Invest, devolve, liberate

A new economic policy in the light of Brexit

Tom Startup
Charlie Cadywould

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Unit 1, 2-3 Mill Street
London SE1 2BD

T: 020 7367 4200

hello@demos.co.uk
www.demos.co.uk

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ABOUT THIS REPORT

This report aims to address the question of how domestic economic policy should respond to the long-term economic challenges the UK faces in the light of our intention to the leave the European Union. It does not attempt to tackle the complex issues of what we should aim to achieve from the Brexit negotiations or how they should be conducted. Instead it focuses on what we know about the long-term economic challenges facing the UK and how Brexit is likely to impact them. Lastly it suggests policy reforms which should help remedy these challenges and prepare us for life outside the EU.

It is informed by three expert seminars that were held at the Labour and Conservative party conferences and in London during September and October 2016. The seminars were held under the Chatham House Rule and included economists, business leaders and other experts. They were asked to consider possible solutions to the long-term economic challenges highlighted in Chapter 1 and the Implications of Brexit in Chapter 2. Our conclusions and policy recommendations are detailed in Chapters 3 and 4. We thank all who attended for their contributions.

INTRODUCTION: ECONOMIC POLICY RESET

It is often said that 1945 and 1979 mark crucial turning points in the political and economic history of the UK. In the future, it may well be said that 2016 was another such moment. When the result of the UK referendum on membership of the EU became clear in the early hours of June 23rd 2016 it triggered the resignation of David Cameron who had campaigned to remain. After Theresa May was appointed Conservative leader and Prime Minister on 13th July, a new government took office tasked with implementing Britain's exit from the EU. In the space of weeks three party leaders either stepped down or were challenged for the leadership. The economic policies of the last six years hang in the balance.

However, despite all the political turmoil and predictions of calamity, the performance of the economy since the vote has been mostly steady, rosy even. [1] The short-term falls in the stock market have been reversed, while the housing market is stable if slowing, so far. Consumer confidence has been robust and retail sales healthy.[2] Business investment, against expectations, rose in August,[3] and economic growth was a healthy 0.5% in the third quarter.[4] However, the initial 13% fall in the pound has not been reversed and is now feeding into higher business costs.[5] May's speech at the Conservative Party conference triggered a sharp sell-off in the pound, now down a further 4% against the dollar since early October. Gilt yields have also risen in response to fears of the implications of a 'hard Brexit'.[6] The economy is forecast to slow dramatically over the next year.[7] The IMF has cut its growth forecasts for the UK by 0. 9% for 2017, and warned that the vote has thrown a 'spanner in the works' for global growth. [8]

Meanwhile the Bank of England has cut interest rates to 0.25% and restarted quantitative easing in a bid to head-off any economic downturn while Phillip Hammond, the new Chancellor, is preparing an Autumn Statement to steady nerves and lay the foundations for future economic policy. Now that Jeremy

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[1] https://www.theguardian.com/business/2016/aug/19/boom-or-gloom-the-economic-impact-of-brexit-so-far - sources are ONS, Reuters, IHS Markit
[2] http://www.bbc.co.uk/news/business-36956418
[3] http://uk.investing.com/economic-calendar/business-investment-30
[4] https://www.ons.gov.uk/releases/grossdomesticproductpreliminaryestimatejulytoseptember2016
[5] http://www.bbc.co.uk/news/business-36956418
[6] https://www.theguardian.com/business/2016/oct/17/uk-government-bond-sell-off-continues-keeping-pressure-on-pound
[7] https://www.theguardian.com/business/2016/sep/12/uk-economy-near-standstill-brexit-vote-hits-investment-bcc
[8] http://www.ft.com/cms/s/0/34eaff02-4cfa-11e6-88c5-db83e98a590a.html#axzz4K7wyqVMg

Corbyn has been re-elected, Labour too will be attempting to formulate a coherent economic alternative to present to the public.

The time is surely ripe for a new economic policy for the UK. But what sort of economic policy is suitable in the context of Brexit? To answer this, we first need to understand the economic performance of the UK economy and the likely implications of Brexit.

1 THE LONG-TERM ECONOMIC CHALLENGES

Economic policy since 2010 has been dominated by three main aims: reducing the budget deficit, liberalising the economy to boost growth and living standards, and rebalancing the economy to be less reliant on services and London.[9] The government has used large cuts in public spending, more moderate cuts in taxation, deregulation and a devolution of power to Scotland, Wales and the English regions to achieve these aims. (A fuller overview is available in the Appendix.) Meanwhile monetary policy has remained extremely loose to coax the economy back to normal after the financial crash of 2009.

However, it has been at best a mixed success and has largely failed to address the UK's long-term economic problems. While economic growth has slowly returned to normal, unemployment has been successfully lowered, and inflation is generally under control, the economy is plagued by interconnected problems: a persistently high budget deficit, weak investment, regional and sectoral imbalances, low productivity, and a bloated current account deficit.

Economic Growth

Like many countries, the UK's recession of 2008-9 was the most severe since the Great Depression of the 1930s. Output fell by over 6% peak to trough and the recovery was remarkably slow.[10] Since then, levels of economic growth, while not high, have been comparable to other countries and the economy has now surpassed its pre-recession peak. A combination of very low interest rates, quantitative easing, and a lower exchange rate has helped offset the contractionary effects of government's fiscal policy. GDP growth has generally been below 2% per annum but recently has accelerated and been higher than in either the US, France or Germany.[11] On a per-person basis, the UK's performance has been comparable with other major countries and since 2012 better than France or Germany.

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[9] https://www.gov.uk/government/speeches/transforming-the-british-economy-coalition-strategy-for-economic-growth
[10] http://www.telegraph.co.uk/finance/economics/11900934/UK-GDP-growth-stronger-previously-though-recovery-ONS.html
[11] https://data.oecd.org/gdp/quarterly-gdp.htm#indicator-chart

Figure 1 UK GDP growth (annual % change)

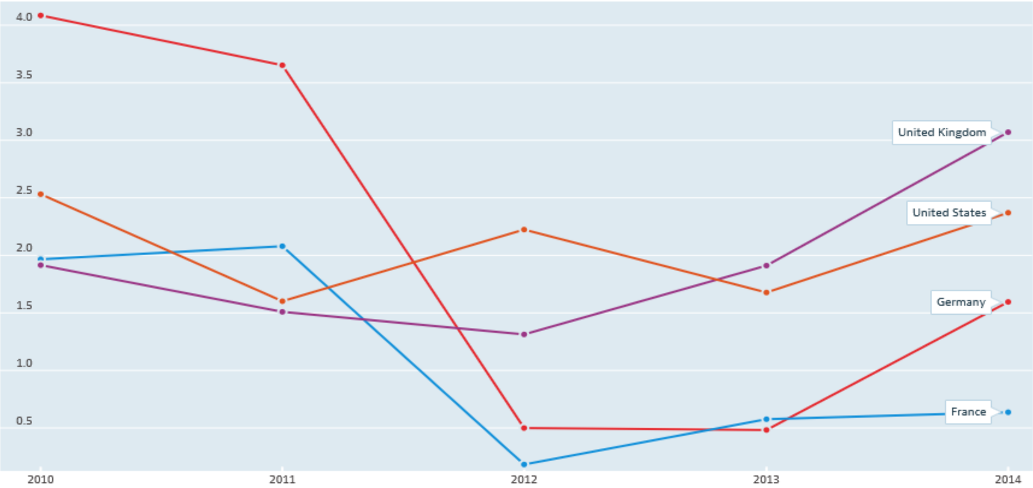
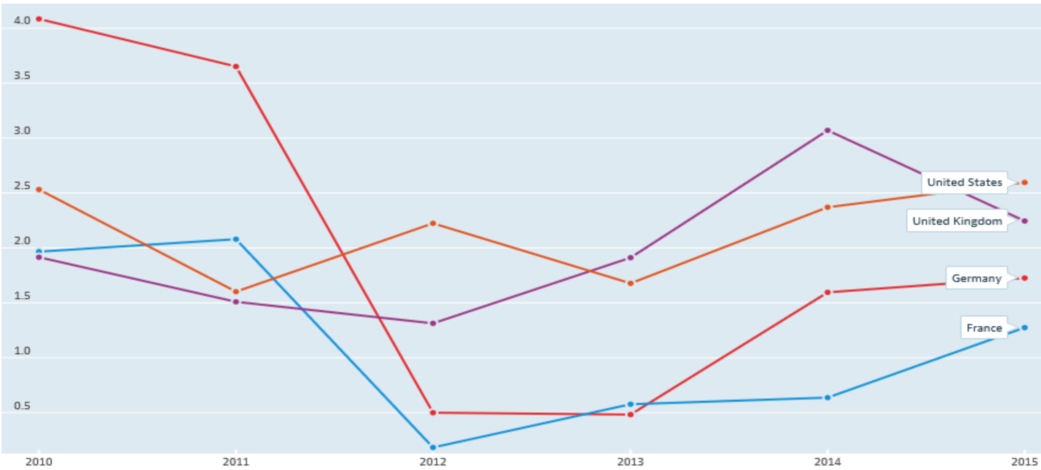


Figure 2 UK GDP per capita growth (annual %)[12]



Unemployment

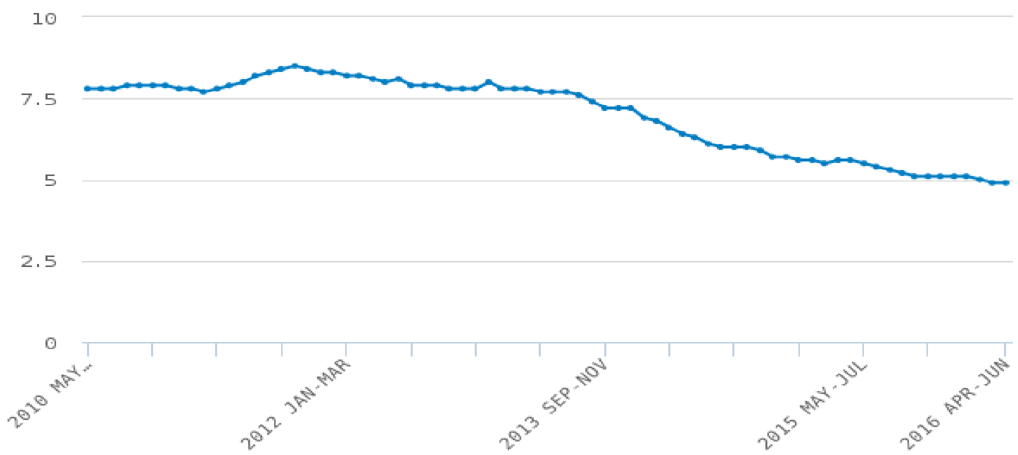
When the financial crisis hit, it was widely expected that unemployment would soar to over 3 million, as in previous recessions. [13] In the event, unemployment peaked at just 2.7 million and then declined rapidly.[14] Unemployment fell from 7.9% in 2010 to just 4.9% now.[15] Rates of long-term unemployment and youth unemployment have also fallen. Nor has this has not been at the expense of

[12]https://data.oecd.org/gdp/quarterly-gdp.htm#indicator-chart
[13]See e.g. http://www.telegraph.co.uk/finance/recession/5274467/EC-demolishes-Alistair-Darlings-recovery-forecasts.html
[14]https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment/timeseries/mgsc/unem
[15]https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment/timeseries/mgsx/lms

growing inactivity, as the employment rate has risen from 70.4% in 2010 to 74.5% now.[16]

Britain's flexible labour market meant that many firms either cut hours or pay rather than laid off workers. Falls in real wages enabled businesses to retain workers even while profits fell. As the cost of investment rose firms took on labour rather than spend on new capital. At the same time government reforms to the welfare system, e.g. the introduction of the Personal Independence Payment, greater use of benefit sanctions, and Benefit Cap, may have increased the willingness of workers to take jobs.[17]

