United Kingdom: Voters face stark choice at upcoming election

HENRY COOK
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1591
E: henry.cook@uk.mufg.jp

MUFG Bank, Ltd.
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The two main parties are taking very different approaches

There are nine days until the UK's general election on 12 December. The two main parties, Labour and the Conservatives, have now unveiled their manifestos. These contain very different visions for the UK's future.

The Conservatives emphasise the need to "get Brexit done" by ratifying Boris Johnson's withdrawal agreement but, beyond leaving the EU, the Conservatives have a very cautious programme. After nine years in government, and with a strong lead in the polls, their manifesto seeks a broad continuation of the status quo, and any bold new policies which might unravel under scrutiny have been avoided. That said, there would be higher government expenditure (an increase of around GBP 3bn, on top of the various measures on healthcare and education which are already in the pipeline).

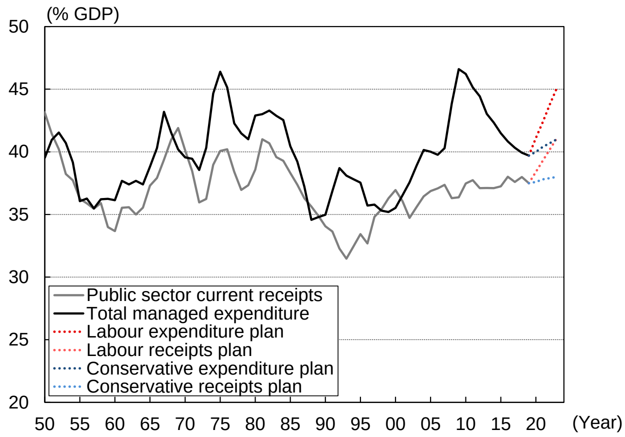
Labour, by contrast, has put forward a radical series of proposals which would entail a restructuring of the UK's economic model towards a larger state. In a clear divergence to the Conservatives' approach, public spending would increase by more than GBP 80bn by the end of the parliament, with an additional one-off payment for women affected by pension changes on top. The tax burden would increase significantly. There would be a flurry of nationalisations: "rail, mail, water and energy" would be brought into public ownership. A national investment bank would be created, free broadband would be provided to every home in the country, and there would be healthy pay rises for public sector workers. There is also the aim to move the country to a four-day working week after 10 years of Labour government (the ambition is that productivity gains would allow pay to remain the same).

Taking a broad view, this means that there are two broad questions now facing the UK public ahead of the election: 1) How large should the UK state be? And 2) is Johnson's Brexit deal acceptable?

A Labour government would mean a rapid expansion of the state

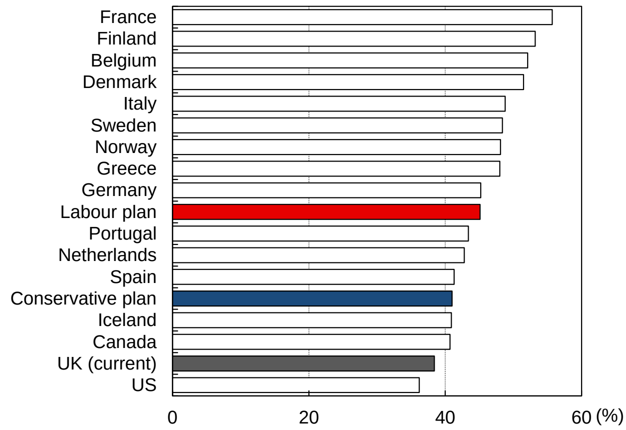
After years of tight fiscal policy and against a background of ever lower borrowing costs, there is a sense that both parties are ready to loosen the purse strings. However, the Conservatives' manifesto actually contains only modest spending pledges. Government expenditure to GDP would increase, but only by around 1pp over the course of the next parliament. The tax take, relative to GDP, would remain steady (helped by the shelving of a planned cut to the corporation tax rate). There is a commitment to have lower government debt to GDP by the end of the next five-year parliament term.

