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## Knowledge Exchange Seminar Series (KESS)

# OPPORTUNITY BREXIT? INSTITUTIONAL ECONOMIC IMPLICATIONS FOR NORTHERN IRELAND

'In the middle of difficulty lies opportunity', Albert Einstein

'If one does not know to which port one is sailing, no wind is favourable', Seneca

The vote for Brexit has created a situation where economic policy, to a certain extent, is developing faster than textbook theory. Northern Ireland's economic predicament is a combination of UK-wide processes, more intense forms of UK-wide problems and processes unique to the region. The speed, sequence and 'architecture' of regional economic policy-making, as well as its content, requires consideration if Brexit is to provide an economic opportunity. Designing appropriate economic policy responses requires considering not just the policies to be pursued but also the design of the organisations needed to implement policies.

### Introduction

This policy briefing focuses on institutional design and economic policy as they relate to the economic consequences of Brexit for NI. Many of the institutional themes and findings of the earlier contribution by my colleague, Professor Rob Gilles are echoed and expanded upon in this briefing (Gilles, 2016).

Consideration of space means that this paper cannot discuss in detail all the potential microeconomic, macroeconomic and public finance consequences of Brexit. In any case, there a number of useful quantitative analyses already that cover such ground. DETI commissioned Oxford Economics to produce research addressing the economic implications of Brexit for NI (Oxford Economics, 2016; Ramsey, 2016). Likewise, the ESRI has considered the economic implications for the island as a whole (Barrett et al, 2015). Summarising these reports, and a range of other reports on the macroeconomic effects of Brexit, we can conclude that Brexit could have repercussions for both economic efficiency and equity (Ebell and Warren, 2016).

Three preliminary points need to be made. First, many of the economic (and associated social) problems that face policy-makers after the vote for Brexit would have faced policymakers even if the 'remain' side had won. For example, the related trends toward devolving tax and spend and the possible reform of the Barnett formula are trends that both predate Brexit

(Birnie and Brownlow, forthcoming). Second, the “shock” of Brexit could have unintended and even favourable consequences for parts of the NI economy. Third, academic economists had traditionally considered EU membership as involving a slow, cumulative process of economic integration. So to an extent, Brexit is an example of economic (dis)integration that implies that policy (practice if you will) is developing faster than economic theory! Necessarily, as economists need to draw creatively on a range of models devised for other purposes rather than merely reaching for existing “off the shelf” textbook solutions, evaluating the prospective economic policy implications of Brexit will require an increased role for judgement and analytical capacity relative to formal modelling. The willingness and ability of policymakers in NI to draw on such capacity are themes I will return to later.

The structure of this piece is as follows: first, the scene is set regarding the state and prospects for the NI economy. In the second section the observation is made that there are three inter-related processes that are at work in the NI economy. Crucially these processes predate Brexit. The third section introduces some institutional economic analysis to consider the impacts of Brexit and then the remaining sections consider the implications of Brexit for the draft Programme for Government (PfG) and the issues of policy architecture and implementation.

## Brexit, Economics and the NI Economy: setting the scene

It is noteworthy that the mainstream of the economics profession in the UK, as well as beyond, favoured a ‘remain’ vote. For example, ten Nobel laureates in Economics wrote a letter to *The Guardian* setting out their opposition to Brexit (The Guardian, 2016). It is also humbling that such pleas were unsuccessful. The consensus amongst academic economists was that both short run transition costs as well as longer run effects would be profound. These longer run negative effects were to be felt via permanently lower levels of productivity and income (Table 1) (Crafts, 2016).

**TABLE 1**

**Table 1** Long-run impact of Brexit on level of real UK GDP (%)

LSE	-7.9
HM Treasury	-3.8 to -7.5
NIESR	-7.8

Source: Crafts (2016) adapted from Ebell and Warren (2016).

Note: forecast estimates run from 2016-30

EU accession appears from econometric studies to have impacted the level of UK GDP rather than the trend growth rate; it was domestic supply-side policies that altered the growth rate. Quantitative studies also indicate that a key transmission mechanism for EU membership in boosting UK productivity was that membership encouraged product market competition, which was an antidote to managerial weaknesses that tended to stifle productivity growth (Crafts, 2012, 2016). Alas we don’t have an NI specific study regarding this transmission mechanism, but there are quantitative studies suggesting that market structure and management quality are particularly intense problems in NI (Bloom and Van Reenen, 2010). If, this an accurate diagnosis, then Brexit may provide additional challenges to closing the productivity gap. This is a worrying conclusion because since the Global Financial Crisis (GFC) of 2007/8, NI’s growth has languished relative to the overall UK picture (Gilles, 2016, p.5).

