D2 JOINT COMMITTEE FOR ECONOMIC PROSPERITY

29 November 2018

BREXIT BRIEFING

1. Purpose of the Report

To provide an overview of the potential macro-economic impact of Brexit and its likely impact on local government.

2.0 Discussion/Decision Required by the Committee

To note and discuss the report.

3. Information and Analysis

3.1 Introduction

This report sets out high level considerations of the impact of Brexit from two perspectives:

- External – the likely macro-economic impact on the UK economy both short term and long term
- Internal – the impact on local government services and budgets in a number of key areas

Lack of clarity and uncertainty is a major caveat around any consideration of the impact of Brexit at this point. A vast body of journals, studies and reports (both government commissioned, politically motivated or independent research) have speculated on the likelihood and severity of impact across a range of scenarios from "no deal" through the various "deal" options (both transitional and long term) to the possibility of a second referendum and potential no withdrawal. All of these scenarios will have a clear impact on the ability of councils to deliver both statutory and discretionary services, the role local government has to play post-Brexit and potential opportunities and risks that may arise in the long run from removal of the EU regulatory framework.

The recently published draft Brexit deal has, for the first time, provided the Government's detailed option following two years of negotiation since Article 50 was triggered. However, the ensuing political debate means that uncertainty remains for the UK's position on 31st March 2019 with the various options set out in the previous paragraph still possible. It should also be remembered that the deal only covers the transition period and the main substance of our future relationship with the EU will only commence once a deal is signed off.

To summarise, the key headlines of the draft deal (relevant to this report) are as follows:

- Immigration – during the transition period, the free movement rules still apply until December 2020. Once the transition finishes, free movement ends and the UK can set its own immigration policy. Any British people who take up residence elsewhere in the EU before that date will be allowed to stay there, as will Europeans who settle in Britain.
- Trade – the draft arrangements ensure that deliveries can be made without being delayed at the border until the end of the transition period. If a trade deal is not agreed during transition, the customs "backstop" will allow UK to continue to be able to trade with the EU with no tariffs but the UK would not be able to strike deals to lower tariffs with other countries outside the EU until the backstop ceases to apply.
- EU laws and standards – under the proposed backstop, the UK must observe "level playing field" commitments that align Britain and the EU on issues such as state aid, employment and environment standards.

3.2 Macro-economic impact

As stated above, the likely short and long term effect of Brexit on the UK economy is an arena of much debate.

- **Pre-Brexit**

Most experts agree that economic growth has slowed and that the UK economy is 1-2% smaller than it would have been following a remain vote in the 2016 Referendum. There are three probable reasons for the slowdown:

- The weak pound – causing an increase in the cost of imports and knock on to goods
- Uncertainty and a fall in business investment as well as consideration of relocation away from the UK
- Fall in EU migration

However, it should be noted that exports have been boosted by the fall in sterling making our goods cheaper abroad, although this has occurred at a time when the EU remains our main export market (43%).

- **Long Term Economic Forecasts**

Opinions remain divided on the long term impact of Brexit on the UK economy (regardless of any "no deal/deal" scenario). However, economic orthodoxy suggests that the mid-term effect will be negative. The long term is difficult to predict at this stage.

The International Monetary Fund's (IMF) latest assessment of the UK economy echoes what Bank of England governor Mark Carney reportedly told the Cabinet: a no deal Brexit would seriously disrupt the UK economy. The Governor of the Bank of England re-iterated his concerns and provided a tacit backing for the draft deal at the recent meeting of the Treasury Sub-Committee, stating that it would provide an orderly Brexit as opposed to the "large negative shock" of a no deal withdrawal which would lead to "a reduction, all things being equal, in the supply capacity of the economy. This could mean lost output, lost jobs, lower wages, it means higher inflation".

However, this sentiment contrasts markedly with Jacob Rees-Mogg's statement from the Conservative Party European Reform Group (echoed in newspapers such as the Express and the Telegraph) that there was "nothing to fear" from a no deal scenario. Rees-Mogg backed up his reassurance by presenting new research, which says UK economic output could be boosted by 7% (or £1.1 trillion over 15 years) by trading with the EU under World Trade Organization (WTO) rules rather than trying to reach a special agreement with the bloc.

- **The Impact of "No Deal"**

As of 26 November, a Deal has been secured with the Commission but there remains the very significant challenge of securing agreement through Parliament. Currently, opposition members and a number of Conservative backbenchers are advising they will not support the Deal. The threat of 'no deal' therefore remains.

Although all political parties have indicated a commitment to avoiding the prospect, the effect of a "no deal" Brexit is likely to be damaging from a macro-economic standpoint in the short to medium term. The key short term impacts would include the need to revert to World Trade Organisation (WTO) regulations (the re-introduction of import and export tariffs) and a poetntial further weakening of sterling. Tariffs would be imposed on goods that the UK sends to the EU and the same for goods that the EU sends to the UK. Tariffs on agricultural goods for example could be as high as 60%. A detailed analysis by Government of the long-term economic impact of a "no deal" Brexit found that UK gross domestic product would be about 8% less over the next 15 years than it would be otherwise.