1. Public Expenditure vs Receipts (and proposals)



Source: Resolution Foundation, OBR, MUFG Bank Economic Research Office

2. Government Spending to GDP



Source: Resolution Foundation, IMF, MUFG Bank Economic Research Office

Meanwhile, a Labour government would see public spending increase by around 5pp over the course of the next parliament, to 45% of GDP. This would be very close to the post-war high figure, but, unlike in previous occasions, would occur during a period of (muted) economic expansion. It would be a significant pro-cyclical boost. Higher spending would be accompanied by higher taxation (with the burden shifted to high earning individuals, corporations and asset holders). These plans do not look especially radical when compared to peers: total government spending to GDP under Labour would be slightly less than it is currently in Germany. But, as we discuss below, the timetable to make this sort of fundamental change to the UK's economy looks incredibly tight – not least with Brexit likely to dominate parliamentary procedures in the first part of the next government's term.

There is an argument for higher government spending…

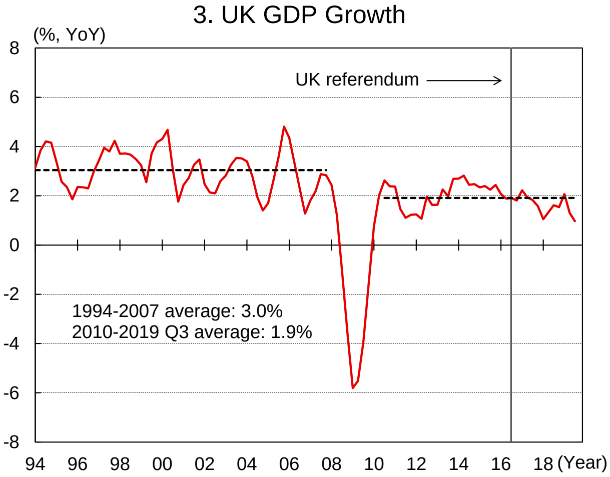
With low borrowing costs, there is some merit to the idea that some higher government spending could help to move the UK economy past the post-GFC doldrums, especially given the additional effect of Brexit uncertainty. GDP per hour worked increased by just 0.9% between 2016 and 2018. The link between the UK's feeble productivity growth over the last decade and its public finances is something that we discussed two years ago[1]. Lower productivity growth drags on the growth outlook and has implications for government revenue projections.

[1] See here: www.bk.mufg.jp/report/ecoeu2017e/BTMU-Economic-Brief-UK20171214.pdf

On paper, targeted public spending to improve supply capacity of the economy could result in productivity gains. However, the risk is that a Labour government would mean significantly higher government spending without any improvement in productivity. The scale and breadth of the party's proposals, if enacted over a five year parliament, make wastage and inefficiencies likely. We note Labour's proposed payment of lump sum (averaging 15,380 GBP) to women affected by pension age changes made in 1995 is a particularly expensive policy which has little economic merit (although economists might find it useful to study the effectiveness of 'helicopter money'…).

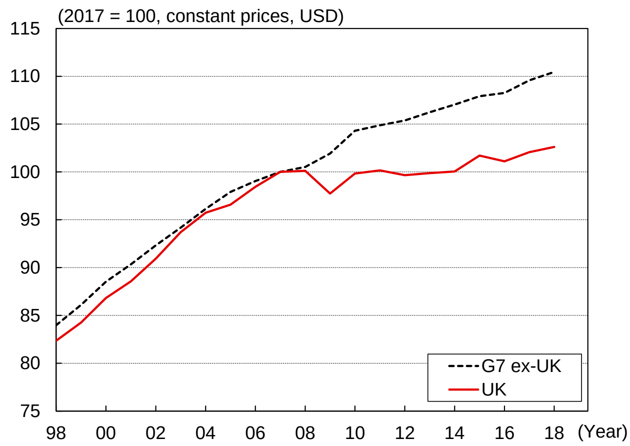
For the Conservatives, the flipside of having a cautious manifesto is that there is little in there to suggest a sharp improvement in UK productivity growth. It does contain some limited supply-side measures which could foment a gradual improvement, however (e.g. a 'National Skills Fund', improved internet infrastructure, investment in roads).

