**REFLECTIONS ON BREXIT AND ITS IMPLICATIONS FOR ECONOMIC POLICY**

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Leaving the European Union represents the biggest change in Britain’s role in the world in sixty years. And it is going to happen in 501 days' time.

Tonight, I want to set out what this will mean for the economy and for economic policy and what government should be seeking to do now to minimise the risks and maximise the opportunities.

I do not want to rerun the arguments of the 2016 referendum. The decision has been taken.

But it is one thing to decide to leave the European Union. It is another to determine the destination: the final resting point outside the EU.

Political campaigning is all about “difference”. The advocates of BREXIT could paint an attractive picture where we got “our country back”. Our borders would be controlled. More money would be available for the NHS. And judges in London and Edinburgh would be the ultimate arbiter of the law rather than the court in Luxembourg.

But the one thing I learnt from 30 years of working in the Treasury was that the prose of governing is rather more heavy-going than the poetry of the campaign trail.

As a medium sized and very open economy, the UK cannot opt out of the international economic system. Any deal will involve a considerable amount of compromise. Having seen at first hand how the British government engaged with Iceland and Ireland during the financial crisis, I am all too aware that larger entities tend to get the better of smaller entities. In this respect, at least, Thrasymachus’ claim in book 1 of Plato’s Republic still resonates: might is right. Whether our politicians have prepared us for the likely end game, I shall leave to others to judge.

It is easy to criticise the Government for triggering Article 50 before it had forged a national consensus on Britain’s future relationship with the EU and others. And people I meet from mainland Europe tend to be puzzled that 16 months on from the referendum the Prime Minister seems to spend rather more time negotiating with her Cabinet colleagues than with the European Council.

Predicting the final outcome on BREXIT is a mug’s game. But it is a game which businesses who either trade regularly with the EU or who employ EU labour are already having to play, like it or not.

First, there is the possibility beloved by Mr Redwood and others of refusing to do a deal. Instead, we would simply leave the EU no later than the expiry of the two year deadline provided for in Article 50. We would not pay the EU a penny. And we would rely on World Trade Organisation terms to look after our interests. There is superficial attraction in this. For many goods, WTO terms do not involve particularly high tariffs, though for others, in particular agriculture, they do. But tariffs are the easy part. It is the issue of standards which is more difficult. It will not be enough for British exporters to assert their goods conform with the relevant standards; the EU will need to recognise that conformity. And that will require a plethora of mutual recognition agreements of the sort the EU has with the United States. The WTO is also notoriously quiet on services, which account for the vast majority of the UK’s GDP. And of course if the EU feels that the UK has reneged on paying its dues, it is unlikely to make trading with it easy.

The fact is the WTO provides no more than a platform on which states build bilateral and multilateral agreement to provide for better market access. WTO terms on their own are distinctly uninviting, which is why so many countries try to avoid. It is no coincidence that the countries with whom the EU trades on WTO terms are few and far between: Yemen and Venezuala come to mind.

Here advocates of “no deal” argue that the UK has a big deficit in trade in goods with the EU. And so German car manufacturers among others will force their governments to come crawling back to the negotiating table. This may happen. But I fear that it won’t. The fact is the UK’s exports to the EU account for 13 per cent of GDP while the EU’s exports to the UK account for just 3 per cent of GDP. We simply aren’t important enough.

I’m a rationalist. And, for that reason, I still think that the balance of probability still points to a negotiated deal leading to a hard BREXIT, by which I mean the UK will leave the Customs' Union and the Single Market. That is, after all, the stated policy of the Government. And although the main opposition party is rather more emollient, it has yet to commit to a different course.

In EU argot, the UK will become a third country, necessitating border checks of some sort both at Calais and closer to home on the border between Northern Ireland and the Republic. Under this scenario, the only question is when the hard border comes into effect. Will there be a transition, and if so how long will it last?

In principle, a transition could last a long time. Its legal base will be tricky. The easiest base would be to extend the Article 50 period beyond two years and effectively stay in the EU. But that is likely to be seen as betrayal by supporters of BREXIT. The alternative which no doubt the Government will seek to pursue in the months ahead is some sort of after life in the single market and customs union after we have left the EU. I am told this presents a number of obstacles, in particular in relation to trade with other countries outside the EU. And of course the agreement would have to be ratified by all 27 Member States.

But let’s assume the Government gets what it wants, which is an ambitious Free Trade Agreement with the EU, something along the lines of the EU’s free trade deal with Canada. That will certainly put the UK in a better position than the no deal WTO scenario. The Canada model provides some provision for services, though it would leave asset managers and banks well short of the access they get under the Single Market. And it will leave a border of varying hardness with the EU: even Norway which is a member of the European Economic Area, which we won’t be, is subject to rules of origin.

