Conservative party leadership elections: The battle to be the next PM

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Key points

- Liz Truss remains solidly ahead of Rishi Sunak in the polls and we expect a Truss victory
- The incoming Prime Minister however faces a myriad of challenges with the cost-of-living crisis top of the agenda. A more targeted response, which both candidates have yet to deliver, is required
- Truss's proposed tax cuts cost £40bn (1.7% of GDP) and are likely to require more public borrowing but public finances are set to remain constrained in the long term
- We see GDP being boosted by 0.4% and Consumer Price Index inflation by 0.3 percentage points higher under Truss and expect the Bank of England to deliver 25-50 basis points of tightening than otherwise would be the case.

Following months of controversy, Prime Minister (PM) Boris Johnson, was finally compelled in July to resign as Conservative Party leader. He will step down as PM once a new leader is elected. After initial votes by Conservative Members of Parliament (MPs), two candidates were left: the Foreign Secretary Liz Truss, and former Chancellor of the Exchequer, Rishi Sunak. Conservative party members – around 175,000 – will decide who of the two will be the next leader of the Conservative Party and PM, with results due on 5 September.

In this paper, we examine the candidates' proposals and examine the potential impact a Truss victory would have on the UK economy.

Truss the frontrunner

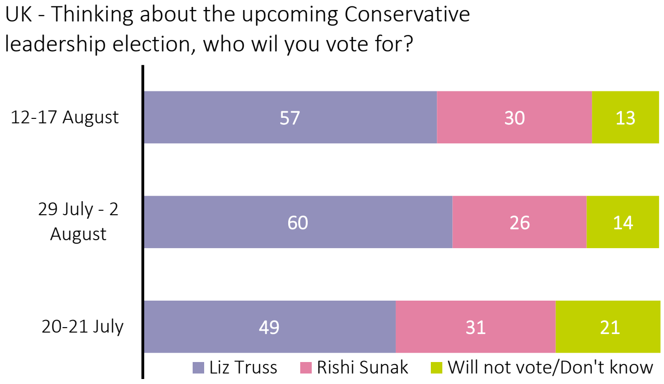
The momentum in this contest is solidly with Truss. Well before the leadership election Truss had been identified as a favourite of grassroots Conservative Party members, consistently topping monthly rankings of Cabinet MPs compiled by ConservativeHome.[1]

[1] Goodman, P. and Hill. H., "Our Cabinet League Table. Wallace top, Truss up, Mercer comes in third – and Dorries falls to last", Conservative Home, 1 August 2022

Despite this grassroots popularity, Truss' campaign started slow, trailing both Sunak and Penny Mordaunt in the first stage of the contest. However, since making the final membership ballot her support has swelled and a string of key endorsements by prominent Conservative MPs and donors has cemented her place as the frontrunner.

In contrast, of all the candidates, Sunak initially enjoyed the most support from MPs but he has struggled to translate this popularity to party members. This is likely reflecting, in part at least, the perception of disloyalty to Johnson as Sunak's resignation played a key role in his downfall – and Johnson remains a favourite of some party members.[2] Sunak's appeal has also likely been affected by controversies around his wife's non-domicile tax status, his perceived failure to provide adequate support for the cost-of-living crisis (having been a highly popular Chancellor as he provided support during the pandemic) as well as the high levels of taxation which persisted under his stewardship.

Exhibit 1: Polls suggest Truss will win comfortably



Source: YouGov and AXA IM Macro Research, 25 August 2022

All recent polling indicates that Truss holds a clear lead over Sunak (Exhibit 1) – although significant differences in the size of this lead have been reported by pollsters. Prior to shortlisting, Truss led Sunak by 18 points in a 21 July YouGov poll of Conservative Party members. The most recent YouGov poll conducted 12-17 August saw her lead extended to 27 points. Amongst those sampled, two-thirds had already cast their votes; Truss remained solidly in the lead amongst this group, with 68% voting for Truss and 31% for Sunak. However, there are considerable uncertainties around the scale of Truss' lead due to difficulties in accurately polling Conservative Party members, stemming from difficulties in using usual sample methods with the Tory party base which tends to be older. This leads to a higher error margin around poll estimates. However, given the scale of Truss's lead it would now be a surprise to see her not become the new Prime Minister.