The most recent Department for the Economy (DfE) economic update at the time writing (July 2016) acknowledged that the NI employment rate at 69% had increased for four consecutive quarters: however, it continued to remain below the UK average (74%) (DfE, 2016). Even before the Brexit result, Danske Bank revised its 2016 economic growth forecast for NI to

1.6% from 1.8%. Worryingly for the UK economy regional profiles of recovery are very uneven. In only two regions –London and the South East- was GDP per head in 2015 greater than the pre-GFC peak. In contrast, N. Ireland remains 11% below its peak, Yorkshire and Humberside 6% below and in Wales 2% below (Haldane, 2016, p.8).

The contrast with the ROI in terms of growth performance and potential is stark. The rebound of the ROI economy has been exceptional and the most recent IMF survey projects real GDP growth to decline to just below 5 per cent in 2016 and to converge to the estimated potential (approximately 3 percent a year) over the medium term on the back of more moderate export growth and investment activity (IMF, 2016). Furthermore, econometric modelling indicates that the regulations which it might be feasible to remove post-Brexit do not include anything that could alter substantially productivity performance: hence, Brexit in isolation is unlikely provide an adequate substitute for a concerted policy of supply-side reform (Crafts, 2016). Indeed, if as noted above, Brexit allows managerial weaknesses to continue unchecked, then it may reduce economic prospects. Brexit supplemented by supply-side policies does however provide potential. Indeed, one challenge of Brexit is that it increases the need for what has been termed 'fourth generation industrial policies' (Pryce, 2012). Such policies are characterised by a presumption against sector specific policies and a greater emphasis on 'horizontal' policies and cross-cutting issues (Pryce, 2012). In the case of NI one complexity in implementing policy is that agri-food may need particular monitoring.

For NI the potential efficiency effects of Brexit include (but are not limited to): facing the chill of economic slowdowns on both sides of the Irish Sea, reduced trade and investment, uncertainties over the electricity market as well as the ambiguous equity effects that depend on the price level and impact on the labour, capital and product markets. Furthermore, greater export exposure to the EU, associated with sharing a land border, implies that exchange rates, agriculture, tourism, food production and EU structural funds are all germane. The potential impacts for attracting inward investment, the role of corporate taxation in attracting such investment and affordability of varying Corporation Tax have also been brought into sharper question by the vote for Brexit (Ramsey, 2016).

### **Beneath the Surface: Brexit and Three Processes within the Northern Irish Economy**

The material presented so far should remind us that the UK economy was a spatially very uneven one before Brexit. Moreover, the GFC tended to widen the regional distribution of income (Haldane, 2016). Thinking of NI's economic predicament regarding the consequences of Brexit in terms of a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis reminds us that each components of the 'SWOT' has many sources. As the material presented already indicates, it would be wrong to blame any future travails solely on Brexit; yet there are clues to thinking about how Brexit may shape the NI economic performance and policy. The starting point for thinking about the long-term SWOT of the NI economy is to recognise that at least three distinct (but interrelated) set of processes have always been at work in the regional economy (Brownlow, 2015).

The first set of processes are those that are UK-wide. So obviously any macroeconomic 'shock' to the UK economy caused by Brexit will feed through. Note that the ROI shares with NI this feature, which reflects integration of the economies of the UK with the ROI. Those ROI firms that have expanded abroad, the UK is the dominant destination; almost a third of workers these firms employ are located in the UK (FitzGerald and Honohan, 2016). The close integration of the labour market on both sides of the Irish Sea has operated ultimately as a safety value for both jurisdictions on the island. The relatively rapid reduction in the ROI's rate of unemployment from 12% in 2012 to under 8% in 2016 can in large part be attributed to job growth in Britain (FitzGerald and Honohan, 2016). Second, NI has and continues to also face problems that are magnified versions of UK-wide problems. Rebalancing and external trade are two such challenge. The key example however is productivity. As noted earlier, the UK has a well-known productivity weakness and NI faces an even more intense form of productivity weakness. The earlier comments about the effects of EU membership and managerial quality are worth a reminder. While other peripheral regional economies such as Wales and the English north east share with NI the first two sets of problems, NI uniquely faces economic obstacles that are not faced by these other UK regions. For example, the issue of the possible reintroduction of physical border controls is an example of this third set of issues (FitzGerald and Honohan, 2016). Such a consideration will be important in designing the future arrangements for controlling the movement of goods and people. For example, in some important firms within the NI agri-food sector issues related to migration and labour mobility are crucial to the success of their business model (Ramsey, 2016).

## **Brexit as a Window of Institutional-Economic Opportunity**

Developing the SWOT line of argument and focusing on the 'opportunity' part of the equation, the Nobel laureate Oliver Williamson has noted within economics, cumulative institutional-economic changes of a progressive (i.e. those with overall net benefits) kind are often very difficult to orchestrate (Williamson, 2000, p.598). Established breaks from procedures are rare, but when they happen such discontinuities may provide 'windows of opportunity' that can open up an economy to successful broad reform. Two historical examples Williamson places in the positive category include reforms to the Japanese economy that followed the Meiji Revolution and the 'Rogernomics' reforms that occurred in New Zealand in the wake of financial crisis (Williamson, 2000, p.598).

