Lies, Damn Lies and the Treasury’s Brexit Reports

Kevin Dowd

[This draft: 9 June 2016.]

SPOT THE DIFFERENCE!

The gravity model used by the Treasury in its first Brexit Report

Amongst all the extraordinary nonsense spouted in the Brexit debate, on both sides, arguably the most infamous are the recent Treasury reports – here and here – on the impact of Brexit on the UK economy. These reports exemplify John Kenneth Galbraith’s dictum that the only purpose of economic forecasting is to make astrology look respectable.

The message of these reports is clear. To summarise the results in the first report, the UK would be unmistakeably worse off outside the EU by 2030. GDP per household by 2030 would be £2,600 per annum lower if we moved to the European Economic Association (EEA), £4,300 lower if we moved to the European Free Trade Association (EFTA) and £5,200 lower if we moved beyond that. These are equivalent to permanent reductions in GDP of 3.8%, 6.2% and
7.5% p.a., relative to remaining in the EU. To paraphrase the second report, a vote Leave would produce a self-inflicted shot in the foot, creating needless uncertainty and even a DIY recession, relative to the certainty of remaining in.

I am not the first to point out that these reports are tosh. They have been scathingly criticised amongst others by Ryan Bourne and Patrick Minford here, here and here. To quote Bourne, the Treasury's work is “riddled with bizarre assumptions” that undermine any credibility it might otherwise have had. And to paraphrase Professor Minford: the Treasury and the establishment picked out the worst case and served it as if it were fact, entirely ignoring both any possible benefits from leaving and any possible costs from remaining in. This is, he rightly said, a “deceit”.

And today, a new report by [disclosure: my long-term friend and collaborator] David Blake of City University offers a further deconstruction of the Treasury’s ‘analyses’ – and it is a devastating one too.

In this posting, I would like to offer a précis of David’s report, whilst adding some observations by other people and a few of my own.

Let’s begin with the headline claim – repeated regularly by George Osborne and other Remainers (or should I say, Remainders?) - that each UK household would be £4,300 worse off post-Brexit. To quote the editor of the Spectator, Nelson Fraser:

Sometimes, George Osborne’s dishonesty is simply breathtaking. ...
But it’s his maths, today, which shames his office – and his use of this maths to make the entirely false suggestion that the Treasury thinks Brexit would make you £4,300 worse off. For anyone who cares about honesty in politics, and the abuse (and reporting) of statistics, this is an interesting case study.

His chosen date is 2030. By then, the UK economy is expected to have grown by around 37 per cent, but the HM Treasury document claims that this would be closer to about 29 per cent growth after Brexit. A fairly straight situation, which Osborne fundamentally misrepresented ...

Deception 1. Osborne falsely claims that people would be ‘permanently poorer’ when he’s talking about the difference between 29pc GDP growth and 37pc GDP growth. The most he can claim is that they won’t be as much better off as they would otherwise be.

Deception 2. Osborne then translates this reduction in potential GDP to household income. But they are two fundamentally different things. This is Osborne’s crowning deception, to allow him to conjure up his headline figure of £4,300. This is what he wants households to remember, and is as intellectually dishonest as any
manoeuvre ever attempted by Gordon Brown.[1] The Treasury and the OBR discuss GDP all of the time: never do they convert it into a per-household cash figure because (unlike debt, tax etc.) it’s meaningless. GDP contains measures like the operating surplus of corporations; and all manner of other measurements.

GDP per household, this bogus invention, bears no relation to household income. If GDP is divided by households it’s £68,000: nothing like they average disposable income (£18,600 per head, or £45,400 per household)

Deception 3. To arrive at the £4,300 figure, the Treasury divided GDP in 2030 by the number of households today. Arguably the most dishonest trick of the lot because, with all that immigration, there’ll be plenty more households by 2030. ...

So having established 1) a means of dressing up an increase as a decrease and 2) a bogus conflation of GDP with household income and 3) a way of covering up the immigration-driven surge in households Osborne comes up with his grand deception:

‘Britain would be permanently poorer if we left the European Union, to the tune of £4,300 for every household in the county. That’s a fact everyone should think about as they consider how to vote.’

It’s not a fact, it’s an invention

It is then downhill all the way.

