<u>Jacob Rees-Mogg MP's speech at the launch of Economists for Free Trade's *Budget for Brexit* report</u>

<u>Tuesday 14th November 2017</u>

CHECK AGAINST DELIVERY

The Chancellor generously asked for ideas for his Budget so with the help of Patrick Minford and Economists for Free Trade I am delighted to offer some suggestions that are positive and will contribute to a bold Brexit.

Underpinning all budgets are modelling assumptions about the effects that economic policies will have on growth and either directly or indirectly on taxation or spending. The Office for Budget Responsibility was set up in 2010 under the admirable Robert Chote because it was believed that the Treasury's forecasts were determined by party political machinations rather than economic reality. It was correctly thought that an independent body would give the figures more credibility. This has made the figures more honest but not more accurate. Nor is this a new problem. Harold Macmillan complained in 1956 that he had to set economic policy using last year's Bradshaw.

Last year, in an important speech, Andrew Haldane, the Chief Economist at the Bank of England, set out some of the failures of forecasting, especially around the financial crisis, and asked if his industry had faced its Michael Fish moment? It is certainly true that some of the failures of economic and behavioural modelling exacerbated the financial crisis. However, budgets cannot be produced without some sort of forecast, but it is sensible to aim to get the most reliable one.

This is where the work of Professor Patrick Minford is so valuable. His record stands unchallenged. He correctly opposed the 364 economists who wrote to The Times in 1981, he opposed the exchange rate mechanism and the euro, and he has foreseen issues that others have ignored. Although being correct when the consensus was wrong several times in the past is no guarantee of accuracy in the future, it is certainly a useful indicator. His forecasts are based on classic economic models not on the gravity models used by HM Treasury and others, and he bases his work on the assumption that zero tariffs and non-tariff barriers should be applied to UK imports from the whole of the rest of the world. This is the key Brexit insight that we have the power to implement ourselves, independent of any Article 50 negotiation with the EU.

This may be a counter-intuitive view. That in order to maximise economic benefits of Brexit we should adopt a selfless policy rather than selfish protectionism or self-interested tit-for-tat trade retaliation. If you do build a Brexit policy and a Budget on this apparent generosity, the fiscal consequences are considerable. Consumers gain in the short term from lower prices and companies and consumers gain in the long term from the dynamic effects of competition driving up productivity and incomes. These are the foundations on which these Budget proposals are built.

The UK economy has performed robustly since the Brexit vote, in complete contrast to the scenarios outlined by HM Treasury in their documents prior to the referendum. The OBR is expected to report shortly that the UK economy will grow by some 1.6%. This is slightly lower than the rate expected by the OBR in the spring, but is considerably higher than predicted by the Treasury and almost all outside forecasters before the Brexit vote.

It is true that this year the UK economy may underperform the economies of the Eurozone and the United States but this is understandable after several years near the top of the table and is not likely to continue, provided that we manage our affairs appropriately.

Recent good performance by the Eurozone contrasts with its longer term history. Since the first quarter of 2008, while the UK economy has registered cumulative growth of 10% the Eurozone has managed only 5%. Within this total, the experience of some member countries has been much worse. Over the period, the Italian economy has contracted by 6%. If this comparison were made since the formation of the euro in the first quarter 1999, then we find that whereas the UK has grown by 40% the Eurozone has expanded by only 28% and Italy a feeble 8%.

When the UK decided against joining the euro, it was widely argued that this would be an act of irreparable self-harm as the countries of the Eurozone were set to surge forward on a wave of new prosperity unleashed by the single currency. Gravity models predicted a tripling or doubling of UK trade if we joined. Only a few brave souls stood out against this overwhelming consensus, but not for the first time in our economic history a small band of contrary thinkers won the day. For the countries of Southern Europe not a wave of prosperity but a tsunami of unemployment.

It is widely suggested that the Brexit vote has caused substantial weakness in consumer expenditure. This is untrue. This year it should grow by 1.8%. This is lower than last year, which is hardly surprising given that last year's sharp fall in the pound caused inflation to rise, thereby precipitating a squeeze on consumers' real income. Inflation has risen to 3% but this is not far from its peak. In the next few months, it may reach 3.2% before starting to head down towards 2% in the second half of next year. This will allow real incomes to rise again, thereby underpinning more robust growth of consumer spending.

Many commentators have viewed last year's sharp fall in the pound as some sort of disaster. They could not be more wrong; the pound has been overvalued for some time and it needed to fall in order to make the UK more competitive and thereby to improve the UK's current account position. The Brexit vote proved to be the trigger for this welcome adjustment, the weak pound should help rebalance the economy by slowing the growth of consumer spending and boosting the growth of net exports. Accordingly, this year's consumer slowdown, far from being some unanticipated disaster is part of the process by which the UK economy returns to full health.

