From Project Fear to Project Prosperity

An Introduction

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In March 2016, Economists for Brexit was formed to present what we saw as the economics of the EU, our membership of it and the economics of leaving. At the time, the referendum was raging and soon Project Fear would be launched by the Treasury, with its warnings of economic doom if we chose Brexit. On the Leave side, not much at all was said about the economics and the only response to Project Fear was to damn 'experts'.

We felt then that - instead of economics - we were witnessing propaganda with little or no economics behind it. We hoped to present economic analysis in a form that would readily be understood by non-economists and would place all this propaganda into context.

We are now almost a year and a half further on; Brexit won in the referendum and following a long period of policy development by the May government towards what we felt was the right strategy of free trade outside the Single Market and the Customs Union, we had the snap election. In this election, Mrs May lost her absolute majority but the Commons amendments calling for the UK to stay in the Customs Union and the Single Market were resoundingly defeated. So the UK is embarking on negotiations with a determined stance.

In this Introduction to our forthcoming report, *From Project Fear to Project Prosperity*, Economists for Free Trade - as we are now renamed - is setting out the key arguments for free trade, properly understood as global free trade and not simply free trade with the rest of the EU.

The Fallacy of 'Soft' Brexit

We have noticed that, like Humpty Dumpty, some politicians have used words in what we consider to be highly misleading ways. Some say they want a 'soft' Brexit, implying that this is better economically than a 'hard' Brexit. Yet what they mean by 'soft' is a Brexit that changes the status quo minimally: in it, we retain the customs union and the single market and consequently also the EU's freedom of migration. This status quo agreement would promote the interests of existing producers who obtain protection from the EU through its high trade barriers on food and manufacturing, who benefit from EU regulation that supports the aims of large lobbying businesses against smaller competitors and who gain from taxpayer-subsidised cheap unskilled EU labour.

By contrast 'hard' Brexit would eliminate this protection and regulation in favour of free trade and full competition and would remove taxpayer subsidy from unskilled migration. These moves benefit UK consumers, lowering the cost of living by 8% on our estimates and by so introducing competition raising productivity across the economy - with a total gain in UK welfare and GDP of around 4% from free trade and another 2% from improved regulation, a total gain to GDP of 6%. On top of this there are gains from regaining our net EU budget contribution (0.6% of GDP) and removing the taxpaper subsidy to unskilled Immigration (0.2% of GDP). There will also be longer term gains to growth through enhanced innovation and entrepreneurial activity. [1]

So the correct conclusion is, 'hard' Brexit is good for the UK economically while 'soft' Brexit leaves us as badly off as before.

But you would hardly guess from these labels that 'hard' is economically much superior to 'soft'. The proponents of 'soft' Brexit support this notion by saying it would 'preserve jobs'; yet what they mean is it would preserve existing jobs by stopping competition from home and abroad. As every schoolboy knows and every politician ought to know, this aborting of competition reduces jobs in the long run. We never would justify stopping competition in order to keep existing jobs because we know the dynamics of a modern economy require that existing jobs go if they cannot compete with better ones. Competition increases productivity and so employment because higher wages paid for by higher productivity make work more attractive; competition also increases our general welfare because we produce more.

Why is Global Free Trade Good?

What exactly is global free trade? Some people think it means that foreign trade barriers must come down against our exported goods and services while we also eliminate trade barriers against our imports of others' goods and services. However, it is obvious that this is an idealistic vision as we cannot realistically expect all other countries to eliminate their trade barriers, excellent as that would be for the world economy. There have been efforts for the last twenty years to obtain such general reductions in trade barriers under the 'Doha Round' of talks within the WTO and they have come to nothing.

What many people do not realise is that the biggest gains from free trade come from a country eliminating its own trade barriers against imports from the rest of this world. Indeed, most people think the opposite: that the big gains come from other countries lowering their trade barriers against our exports. But this is quite wrong for a country like the UK, which though the fifth biggest in the world, is still rather small relative to the world economy – about 3% of it. Why is this?

World trade is clearly highly competitive in most markets - think of the vicious competition to get into those ubiquitous global supply chains, or the cutting down of big brands like Nokia and Blackberry. We sell cars like Jaguar and Land Rover into world markets where other luxury brands like Mercedes Benz and Lexus compete head to head. Our City services compete with New York, Singapore and Hong Kong.