Figure 3 Unemployment Rate

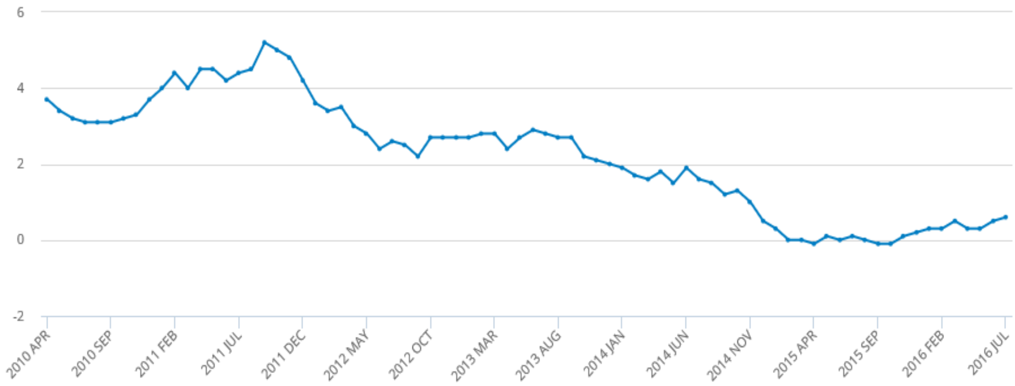


Inflation

Before the financial crisis, inflation was above target due to a positive output gap, rising commodity prices and rising wages. During the great recession it fell sharply to 1% as a result of the sudden fall in demand. It then rose due to the depreciation of the pound, and rebounding commodity prices, peaking at 5.2% in 2011. Since then it has fallen steadily due to falls in wages and commodity prices and, since December 2014, has been below the target of 2%.[18] Unlike many countries the UK has avoided deflation.[19] However, recently inflation has been rising, and is expected to rise to around 4% next year due to the sharp fall in the value of the pound.[20]

[16] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/timeseries/lf24/lms
[17] http://www.res.org.uk/details/mediabrief/6194611/THE-GREAT-BRITISH-JOBS-AND-PRODUCTIVITY-MYSTERY.html provides a useful overview of the main factors.
[18] https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/d7g7/mm23
[19] http://oecdobserver.org/news/fullstory.php/aid/4485/Europe_92s_deflation_risk.html
[20] https://www.ft.com/content/556449a0-a04c-11e6-86d5-4e36b35c3550

Figure 4 CPI: Consumer Prices Index (% change)

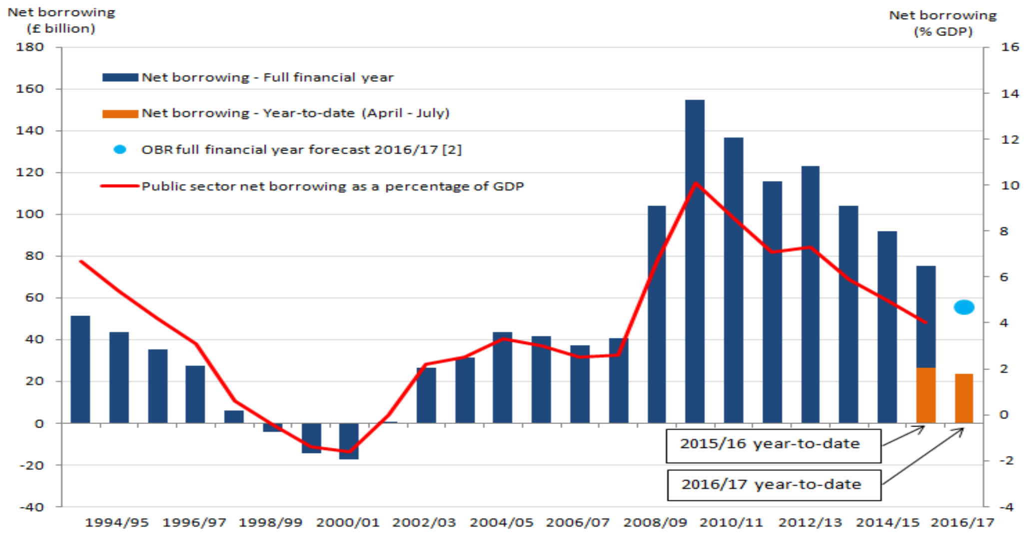


The budget deficit

In 2010, with a budget deficit over 10% of GDP, the Government set out plans to have the structural current deficit balanced by 2014, with public sector net borrowing to have fallen to £20bn by 2015/16. Public sector net debt was to fall to 67% of GDP by 2015/16.[21]

However, the budget deficit has not fallen as fast as the government wanted it to so national debt is still rising. The government has failed to eliminate the structural current deficit – it is down from 3.8% in 2010/11 but still 1.9% of GDP in 2015/16. Public sector net debt, rather than falling to 67% of GDP, has risen from 71.2% in 2010/11 to 83.7% of GDP.[22]

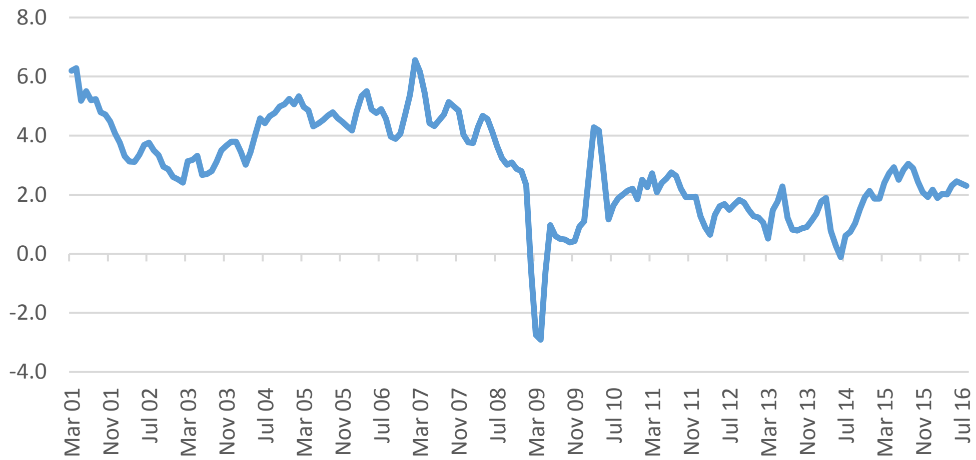
Figure 5



[21]https://www.theguardian.com/uk/2010/jun/22/budget-2010-key-points
[22]http://budgetresponsibility.org.uk/download/public-finances-databank/

This has primarily been because tax receipts have consistently and increasingly fallen short of government expectations. By 2014-15 there was a £52bn shortfall in tax revenue, compared to projections.[23] This is partly because earnings growth has been much lower since 2010 than previously, depressing tax revenues.[24]

Figure 6 % Change in Average Weekly Earnings (3 Month Average)



Despite this, overall government debt is at comparable levels to other major countries[25] and historically unremarkable.[26] While gilt yields have risen slightly in recent months, they remain at extremely low levels.[27] As a consequence, despite higher levels of debt, interest payments have fallen from 2.2% GDP in 2010 to 1.5% now. They remain at historic lows.[28]

[23]Data from 'Economic and Fiscal Outlook' annual reports (March 2011-2015) of Office for Budget Responsibility. Demos analysis.
[24]https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics
[25]Data from https://data.oecd.org/gga/general-government-debt.htm
[26]www.researchbriefings.files.parliament.**uk**/documents/SN05745/SN05745.pdf. General government debt differs from public sector net debt in that it excludes the debt of public corporations and does not net off liquid assets. More info available here: http://www.ons.gov.uk/ons/guide-method/method-quality/specific/economy/public-sector-statistics/government-and-public-sector-debt-measures.pdf
[27]http://www.tradingeconomics.com/united-kingdom/government-bond-yield
[28]https://www.ifs.org.uk/tools_and_resources/fiscal_facts/public_spending_survey/debt_interest_payments

Figure 7 Public sector net debt (% GDP)

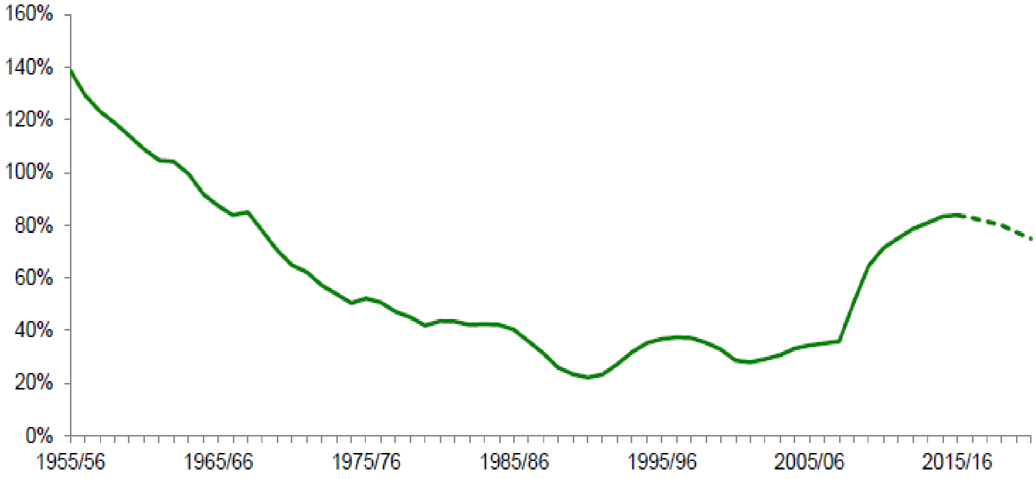
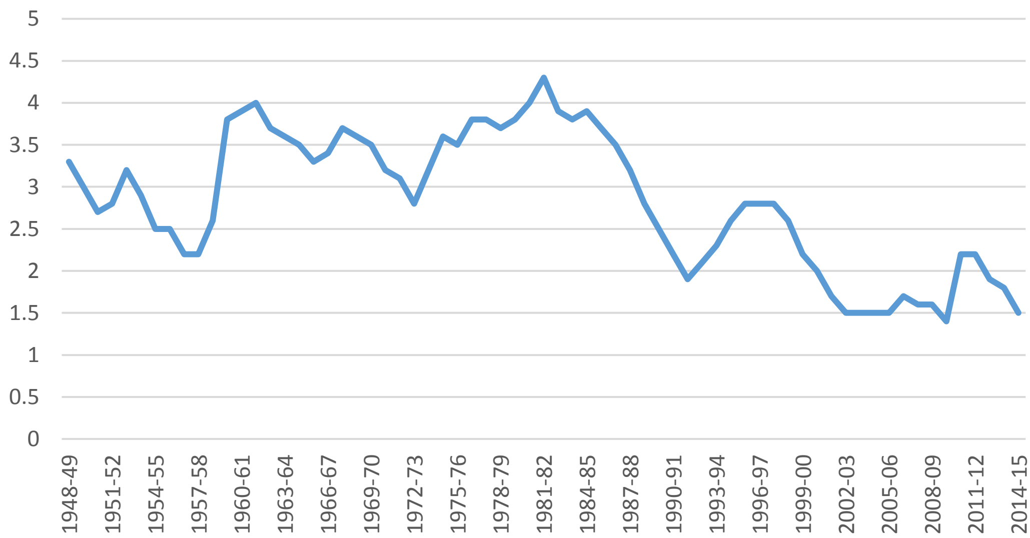


Figure 8 Interest payments as % GDP



Infrastructure and investment

Historically business investment in the UK has lagged our competitors. [29] Following the recession business investment recovered strongly but remains lower than other major countries.[30] Partly to address this, government has cut corporation tax from 28% to 20% and it is scheduled to fall to 17% by 2020. [31] Recently they have announced an increase in the Annual Investment

[29] http://researchbriefings.files.parliament.uk/documents/SN06594/SN06594.pdf
[30] http://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/businessinvestment/quarter1jantomar2016revisedresults
[31] http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/cbt-coalition-report-final.pdf

Allowance.[32] Despite this business investment fell in the last quarter of 2015 and first quarter of 2016, and only grew modestly in the second quarter. [33]

Public spending by the government on infrastructure has been cut substantially since 2010. Net investment fell from £47bn in 2010-11 to £34bn in 2015/16.[34] It lags way below the levels recommended by the OECD; it is estimated that there will be a funding gap of £38bn by 2020/21.[35]

Figure 8 Total investment as a % of GDP (Gross fixed capital formation, IMF data)

