ECO

Focus

Credit Agricole Group economic and sector analysis

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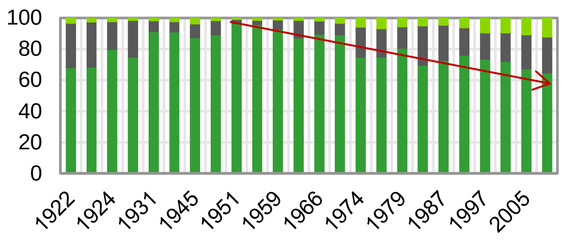
UK politics: 2015 general election and the erosion of the two-party system

- **The main 'known' risk event this year in the UK is the general election, which will take place on 7 May. This is set to be the most unpredictable legislative election for nearly a century. Polls suggest that neither of the two mainstream parties will have sufficient support to secure a majority, leading to a hung parliament and a coalition as the most likely scenario.**
- **With three months left to the election, there is still substantial uncertainty over which party leads in the election. Most of the pollsters predict the Labour party, but just short of a majority. A coalition of the left with the Liberal Democrats and/or the Scottish Nationalists therefore appears to be the most likely scenario, although surrounded by a high level of uncertainty.**
- **Whichever party is entitled to form a government, the key issue to deal with will be the continuation of the fiscal adjustment process. The plans of the three main parties imply substantially different amounts of borrowing, and hence different levels of debt in the medium term. Labour and the Liberal Democrats' fiscal rules are consistent with a much less aggressive fiscal tightening than the current coalition and the Conservatives.**
- **The prospect of an in/out referendum on UK membership of the EU, in the event of a Conservatives-led government, would likely be the main source of concern for businesses and markets. Although we see the risk of an UK exit from the EU as remote, the uncertainty about the UK's future in the EU could negatively impact UK assets and capital flows.**

The political landscape and the election timetable

The May general election is by far the main event risk for UK markets this year. Uncertainty is running high over the configuration and stability of the next government. As in other European countries, there has been a loss of voter support for the largest parties and populist parties have profited: the combined share of Labour and Conservatives has reached record lows (barely 65%), enhancing the pattern of erosion of the two-party vote that has been observed since WWII.

UK: trends in party support



Source : Parliamentary affairs, Vol.63 No.4, 2010, Crédit Agricole S.A.

The surveys of voting intentions suggest that no party is going to obtain an absolute majority, resulting in a hung parliament. The winner will have to compound with smaller parties to form a coalition, which requires 326 seats in the 650 member parliament. But, the Liberal Democrats have lost a significant share of public support, falling from 23% at the 2010 election to 6% today. They might not receive a sufficient number of seats to form a workable coalition. Therefore, a formal agreement or even a coalition with populist parties, such as the UK

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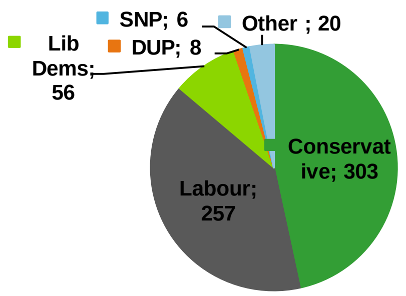
Independence Party (UKIP) or the Scottish National Party (SNP), is a possibility that should not be underestimated. In that case, forming a coalition will not be an easy task and might come at the expense of uncomfortable agreements on thorny questions, such as an accelerated EU referendum or a renewed debate over Scotland's position in the UK. In order to halt UKIP's rise, Prime Minister Cameron has promised a referendum on the UK's membership of the EU, but without success: UKIP has gained 7% in the polls since January 2013 to stand at 17% at the beginning of 2015.

Publication of the parties' manifestos is expected in late February/early March. The 2015 budget, to be released on 18 March, will be the last main policy announcement of the outgoing Parliament. The Parliament will be dissolved on 30 March. If the current government is not re-elected, a supplementary budget will be announced shortly after a new government is sworn in.

