Brexit revisited: why closer UK-EU ties won't lessen Britain's squeezed public finances

The UK government desperately needs higher economic growth as it grapples with spending cuts and potential tax rises later this year. A reset of UK-EU economic ties would help, and sweeping changes are becoming more likely. But they're unlikely to unlock the much-needed, substantial increases in fiscal headroom

The UK Treasury is caught in a bind. Higher debt interest costs mean painful spending cuts at the Spring Statement on 26 March now look inevitable. And further tax rises look increasingly likely later in the year.

Now more than ever, the government needs growth, which is why the UK is contemplating a major economic reset with the European Union.

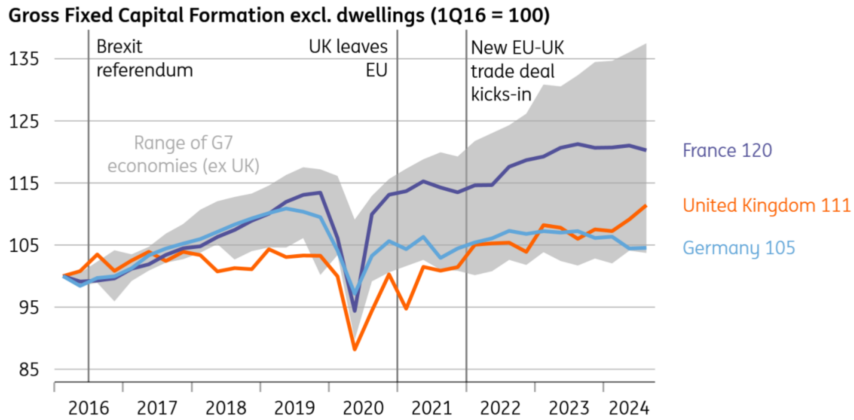
The rationale behind improving EU trade ties

Higher economic growth – and the increased revenues it generates for the Treasury – means more money to spend under the government's main fiscal rule, which dictates that the current budget must be projected to be in balance or surplus in 2029/30. In November, that rule was met by the finest of margins and has since been eradicated by higher market rates.

Chancellor Rachel Reeves desperately needs to convince the Office for Budget Responsibility – the independent arbiter of the fiscal rules – to change its perceptions about future growth. That's proving to be easier said than done; recent announcements, from planning reform to airport expansion, are unlikely to have moved the needle much, at least not over the short-term horizon relevant for the fiscal rules. If anything, those growth forecasts are set to be revised down this month, at least for 2025.

But on EU trade ties, there's a precedent of the OBR making big changes to its forecasts. The UK's customs union and single market exit saw the OBR make sizable downward revisions to the UK's growth potential via a major hit to productivity. Logic dictates that it should do the opposite were the UK to forge a closer relationship with Europe.

UK investment suffered post-2016 but recovered once the trade deal was agreed



Source: Macrobond, ING calculations

How the UK could move closer to Europe

There's plenty of evidence showing that UK investment has suffered following the Brexit decision, while the number of trading relationships between UK and EU firms has dwindled. Reversing that requires a significant reduction in paperwork and costs at the border.

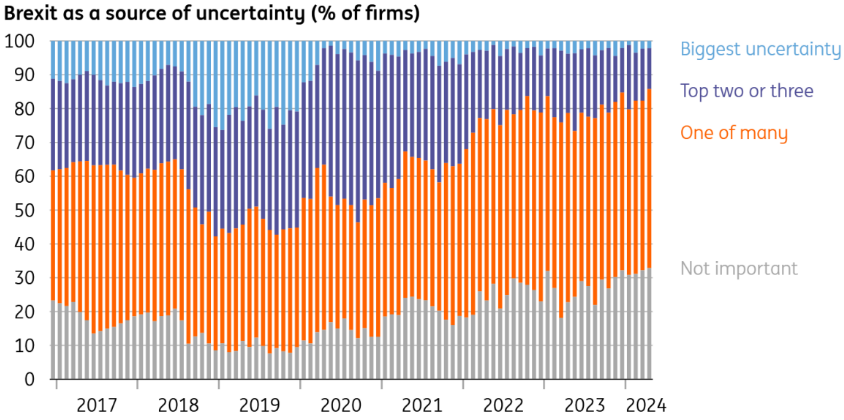
Could the UK attempt to rejoin the single market for goods, which would see Britain re-adopt EU regulations across a swathe of different products? The government is clearly tempted, at least for some types of products. For instance, it's openly seeking a Veterinary Agreement to reduce cumbersome physical checks and paperwork on plant/animal products at the border. Whether that could extend to other product areas is less clear. But we know UK firms across various sectors have suffered from increased bureaucracy, even though Britain has opted against materially diverging from EU regulations since exiting the bloc.

What about a customs union? That would remove tariffs entirely between the UK and EU and see Britain accept a common external tariff.

In theory, trade is already tariff-free under the free trade agreement struck in late 2020. In practice, it is contingent on goods meeting rules of origin, requiring a certain percentage of the product to be made in either Britain or the EU. Roughly a quarter of UK-EU goods trade didn't meet that test in 2022, according to the Trade Policy Observatory. That means there's something to be gained if tariffs are removed entirely in some form of customs union.

