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UK General Elections: A one horse race to Number 10

Macroeconomic Research

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Key points

- Since UK PM Rishi Sunak announced there would be a snap general election on 4 July, little has changed in the polls. Labour looks set to win with a comfortable majority – with some even suggesting a landslide victory
- The Labour party is focused on supply-side reforms – including shaking up the planning system and investing in the green transition – while the Conservatives have pledged to cut taxes and reform the welfare system
- Both major parties have committed broadly to the same fiscal rules and have ruled out raising the three main taxes: National Insurance, Income tax and VAT. They will retain the freeze on income tax thresholds for at least the next three years and implicitly will be frugal on spending
- The stark reality of the public finances, however, will likely require the next government to implement additional fiscal tightening but we believe there may be some economic benefit to such an approach

UK Prime Minister Rishi Sunak surprised even the keenest political watchers by announcing that the next UK general election would be on 4 July, earlier than the expected October/November date. A key question was why the earlier election? One answer was probably that things were unlikely to get much better for the Conservatives.

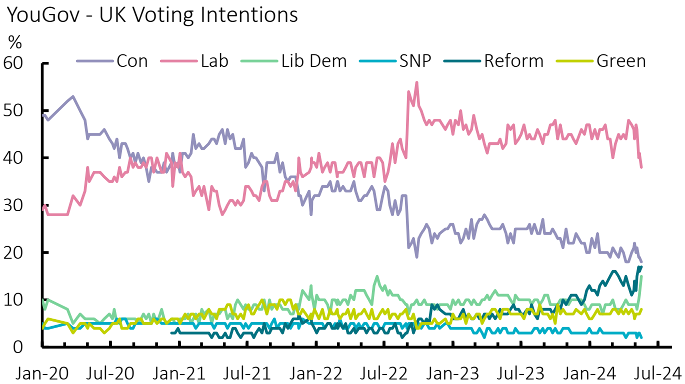
On the economic front, Sunak was likely buoyed by the chunky 0.6% quarterly rise in GDP in the first quarter (Q1) and the drop in inflation back to within the 0.5% range either side of the 2% target in April (now at target). Two of his five main pledges were to halve inflation and boost growth. Moreover, the timing was likely aimed at catching the opposition off guard, although interestingly this might have been less targeted towards Labour – who have been prepared for an election all year – but more so at Reform UK.

The gamble doesn't appear to have paid off. Polls suggest Labour is still on track to win a significant majority, while Reform UK is closing in on the incumbent party. In this paper we examine the current polling and consider what this will mean for government formation; we run through the key main policy differences; and discuss the stark reality of the public finances facing whoever wins on 4 July. We then consider some broad market implications.

Labour way out ahead in the polls

The polls have been consistent since the election was called on 22 May; Labour looks set to win with a comfortable-to-large majority. Different polls tell slightly different stories with Labour's lead ranging between 15-25 points (Exhibit 1). But polls can be wrong, as we have recently witnessed in India - President Narendra Modi did far worse than anticipated from the exit polls[1] – and in Mexico too – where incoming President Claudia Sheinbaum won a far larger majority[2].

Exhibit 1: Labour has maintained a healthy lead



Source: YouGov and AXA Investment Managers, June 2024

The margin of error in the 2019 UK election polls, however, was small; the Conservatives ended up just 1.4 points below the level implied by polls, while Labour was just 0.5 points above. Remember too that in the UK there are many different polling companies all with different methodologies and samples; it is statistically unlikely that every poll is getting it so wrong.

The stable headline message masks some interesting developments among the other parties. First, the Liberal Democrats party was the only one to really see any movement from its manifesto launch, rising around one-to-two-points on average over the following days. Second, Reform UK has made significant gains following the announcement that Nigel Farage would be taking the helm as leader and running as a candidate in Clacton, Essex. The party had been polling pretty consistently – around 11 points – prior to the news but jumped by around four to five points on average in the following week. In a further blow to the Conservatives, Reform has edged ahead into second position in one or two polls over the past week or so, following PM Sunak's decision to leave the 80th D-Day celebrations early and the lacklustre reaction to the Conservative Party manifesto launch.

Greater uncertainty appears to lie in how the polls translate into seats. This is where it gets tricky given the UK's first-past-the-post (FPTP) electoral system. Indeed, a party may have a significant lead in the polls heading into election day but could perform differently on seat wins depending on whether support is concentrated in a few constituencies or more distributed across the country.

