ACADEMY of SOCIAL SCIENCES

PROFESSIONAL BRIEFINGS

HOW CAN THE UK PROSPER OUTSIDE THE EU?

June 2017

ISSUE 11

HOW CAN THE UK AND SCOTLAND PROSPER OUTSIDE THE EU?

The papers in this issue are derived from the Academy's day conference held, in association with the Society of Business Economists and the Scottish Economic Society, on 10th May 2017 at 33 Finsbury Square, London EC2A 1AG

Contents

Academy of Social Sciences
33 Finsbury Square
London EC2A 1AG
+44(0)207 682 4662
www.acss.org.uk
www.campaignforsocialscience.org.uk

sbe

Scottish Economic Society

THE EU REFERENDUM: HOW CAN THE UK PROSPER OUTSIDE THE EU?

Professor Vicky Pryce FAcSS, Centre for Economics and Business Research and former Joint Head of the Government Economic Service.

Summary

Following Britain's vote to leave the European Union on 23rd June 2016 the economy has performed better than expected and confidence has returned. However, much of that was due to the huge injection of liquidity into the economy by the Bank of England, which encouraged households to borrow at record levels and sustain the economy by high consumer spending. Up to a point the sharp fall in the pound, when interest rates were cut to a new record low in August 2016, also helped by improving the competitiveness of the manufacturing sector.

But, net trade has continued to be a negative contributor to growth as prices of imported goods have risen and business investment remains weak. With uncertainty remaining, and exacerbated by the surprise call for a snap election, economic forecasts are particularly tentative and are revised upwards and downward following each release of growth data. And the confusions over what sort of Brexit we may have is continuing. Business, social scientists and civil servants should be working together to improve the evidence base so that proper thinking can enter the negotiating process.

Short term	Risk likelihood	Comment
High inflation and lower consumer spending?	High	Rate of inflation rising sharply - 2.3% in February and March due to fall in pound since Brexit vote. Total input prices rising at a staggering monthly rate of nearly 5% - businesses, especially SMEs, will only be able to absorb profit erosion for so long. Consumers' disposable incomes affected as wages don't keep up. But worries of higher interest rates to come eased by slower growth in Q1. General election adding to uncertainty.
Slump in business confidence?	Medium	After Brexit negotiations begin the coverage of developments will have an impact on business confidence. Therefore, any setbacks could induce a confidence slump. Theresa May's speeches indicate hard Brexit, although Article 50 letter and recent pronouncements have been softer. But latest spat with Juncker not helpful
Rising gilt yields as public finances strained?	Low	Government has acknowledged that deficit will not be eliminated within this parliament. Cost of Brexit £60bn between now and 2020 (OBR estimates). More austerity with cuts still coming in many government departments and councils while pressure in NHS, social care, education, justice etc mounts.
Substantial slowdown in housing market?	Medium	Brexit has mostly had a downward impact on the price of prime central London property. Elsewhere a shortage of properties has until recently supported price growth but transactions have been down. Most activity centres on re-mortgaging.

The current situation

After the initial shock of the referendum result, and a serious drop in confidence, the economy moved back to growth helped by a huge injection of liquidity by the Bank of England. On the morning after the referendum vote Mark Carney, the Governor of the Bank of England, stressed that the Bank had been holding weekly liquidity auctions to ensure that financial stability concerns were kept at bay. A further cut in interest rates in August and a new £60bn of quantitative easing also helped, which was extended also to cover £10bn of corporate bond purchases in September. Confidence rebounded and the fall in interest rates helped equity prices stay high as some 80% of the FTSE 100 companies' earnings are from overseas, and manufacturing benefited from the improved competitiveness afforded by the sharply lower pound. So, after a weak start to 2016 because markets were fearful of a 'No' vote, GDP grew by 0.7% in both Q3 and Q4, bringing the increase in the year to 1.8%. As a result, the recession that some people were predicting had been avoided, albeit at a cost to the public purse and depending mostly on consumers who borrowed at record levels to finance spending. Additionally, businesses met the increased demand not by investing, but by hiring more labour, which is easy to shed if trends move in the other direction.

Since then the UK economy has continued to grow, though at a reduced rate. There is no doubt that the UK is facing a series of short term risks. The first is that the rate of inflation is rising sharply: 2.7% in April, due partly to fall in the value of the pound since the Brexit vote. Total input prices are rising at a staggering monthly rate of nearly 5%: businesses, especially SMEs, will only be able to absorb profit erosion for so long. Consumers' disposable incomes are negatively affected as wages don't keep up - rising by just 2.1% in March without bonuses - year on year. There are already signs of people switching spending mainly to cover essentials such as petrol and food, which are becoming more expensive, and although the late April timing of Easter allowed for some rebound in retail sales for the month, the trend appears to be clearly downwards.

