Brexit: Why, What Next and How?

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Now that the unexpected has occurred, what about half the British electorate regard as the unpalatable process of leaving the EU is likely to happen. In fact, it could be more than half if those who voted in protest, rather than out of conviction are counted. There are even commentators in Britain who query whether Brexit will go ahead. In this regard, the lack of a written constitution in this country could well be critical, because the very absence of a clear pathway means that much is possible. However, the unprecedentedly rapid anointment of Theresa May as David Cameron's successor and the mix of cabinet ministers she has appointed suggest that for her government, at least, there can be no turning-back. Yet there are still many unknowns about how Britain will go about disengaging itself from the EU, the timetable and what the most likely outcome will be, and what it will imply for the future of European integration.

Britain has long had a much more transactional and less political approach to EU membership than most other Member States. Having been present at the Messina talks in 1956 that led to the Treaty of Rome, Britain chose not to participate in the founding of the European Economic Community, but by the 1960s the strategic economic case for shifting from the Commonwealth as a key trading partner to the (then) dynamic market of continental Europe was increasingly compelling. Not joining the euro was, similarly, more of an economic calculation based on Gordon Brown's 'five economic tests'[1] than an overtly political decision (see also Brown 2016).

This stance has meant that Britain has often been at odds with its EU partners, although it frequently gave voice to views others were reluctant to express. Even so, the deal negotiated by Cameron in February gave fresh impetus to British exceptionalism, albeit with the ironic outcome that it barely featured in the campaign. The deal now lapses following the vote for Brexit, yet it is an open question whether the genie of differentiated integration is now out of the bottle.

This paper looks at the economics of Brexit, considers why the referendum resulted in the vote to leave and explores what the ramifications are for both Britain and the future of the European Union.

The economics of Brexit

As the referendum campaign proceeded, studies of the likely impact of Brexit proliferated. Few readers will be surprised that some of the more positive assessments emanated from supporters of Brexit (for example, a group of *Economists for Brexit*[2]) and *vice versa.* International organisations such as the IMF and the OECD also weighed into the debate, though more from the standpoint of assessing global risks, while the Bank of England, in various interventions, stressed its duty to speak up on risks, especially to financial stability. There were also studies looking only at certain facets of Brexit. Examples include analysis of the direct effect of Brexit on the Britain's public finances,[3] assessments of the regulatory burden on this country and the impact on jobs.

A lengthy study by HM Treasury[4] represented the official government position and can be placed within the mainstream. Other influential mainstream studies included a series of papers by economists at the Centre for Economic Performance at the London School of Economics, Oxford Economics and the National Institute for Economic and Social Research. What these studies all found was that the long-term effect of Brexit will be to reduce UK GDP compared with the

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[1] http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/documents/international_issues/the_euro/assessment/report/euro_assess03_repintro.cfm.

[2] http://www.economistsforbrexit.co.uk/.

[3] See e.g. http://ukandeu.ac.uk/wp-content/uploads/2016/01/Who-pays-for-the-EU-and-how-much-does-it-cost-the-UK-Disentangling-fact-from-fiction-in-the-EU-Budget-Professor-Iain-Begg.pdf.

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf.

counterfactual of staying in the Union, but with the extent of the loss contingent on the terms of the post-Brexit trade and investment regime.

Although there are inevitably differences in methodologies and assumptions between different studies, the HM Treasury study is fairly representative in setting out three scenarios reflecting possible reconfigurations of the post-Brexit UK relationship with the remainder of the EU (rEU). These are: an arrangement similar to Norway, with nearly the same market access; a 'Canada model' akin to the one currently in the concluding stages of negotiation between the EU and Canada; and a 'WTO model' in which Britain has only the same most favoured nation status as other third countries. The Treasury's conclusion is succinct: "the UK would be permanently poorer if it left the EU and adopted any of these alternative relationships".

Work by Minford,[5] using a rational expectations model, secured attention as the main alternative view, finding that the UK economy could prosper outside the EU. His reasoning is, in part, the rational expectations one that Brexit is so far-reaching a regime change that previous statistical regularities have little relevance – a classic Lucas critique argument. The analysis also relies on the assumptions that British consumers will gain from switching from producers protected by EU trade restrictions to cheaper world prices, while UK businesses can benefit from avoiding costly regulations imposed by 'Brussels'. According to Minford, these factors will add up to a four percent gain in GDP.

In a further study, HM Treasury[6] suggests considerable short-term risks from Brexit, including the possibility of triggering a recession. The main reason is that a decision to leave would inflict a negative shock on the economy, although in the most optimistic scenario it might be short-lived. However, the study also noted that there were already signs of some of these factors weighing on the UK economy in the form of higher risk premia for UK debt and a decline in business confidence. The three distinct components of the expected shock are:

- The direct 'transition effect' of shifting to less open trade and investment regimes. Employers reliant on the current trade regime would be faced with pressures to reduce costs and would be expected to reduce investment.
- An uncertainty effect leading investors to put off decisions on new projects, leading to lower demand in the economy.
- A financial stability effect resulting from a reassessment by financial markets of the riskiness of UK assets.