What all this means is there is a going competitive price for the goods and services we sell around the world that we must match. If we do so, we can sell everywhere at this price. This price effectively is the price at the border - or for the home producer, the ex-factory price. From that point in every country, there are particular distribution and other costs (including that country's trade barriers) that raise the price to the consumer.

The implications of this are stark. If another country gives us a special preferential tariff deal, then yes, we will sell more there because we are cheaper than the competition. But this does not mean in the end we will sell more overall! How can we? We have limited land and labour, even if we can get more capital easily from the world market. Our output, as a country, is limited by our resources.

Therefore, when this preference is given, we sell more into that market and less into others; vice-versa, other countries sell less into that market and more into others. It is true that, in the short term, we might possibly make some gains by selling more into that preferential market - perhaps we could get a higher price for a time - but these gains are simply short term and trivial when compared with the permanent long term gains we can make from trade policies that promote competition.

Now, think about what happens if we reduce our trade barriers on imports. We reduce the prices of imports to consumers, and this creates both a gain to them and more competition with our home producers, forcing them to raise productivity. This is a most definite and permanent gain to our economy - a rise in consumer welfare and in GDP. A natural by-product of this is, as we produce more, we export more to pay for our higher imports. In the short run, this comes about by a fall in sterling to stimulate these sales; in the long run, once our new markets are established, sterling recovers to its old level, its job done. We are quite familiar in the UK with this sterling movement; the pound regularly falls when we need to stimulate output in export industries, as it has done after Black Wednesday when we left the ERM, also after the financial crisis, and latterly after Brexit.

So when we talk about global free trade we mean getting rid of our own trade barriers against all of the rest of the world. Of course, we would also be delighted if the rest of the world got rid of its trade barriers too because this would make the whole world more prosperous, but that is not where the big gains come from for us. And the critical point to understand is, we get these gains even if other countries do not reduce their trade barriers against us. All they achieve by maintaining import trade barriers is to cause injury to their own economy and reduce their citizens' welfare.

There are two ways to achieve global free trade. One is the apparently easy path of negotiating free trade agreements with first, the EU and then, the rest of the world. Unfortunately, this path can turn out to be difficult and treacherous because each agreement involves a cooperating partner. In the case of the EU, cooperation cannot be taken for granted, as is obvious from the many aggressive statements by EU politicians. Nor can it be taken for granted that the rest of the world will agree to trade terms we can accept, as they may make excessive demands, for example, for migration access or for rights under our laws. In addition, such agreements take time to complete and it is unlikely that 100% coverage of the world will ever be achieved.

Thus, this potential lack of cooperation from other countries could hold up or even entirely derail the free trade agreements needed to achieve global free trade.

Unilateral Free Trade - the Threat that will Force the EU to do a Trade Deal

It is fortunate, therefore, that there is another route to free trade that depends solely upon our own actions. This is unilateral free trade (UFT) whereby we simply abolish our trade barriers without asking for others to do the same. This approach – entirely under our own control –allows us to realise the gains to our economy and consumer welfare outlined earlier. The most famous example of this was in 1846 when Sir Robert Peel abolished the Corn Laws greatly reducing the price of food and helping to stimulate the industrial revolution.

Some people are concerned that, if we do this, we would undermine the incentives for other countries like the EU or the US or Australia to conclude a free trade agreement with us. After all, if we unilaterally abolish our trade barriers why would these other countries want to offer us agreements to reduce their own trade barriers against us?

Here we need to distinguish between the EU and the rest of the world.

With respect to the EU, our adoption of UFT would cause immense damage to EU interests. Imagine that we invoke UFT following a failure by the EU to offer reasonable terms in a general agreement on trade. EU exporters to the UK would immediately face a UK market in food and manufactures where prices were much lower (both by around 20% on our calculations) with imports able to enter the UK from all over the world without any tariffs or other trade impediments. These EU exporters would therefore lose substantial profits and/or volumes on their UK sales. By contrast, in a trade agreement, they would seek to negotiate at least some transition period in which their markets would remain unchanged and possibly also some further deferment of free trade in particular sectors, so keeping these markets protected for even longer. If we enact UFT, none of this would be possible.