However, more usually, because of what Williamson termed 'our primitive understanding' of such institutional economic processes, our response to such opportunities are often failure. Indeed, Williamson presented the slow pace of reform within the EU as an example of what occurs when prospects for reform are absent. The potential implications for Brexit are worth noting: it will provide an opportunity for net benefits only if it is effectively managed. This observation leads on to the final two sections of the briefing note, which are concerned with the willingness and ability of policymakers in NI to implement economic policies post-Brexit.

## **Brexit, Trade-offs and the Draft Programme for Government**

The Brexit vote was not merely about economics, indeed it was probably primarily about what many would regard as 'non-economic' issues concerning migration and national identity. Of course, even overtly 'non-economic' debates on immigration were fused with a more 'economistic' concern that scarce resources in public expenditure could have been better spent. From an economic perspective (i.e. one focused on trade-offs), any effective Programme for Government (PfG) requires not merely that objectives are to be measured, but that conflicts between objectives need to be considered (NI Executive, 2016). Furthermore, the literature on economic policy is huge and the evidence base on what works within regional economics and what does not is large. Good policymaking needs to draw on such literature if it is to be genuinely 'evidence-led'.

The good news is that the draft PfG illustrates that policymakers within NI have at least begun to recognise the need for measurement, an important improvement on previous exercises. The expressed desire to create an approach to policy-making generally that is based on 'results rather than intentions' (NI Executive, 2016, p.7) is music to ears of any well-trained economist! However, in terms of economic analysis, the draft PfG was notably weaker on recognising and resolving policy conflicts and it is also weak in terms of being evidence-led. Brexit puts such conflicts into sharp relief. In any case the chosen 42 indicators are tilted towards those requiring additional public expenditure; the possible perverse effects of pursuing indicators are not discussed. Furthermore, the draft PfG provides no discussion of how NI fits into the wider devolution settlement.

In terms of direction of travel then, Brexit confirms the conclusion that while the direction of travel within the draft PfG is the right one, more work needs to be made if it is to translate into a step change in economic performance. In terms of policy advice as well as the 'fourth generation industrial policy' framework outlined earlier, Moretti's emphasis on skills within regional economic regeneration also should also influence date on the post-Brexit direction of policy (Pryce, 2012; Moretti, 2012).

## **Brexit: Policy Implementation and Architecture**

In this final section, the design of policy architecture is discussed as it relates to Brexit. Economists have for decades considered not just the economic consequences of policies, as economists traditionally have considered, but the design of the institutions that produce policies. Perhaps the biggest issue surrounding the possible economic policy implications of Brexit is that it draws into stark relief the inter-related issues of confidence-building, policy architecture and sequencing. As of 2016, NI lacks an effective governmental economic 'think tank' publishing research and organising seminars. Moreover, civil service economists are not active participants in events organised by the two universities. There is widespread criticism within the business community regarding implementation. It is one thing to design a strategy for the economy, and produce an accompanying document, it is quite a different thing to convert that document into an effective set of policies.

As long ago as 2003, within a Northern Ireland Economic Council (NIEC) report, David Heald, one of the most distinguished academic experts on regional public finance, decried NI's low level of what he termed economic 'policy capacity' (Heald, 2003). He observed that the historical inheritance was a partial explanation. The pursuit of parity and Direct Rule bred a situation in which matched funding and/or lagged imitation of policy in Great Britain hindered the development of policy capacity. Heald additionally noted that policy engagement by academic economists had not been developed (Heald, 2003, pp.75-77). Likewise, a 2010 report by PwC argued that while NI has had a surfeit of economic strategy documents since the 1950s, these reports had failed to deliver on their promise. In the view of PwC, effective economic policy required more attention be made to policy design and a greater emphasis on implementation (PwC, 2010). PwC suggested that there needed to be greater clarity about priorities. Namely, such priorities needed to be realistic, achievable and limited in number.

Unfortunately, in some regard economic policy capacity/implementation has not grown since either of these reports. In fact, the analytical capacity regarding economic policy might be argued to have shrunk! The abolition of NIEC and NIERC, after the short-lived merger into ERINI, represents a retrograde step. Readers can gauge for themselves if they think that the draft PfG represents absolute clarity in terms of priorities. Likewise, the limited extrinsic incentives for academic economists to engage in policy-based research has not been altered. One opportunity for Brexit then is that it might force both elected and administrative policy makers into thinking about how to better convert NI's economic brain power into better outcomes. In conclusion, Brexit may act as a catalyst forcing policymakers into improving the implementation of economic policy, but such an outcome is not inevitable and will require a change in emphasis among policymakers within NI.

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