The UK electoral system

The UK operates a first-past-the post system (or single-member plurality) electoral system in which the party with the largest number of parliamentary seats (simple majority) is asked to form a government. Historically, the UK has tended to form a government comprised of a single party. If the largest party obtains less than 325 seats, there is a hung parliament. The incumbent then has the first go at building a coalition or governing through a minority government. When this is unachievable, the Prime Minister resigns and the Monarch then invites the next most likely party to form a government. Since 1929 there have been only two instances of hung parliaments in the peacetime history of the UK: one in 1974 and the other in 2010. The 2010 UK election was the first to be immediately followed by the formation of a coalition government, between the Conservatives and Liberal Democrats.

Current state of the House of Commons

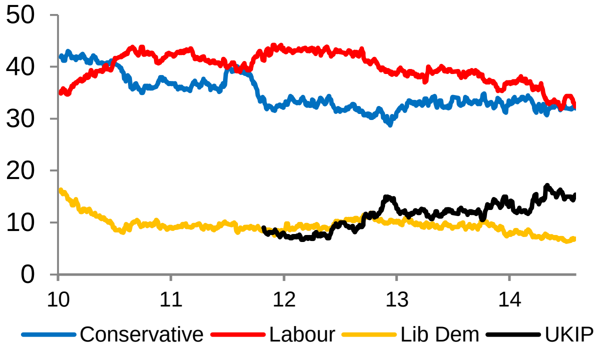


Source : House of Commons, Crédit Agricole S.A.
Note: Other includes Sinn Fein 5, independent 3, Plaid Cymru 3, SDLP 3, UKIP 2, Alliance 1, Green 1, Respect 1, Speaker 1

Possible scenarios

Opinion polls are unanimous that the 2015 general election will likely result in a hung parliament. However, contrary to the 2010 general election when the Conservatives were clearly leading the polls, today we cannot even be sure as to which party will win the highest number of parliamentary seats. The Labour party has a tiny lead over the Conservatives, although it has been consistently declining. Historically, in the twelve months before the election, there is a swing in voting intentions from the opposition to the governing party estimated at 2.7% on average since 1955[1]. This has not been the case so far, with the Conservatives' position having remained relatively stable whilst failing to capitalise on the improvements in growth prospects. The uncertainty over the composition of the next government is heightened by the dramatic loss of support for the Liberal Democrats, the third largest party at the 2010 election. They are unlikely to receive enough seats to hold the balance of power, which raises the likelihood of a multiple-party coalition involving populist parties.

Opinion polls ahead of the 2015 election



Source : YouGov, Crédit Agricole S.A.

The fragmentation of party support suggests that various scenarios for the composition of the next government can be envisaged: a coalition between Labour and the Liberal Democrats, a broad coalition of the left including the SNP and the Greens, a coalition of the right (less likely given falling support for the Liberal Democrats and the unwillingness of UKIP to participate in a coalition), a Labour minority government or a Conservative minority government, a succession of minority governments followed by snap elections or even a government of national unity. Here are the three most likely possibilities in our view:

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[1] See, for example, 'It would take a small miracle for the Conservative Party to win a majority in 2015', The Telegraph, 17 July 2014 http://blogs.telegraph.co.uk/news/pollingobservatory/100280471/it-would-take-a-small-miracle-for-the-conservative-party-to-win-a-majority-in-2015/.

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- ✓ **At present all pollsters point to a coalition of the left as the most likely scenario.** Most election forecasters are predicting the Labour party as the election winner, but short of an overall majority. A natural partner to form a coalition would be the Liberal Democrats: they have already indicated that they are open to negotiations with Labour in the case of a hung parliament and share a number of common policies (eg, the mansion tax). **The Labour party has a less aggressive fiscal stance than the Conservatives,** allowing for a higher level of spending (please see the following section). The counterparty of higher spending would be higher debt and hence more spending devoted to debt interest payments. Labour has already announced tax rises, among which an increase in the top rate of income tax, an introduction of a mansion tax and a reversal of the government's plans for a cut in the main rate of corporation tax, which may negatively impact investor and business confidence.

