CENTRE FOR EUROPEAN REFORM

Brexit will make Britain's mediocre economic record worse

by Simon Tilford

Britain is already an average economic performer by Western European standards. Brexit will further sap its economic dynamism and aggravate startling regional disparities.

An observer of Britain's Brexit campaign would be forgiven for thinking that the country's economy had been one of the EU's star performers over the last 15 years or so. Much of the debate focussed on how EU membership was holding back the British economy. Boris Johnson, a leading figure in 'Vote Leave' (the official Out campaign), rarely passed up an opportunity to claim that the EU economy was the world's weak link, and that the UK's dynamic and flexible economy had little to risk from leaving it. Britain was – explicitly or implicitly – put in the same company as Germany, the Netherlands and the Nordics – reformed, flexible and dynamic. The reality is rather different. And Brexit threatens to make matters worse.

The UK's economic performance relative to the other big EU-15 economies – France, Germany, Italy and Spain – does not stand out as impressive, at least once we adjust for the different prices of goods and services across these countries. UK economic growth between 2000 and 2015 lagged behind Spain and Germany but also France, a country that has become synonymous in Britain with economic weakness.

Looking at economic growth per capita further tarnishes the image of the UK as a strong performer. Germany emerges as by far the best performing big EU-15 economy, with the UK fourth, ahead of only Italy. The British are no richer relative to the EU-15 average than they were 15 years ago. Moreover, the average Briton has to work more hours than the average Frenchman or German to achieve that level of income.

Indeed, it is when we turn to productivity that the UK's status as a strong economic performer is most clearly exposed as wishful thinking. Britain's GDP per hour worked has fallen to just 90 per cent of the EU-15 average, 25 per cent below French and German levels. Sustainable increases in living standards require economies to combine land, labour, capital and technology in ever more efficient ways; Britain has made a poor job of this, helping to explain why Britons' wages have risen by much less than their French and German counterparts over the last 15 years.

Not only is the UK's performance mediocre, it is highly skewed by London and its environs. Apart from London, just one British region – the south-east of England – has a GDP per capita in excess of the EU-15 average. And far from catching up with the richer regions of the EU, most poor UK regions have been falling further behind.

The UK's poor performance does not seem to be down to poor macroeconomic policies, at least in comparison to the other big EU-15 economies. There is little doubt that the British government overdid austerity in the 2010-12 period, but not by as much as the French, Italian or Spanish. Nor is there any evidence that government borrowing is 'crowding out' private sector investment; interest rates are extremely low, pointing to a surfeit of savings over profitable investment opportunities. For its part, the Bank of England has been more aggressive about cutting interest rates and embarking on unconventional monetary policies, such as quantitative easing, than the European Central Bank.

That leaves supply-side failures. The UK is generally perceived as a liberalised economy. And in terms of some measures of labour market performance, this is no doubt true: non-wage labour costs are low and it is easy to lay off workers, which together reduces the costs of taking them on in the first place. But labour market performance is about more than the freedom of firms to hire and fire workers easily; it is also determined by the skills of workers, alongside the efficiency of other markets such as housing, and the quality of a country's infrastructure. Here the UK has some real weaknesses.

A significantly higher proportion of British 16-19 year-olds suffer from weak literacy and numeracy than in France, Germany, Italy and Spain. Despite strong population growth and rapid price increases, the UK is building little more than half as many houses as in the 1970s. Moreover, the supply of subsidised (or social) housing has pretty much dried up. As a result, it is hard for many British workers to move to where the jobs are.

Another serious supply-side problem is Britain's infrastructure. The UK has invested less in roads, railways and air travel than the other large EU-15 economies over a prolonged period of time. Infrastructure can increase the productivity of labour and other inputs to the production process, raising the return on investment and boosting foreign trade. It can hence play a major role in addressing regional disparities in productivity.

Two further factors help explain the UK's poor performance. The first is that the UK is one of the most politically centralised democracies in the world. Regions as economically diverse as the north-east of England and London are essentially run as if they have similar economic structures and face the same challenges. Scotland aside, British regions have scant scope to tailor policies to their own particular needs.

The second is corporate governance. Listed British firms are still under too much pressure to maximise their short-term profitability, which can often impair their ability to create value in the long-term. The emphasis on the short-term is reinforced by executive pay being too closely linked to share performance, in particular short-term share performance.

By hitting economic growth and exacerbating regional disparities, could Brexit force the British authorities to address the country's supply-side problems? The government will no doubt provide some fiscal stimulus to counter the weakening of economic growth caused by Brexit. But it is unlikely to be the kind of long-term investment in infrastructure and skills needed by the UK. The Conservatives have few MPs in the poorer regions that would benefit disproportionately from such spending, while the resulting higher borrowing and/or taxation would be unpopular with their core vote in the wealthier southern English heartlands. And in any case, they are all but guaranteed to win the next election regardless of the policies they pursue, because of the implosion of the opposition Labour Party.

Similarly, ideology and political expedience mean the Conservatives are poorly placed to confront the UK's inefficient housing market. They are opposed to land taxes, which would encourage landowners and construction firms to develop land rather than sit on it (and profit from rising prices). And they are steadfastly against the building of social housing.

The government may take modest steps to address the short-termism encouraged by Britain's system of corporate governance. But it is all but certain to shy away from political devolution that would bring an end to the one-size-fits-all labour, tax and industrial policies that have contributed to such a concentration of commercial activity in London. The lesson that the Conservatives have drawn from Scottish devolution is that it encourages the creation of rival centres of power to Westminster.

The UK economy was a mediocre performer in an EU-15 context even before Brexit. But quitting the EU's single market threatens to further erode the country's economic dynamism and to worsen its striking regional imbalances.

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