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Some views on the economics of Brexit



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IPPI POLICY BRIEF

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1. Introduction

In this paper I attempt to bring together a selection of the economic issues that have emerged during the debate running up to the 23rd June EU referendum. This selection is by no means complete. Further I fully accept that there are a range of other, non-economic, issues which individuals may wish to take into account before they cast their vote. Nevertheless I do hope that this contribution on the economic front will provide some information and views of some value to those making up their minds on such a critical topic.

I wish to stress three points that I believe merit repetition at the outset of this IPPI Policy Brief.

1. First, in discussing the economic impact of possible Brexit nothing can be certain. We do not know what form exit would take or over what timetable, and we most certainly do not have any ideal model to examine the difference between in and out with any degree of precision. Educated guesswork is the best we can hope for. Further we have a better chance of being nearer correct in the short term; the uncertainties mount as we head to the longer term – but that longer term is what really matters.
2. I am upset by the spurious claims and unsubstantiated statements being made from both sides; but in particular by some of the (to be frank) arrant nonsense coming from the Vote Leave / exit campaign and its expectation of credibility. It seems wrong that the uttering of blatant untruths is accepted.²
3. But then as a child of March 1945 I am inherently pro-European from a political perspective. European co-operation of one type or another has been symptomatic of relative peace in Europe through my lifetime; and we should note that the only European, or indeed world, leader to come out in favour of Brexit has been Vladimir Putin. ³

¹ This IPPI Policy Brief has emerged from a talk that I gave on 8th June 2016 to a 'Devonshire House' dinner. However, the responsibility for the contents of the paper is entirely mine. Perhaps more than is usual, it is important to stress that the views expressed are mine in a personal capacity and not those of any organisation with which I happen to be involved.

² It was very brave of a Tory MP, Sarah Wollaston, to switch allegiance from exit to remain on the very day I gave the talk, and to do so because she saw the £350million per week figure of funding for the NHS (see below) as blatantly untrue.

³ Professor John Curtice tells me that Mr. Putin has not expressed this view. Other sources say that he has – but one should never really doubt Professor Curtice!

2. The short term

The first effect of a vote for Brexit would be increased **market turbulence and uncertainty**. We have seen in recent days that sterling has tended to fall, against dollar and euro, as the polls have edged towards an out vote. At the same time all measures of actual and expected volatility have also risen sharply – towards levels last seen around 2008.⁴

Forecasting **exchange rates** is a mug's game, as I discovered several times while Group Chief Economist at RBS, but the expectation has to be that an out vote would signal a decline in the value of sterling, at least initially. The probability is that this would also tend to be associated with the futures markets signaling expectations of higher interest rates – yield curves would probably shift upwards. Goodness knows by how much or for how long.

3. Macro-economic impacts

The Treasury modeled the **macro-economic** impact⁵ of 3 scenarios – where the UK joins the European Economic Area (EEA – along with Iceland, Norway and Lichtenstein; Switzerland has negotiated a bilateral treaty); where the UK negotiates bilateral agreements; and where the UK takes what the WTO delivers.

Their calculations have of course been seen as biased by out campaigners. I have not analysed their work in any detail and hence simply quote their results as one source of evidence. What the Treasury calculations suggest is that GDP would, after 15 years, be 3.8% lower under the first scenario and 6.2% and 7.5% respectively in scenarios 2 and 3. This amounts to GDP per household being lower by £2,600, £4,300 and £5,200 respectively.

Mark Carney has stated – and a Bank of England Governor usually weighs his words with care – that the risks of the UK leaving the EU “could possibly include a technical recession”.

Certainly one should expect the Monetary Policy Committee (MPC) to consider raising interest rates as volatility struck and sterling depreciated (raising inflation risks). But at the same time the MPC would be wary of tightening policy if there were risks of any sharp slowdown in growth. There would be major policy dilemmas on the monetary front as well as major uncertainties with regard to the state of the public finances and the outlook for sterling.

⁴ See Financial Times page 2, 7th June 2016.

⁵ See HMT April 2016.

4. The public finances

Turning to the **public finances**, it is here that the out campaigners have waxed most lyrical – and wrong. One pronouncement (from Michael Gove) that I particularly admired was the claim that if we left the EU then we would not be required to add indirect taxation to fuel duties and therefore all drivers could look forward to lower prices for petrol and diesel.