The OBR is forecasting zero growth in disposable incomes in 2017 with only modest growth in the years to 2020. With inflation forecasts being raised, anxieties around potentially higher interest rates and their impact on consumer indebtedness are beginning to worry the Bank of England, which has just reduced its own growth forecast for 2017 from 2% to 1.9%. The forecasts for next year are slightly higher than before but still show a slowdown overall: to 1.6% and 1.7% respectively.

The impact of the election campaign

The General Election is adding to the uncertainty that was already evident before the snap election was called, as firms fear the impact of leaving the single market and the customs union. They also feel that their voices are not being listened to. Business investment fell in 2016 as a whole and it has remained weak in the early part of 2017. Investment is the only way innovation and increases in productivity take place, and a potential loss of foreign direct investment if the UK ceases being an attractive and useable gateway to Europe will limit long term sustainable growth and competitiveness for the UK.

Fear of losing access to migrant labour, much of it from the EU, is particularly worrying in areas such as banking and insurance, financial services, the FinTech market, the creative sector and the digital economy. However, a sharply reduced rate of inward migration will impact across the economy, from public sectors such as the NHS to manufacturing, agriculture and construction. Business and the public sector have benefited from the ample availability of both skilled and unskilled labour from the rest of the EU and wider, and the economy has been able to meet increased demand by accessing workers from a wider pool of talent than those grown just from within the country, which eased the costs of expansion.

For the economy as a whole globalisation and free movement of people from the EU - and people coming in in large numbers from outside the EU - have contributed to the absence of inflationary pressures from the wage growth that would otherwise have developed, given that employment is at record levels and the unemployment rate is at 4.6%, the lowest since July 2015. The inflation increase witnessed recently has been due to external factors such as the fall in the pound since the referendum vote rather than any internal upward pressures. It is very likely that globalisation and migration have in fact contributed to what now looks like a lowering in the level of the non-accelerating inflation rate of unemployment (NAIRU) in the UK, which means we can grow for longer without serious and constraining upward inflationary pressures developing.

How well has the wider community articulated the concerns?

It is now clear that the business community has failed to make the case well enough for staying in the single market and the customs union, or explain properly to the civil servants and politicians - and the general public - the extra transaction costs involved if one is outside it along with the implications for trade, output and employment. After years of complaining about EU bureaucracy the business community seems now to have realised that, in effect, the EU single market is actually the best free trade deal that can be obtained and that being outside it, particularly under a 'hard Brexit', will increase the burden on business.

Over the past four decades of our membership of the EU, the EU treaties, the ECJ and the EC Competition Directorate ensured that, as far as possible, the market worked without discriminating against non-domestic players and with transaction costs kept to a minimum. Capital, goods and - to a considerable extent - services and people moved in a reasonably frictionless way across borders. As the architects of the single market forecast, the consumer benefited hugely. 'Open skies', for example, have greatly increased airline competition and consumer choice and kept travelling costs much lower than would have been the case if previous regulatory restrictions on who can fly between which countries still prevailed. We see it also now with mobile roaming charges. All of these areas - and many more - may be under threat, and the ultimate loser will be the consumer whose surplus will be eaten away.

The importance of services

Airlines and roaming charges are just two obvious examples. Of course the truth is that the single market is still not complete, particularly in services, but the process is gathering speed. Look at the moves now towards a single energy market, a single digital market, a banking union, a capital markets union, further steps on encouraging e-payments across the EU, which have so far constrained online shopping and e-commerce more generally, and a proper implementation of the EU services directive.

According to a recent study by the European Parliament, *The cost of non-Europe* (a title borrowed from the famous Cecchini report of 1988 before the single market was created), all these moves would add up to a cumulative gain of an extra €1.6tn by 2019 to EU GDP - though , of course, that was the EU-28 from which the UK will now have to be excluded. Interestingly, many of these moves are in the services sector where the UK has a competitive advantage - and yet it may be excluded from sharing in those benefits in the future. The Cecchini report itself, named after Paolo Cecchini (then the Deputy Director General for the Commission's DG for the Internal Market and Industrial Affairs), had calculated that the benefits would add some 5%-6.5% of GDP to the EC countries, mainly through benefits to consumers from higher incomes, better business opportunities and greater consumer choice.

Much of this seems to have been proven to have indeed happened in practice. A study by Bertelsmann Stiftung in 2014 (*20 years of the European Single Market: Growth Effects of EU Integration - Policy Brief #2014/02*) found that per capita incomes had increased substantially through greater integration in all EU countries between 2002 and 2012, except in Greece where things have gone seriously backwards since the financial crisis of 2008.

Fiscal Impact of Brexit

The other concern relates to the significant worsening in the fiscal profile as a result of Brexit. Not only had the previous Chancellor of the Exchequer, George Osborne, seriously under-estimated the budget pressures from an ageing population (despite the years of austerity he had imposed on many government departments, regions and councils since 2010), but Brexit is adding to this through the lower growth being forecast by, for example, the Office for Budget Responsibility (OBR) and bodies such as the Institute for Fiscal Studies (IFS).

