Balance of Competences Review

Setting Business Free: Into the Global Economy

Professor Patrick Minford CBE

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Patrick Minford CBE has been Professor of Applied Economics, Cardiff Business School, Cardiff University since October 1997. He has held economic positions in the Ministry of Finance, Malawi; Directors' staff, Courtaulds Limited; H M Treasury; HM Treasury's Delegation to Washington, DC; Manchester University; The National Institute for Economic and Social Research. From 1976-1997, Patrick Minford was professor of economics at Liverpool University. He was a member of Monopolies and Mergers Commission 1990-96 and one of the H M Treasury's Panel of Forecasters ('Six Wise Men') 1993-1996. He is author of many books and articles on exchange rates, unemployment, housing and macroeconomics.

The Hampden Trust presents:

Balance of Competences Review: Setting Business Free: Into the Global Economy

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Executive Summary

The European Union – especially the Eurozone - is experiencing an economic crisis that is hurting the United Kingdom. In this book, Professor Patrick Minford CBE outlines why the continued problems associated with the euro-crisis means that the UK must now choose to leave the EU.

In arguing that the EU will be obsessed with the euro-crisis for the coming decade, the book argues that results of this obsession will be excessive regulation and the stalling of any progress towards liberalising markets and increasing competition.

By freeing itself from these constraints, the UK would be able to connect with the global economy without the costly consequences of continuing in the EU. In doing so, Professor Minford explains how the case for leaving the EU has now become "overwhelming".

Main Points

• EU protectionism will probably increase; even within the EU, covert protection against non-euro countries could occur.

• Even without any change in the status quo the economic costs to the UK of the EU are substantial and are likely to increase under the pressure of the euro crisis.

• Claims that the UK would lose Foreign Direct Investment (FDI) are entirely fallacious and that, free from EU membership, the UK economy's productivity is likely to be maximised.

• Free from the EU's Common Tariff, the UK could instantly benefit from free trade by around 3 per cent of GDP.

• Concern that the UK will not enjoy the 'muscle' of the EU in trade negotiations with third countries if it left the EU is confused and that, trading at world trade prices, it would be against the interests of the other parties to introduce trade barriers.

• The UK is being constrained through regulation by countries that do not share the same industries. By leaving the EU, the UK would be able to reset its regulations in its own free-trade interests and open the UK to the global economy.

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Background

This submission covers both trade and regulation and includes work done over a number of years under the auspices of the Julian Hodge Institute of Applied Macroeconomics in Cardiff University Business School. A full account of the original research work can be found in 'Should Britain leave the EU? An economic analysis of a troubled relationship', by Patrick Minford, Vidya Mahambare and Eric Nowell, Edward Elgar in association with the Institute of Economic Affairs, 2005, pp.254. Updating of the work there on trade can be found in 'Measuring the extent and costs of EU protectionism' by Vo Phuong Mai Le, Patrick Minford and Eric Nowell, chapter 15 in International Handbook on the Economics of Integration, Vol III, Factor Mobility, Agriculture, Environment and Quantitative Studies, ed, Miroslav N. Jovanovic, forthcoming 2011, 316-342.

The simulations that lie behind the estimated costs of regulation were done on the Liverpool Model at various times. This model is described in 'The Liverpool Macroeconomic Model of the United Kingdom', by Satwant Marwaha, Kent Matthews, Patrick Minford and Alison Sprague), Economic Modelling, Vol. 1, No.1, January 1984, pp 24-62. Some discussion of the issues involved in such calculations is in 'Europe and the Supply side', by Patrick Minford in The Art of Full Employment, (ed. C. de Neubourg), Elsevier Science Publishers BV, 1991, pp 379-397.

Introduction and Background: The Eurozone crisis means Britain must now leave the EU

The Eurozone crisis is likely to continue for a number of years, with the European Central Bank acting as a backstop until agreement is reached on a new institutional structure sufficiently reassuring to Northern Europe that its transfers to Southern Europe will have a good chance of being repaid. The UK's exclusion from the euro has meant that it is neither vulnerable to the panic that has engulfed Southern sovereign bonds nor in direct line to make transfers to the crisis-stricken South.

