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UK election result–Three key economic policy areas to watch

In the Loop
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Key Insights

- The Labour Party has won the UK election, returning to power for the first time since 2010.
- There is potential for key policy changes under a Labour government that could have knock-on implications for inflation and economic growth.
- The new government is expected to take a prudent approach to fiscal policy and push for reforms in the labour market.

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The victory of Sir Keir Starmer's Labour Party in the UK general election paves the way for policy changes with potential macroeconomic implications. Although some of these policies may keep inflation above target, other policy plans—especially on the supply side—could support UK economic growth over the medium term.

Below, we discuss the likely approach of the new Labour government to three key policy areas and the implications for the UK economy.

1. Fiscal policy—Prudent approach expected

The new government is expected to adhere to current fiscal rules, which stipulate that government debt should fall as a percentage of annual gross domestic product (GDP) in five years' time.

At present, UK debt to GDP is just under 100% of GDP. Fiscal headroom is limited, so it is unlikely that the new government will announce major spending increases or tax cuts. The first budget should come in the autumn, and a prudent approach is expected. Throughout the electoral campaign, Labour emphasised its commitment to fiscal responsibility in a bid to reassure investors that it will avoid a repeat of the chaos that engulfed UK government bonds when former Conservative Prime Minister Liz Truss announced unfunded tax cuts in September 2022. If there are spending shortfalls, the new government is likely to favour raising additional taxes rather than increasing borrowing.

2. Labour market reforms—Proceed with caution

The new government is likely to use labour market policies to reduce social inequality and may announce reforms quite soon. These may include raising the minimum wage and linking it to inflation so that employees receive a wage adjusted for the cost of living. Such measures should help those on the lowest incomes and reduce income inequality. However, the

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government will need to be cautious in designing the policy to ensure it does not exacerbate inflation pressure in the economy. Otherwise, interest rates may need to stay higher for longer.

The new government may also push for changes to zero-hour contracts and give employees greater rights from their first day of work. These measures are designed to provide fairer employment conditions across the board. The UK's labour market is currently quite flexible, particularly when compared with other European countries. This allows for a much faster adjustment to adverse shocks and a lower unemployment rate. These new policies will need to be designed to ensure that these important advantages of the UK labour market are not sacrificed. Communication during the election campaign suggests that the new government will be mindful of these factors, but we will only see whether these measures have an impact on labour market flexibility once they are introduced.

3. Supply side reforms—Difficult to implement, but economically rewarding if achieved

The new government will likely look to push through housing and planning reforms that, if radical enough, could raise the potential growth rate of the economy. This may be politically costly, but the long-term economic benefits for the UK could be significant. It remains to be seen, however, how quickly such a major change in planning reform could be implemented.

There is also the status of the UK's relationship with the European Union (EU) to consider. Although Labour will not seek to undo Brexit, it may seek closer ties with the EU to ease some of the current trade frictions with the 27-member bloc. As with housing reform, this would take a significant amount of time and would require extensive negotiations. However, if a closer UK-EU relationship is forged, it would probably raise the level of potential GDP and lead to a rebound in investment.

In summary, the new government is expected to take a prudent approach to fiscal policy—at least in the near term—which is encouraging and should help maintain market confidence. However, while there is some risk that new regulations could reduce labour market flexibility, supply side reforms could support the UK economy, which has been languishing behind peers since voting to leave the EU in 2016. Such progress would be welcome but may take time to achieve due to the complexities involved with implementation.

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