Inflation, recession fears and tax cuts: any new UK chancellor faces an unenviable in-tray

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The dramatic political events in Westminster have left Nadhim Zahawi currently holding the reins at the Treasury. But any honeymoon period for the new chancellor is likely to be short-lived. The UK's economic circumstances are dire – the worst in living memory (at least since the early 1970s).

Zahawi inherits an unenviable in-tray with a cost of living crisis(fuelled largely by high energy prices, Brexit disruption and ongoing supply chain bottlenecks), rising interest and mortgage rates, and the highest tax burden and public debt to GDP ratio in over 70 years. No wonder consumer confidence has plunged to record lows, raising fears the UK is already in recession. The UK is forecast to be the worst performing economy – bar sanctions-hit Russia – in the G20 next year.

Recent falls in the stock market and the value of sterling only add to the gloom, with the latter likely to stoke further inflationary pressures.

Also, the government's political gesturing with the EU over the Northern Ireland protocol could jeopardise the EU-UK trade and cooperation agreement. The UK's latest trade figures are the worst on record . So a new trade war with the country's biggest trading partner is the last thing British exporters need.

On top of all this, the UK's long-standing and perennial economic problems remain: low business investment, low productivity, impoverished public services and the widest regional inequalities among advanced economies.

Initial musings from the new chancellor are that he will seek to prioritise tax cuts for business and households to get the economy going again. This will be music to the ears of the Tory backbenches.

But any such tax cuts are likely to be small and largely ineffective. The UK's economic model is fundamentally broken. Addressing the scale and deep-rooted nature of the economy's problems will require a radical reset and a move away from the neoliberal model that has dominated policy since 1979. The new chancellor though is known to be a committed free marketeer and so, overall, economic policy is likely to be "more of the same".

Rishi Sunak resigned as UK chancellor on July 5 2022, citing Prime Minister Boris Johnson's leadership and differences of opinion with him on the economy. Andy Rain/EPA-EFE

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Rishi Sunak's resignation letter sums up the dilemma of all modern chancellors: people want a low-tax, high-growth economy and world-class public services.

In the current economic environment, however, state-provided services led by the NHS are pleading for more funds following a decade of cuts or unusually low spending rises in the wake of the 2008 global financial crisis. Defence is also demanding more money to confront new threats from the east.

The wider budget deficits that have appeared as a result, alongside unusually slow economic growth, have pushed public debt to record peacetime levels.

Conservative economists have traditionally argued that fiscal deficits raise inflation and undermine growth. So Sunak, even while continually restating his low-tax ambitions, used his two years as chancellor to raise the overall tax take. The prime minister's unease over this deficit-cutting strategy played a role in the chancellor's decision to quit, according to his resignation letter.

Former Education Secretary Nadhim Zahawi has replaced Rishi Sunak as UK chancellor after his resignation on July 5 2022. Neill Hall / EPA-EFE

Nadhim Zahawi arrives at Number 11 with a record similar to Sunak's. He views tax cuts as key to an economic revival. The idea here is that people and businesses work harder, invest more and innovate faster when government takes less of their income.

It worked – electorally if not economically – the last time the UK encountered stagflation (when high inflation meets low economic growth), propelling Margaret Thatcher to power on the promise of lower income tax. Zahawi can draw on supportive economists who blame the current high inflation on a wrong-footed Bank of England, and argue that debt is best curbed by making GDP grow faster. A tax cut might promote this, if it leaves cash-strapped households a bit more to spend.

The risk for the new chancellor, if he sticks to the low-tax mantra, is that budget deficits mainly drive up prices, as production hits new supply-side constraints. The government's borrowing costs could also rise more steeply as investors start to wonder how much more debt the UK can take on if it won't impose more taxes. And unless tax cuts quickly unleash faster growth – reversing the present slide towards recession – the loss of revenue might just make rising demands on the public sector even harder to fund.