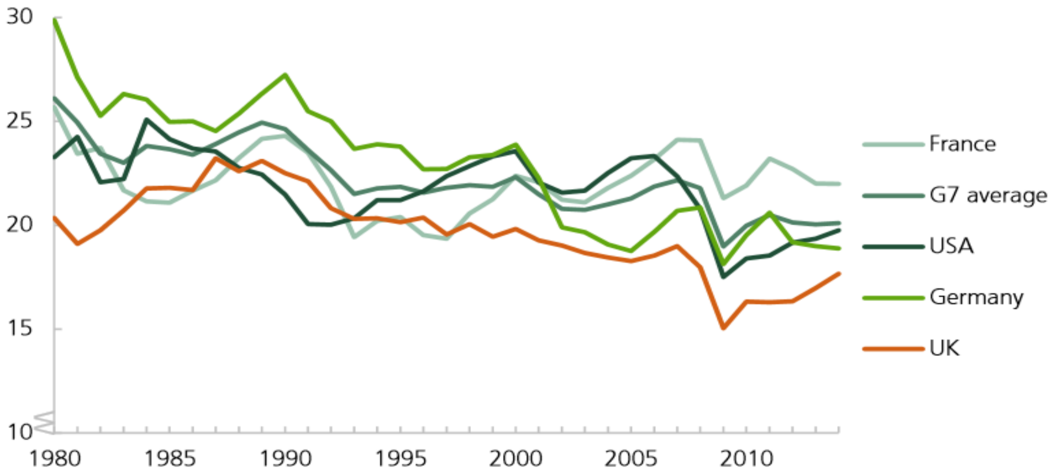
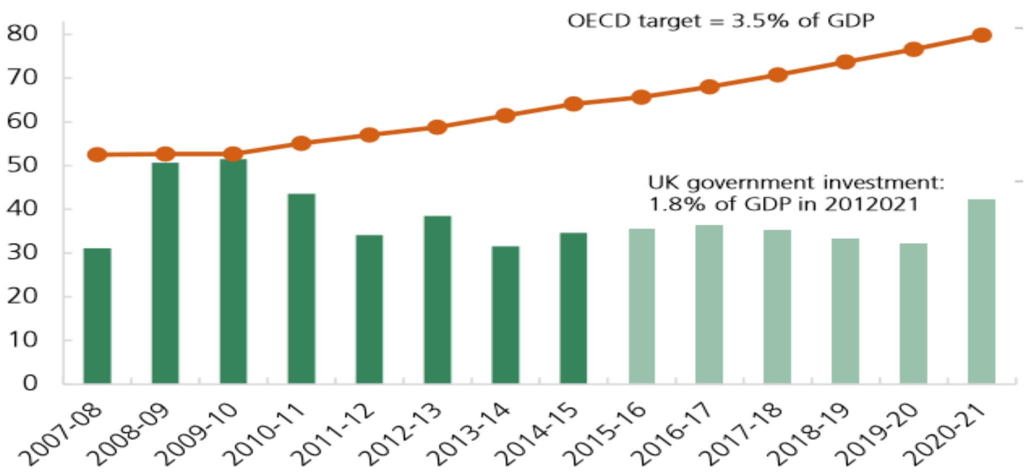


Figure 9 Government spending on infrastructure and ideal spending (£ billions, PSNI and OECD ideal infrastructure spending)



[32]https://www.gov.uk/government/publications/annual-investment-allowance-permanent-increase-to-200000/annual-investment-allowance-permanent-increase-to-200000
[33]http://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/businessinvestment/quarter2aprtojune2016revisedresults
[34]https://data.oecd.org/gdp/quarterly-gdp.htm#23indicator-chart
[35]Ibid.

Regional and sectoral imbalances

Over many decades the UK economy has gradually transitioned away from manufacturing and towards the service industry. This process is partly the result of changes in the global pattern of comparative advantage and government policies such as privatisation and deregulation. These changes have been accompanied by a rise in regional inequality, with a prosperous London and South-East, specialising in services, stretching further away from northern and western regions which have suffered relative decline.

Since 2010 the government has attempted to reverse these changes through attempts to 'rebalance' the economy.[36] However they have been mostly unsuccessful. The service sector still accounts for 78.8% of GDP, slightly down from 79.2% of GDP in 2010.[37] Manufacturing has slightly increased its share from 10% to 10.3%, but overall the changes are minimal.[38] Comparing the UK to other countries since the recession we see that economic growth has disproportionately been driven by the non-financial services sector, not manufacturing (financial services have declined). The contribution of manufacturing to growth was the smallest for the UK than for any major European economy except Spain.**[39]** While the economy has now surpassed its previous peak, manufacturing output remains below its 2007 peak.[40]

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[36]See Appendix for more details.
[37]https://www.ons.gov.uk/economy/grossdomesticproductgdp
[38]Ibid.
[39]https://www.ons.gov.uk/economy/grossdomesticproductgdp/compendium/unitedkingdomnationalaccountsthebluebook/2016edition/nationalaccountsataglance
[40]http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN01942

Figure 10 Output contributions (% pts) to total gross value added growth for major European economies from 2009 to 2015[41]

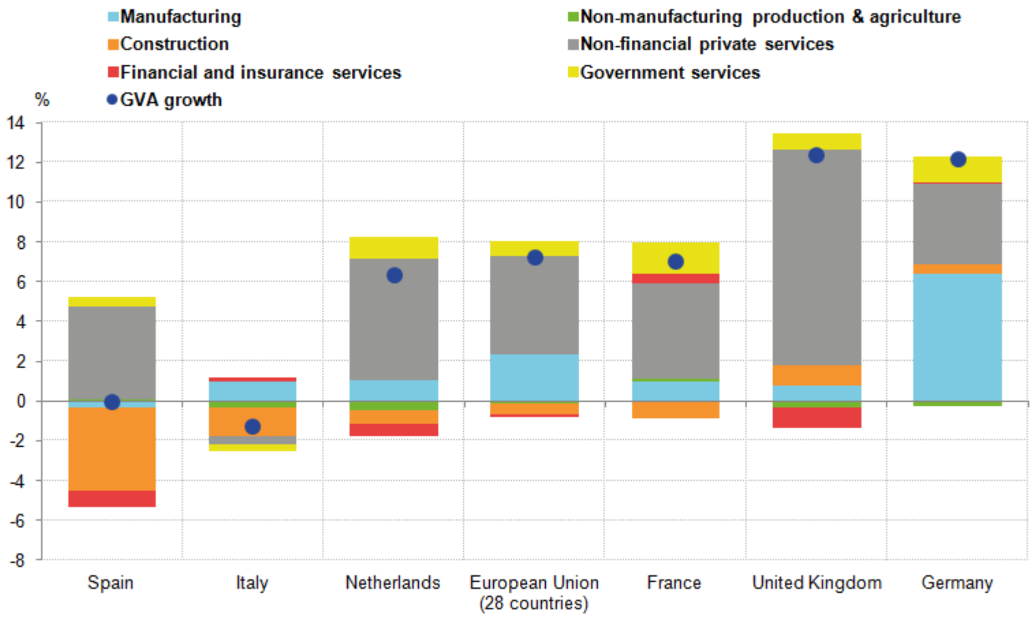
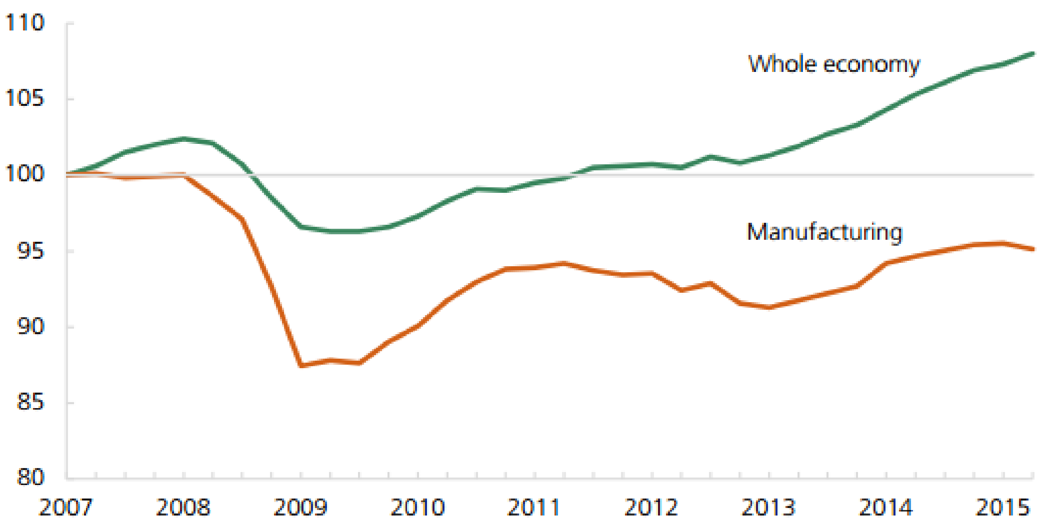


Figure 11 Economic output (Gross Value Added)
(Indexed, Q1 2007 = 100: ONS series L2KK, L2KX)



The UK also continues to have large regional disparities in income and wealth. The following map of the UK illustrates how London earnings significantly outstrip the rest of the country.[42]

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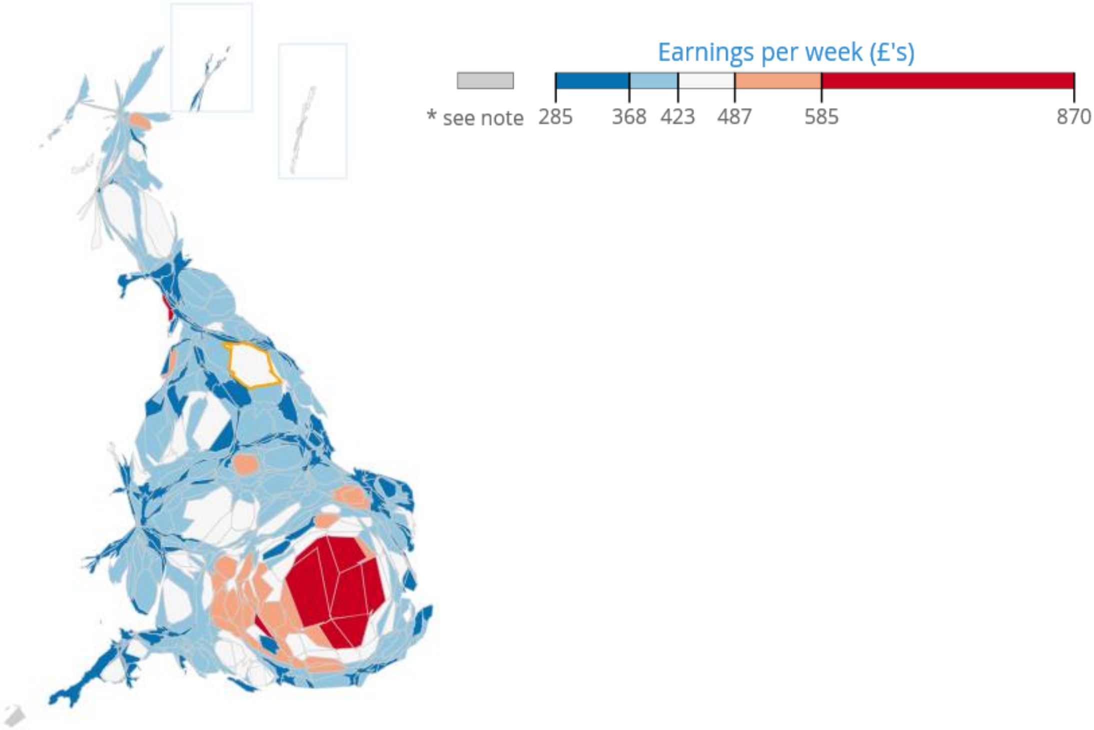
[41]https://www.ons.gov.uk/economy/grossdomesticproductgdp/compendium/unitedkingdomnationalaccountsthebluebook/2016edition/nationalaccountsataglance
[42]http://www.neighbourhood.statistics.gov.uk/HTMLDocs/dvc126/

Figure 12 Size of areas is proportional to number of jobs



Furthermore, geographic inequality has worsened since 2010, with London becoming more, not less economically dominant. The most recent data show that London's share of Gross Value Added (GVA) increased from 21.5% in 2010 to 22.6% in 2014, while GVA per head also grew quicker in London than elsewhere, exacerbating inequality.[43]

Productivity

Historically, UK productivity has been lower than other major economies. The latest data show that this is still true. Output per hour worked in the UK was 18% below the average for the remaining six members of the G7 group of industrial nations in 2014.[44] This is the widest gap since 1991.[45] German, French and US productivity is 25-30% higher than in the UK. While there has been a widespread decline in productivity growth across most Western economies in recent years, the UK's performance has been particularly poor. Productivity has

[43] http://webarchive.nationalarchives.gov.uk/20160105160709/http://ons.gov.uk/ons/rel/regional-accounts/regional-gross-value-added--income-approach-/december-2011/index.html

[44] ONS international comparisons of productivity https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datalist?filter=datasets

[45] https://www.theguardian.com/careers/2016/aug/16/why-are-uk-workers-so-unproductive

grown more slowly than the rest of the G7 – only just exceeding the level achieved in 2007 [46]

Figure 12 Current price GDP per hour worked, 2014 (UK=100)