- ✓ **A Labour minority government might be more attractive than a rainbow coalition.** A Labour/Liberal Democrats coalition would probably obtain less than the required 325 seats. Therefore, Labour might have to look for a broad coalition with some or all of the Scottish National Party, the Greens and Plaid Cymru. Given the anti-austerity stance of these parties, such a broad coalition might prove politically unstable and threaten the UK's fiscal credibility. The fiscal adjustment process will likely slow down. Instead, the Labour party may choose to govern through a minority government, in which case legislation would be supported on an *ad hoc* basis by other parties in order to give a majority. In both cases, political instability is unlikely to be investor positive.

- ✓ **A Conservative minority government with a formal arrangement** with the Democratic Unionist Party (DUP) and possibly UKIP looks more plausible than a coalition of the right. A coalition between the Conservatives and the Liberal Democrats might not be feasible as the Liberal Democrats will have to make a lot of concessions, notably to agree to the Conservatives' plan to hold an EU referendum. A right-wing coalition involving the DUP would not secure enough MPs to be viable, while UKIP has indicated that it would not accept a coalition with either party. Hence, a conservative minority government looks more plausible than a coalition of the right, in our view. As in the case of a Labour minority government, legislation would only be passed with the support of other parties. **A Conservative-led government would mean a larger tightening than Labour and greater cuts to departmental spending.** The Conservatives' plan implies a fiscal tightening of 4.3% of GDP over the next parliament versus 3.0% of GDP for Labour and the Liberal Democrats, according to estimates by the Institute for Fiscal Studies[2], IFS, (under the assumption that each party chooses to use all the leeway provided by their mandate and carries out the tax policy and welfare spending that have already been announced by the coalition government). Cuts in departmental spending would be almost four times larger than under Labour.

The fragmentation of the political landscape, the ideological differences between the parties and the large gaps in terms of fiscal plans means that a multi-party coalition or minority government might not last a full five-year term. A series of short-lived minority governments followed by a snap general election should not be ruled out.

The 2011 Fixed-Term Parliament Act (see the box below) adds a further degree of difficulty in predicting the sequence of future developments. In our view, it lowers significantly the attractiveness of a minority government, as it is almost impossible for the incumbent to call for early elections. A minority government would need legislation to be supported on an *ad hoc* basis, suggesting that neither party would be willing and able to govern on that basis for an entire five-year parliament. The party which wins the election would hence be much more disposed to form a coalition or at the very least establish a formal arrangement that could last for five years with a smaller party.

The 2011 Fixed-Term Parliament Act

The 2011 Fixed-Term Parliament Act sets the period between elections at five years, thereby providing a five-year fixed term for the House of Commons. An early parliamentary general election can only occur in two cases: (1) a motion of no confidence is passed by a simple majority and no alternative government is confirmed by the Commons within 14 days, or (2) if the House of Common votes on its own dissolution at a majority of two-thirds including vacant seats (currently 434 out of 650). The Fixed-term Parliament Act reduces the ability of incumbent governments to schedule elections at discretion and for electorally opportunistic reasons.

In order to precipitate snap elections, the government may undertake to repeal the Fixed-Term Act. This temptation could run high, especially when a motion of no confidence in the government is passed and no 'constructive' alternative majority appears likely or if the Prime

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[2] See R.Crawford, C. Emmerson, S. Keynes and G. Tetlow, 'Fiscal aims and austerity: the parties' plans compared', The IFS Briefing Note BN158, December 2014.

Minister cannot obtain the two-thirds majority to dissolve Parliament. Technically, the Act can be easily repealed by an 'ordinary' law, thus placing Parliament back under the old dissolution regime (on a personal decision of the Prime Minister using powers delegated to him by the Queen). But such a scenario is rather unlikely in our view. The political cost of such a repeal would be too high: this reform is commonly perceived as a significant step towards a more equitable constitutional regime.

