

Prospects

Aperiodic – No. 19/202 – 22 November 2019

UNITED KINGDOM – What can we expect from the December elections?

- The UK has called snap elections for 12 December amid the long, drawn-out Brexit process. While most polling firms give the Conservative Party a clear majority, the outcome remains uncertain. The elections could very well result in another hung parliament, with no party gaining an absolute majority.
- A predominantly conservative government (our central scenario) would pave the way for the ratification of the Boris Johnson deal and make it more likely that Brexit would take place on 31 January 2020, followed by negotiations on long-term future relations. Options include a free trade agreement or, failing that, a partnership governed by the rules of the WTO. Fiscal policy would be relaxed, but to a much lesser extent than under the Labour Party.
- In the hung parliament scenario, a Pro-Remain alliance headed by Labour is more likely than a new government with a Conservative minority, as are another extension of Article 50 (for the purpose of negotiating a Soft Brexit) and another referendum some time in 2020. In terms of domestic policy, Labour has promised strong fiscal stimulus measures - primarily by way of investment - partially funded by tax hikes and a sweeping plan to nationalise key public services.
- No matter how the elections play out, political uncertainty is sure to remain very high. A Conservative victory would only improve visibility in the short term. Details on future UK-EU relations, and particularly the terms of a free trade agreement, will only become clear over the course of a transition period under the ever-present risk of a No-Deal Brexit (future relations governed by WTO rules).

Navigating Brexit becomes a delicate balancing act in a deeply divided country

Elections organised in the hope of restoring a majority in Parliament

With Parliament at an impasse on Brexit, Boris Johnson succeeded in skirting the 2011 Fixed-Term Parliaments Act to pass a bill approving snap elections on 12 December 2019. Having dispelled the risk of a No-Deal Brexit thanks to the European Commission's extension of Article 50 to 31 January 2020, the Labour Party had run out of excuses against holding elections. Parliament greenlighted the elections with a majority of 438 to 20 and dissolved on 6 November to make way for the elections five weeks later.

Boris Johnson hopes to take this opportunity to return the majority to the Conservative Party lost by Theresa May during the 2017 elections. May's defeat had forced her to call on the DUP (Northern Ireland's Democratic Unionist Party) for back-up, an alliance that went a long way towards preventing the government from finding a solution to the Irish border problem and having it approved by Parliament. Although Parliament did ultimately approve Boris Johnson's revamped Brexit deal "in principle", it rejected the PM's fast-track ratification proposal. MPs backed an amendment postponing the final decision on Johnson's Brexit deal until the accompanying legislation is passed into law, which would inevitably open the floor to other amendments (including the one proposed by Labour for a customs union with the EU) liable to jeopardise some of the deal's underlying principles.

A high-risk bet for Boris Johnson

Election polls may currently peg the Conservative Party as the winners, but caution is the watchword now more than ever. The disastrous turn taken by

Theresa May's 2017 elections come to mind. Early in the 2017 campaign, the Conservative Party was credited with a crushing 20-point lead over Labour based on voting intentions, and election forecasters saw the Conservatives gain a comfortable majority in Parliament, in some cases by more than 100 seats. In the end, a unique set of circumstances (terrorist attack in Manchester), an unexpected shift in Tory policy on key tax measures (social security reform), a successful Labour Party campaign and strategic errors by the Conservatives (aggressive campaign in Labour-dominated northern England while neglecting the Pro-Remain southern regions) conspired to defeat Theresa May.

Consequently, the main challenge currently facing the Conservatives is not to make the same mistakes this time around. Their manifesto needs to convey a relatively balanced view on Brexit, i.e. a sufficiently "hard" Brexit to draw in votes from Labour's Pro-Leave constituents in northern England, but ruling out a No-Deal Brexit to avoid sacrificing the support of Pro-Remain voters, particularly in southern England and Scotland. The Tory election campaign is thus unlikely to put a No-Deal Brexit on the table.

Nigel Farage's 11 November decision not to contest the 317 seats won by the Conservatives in 2017 was a major event in that it signalled the unification of the Pro-Leave parties, as opposed to the sharply divided Pro-Remain vote (split between Labour, Liberal Democrats, Tories and Greens). A YouGov poll taken in the wake of Farage's speech showed Brexit Party voting intentions down from 10% to just 4%, largely in favour of the Conservative Party. Even so, the Brexit Party will challenge the Tories in regions traditionally held by Labour. If Pro-Brexit Labour supporters abandon their traditional attachment to the Brexit Party, at the expense of the Conservative Party, the Conservatives could end up losing an absolute majority as a result.

