

OVERVIEW OF TREASURY BREXIT FORECASTS PUBLISHED ON 28 NOVEMBER 2018

Submission to the Treasury Committee

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After discarding use of its widely criticised 'gravity-like' model used in the initial Project Fear Referendum forecasts, the Treasury has now adopted use of a Computable General Equilibrium (CGE) model (GTAP from Purdue University) that is similar in approach to the World Trade Model at Cardiff University.

In this note we ignore the migration assumptions made by the Treasury which create large extra costs supposedly; however, these costs are based on absurd assumptions about abruptly cutting off the flow of migrants, when it is generally agreed that skilled migrants will be flexibly treated and unskilled migrants will be allowed in temporarily and without access to state benefits.)

Based on the latest Treasury Report and its Technical Annex, the assumptions are flawed in three fundamental ways:

1. They assume de-minimis benefits for the UK economy from future free trade agreements with non-EU countries

- Only a 0.2 per cent boost to GDP is forecast vs an estimate for Australia on the same model of more than 5 per cent from its 30 years of trade liberalisation
- It gets this by assuming
 - Quite low estimates of EU Non-Tariff Barriers (based on econometric work) around 7% for goods (other estimates suggest 16%). For services, it assumes UK NTBs after leaving the EU would be 15% (our estimate is zero as the UK has a liberal regime for services trade)
 - Only half of the goods NTBs can be abolished, and only one third of the services NTBs, giving the resulting NTBs to fall as follows:

Table 3.A: Summary of estimates of changes to UK-Rest of World NTB compared to today's arrangements for all scenarios

Compared to today's arrangements (per cent change)	NTBs into the UK for ROW trade partners (per cent)	NTBs into ROW trade partners for the UK (per cent)
Manufactured Goods	-3.3	-2.3
Agri-food	-3.6	-3.8
Services	-2.6	-4.2
Financial Services	-5.0	-5.6
Networks	-3.8	-3.6

Negative figures reflect a reduction in NTB costs compared to today's arrangement.

Source: HMT Tech Annex

- Adding these abolishable NTBs to the average tariffs on goods gives a total eliminable of 8% on goods (average tariffs 4%); and 5% on services (no tariffs here)
- Under GTAP if these were abolished via FTAs that achieved the same barrier reduction on our imports as unilateral free trade, the gain would be 1.6% of GDP
 - However, in practice HMT assumes only around half of these gains would be achieved by FTAs, because of limited coverage. This brings the gain down to 0.8% of GDP. (Would like to see more detail on this of how HMT did the simulations.)
 - Then HMT assumes that only one quarter of this programme will occur as it is ‘under development’ - see following para 76 from annex

76. The Government’s approach to agreements between the UK and prospective trade partners is currently being developed. In this illustrative and indicative approach, representing ambitious agreements including but not limited to FTAs, it is estimated that under the central ambition case, 25 per cent of the actionable goods and services barriers might be reduced. These are applied in all the modelled EU exit scenarios. As set out in section 2.3.3 of the analysis document, the analysis does not model any constraints that the Government’s policy could impose on future UK-RoW agreements.

Source; HMT Tech Annex

This reduces the gain to the headline 0.2% of GDP.

2. **High border costs are assumed for the processing of customs declarations, rules of origin certificates, and goods inspections.** This reflects a lack of understanding of how modern computerised, pre-declared border procedures work
 - Typical actual costs of modern procedures are well below 1 per cent and the Swiss customs authority reports costs of 0.1 per cent
 - Inspections are intelligence led and a rarity (typically only 1 to 3 percent of shipments). They often require only confirmation of computerised documentation and can take place away from the border.

These costs across goods and services give rise to a loss of 1.8% of GDP.

3. **Imaginary high compliance costs are assumed for exporters/importers to meet hypothetical new non-tariff barriers springing up immediately after Brexit.** These NTBs (see next Table) include the border costs discussed in the previous paragraph.

Table 2.D: Summary of estimates of changes to UK-EU NTBs by sector compared to today's arrangements.

