A Budget for Brexit

An Economic Report

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THE BUDGET ON 29 OCTOBER
A BUDGET FOR BREXIT ECONOMIC REPORT

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This government has been consumed by the Brexit process. This is not surprising, as governments typically can only manage one big project at a time. However, with Brexit now only six months away, it is time that the government thought about fiscal policy, which has been drifting in an 'austerity fog' since the 2015 election. The Treasury has trodden water refusing to give way on its basic austerity-set plans for spending, while maintaining the overall tax rate approximately unchanged. The result has been a rather rapid move towards surplus: in 2015/16 the PSBR was 3.8% of GDP and in 2018/19 this will have fallen to about 1.4%.

During this time, the share of government revenue in GDP has remained steady at 35%. By implication government spending has fallen from nearly 39% to around 36.4% of GDP. This reduction has come virtually entirely out of current spending, as capital spending has continued at about 3% of GDP. The Treasury will have congratulated itself on managing to control spending in this way, in spite of the endless pressures from most departments to raise it.

Apparently, having learned nothing from its failed and widely derided Project Fear forecasts, it continues to embark on gloomy warnings of the effects of Brexit on the economy and so tax revenue. Although the Chancellor has admitted that models are no longer an issue (since the Treasury has finally adopted CGE models), the Treasury steadfastly fails to submit its assumptions to public scrutiny or engage with economists outside of Whitehall.

This is particularly acute when it can be shown that its negative forecasts are contradicted by its own model when different assumptions about EU-UK trade barriers and Free Trade Agreements with other countries are fed in. The Treasury gloom fulfils two purposes: to dampen departmental spending demands and to push the government towards the 'softest' possible Brexit, as close as possible to the status quo.

While all this may suit the Treasury, it is bad for the economy to perpetuate this negative mindset towards change in tax and spending. Furthermore, it is politically dangerous for the survival of a free market economy, now threatened by Jeremy Corbyn's extreme socialist plans. Between now and the next election the Conservative government needs to put forward plans that inspire new faith in that economy.

A good starting point for this process would be a set of forecasts for post-Brexit years that build on the proper assumptions. Opening up the UK to free trade not just with the EU should bring substantial gains, as free trade has in the past. Our calculations suggest around 4% of GDP. There is also the gain from regaining control of regulation, especially in finance, but also across the whole economy; true there may be curbs on change from the EU Brexit agreement for a time but in the long run the UK will now be able choose whatever path it likes in this respect. Finally there are the gains from ending the financial transfer to the EU and closely limiting unskilled immigration with its high fiscal costs. Overall the boost to GDP could reach 7% or more, with better regulation particularly important in the longer term and adding much more to this, as we face a world of much faster technical change.

My Cardiff research team has calculated that, with the trends now developing in the public finances plus the revenue gains from this Brexit boost to the economy, the government is in a position to reach a safe ratio of debt to GDP by the mid-2020s and still have scope for tax-cuts and spending increases of the order of £25 billion a year from 2020 and a further £40 billion a year from 2025. This total comes to around 2% of GDP. If applied intelligently to boost the competitiveness of the economy, it could raise the growth rate from 2025 to 2030 by a further 0.2% per annum.

It is an extraordinary thing that economists like us feel the need to encourage politicians to spend more money and cut taxes. Usually it is our role to discourage profligacy in the name of 'economy'. However, the mantra of austerity has truly taken hold in the UK, so long (now a decade) has it been necessary to subscribe to this policy to bring debt down to sustainable levels. With popular tolerance fraying and the threat of an opposition determined on largescale socialism allied with a massive spending programme, this really is the time for Conservative politicians to show some strategic intelligence and boldness in fiscal plans.

In what follows we set out our analysis of the economy up to 2025 and make proposals for long term budgetary policy that we believe will strengthen the economy and preserve the attractiveness of its essentially free market nature.

Our Report falls into the following sections:

- **Commentary on the recent behaviour of the economy**
- **The Brexit negotiations and possible outcomes**
- **Projections of the UK economy to 2025 under three different scenarios: status quo, Canada+ from January 2021, and a World Trade Deal exit under WTO rules from April 2019**
- **Discussion of how fiscal policy might best utilise the large Brexit Dividend**

BEHAVIOUR OF THE UK ECONOMY

The political classes are in uproar, arguing over the various forms of Brexit. Yet the economy sails on serenely, clocking up yet more record employment, with inflation coming down towards its target, interest rates finally rising, productivity recovering, the balance of payments improving and growth proceeding close to 2% (and on the latest ONS three month estimate May-July at a 2.5% annual rate). The pro-Remain media trumpet the 'uncertainties' and even the possible 'terrors' of no trade deal. But no one takes any notice apparently, outside the usual representatives of 'industry', such as the CBI.

The Strange Imperturbability of the British Economy

What on earth is going on? We sometimes hear from pundits that ordinary people are ignorant of economic issues. Yet - when we check the behaviour of their personal economies - we typically find that their expectations are rational. This is not surprising since it is their interests that are at stake; and it is a stupid person indeed who ignores his or her very own interests.