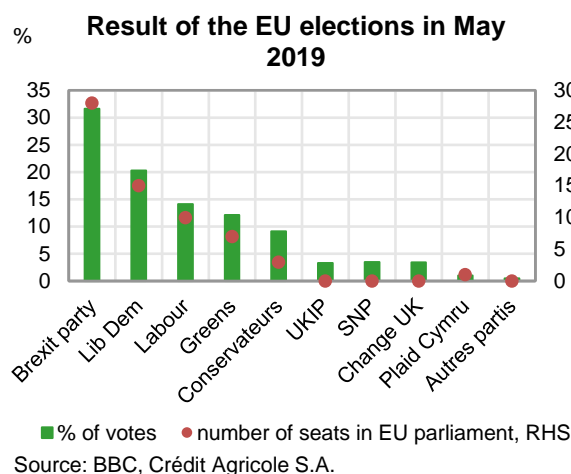
Labour's dilemma

For the longest time during Brexit negotiations, Labour adopted a policy of "constructive ambiguity" in response to significant internal conflicts. At present, Labour is facing a dilemma stemming from the incompatibility between a) the Pro-Remain bias of Labour voters (68% voted Remain during the 2016 referendum) and b) the majority of Labour seats held by Pro-Leave MPs (61%)¹.

As opposed to Conservatives, who from the very beginning of negotiations announced and staunchly defended Pro-Hard-Brexit red lines (exiting the customs union and the single market), Labour took a more flexible approach to Brexit. In its 2017

manifesto, Labour accepted the outcome of the referendum and promised to put an end to freedom of movement. At the same time, however, it wanted to keep the benefits of the single market and customs union, which is contrary to the principle whereby the four fundamental principles of the single market are indivisible.

In January 2019, Labour ended up proposing a permanent customs union with the EU, and the idea of a second referendum gradually became an official party proposal, particularly after the European elections in May when Labour was thoroughly trounced by the Liberal Democrats.



Labour has promised a nine-month Brexit: three months to renegotiate the withdrawal agreement and six to organise a referendum allowing voters to choose between the new deal or to Remain in the EU. Negotiations with the EU are expected to centre on the political declaration to include commitments to remain in the customs union while calling for a close regulatory alignment with the single market.

Polls pointing to a conclusive Conservative Party victory?

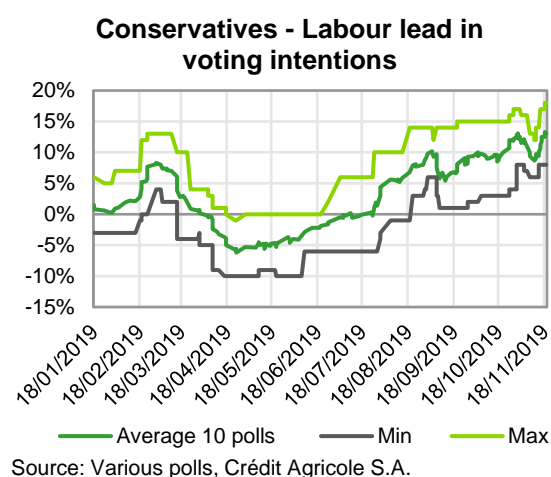
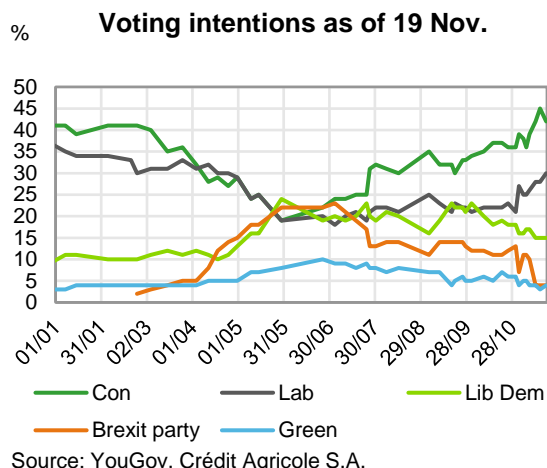
In terms of voting intentions, polls give an average lead of 10 points to the Conservative Party over Labour (12 points according to the latest YouGov poll conducted on 19 November). Even so, the election results are still shrouded in uncertainty, given the inevitability of polling errors and potential opinion changes over the course of the campaign, not to mention tactical voting, which could play a particularly important role in this election.