Against that, we will be able to negotiate our own trade deals, the reason why the Government is so keen to leave the Customs Union. I am quite certain that some of these deals will be better than the status quo. Others will be harder going, in particular with the United States which tends to see trade policy as an instrument of US hegemony.

However, there is a reason why so much of our trade is with the EU: proximity. Modern supply chains tend to be regionalised, enabling “just in time” delivery and low inventories. And trade with the rest of the world tends to start from a low base. For example, last year, the UK exported as much in goods to Ireland, as it did to Japan, South Korea, Australia and India put together. And the previous year, the UK exported more than three times as much in services to Ireland as we did to China.

My guess is that some time around 2030, the UK will find a new equilibrium. It will be outside the European Union. But it will not be very different from where we are now. We were never properly in the European Union: we weren’t in the single currency nor in the Schengen area. We have opted out of both rights and responsibilities.

But the intervening period will be one of uncertainty and disruption. The British economy will continue to grow. It generally does. But it will grow more slowly.

I have never been one of those who think the British economy will fall off a cliff as a result of BREXIT though if the Government plays its cards badly there could be the odd shock along the way, with air traffic grounded and lorries backing up from Dover around the M25. More likely, the economy will grow just a little slower, driven partly by lower immigration but mainly by lower productivity and living standards. We may already be seeing this with investment growing slowly if at all. Swati Dinghra and others at the Centre for Economic Performance at the LSE have estimated the long term cost of BREXIT at 6.3 to 9.4 per cent of GDP once the dynamic consequences for trade, FDI and productivity are taken into account. The Treasury estimated the cost in 2016 at 6.2 per cent assuming a negotiated trade agreement.

I see no reason to think these estimates as exaggerated, and would expect them to play out in living standards rising by ¼ to ½ per cent less a year than they otherwise would have done over the next decade or two. The impact will be barely perceptible year by year.

But the cumulative effect will be considerable, as will the opportunity cost in terms of revenue foregone. The upper end of the LSE estimate would leave revenues £70 billion a year lower. But let’s be optimistic and assume fashionably that the experts have got it wrong. Let’s suppose there is a relatively small transition impact on national income of just ¼ per cent a year for twelve years; that would still leave revenues £20 billion lower a year in perpetuity. That is one reason, in my view, why it would be good economics for the British Government to put more money on the table now as a one-off payment to secure a better trade deal with the EU, the better to improve incomes and revenues year after year in the decades ahead.

It is just about conceivable that as the consequences of BREXIT become clear, the British people will turn against it and the Government will put a stop to it. As Lord Kerr pointed out last week, “we can change our minds at any stage during the [Article 50] process”. But the solidity of the Tory-DUP alliance makes this implausible. Far more likely, the consequences will become clear only when we have left the EU. And then it will be too late. As Lord Kerr also pointed out, once a country is out: return will be difficult and there will be a price to pay.

And so, like it or not, we need to face up to life outside.

The question which I will now turn to is what is the right economic policy response for the times ahead.

First, in my view, the Government needs to accept that macroeconomic policy is likely to have little impact on growth. The Bank of England will need to set monetary policy to achieve the inflation target. It raised interest rates ten days ago for the first time in a decade, rightly in my view. It was reasonable to loosen policy in the light of the referendum result, and the fall in sterling has helped ensure Britain has remained competitive at a time when the Eurozone economy had been growing rapidly. However, we are currently at full employment and it is important that the markets don’t get the impression that the authorities will always let sterling take the strain. That is the road to inflationary ruin. Quantitative easing provides a large overhang of loose policy which has inflated asset prices. The Bank understandably makes a fetish of precision, and has been studiously reinvesting the proceeds of gilts which have matured. But I am encouraged by recent remarks which suggest that the Bank may end this practice sooner rather than later.

At a time of political uncertainty and weak government, it is particularly important that our independent economic institutions provide a policy lead. I am optimistic that the Bank will demonstrate its commitment to sound money.

For all the talk of policy tightness, the same cannot be said for fiscal policy. Since the Election, the Government has shown itself remarkably reluctant to take tough decisions on how new spending commitments will be paid for. The Conservative Party dropped a number of sensible ideas to rein in public spending in pursuing its alliance with the Democratic Unionist Party. Perhaps, most important of all was its dropping of its electoral promise to end the triple lock, one of the greatest source of pressure on the public finances and the biggest contributor to intergenerational inequality. Since the election, the Government has made a number of new spending commitments, for example on housing and BREXIT planning. It has not made clear how these spending commitments will be paid for.

Mr Hammond may put this right in his Budget in ten days’ time. But since he found it impossible to enact a perfectly sensible proposal to reduce the national insurance subsidy to the self-employed when he had a majority in Parliament, I am not optimistic

In the short run, revenues have held up reasonably well, helped by debt financed consumption and good export sales to Europe. But with real wages falling, it seems unlikely that revenues will hold up indefinitely.