Some argue that, instead of adopting UFT, we should retaliate by levying tariffs on the EU in the event of no trade agreement. But this makes less sense for the simple reason that, by levying such tariffs, we damage ourselves! While some politicians believe this would deter the EU from failing to agree a trade deal, threats to damage oneself are less credible and therefore may deter less effectively. So the threat of UFT provides a strong incentive to the EU to do a trade deal with us - which politically is what we want. This is the origin of the political sound bite, 'No deal is better than a bad deal'.

In fact, no deal is better than the arrangement we have today if we do not raise tariffs against the EU. Such a 'tit-for-tat' scenario is, in fact, the scenario analysed by Remain in order to discredit the notion of trading under WTO rules.[2] Nevertheless, even if we did go for tit-for-tat on general political grounds, it can be a viable strategy - provided we achieve FTAs with key rest of the world exporters quickly (see next section).

Now consider the rest of the world. It is true, if the rest of the world thought we would do UFT in the absence of a trade deal with them, their incentive to do one on food and manufactures where trade barriers prevail might be reduced. But, actually, we do not really care about this. The gains for us from trade deals with them come from ourselves dropping our trade barriers. Once these have gone, we can still benefit from doing trade deals on broader issues where there are subtle barriers and general issues of competition in all markets - such as removal of other trade distortions on goods, facilitating trade in services, enabling competitive public procurement, guaranteeing full legal protection for foreign direct investment, improving protection of intellectual and other property rights, and so on.

So trade negotiations with the rest of the world would continue but on a much broader canvas - with the hope of wider, if smaller, gains by reducing the less visible barriers in other areas of trade.

Thus, in order to pursue global free trade, we need to have a definite strategy if trade agreements prove difficult to attain, especially with the EU. UFT – or FTAs with the rest of the world- acts as 'the club in the closet' to bring the EU to a proper trade agreement with us. As far as the rest of the world is concerned, we can invoke UFT if negotiation progress is slow; then the slowness will not matter as the talks switch to areas of less urgency.

The Case of 'Tit-For-Tat'

Some say that UFT is not 'politically practicable' and so irrelevant to our situation: therefore, we must get to free trade via FTAs, keeping intact the external tariffs we 'inherit' from the EU. The FTA approach enables politicians to 'buy off' business opposition to the reduction of barriers against imports by obtaining reduced barriers in foreign markets. If our government chooses to go down this route for such political reasons, it can offer quite good results - although not as good as UFT.

The vital proviso is that we definitely abolish the CAP elements and are, in fact, successful in quickly signing FTAs with key world suppliers of food and manufactures, such as the US, Australia and New Zealand, all of whom have expressed eagerness to do so. Again, it does not matter hugely whether the EU signs a deal or not; if not we will trade together under tariffs of some 3-5%. Such tariffs are de minimis and would be easily absorbable on both sides. Because of our existing mutual conformity with regard to non-tariff barriers, any attempt by the EU to re-create such barriers would be illegal under WTO rules.

Thus, we can think of this FTA approach to free trade as only different in detail and timing to UFT and with a similar endpoint. It too would strongly incentivise the EU to agree an FTA.

Practical Worries about Unilateral Free Trade - the 'WTO Option'

UFT is often referred to as the 'WTO Option' or the 'No Deal Option'. An aspect of Project Fear has been the unrelenting claim by Remoaners that, if we 'crash out' of the EU without a deal and are forced to trade under WTO rules, we will be faced with various disasters ranging from airline flights being cancelled to queues of lorries piling up at Dover to our manufacturers being unable to export to the EU.

To understand why such fears are not, in fact, great concerns, it is first necessary to understand how WTO rules work. Upon leaving the single market/customs union under WTO rules, we would immediately adopt the Most Favoured Nation (MRN) tariffs that initially would be the same as we operate now. So, no immediate change. However, what generally is not understood is that these MFN rules do not dictate the level of our tariffs – only the maximum tariffs we can levy. We are free to reduce or even eliminate tariffs (as long as we treat all countries the same) thereby allowing us to adopt UFT and avoid raising tariffs against the EU – as discussed above. WTO rules also prevent the EU making a special case of the UK – ie, they are prohibited from 'penalising' us out of spite.