Given the mechanics of the UK electoral system ("first past the post"), there can be a wide gap between the percentage of votes earned and the number of seats won in Parliament. What matters more than the percentage of total votes is the lead secured over the party in second place². This

¹ See https://www.britishelectionstudy.com/bes-findings/labours-electoral-dilemma/#_ftn1

² For example, in 2015, the Conservative Party took the majority with 330 seats after earning 36.8% of the vote (beating the

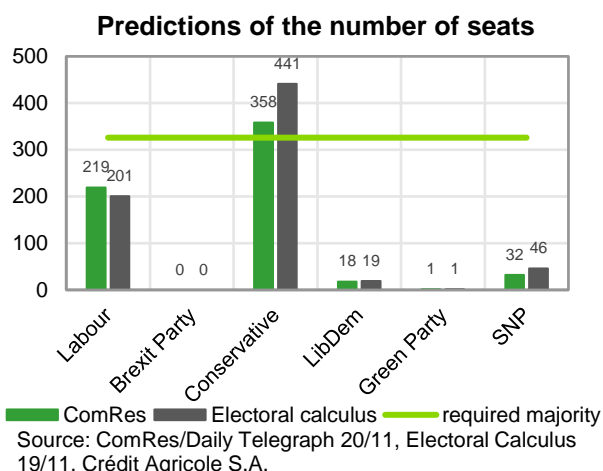
system favours parties with a firmly established geographical base over parties with geographically dispersed voters. Consequently, the polling firms never expected the Brexit Party to win seats in Parliament despite it being credited until recently with more than 10% of voting intentions.



In terms of Parliament seats, most polling firms see the Conservatives taking a comfortable majority, but results vary considerably, very likely because of methodology and sampling differences. To that point, it is important to note that methodology errors (particularly regarding the representativeness of samples) have often sparked significant forecast errors in the past, as was the case during the 2015 election³.

Labour Party's 30.3% by 6.5 percentage points), but did not win the absolute majority in Parliament in 2017 despite securing 42.3% of the vote (this time topping Labour's 40% by 2.3 percentage points).

³ The Conservatives won the 2015 election with a razor-thin majority in Parliament, whereas most polls had predicted a hung



In addition, late-swing changes in voter preferences can lead to major forecast errors, as was the case for the 1970 and 1992 elections which both resulted in a surprise win for the Conservatives. The volatility of voting intentions rose sharply during the 2015 and 2017 elections, as recently shown by [the British Election Study \(BES\)](#), which found that the 2017 election recorded the highest percentage of defectors between the Labour and Conservative parties since 1964. Over the course of three elections from 2010 to 2017, nearly half of voters (49%) chose not to vote for their party. "Electoral shocks" such as Brexit, the 2008 crisis and immigration have a big influence on volatile voter preferences. With the Brexit shock still firmly in place, the BES says it is impossible to predict how the people will vote in 2019 elections.

Finally, polling results can also be distorted by tactical voting. Voters are facing an even greater challenge this election because they have to base their decision on their Brexit preference (Leave vs. Remain) and their economic and social preferences (Left vs. Right). For example, Pro-Remain conservative voters (fairly common in southern England) may be tempted to vote for the Lib Dem Party while worrying that could lead to an alliance with Labour and the risk of seeing Jeremy Corbyn rise to power. In that case, there would be no other choice than to resign themselves to Brexit by voting conservative, or else refrain from voting altogether. Pro-Remain Lib Dem voters might choose to vote Labour if they are in a region dominated by both traditional parties, in a bid to avoid diluting the Pro-Remain vote. Tactical voting is thus very important in this election in that it could promote a shift in votes to traditional parties, reversing the outcome of the May 2019 European elections.

parliament and a probable alliance between Labour and the Lib Dems. [A post-election analysis](#) by the British Polling Council found that pollers had overweighted Pro-Labour votes and underweighted Pro-Conservative votes.

Possible scenarios: a stronger Boris Johnson or another hung parliament

Scenario 1 (central): the Conservative Party wins the election with an absolute majority and Parliament approves the Boris Johnson deal. Brexit happens on 31 January 2020, followed by a transition period.

Our central scenario has the Conservatives winning the election with a majority in Parliament. The Brexit deal negotiated by Boris Johnson is passed by Parliament, a fast-track ratification procedure takes place and the UK leaves the EU under the terms of the PM's deal, as scheduled on 31 January 2020. The transition period (implementation period) will run from 1 February to 31 December 2020 and may be extended once (from one to two years) if the request is made before 30 June 2020.

Scenario 2: the Conservative Party wins the election but fails to secure a majority (322 seats).

In that case, the election would result in a hung parliament. Political uncertainty in the short term would be high: the outcome would depend on how well the two major parties could drum up support from one or more minority parties to form a majority in Parliament. The incumbent Prime Minister would remain in power and have first crack at forming a government. That could either happen through an official coalition or a minority government, with the

support of other parties under a supply and confidence agreement.