A mild 'shock' scenario results not only in a loss of 3.6 percent in GDP over two years, compared with what would otherwise happen and a jump in unemployment, but also higher inflation because of a fall in the pound – something that has already happened since the 23rd of June. Under the 'severe shock' scenario, GDP would be some 6 percent lower after two years and the unemployment and inflation effects would be greater. Moreover, the Treasury does not allow for what it calls 'tipping-points' such as a sudden stop in the willingness of financial markets to finance the already large UK deficit on the current account of the balance of payments.

Unsurprisingly, the analysis was criticised as scaremongering, yet the Treasury findings are consistent with others (even the *Economists for Brexit* accept some short-term disruption) in pointing-out that the conjunction of uncertainty about the outcome and the dislocations that will arise from Brexit will reduce GDP. What distinguishes the various protagonists is, first, whether it is by enough to result in recession, and second, whether it has an enduring impact or is only a transitional cost likely to be rapidly overcome.

According to the IMF in its routine Article 5 report for 2016 on Britain,[7] 'the largest near-term risk relates to the referendum on EU membership', explaining that Brexit would create uncertainty about future UK trading relationships with rEU, the sixty other countries which are covered by collective EU deals and a further sixty-seven currently under discussion. Like many other commentators, the IMF argues that negotiating new deals for an independent Britain would be a lengthy process. A distinctive element in the IMF assessment is that Brexit could well accentuate some of the other risks to the UK economy, such as weak productivity, the housing market and the sizeable balance of payment deficit on current account. Kierzenkowski *et al.* (2016) express concern that a slowdown in inward investment would aggravate an already poor productivity record, undermining potential growth.

[5] http://www.economistsforbrexit.co.uk/.

[6] https://www.gov.uk/government/publications/hm-treasury-analysis-the-immediate-economic-impact-of-leaving-the-eu.

[7] http://www.imf.org/external/pubs/ft/scr/2016/cr16168.pdf.

Competing methodologies

These various exercises raised methodological questions about how a change as profound as Brexit can best be modelled. Several of the mainstream approaches use 'gravity models' predicting more intensive trade and investment flows between countries geographically close to one another. There is both a strong theoretical basis for this and, as a paper from the LSE's Centre for Economic Performance (CEP)[8] stresses, empirical evidence. However, Minford remains highly critical of gravity models, despite the evidence that they predict the levels of trade well in a statistical sense, but only as long as the basic assumption that everything else is held constant is true – i.e. all the shocks and fixed assumptions implicit in the underlying empirical analysis, such as other tariff and policy changes and technological developments. He goes on to argue that when there is a wide-ranging change not only in the trade regime, but also in the nature of regulation, the statistical regularities on which the gravity models depend cease to be reliable. He also asserts that the nature of the relationships will differ depending on the sort of change and its magnitude. By implication a small change in, say, a tariff (such as reducing it from 10 percent to 8 percent) can be analysed using these tools, but a wholesale change in the regime cannot.

In its hard-hitting rebuttal of the Minford critique, the authors from the CEP observe that to take the position that since no econometric work can be perfect, all inconvenient facts should be ignored is poor scholarship and bad science. They also assert that the argumentation by Minford is flawed because it relies only on theoretical propositions of dubious merit. The core of Minford's argument is that, because the EU is a customs union, the tariffs it imposes on imports from the rest of the world, together with regulatory restrictions (especially on service industries) are trade-reducing.

The influence of movement of workers

One dimension worth stressing is that immigration has been a major driver of growth in Britain, accounting for perhaps half of recent growth according to Kierzenkowski *et al.* (2016). Yet, this is precisely the point that opponents of free movement highlight: the higher growth does not necessarily benefit indigenous people. EU migrants (who ought, in any case, to be described more accurately as mobile workers) have a higher employment rate than indigenous workers, make a net contribution to public finances and help to fill labour shortages in industries such as health care and agriculture). Many of those classed as immigrants from EU countries are, moreover, students and thus constitute invisible exports by a globally competitive UK industry: the university sector.

According to data summarised by Lisenkova and Sanchez-Martinez (2016), the share of migrants in the working-age population doubled between 1995 and 2014 to 17 percent. However, this has not had an adverse effect on the unemployment rate of indigenous workers, even amongst lower skill groups, although there is some evidence of a small downward pressure on wage rates.[9] Migrants have also consistently made a net contribution to the public finances according to Dustmann and Frattini,[10] although it has to be recalled that this finding aggregates very high earning professionals alongside agricultural workers paid the minimum wage.