Of course we could cut fuel duties if we left the EU, but how then would the massive gap in the public finances be filled – what cuts would be made in public expenditure and what higher taxes elsewhere? Or would Mr. Gove simply let the deficit grow dramatically? And what would he do about our climate change obligations? Simply ignore the sharp rise in emission levels as petrol and diesel consumption rocketed?

The more regular claim is that anointed on the Vote Leave battle bus - that being in the EU costs the UK £350m per week; money which if we left could be spent on the NHS.

£350m per week amounts to some £18bn pa. This is about the amount that the UK would, in principle, be paying per year over the coming years. But this is by no means the end of the story – as even those on the Vote Leave battle bus must know.

Some one quarter of that amount is never paid over to Brussels⁶; that is Maggie T's rebate still at work. Further, some £5billion comes back to the UK via the Common Agricultural Policy (CAP), structural funds and research funding etc. The net UK contribution is some £150million per week or £8billion pa in total.

And it cannot even be claimed that we could have this £8billion to spend on the NHS – desirable as that would be. The IFS has agreed that leaving the EU would free up £8billion – in the sense that it would not be paid to Brussels. That point was seized upon by Mr. Gove - and then abused. The IFS – who I trust and respect as objective and informed – went on the state that:

“... even a small negative effect of just 0.6% on national income from leaving the EU would damage the public finances by more than that £8billion. There is virtual unanimity among forecasters that the negative economic effect of leaving the EU would be greater than that.”⁷

So Brexit would “leave us spending less on public services, or taxing more, or borrowing more.”⁸

⁶ In response to Sarah Wollaston John Redwood stated that £350million was the gross figure. That all depends upon definition. I would rather see 'gross' as defining the amount actually paid over to Brussels, i.e. £350 million *less* the Thatcher rebate.

⁷ And compare this figure with the HMT figures cited above.

⁸ As quoted in Financial Times, 7th June 2016

There is another wrinkle to this argument. If we exit then I believe that all are agreed that we will need some deal to maintain access to the European single market. One route is via the EEA. Members of this organisation have to adopt some EU laws *and* contribute financially to the cost of the single market. And no funding comes back to them. Their gross spend equates to their net spend and in the case of Norway this amounted to £106 per head in 2011. This is to be compared with the UK's net £150 per head p.a. – and for Scotland £64 per head p.a., as we gain far more from CAP, structural funds and research awards than does the UK as a whole. So Norway spends *more* than Scotland and nearly *as much* as the UK to be outwith the EU, but inside the single market.⁹ I would further note (see below regarding non-tariff barriers) that this spend by Norway achieves a far less satisfactory deal on access to the market than the UK has as an EU member state.

In sum the £350million per week is fraudulent because: -

1. It does not allow for the Thatcher rebate
2. It does not allow for the EU funds received back by UK
3. It does not allow for losses on the public finances as a result of UK leaving; and
4. It does not allow for the costs of EEA entry or any other means of the UK subsequently accessing the single market.

5. Three areas of Scottish interest

Let me turn to three areas of specific interest to Scotland. First **trade**, where the key markets for us are the rest of the UK and the EU.

Out campaigners blithely assume that not only can we readily re-claim the unfettered access to the single market but that as a lone agent – and member of the WTO in our own right – we can expect to negotiate far better deals than does the EU with third countries such as the USA, China, India, Brazil and Japan.

Let us first note that the USA, Japan, China, India, et. al. all want the UK to stay in – all bar Mr. Putin¹⁰. I have already noted that there is a route to the single market via the European Economic Area or bilateral negotiations, as in the case of Switzerland. But (a) this is not free in terms of money or wider obligations and (b) we would not start on the best of terms with the remaining member states. Out campaigners will tell you that the EU exports more to us than we export to them. Correct; but that does not mean that they would be gagging for a trade deal with the UK. We export far more to the EU than any single member state exports to us. From

⁹ See Professor David Bell's Chapter 3 in 'Britain's Decision; Facts and Impartial Analysis for the UK Referendum on 23 June 2016.', published by the David Hume Institute, the Centre for Constitutional Change and the Hunter Foundation.

¹⁰ Noting again that Prof. Curtice could be correct.

the perspective of each remaining EU member state, negotiating a UK deal would be far less important than it would be to us.

Indeed the UK is no longer the huge economy to which all states in the world would give priority to on the treaty negotiation front.