Typically, the Conservatives benefit from the FPTP system: the current government gained a large majority of 80 seats (365 out of 650 in total) with just 43.6% of the vote. That said, most models suggest the Conservatives are on track to lose a substantial number of seats this time round. Exhibit 2 below shows a range of predicted outcomes. Poll aggregator Britain Elects puts the total number of seats lost at 258 – that would be more than in 1906, when Arthur Balfour's government lost 246. Labour, meanwhile, looks set to win 435 on the same measure, more than Tony Blair's election in 1997, at 419. This would be one of the largest swings in modern politics. Several factors have served to boost the outlook for the Labour Party, including an expected realignment in Scotland after a long period of Scottish National Party (SNP) dominance. But barring a major shock, with less than two weeks to go, the expectation is for the Labour Party to win a commanding majority with a comfortable-to-large win.

Exhibit 2: The strong polling looks set to translate into seats

UK General Election Seat Predictions							
	Labour	Tory	LibDem	Reform	Green	SNP	Other
Electoral Calculus	475	75	61	0	2	16	23
YouGov	422	140	48	0	2	17	21
The Economist	390	185	22	0	-	24	4
moreincommon	382	180	30	0	1	35	22
Pollingreport	392	190	30	0	1	18	19
BritainElects	435	114	58	-	-	-	-

Source: EC, YouGov, Economist, Moreincommon, Pollingreport, BritainElects and AXA IM Research, as of 12 June 2024

A Labour government: Five key missions

Labour has long outlined five key missions including kickstarting economic growth; making Britain a clean energy superpower; getting the National Health Service (NHS) back on its feet; cracking down on anti-social behaviour and breaking down barriers to opportunity. Specific policies include a commitment to build 1.5 million new homes over the next parliament and setting aside £23.7bn for green initiatives over the same timeframe – more than the additional spend on health or education, including setting up Great British Energy, a new publicly-owned clean energy company. The party also pledged to create 40,000 more NHS appointments each year, work towards a National Care Service with a focus on home-first care, widen access to free school meals and increase the number of teachers (Exhibit 3).

[1] Richards, D., "India's economy: A compelling growth and investment story but challenges remain", AXA IM Research, 11 June 2024

[2] Lopez Vivas, L., "Mexico's General Elections: Continuity likely but headwinds ahead", AXA IM Macro Research, 21 May 2024

Exhibit 3: Labour focus on supply-side reforms, Tories aim to cut taxes

	Key Policies	Key Outline	Cost	Funding
Labour	Get Britian building again	Strengthen public finances, restore economic stability & keep mortgages, taxes and inflation low as possible		Tough spending rules
Labour	Great British Energy	Cut energy bills and boost energy security	£23.7bn per year (£4.7bn per year)	3% increase in windfall taxes on profits of oil and gas companies
Labour	Get the NHS back on its feet	Reduce NHS wait times and backlog	£1.3bn (some estimate £1.6bn inc. dentist)	Tackling tax avoidence and non-dom loopholes
Labour	Take back our streets	Reduce violence, rebuild security & confidence in policing and the criminal justice system	£360m a year	Cutting outside contractors and waste
Labour	Break down barriers to oppurtunities	Free school breakfast clubs and recruit 6,500 new teachers for high quality teaching	£1bn per year	Ending tax breaks on private schools
Conservatives	Strong economy	Abolish NI for self-employed, reduce NI for employees by further 2p & increase personal tax-free allowance for pensioners	£8bn a year for NI cuts	£6bn per year crackdown on tax avoidence & cut welfare bill by £12bn a year
Conservatives	Young people's future	National service to provide new skills and oppurtunities & fund 100,000 new apprenticeships	-	-
Conservatives	Borders and national security	Legal cap on migration, regular monthly flights to Rwanda & boost defence spending to 2.5% of GDP by 2030	Flights to Rwanda: £541m over 5 years	-
Conservatives	Our communities	Build 1.6m homes in 5 years, returning the help to buy scheme, make stamp duty threshold £425,000, ban no fault evictions, build new prisions providing 20,000 new places, 8,000 more full time police officers, 120,000 more doctors and nurses and £86,000 cap on social care	-	Social care: 1p increase in National Insurance to raise £12bn but this has been scrapped now

Sources: Conservative Manifesto, Labour Manifesto, The IFS and AXA IM Research, June 2024

These policies are wide-ranging, but the thrust of Labour's plan, from a macro perspective, can broadly be characterised as supply-side reforms, with the aim of encouraging investment and growth and therefore living standards, as opposed to fiscal loosening. As well as the policies aimed at stimulating private investment – such as boosting housebuilding and investing in the green transition – the party want to improve stability by committing to Bank of England (BoE) independence, firming up the Office for Budget Responsibility's (OBR) mandate, capping the corporation tax at 25% and outlining a roadmap for business tax. Labour market reforms, including improving employee rights and getting people back to work through a stronger NHS should also help at the margin, boosting labour participation.

