

The implications of Brexit for household incomes

Introduction

The Counsel General and Minister for European Transition asked the Wales Centre for Public Policy to consider the implications of Brexit for household incomes and poverty in Wales. The Welsh Government wishes to understand the likely cumulative effects of Brexit - and more specifically the end of the EU transition period in December 2020 - on households, and the feasibility of identifying at-risk groups and communities, both to inform negotiations with the UK Government and to identify interventions that it could make to mitigate these impacts.

To inform this, we facilitated a series of virtual conversations in April 2020 with officials and three external experts to provide some preliminary answers to these questions. The Welsh Government provided briefings for the three external experts: Professor Jonathan Portes, Professor Gill Bristow and Dr Peter Levell.

This note summarises our experts' contributions. Although the initial focus of the work was Brexit and its inception pre-dates the COVID-19 pandemic, we think it provides valuable analysis which is also relevant to COVID-19 recovery: and, where relevant, we asked experts to include their initial reflections on likely effects of the pandemic on household incomes and policy responses to this

Professor Jonathan Portes

First, a higher-level point on framing this work. At the moment it's quite difficult to think about the impact of Brexit, and the possible policy responses by the Welsh Government, without thinking about how this is changed by the COVID-19 crisis. Until we know the implications of the latter - a relatively sharp if very deep contraction followed by a V-shaped recovery that leaves the basic structure of the economy broadly unchanged, or a much more prolonged period of disruption leading to some significant medium and long-term shifts - it is quite hard to know how to overlay Brexit implications.



Professor Jonathan Portes

Both because of this, but also for broader psychological/political economy reasons, I would prioritise thinking about how COVID-19 might, under different scenarios, impact on the Welsh economy, and overlay future Brexit-related policy choices on that.

With that in mind, some reactions to the very interesting material you have supplied us with:

- One interpretation of the potential economic impacts is that individual/household outcomes are driven primarily by individual characteristics (especially skills/education/labour market attachment). Poor places are poor because poor people live there. The focus of economic policy to reduce disadvantage, therefore, should overwhelmingly be on education/human capital acquisition/labour market attachment; and the focus of social policy should be individual level income support (i.e. the benefit/tax credit system)

Underinvestment in infrastructure, skills and public services means Wales [is] quite vulnerable both to Brexit and to the COVID-19 shock.

- What implication does this have for policy response to shocks (like COVID-19 or Brexit)? First, it's hard to predict the sectoral/geographical impact of shocks, but we know what makes individuals resilient – and again it's human capital, broadly defined. Similarly, cushioning shocks that result in job losses/income falls is best done at individual level via the benefit system. One conclusion is very clear – we should be most worried about people who are already unemployed/poor/on low wages, people with disabilities, and young people with low skills entering the labour market. Policies should be directed at avoiding scarring effects for these groups (and, arguably, this would apply with even greater force for COVID-19

than Brexit). Sectoral/spatial issues are likely to be secondary.

- Another interpretation is very much attuned to the current “levelling up” agenda. This describes Wales as suffering from persistent disadvantages resulting from its position as a “peripheral” economy within the UK (both spatially and in a broader sense). Underinvestment in infrastructure, skills and public services means Wales has relatively little in the way of high value, high productivity service industries – it has mostly lower productivity services, manufacturing, tourism and agriculture, and lots of small firms. This makes it quite vulnerable both to Brexit and – perhaps even more so - to the COVID-19 shock. Moreover, its dependence on large fiscal transfers from the UK as a whole (meaning London/South East) also make it vulnerable politically.
- This policy response therefore draws heavily on the Mariana Mazzucato view (partly if idiosyncratically shared by Dominic Cummings) – the first prerequisite is state capacity, which then can be used proactively to drive growth in high-value sectors. This partly requires much greater investment in high level skills, but it is not limited to skills; there will need to be much greater focus both on specific sectors and specific places than at present; and (implicitly) this involves some effort devoted to “picking winners” rather than trying to help losers.



I'm oversimplifying hugely here, of course, but I do think this is a useful way of framing the issues. Clearly the two perspectives aren't mutually exclusive – raising skill levels is likely to be a focus in any case, for example – but they do potentially drive quite a different set of priorities, certainly in the context of the response to COVID-19 and Brexit. The latter, in particular, might imply that one views the COVID-19 shock - which will, inevitably, lead to a large number of business failures/increased unemployment - as the “burning platform” from which to reshape the Welsh economy for the (post-Brexit) future. This is particularly the case given a number of the points Peter Levell highlights about the persistence of shocks, and the possible concentration of such shocks within Wales.

Where does one go with this from a policy perspective? I think it's worth thinking through the potential scenarios; in particular, what happens if the COVID-19 crisis is relatively short and, from an economic perspective, V-shaped – or what happens if we have a persistent period of stagnation in the UK and global economy. If the former, what are the opportunities for proactive investment to take advantage of a period where demand will actually be growing very fast (or put the other way how do we avoid simply recreating the same structural deficiencies we have now, which of course is what happened in 2009 and thereafter). If the latter, is the optimal strategy to “localise” the economy and try to build sectors that are more insulated from global trends?

I hope this is all helpful and a useful frame (and aware that I'm raising more questions than answers). I assume that there is little time for Brexit right now – and rightly so – but I think these framings are helpful.



Professor Gill Bristow

I think that focusing overtly on the sectoral effects of Brexit will not be particularly helpful. Brexit is not a sector-specific shock – it will have impacts which cut across numerous sectors – and even if it was, there is a general trend to greater sectoral similarity across the Welsh and UK economies. So we're structurally not that different from the rest of the UK and with the integration of our economic systems, there will likely be similar effects in Wales as across the rest of the UK.