All in all, the UK faces major political uncertainties related to the composition and stability of the government which will be formed after the general election on 7 May 2015. Heightened policy uncertainty may in turn impact negatively the investor climate and weigh on the UK's growth prospects in the coming years.

A 'Brixit' is unlikely in our view

An EU referendum is highly uncertain

The prospect of an in/out referendum on UK membership in the EU is highly contingent on the outcome of the 2015 general election. A Labour victory would significantly reduce the risk of an UK exit from the EU ('Brixit') simply because this referendum might not be held: Ed Miliband, the Labour leader, has ruled out holding a straight in/out referendum on EU membership. The referendum is David Cameron's promise and all left-wing parties are firmly pro-European.

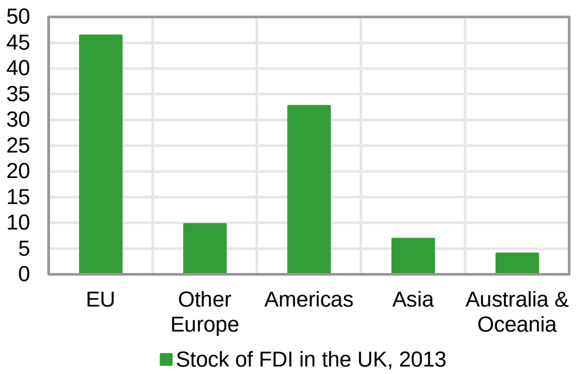
The prospect of an in/out referendum on UK membership of the EU would likely be the main source of concern for businesses and markets in the event of a Conservative-led government. The possibility of a formal arrangement between the Conservatives and UKIP might even increase the odds of a referendum on EU-membership to be brought forward, probably before 2017[3]. This 'worst-case scenario' would mean less time for the government to negotiate the terms of the membership with EU institutions. The British people might, in the end, face a difficult choice between getting out of the EU or choosing a new arrangement on membership that they do not like. Hence, any dissatisfaction with the result of the negotiations with the EU would increase the risk of the country drifting towards an exit 'by accident'. Although we see this risk as remote, the uncertainty about the UK's future in the EU could negatively impact UK assets and capital flows.

In the event of an in/out referendum on EU membership, there is significantly more chance of 'in' than 'out'

The people's mood has changed significantly since David Cameron's announcement in January 2013. At present polls show that the British public are increasingly positive about staying in the Union. A YouGov survey reported an 8 point lead for those who want the UK to remain in the European Union, the largest lead recorded since the beginning of the survey in September 2010. 44% think they would be worse off economically if they left the EU, while 29% think they would be better off.

The ramifications of a 'Brixit' would be negative for both sides, politically and economically[4], given the strong integration between the UK and the EU. The EU is the UK's largest trading partner and the largest source of foreign direct investment. The loss of access to the single European market for goods and services would come with a significant economic cost for the UK. Commercial trade, capital flows, business investment would all be impacted by the uncertainty that would involve in terms of regulation (new agreements between European countries and the UK, probably on a bilateral basis, will have to be negotiated). Uncertainty about the long-term environment would be detrimental to foreign direct investment. Crucially for the financial sector, the position of the City of London as a key financial centre and as a point of entry to the EU single market would be affected. Politically, the UK would lose influence in the decision-making process in the EU and its bargaining power on the international scene would be weakened.

The EU is a significant source of investment



Source : ONS, Crédit Agricole S.A.