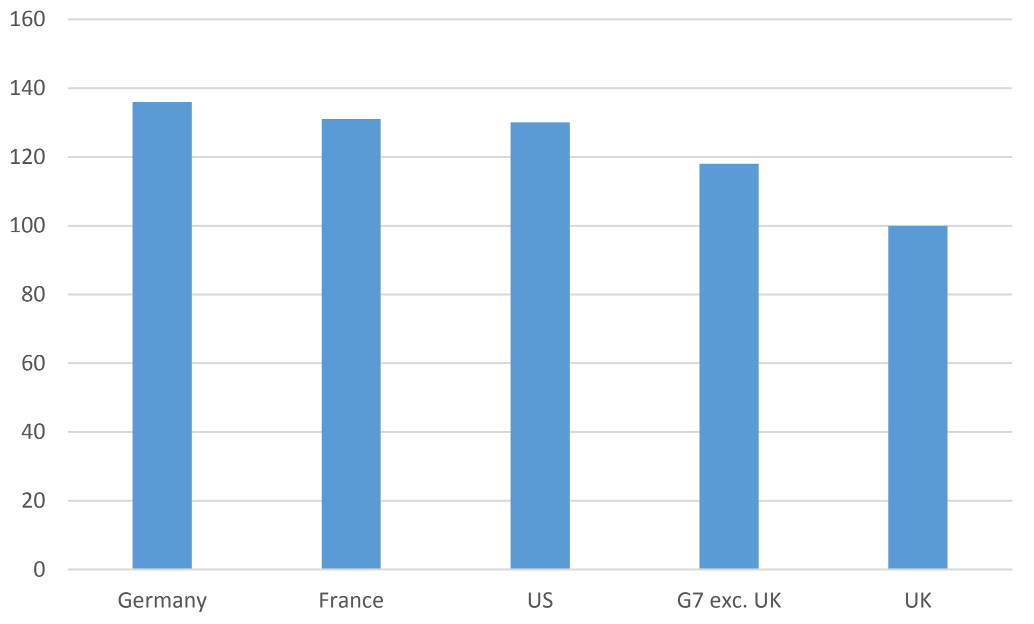
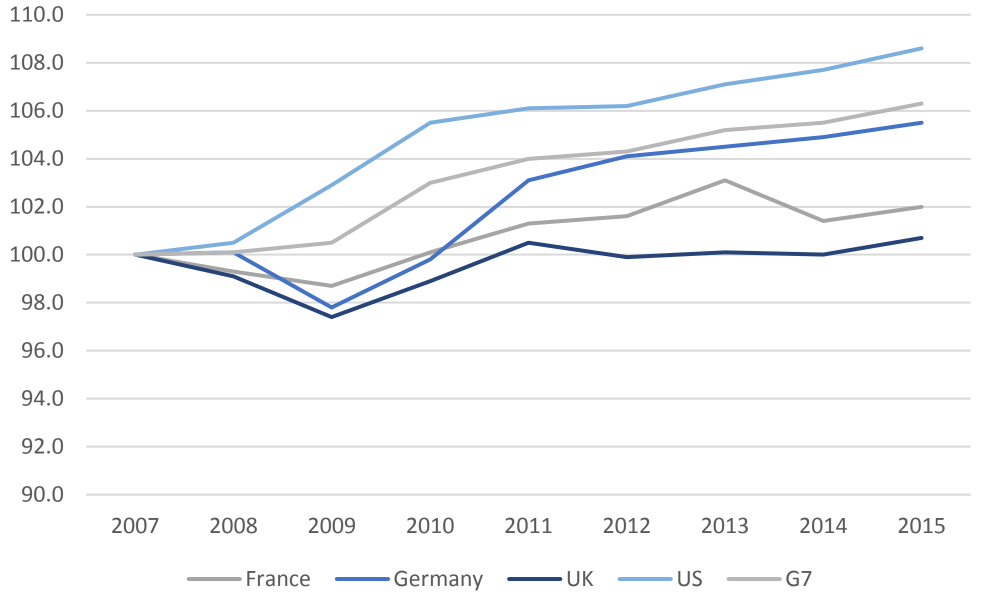


Figure 13 Constant price GDP per hour worked (2007=100)



[46]https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/internationalcomparisonsofproductivityfirstestimates

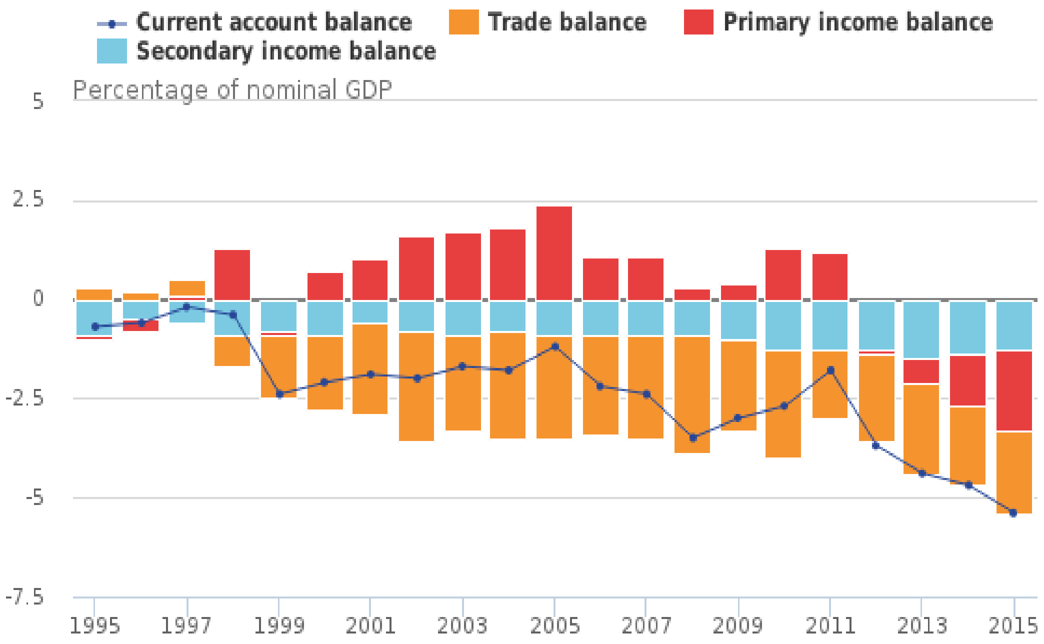
In line with the regional imbalances highlighted above, productivity is also much higher in London than other regions of the UK.[47] Output per hour worked is around 30% lower in the East and West Midlands, 30-40% lower in the North East and North West, and nearly 60% lower in Wales and Northern Ireland.

Current account and trade

For many years, the UK has suffered from a persistent current account deficit. This deficit – the gap between what we earn and what we spend abroad, has deteriorated since 2010. A persistent and large current account deficit causes economic growth to slow and debt to build up in the economy. It means that the UK is heavily reliant on foreign investment into our financial account. In the event of a loss of confidence, for example if Brexit negotiations went wrong, we may be vulnerable to capital flight.

Initially there was an improvement following the financial crisis, as the current account balance moved from -2.7% in 2010 to -1.8% in 2011. However, it then worsened as the primary income balance (mostly net income from investments) moved decisively into a deficit.

Figure 14 Components of the Current Account, United Kingdom, % nominal GDP.

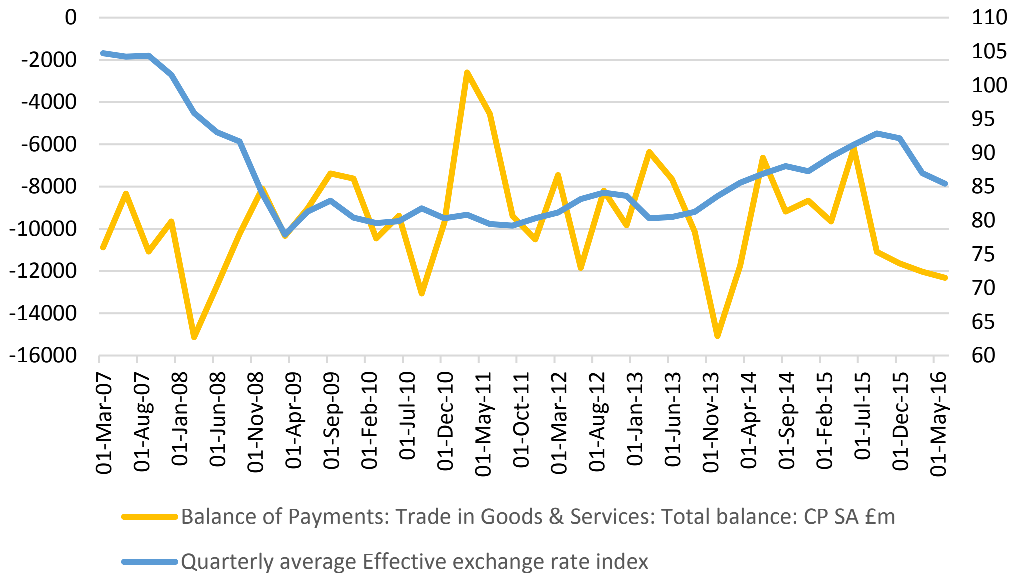


47 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/datasets/labourproductivitytables110andr1

Latest figures show the current account deficit widening to -5.4% of nominal GDP in 2015, representing the largest deficit (in annual terms) since records began in 1948, and the worst in the G7. This is despite a moderate improvement in the trade balance since 2010: moving from -2.7% of GDP in 2010 to -2.1% in 2015: a trend that is entirely due to services, not goods.[48]

In theory, the 20% devaluation of sterling in 2008-9 might have been expected to improve the UK's trade balance by increasing the price of imports relative to exports. However, evidence shows that if this effect occurred, it was very modest.[49]

Figure 15 £ Devaluation against trade balance of payments, 2007-16



A supply-side knot

These five problems: a persistent budget deficit, low investment, sectoral and regional imbalances, low productivity and a large current account deficit are the result of long-running weaknesses on the supply-side of the economy. Successive governments have prioritised short-run economic objectives on growth, inflation and unemployment but have failed to take sufficient action to address the fundamental barriers to our long-run economic success. Low levels

[48]https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/unitedkingdombalanceofpaymentsthepinkbook/2016#trade

[49]Data from http://www.bankofengland.co.uk/boeapps/iadb/index.asp?Travel=NIxIRx&levels=1&XNotes=Y&C=IIW&XNotes2=Y&Nodes=X3791X3873X33940X3951X41107&SectionRequired=I&HideNums=-1&ExtraInfo=true&G0Xtop.x=32&G0Xtop.y=6 and https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/timeseries/ikbj/pn2

of investment have contributed to low levels of productivity, particularly outside of London. Consequently, our businesses are not producing and exporting enough, leading to a huge mismatch between what we earn abroad, and what we spend. In addition, low productivity has contributed to real wages and profits not growing fast enough – partly why tax revenues have not grown at the rate expected, and contributing to a persistent budget deficit.

2 THE IMPLICATIONS OF BREXIT

The consequences of Britain's vote to leave the EU are swathed in a fog of uncertainty. The new administration is struggling to come to terms with the magnitude of the change and beset by many practical obstacles in its preparations for negotiation. "Brexit means Brexit" is the thinnest possible reed on which to base government policy. However, it does at least suggest that a second referendum on EU membership or a refusal to trigger Article 50 will not be countenanced under a May administration. However, an important legal ruling now means that it cannot be triggered without a vote in Parliament.[50] This raises important questions about how it will be agreed in Parliament and with what provisos

If parliamentary approval is given and the May government remains intact, the most scenario is that:

i. Article 50 will be triggered in March 2017. [51]

ii. Government will insist that it retain significant control over immigration and law-making in any future arrangements.

iii. Given ii, it is likely that government will secure only limited access to the single market[52], possibly only accessing free trade in goods.[53]

iv. There may be future voluntary payments to the EU, but lower than the current level.

All or any of the above could change. However, using it as a working theory, it yields some important conclusions for future economic policy.

First, that there is likely to be a short-term fall in business confidence and investment when Article 50 is triggered. The certainty that Brexit will happen will cause firms to reconsider investment decisions and possibly relocate parts of their business. There are already ominous warnings of this from Japanese firms.[54] Nissan has had to receive assurances from the UK government to safeguard investment in its Sunderland plant.[55]

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[50]https://www.theguardian.com/politics/2016/nov/03/parliament-must-trigger-brexit-high-court-rules
[51]See http://www.bbc.co.uk/news/uk-politics-37532364
[52]This is because EU leaders have made clear that the four freedoms are indivisible
[53]https://www.facebook.com/pestonitv/posts/1687094161615322
[54]http://news.sky.com/story/japans-unprecedented-warning-to-uk-over-brexit-10564585
[55]https://www.theguardian.com/business/2016/oct/27/new-nissan-super-plant-hopes-for-tariff-free-eu-access

Such falls in investment may cause a fall in growth and a rise in unemployment. This projection is consistent with those from e.g. PriceWaterhouseCoopers[56] and the Bank of England.[57] It is unlikely to be mitigated by the devaluation of the pound (see Chapter 3), although it may be partly offset by lower interest rates and additional quantitative easing. This suggests a likely short-term demand shock and worsening economic outlook in 2017-18 which economic policy will need to address.