Nevertheless, migration ultimately became the biggest factor influencing the outcome of the referendum for an obvious, if under-appreciated reason: the claims of aggregate gains simply did not resonate at the level of the individual. Pressure on school places, health services or (the limited) stock of social housing meant that, in many localities citizens could point to direct adverse consequences for them, whereas the macroeconomic benefits were much more abstract. Those who pointed out that if public services were not keeping pace with the additional demands, it was the government's fault, not the migrants', were unable to make headway with their argument.

There is, arguably, a lesson here about the use of aggregates. Whether it is the economic effects of migration or claims about changes in GDP, they can be very remote from the circumstances of the individual. In the end, none of us is average and quoting averages can be counter-productive.

Can the vote be explained?

Although the foregoing economic analysis featured prominently in the campaign and was generally seen

[8] http://cep.lse.ac.uk/pubs/download/brexit06.pdf.

[9] However, as wage rates were the principal channel for adjustment of the UK labour market during the crisis years, this effect will have been marginal by comparison.

[10] http://www.cream-migration.org/files/FiscalEJ.pdf.

as among the more powerful of the 'remain' arguments, it gave rise to a narrative labelled 'project fear', enabling the opposition campaigns to portray Brexit in much more positive terms. Through a combination of disciplined focus on the compelling slogan 'take back control' and, it has to be said, cynical misrepresentation of facts about, for example, the potential budget savings from Brexit and of the prospect of waves of Turkish migrants arriving in Britain, the 'leave' side was able to project a more positive case.

The vote for Brexit was unusual in the nature of the groupings on either side, reflecting a range of different cleavages within British society. Older people and the less well-educated wanted Brexit, while youths and those with university degrees favoured remain. London and Scotland voted very emphatically for remain, and there was a majority for it in Northern Ireland, but much of the rest of England voted leave, as did Wales. One particular group that probably proved decisive was the core Labour party supporters in England who seem to have rejected their party's line to support 'remain'. In places this was something of a puzzle given the specialisation of the local economy: in Sunderland, home to the giant Nissan factory which exports more than half its output to other EU countries, barley a third of voters went for remain. The implication is that economic self-interest was being over-shadowed by other considerations.

One interpretation of the result is that British voters have ignored their leaders, rejecting warnings from experts about likely negative consequences. This echoes developments in other mature economies. In France, Germany and the Netherlands, nationalist parties have made significant progress, while in Greece and Portugal, parties that reject current economic orthodoxies have made rapid advances. Similarly, the success of the anti-establishment campaigns of Trump and Sanders in the United States testifies to a widespread disenchantment about globalisation. It is probably too early to sound the death-knell for globalisation, but it is worth recalling that the globalisation of a century ago went into reverse.

The polls struggled to track voters' intentions and were quite volatile throughout the campaign, but by the day of voting, seemed to signal that 'remain' would win, as did the bookmakers. That they were proved so decisively wrong is due to a combination of reasons. A first is misunderstanding the depth of hostility to migrants, especially among working-class Labour voters. Second, because there is no real tradition of referenda in Britain, the pollsters have very little history to draw upon in interpolating from their surveys, in contrast to general elections. More fundamentally, the result reflects a new mood in the electorate of antagonism to elites and experts, and even the polling organisations may be regarded as part of this elite and thus not to be trusted.

The tone of the campaigns made a difference. Brexit was able to sound positive, whereas remain came over as defensive and focused on what could go wrong if Britain left the EU, with too few of its representatives setting out positive reasons for staying. With hindsight, years of Brussels-bashing across the political spectrum in Britain took a toll and meant that those politicians trying to make the case for EU membership came over as lukewarm and unconvincing. Two examples illustrate this. First, prior to concluding the February renegotiation, David Cameron made clear that unless a satisfactory deal could be reached on what were, after all, relatively minor demands, he would recommend a Brexit. When he subsequently spoke of Brexit as a risk to world peace and laid out all the risks he foresaw, it was not exactly persuasive. Second, the Labour leader, Jeremy Corbyn, had been associated with the left campaigns in the 1980s against European integration and, when asked on one occasion[11] about his new enthusiasm for the EU, said he gave the EU 'seven, seven and a half, maybe seven' out of ten. In the same interview, Corbyn also explained his refusal to share a platform with David Cameron as being because his case for the EU was entirely different.

It is no surprise, therefore that potential 'remain' voters were confused, especially among working-class Labour voters who had trouble deciphering their own party's message. In the end it seemed to come down to a choice between the emotional appeal of regaining identity, the right to control borders and to curb immigration, on one side, against the likelihood that Brexit would be economically damaging, on the other.

What next?