The institutional framework now being developed implies a high degree of monitoring and intervention by creditor countries of debtor countries within the Eurozone. There will be controls on bank behaviour, targets for governments, and new financial taxes. While in principle this will take place within the Eurozone, there will be pressure to extend it to all EU countries on the grounds that other EU members could 'undercut' Eurozone arrangements. The UK will be seen as an offshore competitor with banks, businesses and governments in the zone that are burdened with these controls and regulations. Such competition will be argued to be unfair under the Single Market, for which Qualified Majority Voting applies. It would be easy to extend these things to the UK by majority vote. Already, as noted in Table 1, regulations in place in 2005 were causing major costs to the UK economy, mainly via the labour market. These costs come about because restrictions on hiring and firing and additional powers awarded to trade unions by Brussels raise the cost of labour to businesses; facing as they do foreign competition, this reduces their output and employment, causing unemployment. The costs shown in Table1 are the computed losses of output from this intervention.

The range is high because the scope for EU intervention is very wide and there is therefore much uncertainty about how far it will go. One can think of recent events as pushing the estimates towards the upper end of this range.

Furthermore, the pressures for protection will increase in order to produce as much Eurozone growth as possible, for best prospects of debt repayment. Serious recessions for long periods such as the Eurozone is undergoing make such pressures intense. The UK suffers at present from the degree of protection for the EU as a whole: this comes about because the EU customs union raises the prices of products protected by the EU's common protective tariffs (or tariff-equivalent measures such as ant-dumping duties). This protection will probably increase; even within the EU covert protection against non-euro countries could occur.

At best, the Eurozone will be obsessed with the euro crisis for the coming decade, stalling any progress in liberalising markets and in increasing competition, things that could have lessened costs of membership to the UK. This tendency for the euro to strengthen the drive towards excessive regulation as a way of bolstering the single currency was something widely foreseen at the start of the euro. But the crisis is likely to make this much stronger.

For the UK this prospect is extremely damaging. Even without any change in the status quo the economic costs to the UK of the EU are substantial: Table 1 below summarises the estimates I made in 2005, totalling between 11 and 38 per cent of GDP; I have revisited these with more up to date information since and they still seem to be of the right order of magnitude. The main change has been the rise of trade with China, which has led to a

further wave of protectionism (the latest example being the proposed 40% anti-dumping duty on Chinese solar panels), at the same time as protectionism against older competitors such as South Korea has diminished. Meanwhile EU-inspired social intervention has continued to make inroads into UK life, the latest one being widespread rights for temporary workers. With the changes the euro crisis threatens, these costs will increase towards the upper end of the possible spectrum identified in my original work on them.

Table 1: A survey of costs from EU membership

	(% of GDP)
Net UK contribution	0.4
Costs of Common Agricultural Policy	0.3
EU protection of manufacturing	2.5–3
Regulations	6–25
Bail-out transfers	2–9
Total costs	11.2-37.7

Source: Minford, Mahambare and Nowell, Should Britain leave the EU? 2005, Edward Elgar with IEA

A contrary and popular argument for the benefits of the EU to the UK revolves around Foreign Direct Investment (FDI). However this argument is entirely fallacious. FDI brings benefits because of technological spillovers from foreign firms, which raise productivity. The UK economy's productivity is likely to be maximised when comparative advantage is allowed its fullest rein, i.e. outside the EU, under free trade.

If this structure implies that industries operating in the UK are more efficient, then less FDI will be required. But this will reflect the fact that the UK is more productive, not less.

Another argument alleges that exclusion from the EU's Common Tariff would be damaging. But this is a misunderstanding; exclusion would mean we would face world prices (free trade) on all our goods, exports and imports. This is beneficial to us because our trade would be governed by our comparative advantage; consumers would benefit and our production would gravitate to more efficient industries. The gain we calculated is shown above as around 3 per cent of GDP. This is calculated by the use of a four-sector trade model of the UK, the rest of the EU, NAFTA and the rest of the world; the data on protection is obtained from comparing prices of a wide variety of products within OECD countries- this price data is collected by the UN for calculations of purchasing power parity and was made available to us by the OECD. The nature of the loss from this EU protection is that consumers are induced by higher prices to consume less of the protected goods while producers are induced to produce more of them at the expense of goods they produce more efficiently. The resulting misallocation of resources is the main cost. This is supplemented by the cost of paying more than world prices for imports from the rest of the EU.