Second, a future trade deal in which we are outside the EU with only limited access to the Single Market is a significant long-run supply shock to the UK. This is not only because the future costs and restrictions on trade are likely to be higher, but also because businesses will have more restricted access to EU labour. Skills shortages are likely to worsen in important areas of the economy. In addition, inward investment into the UK from the EU is likely to fall as European firms seek to avoid these limitations. The CEP has estimated that the UK could face a 22% fall in investment over the next decade, with the car manufacturing and financial sector worse affected.[58] A more limited trading relationship between the UK and EU will reduce competition between domestic firms and EU ones; this could lead to lower productivity and higher prices for UK consumers. Given the dominance of the service sector to the UK economy, lack of access to the single market will be particularly damaging, with the City of London being particularly hard-hit.[59] Other things being equal this will reduce the long-run growth rate of the economy. The best estimates of the magnitude of this is that the UK economy will be permanently smaller by 6-9% of GDP.[60] This supply-shock potentially compounds the existing long-run economic challenges the UK faces. Economic policy will therefore need to provide a significant *positive* supply-side improvement if the long-run rate of economic growth is to be maintained or improved.

Third, depending on the future economic relationship between the UK and the EU,[61] the UK may gain some new freedoms which could have significant

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[56] http://www.pwc.co.uk/services/economics-policy/insights/uk-economic-outlook.html a
[57] https://www.theguardian.com/business/2016/aug/19/boom-or-gloom-the-economic-impact-of-brexit-so-far
[58] http://cep.lse.ac.uk/pubs/download/brexit03.pdf
[59] See http://www.prospectmagazine.co.uk/magazine/capital-flight-london-economy-brexit-business
[60] See e.g. the government's estimate: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf or the CEP's which thinks it may be conservative http://cep.lse.ac.uk/pubs/download/brexit04.pdf
[61] See for an overview of main models: http://www.bbc.co.uk/news/uk-politics-eu-referendum-36639261

economic benefits. This might include freedom over trade policy, including the freedom to negotiate trade deals outside the EU and use trade restrictions such as tariffs (although limited by WTO rules). This might enable us to form new free trade agreements with countries outside the EU such as Australia, the US and Canada, which could be a major economic opportunity.

Another area of potential new freedoms may be over regulations, competition policy and employment relations, where there may be scope in some areas to reduce or amend regulations to support businesses. It may be that we gain new freedoms on State Aid rules, or competition rules which might help us improve productivity (see Chapter 4). In addition, there may be new policy-making powers in the areas of agriculture, fisheries and the environment. Policies in these areas have been subject to widespread criticism, and the ability to change them might be very advantageous.[62]

Finally, another area of potential gain is in relation to our contributions to the EU budget. Our net contribution to the EU budget is around £8.5bn each year.[63] When we leave, payments will at the very least be lower, or could be abolished entirely. This potentially frees up more government funds which could be spent in other areas of priority.

Be prepared

The outcome of the negotiations Britain will have over its future relationship with EU are unknown, as are its economic consequences. But it would be prudent for economic policy to, if not prepare for the worst, at least anticipate likely risks and take pre-emptive action to deal with them. Accordingly, in the short-run, economic policy should aim to boost aggregate demand, particularly investment to offset a possible short-run decline in growth. If that decline does not materialise then any excess stimulus can simply be offset through a tightening of monetary policy. Furthermore, action should be taken now to attempt to offset the potentially significant supply-shock of leaving the EU. Policy-makers should aim to bring about a significant supply-side improvement to mitigate some of the potential losses due to Brexit.

On a more positive note, as the shape of our future relationship with the EU becomes clearer, policy-makers will gain new freedoms over regulations, policy-making, trade and EU contributions. How these new freedoms can be best utilised is a vital area for future work.

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[62] See e.g. http://www.reformthecap.eu/cap-reform-in-a-nutshell
[63] https://fullfact.org/europe/our-eu-membership-fee-55-million/

3 A NEW ECONOMY POST-BREXIT

The central task of economic policy in the UK over the next few years is to both mitigate the risks and seize the opportunities that arise from Brexit in a way that effectively meets the long-term economic challenges. Looking through the fog of uncertainty, the UK needs to form a vision of a new economy. Based on this analysis of the long-term challenges facing the UK and the implications of Brexit, the following might provide a useful focus:

> *Britain, post Brexit, should aim to be an economy, still largely open to foreign investment and trade, where higher rates of productivity and investment help raise export and tax revenues, and close the gap between London and the rest.*

Devaluation – a mixed blessing

Since Brexit was announced, there has been a significant and sharp drop in the external value of pound, losing nearly a fifth of its value against the dollar.[64] This has prompted speculation about the costs and benefits of such a change, particularly as we leave the EU. For some, the move is welcome, bringing with it a much-needed gain in price competitiveness which could boost our exports and help reduce our current account deficit.[65] Others have argued that this is the reversal of a previous over-valuation due to the dominance of financial services.[66] Such a fall may also, it is said, compensate for the impact of future tariffs we may face should we leave the EU. Then there are those who point out that the fall will cause higher inflation which will reduce consumers' purchasing power, eroding real incomes.[67]

To what extent can devaluation help address the problems outlined? It may help, but it is no panacea. We have, of course, gone through periodic devaluations many times before, the last of which was in 2008-9 without significant lasting impact on the current account position, levels of investment or productivity. Much depends on technical matters such as the magnitude of elasticities, about which there is great uncertainty.[68] Furthermore the impact of

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[64] www.independent.co.uk/news/business/news/pound-value-dollar-drops-sterling-currency-exchange-theresa-may-eu-summit-a7374336.html

[65] http://www.telegraph.co.uk/business/2016/10/29/with-the-right-policies-a-weak-pound-can-help-the-uk-pay-its-way/

[66] http://krugman.blogs.nytimes.com/2016/10/11/notes-on-brexit-and-the-pound/

[67] http://www.economist.com/news/britain/21709015-not-first-time-relatively-poor-households-who-tended-vote-leave-will-suffer

[68] For instance the OBR estimate that a 1% fall in the value of the pound will only lead to a 0.06% rise in the trade balance. See pp 32-39 of

the devaluation on the other components of the current account is not entirely helpful. While it increases the sterling value of foreign flows of investment income, it also increases the sterling value of some net transfers abroad such as payments to the EU and IMF. A cheaper pound may also attract foreign investment into the financial account, which would worsen the current account position.

Devaluation, in so far as it suddenly makes the rest of the world more expensive to us, is primarily a brisk reassertion of our true standard of living.   The expectation would probably be that it will have an eventual, modest positive impact on the current account position. In the light of Brexit this is generally welcome. However, it cannot of itself address the long-standing supply-side problems highlighted above. For that we need changes in the productive capacity of the economy.

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http://budgetresponsibility.org.uk/docs/dlm_uploads/Final_Model_Documentation.pdf. Other sources such as *Does Exchange Rate Policy Matter?* European Economic Review vol 30 (1987) find much higher elasticities. Some have argued that if the exchange rate drops sufficiently elasticities will become much higher, with a consequent strong impact on the trade balance and viability of manufacturing in the UK.

4 POLICY RECOMMENDATIONS

A note on 'rebalancing'

The question of 'rebalancing' can mean many things. In our view, the issue of regional imbalances and the dominance of the service sector relative to manufacturing, while related, should be considered separately. The fact that there are huge differences in the productivity, incomes and economic performance of London compared with other areas is a legitimate area for concern. It is a sign that the economic potential of many areas is not being fully realised and that public resources are being allocated inefficiently. Hence there is a case for seeking to reduce these imbalances through policy.

The balance of the economy between services and manufacturing is a more contentious area. While for overall economic performance there is no reason for the government to seek to 'pick winners' or to prefer one sector over another, there are some strong arguments in favour of a more mixed economy than is currently present in the UK. A reliance on financial services poses a significant risk to economic stability given the tendency for periodic financial crises like that in 2008-9. Furthermore, the UK's large trade deficit in goods provides a further justification for believing that a larger share of the economy devoted to manufacturing may be desirable. Lastly, there is some evidence that productivity growth is higher in manufacturing than in other parts of the economy.[69] Some might argue that a policy of low investment, as has been the case in the UK for many years systematically penalises manufacturing given its capital-intensive nature. This suggests that policy reforms that aid manufacturing (without unfairly penalising services) may be beneficial to future economic performance.

Summary of recommendations

To help the economy transition to this new vision and manage the effects of Brexit a policy programme is needed to help achieve the following goals:

- Increase demand through short-term stimulus (D)
- Increase investment (I)
- Reduce regional imbalances (R)
- Reduce sectoral imbalances (S)
- Increase productivity (P)
- Reduce current account deficit (C)

[69] https://www.ons.gov.uk/economy/grossdomesticproductgdp/compendium/unitedkingdomnationalaccountsthebluebook/2016edition/nationalaccountsataglance see p. 9. For e.g.

Table 1

Policy	Goals
1. Abolish current targets on budget deficit and national debt, and replace with discretionary target on debt/GDP	D, I
2. Raise public investment towards the OECD target of 3.5% GDP	D, I, S, P
3. Ensure that new transport infrastructure is not just to speed-up travel between city-regions, but also within them.	R
4. Abolish plans to cut corporation tax and instead cut business rates.	D, I
5. Accelerate the devolution of political powers of housing, transport and skills to city regions	R
6. Have combined authorities publish a plan that sets out a clear vision for the economic future of all parts and economic sectors of the region.	R, S
7. Have combined authorities work to strengthen links between universities and local businesses	R, S
8. Analyse the likely impact of different trading arrangements on different sectors and regions of the UK.	R, S
9. Reform competition policy to ensure that the benefits of technological innovation spread to the wider industry.	P, CA
10. Co-ordinate industrial strategy with skills strategy and significantly increase investment in skills.	P, CA

1. *Abolish current fiscal targets on the deficit and national debt and replace them with a discretionary medium-term target for national debt as a % of GDP, perhaps that overall debt should remain below 100% of GDP over the next 10 years.*

When the Conservative-Liberal Democrat coalition came to government in 2010, the budget deficit was nearly 10% of GDP. They then embarked on a programme of fiscal tightening to reduce the deficit and put the public finances on a more sustainable footing. This programme has been much debated,[70] but regardless of its exact effects the case for an at least partial relaxation of fiscal policy is now very strong.

First, monetary policy is no longer likely to be very effective in compensating for lost demand. it is increasingly clear that we are close to the Zero Lower Bound, and that further use of lower interest rates or quantitative easing are likely to be increasingly ineffective, or meet new difficulties.[71] If a recession occurs, monetary policy will be in a weak position to deliver the stimulus required. Further tightening of fiscal policy as we head towards a likely demand shock from Brexit would surely be irresponsible. There is also the argument that looser fiscal policy, if effective, will enable monetary policy to slowly return to a more normal situation in which there is comfortable room for future cuts in interest rates. While government debt levels are elevated, they are so across most Western economies, with very likely a 'new normal' on the acceptability of public debt. With a primary deficit of about 2% of GDP, provided borrowing costs remain low, with adequate levels of economic growth and inflation, debt as a proportion of GDP can still stabilise at an acceptable level, or even start falling with no further fiscal contraction.[72]

Although there may still be a concern that the confidence of foreign investors may be undermined by a relaxation of fiscal rules, there are increasing signs that the opposite is true: that investors are looking for governments to stimulate growth and relax fiscal rules.[73] In the highly uncertain environment of Brexit, the government needs maximum flexibility to be able to cushion the economy from any adverse shocks. For these reasons, there is a very strong case for the relaxation of current short-term rules on cutting the fiscal deficit and lowering national debt. However, there may be a case for retaining a discretionary target

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[70]See for instance Simon Wren-Lewis's https://mainlymacro.blogspot.co.uk/2015/06/no-basis-in-economics.html for a trenchant critique and John Fender's http://www.res.org.uk/view/article5Oct12Feature.html for a qualified defence.

[71]See e.g. http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech840.pdf

[72]Long-run debt-GDP ratio is given by Primary Deficit / (Nominal GDP growth – interest rate on debt). Primary deficit (current deficit – interest payments) is currently 2.4% and interest rates are about 1.1%. If Nominal GDP growth is 3.5% then debt will stabilise at 100% of GDP with no further changes to fiscal policy. If we can achieve nominal growth of 4% (say inflation of 2% and real growth of 2%) then debt will stabilise at about 82% of GDP – *lower* than it is now. This illustrates the key role of nominal growth rates (and low interest rates) in ensuring debt stabilises at an acceptable level. See OBR for data: http://budgetresponsibility.org.uk/data/

[73]http://www.wsj.com/articles/investors-new-message-to-global-governments-spend-more-1477250595

on national debt remaining below a percentage of GDP. This, rather than a deficit target, puts the focus more firmly on achieving growth, and may help ensure investors that a long-term commitment to sound public finances is retained.