The truth is that ordinary people have got this right: they realise that, for all the posturing by politicians, trade will continue largely undisturbed by Brexit and that Brexit will bring some longer term trend changes that they have by a substantial majority approved. The formal referendum majority was 4%. But it is well-known from previous polls that British opinion has been 'eurosceptic' by a much larger majority for a very long time. When they voted to join the EEC, they did not expect or want to be ruled by Brussels in the way things turned out and then to be threatened further by a journey towards political union.

Possibly a fair percentage of the electorate was sufficiently scared by the doomladen warnings of Project Fear into voting Remain. Those warnings proved the opposite of the truth. Now we know from the same polls that the vast majority of the electorate regard the issue of Brexit as settled and want the government just to 'get on with it'.

Nor are they worried that the government will somehow renege on 'full Brexit'. The British have enormous confidence in their democracy. They know full well that no government can survive by standing out against settled public opinion. The Conservatives are now reacting sharply to the unpopularity of this Government's Chequers proposals that have greatly alienated the referendum majority and caused a swing away from the Conservatives that could be sufficient to let in a Corbyn government.

Public Finances Tell the Tale of the Steadily Improving Economy

It is now ten years since the financial crisis struck, gaining ferocity in September 2008 with the collapse of Lehman. Recession began in 2008 with a fall in GDP of 0.5%, followed by a fall of 4.2% in 2009.

It took three slow years to get GDP back to its pre-crisis 2007 level. By 2017 GDP had grown by an accumulated 11.2% above that level. This recovery from the Great Recession has been accompanied by an 'austerity' programme conducted first by the Coalition government of 2010 and, since the 2015 election, by the Conservative government.

Public debt as a percentage of GDP, excluding the Bank of England's monetary operations and also various bank bailouts, peaked at 81% in 2015 and was down to 75.2% at end July. Public Sector Borrowing fell in the 2017/18 financial year to £39.4 billion, or 1.9% of GDP. This borrowing rate - if it persists - would lower the debt/GDP percentage by about 1 percentage point a year, as GDP growth would more than offset the effect of new borrowing. But on present minimalist Treasury policies the PSBR is also falling steadily as a percent of GDP. It follows that the UK is now moving, slowly but encouragingly, towards a target safe debt percentage of around 60%.

The latest PSBR figures up to end-July are more encouraging still. Compared with the same period last year, borrowing over April-July was £8.5 billion lower, at £16.8 billion. This suggests we are well on track to undershoot our previous full year forecast of £35 billion for 2018/19 – which was well below the OBR Budget forecast of £39.5 billion.

Moreover, with employment still growing and inflation at around 2%, incomes will be growing steadily during this financial year; revenue has a strong response to such steady growth. Income tax and VAT both grow about 1.5-2 times as fast as money GDP. Thus, we have revised our forecast PSBR downwards to £30 billion. On unchanged policies, our forecasts now suggest that the UK will reach the 60% public debt to GDP target within five years.

Other indicators suggest the economy is picking up steam again after the weak, weather-affected, first quarter. The ONS estimate of GDP growth for Q2 is 0.4%, while the Purchasing Manager Indices are pointing to 0.5% in Q3. The ONS June-August estimate for GDP growth is 0.7%, a 2.8% annual rate. The latest PMIs in September are well above the neutral no-growth level of 50: manufacturing 53.8, services 53.9, and construction 52.1 (maintaining its recovery from its weather-related drop to 47 in March).

Meanwhile, retail sales in the three months to July surged by 2.1% on the previous quarter; they were up 3.4% on a year earlier, establishing that consumer spending is rising rather strongly again.

Unemployment continued to fall, to 4.0% in May-July from 4.3% a year ago, and employment as a share of the labour force aged 16-64 continued to rise, to 75.5% from 75.3% a year ago, defying the labour market's increasing tightness. Total weekly hours were unchanged over the past year; this suggests that productivity (per hour) may at last be recouping some of its past sluggishness as the labour market tightens (ironically, just as the OBR reduced its productivity forecast).

The economy is also rebalancing away from its excessive balance of payments deficits on current account. The quarterly deficit peaked at 6.7% of GDP in 2015 and averaged 5.9% of GDP in 2016. By Q1 2018 it had fallen to 3.4% of GDP. Most of this has been due to trade, with some coming from net foreign income. It is plainly due to the Brexit devaluation, which has stimulated net exports at the expense of consumption demand.

The 'Brexit Effect'

The usual round of 'Brexit analysis' from City and other firms continues - 'showing' that growth has been lower than it would have been because of Brexit.

The favourite method - used by several analysts including the Bank of England and now recycled by UBS in a recent offering - is to create a 'comparator group' of countries and compare their growth and other behaviour with that of the UK. These countries can vary – eg, Eurozone or North America. The problem with this method for judging business cycle behaviour is simple and damning: cyclical experience is highly specific to individual countries if one is judging percent changes over very short periods.