Fiscal consolidation: still a long way to go

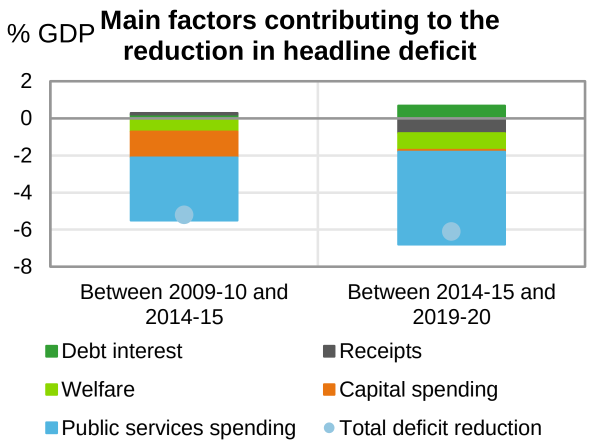
The realised deficit reduction has come mainly through cuts in public services spending

[3] David Cameron did not set a date for the referendum, saying that it would be held « within the first half of the next parliament », i.e. by end-2017.

[4] For an extensive discussion on the implications for Europe of UK's exit, please see our EcoFocus "What would a UK exit imply for Europe?".

According to forecasts by the Office for Budget Responsibility (OBR), between 2009-10 and 2019-20 the budget balance is expected to move from a post-war record deficit of 10.2% of GDP to a surplus of 1% of GDP – a turnaround of 11.2% of GDP. By 2014-15, around 46% of that planned reduction – 5.2% of GDP – will have been completed.

The following chart compares sources of deficit reduction during the first five years of the consolidation with those in the next five years, such as those implied by Government plans and the medium-term assumptions that underpin the OBR's forecasts.



Source : OBR, Crédit Agricole S.A.

The bulk of deficit reduction, between 2009-10 and 2014-15, has come from cuts in public services and administration spending (3.4% of GDP), with the cuts to-date concentrated on unprotected departments outside health, schools and overseas aid. The second largest contribution to the deficit reduction has come from cuts in welfare spending (0.7% of GDP) and capital spending (1.4% of GDP). Receipts have had almost a neutral impact on deficit as tax increases (notably the main rate of VAT) have more than offset tax cuts (notably corporation tax, fuel duty rates and increases in the income tax personal allowance).

The current coalition has a particularly ambitious plan in terms of cuts in spending

As outlined in the Autumn Statement in December 2014, the headline budget balance is expected to improve by 6% of GDP between 2014-15 and 2019-20, moving from a deficit of 5.0% of GDP to a surplus of 1% of GDP. Only a small part of this improvement (0.7% of GDP) is expected to be due to the economic cycle; the remaining 5.3% of GDP is implied by the coalition's plans. According to estimates by the IFS, **around two-thirds of this structural effort are expected to come through cuts in current spending (3.2% of GDP)**. In particular, according to the IFS, cuts to 'unprotected' departments (other than the NHS, schools and official development assistance) would average 26.3% of GDP between 2015-16 and 2019-20, which, if implemented, would represent a substantial effort. This would come on top of a cut of 19.9% in those departments between 2010-11 and 2015-16. Tax receipts are expected to contribute to only 0.2% of GDP for the structural effort, while the remaining fiscal consolidation effort is expected to come from cuts in benefits (0.6% of GDP).

Whether the current coalition would be able to implement such an ambitious plan in terms of spending cuts – the aim of the Conservatives is "to shrink the state's claim on national income to around 35%" – without raising concern over the long-term viability of public services is doubtful and has been one of the key reasons why the popularity of the Conservatives has not risen despite the strength of the recovery and the fall in the unemployment rate.

The parties' fiscal rules

Whichever party wins the election, the main challenge will be to implement additional fiscal tightening in order to reduce the still significant public deficit. None of the parties would be able to avoid austerity completely without threatening its public finances' targets.

Although the parties' manifestos have not been published yet, the three main UK political parties have already set out their fiscal objectives, including more or less specific targets for borrowing in the next parliament. Perhaps oddly, **the current government's policy (as set out in the 2014 Autumn Statement) implies a substantially tighter fiscal stance than is strictly required either by the government's own new fiscal aims** (see the box below) **or by any of the targets outlined by the three main UK parties**. Of the three main parties, the Conservatives have set out the tightest objective for medium-term fiscal policy.