At the time of the Brexit vote, it was suggested that business investment, which accounts for about 10% of the UK's GDP, would be severely weakened by a vote for Brexit. All that has happened is a moderate level of growth this year but the surveys suggest it will pick up next year. The notion that investment is being held back by Brexit is certainly erroneous. Large parts of the UK economy are unaffected by EU trade. Exports to the rest of EU account for about 12% of the UK economy. This means, of course, that 88% is accounted by things other than exports to the EU. What matters for the 88% is that we run our economy well and that we stabilise the public's finances, as has happened over the last 7 years. For the 12% the overwhelming bulk of UK exports to the EU will continue anyway.

Fiscal Prospects

In 2010 the gap between government revenue and expenditure, i.e., the Budget deficit, reached 10% of GDP. The Coalition and the Conservative governments under Mr Cameron and Mrs May set about reducing the deficit and bringing down the ratio of public debt to GDP. This work is not complete but is well under way. This year the deficit should come in at about 2% of GDP and the OBR is expected to revise its forecasts for this year's borrowing downwards. The debt ratio ought now to start to fall.

Post-Brexit Fiscal Freedom

At the heart of these forecasts is the fiscal reality that by taking a more optimist view of the growth consequence of Brexit, based on the static and dynamic stimulus from classic free trade and combining this with continued restraint in public spending, then when post-Brexit fiscal freedom opens up, public spending net borrowing (PSNB) moves into steadily increasing surplus from 2021 and the public sector debt to GDP ratio falls to 60% by 2025.

These forecasts quantify what we call post-Brexit fiscal freedom of £135 billion between 2020-2025 and a further £40 billion per annum from 2025 onwards. This includes the £10 billion a year saved by not having to make contributions to the EU budget.

The window of post-Brexit freedom will remain firmly shut to those forecasters who subscribe to the modelling approach adopted by HM Treasury, which has a neo-protectionist approach and inbuilt bias towards a pessimistic assessment of Brexit. It is worth taking a few moments to make some crucial observations about the use of gravity modelling by HM Treasury.

There is a dark secret hidden in HM Treasury and unseen outside until exposed by Patrick Minford. There was not and is not any HM Treasury gravity model of UK trade. Brexit was never modelled in the fullest sense and this has profound consequences.

It also assumed that on leaving the Customs Unions the UK would apply the common external tariff to EU goods. This would be a lunatic thing to do as it would harm consumers directly through higher prices and indirectly from damaging knock on effects to the general economy. Fortunately, after a year’s work, Professor Minford and his research team at Cardiff University have done what the Treasury ought to have done, and what does this tell us? The gravity modellers did not do their jobs properly. If they had adopted a full model with full free trade effects they would have emerged with a positive instead of a negative Brexit story.

This leads to forecasts which provide headroom for fundamental change in fiscal policy and the first thing to do as a matter of prudence is to allocate sufficient funds to prepare us to leave the EU without a trade deal. The Chancellor has so far made

£250 million available this ought to be increased to £500 million with a contingency fund of £2 billion for other matters that may arise. This will probably not be needed and can be added back to sums already referred to.

This year's Budget could mark a real opportunity for a turning point in the conduct of fiscal policy in the UK. Brexit provides the chance to signal to the world that Britain is open for business and that this Government is going to make the UK one of the most competitive economies in the world.

The question is how to use this new-found freedom, and inevitably people will differ accordingly to their political principles as to whether they focus on tax cuts or expenditure. However, in my view, the priority must be to show that Britain is open to the world, not closed to Europe. London's position as the leading financial centre needs to be cemented and to this end stamp duty land tax (SDLT) ought to be capped at 5% for five years to encourage the central London property market where SDLT revenues have actually fallen recently, despite the very high rates. The problem with housing is the planning system and attacking buyers is a poor palliative ignoring the major problem.

We also need to encourage wealth creators into this country so the non-dom tax ought to be suspended for five years so that anyone who arrives in the UK from today's date will not have the first five years counted towards the period spent in the country for the purposes of the remittance basis charge.

Most importantly, from the 29th March, 2019 all tariffs on goods imported from anyway in the world should be zero rated immediately if the UK has no domestic production on any significant scale or if the tariff rate is below 15%, in which case domestic producers have already benefited through the fall in the pound to compensate them for the removal of tariffs. Many of the tariffs in the Custom Union protect inefficient continental manufacturing or agriculture that has no benefit for the UK consumers or businesses. In the long-term, protections harms the businesses they purport to help so other tariffs ought to be phased out.