The only fact is that the Treasury’s reports are based on a series of dubious assumptions – a case of garbage in, garbage out – and perfidious tricks that serve to bias the results towards the politically convenient conclusion that Brexit would be really bad for the UK economy.

One key assumption is that the UK would be stuck in some trade limbo, unable to make new trade deals with other countries, and then stuck with the additional problems of being outside rather than inside the ‘protection’ of the EU tariff wall. The world’s fifth largest economy would be ‘isolated’ etc.

Such claims have it exactly upside down.

If we vote Brexit, there would be no interruption at all to current trading arrangements. The principle of continuity for the EU’s third-party country trade agreements would continue to apply – business as usual, until mutually agreed otherwise. Those who suggest otherwise are scaremongering.

As an aside, those guilty of such scaremongering include US President Barack Obama, who helpfully did his bit for the Remain cause by warning us that a post-
Brexit UK would go straight to the back of the queue when it came to trade deals with the United States.

Thank you for your thoughts, Mr. President, but if the United States wishes to put this trade issue on a backburner, as is their right, we would simply trade with the United States under the auspices of the WTO and encourage American exporters to the UK to lobby Congress for a free trade deal. The benefits from free trade are mutual.

Your Excellency’s enthusiasm for the EU might however be more convincing if the United States were as keen to join it themselves as you are for us to stay in it.

Outside the EU, we would be free to trade using the low tariffs already guaranteed by the UK’s membership of the WTO: there would be no need to renegotiate separate treaties with every other trading entity on the planet. We would be able to make new trading deals with other countries unfettered by obligations to operate under existing EU tariffs.

We should bear in mind that it is the EU itself that has stopped us being able to negotiate such deals earlier. Dan Hannan MEP put this well:

Geographical proximity has never mattered less. Freight costs have fallen, and the Internet has made it as easy for a firm in my constituency to do business with Dunedin as with Dunkirk. Easier, in fact. New Zealand uses common law and is English-speaking. Its companies have the same accounting systems as ours, and operate according to the same unwritten codes of business etiquette. Should there be a dispute, it will be arbitrated in a way familiar to both parties. None of these things is true of France, despite 40 years of single market directives.

Yet Britain cannot sign a bilateral free trade agreement with New Zealand. Nor with any other non-EU state. That power was ceded to Brussels on 1 January 1973, along with our right to speak and vote in what is now the World Trade Organisation. The European Commission speaks for us on the WTO – currently in the person of a Swedish former sociology professor – and tends to pursue a far more protectionist trade policy than Britain would adopt on its own.

Last year, free trade agreements entered into effect between China and two EFTA states: Iceland and Switzerland. But Britain can’t sign a similar deal, because Brussels has to give due weight to the protectionist interests of Italian textile corporations and French film-makers and so on.

Yes, the whole point of a customs union is not to have the benefits of free trade.

Free of EU shackles, we would no longer have to pay the costs of the Common Agricultural or Common Fisheries Policies, let alone pay our annual subs of £13
billion or whatever to Brussels to waste at whim. Consumer prices would fall, the price of food especially. The costs of trade (including the costs of imports) would fall, leading to lower manufacturing costs. There would be a shift in the structure of production away from sectors that currently benefit from protection (i.e., the less productive and often bloated ones) towards sectors that are not so protected. Productivity would rise and we could reap more of the benefits of comparative advantage. We could reduce regulatory barriers, and avoid the many dangers of staying in: the risks of more protection, more regulation, more centralisation and most of all the risks of staying inside a corrupt and democratically deficient EU that is obviously a failing state in the process of falling apart. Take just one long hard look at the state of the EU and it is obvious that the biggest risk is to Remain.

None of these benefits is considered in the Treasury reports.

Well, if you do a cost-benefit analysis of anything at all, but exaggerate the benefits and ignore the costs, then you can only ever expect one result ...

A key piece in this story is the way in which the Treasury abused one of its core models, the so-called gravity model. Loosely speaking, the gravity model is similar to the model that Isaac Newton used to explain the orbit of the planets around the Sun in our Solar System. Think of the EU as the Sun and the different European countries as planets orbiting the Sun. The countries closest to the centre of the EU have the greatest economic benefits from membership of the EU. As countries ‘move away’ from the centre of gravity, e.g., by exiting the EU, their trading benefits diminish and they become worse off.