A key question is whether these policies will make a difference to the growth outlook. We argue that they should, although the boost is likely to be small. It is true this manifesto was not for those looking for big numbers. But there is a lot to be said for a centrist government with a large majority committing to economic institutions. This looks set to deliver political and economic stability that has been lacking in the UK for the last decade. That said, more recent revisions to business investment is broadly in line with pre-Brexit norms, so a sharp increase sufficient to boost productivity in the longer term will be a challenge.

Some policies will also take longer to implement, and the impact felt further down the line from others. Nevertheless, firm commitments would likely go a long way after years of uncertainty.

The other big question is how Labour intends to fund the additional spending associated with some of these measures. Labour have stated that it will scrap the charitable status of private schools, which will mean they are no longer exempt from VAT, to fund its commitment to extra teachers; the Institute for Fiscal Studies (IFS), an economic research institute, estimates that this will bring in an additional £1.3bn to £1.5bn per annum. The party also wants to expand the Energy Profits Levy, a windfall tax on energy companies, estimated to raise £8bn-10bn, and raise revenue from cracking down on tax avoidance, which they expect to bring in around £5bn. Labour has stated that its package is fully costed and has pledged its commitment to the current fiscal rule on debt and ruled out any increase in the three main taxes: National Insurance, Income tax and VAT, though the party has said it will keep income tax thresholds frozen for at least the next three years. Subsequently, Shadow Chancellor Rachel Reeves also ruled out changes to Capital Gains Tax, Inheritance tax and wealth taxes.

The IFS, however, has raised some concerns on the amount these tax policies are likely to generate, particularly with regards to tax avoidance. Note some form of this policy has been in pretty much every party's manifesto since the 2015 elections, and is also a mainstay of the Conservative manifesto.

The Conservatives: Tax cuts on the agenda

The Conservative party continues to focus on reducing tax, which includes a proposal to decrease National Insurance contributions by a further 2pt and a commitment to scrap the tax for the self-employed altogether by the end of the next parliament. The party also pledged to introduce a two-year tax break allowing landlords to sell properties to existing tenants and increase the personal tax-free allowance for pensions alongside inflation. In total, £17bn worth of tax giveaways are expected by the end of the parliament. The manifesto also pledged to bring back the Help-to-Buy home ownership scheme, raise the Stamp Duty threshold to £425,000 for first-time buyers in England and Northern Ireland, fund 100,000 extra apprenticeships a year by closing some degree programmes and increase defence spending to 2.5% of GDP.

To fund both the tax cuts and the big hike in defence spending, the party intends to crack down on the welfare system, reduce civil service numbers and clamp down on tax avoidance. Crucially, the Conservatives expect to raise £12bn from welfare reforms, which include making it more difficult to claim disability benefits, particularly for issues around mental health which have soared since the pandemic.

IFS Director Paul Johnson stated that some of the policies have already been announced by the Tories and are therefore included in the OBR's analysis of the March Budget. He also suggested that "others are unlikely to deliver sizeable savings on the timescale that the Conservatives claim"[3]. He added that the current policies will not achieve this reduction in welfare spending. Note too that the number of people claiming out-of-work benefits has jumped over the past few years due to the rise in long-term sickness following the pandemic; the stubbornness of NHS waiting lists means this is unlikely to reduce anytime soon.

In addition, several institutions have pushed back against the prospect of tax cuts in the UK, given the high levels of public debt and growing demand on public services. Previously, the International Monetary Fund (IMF)'s Chief Economist, Pierre-Olivier Gourinchas, advised against further discretionary tax cuts, highlighting growing demands for health, social care, education and environmental investment. He said it's very important "to have in place medium-term fiscal plans that accommodate these pressures, at the same time as ensuring that debt dynamics remain stable and contained"[4]. It is an irony that Sunak, who came to power in the wake of the economic havoc wrought by his predecessor in an ideological pursuit of tax cuts that were unfunded, is ultimately pursuing policies that trusted institution adjudges ill-advised and not fully funded.

Whatever happened to Brexit?