It is also said that we would no longer influence EU regulations, which is true. But we do not influence the regulations of any country to which we export and our exports are made to conform to them; this is part of our export costs and our influence in the EU has little if any impact on these costs. But by leaving we avoid the massive cost of these regulations to our own production in general, as shown in the table above.

What will happen when we leave is that our exporters will have to continue to observe EU regulations on their products as they do now and as they do for all other countries to which they export; this is simply a normal cost of exporting anywhere. As for everyone else (over 90% of GDP) EU regulations will cease to be relevant, lifting an enormous burden and indeed future threat.

It is true that the EU restrains UK politicians from self-damaging acts, such as subsidising particular industries. However, politicians of most parties are now generally aware of the costs of such measures; and also the World Trade Organisation has become more effective in discouraging them. But in any case the costs of such actions are relatively minor.

A final argument one hears, from europhile politicians (it is a favourite of Nick Clegg) and also from self-interested businesses that directly benefit from EU protection, is that several million jobs are tied up with exporting to the EU and that these 'would be lost' if we left the EU. This statement confuses a static situation where people are employed in a particular set of industries with a permanent loss of jobs because these people if not employed in these industries would be unemployed. The calculations we have done are of what would happen to the UK economy after reallocation of people to more efficient industries. Necessarily there would be a contraction in some industries currently supplying the EU because they benefit from protection. However, after departure and a return to free trade other industries would expand that offer good prospects for profit and employment. As is well-known the UK economy has been through big structural changes since the 1970s as services have expanded employment massively and manufacturing employment has fallen.

Much the same sort of thing would occur on leaving the EU, though on a much smaller scale as workers were redeployed from inefficient protected industries to more efficient industries, probably in services. Overall there would be a rise in productivity and thus also a rise in employment.

Thus the costs to the UK of being in the EU, already high, are likely to increase under the pressure of the euro crisis. This implies that the case for leaving the EU will become even stronger, to the point where it overcomes the inertial force of the status quo. A referendum on a) renegotiation and b) departure if renegotiation is denied will become difficult to avoid. As can be seen from the figures above, in any case total departure is the desirable option, with some arrangements on particular issues of common interest, such as rights of migration, free capital movements, and possibly trade agreements on particular industries like cars where there is large-scale cross-investment. Of course political cooperation will continue in areas of mutual interest as with all our allies.

Transitional issues

There are a number of problems of transition from our current full membership to total departure. These must not be allowed to blur the basic point: that our interests lie in leaving because of a large balance of long-run costs over benefits of EU membership. Transitional issues basically relate to the adjustment for industries and groups currently enjoying gains from the protection given by EU arrangements. These industries and groups are likely to be vocal in their opposition to leaving the EU; they will get added impetus from the CBI and CityUK which are the two big organisations to which they belong and which largely they dominate. We also see these arguments repeated in pro-EU newspapers and magazines such as the FT and the Economist (whose leader on the EU some months ago read more like a litany of support for protected firms than a piece of reasoned economics). This opposition will be reminiscent of the opposition from essentially the same groups to the UK decision not to join the euro.

Mostly these groups will have to adjust, using their own resources and strategies. Such adjustment is a standard feature of dynamic capitalist economies as growing industries replace contracting ones; it inevitably involves some 'frictional' unemployment as people search for the new jobs. But as the cost is transitional it is greatly exceeded by the accumulating permanent gains.

For example, it is likely that the euro-zone and the EU after we leave will attempt to restrict certain euro financial transactions from being outside the EU. This means that City institutions that previously enjoyed this market will need to find alternative markets. The general efficiency of the City is such that it dominates the world market in a wide range of financial transactions; it will find little difficulty in attracting other worldwide business in place of frustrated euro business.

Another industry that is likely to suffer from EU departure is volume cars. In this industry factories in parts and assembly have been located all around the EU under the assumption of continued customs union. When the UK leaves the EU cars from non-EU countries would be free to enter the UK at world prices in as large a quantity as consumers desire. Hence UK prices would drop to world prices. UK and EU producers of volume cars will therefore sell their cars in the UK at world prices. UK producers of volume cars will not get protected prices in the EU markets, while EU producers will continue to do so. In the long run this must lead to a contraction of UK-based capacity up to the point that the remaining industry can survive at world prices. The industry will lobby intensely for some transitional compensation, arguing that assurances were given by government for the previous arrangements. It seems doubtful that any were, however the political pressure will be considerable since car plants are sensitive politically. Probably the easiest way to provide compensation is through transitional trade arrangements. This is also the most likely route for other sensitive industries affected. To these and other trade agreements we now turn.