The Treasury estimates the consequences of the UK leaving the EU and moving out first into the European Economic Area, then into the EFTA and then into the Rest of the World (ROW) beyond Pluto where World Trade Organisation (WTO) rules operate. The Treasury gravity model’s predictions are then clear: the UK would be worse off outside the EU by 2030 and there are no circumstances, period – or, more precisely, no circumstances factored into the model or considered in the report – in which the UK could be better off outside the EU.

Put another way, you have some core region and some outlier country. The economic ‘gravity’ is then the strength of the trade relationship between two. In a typical application, the modeller selects a core region and an outlier country. As the barriers to trade are lowered, trade between them increases and the outlier country becomes better off. Conversely, if barriers are increased, e.g., by the outlier country leaving a customs union with the core region, then that country becomes worse off. Indeed, once one specifies the core region and the outlier, then the result – that the outlier is better off closer to the core – is inevitable because it is baked into the model.

However, the gravity model goes much further – and one might say too far. As Blake points out, it implies that far from Brexiting, the UK should go in the opposite direction and join the euro. It also implies that “All countries would be better off joining the EU, since, according to the model, Europe is at the centre of
the known universe – something which many European leaders have, of course, believed for centuries."

You see, once you become ‘trapped’ in any gravity solar system, the model tells you that you are never better off leaving – regardless of any other considerations. A gravity model applied to any COMECON country, for example, would have implied it was better off under COMECON than under any other conceivable arrangement.

We should also recall the performance of the Treasury's gravity model in the run-up to the referendum on Scottish independence. The Treasury's model assured us that cross-border trade between Scotland and the rest of the UK would fall by 80% in the event of an ‘Out’ vote. Never mind the previous 300 plus years of political and economic union, the geographical proximity, the common language and currency, the similar legal systems and many other close links. Such a prediction lacks any plausibility and merely proves that the Treasury's model cannot be trusted.

Consider too the case of a very small country considering leaving the EU, despite that fact that it is ‘dependent’ on the EU for over 90% of its export market. Madness, you might think, but in any case, it didn’t happen. Wrong on both counts! Greenland left the European Communities (the predecessor to the EU) in 1985 without triggering the economic problems highlighted by the Treasury reports. On the contrary, it prospered: in the last five years pre-exit, its economic growth rate was 0.7%; in the five years immediately post-exit, its growth rate rose to 5.7%. The Treasury's gravity model would have predicted an economic catastrophe.

But before one concludes that the gravity model is just another silly economic model best consigned to the dustbin, there is one special case where it works properly (unless frightfully miscalibrated, which can never be ruled out), and this is where the ‘core region’ is the Rest of the World (ROW), which is the obvious choice in the first place. If we make this assumption, then it gives the results we would expect from Trade Theory - that barriers to trade retard economic welfare and that removing them improves it. Therefore, the problem is not with the gravity model as such, but with any application of it that assumes that the core region is anything less than the ROW. Any such application will then inevitably produce nonsensical results of the sort just outlined, which by the way also fly in the face of basic Trade Theory – not that anyone in the Treasury seems to have noticed.

The Remain campaign was quick to claim that the Treasury reports confirmed the ‘consensus view’ that Brexit would be bad.[2] Well, this claim might be true, but appealing to the ‘consensus view’[3] is a two-edged sword. In fact, when it comes to macroeconomics, the majority view in this country has a long history of getting it wrong. In the 1960s the consensus was wrong on the Philips curve. In the 1970s, they were wrong on the unions, wage-price controls, inflation and monetarism. They were famously wrong on the 1981 budget. They were wrong on privatization and they were wrong on the ERM. If they had had their way,
they would also have dragged us into the Euro, and they were wrong about that too – as people like Patrick Minford and yours truly pointed out at the time. Now they are telling us that we should vote to stay. Were I inclined to vote Remain, a track record like that would have me wondering whether I should change my mind.

It was unfortunate, then, that Remain leaders have chosen to base much of their campaign on these two execrable reports. Consider Chancellor George Osborne’s comments on the second report:

The analysis in this document comes to a clear central conclusion: a vote to leave would represent an immediate and profound shock to our economy. ...