The Winner's Curse

Whoever wins the leadership contest faces a huge task in leading the UK through a particularly difficult period. The new PM will face numerous challenges, these include:

- Leading the country through an historic cost-of-living crisis: Inflation currently stands at 10.1%, energy prices are set to rise by 80% to £3,564 in October and further in 2023 and we forecast inflation reaching 13% before year-end
- The Ukraine war – a situation which could deteriorate further if Russia cuts gas supplies to Europe this winter
- The spate of industrial action; transport strikes are having a major impact on economic activity
- The likelihood of the UK entering a recession in the fourth quarter (Q4)
- Post-pandemic stretched public finances. Key areas facing strong calls for additional expenditure include the National Health Service (NHS), education as the government has promised a "catch-up" from the last two-year's disruption and social care
- The economic realities of Brexit

In the light of these challenges, we look at the policies discussed by each candidate and the implications for the broader country and economy.

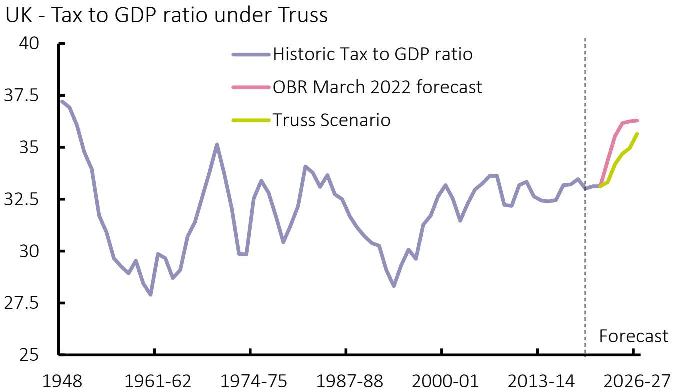
Tax cuts – when, not if

Taxation has been a key battleground. Both candidates have expressed preferences to see taxes reduced, but their respective proposals differ. Truss has touted tax cuts as a support to households through the cost-of-living crisis. She has proposed large cuts for both households and firms; reversing the recent National Insurance hike and reversing a planned increase to corporation tax remain her flagship policies. Truss' policies amount to around £40bn per year (1.7% of GDP). These policies would see the tax-to-GDP ratio continue to rise (Exhibit 2), but at a slower rate than forecast by the Office for Budget Responsibility (OBR) in March.

However, these proposals appear to be a long way from providing broad support through the current crisis. Truss's proposed cuts are set to benefit higher earners the most – those already best placed to weather the income shock from rising prices. Truss has also focused her campaign on a commitment to cut taxes "from day one".

[2] According to a YouGov poll, 53% of polled Conservative members think it was wrong to oust Boris Johnson (conducted 29 Jul – 2 Aug 2022)

Exhibit 2: Tax burden is still set to rise



Source: Office for Budget Responsibility and AXA IM Macro Research, 25 August 2022

Truss's proposed cuts include a commitment to reverse the recent increase in National Insurance, the Health and Social Care Levy, which was brought in to help fund increases in social care spending costing around £17bn. Truss also intends to scrap the planned increase in corporation tax to 25% from 19% coming into effect in April 2023. This is expected to reduce government revenues by over £10bn during 2023 and 2024 rising to over £15bn in subsequent years. She has also committed to removing 'green levies' – the range of environmental and social policy costs added to consumers' utility bills to fund required investments to help meet the UK's climate ambitions.[3] Removing these policy costs would reduce the energy price cap by £159 amounting to around £4bn. Truss has suggested she would use the additional headroom in the public finances identified in the March Budget to fund these cuts, but further borrowing will likely be needed to meet all of these commitments.

