A BUDGET FOR BREXIT UPDATE
Economists for Free Trade

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The continuing robust economy since the time of the last Budget has reduced concerns about the post-Referendum economy supporting the view expressed in our pre-Budget publication, *A Budget for Brexit,* that the economy would continue to do well and the Government's declared Brexit strategy could deliver a major boost to the economy.

This report updates our views of last November and explains that

- **As we predicted, the economy has continued to do well, in spite of the OBR's pessimistic projections**
- **The OBR's negative assumptions about productivity appear to have been exaggerated, as we stated at the time**
- **Recent events underpin our view that proper implementation of the Government's declared Brexit strategy can produce a major Brexit Dividend**

ROBUST ECONOMY SINCE THE BUDGET

When we published *A Budget for Brexit*[1] a week before the November Budget, we assessed that the UK baseline economy was growing at around 2 per cent. Office for Budget Responsibility (OBR) figures at the time implied GDP growth around 1.5 per cent in 2017 but we believed this would be revised upwards to about 2 per cent, in line with data from surveys such as Purchasing Managers Indices. At that time most mainstream economists were forecasting 2017 growth well below these figures. Furthermore, we forecast that employment would continue to rise, wages would continue to grow weakly, the current account would continue to improve, as would the public deficit.

Since the Chancellor delivered his budget, things have moved on quite a bit. It is, of course, far too early to pronounce on the UK's longer term growth performance and many short term uncertainties remain. What we do know, however, is that the few months since November's budget have seen a flurry of encouraging data about the economy. In the last quarter of 2017, GDP expanded by 0.4 per cent, giving a growth rate of 1.7 per cent for the year as a whole. This is only marginally lower than growth recorded in the previous 2 years and is still open to revision – quite possibly upwards. Most forecasters have been revising upwards their forecasts of growth in 2018 and beyond. The ONS has discovered that trade has been far more positive than they thought and they have seriously underestimated service output, notably in telecoms.

Spurred by the sharp fall of the pound brought on by the Brexit vote, net exports have been growing sharply and the current account deficit narrowed to 4.5 per cent of GDP in the third quarter of 2017, still too high but well down from the 7 per cent of GDP recorded a year earlier. Inflation has come down marginally to 3 per cent on the latest figures and it seems pretty clear that it will fall further towards the 2 per cent target over the remainder of this year. Given that there are signs of wage

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[1] ***A Budget for Brexit*** - https://www.economistsforfreetrade.com/wp-content/uploads/2017/11/EFT-Budget-for-Brexit-14.11.17.pdf

increases starting to pick up, it seems likely that real incomes will start to rise again before long, thereby underpinning consumer finances.

As we suggested in November, this economic good news has also brought direct benefits for the public finances. It has just been announced that in 2017, the current - ie, day-to-day - budget was in surplus, for the first time since 2002. It looks likely that the OBR's November forecast for this financial year's budget deficit will be bettered by £5-10 billion.

Despite this good performance, the naysayers still claim that the Brexit vote has had a serious negative effect. They point to the fact that whereas, before the vote, the UK's growth rate was at the top of the G7 group of leading economies, last year it was near the bottom. This argument is extremely weak. The UK's recovery after the financial crisis was earlier and faster than some of the other G7 countries, which have only recently started to make up ground. It was therefore on the cards that the UK's relative position would slip back for a while. But there is no reason to suppose that this is likely to be a long lasting phenomenon.

The critics also claim that the UK's continued growth in the face of the Brexit vote is due mainly to the strong performance of the world economy that has dragged up just about every economy, including the UK. Undoubtedly, this strength has been a help but it is difficult to argue convincingly that it has been the main factor behind the robustness of the UK economy. Exports have done well but - as we expected – this is primarily because of the Brexit devaluation. This, in turn, has set in train a substantial rebalancing of the economy towards trade and profitability in the traded sector. Consumer spending following the devaluation has slowed somewhat, as we predicted, but has still continued to grow, as contrasted to the slump in consumer and investment spending anticipated by the naysayers. Business investment has grown by 2.4 per cent on a year ago, according to recently revised OBR figures.

The very same commentators who have bemoaned any consumer slowdown as an evil Brexit effect have spent years in the past bemoaning our current account deficit and excessive consumer spending financed by over-fast credit growth. So now that Brexit has brought about a corrective, they should explain its corrective effects, not attack it.

PRODUCTIVITY COULD BE TURNING

The main feature of the November budget was a very substantial downgrade of the official forecasts prepared by the OBR. The ostensible reason for this downgrade was that the OBR had become pessimistic about UK productivity growth. For several years previously it had stuck to the view that the slump in productivity growth following the financial crisis would prove to be temporary and, accordingly, productivity growth would return to somewhere near its previous path of about 2 per cent per annum. In fact, though, productivity remained obstinately flat and last November the OBR capitulated. It cut its forecast of future productivity growth to 1.2 per cent.