3. UK GDP Growth



Source: ONS, MUFG Bank Economic Research Office

4. Productivity (GDP per Hour Worked)



Source: OECD, IMF, MUFG Bank Economic Research Office

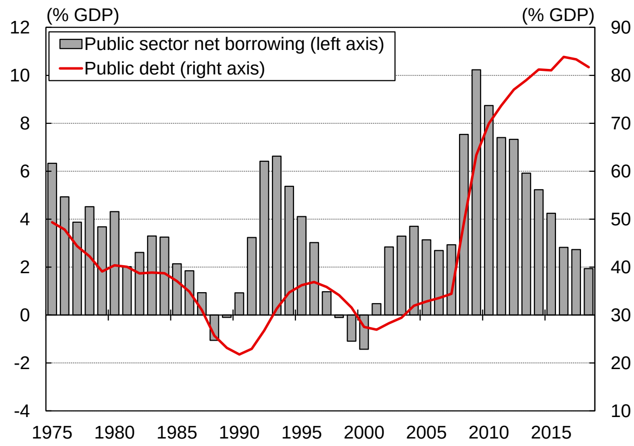
...but much looser public finances would raise questions about sustainability

Both main parties would loosen the current fiscal rules. The Conservatives' previous pledge to keep the overall budget deficit below 2% of GDP in 2020-21 is out of the window, replaced by new guideline stipulating that the current budget (i.e. excluding expenditure on net investment) should be balanced. Up to 3% of GDP can be spent on net investment as long as debt interest payments do not exceed 6% of revenue. Labour's rules are looser still: the debt interest limit is 10% of revenue, and the current budget would only be balanced in five years' time.

With Labour lagging in the polls, UK gilt markets have so far shrugged off the threat to public finances of a Corbyn-led government (since parliament was dissolved on 6 November, 10Y yields have hovered between 0.6 and 0.7%). UK government debt increased sharply following the GFC and, despite recent improvement, remains high at around 80% of GDP. This would likely rise in the case of a Labour government, leaving much less room for manoeuvre during the next downturn. The UK's very long average debt maturity (of around 15 years) would cushion the immediate refinancing risk. But Chart 6 shows just how high Labour's proposed debt interest payment to current receipt ratio would be in a historical context.

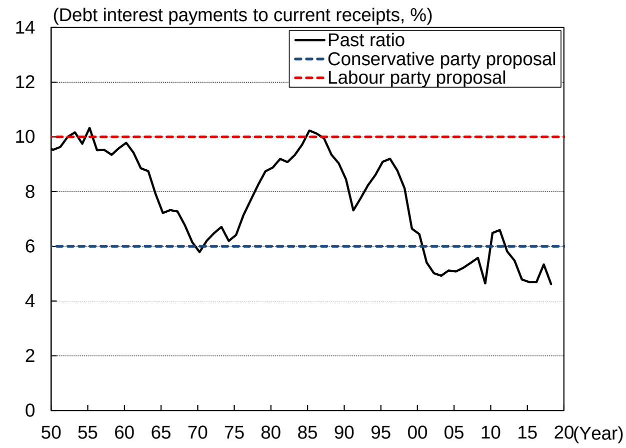
In terms of GDP growth, while there would be a large fiscal boost, a Labour government would likely mean a drag from business investment. A shift to a less ‘business friendly’ environment, highlighted by Labour’s nationalisation policies and increase in the corporation tax rate (from 19% to 26%), would probably deter foreign investors, especially in certain sectors such as utilities. Combined with the hangover from the UK’s reputational blow after the Brexit vote, a Labour government may be bad news for the UK’s attractiveness as a destination for outward investment, which would drag on the outlook for public finances. We think there would also be a headwind for productivity growth. Foreign-owned businesses tend to be more efficient (perhaps due to economies of scale and knowledge of best practices). The UK’s Office for National Statistics has found that “in 2017, foreign-owned businesses were, on average, almost twice as productive as domestically-owned firms”.

5. UK Debt and Deficit



Source: OBR, MUFG Bank Economic Research Office

6. Proposed Fiscal Rules on Debt Interest Payments



Source: OBR, MUFG Bank Economic Research Office

Meanwhile, Chart 6 also emphasises how modest the Conservatives’ spending proposals are given the secular decline in borrowing costs (to our minds, it might be more appropriate to have a limit of around 8% over the next parliament to help to smooth the UK’s transition from EU membership).

The Conservatives’ radical policy vision: a hard Brexit

It is worth stepping back from fatigue surrounding the UK’s long-winded departure from the EU to emphasise that Johnson’s deal points to a hard Brexit and a significant rejigging of the UK’s trading relationship with its closest neighbours. Moving from Single Market membership to FTA can also be considered as a radical policy. It would be harder to return to EU membership (or transition to a ‘softer’ Brexit model) than reverse much of what Corbyn might be able to do during a single parliamentary term, especially as Labour’s most plausible route to power seems to be a coalition agreement with other parties. In that case, some of their more radical policy proposals would probably not have sufficient parliamentary support.