In addition, negotiations on trade arrangements must be separated from negotiations on the myriad of arrangements that govern the day-to-day lives of UK and EU citizens – eg, airline arrangements. While such areas are detailed and tedious, they are separate from the subjects of trade arrangements and there are powerful incentives for all sides to find solutions.

Customs Clearing. A concern some express about the WTO Option is that it could lead to customs 'hold-ups'. People envisage queues at customs points around the world and particularly at the EU border. But modern customs bear no relation to what is in most people's minds – ie, border queues as 'paperwork is checked'. Modern customs procedures are almost entirely computerised and so 'virtual'. If a consignment's (electronic) paperwork is out of order, this will be known well before arrival at port and will either have been fixed by arrival or if not, unusually, that particular cargo will be stopped. In 2016, the World Bank Logistics Performance Index for fifteen developed countries shows that 95% to 99% (average of 98%) of all goods were cleared without physical inspection and the median clearance time of the 2% requiring physical inspection was one day – most likely within a few hours.[3]

Another related worry is, if the EU were to levy tariffs on our exports where currently none exist, then many of our industrial inputs would be subject to tariffs and, because they 'cross borders many times', they would face tariffs multiple times. First, tariffs on inputs are levied in a 'virtual warehouse' manner. If any input is re-exported, it is not subject to duty as an input; hence, duties are not payable unless the end product is consumed inside the border. So, inputs crossing borders multiple times simply does not matter - duties will be paid only if they finally do not leave the country. Note that this applies crucially to Irish-Northern Ireland trade; if inputs are crossing this border many times they will pay no duty at all if the final product is for export to the rest of the world.

Furthermore, in spite of Project Fear stories to the contrary, the majority of inputs do not cross the EU-UK border multiple times. For example, most auto components come from the EU to the UK and remain unless the finished car is exported to the EU (when, as above, no tariffs would be levied on the inputs). And, the EU has agreed that tariffs are not payable at all on inputs in sectors, such as aerospace, where inputs do cross borders multiple times.

The above illustrates another powerful argument for not levying tariffs against the EU - even if they insist on doing so to us – as this would add complication and costs to manufacturing supply chains.

EU Import Tariffs. As for tariffs the EU levies on our manufacturing exports, these are rather low on average, at around 3.5% on our manufactures – far less than half of our current net annual budget payment to the EU. In fact, the large fall in sterling has more than compensated for any potential EU tariffs on manufacturing exports and we believe sterling is likely remain low for many years. Even if this does not prove to be the case, analysis shows that the lower cost of inputs from the rest of the world coupled with enhanced productivity opportunities once out of the EU, mostly compensates for any EU tariffs[4]. And, our manufacturers could always decide to raise their prices in the EU and lose some market share, diverting this product to the rest of the world where they already on average sell half their output.

Farmers. Global free trade means lower, world prices for farmers - an end to EU protection. This is inevitable and important for the UK and our consumers if we are to reap the full gains of leaving the EU. EU tariffs on food are high, at nearly 20% on average. But under global free trade, we would cease to levy these food tariffs and our farmers' prices would fall to world levels. They would export their food to the world market at these lower prices. If they export to the EU, they would get these same lower prices, on top of which EU tariffs would be paid bringing the total price up to the EU price level for EU consumers. If we were to levy tit-for-tat tariffs against the EU on food (not advised), then our farmers would get the same home prices as received today until we sign trade agreements with world producers like the US, Australia and New Zealand. At this point, their prices again would fall to world levels assuming genuine zero tariff deals were agreed.

However, our farmers still can be supported as required; but they will need to raise productivity and switch crops to gain the greatest efficiencies. The UK taxpayer could support farmers directly in both the short term (as they adjust to new competition) and in the long term (as we protect our environment), thereby providing the country with a huge gain relative to the current regime of EU protection and the Common Agricultural Policy.

Competing With the EU. Another concern is that the EU 'will not like' our independent settings of trade, regulation, tax and immigration policy; some politicians have 'assured' the French we will continue to play by EU rules, even after we have left.

Why so? To do that would risk simply throwing away our hard-won freedom from EU rules that reduce our competitiveness as a nation; we would be throwing away the very gains from Brexit that we enumerate above. If the EU does not like competing against our new UK rules, then it is free to adjust to them as it likes: it could follow free trade, more liberal regulation and more sensible immigration policies itself. Indeed, it might well have to because of the new competition it would face on its own doorstep. This is an entirely healthy reaction, beneficial to the world economy. It is argued by some that the EU would instead become yet more protectionist, especially against us. But, as we have seen already, this would harm them not us.