Professor Gill Bristow

I would strongly endorse the importance then of looking more closely at the business-specific factors that are likely to influence how the Welsh economy is impacted. The research I undertook with colleagues at Cardiff on resilience to the post-2008 global economic shock highlighted the adaptability and innovative capacities of businesses as being critical - how well they were able, for example, to shift to different markets, change their modes of production or ways of working. And research on the resilience of firms in the Cardiff Capital Region shows that the supply chains businesses are engaged with, where their company HQs are, are some of the other factors that matter (see Soroka et al., 2019). These are characteristics that are important for the resilience of businesses and economies consistently over time.

These facets of adaptability are critical for households too. So whilst I think it's correct to highlight the link between disadvantaged people in the labour market and more negative consequences from economic shocks such as Brexit, I think we need to interpret this in terms

of lower capacities to adapt. Those who are already disadvantaged in the labour market have less resilience – few buffers in terms of household savings, higher levels of debt, less capacity or willingness to move from where they live, less capacity to-retrain or change jobs (see Healy and Bristow, 2018)

With this in mind, I'd challenge the notion that lobbying for greater distribution from the UK Government in terms of welfare will be sufficient. I think we need to look at wider issues around skills, re-training and individual /household/ workers' capacities to adapt.

Regarding Welsh Government capacity and responsibilities, the issue on borrowing is key and I see that the Wales Governance Centre has just released a report calling for a relaxation of controls on the Welsh Government's ability to borrow as it seeks to deal with the COVID-19 crisis.

A number of other things strike me as salient here. The fiscal dependence of Wales on the UK Government reinforces the importance of working with other devolved administrations and authorities/organisations lobbying the UK Government for strengthened investment in the levelling up agenda through interventions such as the Shared Prosperity Fund.

The scale of the economic consequences of COVID-19 for Wales are becoming clear, and issues around Brexit are now inherently tied to this.

The need for the Welsh Government itself to adapt in terms of its resources, sectoral focus and skills seems critical too and I think it would be interesting to have more understanding of how this is going to be tackled. The need to reorientate industrial policy and skills towards higher value skills, the sectors and jobs of the

future is also a critical point and is something which is again brought sharply into focus by COVID-19 and the value of strength in digital infrastructure, engineering innovation and R&D etc.. There is clearly an important role for the higher education sector here both in terms of its research agenda and in terms of educational provision and I think there is a need for much greater attention as to how to work collaboratively across the sector and with WG to achieve this. Again, I suspect the COVID-19 crisis might ultimately prove to be potentially transformative here in shifting attention towards online provision of programmes and more part-time and modular learning in critical areas e.g. public health, engineering, business and economic resilience. The imperative to change is likely to have been significantly catalysed by current circumstances.



The scale of the economic consequences of COVID-19 for Wales are becoming clear, and issues around Brexit are now inherently tied to this. A longer transition period might be necessary given the extent to which resources are having to be directed to deal with the public health emergency and immediate economic crisis associated with widespread lockdown, but there are of course some risks associated with a delay and what this means for already vulnerable businesses in Wales. A recent report from McKinsey (2020) offers some insight into how national and sub-national economies might re-start following the pandemic and asserts the importance of active government intervention now to 'shape the next normal'. This may be useful and offer some interesting food for thought on how Welsh Government might decide on priority economic sectors to release from the lockdown.

Dr Peter Levell

- I suggest a paper on the labour market implications of Brexit (Griffith et al., 2020). Here we've been a bit bold and tried to work out which groups in the labour market are more affected than others. We have also looked at the degree of insurance affected workers get by being partnered with another member of the household. It turns out splits by occupation group are key as manufacturing workers (who are worse hit) tend to specialise in a few occupations, as well as being regionally concentrated.



Dr Peter Levell

- We didn't really find evidence that effects are "socialised" by linkages across the economy (our model incorporates these linkages). In fact when you ignore these linkages, the differences in the distributional impact tends to be more equal. This is because UK manufacturing firms supply each other and also receive inputs from the EU - including them therefore compounds the impact on UK manufacturing.
- Similarly there's a bunch of evidence that suggests the impact of shocks on local labour markets can be highly persistent (see for example the citations in the attached). I get an impression that there's an expectation that some of the impacts will be evened out in the long-run by labour market churn and links with

the rest of the UK; I'm not sure that's the case. A lot of studies have predicted quite different impacts across the UK.

- It is also important to get across that impacts within Wales are likely to be quite different. Local labour markets can be very local indeed and workers can be quite slow to move in response to shocks (we cite some references in the paper). We try to highlight the importance of mobility for distributional impacts in our paper.
- The proportion of small firms, and low productivity firms, is likely to be important. There is some descriptive evidence to suggest smaller firm are more likely discouraged by new trade barriers (ONS, 2018). Wales also stands out in having lower productivity than other UK regions which may also be relevant (Bernick et al. (2017)).

All this should be taken with a pinch of salt, as there is a lot of uncertainty/unpredictability about all of this. I also have some more general thoughts:

- I thought the discussion of capacity in the Welsh Government important. This is something I hadn't really thought about but which is likely to become more important as certain powers are repatriated after Brexit. There's an interesting chicken and egg problem - powers over policy can't be granted without Wales having the capacity to use them, but that capacity probably won't arise if there are no powers.
- The key question is how Wales' funding is likely to change with the arrangements after Brexit. The slides focused a bit more on how much Wales currently gets.

- One thing that might be important for the whole discussion is to think about how valuable policy flexibility (e.g. the ability to borrow) is relative to additional funding. If you had to ask for one or the other, which would you choose? The answer might vary across policy areas. It might provide the basis for a more constructive discussion with the UK Government.

Sources

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