Consider, for example, how specific experience of the Eurozone is compared with the UK. The Eurozone weathered the early financial crisis well, then the euro's own crisis hit; there was then a late burst of QE from the ECB; now it is coping with difficult banking problems across the zone but especially in Italy.

Or consider the US with its 'Trump effect'. The margin of error due to non-comparable features is simply too great to estimate differences in short term growth of a few percent. The method has reasonable validity when one looks at long periods of growth. For example if you compare the much faster growth of mainland Europe from 1945 to 1979 with the UK's, you can reasonably treat this as evidence that we failed to achieve our potential during that period. Alternatively, compare the recent growth rates of the UK and the EU from 1979 and you obtain evidence that UK policies raised the UK's performance rather remarkably. In these cases of a long period of history enough features of the two economies are similar to use the difference in long run growth to support good analysis based on economic modelling.

We have argued before that it is difficult to ascribe any significant 'demand limiting effect' to Brexit when the UK economy keeps on setting employment records in the region of full employment: could we have got 'more than full' employment without Brexit? On the supply side, any effect on investment would have only a miniscule effect on the capital stock (this being some 20 times the size of investment). As for productivity, how could Brexit affect that, since this has been a long standing 'puzzle' since the financial crisis hit? One is tempted to suspect that those who do attribute a 'productivity hit' to Brexit do so because they find it convenient to justify their general negative bias about Brexit.

Brexit will have its long run effect on the supply side only once it comes in. We will then be in a position to judge whether free trade has brought a productivity gain or whether a 'gravity effect' of distancing ourselves somewhat from the EU diminishes it (contrary to our research assessments).

Views of Other Commentators

In the past week, we have seen published assessments of the post-Brexit future from the OBR, the IFS and Open Europe.

The OBR remains guardedly pessimistic but largely agnostic about the future, taking the view that it will assess trends 'as they emerge'. To read the OBR's magnum opus is to experience the joys of a reading a good undergraduate essay – ie, a massive literature survey that draws no resulting insights. The OBR remains blissfully ignorant of the arguments - now accepted by even the Treasury - that gravity correlations used in 'gravity models' cannot identify causal processes, so that a CGE model must be used. There is nothing new in this recent OBR work and much that is not understood. In particular, the OBR fails to understand the WTO rules on standards non-discrimination and on the behaviour of border customs authorities; these do indeed prevent the post-Brexit emergence of non-tariff barriers that the OBR and also the Treasury believe to be likely.

The IFS continues its rather aggressive pessimism about future fiscal prospects, concluding that the Chancellor must raise extra taxation to offset the negative effects of Brexit on the economy and so the public finances. However, the IFS has done no work at all on trade modelling and - without any thought or analysis - has simply copied the average of 'all Brexit studies' into their forecasts. This, for a supposedly independent and prestigious Institute charged with neutral research on fiscal matters, is a sad failure to embrace critical economic thinking.

Open Europe uses the same type of CGE model we use - and as the Treasury now uses - and plots a middle way between the Treasury's estimated <u>very</u> large negative effect of Brexit on GDP and our own estimated large positive effect. They suggest that the net Brexit long-run <u>trade</u> effect on GDP will be close to zero; it notes that the vigorous prosecution of FTAs with the non-EU rest of the world can offset any negative effects of any new trade barriers between the UK and the EU. Unsurprisingly, Open Europe reaches these conclusions by using assumptions about UK-EU post-Brexit trade barriers and the benefits of potential FTAs that are roughly midway between the Treasury and ourselves. This confirms what the Chancellor and we have agreed: that the disputes today about the Brexit effects concern assumptions, and no longer is a dispute about models.

The unacceptable side of this is that the Treasury simply refuses to publish its methods and assumptions or engage in any discussion about them – as we have been attempting to do unsuccessfully since last December. Meanwhile, they take every opportunity to broadcast their dire forecasts to the world at large. The inescapable conclusion is that the Treasury hopes to avoid any scrutiny of their methods (cynically referred to internally as 'policy-based evidence making') so that they can bounce parliamentarians and the public into their negative view at the time of a Parliamentary vote on Brexit.

Policy and the Economy

The Bank of England has now reconciled itself broadly to Brexit. It is now eager to retake its role as regulator of the City in world markets. In its monetary policy judgements it is returning to normal analysis, arguing that whatever the trends in the economy due to non-monetary factors such as Brexit or productivity drivers it is simply their job to control inflation, not to try and use monetary policy to offset such trends - which it is incapable of affecting anyway in anything other than the very short term.

As previewed above, the last policy shoe to fall is the Treasury, which remains unreconciled to Brexit. In this attitude it reminds one of HM Treasury in the very early years of Mrs Thatcher, unreconciled then to her monetarist policies. Then, as now, it staged a mandarin rebellion. After a decent interval those mandarins had to go, having totally misjudged the democratic mood. And go they did.

The Treasury is still playing the game of announcing doom-laden forecasts. Yet, as Denis Healey memorably remarked 'when in a hole, stop digging'. The Treasury's predictions of doom have been so badly wrong that they are entirely discredited as a forecasting organisation - even the new Brexit Secretary has poked fun at them.