Research as part of the UK in a Changing Europe Initiative has suggested that the results for a "no-deal" Brexit scenario could put more than 2.5 million UK jobs directly at risk, and almost £140 billion of UK economic activity annually. In a recent article, the Financial Times suggested that "no deal" could cost the average UK household £1,000 per year and is likely to be regressive, hitting low income households comparatively harder.

There remains 'noise' about the increase in import costs and possibility of scarcity of goods that might arise from an increase in border checks which could increase prices and depress "real" wages leading to a threat of inflation. Increased labour costs in some sectors due to reduced levels of inward migration from the EU will put further strain on the margins of business.

Within this scenario, discretionary consumption would fall as households look to “belt tighten” which would have a knock-on effect to consumer sectors (such as retail, tourism, food and drink), many of which are a particular feature of the Derbyshire economy.

The fall in sterling would lead to a reduction in bank lending that would further hit business investment. The policy uncertainty created by a “no deal” may also make any changes in monetary policy to stimulate the economy such as a reduction in interest rates less effective, as businesses will be more likely to postpone investment decisions until more precise information becomes available.

The Bank of England has also warned that house prices could drop significantly over the next few years leaving homeowners in a situation of negative equity and also rising mortgage costs. The positive impact of a reduction in house prices for first time buyers and lower income families are obvious, however.

A “no deal” outcome could also mean it is likely there will be an end to the 21 month ‘transition period’ outlined in the draft deal which has been designed to enable businesses and public bodies to plan for withdrawal. Additionally, all EU rules and regulations would instantly cease to apply to the UK. This means there will be no remaining agreements on how to manage customs, trade, travel and the rights of the three million EU citizens living in the UK and more than one million UK citizens living in the EU.

In a “no deal” scenario, the UK would not be legally bound to pay the £39 billion divorce bill though. Additionally, the Government would not have to pay the annual £13 billion contribution to the EU budget. However, the UK will lose out on some EU subsidies such as the Common Agricultural Policy (CAP) which gives £3 billion to farmers.

Given the very recent news now that a Brexit deal has been secured with the Commission, there is the possibility of an economic upturn or “Brexit bounce” as a result. This is a combination of “relief” factors (business confidence) and exports could remain strong. However, with the EU remaining by far the largest market for UK goods, the imposition of new customs arrangements will likely have a more detrimental impact in the longer term. Currently around 53% of UK trade goes to countries that have a trade agreement with the EU and which the UK currently benefits from. The longer-term impact will depend on the extent to which the UK can negotiate effective trade deals with these states independently and that will need to be undertaken within the context of the trade “backstop”. The impact of increasing import and export costs would add permanent costs to businesses and reduce competitiveness.

At a sectoral level, manufacturing, retail and logistic sectors (all of which are strengths in Derbyshire) are most exposed to tariffs and border checks. Firms and sectors heavily dependent on just-in time supply chains, including almost all UK supermarkets, medical supplier networks and most online retail services, would be severely impacted by customs and border checks.

Toyota UK has said that a “no deal” Brexit would temporarily halt output at its plant in Burnaston. The plant produced nearly 150,000 cars last year, with 90% being exported to the EU. Stopping the production line would be expensive as Burnaston produces about £12 million worth of cars every day. Toyota has also said that a “no deal” might affect plans at the site. Burnaston is one of nine Toyota plants in the EU and each time there is a new project, all the plants compete for the same work.

A recent article published in a Changing Europe Initiative shows the Midlands and the North of England are by far the most vulnerable from Brexit as they are much more dependent than other UK regions on EU markets for their trade. Additionally, evidence from East Midlands Chamber’s Quarter 2 Economic Survey identified that manufacturers were not as optimistic as service businesses, reflecting some of the more direct impacts that leaving the customs union and single market might have on businesses more heavily engaged in importing and exporting. There is also a mixed picture for manufacturing investment with some investing for growth, but also some making defensive investments to safeguard against future trading arrangements, including in overseas facilities.

3.3 The Impact of Council Services and Budgets

Combatting the likely challenges of Brexit will largely depend on Government policy, most notably via the Industrial Strategy and similar documents such as the 25 year Environment Plan and the DIT Trade Strategy (to name but two).

Local government has been lobbying vigorously via the LGA and Government has responded positively through the establishment of a Local Government Advisory Board and the Ministry of Housing, Communities and Local Government inquiry into ‘Brexit and Local Government’.

The Local Government Association (LGA) has produced a number of policy papers outlining both the challenges and opportunities facing councils across the UK. This report draws heavily on the LGA report “Brexit: Moving the Conversation” (published in June 2018) which highlights key issues and sets out proposals for how local government can manage the transition and champion local communities.