Border Controls. A final worry concerns the movement of people across UK borders. However today, everyone generally has to show identification at these borders since the UK is not in the

Schengen agreement. It is a matter of detail what identification is needed and how it is controlled. This worry particularly is invoked for the Irish-Northern Ireland border but the government has already announced its post-Brexit policy of maintaining the Common Travel Area between Ireland and Northern Ireland. It is worth remembering that there is no EU border agency: EU governments each provide the border service on its behalf

The WTO Option and the Welfare of UK Manufacturing Industry

Plainly the end of EU protection of manufacturing must mean greater competition for UK manufacturing. However, much of UK manufacturing is high-tech, high value-added in nature, much of it competes successfully in world markets and the trends continue in this direction. This sector is one that increasingly resembles services where the UK has a strong comparative advantage because it is intensive in skilled labour.

Inefficient low-tech manufacturing will struggle. Judging how much of manufacturing (currently 10% of GDP and 8% of employment) falls into the high-tech category is difficult. However, we know that productivity growth in manufacturing has been strong for decades. Over the last 30 years it has averaged around 3 per annum. To offset the long run effect of losing EU protection, manufacturing productivity needs to be raised, compared with no Brexit, by only about 1% a year for a decade, which looks entirely feasible.

Another important element is the fall in the exchange rate post-Brexit. At 15%, this has greatly boosted manufacturing profits and provided a cushion, which we believe could well last five or ten years, during which productivity adjustment can take place. Our analysis shows, for example, that auto manufacturers will improve profitability post-Brexit. If sterling regains pre-Brexit parity, only a modicum of incremental productivity improvement and re-sourcing of supply chains (both facilitated by Brexit) will be required to compensate for the increased strength of sterling.

The effect on jobs of this adjustment will be positive, as indeed it has been overall during the contraction of manufacturing from 35% of employment in 1970 to the 8% of today. Because jobs have been created in services to replace jobs displaced from manufacturing; we have full employment in the UK and also a record level of employment at 75% of the population of working age. Time and again, some short-sighted politicians have proclaimed their intention to 'revive manufacturing' to 'create jobs'; in this they have failed but jobs have certainly been created in the economy as a whole as manufacturing has necessarily contracted in response to the changing nature of society and competition from the world economy. Note however, because of growth in the economy and population, a decline in the share of manufacturing does not necessarily equate to an absolute decline.

Economic Prospects

In spite of the continuing dire forecasts from Remoaners, we believe the economy will continue with business as normal while also gradually benefiting from the Brexit gains we have identified above. As we have argued repeatedly in our publications, the devaluation brought on by Brexit is acting as a powerful stimulus to the economy, switching demand away from consumers to net exports and business investment, and boosting corporate profits. This is a normal exchange rate response to a large regime change like Brexit. As capacity gets used up, business investment will strengthen further. As labour availability gets used up, wages will start to rise faster. Once immigration controls bite on unskilled EU immigration, this situation will get tighter; so far, the labour market still seems to be somewhat slack, with many workers working less hours than they would like.

With the economy still not tight on either plant or labour capacity, we have some leeway on monetary tightening. However, the zero interest economy underpinned by massive printing of money and combined with draconian regulation of banks, is causing widespread problems; government, large and inefficient corporations and so-called 'safe' borrowing like mortgages and car loans, are artificially subsidised while savers get negative real returns and small businesses get poor access to credit and on tough terms. It is time to withdraw slowly from this distorted situation, by raising interest rates in a studied gradual way, slowly withdrawing with it the vast pool of printed money and also loosening the excessively tight regulations on bank lending. In doing this it will be joining the US Fed and probably quite soon also the ECB.

Against this background, Brexit will lead to a strengthening of competition and growth, while also slowing inflation. The full gains will take around five to ten years to come through but we envisage growth reaching the 2- 4% range by 2020 as against the current 2-3%. Besides the one-off gains from Brexit that push up this growth rate in the medium term, we have identified a further longer term gain in growth due to the boost to innovation and entrepreneurship created by the more competitive environment. This should keep growth in this higher range for a prolonged period of time.

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