Sunak previously refused to commit to any immediate tax cuts. His position has shifted in an attempt to remain in the race, proposing a temporary removal of the 5% Value-Added Tax applied on energy bills – this policy alone will cost an estimated £5bn. He also plans to provide additional targeted income support, to pensioners and those on benefits, to provide additional cost-of-living support. With more grandeur, Sunak has also stated that should he become PM, the basic rate of income tax would fall to 16% by the end of the decade – a further three percentage point (ppt) cut on top of the one ppt cut (from 20% to 19%) already planned for 2024-2025. This is estimated to cost an additional £20bn.

Either way, the new PM will be required to provide additional support to households over the winter months. Most policies thus far do not match the scale of the rise in bills set to face households. Labour Leader Sir Keir Starmer has suggested that utility bills should be frozen for a year.[4] Scottish Power's chief executive Keith Anderson has presented plans to freeze energy bills for two years, estimating it would cost £100bn (4.3% of GDP). Both leadership candidates have ruled out taking this approach should they become PM, but further support will be a priority for whoever wins.

Can public finances sustain the splurge?

Truss has set out ambitious plans, but it is not obvious how these will be financed. The Spring Statement saw the public finances with £30bn headroom relative to the current fiscal target[5]. Since March's forecasts inflation has been higher than OBR estimates, with prices rising by 10.1% in July, well above the 7.7% expected. With prices higher and despite downward pressure on real growth rates, nominal GDP and government revenues are expected to be higher than forecast in March. However, at the same time higher interest rates and inflation will see public spending grow. Debt interest payments have risen sharply in the last few months (Exhibit 3) as index-linked gilts make up almost 25% of all UK government debt. Other payments linked to inflation such as benefits, and pensions are also set to rise sharply. The Institute for Fiscal Studies (IFS), a research body, has estimated that the current budget surplus will remain around £30bn in 2024-2025[6] – the year most relevant for the Government's fiscal rules. However, it also acknowledges that there is considerable uncertainty around these figures. In its recent Fiscal Risks publication[7], the OBR warned that public finances are on an unsustainable long-term path with public debt forecast to slowly balloon without tax rises, falls in spending or a combination of both. Unfunded tax cuts will only increase the long-term pressure on public finances.

Both candidates are likely on course to reduce the fiscal headroom to pay for tax cuts, increasing the risk that the latest set of targets will not be met. When faced with the reality of a weak growth outlook combined with higher interest rates and government borrowing costs, both may struggle to maintain their promised tax cuts.

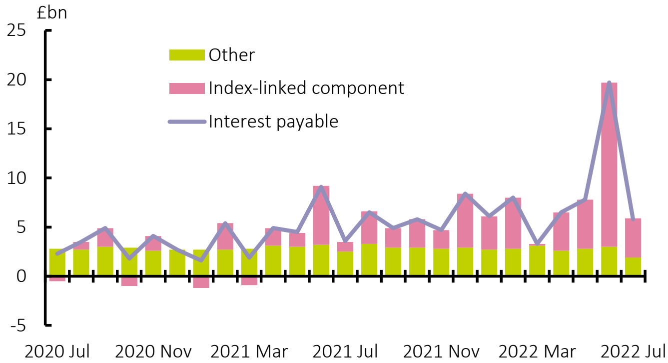
Alongside commitments to lower taxes, the new PM will have to deliver medium-term public spending plans. Departmental settlements were set out in the Autumn Budget in October 2021. The IFS estimates that higher inflation is set to wipe out 40%[8] of the planned real terms increases to departmental budgets. This is likely to be particularly stark for the NHS, which

[3] "Costs in your energy bill", Office of Gas and Electricity Markets (Ofgem)
[4] "Keir Starmer sets out Labour's plan to address the Tory cost of living crisis"– The Labour Party, 14 August 2022
[5] The key fiscal mandate was for public sector net debt (excluding the Bank of England) as a percentage of GDP to be falling by the third year of the OBR forecast
[6] Emmerson, C. and Stockton, I., "The outlook for the public finances under the Bank of England's August 2022 forecast", Institute For Fiscal Studies (IFS), 18 August 2022
[7] "Fiscal risks and sustainability", Office for Budget Responsibility, CP 702, July 2022
[8] Zaranko, B., "The inflation squeeze on public services", IFS, 10 Aug 2022

has already shown signs of strain in the usually quieter summer months. The PM will face a choice of whether or not to compensate departments by topping up spending plans for higher-than-expected inflation – adding to the rising public spending.