Compared to today's arrangements (per cent change)	Modelled no deal	Modelled average FTA	Modelled EEA-type ⁴⁸	Modelled White Paper	Modelled White Paper with 50 per cent NTB sensitivity ⁴⁹
All Goods ⁵⁰	+10 (+6 to +15)	+8 (+5 to +11)	+5 (+3 to +7)	+1 (0 to +1)	+4
All Services	+11 (+4 to +18)	+9 (+3 to +14)	+2 (+1 to +3)	+6 (+2 to +10)	+7

Central estimates and ranges in brackets.⁵¹ Note: estimates are rounded to the nearest per cent. Owing to rounding, narrow ranges (less than one per cent) are not distinguishable in the table.

Source: Treasury Technical Annex

- This is based on the mistaken belief that the EU will suddenly determine that UK exporters do not meet product standards - despite over 20 years of shared rules and standards • Such behaviour would be illegal under WTO anti-discrimination rules that require importers from all countries to be treated the same – ie, a UK importer cannot be required to meet a standard that is not required of, say a US importer or indeed an internal producer from the EU. In other words they must be existing EU standards- which we meet.
- Fails to understand how trade actually works – ie, each importer makes independent decisions as to set their product configurations and the attractiveness of export markets. Hence even as standards change in future, exporters will make sure, from their own commercial interest, that their goods continue to meet these standards, as occurs throughout the world with export trade..

In reply to our criticism of these estimates, the Treasury evades the point, simply saying the WTO rules may not be implemented.

63. Rather than model NTBs with the EU, an Economists for Free Trade study⁵⁶ assumes no additional NTBs. They argue that given the UK's current regulatory alignment with the EU, any attempt to impose trade barriers would be illegal under WTO rules. The OBR notes that 'this appears to be based on Economists for Free Trade's interpretation of the WTO's MFN requirements. But most trade experts interpret these rules as meaning that the EU would be forced to impose the same NTBs that the rest of the world currently faces, unless the UK and EU sign a trade deal to lessen them'.⁵⁷

Source: HMT Tech Annex

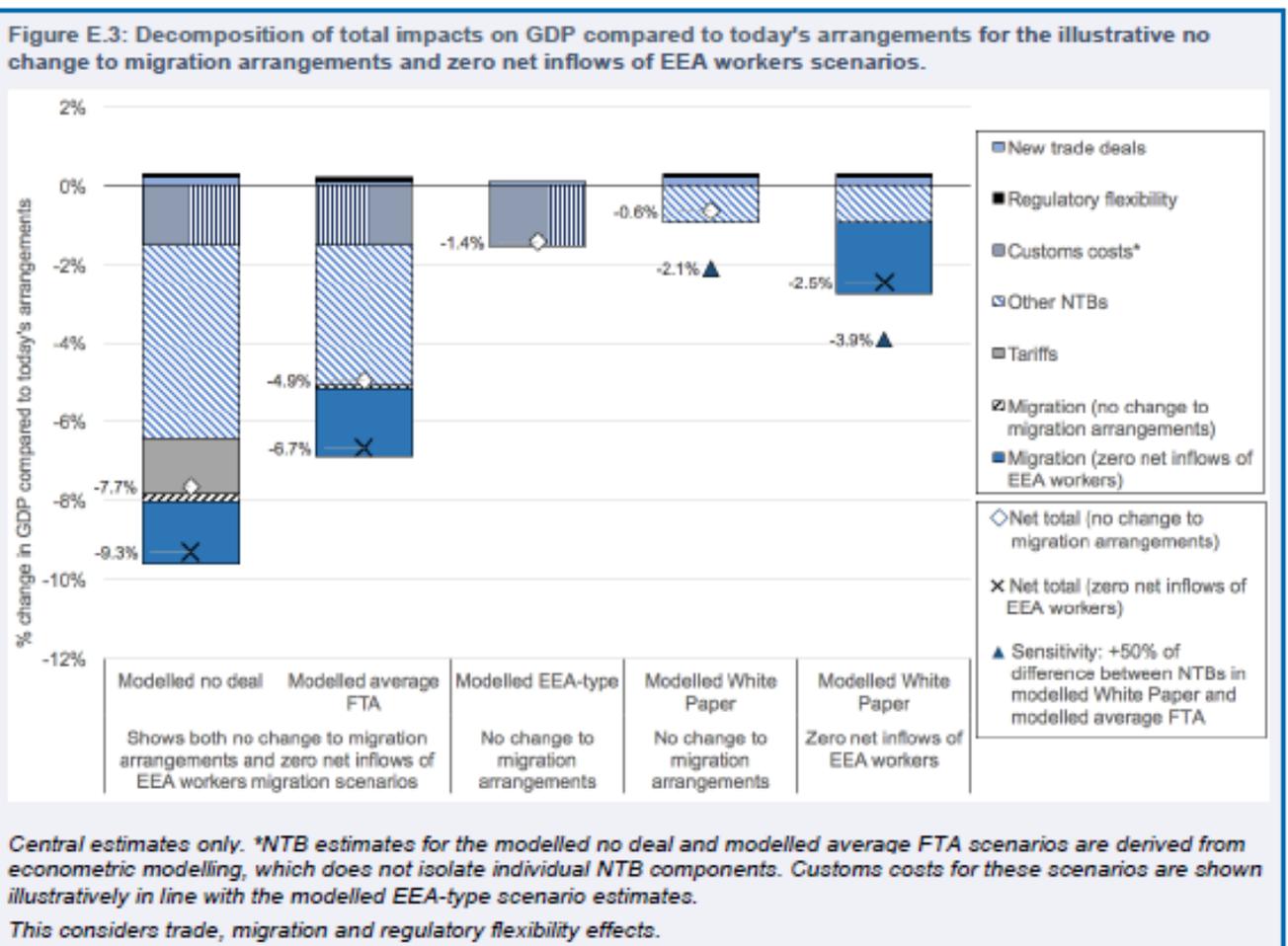
Note that the EU imposes standards that the UK currently meets; these are 'the same EU standards that the rest of the world currently faces'. These standards of course act as NTBs to countries such as the US which cannot meet them.