On taking office, the current Chancellor, Philip Hammond, abandoned Osborne's fiscal targets, and the target for a balanced budget has now moved to the middle of the next decade. It is now clear that debt will be considerably higher and the deficit will take longer to reduce. The markets so far remain sanguine and it seems that the government, barring some serious Brexit accident, will continue to be able to borrow at record low interest rates as, for the moment, markets still consider the UK to be a safe bet. In the end it could be argued that, as long as the markets are happy to provide cheap funds and the money is used for productive investment such as much-needed infrastructure (e.g. broad-band, skills etc) with a clear rationale backed by proper cost-benefit analysis, then there is nothing wrong with pushing the target date for achieving a balanced budget or even a surplus further into the future, especially if one needs to mitigate any negative impacts from Brexit on the economy.

Is this a good time to be having the Brexit negotiations?

Looking ahead, much will depend on the speed and ease with which the 'divorce' settlement process and the sorting out of rights of EU citizens here and UK citizens in the rest of the EU is agreed. If trade negotiations can then begin, at least the UK will be able to benefit from starting to conduct them at a time when (despite worries about protectionism) world trade volumes are picking up strongly again after a worrying slowdown due to sanctions, geo-political tensions and the low commodity prices that affected some developing countries' growth last year. China's growth has stabilised and the US, despite its political wobbles, is set to see faster growth this year. However, for the EU, Europe still matters hugely. The rest of the EU sell us just 7% of their goods and services. We sell them 45% of ours.

At the height of the EU referendum campaign one theme kept being repeated by the Brexiters - and interestingly also by the few economists who were supporting them - namely, that Europe was a slow-growing region which had lost its world relevance and influence to other more rapidly-growing developing nations to which the gravity of growth was moving. That the UK was "shackled to a corpse" was the metaphor *du jour*.

After the referendum there was huge pride among the Leave advocates in the fact that, in 2016, the UK seemed to be growing faster than the rest of the EU, which proved what a good decision 'Leave' was. In fact growth rates were about the same: 1.7% as against 1.8% in the UK. What is more, Europe is recovering rather faster than had been anticipated. Industrial production is rising in the Eurozone at the fastest pace in six years. In the first quarter of 2017 GDP in the Eurozone rose by 0.5% (2% yearly rate) and in the EU-28 by 0.6%. There are still big country variations but, within that, Germany grew by 0.6% and Spain by 0.8%. The GDP rise in the UK by contrast was just 0.3% (1.2% yearly rate), more than halving from the 0.7% growth achieved in Q4 2016.

The composition of growth is also worrying here. For the quarter as a whole, industrial production rose by a mere 0.1% and manufacturing by 0.3% over the previous three months, despite the hugely beneficial exchange rate. In fact the latest monthly data show that UK industrial production actually fell by 0.5% in March and manufacturing production by 0.6%. Furthermore, the trade deficit got worse in the first quarter of this year, doubling from £4.8bn in Q4 2016 to £10.5bn in the three months to March.

Europe doing well should be good for us and the point that proximity matters for trade, which was made by most economists all along, seems to be clearly proved by the latest trade data. What is remarkable is that, while the value of UK exports to EU countries rose by 5.7% in Q1 over the previous quarter, those to non-EU countries actually fell by 3.8%!

So what next?

On current indications barrier-free trade with Europe is now unlikely. Although a transition period of two to three years may be possible to soften the blow, a long and difficult negotiating period would affect business and consumer confidence. Leaving the EU single market and customs union is clearly likely to be bad for many sectors. Low or zero-tariff sectoral deals could help, but non-tariff barriers matter most for services: 'passporting' of services and migration is particularly significant for London and the South East for example in the financial sector, digital, creative, business services, data analysis, and dispute resolution.

What is also evident is that Free Trade Agreements - even 'deep and comprehensive' ones as Theresa May's Article 50 letter suggests we would like to have with the EU - tend to be weak on services. In the end it is possible that there may be some tariff-free agreements on goods in exchange for some payments, but non-tariff barriers will be a serious issue.

The EU has a host of different arrangements. There is EFTA, the European Free Trade Association, of which Norway, Iceland, Switzerland and Liechtenstein are members. All (with the exception of Switzerland, which still relies on bilateral deals for specific industries) are also members of the European Economic Association (EEA) and hence of the single market. None is a member of the customs union, which provides for a common external tariff, and yet Turkey and a few other countries are, but with some exceptions. Each level of membership still has to respect common EU rules regarding free movement - with some minor tweaks - and make a financial contribution to the EU budget, sometimes via payments to specific EU projects. There is, therefore, scope to borrow from some of those while still branding any arrangement as a UK-specific solution, particularly if we end up with a long transition period which requires taking an 'off the shelf' package for a while. That would, of course, require politics at home to be aligned and the Europeans to be minded to be flexible.