2. *Raise public spending on infrastructure towards the OECD target of 3.5% of GDP. This should be devoted to transport, housing, energy, and technological assets such as high-speed broadband, particularly outside the SE of England.*

3. *Recommendation 3: Ensure that new transport infrastructure is not just to speed-up travel between city-regions, but also within them.*

Spending on capital projects is an effective way of raising demand in the short-term (provided they can implemented quickly). The OBR estimates it to have the highest multiplier, making it an efficient way of spending public funds:

Table 2 Estimates of fiscal multipliers

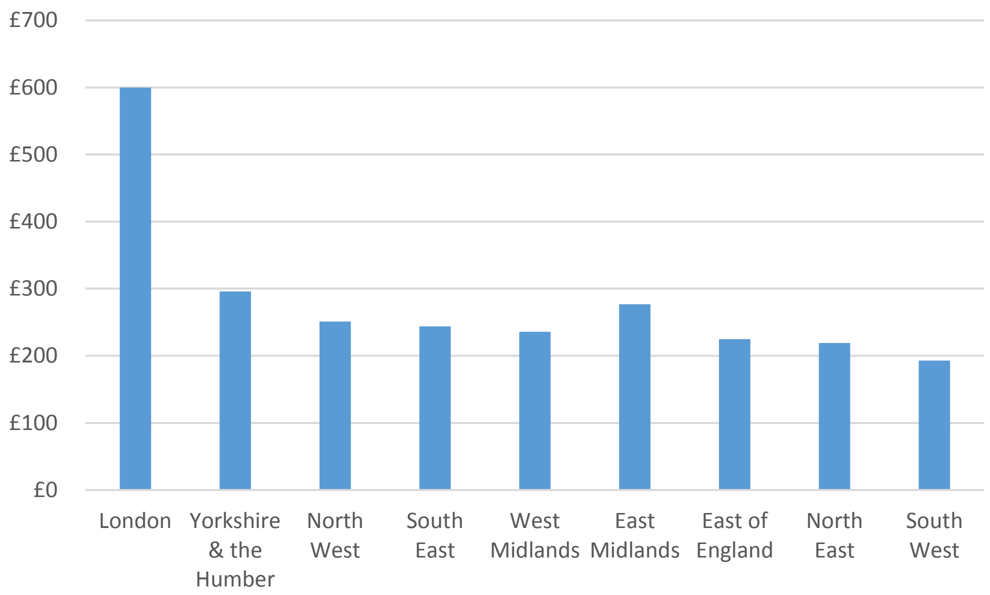
	Impact multipliers
Change in VAT rate	0.35
Changes in the personal tax allowance and National Insurance Contributions (NICs)	0.3
AME welfare measures	0.6
Implied Resource Departmental Expenditure Limits (RDEL)	0.6
Implied Capital Departmental Expenditure Limits (CDEL)	0.1

If these estimates are true, and if anything they are now believed to be under-estimates,[74] increased capital expenditure of say £5bn would increase economic output by the roughly the same amount. This would help offset any short-term demand shock caused by the triggering of Article 50. Another part of the rationale is that private business investment remains too low and in the atmosphere of uncertainty created by Brexit is likely to remain low for a prolonged time. Public investment is therefore needed partly to replace it, but also to stimulate private sector spending. Since manufacturing is a capital-intensive industry, and makes extensive use of the transport system for the movement of inputs and final products, it is also likely that such investment will benefit that sector disproportionately. This will help reduce sectoral imbalances.

[74] http://touchstoneblog.org.uk/2012/10/fiscal-multipliers-the-imf-the-obr/

The case for prioritising transport spending outside London is also clear.[75] Currently spending per person in London is more than twice that in every other region of the UK. While there are reasons why we might expect London to require higher levels of spending, including the high costs of its aged infrastructure (particularly the London Underground) and higher wages, the disparity is quite extreme.

Figure 16 Spending on transport per capita (2014-15)

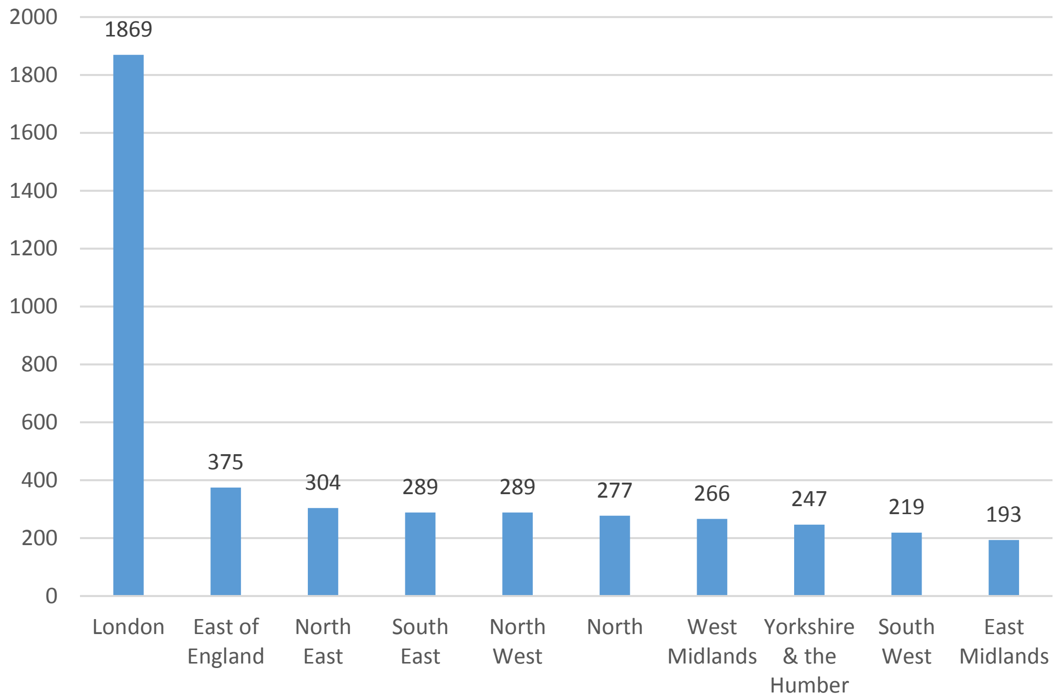


If you analyse transport projects that are due to be introduced in the future, the disparity is even more extreme. According to the National Infrastructure Pipeline planned projects are even more skewed towards London.[76] A reallocation of funds in this area is surely a matter of both efficiency and fairness, and will contribute towards reducing regional imbalances.

[75] Source: Demos analysis. Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476354/Country_and_regional_analysis_November_2015.pdf.

[76] http://www.independent.co.uk/news/uk/politics/north-south-divide-transport-spending-government-theresa-may-chris-grayling-crossrail-london-a7177656.html

Figure 17 Spending on transport per capita by region (£)



The assembled experts at our seminars were generally critical of current transport projects such as HS2, on the grounds of cost, location and the fact that intra-regional transport is at least as important as inter-regional transport. Intra-regional transport is a vital means for ensuring that the benefits of growth surrounding, for example, Manchester also spread to towns such as Wigan, Bolton and Stockport. Government should examine carefully how sufficient additional funds can be devolved to newly-created city-regions, as well as nationally important projects.

Aside from transport, broadband infrastructure should be a priority as it can increase productivity, enable more flexible working patterns and create new markets. But there is evidence of huge variation in the quality of broadband depending on where you live. [77] Download speeds vary greatly by local authority: from just 5.6 MB/S to 45.8 MB/S.[78] Over 2 million premises still can't get more than 10MB/s.[79] Access to super-fast broadband, increasingly important

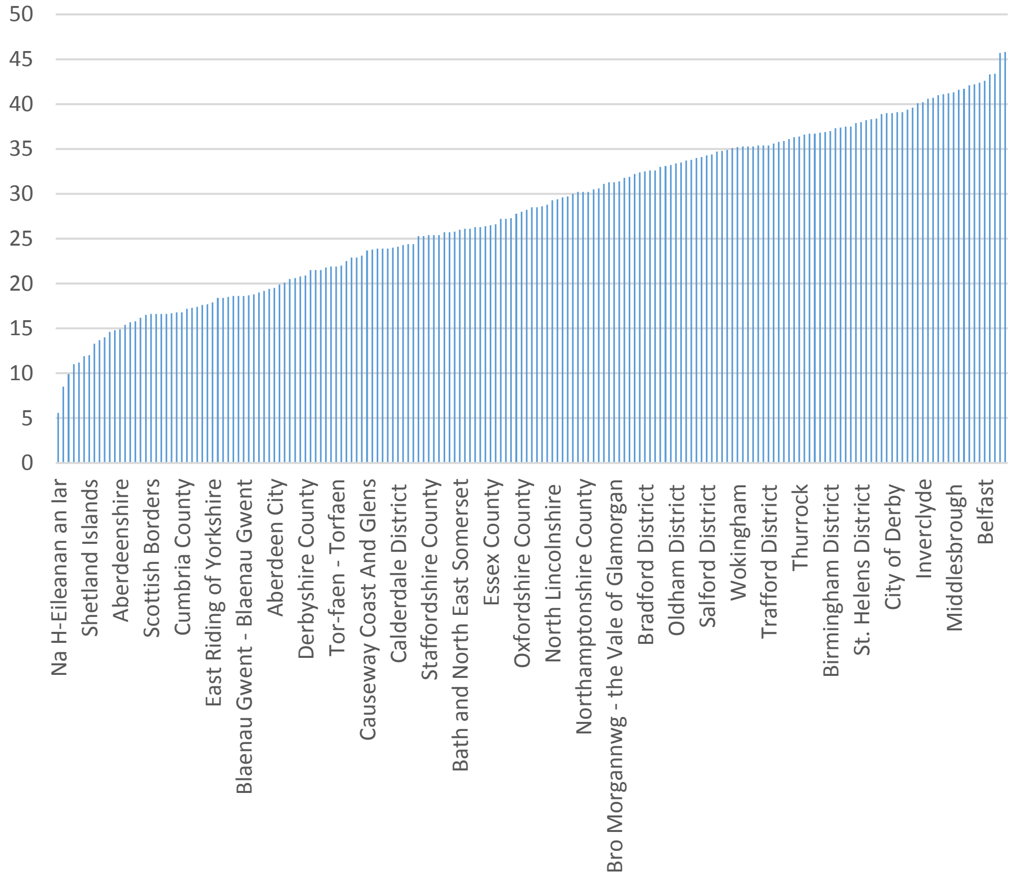
[77] https://www.ofcom.org.uk/__data/assets/pdf_file/0030/78267/fixed-bb-speeds-nov15-consumer-summary.pdf

[78] https://www.ofcom.org.uk/research-and-data/infrastructure-research/connected-nations-2015/downloads. Demos analysis of underlying data.

[79] https://www.ofcom.org.uk/__data/assets/pdf_file/0018/72432/fixed_broadband_services.pdf

for households and small businesses, is also highly variable; in Merthyr Tydfil just 28% of premises can access it, compared with 98% in Luton.[80]

Figure 18 Average download speed (Mbit/s) by Local Authority



4. *Government should scrap planned cuts to corporation tax and instead cut business rates services.*

Since 2010 government has made successive cuts to corporation tax. It was cut from 28% in 2010 to 20% in 2015, and there are plans to cut it further to 17% by 2020.[81] But these cuts have been generally ineffective in boosting investment – as highlighted in Chapter 1. The UK's corporation tax rate is already lower than in the USA, France, Germany or China.[82] It also means that corporation tax revenues are falling as a proportion of tax revenue.[83] Although the cuts are

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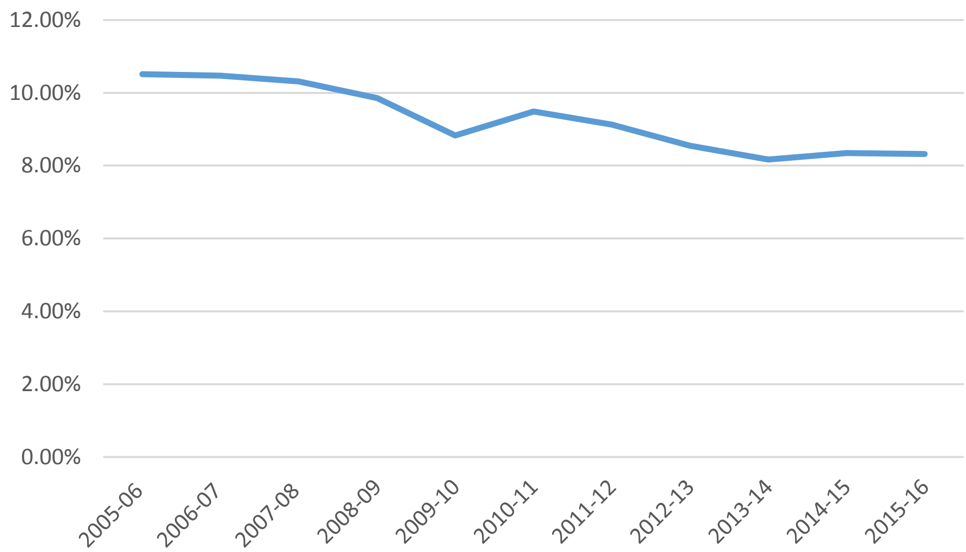
[81] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/548398/Corporation_Tax_Statistics_August_2016_FINAL.pdf
[82] http://www.tradingeconomics.com/country-list/corporate-tax-rate
[83] https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk/ Demos analysis.

accompanied by other reforms which may raise revenue, the OBR estimates that planned cuts will cost the exchequer nearly £1billion a year by 2020.[84]

Figure 19 Corporation tax revenues as % of HMRC receipts



There is a strong argument that the planned cuts could be replaced with cuts to either business rates. Business rates have several problems including: deterring investment in offices and business premises, being based on an out-of-date valuation that is immune to the economic cycle, and being high relative to similar taxes in other countries.[85] Business rates may also unfairly discriminate against businesses which occupy premises rather than operating remotely. A cut could encourage firms to invest in new buildings and office space as well as offer a welcome short-term boost to many small businesses, given the uncertainty surrounding Brexit. To prevent such a cut from reducing the revenue of the new combined authorities (who are due to retain 100% of business rates revenue from 2017) government should consider transitional payments to make up the loss.