Given the last election was fought around the crucible of delivering Brexit, five years later the issue of Europe is most notable by its absence. The Liberal Democrats are currently the only major party making any firm commitments, promising to rejoin the European Single Market over the parliament with the ultimate goal of rejoining the European Union (EU). This is in stark contrast to the two largest parties, both of which have explicitly ruled out rejoining the Single Market, the Customs Union, and the EU itself. The Conservatives, the architects of Brexit, have made no bid to campaign on its delivery. The Labour Party appeared equally happy to avoid the topic in its manifesto. Admittedly, Labour has subsequently discussed renegotiating aspects of the Brexit agreement with a view to better regulatory alignment in the veterinary, chemical and financial sectors.

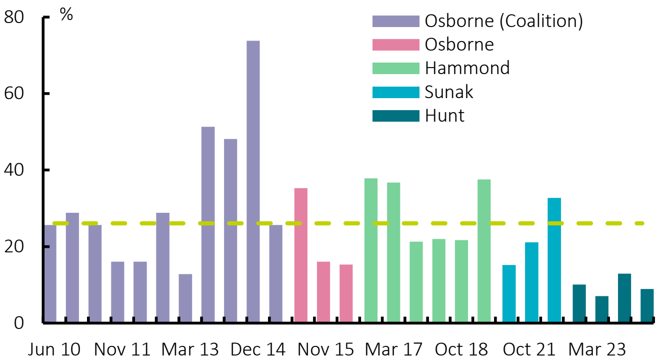
Yet even Labour's more recent intention to try and smooth edges of the UK's hard Brexit is likely to have only a marginal impact. Five years on from the last election, having "delivered" Brexit, UK export volumes were 20% below their 2018 average in March 2024, compared to 6% above on average in all other developed economies, according to the CPB Netherlands Bureau[5].

Beyond manifestos, the stark reality

No matter the election's outcome, the reality is that the new government will be materially constrained by tight public finances. Indeed, the high level of debt, sluggish growth and high interest rates mean difficult choices will need to be made.

Exhibit 4: The headroom against the fiscal rules is tiny

Forecasts for headroom against fiscal targets



Source: The OBR and AXA Investment Managers, June 2024

[3] "The Conservative manifesto: an initial response", Institute for Fiscal Studies, 11 June 2024

[4] Milliken, D. and Schomberg, W., "IMF tells UK not to cut taxes in run-up to election", Reuters Macro Matters, 30 January 2024

[5] CPB Netherlands World Trade Monitor, 24 May 2024

Shadow Chancellor Reeves intends to broadly match the fiscal rules of the current Chancellor Jeremy Hunt, the main difference being Labour plans to balance the current budget – which excludes public investment – so day-to-day costs are met by revenues, freeing funds for investment. By contrast, the Conservatives have, and will continue, to target the total budget deficit so it doesn't exceed 3% of GDP in five years' time. These rules are equivalent if Labour chooses to invest 3% of GDP.

Both intend to fulfil the commitment to a falling debt ratio in five years' time. The incoming government therefore would likely at best face the same wafer thin £8.9bn headroom, as outlined by the OBR in the forecasts produced alongside the Spring Budget in March (Exhibit 4). And on current forecasts this headroom may already have disappeared.

We also doubt the next government will be able to stick to proposed spending plans. To get debt falling as a share of GDP in five years' time, the current government has assumed nominal public spending rises by just 2.3% per year from 2024/2025 to 2028/2029, which the IFS estimates would translate into real-term cuts of 3.3% per year in unprotected departmental spending – departments which do not have their budgets ringfenced such as the criminal justice system and local government.

Current plans also do not factor in the Spending Review – a process which outlines detailed departmental spending plans every three years – which likely takes place over the summer. Historically, when faced with setting new departmental budgets, governments have needed to increase the real resource departmental expenditure limits envelope by around 1.1 percentage points to keep departmental spending unchanged, effectively subsidising underlying budget overshoots. The IFS estimates this would imply an additional £20bn of spending in 2028/2029 this time round. The government clearly has a mountain to climb.

The incoming government would, admittedly, see around £5bn-£10bn of additional fiscal space generated by lengthening the forecast horizon in the Autumn Budget by an additional year. Otherwise, it would rely on the vagaries of stronger growth forecasts to provide some additional headroom - rare in recent years.

