CULTURE, TOURISM, EUROPE AND EXTERNAL AFFAIRS COMMITTEE

INQUIRY ON THE NEGOTIATION OF THE FUTURE RELATIONSHIP BETWEEN THE EUROPEAN UNION AND THE UK GOVERNMENT

SUBMISSION FROM PROFESSOR TONY MACKAY

Comments on Scottish Government report on COVID-19: The Case for Extending the Brexit Transition Period by Tony Mackay, Professor of Economics, Inverness

1. This report was published by the Scottish Government on 3 June, together with a media release from Michael Russell, the Cabinet Secretary for Constitution, Europe and External Affairs. Mr Russell also wrote the foreword to the report.

2. The report extends to 61 pages, including 15 pages of appendices. The report’s authors are not identified but they are presumably from the Office of the Chief Economic Adviser (OCEA).

3. The report is one of a series produced by Scottish Government economists. It makes frequent references to two other reports:

   - Scotland's Place in Europe: People, Jobs and Investment (published in Jan 2018);

4. The first of these reports assesses the likely impact of the UK Brexit vote to leave the European Union (EU). A majority of the Scottish population voted against Brexit. The Scottish Government has maintained its opposition to Brexit and stated many times that if Scotland votes for independence in the near future they will apply for Scotland to rejoin the EU.

5. The second report is the latest in a regular series produced by the Office of the Chief Economic Adviser (OCEA). It includes some analysis of the economic impact of the coronavirus pandemic (Covid-19) but was written before the main impacts of that occurred.

6. This new report combines the OCEA’s estimates/forecasts of the negative impacts of both Brexit and the ongoing pandemic. It uses their Scottish Government’s Global Econometric Model (SGGEM).

7. I am disappointed by the quality of the economic analysis in this new report. It is clearly politically biased. The political objectives of the report are clearly set out by Mike Russell in his foreword. However, I find it very disappointing that the economists who wrote the report have allowed their analysis and conclusions to be heavily influenced by the political issues.

8. The earlier report on “Scotland’s Place in Europe” was strongly criticised by UK Government economists and also by some independent economists in Scotland. Some of the assumptions in it were very dubious and there were some serious errors.
Unfortunately this new report seems to have ignored those errors and possibly repeated them.

9. I taught many courses in econometrics and economic modelling at various universities, and believe I have a good understanding of the Government’s SGGEM model. A common criticism of such models is “rubbish in = rubbish out”.

10. That may be an inappropriate criticism of the analysis in this report but the OCEA authors have again left themselves open to such criticisms by the lack of explanations of their assumptions.

11. Who are the expected “readers” of this report?

12. The Brexit decisions will be taken by the UK Government and not the Scottish Government and the other devolved national governments. I would therefore have expected the report’s objective to have been to try to persuade the UK Government to change its approach and policies in the Brexit negotiations.

13. However, there are frequent and ill-advised criticisms of the UK Government throughout the report. For example, “But, even if an agreement were to be reached, the UK government’s level of ambition for the agreement is now so low that the negative impact would be almost as great as under a no deal outcome, due to a host of new non-tariff obstacles to our goods and services.”

14. I could give many more examples from throughout the report. I do not believe that this was a sensible approach to trying to persuade the UK Government to change its approach.

15. I voted against Brexit but since the result I have taken the view that we must “make the best of a bad job.”

16. Prior to the Brexit vote I wrote many articles about the benefits and costs of UK and Scottish membership of the European Union (EU/EEC). I also had a lot of correspondence with MSPs, MPs and MEPs about these issues.

17. My consultancy business had an office in Brussels for many years. We did a lot of studies for European bodies and also businesses throughout the EU. I therefore believe I have a good understanding of the Brexit issues.

18. I argued that the best solution was to reform specific EU policies rather than withdraw. In particular, I believe that the Common Agricultural Policy (CAP) has been very bad for UK citizens, including those in Scotland, although it has obviously benefitted Scottish farmers and related agricultural businesses such as food processors.