5. *The Government should accelerate the devolution of political powers over housing, transport and skills to city-regions.*

George Osborne set out his vision for a Northern Powerhouse in June 2014. The idea was that a set of northern cities are “sufficiently close to each other that combined they can take on the world.”[86] The Northern Powerhouse concept

[84]See Economic and Fiscal Outlook http://budgetresponsibility.org.uk/data/
[85]See https://www.ifs.org.uk/budgets/gb2014/gb2014_ch11.pdf
[86]https://www.gov.uk/government/speeches/chancellor-we-need-a-northern-powerhouse

focused on four areas: improving the transport network, investment in science and innovation, backing creative industries, and the devolution of power and budgets. Greater Manchester has the most advanced devolution deal, with the power to implement a Community Infrastructure Levy, 100% retention of business rates from April 2017, and a Business Rates Supplement to support SMEs.[87]

However, its impact so far has been mixed. In the two years to July 2016, foreign direct investment in the Northern Powerhouse area had increased by 126%.[88] However a July 2016 Irwin Mitchell report into growth in 38 UK cities found that among northern cities, only Manchester and Liverpool were achieving annual GVA growth of 2%.[89] The top growing cities were Milton Keynes, Cambridge, Oxford and Outer London. While employment is growing fast in Liverpool (3.7% in the last year), it is falling (-0.5%) in Sheffield. Recently, devolution has been at risk of stalling due to opposition from local authorities, concerned about the future of funding after Brexit. [90] Despite this, in his speech to Conservative Party conference Phillip Hammond confirmed his commitment to delivering the Northern Powerhouse, as well as the Midlands Engine.[91]

There remains a strong case for further devolution to help tackle regional imbalances. The evidence on agglomeration suggests that concentrating economic activity within a limited geographic area such as a city-region produces productivity benefits through skills matching, knowledge 'spillovers', and the sharing of supply chains and infrastructure.[92] Devolution will help to spread resources as well as power and decision-making from London to the regions. Reallocating public investment, especially that designed to stimulate private investment, should help to close the gap in economic prosperity between London and the rest of the UK.

[87]It also includes a devolved transport budget with integrated smart ticketing across all local modes of transport, control of a £300 million Housing Investment Fund, joint planning in health and social care, and control of the adult education budget (excluding apprenticeships). The Liverpool and Sheffield deals focus on transport and skills, with the former piloting 100% business rates retention. The first round of mayoral elections for these authorities are scheduled for May 2017. See: http://www.local.gov.uk/devolution-deals

[88]https://www.gov.uk/government/speeches/devolution-and-the-northern-powerhouse

[89]http://www.irwinmitchell.com/ukpowerhouse

[90]http://www.bbc.co.uk/news/uk-england-37312978

[91]See http://blogs.spectator.co.uk/2016/10/full-text-philip-hammonds-conference-speech/ and http://www.local.gov.uk/devolution-deals

[92]http://www.centreforcities.org/wp-content/uploads/2016/06/16-05-31-Building-the-Northern-Powerhouse-Lessons-from-the-Rhine-Ruhr-and-Randstad.pdf

The government should continue to work with local authorities within city-regions to accelerate devolution, by providing appropriate financial incentives. At the very least, the Government should provide guarantees over EU funding that would have been destined for combined authorities in the coming years.

6. *Combined authorities should publish a plan that sets out a clear vision for the economic future of all parts and economic sectors of the region.*

However, there is a danger that in the process of focusing on city-regions, the millions of citizens who live in smaller cities and towns could get left behind. Resources allocated to major cities could cause a transfer of skills, investment and economic activity away from some of the towns and cities that suffered most from de-industrialisation in the past. In the recent Demos report *Talk of the Town*, we found that the socio-economic performance of large cities is very different from neighbouring, smaller urban areas. Using a new index of socio-economic performance, we found that three in five English towns were underperforming compared to their neighbouring larger cities. Towns in the North of England were most likely to have a low score in both absolute terms and relative to their neighbouring city.[93]

Combined authorities will need clear plans about the future of peripheral towns and cities captured within their boundaries. If the eventual fate of the likes of Dewsbury, Rochdale and Dudley is to be commuter towns, then that needs to be planned for, with the appropriate transport and housing infrastructure in place. Authorities need to ensure they provide the right conditions for these areas to exploit their comparative advantages, whether that be in manufacturing or services. One important prerequisite is to ensure that the eventual political settlement results in a fair balance of power between representatives of the core city and peripheral towns and cities.

7. *Combined authorities should work to expand and strengthen links between universities and local businesses.*

One asset that many towns and cities (both large and small) have is a university: a key export for the UK economy. Many of the most successful small and medium-sized towns and cities across Britain are university towns: Oxford, Cambridge, York, Exeter, Loughborough.[94][95] There are many reasons for this.

[93] http://www.demos.co.uk/project/talk-of-the-town/
[94] http://www.demos.co.uk/project/talk-of-the-town/
[95] https://www.ons.gov.uk/peoplepopulationandcommunity/housing/datasets/townsandcitiesanalysis

First, universities are major employers with diverse and relatively high paid employment opportunities; only around half of university employees have academic roles.[96] They directly employ local people, bring in well-paid employees and students with maintenance loans to spend – all of which have benefits to the local economy.

Second, there are potential 'spillovers' between universities' research programmes and the wider local economy. For example, in Cambridge the university has helped foster a flourishing private sector research, science and innovation sector. The university produces a large pool of highly qualified graduates who can work in these sectors and the city's name is a strong brand for these enterprises. There are also direct links between the university and businesses e.g. research and consultancy services through Cambridge Enterprise.[97]

Third, there is a 'softer' impact that universities can have on a local area, such as raising aspirations for young people growing up in the area. Children in towns like Loughborough grow up familiar with the concept of a university life from an early age. Many universities organise outreach events to local schools and student volunteering, while residents may have access to university facilities.

Finally, by helping to bring or keep talented and well-educated people in a town or city, universities can help to improve the skills base within the local labour market, benefiting businesses in the area.

Local authorities in some areas are helping to spread the benefits of universities. In May 2016, the Local Government Association announced pilots for the Leading Places Project which involves university Vice-Chancellors and council Chief Executives and Leaders agreeing a local priority. The aim is that university researchers will identify skills gaps and organise appropriate training.[98] In Portsmouth, the university and local authorities are working together under a new programme to realise the commercial potential of Portsmouth's expertise in marine technology.[99] Many of these programmes may help support the

[96] http://www.universitiesuk.ac.uk/policy-and-analysis/reports/Documents/2014/the-impact-of-universities-on-the-uk-economy.pdf
[97] https://www.enterprise.cam.ac.uk/about-us/how-we-can-help/
[98] http://www.local.gov.uk/media-releases/-/journal_content/56/10180/7822638/NEWS
[99] http://www.local.gov.uk/c/document_library/get_file?uuid=45430ab2-075f-4bd0-9e0c-c1aa362efc87&groupId=10180

growth of manufacturing where graduates now make up 30% of the workforce.[100]

All combined authorities should seek to develop links between universities and local employers. Businesses could be involved in the design of relevant courses to ensure that students develop skills that are most likely to be of use to the labour market, and to help meet skills shortages. In May 2016, the Government announced plans to make it easier to set up new universities by streamlining the process that allows institutions to award degrees.[101] Combined authorities should consider whether additional universities within their region could help to promote competition and productivity.

8. *The new Department for Leaving the European Union should analyse the likely impact of possible trading arrangements on different sectors and regions of the UK.*

Formal negotiations with the European Union after the triggering of Article 50 are likely to focus on sector-by sector deals to secure access to the Single Market.[102] However, the outcome of negotiations for each sector will have different effects on different parts of the UK. For instance, the ease with which UK-based banks can operate in the Single Market will affect London disproportionately, while barriers to trade on cars will affect Sunderland, Swindon and Solihull. While these examples are relatively obvious, the precise sectoral and geographical impact of each step of negotiations, particularly on services, is complex. In anticipation of triggering Article 50, the Department for Leaving the European Union should analyse the likely impact of possible trading deals on different region and sectors of the UK economy, considering a range of factors including economic activity, employment, wages, tax revenues and exports. Similarly, the Brexit Select Committee should conduct an inquiry in parallel to put pressure on the Government to consider these impacts.

9. *Reform competition policy to ensure that benefits of technological innovation spread to the wider industry.*

Low productivity and the current account deficit are related problems. Low productivity causes unit labour costs to be too high – this makes our goods more expensive than those of our competitors and encourages us to buy from overseas instead. As we import more than we export, we finance this by

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[100] See www.ncub.co.uk/index.php?option=com_docman&task=doc_download

[101] https://www.gov.uk/government/news/new-universities-to-deliver-choice-and-opportunity-for-students

[102] https://www.ft.com/content/8281128a-8984-11e6-8cb7-e7ada1d123b1

borrowing from overseas and selling assets. Over time the stock of foreign-owned UK assets increases, increasing the flows of investment income out of the UK – and worsening the current account further.

Raising our productivity is a vital means by which we can sustainably increase wages, living standards and restore our lost competitiveness. The factors which contribute to improving productivity are many and complex.[103] Increased investment and improved productivity through a higher growth rate (see Recommendations 1-4 above) are an important part of it. But there are also other areas where government action may be needed.

Recent research from the OECD has highlighted the central role technology transfer plays in ensuring the productivity gains leading firms create through innovation are spread to other firms in the market.[104] A crucial finding is that the recent productivity slowdown experiences across most Western economies is not because successful firms are innovating less, but rather because those innovations are not spreading quick enough to 'laggard firms' in the same industry.

The authors identify two possible explanations: new technologies are increasingly generating a 'winner takes all' situation in which an innovation enables a firm to corner a market, and on the other hand a failure of laggard firms to be able to exploit the new technologies due to regulatory barriers and insider knowledge. These problems are particularly acute in the service sector, especially the ICT industry.

The conclusion is that increased product market competition and a reduction in market power of leading firms in key sectors may be a vital means for increasing productivity. Accordingly, the government should examine whether and to what extent policy could be reformed in key markets (particularly service and ICT industries) to better support technology transfer. As we leave the EU we may gain new freedoms over this area of policy-making which make such reforms easier.

10. *Co-ordinate industrial strategy with skills strategy and significantly increase investment in skills.*

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[103]See https://www.oecd.org/eco/OECD-2015-The-future-of-productivity-book.pdf for a useful overview.

