should rule out more above-inflation increases.

*...but do not detect positive action.*

Narrowing the GDP per capita gap that has opened up to the US requires going further. Attempts to ease voter discontent through control of consumer prices that impose costs elsewhere will not work. Instead, reform of the planning system, incentives to invest at home, a reversal of the most recent increases in the minimum wage, and a change in energy policy are the growth levers that the government should select. These changes would make it much easier for businesses to succeed. In turn, that might help shift the focus of politicians and the electorate alike from the distribution of income and wealth to the aspiration to create more of it.

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# Economics




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