The government's new fiscal mandate

On 15 December 2014 the current government set out a new fiscal mandate. The revised fiscal mandate is now a forward-looking aim to achieve a cyclically-adjusted current budget balance, ie, borrowing for non-investment spending, after adjusting for the economic cycle, by the end of the third year of the, rolling, five-year forecast period versus five years previously. The revised supplementary target is now an aim for public sector net debt as a share of national income to fall between 2015-16 and 2016-2017 versus between 2014-15 and 2015-16 as previously. Of course, the incoming government could choose to revise the existing targets, just as the current coalition government did when it took office in 2010.

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Tightest fiscal policy under the Conservatives

The Conservatives' pledge allows for some loosening in fiscal policy relative to the current coalition's plans, but it would nevertheless be consistent with tighter fiscal policy than either Labour or the Lib Dems. **The Conservatives have so far pledged that they will achieve an overall budget surplus in the next parliament**, provided the recovery is sustained. On the basis of the coalition's stated policies through to 2019-20, the latest OBR forecast (see table 1 in annex) suggests that the Conservatives' target to achieve an overall budget surplus would be met in 2018-19 and then the budget surplus would continue to strengthen with a forecast at 1.0% of GDP in 2019-20.This implies that the Conservatives' pledge to balance the budget in the next parliament (without specifying the exact timing) can be achieved with a looser fiscal policy than currently envisaged (GBP23.1bn of additional borrowing in 2019-20 than under the coalition's plans).

Labour's pledge allows for a substantial loosening of policy

Labour has pledged to achieve **a surplus on the current budget**, ie, borrowing for non-investment spending, and falling national debt in the next parliament. The party has been vague on the exact timing of achieving these objectives, but it seems that it agrees with three-year horizon on the budget target implied by the revised coalition's mandate.

Under the OBR's latest forecasts the current budget is forecast to be in surplus by GBP50bn in 2019-20, or **2.3% of GDP**. This suggests that Labour could run significantly looser fiscal policy than is implied by the coalition government and still meet their fiscal rules.

The Liberal Democrats' pledge quite similar to the current coalition's plans

The Liberal Democrats have expressed a budget target that is consistent with the government's new fiscal mandate. **They have pledged to balance the cyclically-adjusted current budget from 2017-18 onwards.** Depending on the definition they choose for investment spending, the Lib Dems might retain a more or less tighter fiscal policy, but in principle they could chose to run significantly looser fiscal policy than is implied by the coalition government's forecasts and still meet their fiscal rules.

The table 2 in annex summarises the potential outlook for borrowing in 2019-20 given alternative parties' fiscal rules and assuming that the parties choose to use all the leeway allowed by their fiscal rules without building any margin for error. The figures are also based on the key assumption that all the parties implement the investment spending plans of the current coalition, as outlined in the 2014 Autumn Statement (1.2% of GDP each year starting from 2017-18).

The fiscal rules suggested by Labour and the Liberal Democrats imply significantly less aggressive tightening than suggested by the current government policy. The chart on page 7 compares the implied tightening of the current coalition's plans with those of the three parties:

- ✓ Coalition: 5.3% of GDP;
- ✓ Conservatives: 4.3% of GDP (5.3% of GDP less the 1% of GDP of overall budget surplus for 2019-20);
- ✓ Labour and the LibDems: 3.0% of GDP (5.3% of GDP less the 2.3% of GDP current budget surplus currently forecast for 2019-20 under the coalition's plans).

All of the parties aim, explicitly or implicitly, to achieve a decrease in debt as a share of GDP in the next parliament without explicitly giving a precise target for the debt level. Obviously, different plans for borrowing imply different levels of debt. The less aggressive fiscal tightening under the Labour party means that government debt would remain higher for longer. For instance, according to estimates by the IFS, running a deficit of 1.2% of GDP per year over the decade from 2020-21, consistent with Labour's plans, would result in debt falling by 9% of GDP less than if the budget was balanced each year. Higher debt costs would have to be offset by more spending cuts or tax increases. Higher government debt would also mean that the UK would be more vulnerable to adverse shocks on growth or on interest rates. ■