Clearly, all councils have a duty to consider the implications of Brexit (“no deal” or otherwise) on its communities and the services it delivers (both statutory and discretionary). The Centre for Public Scrutiny (August 2018) recently highlighted a number of key impacts that will have an effect on local government as a result of a “no deal” scenario including:

- a fall in agricultural land prices;
- significant difficulties filling vacancies within councils (eg. social work provision) and in the wider economy (notably seasonal work);
- a fall in income as a result of any economic downturn;
- limits in the availability of basic and vital items – foodstuffs, medicines etc – and potential social unrest;

- uncertainty over the replacement of EU Structural and Investment Funds (ESIF).

The LGA have indicated a number of areas were Brexit will have an impact on local governance, service delivery and policy development:

- **Devolution**

Whatever the scenario, it is highly likely that Brexit will re-ignite the devolution debate, not only for the devolved administrations but also within the English regions. This will focus on the further devolution in powers but also the potential shape of future funding programmes (notably the proposed Shared Prosperity Fund) that replace ESIF and are likely to be delivered via the Local Economic Partnerships. To this end, the emergence of the East Midlands Strategic Alliance is timely, both in terms of arguing the case for greater investment in the region but also in ensuring the East Midlands (and Derbyshire) punches its weight in the new global trade and investment environment.

- **Legal**

Ensuring community wellbeing and public protection are key functions of local government and many of the standards and regulations covering local government service are underpinned by EU law. However, it is argued (beyond any transition period) that Brexit will present an opportunity to review the current regulatory regime and reform to support local economic growth. Two policy areas for potential reform include procurement and food hygiene.

Local government procurement is heavily regulated through EU competition law and the principle of “state aid”. Liberation from competition regulation could provide an opportunity for councils to simplify procurement to promote local economic growth (eg. local supply and employment clauses) and make public sector contracts more attainable for local Small Medium-sized Enterprises (SMEs).

Similarly, the LGA has suggested that food hygiene regulations could be strengthened to raise standards. Clearly, local government will have a strong regulatory voice in any future trade deals especially considering public concern surrounding food standards.

Similar to the above, local government will have a key role to play in a number of regulatory areas including air quality, waste management and consumer rights to name but three.

- **Local Labour & Skills Supply**

Councils have a critical role to play as a major employer but also as a catalyst for business growth and the provision of good public services. Regardless of Brexit, the UK economy continues to have a productivity problem largely as a result of supply side weaknesses such as a poor level of basic/low level skills; a shortage in technical/vocational skills and localised social mobility issues. Brexit will further exasperate these issues through the reduction in EU migration and the cessation of European Social Funds.

Derbyshire has a number of key sectors that will be affected by Brexit including:

- Agriculture with the withdrawal of the CAP and any proposed new Environmental Stewardship programme;
- Construction remains highly dependent on EU migrant skilled labour and the impact this will have on housing delivery;
- Social Care with 10% of the East Midlands workforce as non-UK EU employees;
- Tourism with up to 23% of the UK's visitor economy workforce consisting of Non-UK EU employees.

The LGA has set out ambitious reform proposals known as "Work Local" which lobbies for a major devolution of funding and powers to enable local areas to:

- Identify, target and close their skills gap;
- Ensure apprenticeship provision matches the needs of local employers;
- Create good employment opportunities across places which residents can enter, retain and progress in.

Clearly this will need to integrate with the benefits system whether it be the existing or reformed Universal Credit model.

- **Trade & Investment**

Maintaining trade and investment with the EU and opening up new global markets will be vital post-Brexit and councils have a key role to play in place promotion, stimulating inward investment and enabling local business to "survive and thrive" and seek new opportunities.

Through its regulatory functions (planning, housing and infrastructure delivery) councils will need to ensure local areas create the right climate for investment whilst at the same time, working with partners to promote destinations through international links and investment promotion activity.

Derbyshire have a long established relationship with Toyota in Japan and more recently with Anhui in China and can use these links to lever economic activity. Similarly, Derbyshire Economic Partnership (DEP) is well placed to coordinate high profile inward investment activity and developing investor development and export promotion services.

- **Funding**

As mentioned previously, the UK currently benefits from £5.3bn European Structural and Investment Fund (ESIF) 2014-20. Although HM Treasury have agreed to underwrite committed projects (delivered regionally via the LEPs) until 2022, there continues to be little detail and much speculation around the proposed UK Government funded replacement known as the Shared Prosperity Fund.

Opportunity exists to design a new national scheme that is simplified, joins up currently fragmented funding streams and is largely devoid of the notorious “red tape” of current EU funding programmes. It is likely that new UK funding mechanisms will be introduced to deliver the UK Industrial Strategy. LEPs will be required to develop Local Industrial Strategies to support growth in their local economic areas and it is likely that funding will through this channel.

Finally, Brexit will have an impact on business investment as we withdraw from European Investment Bank membership. More reliance is likely to be made on the British Business Bank (focused on SME growth support) and Public Works Loan Board (infrastructure).

4.0 Recommendations

4.1 There are no direct recommendations contained in this report but furhter action may result from discussion at the Board.