We already know the long-term effects of a vote to leave: Britain would be permanently poorer. Now we know the short-term shock too: an economy in recession, major job losses and a self-inflicted blow to living standards and aspirations of the British people. (My italics)

As Mark Twain observed: “It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.” The only certainty is that there are no certainties in such matters.

Then consider a joint letter by the Prime Minister and the Chancellor:

A few weeks ago, the Treasury published analysis which shows Britain would be worse off to the tune of £4,300 for every household every year by 2030.

This would be, for the first time in our history, a recession brought on ourselves: a DIY recession. (My emphasis)

Oh my, what short memories you have! The recession of the early 1990s was the very embodiment of a DIY recession and it was caused by the last Tory government. In the early 90s, the then-government was determined to keep the pound in the ERM, come what may, all in the interests of the shibboleth of closer integration with Europe. It put the economy through a recession to achieve this end and all to no avail. It all then ended in tears on 16 September 1992.

But as if this is not enough, the political rhetoric gets even more bizarre when the Prime Minister makes his moral case for staying in. Speaking at a B&Q Store Support Office on 23 May 2016, he stated:

The economic case is the moral case – for keeping parents in work, firms in business, Britain in credit, the moral case for providing economic opportunity rather than unemployment for the next generation.
Where is the morality for putting that at risk for some unknown end? It would be like surviving a fall then running straight back to the cliff edge. It is the self-destruct option.

So on the one hand, we know we will be safe with the EU, but Brexit is an unnecessary big risk. I don’t think so.

Mr Osborne, standing next to the Prime Minister, then criticised the Tory Brexiteers:

To those fellow politicians who say we should vote to leave I’d say this: you might think the economic shock is a price worth paying.

But it’s not your wages that will be hit, it’s not your livelihoods that will go, it’s not you who’ll struggle to pay the bills. It’s the working people of Britain who will pay the price if we leave the EU.

This is a little rich. You have been spending too much time studying Gordon Brown’s cookbook, George: you can’t base a credible economic case – let alone a moral one – on economic reports that you blatantly fiddled to produce the results you want.

And as for the post-Brexit uncertainty, you two could help by toning down the hysteria: apart from anything else, post-June 23 you might end up having to reap what are now merrily sowing.

The Treasury’s Brexit reports should not be dismissed as just another couple of badly written Treasury Reports. We have seen plenty of those over years, but these are on all altogether different level. These reports are an object lesson in the economists’ black art of how to lie with models and they should be required-reading for all trainee economists – not, one hopes, as a how-to manual, but as an exercise in how not to carry out economic modelling. As Joan Robinson once observed, the purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists. These reports are a disgrace to the economics profession and I can well understand why their authors would prefer not to put their names to them. As Professor Blake writes, they are also

two of the most dishonest and deceptive public documents I have ever read. The whole exercise should therefore be seen for what it is – an elaborate charade. What is happening is no different from Tony Blair’s [sexed up] dodgy dossier on Saddam Hussein’s [non-existent, as it turned out] weapons of mass destruction. These two reports will rightly gain the same status of dodgy dossiers.

Quite.

**Endnotes**
[1] As Nelson explained in a footnote: “This technique – to present a rise as a fall – ... was actually pioneered by Gordon Brown in 2005 when he was breaking new ground in the abuse of statistics. Labour campaigned against “Tory cuts” but the Tories attempted to circumvent it by pledging to actually outspend Labour: there would be no cuts. So what could Brown do? His answer was brazen, but effective. He worked out that Labour would spend £27 billion more than the Tories, so used this to claim that they would – ergo – impose a £27 billion “cut”. The technique was politically successful insofar as the public just remember the Big Scary Figure.”

[2] As an aside, the two Treasury reports continually repeat the point that other organisations, like the IMF and Bank of England, have models which lead to the much the same dire predictions. Well, they would, wouldn’t they? But this is only because these organizations all use much the same crappy models, which all produce much the same crappy answers. It does not matter how many organizations use these models, the fact remains that the models are still no darn good.

[3] I won't haggle over the point that there isn't really a consensus at all, otherwise we wouldn’t be arguing in the first place. Instead there are conflicting views, but one group likes to assert that is the ‘consensus view’ as if to suggest that no one should have the effrontery to disagree with them.