The combined total effect of these assumptions is that– beginning with product standards and regulations identical to those of the EU –i t would be as if the UK faced an EU tariff-equivalent cost on goods and services combined of around 14.5 per cent (of which only 4.5% is actual goods tariffs),

if trading under WTO rules. This is about three quarters of the effective tariff actually faced by the US that, in fact, trades with the EU under WTO rules.

When these flawed assumptions are fed into the Treasury’s GTAP model, it forecasts a reduction to UK GDP of 7.7 per cent (see bar chart below). This is rather amazing considering that total EU trade accounts for only 12 per cent of total UK GDP and only about 40 per cent of this trade is exports that could be affected by such EU restrictions.

10 EU Exit: Long-term economic analysis



Source; Main Treasury Report

The table below compares the result of HMT model results with the estimated results that would be obtained from the same model if assumptions more reasonable than those used by the Treasury were fed into the model.

It should be noted that, due to the use of econometric estimates, the new EU trade barriers now assumed are lower than the judgements used in the earlier PowerPoint report, and indeed have

been roughly halved. But the response of the UK part of model in the new report has been raised (more than doubled) to compensate and give a similar-sized hit to UK GDP from WTO and FTA scenarios. This alteration of the Treasury model is puzzling and suggests we need to have access to discover just why these changes have been made as well as their empirical justification.

It should be also noted that in separate work we have tested different model variations in our own Cardiff World Trade Model and found that the most accurate model is closest to the perfect competition Classical version.

These observations support the requirement for outside independent economists to be given access to the HMT model.

Table: Trade Effects under Brexit Scenarios According To GTAP-type model used by Whitehall

	A: Whitehall Assumptions		B: Alternative Assumptions	
Trade Barriers expressed as % Tariff Equivalent; Effect on GDP shown as % of GDP in italics				
	Canada+	WTO	Canada+	WTO
Tariffs	-	4.5	-	4.5
<i>Effect on GDP</i>	-	-1.4	-	-1.4
New Standards	16.2	5.5	-	-
<i>Effect on GDP</i>	-3.6	-4.0	-	-
New Customs costs	5.8	4.5	-	-
<i>Effect on GDP</i>	-1.3	-1.4	-	-
Total Tariff Equivalent (%)	22.0	14.5	-	4.5
<i>Total Effect on GDP (% of GDP)</i>	-4.9	-6.8	-	-1.4
FTAs with rest of world				
<i>Effect on GDP (% of GDP)</i>+0.2.....	 +4.0*.....	
<i>All Trade Effects on GDP (% of GDP)</i>	-4.7	-6.6	+4.0	+2.6

*Assumes all EU protection of food and manufactures (20% average on each) eliminated via FTAs