And so there will be no alternative to bring public spending growth more into line with growth in the economy.

Debt has been rising as a percentage of national income for fifteen years. This year it is likely to reach 88 per cent of GDP. There is nothing magic about debt dynamics. But once debt reaches this sort of level, the public finances become increasingly vulnerable to an increase in the interest rate at which the Government borrows. So far that rate has been flattered by quantitative easing and the glut of global savings. With Britain leaving the European Union, the markets are likely to pay greater attention to whether the Government has a credible economic policy. And now that the Bank of England is independent, we can no longer rely on inflation to wipe out the debt as it did in the 1970s and 1980s.

For all the talk of austerity, it is worrying that eight years into an economic recovery debt is still rising, and that we are running one of the loosest fiscal policies in Europe.

But there are two wider problems about the current approach to the public finances.

First, there is too much consumption and not enough investment. And with demographic pressures likely to increase over the coming decade, on pensions, the NHS and long-term care, there will be further pressure to spend more on consumption.

Secondly, much of the fiscal retrenchment has been at the expense of the young, who will not only receive smaller occupational pensions but are expected to pay higher taxes to pay for the pensions of the current retired generation. This is particularly unfair given that poverty is now more prevalent among the working age population than among pensioners. It was striking that the one policy proposal in the main parties’ manifestos designed to address intergenerational inequality was rapidly dropped when it came under pressure in last year’s election. But at some point some party is going to have to address the issue. And perhaps with young people voting in much greater numbers at the last election, the pendulum will begin to swing in their favour.

In the end, the only thing which can offset the likely reduction in growth which will result from BREXIT is supply side policy. This is going to be more important than ever in the years ahead. But it is an area where successive Governments have been better at talking – rarely a year goes by without a new growth or industrial strategy – than delivering.

There is no magic answer to increasing productive potential. Rather it requires persistence, consistency, consensus and hard work. Moreover, since many of the supply side instruments available are devolved, there is scope for the different countries of the United Kingdom to adopt different policies and priorities, and provide evidence of what works and what doesn’t.

A good place to start is public investment. As I said earlier, I would like to see more investment by the public sector and less consumption. But the quality of that investment is of critical importance. The Treasury has had some success in recent years in ranking potential investment projects by their economic return. But all too often investment decisions hinge on prestige and presentation: it is easier to paint exciting pictures of high speed trains or even a garden bridge than a more prosaic road by-pass. But often it is the by-pass which has the highest economic return. Investment decisions need to be made in a long term context and should complement and reinforce each other. The setting up of the Infrastructure Commission in Whitehall is in my view already making for better decision making.

Historically, the cost of building a mile of road in the UK has been higher than in mainland Europe. That needs to change. Some of this is about the planning regime. And the planning regime has also militated against housebuilding. Again, there have been some moves towards a more supply side friendly approach to planning in recent years. But there is more to do. The cost of housing is one of the greatest obstacles to growth in the UK. And that is as true in Edinburgh as it is in London. And as relevant to growth in the Isle of Skye as it is in the Isle of Wight.

The Westminster government has released more resources for housebuilding recently. But the number of houses this will finance is pitifully small. The public sector and local authorities in particular need to take the strain. Last year 170,000 housing units were built across the UK. It may be unrealistic to return to the Wilson era when in 1968 as many as 428,000 houses were built across the UK. To return to the 220,000 a year average of the Thatcher era would be a start, though still not enough to address the growth in household formation.

And if the housing market is going to perform better, it is not just enough to improve the supply side. We need to improve the demand side too. Transactions taxes, like stamp duty and the land and building transaction tax, are about the least efficient way of raising revenue that can be imagined. I was not remotely surprised when revenues from Stamp Duty on properties over £1million fell in England, Wales and Northern Ireland last year. Holyrood and Westminster should follow the Irish example and reduce tax rates on buying a house, and replace the shortfall with an annual property tax based on values. This would encourage a more efficient use of the housing stock.

But alongside more investment (and lower public consumption), we need to see a step change in skills. This is partly about the education system: literacy and numeracy across the countries of the UK tends to lag our competitors. But it is also about technical education, and the support provided by government and employers to develop the skills of those who don’t go to university. This is going to be particularly important if the UK government succeeds in its objective of reducing migration from central and eastern Europe, which has been critical to Britain’s economic performance since the turn of the century.