19. On the other hand, the Scottish fishing industry has fared badly from the Common Fisheries Policy (CFP) because of the access to Scottish fishing waters by vessels from EU countries.
20. In marked contrast, I have long been a supporter of the EU’s regional development policies, which have benefited many parts of Scotland, through the European Structural and Investment Funds (ESIF). Scotland has been a major beneficiary of the ESIF since 1975 with an estimated investment of £4 billion between 1975 and 2006, and a further £820 million for the period 2007-2013.

21. Under the current 2014-2020 programme, Scotland is benefiting from over £780m through the European Regional Development Fund (ERDF) and the European Social Fund (ESF). These Funds have played a vital role in reducing inequalities across different parts of the country for over 40 years, through significant investment in job creation and a sustainable and healthy economy and environment.

22. The Scottish Government is understandably concerned about the replacements for the ERDF and ESF.

23. The UK officially left the EU on 31 January 2020. However, the Withdrawal Agreement has a 1 year transition period to the end of 2020 during which most of the previous arrangements and policies continue.

24. There is also the possibility of a two year extension to the existing arrangements to the end of 2022, as the Cabinet Secretary Michael Russell points out very forcefully. He wants that extension. A decision on that has to be taken by the end of June.

25. Progress with the negotiations has been very slow and undoubtedly worsened by the coronavirus pandemic which has affected all EU countries and the UK.

26. Very briefly, there are two main options for the EU-UK negotiations:

- A Free Trade Agreement (FTA) which would continue many of the current arrangements;
- “No Deal”, in which case the policies of the World Trade Organisation (WTO) would apply.

27. It is very important to bear in mind that most of the UK’s trade agreements with non-EU countries are determined by current EU policies. That applies to major economies such as the USA and China, as well as to Commonwealth countries such as Australia and India, with whom the UK has special relationships.

28. The UK will have to agree to new arrangements with these other countries, of which there are about 200 in total. The negotiations will obviously concentrate on the major economies such as the USA, China and India. For most of the other countries I expect the UK to accept the WTO agreements, at least in the short run.

29. One of the most serious deficiencies in this Scottish Government report is the lack of analysis of the impact of the coronavirus pandemic on the EU economies. Economic activity and output have fallen there, as in Scotland. Some countries, notably Spain and Italy, have fared particularly badly, whereas others, notably Germany, seem to have coped surprisingly well.
30. Imports into the EU have therefore fallen massively. Scotch whisky imports are an obvious example.

31. On the other hand, exports from EU countries to the UK, including Scotland, and other markets have also fallen. That will presumably continue until the pandemic is over. However, the Scottish Government’s modelling for this report does not seem to have taken that into account.

Current status of UK-EU negotiations

32. The negotiations or discussions have gone on for a long time, apparently with little or no progress. The chief negotiators have been David Frost for the UK Government and Michel Barnier for the EU.

33. According to Chris Morris of the BBC: “There's no agreement so far on even the basic structure of what they're trying to negotiate. The EU wants one comprehensive deal covering all aspects of the future relationship, not just trade. But the UK sees that as an effort to keep it tied more closely than it wants to European institutions and ways of doing things.”

34. “The UK argues there should be a series of separate agreements, including a basic free trade deal. But the EU sees that as another example of the UK trying to cherry-pick the benefits it wants, while avoiding the obligations of EU membership.”

35. Yesterday (June 15) Boris Johnson had a video link conference call with European Commission President Ursula von der Leyen. Other senior EU and “UK politicians and advisers participated.

36. Before the conference call Laura Kuenssberg, the BBC’s political editor, wrote on the BBC website that “It's a familiar pattern - talks reach an impasse, things get stuck, the negotiators find themselves saying things and not necessarily listening to each other in a way that actually allows things to move forward. Then the boss comes in, and gives it all a good kind of shove.”

37. “What Number 10 hopes is that now these talks will happen every week from the end of June until the end of July with formal negotiations and smaller group meetings, some even in person, to try to sort of get the chemistry of it going. The question is, if and when they will actually compromise. And the track record, which will be familiar, is that they both do compromise in the end, but only a much later stage.”

38. The political and media responses to the meeting have generally been positive. For example, this morning’s Financial Times (16 June) states that “Boris Johnson has set an end of July deadline for sealing a UK-EU trade deal, amid growing optimism in London that a post-Brexit agreement might be possible….He said he saw no reason why an agreement could not be concluded by the end of July….There was also a recognition in EU diplomatic circles that Britain was engaging positively with Brussels.”