What trade relationship after departure?

As we have already said, one key cost of being in the EU is our inability to trade freely at world prices, whether because our exports to the EU face subsidised prices or because our importers must pay elevated prices for all goods imported from the EU and from elsewhere that are protected by the EU customs union.

Yet the popular debate has it that there is a need to have access to EU markets on the same terms as now. Another popular concern is that we will not enjoy the 'muscle' of the EU in trade negotiations with third countries.

These ideas are confused. We benefit from moving to world prices, including selling to the EU at world prices, and not at prices inflated by EU protection for customs union members. This would also mean that we buy from the EU, as well as from the rest of the world, at world prices, not at EU-customs-union-inflated prices.

As for EU muscle in trade negotiation, as our intention would be to admit goods and services from all countries freely without tariffs or other protection, at world prices, there is really no likelihood that any of these countries would find it in their interest to raise tariffs on our goods or services.

The only possible exception to this lies in areas where world trade is currently highly protectionist, such as airline arrangements. Here it is true that a larger grouping such as the EU has power to negotiate a bilateral reduction in barriers where the UK alone would not. In these areas it would make sense both for the UK (a major airline hub) and the EU to combine forces and share arrangements. Thus one can envisage a UK-EU trade agreement which would recognise such common interests.

Furthermore, for particular industries where largescale intra-EU pooling of factories has occurred a special transitional arrangement could be dealt with through a trade agreement. The main example of this just discussed is volume cars. One can envisage a transitional trade agreement for volume cars that would preserve existing trade arrangements for them and phase these out over say a decade. This agreement would really be a 'non-free-trade' agreement; however, it can be seen that it would be a convenient way of giving transitional compensation to both UK and EU producers of volume cars.

One area where the UK's situation does not in general change is in services where there is no 'EU single market' and there are no common trade arrangements. There are only a few exceptions to this, mainly in financial transactions where the main loser is the UK as other countries have only limited financial industries. It is therefore unsurprising that majority EU opinion was able to pass financial regulations. By leaving the EU the UK would be enabled to reset its financial regulations in its own free-trade interests. It could well lose some business to EU diversionary regulation; but as noted earlier the UK financial sector is the strongest in the world and well able to get replacement business.

Trade with non-EU countries- the importance of being unimportant

Some people argue that we would be somehow 'naked' against trade aggression by non-EU countries if we left the EU and declared free trade. They argue that we should be part of the EU to 'negotiate from strength' with all these potential protectionists. However, this is once again to misunderstand the nature of trade. A small country (such as the UK with its labour force of 30-odd million) offers its goods and services to other countries at world prices, these being what ordinary consumers in a freely trading country would pay for them. Should some country decide to levy a tariff on them, then their consumers would pay more. There would be no question of their price ex-tariff going down because other countries' consumers will pay the full world price. Should that same country put a quota on them, then UK product would be diverted elsewhere. Thus it is a matter of indifference to us if a particular country pursued such policies towards us. We produce finite output in a world of very many consumers, all of whom would be willing to buy it at what it is worth. This is known in trade theory as the 'importance of being unimportant'. It is why one does not hear of countries like Singapore and Hong Kong complaining about facing protection- it is immaterial to them.

One implication of this is that countries have little incentive to levy tariffs on our products because they will get no resulting fall in their price. Instead they will simply inconvenience their own consumers.

All this is to reckon also without the WTO, to which virtually all countries are affiliated and which makes it illegal to erect discriminatory tariffs of this type anyway.

‘Bilateral trade agreements’ would thus largely be unnecessary for a freely-trading UK outside the EU. We would face free trade in our markets, in the sense that we would sell at world prices- we can do no better than that. ‘Free trade agreements’ are in fact ‘non-free trade agreements’ in the sense that they are agreements by two countries, both of which have protectionist policies, to allow the other country’s products freedom from tariffs. If the UK is a free trading nation, then all other countries’ products will have tariff-free access, and we will have access to world prices wherever we sell our products.