May's current stance suggests a 'hard Brexit' but the General Election result could change that. Sterling's recent recovery suggests that the markets believe this, but the election outcome is now beginning to look more uncertain. What are the options? The Centre for European Reform (CER) suggests that the Swiss model is possible: we should focus on goods and then ensure bilateral deals on services. However, its analysis assumes that there are few extra gains likely from further service integration, so a focus on access to tariff-free goods may be the best option. A *Bruegel* paper[1] calls for a 'Continental Partnership' (CP), with close cooperation between countries outside the EU and those within: full mobility of goods, services and capital, but no freedom of movement of workers (though some temporary mobility) and no political integration. This, it says, would be less deep than current EU membership but 'rather closer than a simple free trade agreement'. This approach implies several things, namely: participation in selected common policies consistent with access to single market; a new system of inter-governmental decision-making and enforcement; some contribution to the EU budget; and close cooperation on foreign policy, security and possibly defence. This is, though, most unlikely to happen as Macron's election in France suggests a greater move to European integration and a harder stance towards the UK.

This may therefore leave little option - particularly if the 'divorce settlement' proves difficult - than the one favoured by the Legatum Institute, Patrick Minford and some hard Brexiters, namely: WTO rules and then negotiate services as Free Trade Agreements (FTA), which would be the worse option in relation to growth in the future according to Oxford Economics and others.

Sub-optimal solutions

Even the best option would be sub-optimal. The OECD last year calculated that, even if a Free Trade Agreement were agreed at some point in the future, the UK would still be seeing a decline in UK exports overall compared to the current trends. Why is this? Exports to a country or region within which a Free Trade Agreement exists still have to respect standards and national laws, and that restricts some types of exports (for example, US genetically modified foods would be barred from the EU in any FTA negotiated between the two). Look at CETA (EU-Canada Comprehensive Economic and Trade Agreement), for example, which has finally been ratified by the European Parliament after seven years of negotiations and which nearly collapsed late last year when one regional government in Belgium briefly objected to some of its clauses.

Much of the issue centres on non-tariff barriers that FTAs in general do little to address. FTAs take a long time to be arranged precisely because of the different national norms that exist, although there is a move towards mutual recognition and regulatory equivalence to speed things up. Not only will that be a problem with UK-EU trade arrangements but also with third countries.

Worryingly, while tariffs have fallen across the world, many nations (and trading blocs) have responded by actually increasing non-tariff barriers as a protective measure. Last year the WTO drew attention to the fact that 70% of recently imposed trade protectionist measures were by G20 countries. In this context an FTA agreement with the US would be unlikely to shake President Trump's promise of 'America first'. Additionally, last year's OECD report on 'The Economic Consequences of Brexit'[2] quotes a 2016 Capital Economics report, which estimated that financial exports to the EU (which normally provide a surplus of some £20bn a year) could fall by half if banks' passporting rights that allow the sale of financial services all across the EU were lost.

Conclusions

In 2016 the National Institute for Economic and Social Research (NIESR) attempted to calculate what the impact would be if the UK was outside the single market and the customs union but was able to negotiate Free Trade Agreements with third countries or regions such as the EU itself. Looking at empirical evidence, it estimated that EEA membership - which included membership of the single market - leads to substantial 'statistically significant increases in bilateral trade flows'. It concluded that an FTA arrangement with the EU and other third countries would not be able to replace trade flows lost in the future between the EU and the UK. What is more, they point out that the impact on services, on which the UK depends and where we have a surplus with the EU, would be even greater. This is because, while barriers to trade in goods have fallen consistently over the past decade, implied barriers to services remain some 2 to 3 times higher than those for goods.

It is hard to draw any conclusion other than that FTAs are a worse outcome than what we have now. There is still room for manoeuvre within them of course, so the pressure must be to obtain as close an agreement with the EU as we now have as members of the single market. That may be hard to negotiate. It will be even harder to do so with the agreements with other countries to which we are currently signatories that will have to be renegotiated, and with any future discussions with new countries with whom we would like to forge closer trade links.

The Centre for Economics and Business Research (CEBR) estimates that erection of non-tariff barriers for services from the EU will reduce GDP in the UK by anything from 1.4% of GDP to 2.5% of GDP. NIESR calculates that loss of trade with the EU will not be made up by enough trade from the rest of the world in any reasonable time to compensate for it. FDI (Foreign Direct Investment) will also suffer. There are additional concerns about cuts in EC funding such as: the European Structural funds; European Investment Bank funding, including the European Investment Fund and the European Social Fund; regional venture capital funds; CAP support to UK farmers; and also for R&D through the Framework Programmes, currently Horizon 2020, and beyond. At the same time a reduction in net migration to below 200,000 would, according to the OBR, reduce growth and raise the deficit as a percentage of GDP and also debt as a percentage of GDP by comparison to the status quo.

What can be done by interested parties?