Exhibit 3: Rising inflation sees debt interest payments soar

UK central government interest cost



Source: Office for budget responsibility and AXA IM Macro Research, 25 August 2022

Brexit: The next chapter

The UK also faces a challenge around Brexit and the Northern Ireland (NI) Protocol. Prior to the leadership election in May, the Government – indeed Liz Truss herself - introduced the Northern Ireland Protocol Bill to the House of Commons. The Bill gives the Government powers to unilaterally change parts of the Northern Ireland Protocol, which was agreed alongside the Brexit withdrawal agreement with the European Union (EU) signed in January 2020.

Three months after Assembly elections in Northern Ireland, the Northern Ireland Executive remains in deadlock and has not functioned. Sinn Féin won the most votes in the May elections – the first time a nationalist party has been the largest party in Stormont. The Democratic Unionist Party (DUP) has since refused to allow a government to form and have signalled it will continue to block the formation of an Executive until the Northern Ireland Protocol Bill enters the statute books. The deadlock has left the NI government lacking clear leadership and unable to pass budgets in the region as it faces the squeeze of rising inflation on incomes. It could also force another election. The deadline to form an Executive can only be extended until 28 October 2022. At this point if an Executive still has not formed, the Secretary of State for Northern Ireland is obligated to schedule another election.

The DUP remains frustrated that under the terms agreed in the Protocol, Northern Ireland remains within the EU customs union but faces additional barriers to trading with the rest of the UK.[9] The DUP has remained vocal supporters of the Bill which purports to allow Northern Ireland to operate within the customs union, without incurring additional checks with the rest of the UK. Having passed initial stages in the House of Commons when Parliament returns from the summer recess, the Bill will continue its passage through the House of Lords. Both candidates have signalled they will continue to support the Bill's passage, which is set to face significant opposition in the House of Lords which will certainly delay its progress.

The EU has consistently made its opposition to this approach clear and has begun legal proceedings against the UK, taking steps to prevent the UK from accessing key science and research programmes such as Horizon Europe. If the Bill progresses and becomes law, the EU response is likely to escalate. We see the Bill as an attempt by the UK to force additional concessions from the EU and bring the DUP back into discussions. In our view, the Government hopes not to use the Bill should it become a law – but it risks being forced to, something which could trigger a trade war with the EU.

Despite campaigning for 'Remain' during the Brexit referendum, Liz Truss has become a Brexit hawk as well a key player in the Brexit negotiations and the introduction of the Northern Ireland Protocol Bill. Sunak, by contrast, has been seen as more pragmatic in working with the EU, despite initially campaigning for 'Leave'. During Sunak's time at the Treasury, he focused on aiming to reduce the potential economic costs of increased escalation between the UK and EU. In the Northern Ireland hustings on 17 August Sunak focused on continuing talks on the agreement, arguing that a negotiated settlement with Brussels would be 'far quicker'.

We continue to expect that there will be a negotiated agreement. The prospect of a trade war between the UK and the EU – the country's closest trading partner – would be a costly endeavour. Imposing additional costs on UK trade would add to inflationary pressure at a time where consumers already face price growth at 40-year highs. However, we consider such an outcome as more likely under a Truss, than Sunak, government.

BoE caught in the cross hairs

Speaking at a hustings in Cardiff on 3 August, Liz Truss confirmed her commitment to reviewing the Bank of England's (BoE) mandate. Since the BoE was granted operational independence in 1997, its mandate has been updated twice. The biggest change came in 2004 when the then Labour Chancellor Gordon Brown changed the mandate to a 2%

[9] This is precisely the solution devised by the Johnson government to address the conundrum of the 'open' border between the Republic and Northern Ireland consistent with the Good Friday Agreement.

Consumer Price Index (CPI) inflation target, replacing the previous 2.5% Retail Price Index target. In 2013, Chancellor George Osborne altered it again to allow the inflation target to deviate from 2% if the alternative threatened to trigger an economic downturn.