The consequences of this seemingly innocuous forecast change were devastating. According to the OBR, in 2021-22 the budget deficit would now be £10 billion higher than previously thought.

We said at the time that we believed the OBR was being much too pessimistic. Forecasting short term productivity performance is extremely difficult but we thought there were grounds for believing that productivity growth would pick up. In particular, we saw no reason why it should be adversely affected in the short term by continuing uncertainty after the Brexit vote, nor subsequently by any adverse developments emerging after Brexit itself. On the contrary, our view has been that the economy will continue to be robust in the period leading up to Brexit and in the years afterwards - provided we set policy appropriately - output growth and productivity growth will be fine.

More fundamentally, we pointed out that the difficulty of relying on productivity growth as a guide to the future growth of GDP is one of measurement. Non-services productivity, such as manufacturing, can be reasonably estimated but, even here, it is difficult to capture the huge gains in quality of products, such as those of a mobile phone. But the real problem is measuring the productivity of services, which account for an ever increasing majority of the UK economy. And, productivity of the large public sector economy is defined - by definition - to be zero.

In the event, it looks as though during the last six months of 2017, quarterly productivity growth averaged 0.8 per cent, the best productivity performance since the financial crisis. It increasingly looks as though the OBR threw in the towel at just the wrong time.

THE BREXIT DIVIDEND FLOWING FROM THE GOVERNMENT'S DECLARED BREXIT STRATEGY

In her recent speech, the Prime Minister confirmed in more depth the 'Clean Brexit' she had previously outlined as the UK's objective in her Lancaster House and Florence Speeches. This comprises regaining control of the UK's laws, borders and trade policy, as well as substantially ending the UK's contribution to the EU budget. Trade policy, in essence, would be to agree a continuation of our existing trade arrangements with the EU, followed by signing FTAs with the rest of the world during an Implementation Period of about two years.

Modelling the Government's Brexit Strategy

Given the continuing robust economy and validation of our key post-Brexit assumptions (unlike the OBR whose gloom at Budget time has been proved totally wrong), our forecast of the Prime Minister's Brexit strategy still appears broadly on track. This forecast – based on the World Trade Model at Cardiff University - assumes an Implementation Period of some 15 months so that Brexit 'begins' in the third quarter of 2020. It is summarised below.

Brexit in Q3 of 2020

UK Forecast Summary

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
GDP Growth[1]		1.8	2.2	2.0	1.9	1.9	2.2	2.3	2.3	2.3	2.8
Inflation CPI		1.1	2.6	2.5	2.1	2.0	2.1	2.8	2.3	2.1	2.0
Wage Growth		2.4	2.0	2.3	1.8	1.8	2.6	3.6	2.7	2.5	2.2
Unemployment (Mill.)[2]		0.8	0.8	0.8	0.7	0.7	0.6	0.5	0.4	0.3	0.2
Exchange Rate[3]		80.6	74.9	75.0	74.5	73.1	72.4	71.7	70.7	70.9	69.9
3 Month Interest Rate		0.5	0.4	0.6	1.2	2.4	3.1	3.1	2.6	2.3	2.0
5 Year Interest Rate		0.7	1.1	1.4	2.5	3.5	2.9	2.6	2.4	2.2	2.0
Current Balance (£bn)		-87.4	-65.5	-54.3	-48.9	-39.2	-28.5	-15.3	-12.0	-5.5	0.7
PSBR (£bn)		45.1	39.9	32.9	23.4	6.4	-7.0	-11.0	-24.2	-29.5	-39.0

[1]Expenditure estimate at factor cost
[2]U.K. Wholly unemployed excluding school leavers (new basis)
[3]Sterling effective exchange rate, Bank of England Index (2005 = 100)

Clearly, it is impossible to model precisely such a major regime change to the economy - and there will be many different views amongst economists. However, the direction and broad profile of this scenario is instructive and is completely different in nature to the negative forecasts provided by the Treasury and the 'cross-departmental analysis' in Whitehall. It should be emphasised that, so far, Whitehall has not modelled the UK's declared Brexit strategy, in spite of its outline having been evident for some time. As shown in our recent *Alternative Brexit Economic Assessment*[2], if Whitehall

[2] ***Alternative Brexit Economic Assessment*** - https://www.economistsforfreetrade.com/wp-content/uploads/2018/03/Alternative-Brexit-Economic-Analysis-Final-2-Mar-18.pdf

had modelled properly the Government's declared Brexit strategy, the result would have been similar to our projections above.

Our projections show the result of Brexit reinvigorating the economy and in so doing improving the budgetary outlook. Making the assumption of continued restraint in public spending - so that it grows around 0.5 per cent per annum in real terms - we find by 2025 there is a PSBR 'surplus' (ie, a negative borrowing requirement) of some £40 billion in money terms, around 1.3 per cent of money GDP as it will then be.