So what can various groups do in this area to influence the outcome? We will look at four groups and analyse their possible stance:

1. *How can Parliament and the public sector respond?* Civil service capacity is clearly strained. The Institute for Government worries that Bills are not getting proper parliamentary scrutiny and that many are dropped, as well as that there will be less chance to change, improve, or scrutinise evidence to any significant extent when they come back, given the likely larger government majority. The civil service and legislature will have to cope with a huge workload after the Great Repeal Bill goes through and recreate regulatory, trade and other bodies to replicate and work closely with those in the EU. The long trade negotiations with the EU and others will stretch resources, not least in developing and then monitoring any new migration regime. In that period budgets will be tight and the austerity will continue to be felt by many departments even though the fiscal targets have been loosened in terms of timescales for achieving a balanced budget. There is a need for more cost benefit analysis and regulatory impact assessments for any spending/policy decision.

2. *How can businesses respond?* A clearer message? More lobbying? More joined up voices? Or exploring the competitive advantage in isolation? New markets and alliances can only partly compensate and SMEs are particularly disadvantaged. Competitive deregulation - as in an offshore finance centre - is possible but difficult: there are issues about retaining workers' rights, environmental and technical standards, health and safety, competition safeguards, takeover rules, corporate governance and procurement. The likely outcome is the business costs will rise and the government may well pass a lot of the required bureaucracy and controls in the area of migration for example to business. Already costs of hiring non-EU labour have doubled.

3. *How can social scientists respond?* Perhaps by more expert evidence-based analysis. The benefits of EU membership and of further single market integration have not been well explained. The think tanks, economic and other consultancies and some universities are already producing some very useful work in a number of specialist areas on the impact of the various Brexit options, but this will need to be strengthened, made more public and possibly coordinated better. Additionally, links with the civil service professional groups and policy makers need to improve so that a path can be found for that external work to be more influential in decision making and thus assist the creation of evidence-based policy.

4. *How will the EU respond?* After Macron's victory it will do so in a unified, more determined way and closer integration is likely. But Guy Verhofstadt, lead Brexit negotiator for the European Parliament, wrote recently that 'the EU will not seek to punish the UK or demand one more Euro than is due' (*Financial Times*, 8 May 2017)[3].

Is there an upside?

Could we leave politically but not economically? It is difficult to think how that can be done without keeping the current jurisdiction of the European Court of Justice in dispute resolution in many of our dealings with the EU and for determining the status of current and future EU citizens in the UK. None of this of course is consistent with the Tory manifesto still promising to keep net migration in the tens of thousands, which most calculations, including a recent CEBR report, point to as very damaging to the economy in the medium to long term. Even if the economic arguments are ignored, politics may intervene; solving the question of the Northern Ireland border, for example, and dealing with the threat of Scottish independence suggest some compromise is needed and hopefully will be achieved in this and other areas.

As Donald Tusk, President of the European Council, has made clear: ***'Brexit will be punishment enough'***.

Notes

1. Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker and Guntram B Wolff, *Europe after Brexit: A proposal for a continental partnership.* Breughel, 29-08-2016. bruegel.org/2016/08/europe-after-brexit-a-proposal-for-a-continental-partnership/
2. *The Economic Consequences of Brexit: a taxing decision.* OECD policy paper, April 2016. www.oecd.org/economy/the-economic-consequences-of-brexit-a-taxing-decision.htm
3. www.ft.com/content/2494db66-31ae-11e7-9555-23ef563ecf9a

HOW CAN SCOTLAND PROSPER OUTSIDE THE EU?

Professor Ronald MacDonald, Research Professor of Macroeconomics and International Finance, Adam Smith Business School, University of Glasgow

Introduction

This paper takes a political economy perspective on how Scotland is likely to fare outside the EU, post Brexit. As we shall see, a significant proportion of Scotland's trade is with the EU; however, its greatest trading partner by far is the rest of the UK (RUK). As a result, although a strong line has been taken by the Scottish government for a separate deal for Scotland vis-à-vis the EU, it is the deal that the UK gets with the EU that really matters for Scotland.

Brexit and the failure of the UK government to recognize a special deal for Scotland has been taken by the SNP as a significant 'material change' to Scotland's constitutional position, warranting a second independence referendum. However, given the economic backdrop and the polls indicating that the majority of the electorate in Scotland do not want a second referendum, it is unclear that the Scottish National Party (SNP) themselves actually want a second referendum any time soon. So, the attempts by Theresa May to push the date of any second referendum back in time, in all likelihood, suit the SNP's underlying position.

The economic backdrop

In discussing Scotland and Brexit it is useful to have as a backdrop some key economic indicators of the Scottish economy. The latest Scottish government's revenue statistics[1] figures show Scotland in 2016 with total public spending, including non-devolved items, of £68bn and a net Fiscal Deficit of £14.8bn or 9.6% of GDP. For the last couple of years Scotland has had a slower economic growth rate relative to the UK; indeed, in the last quarter the GDP growth was negative. A combination of the oil price shock combined with continuing uncertainty over Brexit and the possibility of an IndyRef2 are usually cited as the key explanations for this relatively poor economic performance.

The total value of Scotland's exports in 2015 was £78.6bn (that is total international and UK exports), of which £49.8bn (63%) was RUK, £16.4bn (21%) was to non-EU countries, and £12.3bn (16%) to the EU. The USA was the top country destination, with £4.6bn of exports (16% of the total). Exports to Asia were relatively small, coming in at around £1bn and, although this may offer Scotland some scope for diversification of its exports post-Brexit, the key reason why they are not already greater is probably linked to distance.