On the other hand, Johnson has confirmed that every Conservative candidate standing for election supports his withdrawal agreement – so if there is a Conservative majority at the election, it should result in the smooth passage of the Withdrawal Agreement Bill through the House of Commons.

Initially, this would represent a significant clearing of uncertainty and is likely to have some impact on UK economic activity as pent-up demand for business investment is released.[2] But Johnson's deal would likely result in a longer-term loss of output relative to continued EU membership. Even if the UK can negotiate tariff-free trade with the EU, which accounts for almost 50% of its goods exports, there will still be higher friction in the form of paperwork as tariffs on third parties might vary considerably. This means that rules of origin administration will be required, which can be particularly burdensome. Over the longer-term, the economic costs of this type of higher trade friction are likely to add up. After an initial post-deal bounce we estimate that UK GDP growth will remain subdued (at around 1.4% YoY).

There are sources of uncertainty. The stringency of the government's policy on immigration and the UK's relative attractiveness as a destination for overseas investment will be important. The length of the status quo transition period will also matter hugely. Despite the Conservatives' pledge that the transition period will not be extended past 2020, we think that an extension would be likely – it will be extremely hard to conclude the FTA negotiations by the end of next year. However, any extension has to be agreed by July 2020. If this deadline is missed, there is a risk of another cliff-edge scenario at the end of the year, which could weigh on business investment.

Main parties' Brexit stance at the election

Conservatives	Quick ratification of Johnson's Withdrawal Agreement. No further Article 50 extensions. Post-Brexit Free Trade Arrangement (FTA) with the EU. No extension to the Brexit transition period past the end of 2020.
Labour	Another referendum, with the choice between 'remain' or a renegotiated Withdrawal Agreement pointing to a softer Brexit. This would require another Article 50 extension.

Source: Party manifestos, MUFG Bank Economic Research

A Labour-led government would present a plausible pathway to no Brexit at all, or a 'softer' Brexit with closer eventual ties to the EU27. Labour has pledged another referendum with the choice between revoking Article 50 or a new, renegotiated Withdrawal Agreement. This is likely to consist of a closer eventual relationship, probably along the lines of a permanent customs union with the EU27, and would mean lower trade friction.

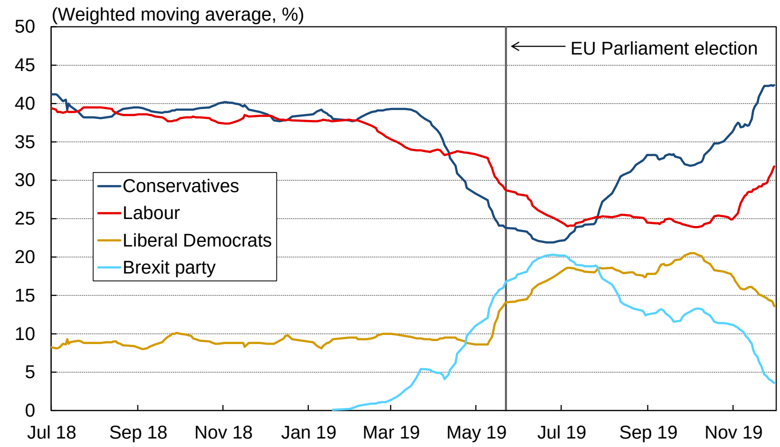
Outlook: Polling suggests a Conservative majority

The Conservatives and Labour have published two very different manifestos. The Conservatives' document contains cautious policy proposals and modest increases in public spending. By contrast, Labour would rapidly and dramatically increase the size of the state with higher expenditure and taxation. While this would not be especially radical when compared to other European economies, the associated loosening of fiscal rules would raise questions about the sustainability of such an approach for the UK's public finances. We also question whether the speed and scope of such a change would result in efficiency gains for the UK economy. Furthermore, Labour's policy mix would deter foreign investment.

[2] See here: www.bk.mufg.jp/report/ecoeu2019e/MUFG-Economic-Brief-UK20190306.pdf

At the moment, with polls showing a strong Conservative lead, it seems that voters are ready to reject such a radical change in the UK's economic model. But it is worth emphasising that a Conservative majority would clear the path for a hard Brexit, a very radical policy in itself, and one which is not without significant risks for the UK economy.

7. UK Polling



Source: Britain Elects, MUFG Bank Economic Research Office