The one situation where we could face damaging discrimination would be where a supplier of products we bought had a monopoly and levied an export tax or other restriction on supply. An example of this rare situation, as noted above, would be the airline market where there are restrictions on competition on transatlantic routes. Under IATA (the International Air Transport Association) such monopoly restriction is permitted and while it has been whittled away gradually by airline deregulation, it still exists. When such monopoly power exists, retaliation can persuade the user of it to desist. It is in these rare situations that we would offer to combine forces with the EU and any other ‘victim’ countries to retaliate and negotiate downwards such restrictions. However, notice that it is in the interest of the EU and others for there to be as many countries in such retaliatory clubs as possible. As in foreign policy, alliances can be formed ad hoc to deal with such situations.

The meaning of withdrawal from the EU single market- integrating into the global rather than a regional market

A customs union and internal single market like the EU can increase competition in a previously national market that was not open to free trade. Whether this was the case with the UK is a matter for economic historians. However, when we view the current choice as one between free trade today and a regional market arrangement like the EU, we can see that it is a choice between integration into the global market and integration into a regional market. The gain from leaving the EU trade and single market system can be interpreted as the gain from joining the global market from which we are significantly divorced by being part of the regional market. The regional market obstructs key elements of our comparative advantage by pushing prices away from world prices; thus it denies us the ability to exploit to the utmost this comparative advantage. It artificially lowers the relative prices of the products we are better at producing and artificially raises the relative prices of other products. Thus it limits the size of the former and increases the size of the latter, to our detriment- one can think of it as reducing our global economic performance through regional intervention, a sort of EU 'ball and chain'.

There is a parallel here with the argument about joining the euro. Those who urged us to join failed to understand that by joining a regional currency area we would fix our relationship with the regional euro and destabilise our relationships with other world currencies, notably the dollar. Since we traded as much, and now far more, especially in dollar terms, with our non-EU partners, than with our EU partners, this meant that the regional arrangement brought no benefits in overall currency stability, while having serious other disadvantages (notably in managing the economy).

The UK politics of leaving the EU

A number of people pay intellectual obeisance to the sort of arguments advanced here but then they say:' The British people will never in the end vote 'out' in a referendum because it would be such a leap into the unknown'. In the end, they argue, for all the huffing and puffing of the debate, the people will follow the advice of the establishment which will as usual be 'we have come back from Brussels with a good deal so let us carry on with the status quo and stay in'.

However, on this occasion unlike the Wilson referendum in 1975 or the Maastricht episode- when though there was no referendum, there was little public appetite for rejection of the euro where we had an opt-out-, something important is different. This is immigration. While the EU as such is further down people's perceived political priorities, immigration is right at the top. And of course immigration control is only possible if the UK leaves the EU. Here we have the double revenge of the ignored masses against the establishment, much as predicted by Enoch Powell in his famous warning to that establishment in April 1968. 'Methinks I see the Tiber foaming with much blood', he said quoting from Virgil's Aeneid book 6 where the Cumaean Sybil speaks of the future wars of Rome.

Now it is a favourite nostrum of the status quo's defenders that roughly only a quarter of net immigration comes from the EU. This makes it sound as if the other three quarters could be controlled and so solve the problem by some squeezing of net immigrant numbers. However, this is quite misleading. The only possible control the government can exert is on entry to the UK; exit is voluntary and cannot be stopped or encouraged, let alone arranged (deportation is extremely difficult as is well-known, under the Human Rights Convention to which we adhere).

Thus when one is measuring the government's capacity to control immigration we have to look at gross entry (immigrant) figures for people coming for reasons other than study. Basically these are overwhelmingly from the EU; only some 40% is from outside the EU/EEA. Thus out of the total flows, in and out, that go to create net immigration, we control less than 20%- viz 40% of the inflow and none of the outflow- as long as we are in the EU; as is well-known, controlling this 20% most of whom are necessary skilled manpower or relatives by blood or marriage of UK citizens, is most unpopular. If we leave however we control all inflow and to the extent that we give time-limited entry to EU residents, we can also control EU outflow. Non-EU outflow will be difficult to control because many of these, once admitted as 'kith and kin', cannot be told to go.