Embarrassingly for the Treasury, in their home area of revenue, the money just keeps pouring in. As explained above, the PSBR keeps on contracting, with the latest forecast for 2018-19 coming down to £30 billion, 1.5% of GDP, with the public debt/GDP ratio now having fallen steadily since 2015.

It is high time the Treasury comes round to accepting Brexit and making policy to optimise our economic prospects, building on the benefits brought by free trade including the potential deregulation Brexit can bring. In contrast to Remain efforts to defend our position within a protectionist EU, the truth has always been that free trade brings benefits in the form of lower prices and more competition.

Furthermore, this freedom does not need to come at the expense of creating new barriers with the EU. Even with a World Trade Deal under WTO rules, such barriers will consist solely of tariffs which are in general low - ie, it will not be possible for the EU to create any significant new non-tariff barriers. Under Canada+, both tariff and non-tariff barriers will be effectively non-existent. In any case - once our markets are open to the world - any barriers with the EU will have an insignificant effect on our economy.

Last year, the Economists for Free Trade 'Budget for Brexit' set out possibilities for imaginative Treasury policies on tax and public spending. We update those conclusions below. The Government now has a good opportunity to get away from its position of endless austerity and to grasp the growth-creating opportunities from Brexit. Improved infrastructure, reformed funding of the NHS, and tax cuts can all usher in a new environment that will build on the extra productivity coming directly from Brexit itself.

Meanwhile, the day-to-day business of normalising monetary conditions needs to continue with due deliberate speed. As we have argued before, now that the economy is plainly no longer in a financial crisis situation, crisis monetary policy must be brought to an end. Interest rates need to go on rising and the Bank needs to sell off its government bonds.

With plenty of excess capacity in world raw material markets the world outlook remains good for a long period ahead. The main challenge for the UK is to create growth from rising productivity now that the economy is coming up against the limits of full employment.

For an economy so long in the tooth in its recovery from the shock of the Great Recession, this is a good picture as we move into the age of applied AI and robotics, which supposedly threaten jobs but promises large gains in productivity. A strong labour market and a budget in good shape is a good background from which to cope with this simultaneous promise and threat. Jobs can be relocated instead of lost for long periods and demand can be supported by fiscal expansion. As we have explained before, the opening of the economy to free trade and better regulation via Brexit should boost productivity and further strengthen the budget.

This is also a time to move monetary policy away from its 'emergency loose' settings before they trigger more serious distortions in asset markets and the economy; savers and small firms must once again be treated normally by the markets for borrowing, and the government and large firms must stop having their privileged access to ultra-cheap money. Besides if this is not done we will have lost the monetary policy tools to sustain the economy when the going gets difficult again.

THE BREXIT NEGOTIATIONS AND POSSIBLE OUTCOMES

In an astonishing development, at the Chequers Cabinet meeting on Friday July 6th, Mrs May finally threw off all subterfuge and pushed through proposals under which the UK effectively stays in the Single Market for goods. She has now made it clear that she also wants the UK to remain in the Customs Union.

This volte-face from her Mansion House speech is described by her with her typical respect for the English language as an 'evolution'. These proposals, even if agreed to by the EU in some 'evolutionary' form, are unlikely get through the House of Commons because of massive Brexiteer opposition in the Commons, the Conservative Party generally, and in the country at large. There is also the possibility of a veto by the European Parliament.

The Chequers Proposals Are Damaging

Since the ill-fated Chequers Cabinet meeting, much has been written about the faults of Theresa May's proposals that were agreed that day. In brief, these are that they subject UK farming and manufacturing to EU Single Market regulations. We also agree to maintain social (including labour) and environmental regulations currently mandated by the EU, which govern much of the activity across the whole economy. This means that we cannot alter these EU standards, many of which discriminate against non-EU suppliers such as the US, when we enter into Free Trade Agreements (FTAs) with the rest of the world; we can reduce or eliminate tariffs but we cannot eliminate the protection created by EU standards. The New Customs Partnership Mark 2 now supposedly makes setting lower or zero tariffs on non-EU FTA partners feasible; however, doubts remain about the practicality of this proposal too. Finally, some formula about enhanced EU migration in the proposals implies that there will also be free migration in some degree from the EU.

Needless to say, these elements all damage the UK's economic interests. Our FTA strategy will be less beneficial as we can eliminate less protection and also get less return access from other non-EU countries. We will be unable to optimise regulations in major parts of our economy that will be subject to continued EU rule. All companies' products will be subject to EU regulations, not just those that export to the EU. In addition, we will not gain control of our borders.

Why Did Mrs May Choose This Route?