Scotland's top five international exports in 2015 (all numbers are in nominal terms) were: Food and Drink (£4.8bn), Professional, Scientific and Technical (£3.5bn), Petroleum and Chemicals (£2.8bn), Mining and Quarrying (£2.1bn) and Wholesale (£1.6bn). Scotland's top five EU exports in 2015 were: Petroleum and Chemicals (£2.3bn), Food and Drink (£1.8bn), Wholesale and Retail (£1.1bn), Professional, Scientific and Technical (£980m) and Manufacture of Machinery and Equipment (£625bn). Scotland's top five non-EU export destinations in 2015 were: Food and Drink (£3bn), Professional, Scientific and Technical (£2.5bn), Mining and Quarrying (£1.5bn), Financial and Insurance (£1.1bn) and Administration and Support Services (£920m).

One key factor that is often overlooked or under-played in the Brexit debate is that approximately 75% of international trade is trade in intermediate goods and services rather than final goods and services. Although Scotland's trade figures are still fairly rudimentary, it is probably fair to say that its trade figures will broadly reflect this percentage and so it is difficult to unravel how much of Scotland's trade with RUK is 'supply chain' trade, that eventually feeds into UK trade with the EU. In other words, Scotland's ability to prosper outside the EU will likely very much depend on the deal that the UK as a whole gets rather than any special deal Scotland itself may achieve vis-à-vis the EU.

Since as we shall see below, alternative post-Brexit plans for Scotland involve further devolution of powers, it is worth stating what the current powers are.

In terms of devolved matters, Health, Education, Local Government, Law, Social Work, Housing, Tourism, Transport, Planning and Environment Agriculture, Forestry and Fisheries, and Sports and Arts are devolved to the Scottish Parliament. Matters that are reserved to Westminster are: Constitutional, Defence, Foreign Policy, Immigration, Economic and Monetary Policy, Energy, Employment, Social Security. Income tax (both bands and rates) is now almost wholly devolved to the Scottish Parliament and 50% of VAT raised in Scotland is assigned back to the Scottish Parliament. A range of smaller taxes are also devolved, including Land and Building Tax, Air Passenger Duty and the Aggregates Levy. The borrowing powers of the Scottish Parliament are capped at an annual limit of £450m with an overall limit of up to £3bn.

Scotland's Place in Europe

At an IPPR (Institute for Public Policy Research) meeting in Edinburgh in July 2016, Scotland's First Minister, Nicola Sturgeon, set out what she saw as Scotland's 5 key interests for any post-Brexit deal:

The so-called 'democratic interest' reflected the fact that Scotland didn't vote for Brexit, with 62% of Scottish votes for Remain, and therefore any post-Brexit deal had to recognize this.

The 'economic interest' picks up that nearly 50% of Scotland's international trade is with EU countries and that there is the importance of 'passporting' to the financial services sector. Furthermore, Scotland's significant rural economy means that Common Agricultural Policy (CAP) payments are very important, and given Scotland's demographic (the Scottish government predicts that over next 10 years 90% of Scotland's population growth will have to come from migration) the free movement of labour and capital is also crucial.

The 'social protection interest' arises from the fact that the EU guarantees core rights and protection, for example for workers in areas such as health, safety and anti-discrimination etc.

The 'solidarity interest' reflects the idea that independent countries come together for mutual protection against crime, terrorism and global challenges. Finally, the 'influence interest' – there is little or no point in paying to be part of single market if we have no say in its rule making.

In order to ensure that the five interests are achieved post-Brexit, the Scottish government set up its Standing Council on Europe in June 2016. This produced the document *Scotland's Place in Europe* (SPE)[2] that December, which became the Scottish government's position on Brexit. This is a substantial document which, at its heart, seeks to address these five key interests.

SPE argues that the first best solution for Scotland after the EU referendum was for the UK to remain in the EU, with the second-best solution for the UK to remain in the EU Single Market via the

European Economic Area (EEA) and EU customs union (EUCU). The third best solution should the UK decides to leave the EU would be that it should support Scotland remaining in the single market even if the UK should leave it. The reasons for the latter being the preferred solution are largely, although not exclusively, economic in that this would avoid frictions to trade through tariffs and quotas and avoid technical barriers (i.e. the mutual recognition of goods and the harmonisation of standards). It would also provide the free movement of labour and capital and, given that much foreign direct investment (FDI) into Scotland is dependent on membership of the EU, stabilize FDI's and the associated productivity gains from such investment.