President Obama and George Osborne have told us that for a USA deal ‘the UK would have to go to the back of the queue [or line, if you prefer].’ Dieter Helm, another worthy of some respect, has stated¹¹ that ‘the reality is that the US and other trade deals will take at least a decade to agree’. David Eiser – now of the Fraser of Allander Institute at the University of Strathclyde - in a David Hume Institute (DHI) publication¹² I commend to you, has confirmed that ‘there are few examples of countries making bilateral trade deals of anything like the scope that EU member states share’.

So on trade we would face at the very least an extended period of uncertainty and in all probability an expensive deal with the EU – in the fullness of time; and less than ideal treaties with other emerging and emerged states – again when they saw fit. One final thought on this topic; LSE researchers¹³ have concluded that even when countries have comprehensive deals as provided by EEA membership, their trade with the EU is still less than it would be under full EU membership – not least because of higher non-tariff barriers which weigh particularly heavily upon service sector trade, including and perhaps especially financial services.

Next I turn to a brief word on **inward investment**. The UK has been the largest recipient of Foreign Direct Investment (FDI) since 1993; and Scotland has been the most successful region of the UK outwith London.

These investors come to Scotland and the UK for a variety of reasons. They are often keen on access to the EU market – which would be in doubt. [72% of investors in EY’s 2015 ‘UK attractiveness’ survey consider access to the EU’s single market as important to the UK’s attractiveness as a destination for FDI.] They approve of the ready availability of many types of skilled labour – which could be at risk where EU nationals are concerned.

There are of course a number of other powerful reasons for actual and potential foreign investors valuing a UK base; reasons which should not be exposed to risk by Brexit. Overall, however, I simply cannot accept that the UK leaving the EU, with all the uncertainties that would impose, could do anything but seriously hamper our ability to attract further FDI. Indeed my

¹¹ Dieter Helm ‘24th June – the day after the referendum on UK membership’ 11th May 2016; available at www.dieterhel.co.uk/publications.

¹² Britain’s Decision, op. cit.

¹³ As quoted by David Comerford in chapter 15 of Britain’s Decision op. cit.

expectation would be that the owners of some existing FDI operations would at least consider whether a move away from the UK would make sense following Brexit. Some hints have already been dropped to this effect.

Finally a word on **financial services** – and here I am grateful to Owen Kelly, former CEO of Scottish Financial Enterprise (SFE), for his chapter in the DHI book¹⁴.

As Owen notes, a key issue for this sector – which despite the decline of RBS and HBOS still matters so much for Scotland – is that of '*passporting rights*'. These allow a provider of financial services to operate throughout the EU from a single base. Again it is not only EU member states that have these rights. Some states have negotiated for the rights, in full or in part, at a cost and subject to further conditions, as has Switzerland on a bilateral basis. So again there would be major uncertainties and again there would be real and longer-term risks.

To cite Owen Kelly further: "The UK financial services sector benefits disproportionately from the trade deals negotiated by the EU as it is larger than that of any other EU state. Without EU clout, the UK could not get the same preferential terms. The US has already said as much.'

In sum, says Owen, "leaving the UK would be costly, disruptive and damaging."

6. Conclusions

I think that by now you will know where I am coming from! But allow me to conclude.

1. First, the only certainty is much heightened uncertainty. This applies to the economic outlook and so much more. Staying in the EU raises uncertainties – what will happen to the Eurozone as the stresses and strains continue? Will the UK be able to maintain its semi-detached position? However exiting would raise even more. We would live in an increasingly uncertain world.
2. Second, it is by no means implausible that the UK could flourish outwith the EU. Maybe in a less regulated State, the UK's 'animal spirits' would be unleashed, entrepreneurialism would be rife, our competitiveness would be enhanced and over time we would become the Singapore of Europe.
3. But third, all the logical and considered arguments to me point to the benefit of staying rather than leaving. Please cast a skeptical eye over everything said on this complex topic. But I suggest a far more critical eye on Messrs. Gove, Farage, Duncan Smith and Johnson than on the President of the US, the Heads of the WTO and OECD and even the Governor of the Bank of England.

¹⁴ Chapter 11 of Britain's Decision op cit.

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He has a distinguished career as an economist and economic commentator and was Group Chief Economist at the Royal Bank of Scotland (1993-2005). He is currently is a member of the Board of Scottish Enterprise and Chair of the Royal Zoological Society of Scotland and was a long-standing Director of the David Hume Institute (2004-14). He is a fellow of the Royal Society of Edinburgh, of the Chartered Institute of Bankers and the Royal Society of Arts.

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