There is a short answer to this question: UK farming and manufacturing wanted it. In particular, the German and Japanese owners of much of the UK auto manufacturing industry wanted it. As Stewart Jackson, former Chief of Staff at DExEU to David Davis, says in *Conservative Home*:

> *"Philip Hammond and Clark's officials, plus wonks friendly to them, were briefing from January this year that the UK would be staying in the Customs Union, and that the Irish backstop was the cleverest possible wheeze to ensure that this happened. For them, it has always been all about following the diktat of the last CEO of a multinational company with integrated supply chains which sat on them."*

Whether it was the CBI and such titans as Airbus or Nissan, or the Institute of Directors and Chambers of Commerce (supposedly) representing smaller businesses, or a host of individual trade associations, a more or less unanimous howl went up from protectionist producers and their trade associations that they wanted existing regulations to continue uninterrupted by any new bureaucratic uncertainty. For them it was immaterial who set these regulations or how; they allowed industry to do what it now does and industry did not want them disturbed.

This view was supported across Whitehall, most strongly by the Industry Department (DEIS) and the Treasury, who leaked the notorious Cross-Whitehall Brexit Report claiming that there would be huge costs to trade and GDP in border barriers between the UK and the EU if we had a Canada+ trade agreement; and still larger barriers of course in the event of No Deal. Only if industry stayed within the Single Market in goods could the threat of new barriers be removed.

Whitehall and industry combined to make a formidable lobbying force, and dominated No 10's thinking. It also strongly influenced Tory rebels such as Dominic Grieve and Nicky Morgan. It was put about that the 'interests of the economy' dictated a 'soft Brexit' in which industry stayed in the Single Market/Customs Union. This is in spite of the fact that the auto industry, for example, accounts for less than 1% of our GDP and employs fewer people than the fishing industry. And, analysis by EFT suggests that auto industry profitability will not suffer post-Brexit.

What is interesting and a matter for relief is that this argument was not deployed in respect of services, at least in recent months. It has become understood that services are different, that the Single Market is of little importance in services, and the City requires UK regulation by the Bank of England appropriate for a world financial centre, which has helped to emphasise this point. As services are 80% of the UK economy, the fact that they are not being involved in these proposals means that service regulation at least can be optimised by the UK government. However, even this will be hamstrung by commitments under the Chequers Proposals to keep social and environmental regulation unchanged and there are some important connections between ’services’ and ‘manufacturing’.

Chequers Approval Unlikely

Negotiations with the EU are currently at an impasse, with the EU proposing that, in order to avoid a hard Irish border, either Northern Ireland or the UK must stay in the EU Customs Union indefinitely until a ‘solution is found’. As we noted above, the issue of the Irish border has become a fig leaf behind which Mrs May argues for accepting a customs union solution in order to deliver on her secret promises to protectionist producers and the EU hopes to bully the UK into indefinite subservience to EU rules on industry and trade.

Mrs May is very unlikely to get such a proposal through Parliament. If any variant of Chequers – even if somehow eventually agreed with the EU - comes before Parliament, it is likely to be rejected. In this case, the default is no trade deal and the relevant scenario is exit under WTO rules - a World Trade Deal, as we have termed it.

An Alternative Solution: Canada+

There is, however, another, better route: a Canada+ free trade deal with the EU Canada+, which the EU has offered on multiple occasions, as recently as this month.

A Canada+ free trade deal would allow us to have zero tariffs between the UK and the EU, and also zero non-tariff barriers, together with freedom to see whatever standards were best for the UK home market. Standards on EU exports would, of course, remain in place as those mandated by the EU; standards on UK imports would be free for us to determine as part of our domestic decisions on standards. If we liberalised these to permit goods from non-EU countries to be sold here, we would not discriminate against EU imports - they would be free to impose their own current EU standards, which would also meet our new liberalised standards which would be more embracing of variety from around the world.

Industry, the Civil Service and Tory rebels need to understand that their fears about a Canada+ agreement with the EU are quite misplaced. Canada+ would provide the same security over border treatment that would occur under the Chequers proposals. But it would also permit the UK to set its own regulations throughout the economy, sign FTAs with the rest of world, and recover control of its borders.

What then of the threatened surge in new trade barriers between us and the EU? The simple point is that there is no such threat. Any such surge would be completely illegal under WTO rules. Border procedures must be seamless and effectively costless; if existing standards on both sides are met by industry, as they already are, then there can be no sudden withdrawal of trade permissions.

What has happened in our internal political debate is that extreme ignorance of how the WTO works has allowed a Project Fear to take hold among industrialists and the Civil Service interacting with them. They have assumed that the WTO world is a lawless world in which ‘hostile governments’ can ‘make trouble’. Yet WTO law is plain- it mandates seamless border procedures and outlaws discrimination on standards. Furthermore, no-one in their right mind would claim that either the UK or the EU would defy international law: both make a particular point of adhering to it, given the centrality of international law to the Treaties on which both take their stands.

Protected industrialists, of course, have their own biased reasons for believing this – all protected producers desire to keep their protection.

The primary hurdle for a Canada+ deal – just as with the Chequers proposals - is the Northern Ireland border issue (or 'wheeze' as Stewart Jackson puts it). Thus far, Canada+ has been offered by the EU only to Britain – not to the UK. Leaving aside the incredibility of this 'issue', it is logically the case that any solution to this issue that is acceptable to the proposed 'deep and close relationship' would also be acceptable for a Canada+ outcome.