Fraser of Allander study and the economics of Brexit

In order to capture the economic impact of Brexit, SPE included a scenario analysis undertaken by the Fraser of Allander Institute (FAI) for the Scottish Parliament in 2016.[3] This report was intended to give the Scottish counterpart to UK studies on the long-run impact (approximately 10 years) of the trade, labour mobility, and investment effects of Brexit. The FAI used a Computable General Equilibrium model with 18 different sectors and inter-regional settings to examine the impact on GDP, real wages and employment under three post -Brexit scenarios for Scotland: the Norway option, the Swiss option and the WTO (World Trade Organisation) option. The main channels of Brexit are given as: trade/openness, labour mobility, the degree of competition and financial integration.

The results of the FAI study are summarized in the table below and show that, unsurprisingly, the biggest hit on real wages, GDP and employment takes place in the WTO scenario, with the Norwegian/ EEA scenario appearing best for Scotland with the lowest impact on GDP/real wages/employment. Clearly none of the scenarios represents a very satisfactory outcome given that Scotland is already facing a poor GDP growth rate.

The FAI study demonstrated that the sectors taking the greatest hit from Brexit were whole-sale and retail, transport and storage, and professional services and research and development. It is noteworthy that the FAI analysis did not factor in any dynamic effects such as the potential reduced FDI spend, and associated potential productivity effects, resultant from Brexit.

Table: The Fraser of Allander Scenario Analysis

Model	GDP	Real wages	Employ-ment
Norway (EEA)	2-3% lower	3-4% lower	1-2% lower
Swiss (Bilateral)	3-4% lower	5-6% lower	2% lower
WTO (Tariffs)	>5% lower	7% lower	3% lower

As an alternative to the FAI study commissioned by the Scottish Parliament, the Scotland Office also commissioned the FAI to estimate the number of jobs in Scotland linked to the demand for exports from RUK, REU and other Inter-national exports. Their approach uses Scottish government data in their most recent input-output tables (2013) and export information published in Export Statistics Scotland, and its focus is on Total Employment (sum of Direct, Indirect and Induced Employment). In sum, the study found that 530,000 jobs (24%) in Scotland were supported by demand for goods and services in RUK; 125,000 jobs (5.7%) in Scotland were supported by demand for goods and services REU; 175,000 jobs (8.1%) in Scotland were supported by demand for goods and services from the rest of the world.

Scotland's Place in Europe also emphasizes that Scotland's rural economy is strongly supported by the European single market in terms of superfast broadband, business development, housing investment and measures to address fuel poverty. Also, Scotland's rural economy is heavily dependent on agriculture, fishing, and food and drink manufacture (a £14.4bn turnover or £5.3bn in Gross Value Added) and on funding from the Common Agricultural Policy. This sector employs 116,000 people and up to 23,000 of these are non-UK nationals. It is noteworthy however (as we noted above) that, although the EU is Scotland's most important regional market (worth £2bn and 39% of total food and drink exports) it is not the largest export destination for this sector.

The university sector in Scotland is an important component of the country's innovation system and R&D from higher education institutions in Scotland was worth £1.1bn in 2014, one of the highest in the OECD. The SPE document argues that strong relationships with other EU universities (including the free movement of researchers) are vital to sustaining this. SPE further argues that 'hard Brexit' impediments would not exist in the European Economic Area (EEA) and exchange programmes such as Erasmus could continue. Additionally, many professional services exported from Scotland are dependent on the ability of the service providers to move freely to and from Scotland.

As previously noted, over the next 10 years the Scottish government predicts that 90% of Scotland's population growth will have to come from migration and already approximately 181,000 non-UK EU citizens live in Scotland, of whom 23,000 are in the food and drinks industry, 19,000 in health and the public sector and 18,400 in banking and finance.

A differentiated approach

If the UK does not stay in the EEA, how can Scotland do so? There are precedents for so-called differentiated variants: Denmark is a member state of the EU, but Greenland and the Faroe Islands are outside the EU and EEA. The Channel Islands are not in the EU but are in the customs union. Liechtenstein and Switzerland are in a customs union with each other, while the former country is part of the EEA and the latter not. Furthermore, the UK government has indicated it may seek differentiated solutions for different sectors of the economy, such as finance and the motor industry.

Scotland's Place in Europe proposes a Norway-style model in which Scotland stays in the EEA with the 4 freedoms - on goods, capital, labour and services - enshrined as part of Scots law. This involves Scotland first becoming a member of EFTA (European Free Trade Association) and then having an EEA agreement. The SPE document argues that the UK government should have done this as part of its letter of intent when triggering Article 50. The benefits of this would be that there would still be free trade and Scottish residents would retain the right to travel, live and work and study in other EU/EEA countries. Additionally, minimum employment, social, environmental and consumer rights would be guaranteed.

In such a setup, free movement of goods and services between the EU and Scotland (EU laws would apply) would be guaranteed and the free movement between Scotland and RUK would continue, with the Irish border given as the precedent for this. But it is not entirely clear how the border would work. The border between Scotland and England is quite 'wide', in the sense that there are no major cities near the border, which could be seen as a limit to potential smuggling, for example. However, the incentives to circumvent tariffs and other trade restrictions leading, say, to distribution networks near the border could be a powerful factor why this may not work depending on the final Brexit deal struck.