The idea of a central bank mandate review *per se* is not controversial. This happens regularly in many countries; with the US Federal Reserve and Eurozone's European Central Bank both recently having undertaken reviews. The Bank of Canada and the Government of Canada routinely review the mandate every five years.

However, concern has been raised by Truss's accompanying populist and naïve comments surrounding a BoE mandate review. Truss rightly identifies the BoE as the institution ultimately responsible for inflation in the UK but has failed to acknowledge significant external developments that have driven inflation higher and made only broad comments, justifying political criticism. Indeed, beyond some differences in the exact rate of inflation, inflation is at multi-decade highs in most advanced economies.

Truss had also suggested the Bank of Japan, which has spent decades grappling - largely unsuccessfully - below target inflation, could be a model for the BoE. The fact she has even suggested she would give ministers the power to overturn decisions made by the BoE, Prudential Regulation Authority and Financial Conduct Authority is a worrying development for institutional independence.

Truss has yet to provide additional detail on what a revised mandate could look like, but broader speculation has included alternative targets such as nominal GDP growth or money supply targets. We could also see an adjustment in the Bank's overall mandate to reduce the tolerance for deviations from target.

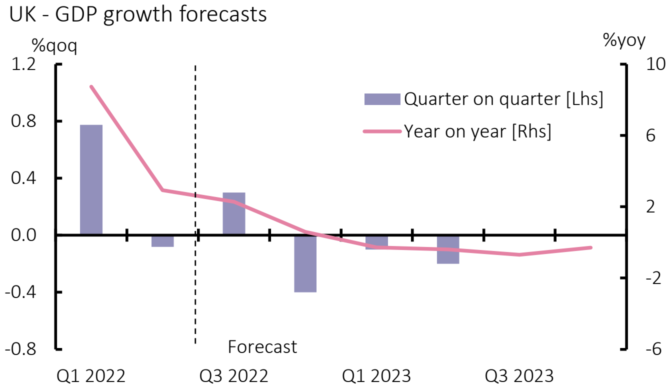
Sunak has made no suggestion of reviewing the BoE's operational mandate. If he did, financial market confidence would likely be higher as such a review would not lead to institutionally retrograde outcomes.

Any move which risks undermining the independence of the BoE and other regulators could risk financial stability and have a broader impact on financial markets confidence in UK institutions. Indeed, Sunak himself has warned that it would be "complacent and irresponsible" to ignore the risk of markets losing confidence. This could be particularly damaging at a time when government borrowing is already high and could directly increase the cost of government borrowing, adding to difficulties at a time when both candidates plan to fund large-scale tax cuts and will likely increase the size and scope of the costs of living support they offer.

Economic implications

We now expect UK growth to average 3.6% in 2022 and -0.4% in 2023, with the economy slipping into recession as rising prices weigh on real incomes. We pencil in three consecutive quarters of negative growth from Q4 2022 to Q2 2023. Rising pressure from gas prices and a pick-up in second-round effects are set to see CPI inflation rise further and we forecast an average 9.4% in 2022 and 9% in 2023.

Exhibit 4: GDP growth set to falter



Source: Office for budget responsibility and AXA IM Research, 25 August 2022

Liz Truss's proposed plans could see growth at around 0.4% higher than it would otherwise be in 2023 and raise CPI inflation by around 0.3ppt. These are included in our baseline outlook. The tax cuts both candidates have committed to in our view will not be enough to prevent the economy slipping into recession and are not targeted to support the most vulnerable. Given this, we expect candidates to do more to support households soon after taking office.

The significant fiscal easing touted by both candidates is likely to lead the BoE to hike interest rates further in its attempts to contain inflation. We include Truss's current policy plans in our assessment that the BoE will now tighten monetary policy to 2.5% by November. We expect the Monetary Policy Committee to hike rates by 50 basis points (bps) in September and 25bps in November. Further measures that have been suggested could follow the new Prime Minister may well require further monetary tightening from the BoE depending on their scale. We see a reduced risk of rate hikes being unwound in 2023 as previously considered.

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