39. The Scottish Government could contribute positively to these negotiations, particularly in relation to key issues such as fisheries.
Executive Summary

40. The Scottish Government report states that “New economic modelling shows the impact of ending the transition period at end 2020 or, with the full two-year extension provided for by the Withdrawal Agreement, at end-2022. We also model the impact of two outcomes to the current EU-UK 5 negotiations, either a basic Free Trade Agreement in line with the UK government’s unambitious aspirations, or no deal. The lack of progress in the negotiations so far and the impact of COVID-19 on the negotiating process make no deal a real possibility.”

41. “These Brexit scenarios are overlaid on two illustrative paths for the recovery of the economy from COVID-19. The modelling indicates that ending transition this year would result in Scottish GDP being between £1.1 billion and £1.8 billion lower by 2022 (0.7 to 1.1% of GDP), compared with ending transition at the end of 2022. That would be equivalent to a cumulative loss of economic activity of between nearly £2 billion and £3 billion over those two years.

42. However, there is little or nothing in the main part of the report to justify these estimates. The Executive Summary states that “This is for two main reasons:

- because of COVID-19, Scottish companies will be in a much more fragile state and less able to absorb the impact of Brexit at the end of this year than in two years’ time; and
- because of the need, rightly, for both business and government to focus now on COVID-19, they will be less prepared now than they would be in two years, resulting in even greater disruption. This would be the case whether or not a deal is agreed.”

43. Also, the Summary states (p6) that “There have been suggestions that one motivation for rejecting an extension is to hide the adverse impact of Brexit In the bigger COVID-19 impacts: no responsible government could choose such a path, but no other convincing argument has been put forward.”

Economic analysis (1.1)

44. This is the main part of the report and extends to about 30 pages.

45. It states (Page 16): “In the no deal Brexit outcomes, the economic path diverges from the illustrative baseline due to the immediate introduction of UK-EU trade barriers and lower investment prospects. Following this immediate impact on GDP, this economic impact worsens over time for two principal reasons.”

46. “Firstly, in addition to declines in existing trade, future Scottish-EU trade is foregone with less trade being created than would have occurred otherwise. Scottish exports into the EU single market lose competitiveness with the cost of Scottish goods and services being higher due to tariffs and non-tariff barriers.”

47. “Secondly, net annual EU migration is likely to fall. With each year following EU exit seeing lower levels of net-EU migration, the level of foregone migration accumulates over time. This results in smaller pools of available workers each year
than would have been the case, putting upward pressure on production costs as well as reducing prospects of business expansion. All of these contribute to a prolonged period where trade levels never recover fully, and GDP is permanently lower in the long term.”

48. The discussion of the first point is poor. A few examples of that are given below.

49. The second point is a very important one for the Scottish economy because EU citizens are now a very important part of our labour force, particularly the lower paid jobs filled by Eastern Europeans. However, I would have liked to have seen a discussion of the possibilities of more of these jobs being taken by Scots.

50. Page 22 is Figure 5: Sectoral Exposures to a No-Deal Brexit and COVID-19. It gives the authors’ opinions on the impacts on 17 various industries/sectors according to three colour categories:

- red = most exposed;
- amber = medium exposure;
- yellow = least exposed.

51. It is a very interesting figure but unfortunately there is little in the text to explain how the authors reached their judgements for the 17 industries/sectors.

52. The overall analysis in this section is very pessimistic, eg p 22 “These exposures are necessarily presented at an aggregated level in order to align with modelled outputs from both our Brexit and COVID-19 modelling. As such there will be variation at firm level. Simply because a firm is not in the red category does not mean the impacts are limited. On the contrary, for many firms within the amber and yellow sectors the impact of COVID-19, although on average less extreme than in the most exposed sectors, will still be enough to jeopardise their future prosperity, or indeed existence.”

53. The sectoral analysis in this section is very brief but more comments on individual industries are given in Annex B: Examples of Difficulties for Businesses. I comment on a few of those below.