This will help the poorest consumers most as the highest levies are applied to food, clothing and footwear, which take a larger percentage of the lowest income. The revenue cost is low, in the region of £3-4 billion, leaving most of the £135 billion available in 2020-2025 and the £40 billion thereafter intact as well, as providing a major boost to the economy.

There are two further essential opportunities for which the money can be used. The first is proof of the country's commitment to business so the corporation tax rate ought to be reduced to 10% by 2025 and could be reduced on the 31st March 2019 in the event that the EU seeks to impose tariffs or non-tariff barriers on the UK once we have left. We should not retaliate by applying tariffs that would make us poorer but applying tax cuts that would make us richer. The second thing that ought to be done is to meet the demands of Simon Stevens, the head of NHS England, the necessity of which I accept both because of what he has said and what I am hearing locally. Indeed at the last election I thought that the challenge of 2022 would be for the Tories to show that the NHS really is safe in our hands.

Although I did not want the £350 million figure used, it was used and the electors believe a promise was made. Politicians cannot hide behind the small print like some disreputable businesses do, but must recognise that the commitment is accepted in broad terms not in pettifogging detail. We promised £350 million for the NHS so we must deliver it. This is £18.2 billion a year, just under half the Brexit growth dividend from 2025, but the money is needed sooner so in 2019/2020 the cash boost needs to be there as far as possible. This puts pressure on the Government not to spend too much on speculative future EU commitments and it is the crucial reminder that any money paid out to the EU is money that cannot be spent on domestic priorities.

In addition to the fiscal measures, regulation must escape the anti-competitive dead hand of Brussels. The City is the world's leading financial centre and post-Brexit we must make it even more attractive and enhance its competitive edge; Solvency II, the AIFMD and MiFID II all reduce competition. The economic history of the world shows that freedom works and we want to free the City to thrive even more. In the wake of the financial crisis, this may make some people nervous but there is no link between the quantity of regulation and financial stability. The key to ensuring financial liability lies in the quality of regulation.

The alarmist reports of tens of thousands of jobs being at stake across the City are poo-pooed by the Chief Executive of Deutsche Bank, who said the estimates of job losses from moving clearing would be 74 not 74,000. London could become an even greater success in the future with Britain outside the EU. Free from the EU's pursuit of a financial transaction tax, which would simply see business flooding away from London, and free from the thousands of pages and millions of words of prescriptive choking regulation, the City of London could carry on doing what it is best at.

In order to maximise the wider economic gains from Brexit, we ought not simply to focus on lifting the burden of EU regulation, we must also lift the burden of UK regulation, so much of which builds upon directives from the EU. As I mentioned earlier, the problem with housing is that the sclerotic planning system stops things being built and is opened to endless challenges from people who oppose development. This system needs to be simplified and made faster as the housing problem will not be solved by tinkering with regulation but by making more land available for building. If planning is simple and cheap the monopoly of the big developers would be broken.

Medium Term Growth Prospects

The OBR will no doubt, as is customary, make its fiscal predictions on the basis of certain assumptions on the UK's productive potential. As always the OBR will conduct this exercise accordingly to the highest professional standards. Nonetheless, I expect the OBR will decide to revise down its estimate of the UK's potential growth rate in response to recent disappointing productivity performance. The government will follow the OBR projections, but it would be better to follow Patrick Minford's, as ultimately the UK's medium term growth and therefore fiscal prospects do not reveal themselves through some desiccated technical exercise. They depend critically upon policy, and especially now upon what we do in face of the challenges and opportunities presented by Brexit.

This group believes that Brexit will be overwhelmingly positive for the UK economy providing we do the right things. The most important are:

- to bring down trade barriers with the rest of the world,
- to reduce excessive regulation of the economy and to refashion the regulatory system imposed on us because of EU membership into a system better suited for the UK.
- to reduce the burden of taxation on both businesses and individuals. To continue to reduce corporation tax in line with already published plans and in addition to reform personal taxation and the complexities surrounding it.

The example of corporation tax shows what lower rates can achieve in terms of higher revenue. This is a free trade approach that focuses on consumers not producers; one that will generate gains to consumers seven times the cost to produces. This is a classical view of the world that has economic history and the latest economic modelling on its side. This is a free trade approach to government that believes Britain's greatest days lie before it and not behind it.

The key to future economic success and our ability to pay for public services will be our managing to maximise economic freedom and simultaneously minimise statism and protectionism.

The results of these ideas will be an intensification of competition in the UK economy, which will improve the UK's productive performance. I confidently believe, therefore, that over the medium term the UK's fiscal prospects are much better than those that will be revealed to you soon in the OBR's short-term projections. It does its work worthily and reputably, but on the basis of false assumptions given to it by the Treasury.

ENDS