But this problem is not nearly as fundamental to the EU as Mrs May's proclaimed desire for a 'deep and close relationship' with the EU. This half-in, half-out' approach fundamentally contradicts third party status and is unlikely ever to be acceptable to the EU.

What If The EU Refuses To Enter Into A Canada+ Trade Deal?

Should the EU refuse to enter into a Canada+ deal, then a World Trade Deal under WTO rules exit where we have no EU trade deal will work well for us. The reasons are the same: 'access' to the EU market for us and for the EU to ours is protected under WTO rules. The border must be seamless and as we each satisfy each other's export product standards there can be no denial of recognition of each other's standards without breaching the rules on non-discrimination.

The only impediment to our trade will be tariffs on goods - possibly each way. These are on average rather low, at around 4%. However they will have a negative effect: on the EU, not on us. Why?

When we leave the EU we will sign FTAs with many countries around the world. Therefore, we will buy from them at world prices with no tariffs imposed from our side. Apart from benefiting our consumers this creates strong competition amongst all producers, whether domestic or foreign. EU producers are no exception; they will have to meet these (lower) world prices to sell anything much here at all.

Similarly, any tariffs we might impose they will have to absorb. As for our producers selling in the EU, they too will sell at world prices since their competitors here would quickly undercut them if they charged more. Therefore any EU tariffs on them will be paid by EU importers, who can easily do so as EU prices are higher because of the tariffs on world producers.

We have calculated, if we leave the EU without a trade agreement under WTO rules (and therefore with no transition, which is dependent on a trade deal), the EU carries the burden of paying about £13 billion a year tariff revenue to HM Treasury, it loses our £39 billion budget contribution for the transition period, and the world competition from our FTAs kicks in two years early. This represents a cost in present value terms of around £500 billion. On the other hand we gain present value of £650 billion.

Much nonsense has recently been talked about 'no deal' halting air traffic, upsetting pensions, derailing Northern Ireland's electricity deal with Ireland and much else. However these matters have nothing at all with 'no trade deal' which is the issue here. They are the basic meat and drink of any competent government to resolve as they deal with the necessary separation from the EU under Article 50, which indeed was created for this very purpose.

For these negotiations about practical matters to fail one would need to assume that the EU and the UK were planning some sort of acrimonious divorce amounting to a level of implicit warfare. Since they are both allies in NATO cooperating on security, and supposedly maintaining friendly diplomatic relations into the future, this would be a serious failure indeed. It would imply that one would kiss goodbye to good cross-Channel relations indefinitely.

ECONOMIC PROJECTIONS TO 2025

In this section, we provide forecasts for the three potential policy scenarios:

1. **The baseline status quo** where we assume that some Chequers-type proposal is adopted, which leads to an indefinite postponement of Brexit
2. **A Canada+ FTA with the EU**, beginning in Q1 of 2021 and FTAs with the non-EU world agreed in parallel
3. **A World Trade Deal** in which the UK leaves the EU without a trade under WTO rules, starting April 2019 and agrees FTAs with the non-EU world as with Canada+

In each scenario we assume the Brexit scenario strategies set out above.

But it is also possible that these scenarios could mutate in the future into one of the others. Scenario 2 looks like the only one that would be sustained indefinitely as assumed. Scenario 1 could likely lead to demands that the referendum be respected, putting pressure on the Government of the day to switch to scenario 3 at some future date. As for scenario 3, it would entail the erection of tariffs between the UK and the EU (possibly in both directions). If either side did not impose them, WTO rules would force them to eliminate tariffs on other countries, thereby amounting to unilateral free trade, which is an unlikely choice for either side. Since these tariffs impose costs, this might at some point in future cause a switch to Scenario 2.

1 - Baseline Status Quo Forecast

Our baseline forecast under a status quo Brexit shows the current account improving, the PSBR steadily going into surplus and the economy growing rather moderately at or around 2 per cent, with inflation settling at 2 per cent. Employment growth continues but quite slowly with the labour market yielding continued increases in participation but total hours flattening off, and measured productivity growth improves. Interest rates slowly rise to return monetary conditions towards normality.

Under the status quo, we are in the EU's customs union and the single market, and so subject to the EU's freedom of migration. This status quo promotes 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.

The proponents of the status quo argue that it 'preserves jobs'; yet what they mean is it preserves 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.

This baseline is not a disastrous one, as in our view actual productivity is growing faster because of unmeasured improvements, and hence causing growing pleasure to consumers. Full employment, expanding job opportunities, and improving products are a good recipe for household satisfaction.

However, this status quo scenario is unsatisfactory for two reasons. First, as we show in the next two sections, it is substantially inferior to a Clean Brexit, either under Canada+ or a World Trade Deal, since these both permit us to obtain free trade with the non-EU world, to optimise our regulative systems, and to end the subsidised and uncontrolled immigration of unskilled labour from the EU.

Second, even more worryingly, it lays the UK open to future EU decisions on such matters as trade, regulation and migration that would be made solely in the interests of EU-27 countries with no input from us that might conceivably result in serious damage to our economic interests. This damage is impossible to quantify now, but its threatened scale could be considerable, judging by past trends in EU decision-making.