A Tory-DUP alliance seems unlikely after the "betrayal" of the Irish backstop negotiations, and would make it complicated if not impossible to get the Johnson deal ratified. The Prime Minister could also call on Nigel Farage for support in the unlikely event the Brexit Party won seats in Parliament. Such an alliance could compromise the negotiation of a free trade agreement and could prevent the implementation period from being extended past 31 December 2020. The risk of a No-Deal Brexit would be highest in both scenarios (alliance with DUP or Brexit Party).

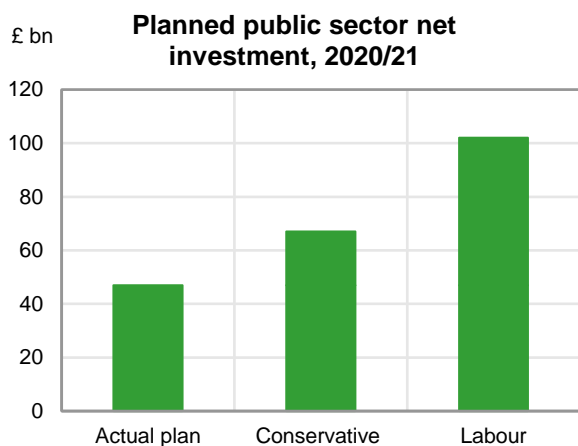
If the Conservatives failed to secure a majority in Parliament, it would be up to the second-place party to try to form a government. This could take the form of a Labour-led minority government allying Labour with one or more other Pro-Remain parties such as the SNP (expected to significantly increase their number of seats), the Greens and the Liberal Democrats. This would in turn undoubtedly lead to the renegotiation of the Brexit deal (to include a customs union and/or a Norway-like model for the future relationship in the political declaration), another Article 50 extension (of at least nine months) and a confirmatory referendum (asking voters to choose between the negotiated deal or to Remain). Lastly, the Liberal Democratic Party and the SNP would very likely call for a new Labour leader as a prerequisite for their backing. The SNP could also be expected to demand a second referendum on Scottish independence.

Scenario	Subjective probability	Type of Brexit
1. Conservative majority government	60%	Orderly Brexit on 31 January 2020 with the B. Johnson's deal, negotiation of a FTA, possible extension of the transition period up to 31 december 2022
2. Hung parliament	40%	
2.1 Gouvernement "Conservatives/DUP"	5%	Renegotiation of the withdrawal deal (notably the backstop), another extension to Art. 50
2.2 Government "Conservatives/Brexit party"	5%	Orderly Brexit on 31 January 2020 with the B. Johnson's deal, negotiation of a basic FTA, risk of no extension of the transition period and of no deal
2.3 Minority Labour government supported by one or several pro-Remain parties (SNP, Green, LibDem)	30%	Renegotiation of the withdrawal deal for a soft Brexit (customs union, Norway +), another extension to Art.50 (+9mths), confirmatory referendum, Scottish independence referendum

A new era is dawning for public finances

The Labour and Tory parties are at competition over government investment spending

In addition to Brexit, the upcoming elections are critical for the UK's future fiscal policy. Right now there is a consensus across parties that more spending is needed, particularly on the investment front. The parties share the same ambition: to take advantage of low-to-negative real interest rates to invest in infrastructure and areas likely to improve the country's productivity and growth potential, while also addressing major challenges such as global warming, the ageing of the population, poverty and inequality.



Both parties are thus planning to significantly increase investment spending, especially in Labour's case: an additional £55bn per year (2.5% of GDP)⁴ versus a more modest £20bn (0.9% of GDP)⁵ for the Conservatives. The Labour also plans a massive boost to day-to-day spending to the tune of £83bn per year. According to *The Resolution Foundation (RF)*⁶, these plans would boost spending (in % of GDP terms) to 1970 levels. With the Conservatives, spending would climb to 41.3% of national revenue through to 2023-2024 (vs. 38.2% in 2019-2020), and to 43.3% with Labour⁷, i.e. on a par with 1966-1984 levels (42%) and well above the average for the two decades preceding the 2008 financial crisis. The spending rises would

⁴ Labour has promised to put £250bn over the next ten years into a National Transformation Fund to invest in clean energy and efficient insulation systems and another £150bn over five years in a new Social Transformation Fund to be spent on infrastructure projects such as schools, hospitals and social housing. The Labour's National Transformation Fund has therefore increased in size to £400bn from £250bn back in 2017.