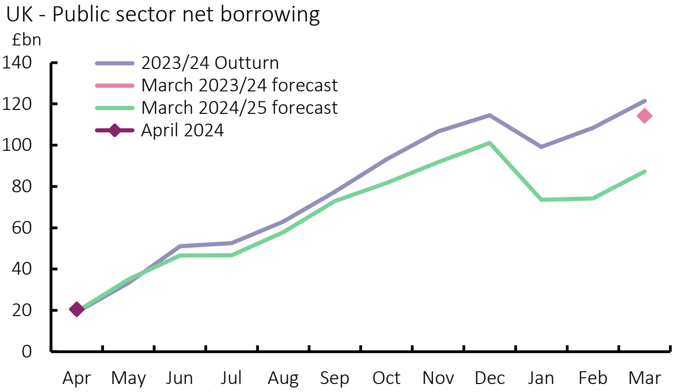
However, the fiscal mandate of getting debt to fall as a share of GDP in five years' time is not binding in any way and does not constrain what the Chancellor can borrow in the intervening years. Indeed, the Chancellor could continue to pencil in vague cuts to departmental spending towards the back end of the five-year window, without ever having to implement them. Chancellor Hunt has helped fund the two last tax cuts with such fiscal arithmetic. This is in part why this is the weakest form of fiscal rule the UK has followed in the 27 years since New Labour introduced fiscal rules in 1997.

This also risks being superseded by financial markets. Gilt markets are likely to continue to show a low tolerance for broadly unfunded measures following former Prime Minister Liz Truss's devastating period in office. More broadly, bond investors appear nervy with regards to high levels of debt across most developed economies in the post-pandemic era. Bond vigilantism means markets are unlikely to extend much leeway to a Chancellor who is not completely clear on how policies will be funded.

More tightening likely, with a bonus

Given the fiscal backdrop it seems inevitable that deficits will overshoot current forecasts. Note government expenditure was already above the OBR's April estimates, leaving borrowing £1.4bn higher than anticipated at the start of the financial year (Exhibit 5). Any new government is likely to have to tighten fiscal policy to maintain consistency with the current fiscal rules, although given the polls it is likely to be Labour that must deliver this.

Exhibit 5: Public borrowing is overshooting forecasts



Source: The OBR, ONS and AXA Investment Managers, June 2024

Given the likely requirement of further fiscal tightening, there is political advantage to delivering it at the start of a new parliament: this can be blamed on the previous government. It also allows time for the pinch to pass and be reversed, fading from electoral memories as the next election cycle approaches. This pattern was followed by Labour Chancellor Gordon Brown in his 1997 Budget as he committed to follow tight budgets for the first two years of the parliament (setting a borrowing requirement of £13.25bn for 1997-1998 and £5.5bn for 1998-1999), while announcing that the government would only borrow to invest, and that public debt would be held at a stable level over the economic cycle. It was echoed by David Cameron's coalition government in 2010, where Chancellor George Osborne delivered fiscal tightening in the hopes of reversal later. This was less successful, and the Lib Dems found that electoral memories did not fade over the period, particularly with regards to student debt.

Labour's current goal to "deliver economic stability with tough spending rules, so we can grow our economy and keep taxes, inflation and mortgages as low as possible,"[6] suggests it may go further. The party may even decide to tighten the fiscal mandate.

Yet unlike the ill-advised austerity of the 2010s, fiscal tightening need not have the detrimental impact it did back then. The key difference now is that unlike in the early 2010s, interest rates are not at their lows but at 5.25% – a 14-year high for the BoE. Fiscal tightening now would likely prompt monetary loosening (over and above what we expect today) as the BoE is forced to offset some of the fiscal headwinds for fear of undershooting its inflation target (already expected somewhat in coming years).

Moreover, because of the UK's unusual institutional framework, BoE rate changes pass through to changes in the government's debt interest bill quicker than was historically the case and quicker than most overseas markets[7]. A government committing to additional fiscal tightening now faces the prospect of cutting top line spending directly, supplementing this with reduced interest costs and not facing a negative reaction in economic growth. This could quickly improve the public finances outlook and create the space for longer-term investment intentions later in the parliament. We consider this could provide incentives for the next government to tighten fiscal policy with a combination of additional temporary tax increases and spending restraints.

Potential surprises

With the Conservatives promising further tax cuts and Labour responding by ruling out change after change, it is not obvious where scope for adjustment comes. However, we consider the following as plausible areas for surprise.