There is also a half-way house that's been heavily discussed recently, called the Pan-Euro-Mediterranean Convention (PEM). This isn't a customs union, but it would allow content from a wider range of countries to count against those rules of origin mentioned earlier. But the countries included are relatively small players in UK supply chains, and in reality, the impact of joining PEM would be pretty negligible.

How Brexit-related uncertainty has faded over time



Source: Bank of England Decision Maker Panel

What about the politics?

Even if the economics makes sense, for a long time neither of the major UK political parties have wanted to revisit Brexit. Labour is publically against rejoining the single market or customs union and that's underpinned our long-held view that the UK-EU relationship would stay broadly the same, beyond a few sector-specific deals.

But that thinking might be becoming outdated; the politics is changing quickly.

Take defence, where there's a growing acceptance in Europe that the UK plays a key role in the continent's security. Incoming German Chancellor Friedrich Merz has recently talked about sharing nuclear weapons.

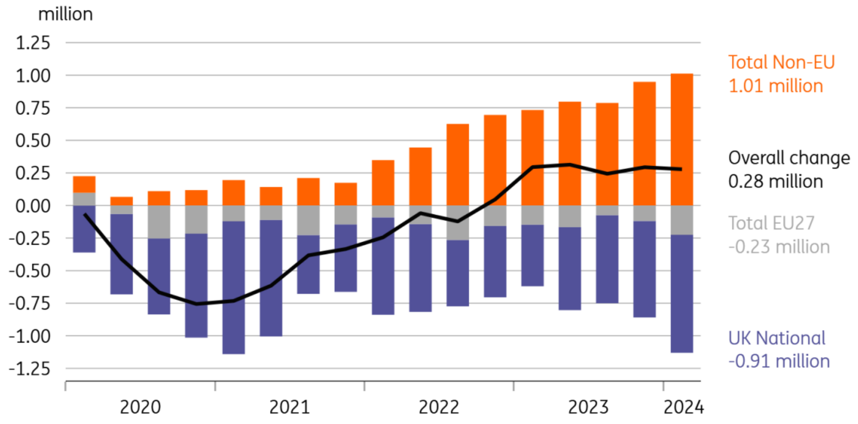
Meanwhile, the free movement of people and migration – previously the price of rejoining European economic structures – is becoming less popular among EU voters and leaders. And given that European labour markets are tight by historical standards, the need to open new markets for EU workers is becoming less pressing. Indeed, official UK data shows there's been a gradual exodus of European workers from Britain since the pandemic, a stark contrast to the net inflows seen over the previous two decades.

In Britain, Brexit has become increasingly unpopular with the public. 55% of the population believe it was the wrong decision, according to YouGov, and only 30% now think it was right. A fifth of people actively oppose rejoining the single market or customs union.

If there's to be a major sticking point, it's Britain's relationship with US President Trump. Rejoining a customs union would cede the UK's ability to set an independent trade policy. And that presumably would draw Britain more squarely into the firing line of American tariffs on the EU.

Still, politicians may fairly conclude that the economic prize of moving closer to Europe is more significant. And that's why we think the chances of the UK joining a customs union in all but name have risen over recent weeks.

The number of EU workers in the UK has fallen since Covid-19



Source: Macrobond, ING calculations

Note: ONS Labour Force Survey data is currently suffering from reliability issues, so these numbers should be treated with caution

The extra 'fiscal headroom' this could generate

The OBR's long-standing assumption is that Brexit will permanently lower the level of UK productivity by 4%. In practice, that means the UK's annual growth potential, or speed limit, is reduced.

Some of that is irretrievable. The OBR reckons that two-fifths of that productivity loss occurred before the free-trade deal was agreed, a result of several years of uncertainty and lost investment following the 2016 Brexit vote. We are generally of the same opinion; it's telling that investment has actually outperformed several G7 peers since the trade deal was agreed, which shows how damaging the uncertainty itself had become.

In short, there's perhaps a 2-2.5ppt productivity boost up for grabs in a scenario of full alignment, but there are two reasons why that's not realistic. First, the UK simply isn't going to fully realign with Europe, even if it did enter into a customs union. Not all of the non-tariff barriers would disappear, nor would the UK return to a position of free movement. Second, even if the OBR did raise its forecasts by that magnitude, it would be spread over a number of years, extending well beyond the five-year period relevant for the fiscal rules.

At most, all of this is maybe worth an extra 0.1-0.2ppts on annual GDP growth in each year of the OBR's forecast. Though it's impossible to estimate exactly what that would mean for 'headroom', some basic calculations suggest it might mean an extra £10-15bn that could be spent each year while still meeting the main fiscal rules.

That's not nothing, but it certainly wouldn't be a game-changer either. It's roughly equivalent to what has been wiped out by higher market interest rates since October's budget. And while it might enable the government to raise real-terms departmental spending by an extra half a percentage-point per year, it's unlikely to be enough to cover the mounting spending pressures coming down the track.

Closer EU ties or otherwise, our view is that further tax rises are coming in 2025.

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