So this status quo projection, while apparently tolerable, represents both a failure to grasp large possible gains and a hostage to serious misfortune.

Baseline Status Quo Forecast

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
GDP Growth[1]	1.9	1.8	1.5	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Inflation CPI	1.1	2.6	2.5	2.1	2.0	2.0	1.9	1.9	2.0	2.0
Wage Growth	2.4	2.9	2.7	2.4	1.8	1.9	2.0	2.1	2.3	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]	82.1	77.4	77.4	74.5	76.2	75.4	75.5	75.2	75.1	74.6
3 Month Interest Rate	0.5	0.4	0.6	1.1	2.4	3.1	3.1	3.1	3.1	3.1
5 Year Interest Rate	0.7	0.6	1.5	2.5	3.4	2.9	2.6	2.6	2.6	2.6
Current Balance (£bn)	-90.9	-65.3	-60.3	-49.5	-39.7	-31.0	-17.9	-16.9	-8.2	-0.4
PSBR (£bn)	45.1	39.4	30.7	21.8	5.6	-6.7	-15.1	-21.0	-26.0	-32.0

[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)

2 - Canada+ Forecast Implemented From Q1 2021

We assume a Clean Brexit takes place under a Canada+ FTA with the EU, which would reduce protection and regulation in favour of free trade and full competition and would remove taxpayer subsidy (through various benefits) from unskilled EU migration. These moves benefit UK consumers, lowering the cost of living by 8 per cent on our estimates and introducing competition raising productivity across the economy - with a total gain in UK welfare and GDP of around 4 per cent from free trade and another 2 per cent from improved regulation, a total gain to GDP of 6 per cent.

On top of this, there are gains from regaining our net EU budget contribution (0.6 per cent of GDP) and removing the taxpayer subsidy to unskilled immigration (roughly a 20 per cent wage subsidy, costing 0.2 per cent of GDP). There will also be longer term gains to growth through enhanced innovation and entrepreneurial activity.

The gains identified above by our World Trade Model come in the long term. For the Budget judgements, we need to translate these long-term gains into their effects on the short and medium term behaviour of the economy. To do this, we employ the Liverpool Model to obtain the supply-side effects, as well as more recent modelling of the UK economy to obtain the timing of effects, the 'dynamics'.

To do this, we take the current forecast without Brexit and allow for Brexit. The assumptions used are based on the above figures for the trade and regulation effects calculated by the World Trade Model (see Appendix). All these changes are phased in gradually over five years.

Canada+ Forecast Beginning in Q1 of 2021

	2019	2020	2021	2022	2023	2024	2025
GDP Growth[1]	1.9	1.9	2.2	2.3	2.3	2.3	2.8
Inflation CPI	2.1	2.0	2.1	2.8	2.3	2.1	2.0
Wage Growth	1.8	1.8	2.6	3.6	2.7	2.5	2.2
Unemployment (Mill.)[2]	0.7	0.7	0.6	0.5	0.4	0.3	0.2
Exchange Rate[3]	74.5	73.1	72.4	71.7	70.7	70.9	69.9
3 Month Interest Rate	1.2	2.4	3.1	3.1	3.1	3.1	3.1
5 Year Interest Rate	2.5	3.5	2.9	3.1	3.2	3.2	3.2
Current Balance (£bn)	-48.9	-39.2	-28.5	-15.3	-12.0	-5.5	0.7
PSBR (£bn)	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)

The main effect of these changes is to boost the economy's supply-side in the longer term. Growth improves as UK costs fall. Unemployment falls slightly - as it is of course already extremely low. Real wages rise as firms demand more labour given higher profits. The higher output drives down the exchange rate as new markets are sought by exporters.

In the shorter term, there is a rise in inflation as the exchange rate falls and demand increases. Interest rates rise in reaction during the early 2020s.

It is interesting to see, after Brexit, the UK becomes a more 'normal' economy, with growth reviving, monetary policy 'normalising', and inflation getting back on track. The fall in the exchange rate and the direct improvement in the current account largely correct the recently persistent current account deficit. The PSBR, as a share of GDP, continues to fall towards balance at the end of the decade, with the growth of nominal GDP boosting revenues. From 2020 onwards there are further gains in revenues which move the PSBR into surplus, enabling debt to fall reasonably swiftly over the decade.

3 - A World Trade Deal Forecast Beginning in Q2 2019

We discussed above how 'no trade deal' with an exit under WTO rules would work out for the UK, and indeed for the EU. We call this a World Trade Deal because, quite contrary to so much conventional commentary, this is a move into an ordered WTO-based world where law and order prevails and is the world where already about than half our trade is carried out. So it a 'deal' rather than a 'no deal' where no trade rules prevail.

We showed in our discussion that the UK would gain compared with a Canada+ FTA with the EU because we would be able to strike FTAs with the rest of the world immediately on exit in Q2 2019, we would gain around £13 billion a year in tariff revenue from EU exporters, and we would not pay the EU about £39 billion in budgetary exit payments. In the Table below we show the forecast under these World Trade Deal assumptions.