- **Changes to Capital Gains Tax (CGT):** The Liberal Democrats outlined a new policy in its manifesto to bring CGT in line with income tax, taxing gains – currently CGT is calculated on the nature of the gains and tax bands – and bring thresholds in line with income tax. The Lib Dems estimate that this would raise £5bn. Labour has so far stated it does not intend to make any additional changes to tax over that outlined in their manifesto.

- **Nationalisation:** Labour has already pledged to renationalise passenger rail services within the next parliament, with a new public body inheriting existing contracts when they expire. In previous manifestos the party had stated they would nationalise utilities companies, water companies and the Royal Mail. Efficiency gains, as well as the fact that the private sector allocates capital based on the companies' needs and pays based on the success of the company, rather than dictated by the size of the public deficit are all arguments against nationalisation. But Greenwich University recently published research stating that privatised water companies paid out over £80bn in dividends since privatisation, while recent developments reveal chronic investment over the same period. [8]

- **Changes to inheritance tax:** Arguments have been made on both sides. On one, some are in favour of closing certain loopholes, i.e. bringing pension pots within the scope of the tax and abolishing agricultural and business reliefs. On the other hand, some argue in favour of increasing the threshold at which the tax is paid. The tax currently brings in £7bn a year, though according to the IFS this look set to rise to around £15bn in 10 years' time. It also estimates that closing the loopholes would generate an additional £1.5bn a year.

Market impact

If Labour wins the upcoming election with a comfortable-to-large majority we would only expect a marginal market reaction, given the steadiness in the polls and broad expectations for such an outcome. A smaller win for Labour might cause a more adverse reaction – with rates inching higher and sterling softening – on the basis that a smaller majority would leave the government more vulnerable to the more progressive wing of the Labour party, that might make it more difficult to deliver the expected spending restraint. This would likely be even more so if Labour were forced into a coalition or some other working arrangement with either the Lib Dems or SNP. We do not consider other outcomes as these appear particularly unlikely.

In our central case, the market reaction is more likely to be focused on subsequent policy announcements. We expect an early announcement of a Budget (for late September/early October to allow the OBR the necessary 10 weeks to fulfil a full forecast round). This Budget is likely to be a more material market event unless the broad trajectory is revealed earlier. On balance, we expect sterling to appreciate modestly and yields to fall.

The outlook for bond yields will be dominated by the balance of fiscal tightening. We envisage more incentive for additional fiscal tightening than currently considered, something that if delivered should soften yields both in expectation of lower short-term interest rates and with improved confidence in the outlook for the public finances.

[6] Labour's first steps for change, 16 May 2024

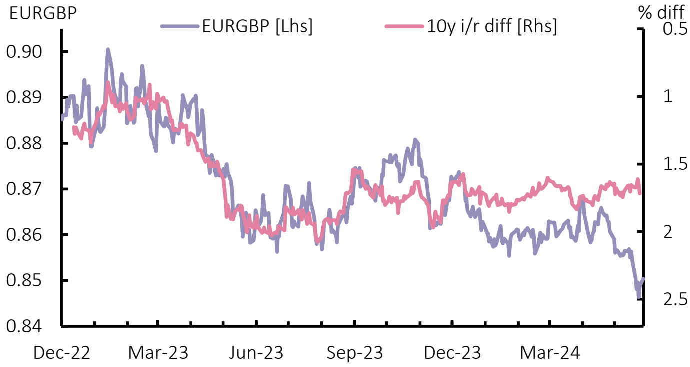
[7] Because the Treasury indemnifies the BoE's Asset Purchase Facility it makes good any running shortfalls with the Bank. This has the effect of significantly reducing the effective duration of its debt portfolio meaning changes in short-term interest rates quickly impact debt interest costs.

[8] Jordan, D., "Water investors have withdrawn billions", BBC News, 20 May 2024

On the face of it, this yield outlook suggests downside risks for sterling. Indeed, we have an additional 50 basis points of cuts pencilled in for the UK by the end of 2025, compared to in the Eurozone and 25bp compared to market consensus, something that, all else being equal, could be consistent with sterling weakening to around £0.865 to the euro. However, we observe that sterling has outperformed rate differentials (Exhibit 6) for most of the last year, something we attribute to other factors including greater inward investment demand in the expectation of greater political stability. This trend could continue. Indeed, following the 1997 election, sterling held on to sharp appreciation (trading between £0.68 and £0.70 to the euro), despite interest rate fundamentals pointing to a sharp depreciation (around £0.85).

Exhibit 6: Sterling outperforming fundamentals

EURGBP and 10-year gilt-bund differential



Source: Bloomberg and AXA Investment Managers, June 2024

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