Successive governments both in London and Edinburgh have announced “radical reforms” to the skills system. Sadly, over a hundred year period, these changes have made little difference. More than any other area, this is one which requires persistence and consensus building, rather than rearranging the deck chairs every few years. The skill system needs to be more demand led, with employers more actively involved as in continental Europe. Decisions need to be devolved to a local level rather than imposed from London or Edinburgh. Sadly, when it comes to skills, our political class don’t show much staying power. Nor does our media. As Tony Blair used to say, if you want to keep something secret, announce something in a debate on skills and training in the House of Commons.

But even if a sustained improvement in skills can be achieved, the lead times are likely to necessitate a relatively open approach to migration for some time to come. This is particularly true of the science and technology sectors where historically the UK has had a comparative advantage. Leaving the EU will result in a reduction in funding for science. It will be important that the British taxpayer not only makes up the difference but that the Government prioritises expenditure on science and innovation. This is not about backing winners. But it is about ensuring that British Universities maintain a cutting-edge research base the better to enable the commercial development of ideas.

Securing higher growth in productivity will also require a ruthless approach to competition. When I joined the Treasury in the early 1980s, Government was still wasting large sums of money on supporting low productivity champions like British Leyland; or unsuccessful inward investors like de Lorean. I don’t think anybody is proposing to return to the industrial intervention of those days. But government needs to ensure a complete level playing field between challengers and incumbents, not least to protect the interests of the consumer. As an official, I always found the EU state aid rules hugely helpful in seeing off wasteful ideas: I hope the Government will seek to embed some equivalent of the state aid rules in domestic legislation.

And if we are to raise the UK’s growth rate it will be important to ensure that the tax regime remains competitive. Leaving the European Union will mean that companies will no longer see the UK as a market friendly gateway to one of the biggest markets in the world. That means the tax regime for capital and labour will become more important in investment decisions. Governments have prioritised reductions in the main corporation tax rate which has fallen from 33 per cent in 1997 to 19 per cent this year and is set to fall to 17 per cent in 2020. It may be necessary to go further. Equally, it will be important to ensure that marginal income tax rates remain competitive. There are indications that the French are wanting to create a more competitive tax regime. If Edinburgh, Glasgow and London are going to remain competitive with Paris, our Governments cannot afford to increase the tax burden further; if anything the contrary. That does not mean Britain has to turn into Singapore. The revealed preference of the British people is that they want European levels of public services. But it does mean that we need political leadership on the trade offs and choices facing the electorate.

I would like to finish with some observations on BREXIT’s implications for Scotland. Clearly, there are specific issues around agriculture, forestry and fisheries which I hope can be resolved satisfactorily. Ideally, Scotland would be able to determine its own approach to migration since demographic pressures are very different from those in England, dominated as it is by the south east. But despite efforts by the Scottish Government to get a special deal for this country, it seems inevitable that Scotland will be leaving the EU on the same basis as England and Wales. On the plus side, Scotland has many of the tools at its disposal to improve the supply side which are available to Westminster. It too has the choice to invest more and consume less, to improve education and skills and so on.

I haven’t detected much enthusiasm of late for another referendum in Scotland. And I don’t feel qualified to opine about the merits of independence. Suffice it to say, if it does happen, Scotland will have to consider whether or not to rejoin the EU and on what terms. If it were to rejoin, I would expect the border between the Republic and Northern Ireland to provide a template for the Scotland-England border. I would be surprised if it were frictionless; against that, Scotland would be able to trade freely by sea with 27 EU member states.

It will also be necessary to consider what an optimal economic policy would be for an independent Scotland. This is, of course, all hypothetical. However, as I have said before, recent events provide a golden opportunity for proponents of independence to reappraise their economic prospectus. First, on the currency, I strongly believe that monetary union with the rest of the United Kingdom would not be in Scotland’s interests. And in any case I can’t see the UK government agreeing to it in the future having ruled it out so conclusively in 2014. And so I see no alternative at least in the early years of hypothetical independence to Scotland maintaining its own currency and allowing it to float freely against Sterling and the Euro. That way the Scottish pound could find the right level, which would be determined at least in part by where the world is in the oil price cycle.

Small countries can be very successful. Ireland is proof of that. But to realise those potential benefits, economic policy has to be credible. I would advise any Scottish government to aim broadly to balance the budget. At present, without support from Westminster, Scotland would be running a large deficit. If the proponents of independence want to increase their economic credibility, now is the time to start setting out how that deficit could be closed. And it will also be important to consider how best to establish a competitive and efficient corporate and personal tax regime, the better to attract capital and skills.

I am in no doubt that leaving the European Union will create challenges for all the countries of the UK. We need to face up to its inevitability. And we need to accept it will impact on trade and living standards. But if the government in London and indeed in Edinburgh can put in place the right economic policies and stick to them, not just for a year but for a decade or two, it should be possible to limit any permanent damage. Indeed, if BREXIT results in better economic polticymaking, there may yet be a silver lining.