The debt/GDP ratio starts to fall as nominal GDP grows around 4 per cent, more than offseting the PSBR at 2 per cent of GDP thereby reducing debt by about 1.5 per cent of GDP. This why the PSBR will be steadily falling and going into surplus. If this growing fiscal gain is allowed to reduce debt, by the end of the 2024 financial year, the debt/GDP ratio would have reached 60 per cent by the end of 2024. The reasonably 'safe ' ratio is usually set at 60 per cent, in the sense that, if there were a large rise in the rate of interest, it would not trigger too large a rise in interest payments on the national debt, requiring harsh and difficult cuts. In fact, the Maastricht target of 60 per cent, was chosen for this reason.

The Brexit Dividend

So, our post-Brexit forecast would get our finances into reasonable shape by 2024, permitting the Government to start spending more beforehand without endangering progress to a 60 per cent target by around the middle of the decade. One per cent of GDP per annum could therefore be spent additionally from the 2020 financial year over the succeeding 5 years, while still reaching a 60 per cent debt/GDP ratio in around 2026. This amounts to about £135 billion in total. Therefore, beginning from the date of Brexit in 2020, somewhat more than £25 billion extra spending a year could be accommodated, while still reaching the 60 per cent debt/GDP target by the end of 2025.

From 2025, the debt arithmetic becomes even more friendly. A surplus of £40 billion (1.5% of GDP) implies that, because of growth in nominal GDP, the government can spend this surplus and also another 2.4 per cent of GDP on top, without raising the debt/GDP ratio. In total, this would imply approximately 4 per cent of GDP as an additional 'dividend'. To take it all probably would not be a desirable choice because it would be better to spend less and let the debt/GDP ratio continue to fall slowly. But the government could reasonably run a small deficit of say 1 per cent of GDP, allowing a total dividend of some £65 bilion to be used. This would imply that from 2025 a further £40 billion per year could be used for taxcuts and/or higher spending, and still the 60 per cent debt ratio target would be hit in 2026.

Spending Options

What could this money be spent on? Plainly it could, on the one hand, be used to ease the spending constraints on key public services or spent on infrastructure.

On the other hand, it could be used progressively to improve the competitiveness of the economy through tax cuts. To give an idea of the tax cuts possible we take HMRC's tax 'ready reckoner' estimates for 2020-21 and uprate them in line with projected nominal GDP growth. For example, a 1 per cent rate cut in

- Corporation tax would cost £3.2 billion by 2025
- The standard rate of income tax, £5.6 billion
- The top rate of income tax, £1.5 billion

- The very top ('additional') rate,£0.2 billion.

From the viewpoint of supply-side incentives, corporation tax and the two top rates are the highest priorities for taxcutting. If corporation tax and the top rate were both cut by 2 per cent in 2025, bringing the very top rate to equality with the top rate, the cost would be on the order of £11 billion. Together, with additional spending of £14 billion, a 'Brexit Dividend' from 2020 of £25 billion would begin to reduce the strains in the public sector and also give a useful boost to competitiveness.

From 2025, the further dividend of £40 billion per annum could be taken. At this point,

- The standard rate could be cut by 2 per cent, at a cost of £11 billion (raising the tax threshold is very expensive and hardly affects any marginal rates, mainly going in the form of lower taxes to the better off, barely helping the less well-off because they lose benefits)
- Corporation tax could be cut another 3 per cent, costing another £10 billion
- The top rate could come down by 2 per cent, costing around £3 billion
- The remaining £16 billion could be used on spending.

With the use of the Brexit Dividend (a 'Post-Brexit Fiscal Fund ') in this way, it would be plain to all that, indeed, Britain was 'open for business'.

The Path of Public Borrowing and Debt with The Post-Brexit Fiscal Fund

(£ Billion, Current Prices)

	Brexit PSBR	+Fiscal Fund	Debt	GDP (Mkt Prices)	Debt/GDP % (ratio without Fund)
2018	32.9		1679	2127	78.9
2019	23.4		1702	2215	76.8
2020	6.4	+25	1734	2310	75.1 (74.0)
2021	-7.0	+25	1752	2410	72.7 (70.6)
2022	-11.0	+25	1766	2514	70.2 (67.3)
2023	-24.2	+25	1767	2630	67.1 (63.4)
2024	-29.5	+25	1762	2753	64.0 (59.5)
2025	-39.0	+65	1788	2891	61.8 (55.3)
2026	-49.0	+65	1804	3035	59.4 (51.0)

Note- Public sector net debt (excluding public sector banks) estimated at £1646 billion at end 2017-18 FY (in Sept 2017 £1638 billion, source ONS.)