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Table 1: Key forecasts for public finances

The OBR's central fiscal forecast (% GDP unless otherwise specified)

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Public sector net borrowing (£ bn)	97.5	91.3	75.9	40.9	14.5	-4	-23.1
Public sector net borrowing	5.6	5	4	2.1	0.7	-0.2	-1
Public sector net investment	1.5	1.5	1.4	1.3	1.2	1.2	1.2
Current budget deficit	4.2	3.5	2.6	0.8	-0.5	-1.4	-2.3
Cyclically-adjusted net borrowing	4.1	4.2	3.6	1.8	0.5	-0.3	-1.1
Primary balance	-3.8	-3.3	-2.2	-0.1	1.4	2.3	3.2
Cyclically-adjusted primary balance	-2.3	-2.6	-1.8	0.2	1.6	2.4	3.2
Fiscal mandate and supplementary target							
Cyclically-adjusted current budget deficit	2.6	2.7	2.2	0.5	-0.7	-1.5	-2.3
Public sector net debt	78.8	80.4	81.1	80.7	78.8	76.2	72.8

Source : Autumn Statement 2014

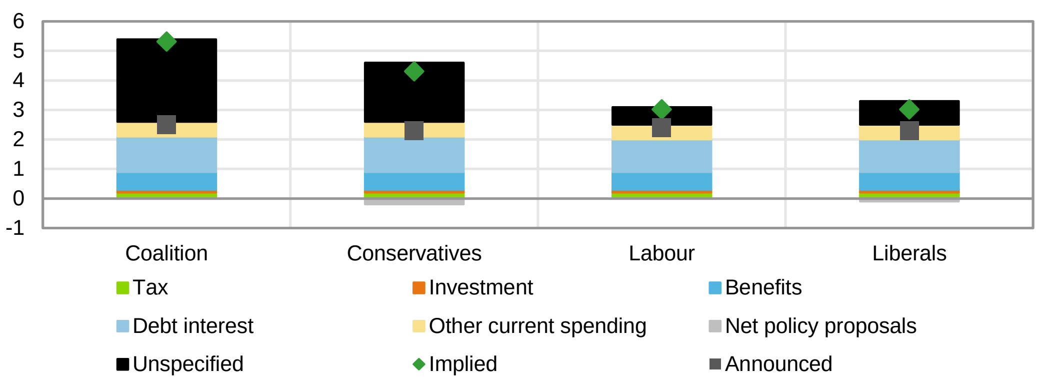
Table 2: Potential outlook for borrowing in 2019-20 given alternative parties' fiscal rules

	Fiscal rule	Borrowing in 2019-20		
		% of GDP	**£ bn, nominal**	**£bn, 2015-16 prices**
Coalition (OBR's forecasts from the Autumn statement)	Cyclically-adjusted current budget balance by the end of the third year of the rolling five-year forecast period (currently 2017-18)	-1	-23.1	-21.6
Conservatives	Budget surplus by end of next parliament	0	0	0
Labour	Current budget surplus by end of next parliament	1.2	26.9	25.1
Liberal Democrats	Cyclically-adjusted current balance from 2017-18	1.2	27.5	25.7

Source: IFS Election Briefing Note 2015, OBR's forecasts in the Autumn Statement 2014

Note: Borrowing in 2019–20 under the coalition plans is given by the OBR's forecasts in the Autumn Statement 2014. Borrowing in 2019–20 for each of the parties assumes that they achieve exactly a balance (rather than a surplus) on their chosen definition of borrowing in 2019–20. The Labour and Liberal Democrat figures assume that net investment in 2019–20 is 1.2% of national income (as was forecast by the OBR in its December 2014 Economic and Fiscal Outlook); the Liberal Democrat figure also assumes that there is £0.6 billion of cyclical borrowing in 2019–20 (again as was forecast by the OBR in its December 2014 Economic and Fiscal Outlook).

Implied and announced fiscal tightening by the three parties



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