Scotland's demographic means that the free movement of people is crucial to the success of the Scottish economy and the Fresh Talent[4] precedent gives one indication of how a differentiated policy on immigration could work. Under *Scotland's Place in Europe* proposals, immigration becomes a devolved matter and the common travel area would be maintained and point of employment legislation (rather than point of entry) would be used to regulate immigration.

The SPE document also argues that matters already devolved to the Scottish Parliament should remain so ('repatriated competences in devolved areas') and that there should be further devolution in areas of health and safety and employment law, consumer protection ('repatriated competences in reserved areas'), and additional powers will be needed to make the new constitutional settlement work: on immigration, company law, energy regulation and import and export control.

Scotland's Place in Europe was very quickly – within 24 hours – rejected by the Prime Minister, Theresa May, which created a 'material change' to policy making in Scotland and, on 13th March 2017, Nicola Sturgeon called for a second Independence Referendum - IndyRef2 - as the only way in which the aspirations of SPE could now be realised. This was ratified by the Scottish Parliament on 28th March 2017. However, it is not clear that the SNP really want an IndyRef2 given the economic backdrop and the economic uncertainty around the currency choice of an independent Scotland and the implications this could have for Scotland's main trading partner, the rest of the UK.

Furthermore, the process, timing and terms of a new EU arrangement would, as with Brexit, still be in the hands of the EU and this would create more uncertainty. It is also unclear what new membership would cost and whether or not an independent Scotland could avoid adopting the Euro and instead stick with sterling, the currency of its main trading partner.

Over time, much of the devolution process has relied on what has been referred to as a credible secession threat; that is, SNP pressure, in various forms, has at critical points led to significant devolution legislation, such as the creation of the Scottish Parliament, the Calman Commission and most recently, as a result of IndyRef1, The Vow[5] and its payoff in terms of the Smith Commission's proposals.[6]

As an alternative to a second independence referendum and the SPE proposals, Jim Gallagher, a constitutional expert, proposes that the various devolved assemblies in the UK should capitalise on Brexit to have further devolved powers given to them. We label this Devo Cubed. In a Scottish context it is argued that a second independence referendum will be toxic and be even more divisive than the first independence referendum since, in circumstances where the outcome of a referendum is close, there are always going to be a significant number of losers and a resentment and grievance culture arising. The Devo Cubed proposal is essentially confederal in nature and shares some commonality with SPE but crucially is not based on membership of EEA.

In sum, the Devo Cubed proposal has four main planks. First, matters that are already devolved should get further devolution of powers repatriated under Brexit and for Scotland that would include agriculture, fisheries and the environment. Second, areas that are already devolved should be allowed to enter reciprocal agreements with the EU and new powers would be needed to do this. Examples of this would be in health, universities (i.e. Erasmus studentships and access to EU research funding); Justice – cooperation on policing (European arrest warrant or enforcement of judgments). Third, and in order to address Scotland's demographic, point of employment legislation rather than border control could allow different devolved areas to effectively have different immigration policies whilst still having free movement of people within the UK. Fourth, the changed nature of intergovernmental relationships would require something like an independent secretariat to avoid consequences of policy on, say, agriculture having detrimental spill-overs in the rest of the UK.

Concluding comments

The majority of the Scottish electorate voted 'remain' in the EU referendum. That the UK as a whole voted to leave is seen by SNP as a 'material change' and sufficient to trigger a further independence referendum. However, this relies on the existence of a significant secessionist threat and it is not at all clear that that threat exists at the moment or indeed is likely to be there in the near future. Indeed, even if such a threat existed, Scotland's main trading partner by far is the rest of the UK, and its trading links and supply chains with it are key to its economic prosperity. As a result a further independence referendum will likely serve only to compound the issues Scotland faces with Brexit since undoubtedly an independent Scotland would have its own separate currency introducing an important friction into Scotland - RUK trade. To set against the trade issue, however, is the issue of immigration which will be crucially important to the prosperity of the Scottish economy given its projected demographic.

For Scotland to prosper outside the EU it should, therefore, try to maximize the devolution of powers arising from Brexit, including labour mobility, perhaps along the lines of the Devo Cubed proposal, and rely on a good deal being struck on trade between the UK and the EU. Given its close trading links with RUK, it is crucially important that no further frictions are introduced either through currency risk or regulatory changes to these links. As with the rest of the UK, Scotland's prosperity outside the EU crucially depends on the success and nature of the Brexit deal achieved by the UK government.

Notes

1. www.gov.scot/Topics/Statistics/Browse/Economy/GERS
2. www.gov.scot/Publications/2016/12/9234
3. www.sbs.strath.ac.uk/economics/fraser/20161006/Long-term-Economic-Implications-of-Brexit.pdf
4. www.talentscotland.com/
5. The Vow refers to the joint statement made by the leaders of the three main unionist parties just before the first Independence referendum promising more powers for Scotland in the event of a No vote.
6. www.gov.scot/Topics/constitution/smith-commission