Brexit in 2019 Q2 under a 'World Trade Deal' Forecast

	2019	2020	2021	2022	2023	2024	2025
GDP Growth[1]	1.9	2.2	2.3	2.2	2.3	2.9	3.0
Inflation CPI	2.1	2.3	3.1	2.9	2.1	2.0	2.0
Wage Growth	1.8	3.3	2.9	2.4	2.2	2.4	2.3
Unemployment (Mill.)[2]	0.6	0.5	0.4	0.3	0.3	0.2	0.2
Exchange Rate[3]	72.7	71.4	72.1	70.7	70.1	70.3	69.3
3 Month Interest Rate	1.8	3.2	3.1	2.4	2.3	2.0	2.0
5 Year Interest Rate	3.2	3.8	2.5	2.3	2.2	2.0	2.0
Current Balance (£bn)	-49.0	-39.3	-25.8	-15.3	-11.9	-5.5	0.7
PSBR (£bn)	14.8	5.5	-12.7	-20.3	-35.8	-37.4	-44.0

[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)

THE POST-BREXIT DIVIDEND AND FUTURE FISCAL POLICY

The forecasts made above shows that Brexit reinvigorates the economy whether it occurs under a Canada+ FTA with the EU or a World Trade Deal. In this section, we spell out the implications for the government's finances. We do so for convenience for the Canada+ scenario : in fact the World Trade deal scenario is slightly better for reasons explained above ; but given that we are dealing with orders of magnitude, these do not change and so we can take our projections as approximately of the same order for both.

The Post-Brexit Fiscal Fund

Through its stimulatory effect on growth, Brexit also improves the budgetary outlook. Making the assumption of continued restraint in public spending - so that it grows around 0.5% per annum in real terms - we find, by 2025, there is a PSBR 'surplus' (i.e. a negative borrowing requirement) of some £40 billion in money terms, around 1.3% of money GDP as it will then be.

The debt/GDP ratio falls from 2016, at which point nominal GDP growth of around 4% more than offsets the PSBR at 2% of GDP, reducing debt by about 1.5% of GDP. Hence, the PSBR will be steadily falling and going into surplus. If this growing fiscal gain is allowed to reduce debt, then by the end of the 2025 financial year, the debt/GDP ratio would have fallen to around 53% of GDP, and reached 60% by the end of 2024. The reasonably 'safe ' ratio is usually set at 60%, 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%, was chosen for this reason.

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% target by around the middle of the decade. Five per cent of GDP could therefore be spent additionally from the 2020 financial year over the succeeding 5 years, while still reaching a 60% debt/GDP ratio in around 2026. This total amount is about £135 billion. Therefore, beginning from the date of Brexit in 2021, some £25 billion extra spending a year could be accommodated, while still reaching the 60% 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% of GDP on top, without raising the debt/GDP ratio. In total, this would imply approximately 4% 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% 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% 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 ; uprating them in line with projected nominal GDP growth their values should be increased by a quarter for 2025-26.

For example, a 1% rate cut in

- Corporation tax would cost £2.6 billion in 2020 (hence £3.2 billion by 2025-6)
- The standard rate of income tax £4.9 billion (£5.8 bn in 2025-6)
- The standard rate of VAT £6.4 billion (£8 bn.)
- The top rate of income tax £1.3 billion (£1.6 bn.)
- The very top (‘additional’) rate £0.2 billion (£0.3 bn.)

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% in 2020, and the very top rate by 7% (to equality with the top rate), the cost would be of the order of £9 billion. Together, with additional spending of £16 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%, at a cost of £12 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); or else VAT could be cut by 1.5% for roughly the same cost
- Corporation tax could be cut another 3%, costing another £10 billion ; and
- The top rate could come down by 2%, costing around £3 billion.
- The remaining £15 billion could be used on spending.

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

Table : 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	+25	1752	2410	72.7 (70.6)
2022	-11	+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	+65	1804	3035	59.4 (51.0)
2027	-59	+65	1810	3187	56.7 (46.7)

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.)

APPENDIX

Assumptions Used in the Liverpool Model to Reflect the Impact of Brexit with a Canada+ FTA

- We assume the gain in consumer living standards from leaving the EU customs union is 3.2 per cent due to the fall in tariff-equivalents (which we treat as a fall in the UK expenditure tax) and 0.8 per cent due to an improvement in the terms of trade (whereby the prices of UK imports from the EU fall, partially offset by a fall in the prices of UK exports to the EU, which are some 8 per cent of GDP smaller than the imports).
- The net EU budget contribution, 0.6 per cent of GDP, plus the 0.2 per cent of GDP paid to EU unskilled immigrants is returned to UK consumers in the form of an income tax cut
- The reduction of the regulative burden is modeled as a fall in the employer rate of national insurance by 2 per cent
- There is no direct effect on the public sector borrowing requirement (PSBR) since none of these changes affect the net public revenues
- The 0.8 per cent terms of trade gain plus the 0.6 per cent return of the net EU budget contribution are received as direct improvements of the current account