⁵ In his speech during the September spending review, Chancellor of the Exchequer Sajid Javid focused on the priority of increasing capital expenditures. His plan calls for £100bn of infrastructure spending via a national infrastructure plan dedicated to regions outside London.

be funded, in large part, by an increase in borrowing and, for Labour, in part by higher taxes.

Redefined fiscal rules

In a bid to provide greater flexibility and pave the way for increased investment spending, the two main parties announced fiscal rules based on the current budget balance (deficit excluding net investment expenditures).

Chancellor Javid abandoned the fiscal rules calling for the structural deficit to be kept under 2% in 2020-2021, the budget to be balanced by the mid-2020s and the public debt burden to be lowered. He then replaced them with a new three-pronged policy:

- ✓ balancing the current budget deficit by 2022-2023;
- ✓ limiting investment to 3% of GDP (2% currently);
- ✓ keeping debt servicing costs at 6% of tax revenues (4.6% currently).

By comparison, the Labour Party has announced the following rules:

- ✓ balancing the current budget over a five-year period (2024-2025);
- ✓ increasing the net wealth of the public sector over the next five years;
- ✓ limiting debt servicing costs to 10% of tax revenues.

No room for tax cuts in the election campaign

During his term, Boris Johnson announced some £20bn in tax cuts, including the following measures:

- ✓ raising the threshold for the higher tax rate band from £50,000 to £80,000 (estimated cost: £9bn in 2020-2021 according to RF);
- ✓ raising the threshold for national insurance payments to £12,500 (estimated cost: £10bn);
- ✓ lowering the fuel duty by 2% instead of raising it in line with the RPI (estimated cost: £1.5bn).

⁶ See <https://www.resolutionfoundation.org/publications/the-shape-of-things-to-come/>

⁷ The RF's analysis is made before McDonnell's statement on a 5-year Social Transformation Fund. It is based on the assumption of the 2017 manifesto, which established new spending plans totalling around £70bn, including current spending (departmental and social security) of approximately £49bn and capital expenditures of £25bn per year. The RF's analysis therefore underestimates the levels of spending currently planned by Labour.

These promises were plausible a few months ago in light of the estimate made in March by the Office for Budget Responsibility of a budget surplus of nearly £36.8bn in 2022-2023. This surplus has almost completely vanished since September, however, due to major revisions to student loan costs, a downturn in the budget deficit for 2019-2020 attributable mainly to higher-than-expected public expenditures, and Chancellor Javid's September announcement of a sharp rise (£13.8bn) in public services spending for 2020-2021. [RF estimates](#) suggest that the Conservative Party has no more leeway to announce any tax cuts. Not surprisingly, on 18 November Boris Johnson gave up on the corporate tax cut planned for April 2020 (from 19% to 17%), which would have cost £6bn per year.

The paradox that is Boris Johnson

No election in the UK's recent history has been imbued with higher stakes. An election whose outcome will set a course for a new relation with the EU and some twenty different non-EU countries (including Japan, Turkey and Canada), with whom the UK has to renegotiate a free trade agreement. An election that could raise the possibility of a second Brexit referendum in 2020 as well as another Scottish independence referendum, that could clear the fate of populism through the future of the Brexit Party and possibly set the stage for a radical transformation in domestic policy.

Regardless of how it turns out (election of Boris Johnson with a majority, or another hung parliament), political uncertainty is sure to remain very high. A hung parliament would undoubtedly generate uncertainty in the short term. But, if Labour succeeded in forming a government with other

Pro-Remain parties, EU negotiations would likely be easier and faster because they would lean towards a Soft Brexit with a customs union and a regulatory alignment with the single market. It could also help quiet Scottish claims for independence.

A Conservative victory would bring only short-lived relief, as negotiations on EU relations would be more complicated (because they would stray much further from the status quo than with a Labour government). The financial markets would focus their attention on 30 June 2020, the deadline for the UK government to ask for a one or two-year extension of the implementation period (i.e. 31 December 2022 at the latest). As for trade relations, the Prime Minister plans to negotiate a basic free trade agreement, which would have a stronger impact on the economy than Labour's Soft Brexit. Even if trade barriers (tariffs, quotas) are avoided, the prospect of regulatory divergences will warrant trade controls on products and non-tariff barriers on services. In which case calls for a Scottish independence referendum would grow even stronger.

Lastly, the risk of a No Deal Brexit will prevail throughout the implementation period because, if no free trade agreement is signed and ratified during this period (31 December 2022 at the latest, if an extension is granted), the United Kingdom would become a third country in the eyes of the EU and would leave both the single market and the customs union at the expiry of the transition period, meaning its new trade relations would be governed by the rules of the WTO (with a special status for Northern Ireland, as provided for in Johnson's Brexit deal). ■

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