54. The report states that “Our analysis suggests that the sector most exposed to the combined effects of Brexit and COVID-19 is manufacturing, given its level of international integration. As discussed above there will be variation; for example, sectors such as food and drink, manufacturing, chemicals and life sciences will face higher tariff and non-tariff barriers than some other sectors within the wider manufacturing classification.”

55. In contrast, the Sub-section on inclusive growth is good in my opinion.

**Practical challenges to the exit process (1.2)**

56. This is also a good section and I have no comments on it.
Section 2: How to Use the Breathing Space that an Extension to the Transition Period will Create

57. This is a very brief section of just 6 pages which discusses the New Global Context. No comments.

Annex B: Examples of Difficulties for Businesses if the Transition Period Ends on 32 December 2020

58. This is a brief annex which comments on most of the industries/sectors highlighted in Figure 5. It gives little or no explanation of the rankings shown in that figure – most, medium and least exposed.

59. I give my own comments on three of the industries referred to:

- agriculture;
- fisheries
- oil and gas.

60. The annex refers to the food industry but with little specific mention of agriculture. As mentioned earlier, I believe that the main failure of the EU has been the Common Agricultural Policy (CAP), which has provided massive subsidies for farmers and related businesses in Scotland and throughout the EU. Consumers have obviously benefited from lower food prices but from the economic development perspective I believe that the CAP has generally been a poor use of public money.

61. Brexit will obviously have major implications for the agriculture and related businesses in Scotland and throughout the UK. Nevertheless, this report makes only brief and superficial comments about the implications for the industry.

62. For example, there is no discussion of the financial implications of a two year extension of the Withdrawal Agreement. Would the UK continue to contribute financially to the CAP? Would the UK and/or Scottish Governments introduce different policies from the CAP? The report does not consider these questions.

63. Secondly, it is generally recognised that the fishing industry, including aquaculture, should benefit from Brexit. The main reason for that is that Scotland has extensive maritime waters and the current Common Fisheries Policy (CFP) allows vessels from other EU countries to catch a large proportion of the fish in these waters. The implication therefore is that Brexit should result in a substantial expansion of the Scottish fishing industry and also associated industries such as fish processing and boatbuilding.

64. It is obviously possible to conclude that the proposed two year extension would not benefit these industries. However, there is no discussion of this issue in the Scottish Government report.

65. Thirdly, the oil and gas industry is very important in Scotland, particularly in the North East and the Highlands and Islands. Unfortunately, the analysis of the likely or
possible implications of Brexit and the proposed 2 year extension is very poor. That was also the case in the earlier “Scotland’s Place in Europe” report.

66. A frequent distinction is made between the upstream and downstream parts of the oil and gas industry. The former comprises exploration, development and production, notably from the offshore oil and gas fields in the North Sea and elsewhere in Scottish waters including West of Shetland. The latter comprises the processing or refining of the production, notably at the Grangemouth oil and gas complex on the Firth of Forth.

67. Many of the jobs and economic activity in the upstream industry are in what are known as support services. Many of the businesses involved are located in the Aberdeen area, although some are based elsewhere. The authors of this report define these activities as downstream but they are upstream.

68. There are therefore two separate issues which the report confuses. On the one hand, what will impact will Brexit have on the upstream activities in the North Sea and elsewhere in Scottish waters? My answer is very little. Other issues such as world oil prices are much more important.

69. On the other hand, what are the likely implications for the downstream oil and gas products, many of which are currently exported to EU markets?

70. The report states (pp52-53) that “The end of the transition period brings with it the potential imposition of tariffs, should no FTA be concluded. This will mean that at a time when it is already vulnerable, and attempting to trade its way out of a COVID-19 depressed market, the refining sector will be met with a potential further increase in commercial and logistical pressure with alternative trading arrangements. An extra period of time within the EU’s trading arrangements would allow time for the refining market to plan for any forthcoming disruption to existing trading arrangements and understand more fully the long term changes imposed on them.”

71. These are just three examples of the sector/industry reviews in the report. I could give more.

72. Overall, it is a very disappointing report. The economic analysis in it does no credit to the Office of the Chief Economic Adviser (OCEA).

73. I fully understand Michael Russell’s political objectives but believe that they would have been much better served by a good quality and objective report, to which hopefully the relevant UK politicians and civil servants would have given fair attention. I doubt that they have paid any attention to this report.