[104]https://www.oecd.org/global-forum-productivity/events/GP_Slowdown_Technology_Divergence_and_Public_Policy_Final_after_conference_26_July.pdf

For some years government's approach to industrial strategy has been 'light touch' – it has encouraged certain sectors of the economy, but has fallen short of direct intervention to choose which should be prioritised or expanded. Partly this reflects EU competition rules which limit state support for industry – rules which may expire as we leave the EU. However, the new government appears to wish to refocus policy in this area under the aegis of the newly created Department for Business, Energy and Industrial Strategy. Although details are still light the main elements appear to be: [105]

- Stricter merger and acquisition rules, with more emphasis on a 'public-interest test' for foreign take-overs
- New corporate governance structures, including consumer and employee representation on boards, and greater transparency around executive pay
- Continued work towards higher productivity, including through the development of the science and research base in the UK
- Delivery of infrastructure projects
- Increased house-building
- Continued support for regional development of cities and other economic areas outside London

However, one area that deserves more focus is the relationship between industrial strategy and skills. If skills policy isn't co-ordinated with industrial strategy, the result will be skills shortages in key areas of the economy.[106] Post-Brexit, industry access to workers from overseas is likely to be much more limited, exacerbating this problem further. In this context, Further Education is a critical sector, responsible for providing many young people and adults with the skills they need: it educates over 2 million adults and a further 800,000 young people.[107] It also makes an important contribution towards productivity. But UK adults have poor skills compared to many other countries. England is one the few countries where are young people have worse skills than those about to retire, while levels of numeracy are very poor compared to the OECD average.[108]

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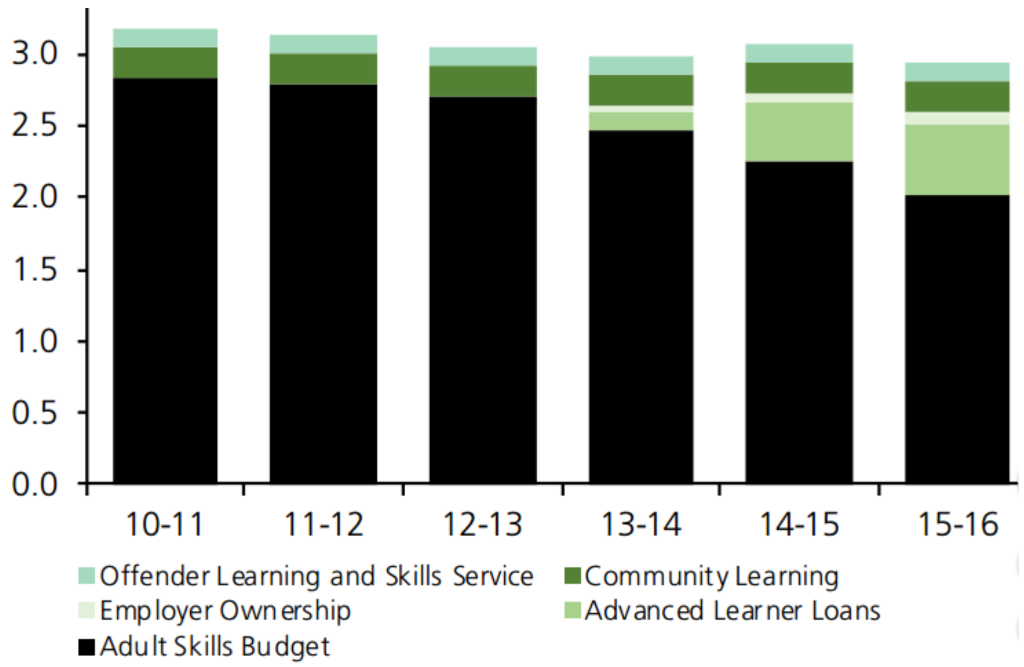
[105] http://researchbriefings.files.parliament.uk/documents/CBP-7682/CBP-7682.pdf
[106] A list of current areas of shortage is here: http://www.visabureau.com/uk/shortage-occupations-list.aspx
[107] https://www.aoc.co.uk/sites/default/files/AoC%20College%20Key%20Facts%202015-16%20WEB.pdf
[108] See OECD Skills Outlook 2013: http://www.keepeek.com/Digital-Asset-Management/oecd/education/oecd-skills-outlook-2013/united-kingdom-england-n-ireland_9789264204256-23-en#.WBBvVSRtFG4#page3

Government has been cutting spending in this area. The 16-19 budget has been cut by 13% in real terms since 2010/11.[109] The adult skills budget has been even harder hit: falling by 32% over the same period.[110]Government has been cutting spending in this area. The 16-19 budget has been cut by 13% in real terms since 2010/11.[111] The adult skills budget has been even harder hit: falling by 32% over the same period.[112]

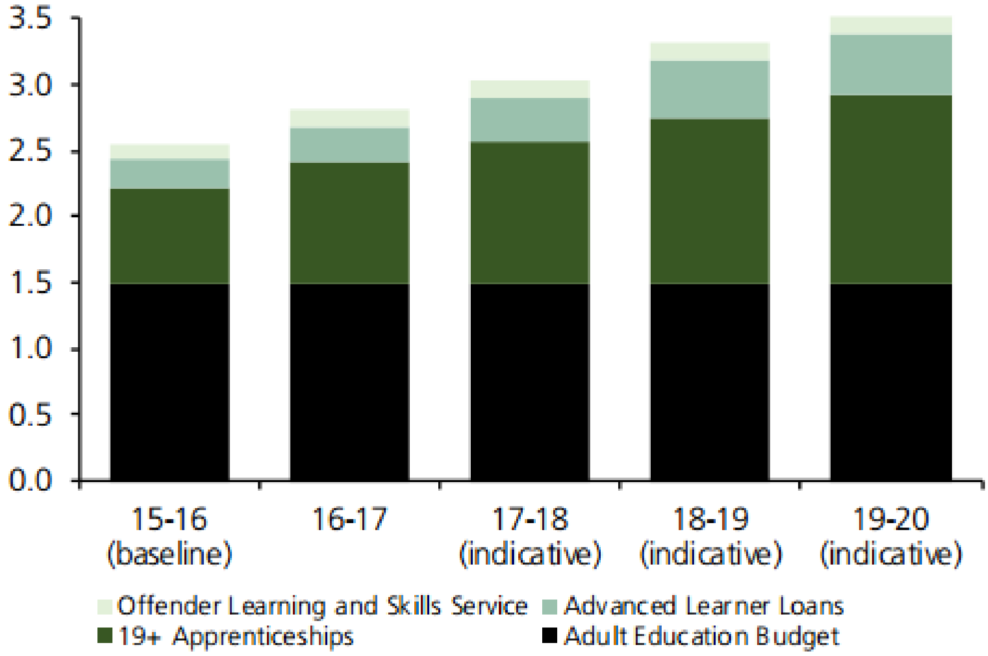
Figure 20 19+ FE teaching & learning funding
(£ billion, cash, initial allocations)



Government has begun to increase spending in this area, primarily through the apprenticeship scheme. However, the adult education budget is not being increased at all. At this rate by 2020, the total 19+ education budget will only be at same levels as in 2010.

[109]https://www.ifs.org.uk/uploads/publications/bns/BN168.pdf
[110]http://www.ncub.co.uk/index.php?option=com_docman&task=cat_view&Itemid=101
[111]https://www.ifs.org.uk/uploads/publications/bns/BN168.pdf
[112]http://www.ncub.co.uk/index.php?option=com_docman&task=cat_view&Itemid=101

Figure 21 19+ FE teaching & learning funding
(£ billion, cash, initial allocations)



This cannot be sufficient to prepare the labour force for the challenges of increased productivity and the unpredictable effects of Brexit. Much more investment is needed. If the Adult Education Budget, grew at the same rate as planned spending on Apprenticeships that would only require an additional £1.3 billion by 2020. As budgets for adult skills are increasingly devolved to city regions or local authorities, extra funding will help ensure that they have the resources needed to increase productivity.

5 CONCLUSION: INVEST, DEVOLVE, LIBERATE

The decision the UK has taken to leave the EU is a watershed moment for British economic policy. Regardless of its merits, it creates both opportunities and risks for the UK economy in the months and years to come. As we reset our relationship with our European partners, now is the time to reset our economic policy. Britain's long-term economic problems are a supply-side knot: a persistent budget deficit, low investment, regional and sectoral imbalances, low productivity, and a large current account deficit.

The central task is to *invest* (looser fiscal policy with more public investment in infrastructure and skills, particularly outside London), *devolve* (more rapid devolution of powers to city-regions with new economic plans for city-regions and stronger links with universities), and *liberate* (reform competition policy and cut business rates). Also, as negotiations proceed, government should analyse carefully the likely impact of Brexit on different sectors and regions of the UK.

Brexit will change the economic landscape for years and decades to come. Ensuring that landscape is one in which we can thrive is a task policy-makers can begin now.

APPENDIX: ECONOMIC POLICY 2010-2016

When David Cameron became Prime Minister in 2010 it was, in large part, because the public no longer trusted Labour with the economy. Britain's worst recession for a generation and the consequent explosion in the budget deficit (which had reached 11% of GDP[113]) enabled a Conservative-led coalition to oust a Labour party that had by then governed for thirteen years. To support the economy, the Bank of England had slashed interested rates to the lowest ever levels of 0.5% and embarked on an unprecedented programme of quantitative easing, injecting £375bn of new money into the economy.

In this context, Cameron set out what he saw as the UK's main economic problems: unsustainable levels of public spending and an economy over-reliant on the government, hampered by excessive tax and red-tape, and skewed towards the service sector and the south-east of England. Consequently, he set out his government's economic priorities: to reduce the budget deficit, liberalise the economy, encourage enterprise and rebalance the economy.[114]

Reducing the deficit

To this end the government set out to eliminate the structural current deficit by 2014 and reduce public sector net debt to 67% of GDP by 2015/16. This was to be achieved primarily by cuts in public spending. Between 2010/11 and 2014-15 departmental spending was cut by 9.5% in real terms. But for unprotected departments (those outside schools, foreign aid and the NHS) cuts were as high as 20.6%.[115] Public investment was hit particularly hard. Originally forecast to be cut by more than a quarter, government softened the blow over the course of the parliament, but it was still cut by over 13% since 2010.

Another area where the government focussed cuts and reform was in welfare where they replaced Disabled Living Allowance with Personal Independence Payment, introduced more conditions for jobseekers, introduced a cap on the amount of benefits working-age people can receive, and replaced a number of incapacity benefits with Employment and Support Allowance.[116]

[113] http://www.parliament.uk/documents/commons/lib/research/key_issues/Key-Issues-The-economic-recovery-and-the-budget-deficit.pdf
[114] https://www.gov.uk/government/speeches/transforming-the-british-economy-coalition-strategy-for-economic-growth
[115] http://election2015.ifs.org.uk/public-spending
[116] https://www.gov.uk/government/publications/2010-to-2015-government-policy-welfare-reform/2010-to-2015-government-policy-welfare-reform

Encourage enterprise

The government decided not to use taxation to raise additional revenue, with VAT the only major tax increased (from 17.5% to 20%) over the course of the parliament.[117] Instead significant cuts were made to direct taxes: the personal tax allowance for income tax was raised to £10,000 and the top rate was cut from 50% to 45%, corporation tax was cut from 28% to 20% and may fall again to 17%,[118]and the inheritance tax threshold was raised.[119]

Such tax cuts were part of an effort to liberalise the economy and encourage the private sector to compensate for lower levels of public spending. To this end the government also introduced the "Red-tape Challenge" to cut and eliminate unnecessary regulations. They identified over 3000 regulations to be cut or improved, and have claimed that the annual savings to business from these reforms is over £850m.[120]

Rebalancing the economy

Efforts to rebalance the economy included using industrial strategy to support growing industries. Industrial strategy was a largely 'hands-off' attempt to encourage industry leaders to boost growth in eleven key sectors: aerospace, agricultural technologies, automotives, construction, information economy, international education, life sciences, nuclear, offshore wind, oil and gas, professional and business services.[121] Limited funding was made available to support research in eight key technologies: big data, satellites, robotics and autonomous systems, synthetic biology, regenerative medicine, agri-science, advanced materials, and energy storage.[122]

The other main aspect to the attempt to rebalance has been devolution. Powers to set income tax, borrow and control stamp duty land tax were transferred to Scotland and following the 2014 referendum further powers over taxation and welfare are being devolved.[123] Wales received full law-making powers in 2011, while new powers over borrowing and tax were devolved in 2014. In England, the Greater Manchester Combined Authority received the power to manage business support budgets, control the housing investment fund, restructure further education and control the Apprenticeship Grant. Control over a

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117 http://sticerd.lse.ac.uk/dps/case/spcc/RR04_SUMMARY.pdf
118 http://blogs.lse.ac.uk/politicsandpolicy/corporation-tax-cuts-after-brexit/
119 https://www.gov.uk/inheritance-tax/passing-on-home
120 https://civilservice.blog.gov.uk/2014/10/31/the-red-tape-challenge/
121 http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06857
122 http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06857
123 http://www.bbc.co.uk/news/uk-scotland-scotland-politics-36353498

Community Infrastructure Levy and a business rates supplement have also been extended. Powers to manage a multi-year transport budget, a Housing Investment Fund and the 100% retention of business rates will be devolved in 2017, with the election of a mayor.[124]

[124] http://researchbriefings.files.parliament.uk/documents/SN07029/SN07029.pdf

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This report explores the question of how domestic economic policy should respond to the long-term economic challenges the UK faces in the light of the new context presented by the result of the referendum on our membership of the European Union. This unchartered territory demands a new economic approach, and presents an impetus to undertake significant and lasting economic reforms.

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Tom is a Research Associate at Demos. He has published reports on poverty, property taxation, local government and the Private Finance Initiative, as well contributing to government white papers.

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