These are all things that the educated metropolitan classes find it distasteful to discuss. However, so dreadful was Labour's record in allowing largely unrestricted immigration during its 13 years in office that popular resentments have now reached boiling point. As we also see the issue is intimately bound up with the issue of leaving the EU. Maybe it would not have been, had immigration been more sensitively handled in the last decade and a half, but as it is immigration is now the detonator that will blow up the inertia that might have kept the people from voting 'out' to the EU.

The UKIP has noticed this and it is the reason for its unstoppable progress. Immigration and the EU are a double bill in which the first carries the second. The British people are fed up with the free entry of EU foreigners and also, though at a less visceral level, fed up with being bossed around politically by Brussels, to the mockery of our democracy. However the combination is causing them serious discontent.

When the public are further informed by the increasing consensus of experts that economically there are serious net costs as well, they are very likely to say 'out'.

Thus it is that the politics of the EU is coming to dominate the coming 2015 election. It could well be that a natural election coalition would be between the Conservatives and UKIP, backing 'out' in a promised 'in/out' referendum and promising a return of immigration control over the EU. The Lib Dems will clearly oppose both the referendum and the 'out'. Labour is in a more ambiguous position; many of its supporters, let alone those it would hope to attract, are also strongly against immigration and dislike equally the pre-emption of so much power by Brussels. Yet Brussels has been Labour's ally in bringing in socialist regulation, especially into the labour market. Labour will find it hard to oppose the Conservative/UKIP platform on immigration and the EU, so it will hedge with weasel words. In this situation one can see the makings of a massive victory for a Conservative/UKIP coalition.

The politics of being 'out': how will it feel to British people?

Much of the economic change that will be ushered in by leaving the EU will take place quite slowly because of the transitional arrangements described above. As regulation of our service industries, especially finance and banking, will revert to the City and the Bank, we will see a consolidation and expansion of this huge world financial centre. At the same time as EU protectionism may well reduce the size of some existing markets, such as in euro-denominated bonds, we will see new offshore markets opening. We may also see a parallel offshore market in euro-denominated assets develop as EU companies, using their offshore components, decide to use London as the legal domicile for their issues. This would be similar to the expansion of the euro-dollar market in reaction to the capping of US dollar deposit interest rates by Regulation Q during the inflationary 1970s.

Free capital movements will not be interfered with, either by the UK or the rest of the EU, and so there will be little change in the participation by EU companies such as EDF, in UK production.

As we have seen, immigration controls will change. Presumably the UK would introduce a general system like the 'green card' in the US and apply it to all non-UK citizens. This would permit greater general flexibility in treating those non-EU citizens affected by immigration controls today; EU citizens already here would obtain 'grandfather rights' no doubt while new entrants would start to face the green card system. People would notice changes in border controls accordingly. There need be no changes in tourist visas, which would presumably be made freely available.

The law would change by the withdrawal of the automatic current supremacy of all EU laws. However, UK courts would continue to take note of precedents and so the law in practice would evolve more slowly than this theoretical shift might suggest. Extradition arrangements would also continue, possibly with some mutually agreed alterations; they are in place for good reasons of mutual advantage, notably the control of terrorism, and so any changes would probably be modest.

In foreign policy some argue that there would be some sea change as a result of withdrawal. However it is not at all clear why much would change other than our withdrawing formally from the EU diplomatic service. Our actions in foreign policy occur within a large number of different treaties and alliances, including the UN, NATO, and the OECD. None of these would change.

What would of course change overnight is the constitutional powers of Parliament and the democratic powers of the British people through Parliament. Again, nothing much would be immediately apparent, but the situation foreshadowed by Jacques Delors at the end of the 1980s whereby '80% of the laws governing Britain would be made in Brussels' would be brought to an immediate end.

Conclusions

The institutional evolution triggered by the euro crisis threatens to make the costs of EU membership higher than ever, in a highly visible way. The case for leaving the EU has become overwhelming. Politically, the intertwining of this issue with the boiling resentment of immigration born of unfettered inflows from the EU has created an explosive mixture which promises to dominate the 2015 election.

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In arguing that the EU will be obsessed with the euro-crisis for the coming decade, the true effects of continued EU membership for the UK are revealed.

By freeing itself from these constraints, Professor Minford explains how the UK would be able to connect with the global economy without the costly consequences of continuing in the EU. In doing so, this book illustrates how the case for leaving the EU has now become "overwhelming".

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