It is hard to know what Britain wants and, more importantly, can plausibly expect from a new deal with its erstwhile EU partners. The models examined in the economic studies are all potential options, but all have potential shortcomings. The Norway model would al-

[11] http://www.bbc.co.uk/news/uk-politics-eu-referendum-36044383.

low Britain to retain much of the market access it currently enjoys to rEU, but with three substantive complications from a UK perspective. First it would mean Britain continuing to make a net contribution to the EU budget. Second, it means accepting freedom of movement and, third, it would mean accepting substantial amounts of regulation with a diminished capacity to influence the rules. Given that savings on the EU budget, curbs on free movement and 'taking back control' were core themes of the 'leave' campaign, the Norway model as an alternative looks unappealing. It is also likely to be resisted by rEU, if only to deter other Member States from seeking such deals.

The 'Canada model' would entail a free trade agreement, with few restrictions on trade in goods, thereby enabling major UK exporters to avoid what could be significant tariffs on exports to the rEU that could result from the 'WTO model'. Carmakers, in particular, would be deeply concerned if they were subject to the EU's ten percent common external tariff. However, the Canada model does not cover many of the non-tariff barriers that could inhibit UK exports of services, especially the financial and business services produced by the City of London. It is no surprise, therefore, that the City is apprehensive. It is also too easily forgotten that in both the Canada and WTO models, trade between Britain and rEU is expected to shrink, probably with mutually negative damaging effects.

It will certainly be harder outside the EU for the City to be the principal financial centre for the Eurozone and the European Central Bank may press for some activities, such as clearing, to be located only inside the EU. In addition, some leading banks have stated that they will need to shift jobs from London to centres inside the Eurozone, all of which points to a steady loss of activity for London. However, the City is a global financial centre and has, when challenged in the past, shown a capacity to reinvent itself. Other European financial centres – not least Frankfurt and Paris, may gain marginally from what London loses, but considering the global dimension, it is more likely to be a negative sum game than a zero-sum one.

The future relationship in other policy domains has been given much less attention but is nevertheless important. Britain has been one of the leading actors in EU security policy and in international relations. Some new arrangement will be reached in due course, but it will not be easy because the Brexit process will have eroded trust between Britain and its current EU partners. In some ways, Britain will go on as before. It will retain its seat on the UN Security Council, have a strong voice in the IMF, still be a leading member of NATO and be a major economy. But it risks becoming isolated, rather than being a leading actor in the world's largest trading bloc.

Economic spillover

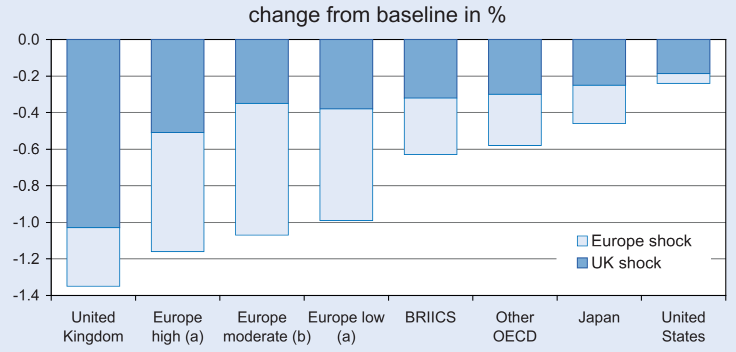
International institutions, notably the OECD and the IMF, produced a series of analyses highlighting both the risks to the UK economy and to global economic prospects. In its latest Economic Outlook, the OECD (2016) identifies Brexit as a major downside risk for the global economy, even before the vote occurred, and commented that it was on the basis that the verdict would be 'remain'. The analysis suggested that the 'leave' vote would worsen financial instability and cause some loss of asset values. Even Janet Yellen of the Federal Reserve,[12] speaking in Philadelphia in June 2016, cited Brexit as one of the downside risks for the US economy, with the corollary that normalisation of monetary policy will again be postponed.

The effects on other parts of the world of Brexit (by 2018) have been calculated by the OECD, distinguishing between the effects of the shock on Britain and on the EU. The main channels are through the financial effect, the trade effect and an effect on FDI. Figure 1 shows these calculations and reveals that the UK shock is more significant for other parts of the world than the direct effect of an EU shock. By contrast, inside Europe, albeit to differing degrees, it is an EU shock that will dominate. In the OECD analysis, the EU countries are classified into three groups according to the strength of their linkages to Britain on three sets of metrics – import demand from Britain as a share of the country's GDP; the stock of FDI from the country in Britain, again as a proportion of GDP; and what is referred to as a 'big data indicator of linkages from Google trends'. Ireland and the Netherlands, unsurprisingly are assessed as being most exposed, as is Luxembourg, whereas Italy and much of central and eastern Europe are least exposed. A middle group includes Germany (which has, so far, made sympathetic noises about how to accommodate the likely post-Brexit demands from Britain), but also France and Spain which have been signalling a less supportive stance.

[12] https://www.federalreserve.gov/newsevents/speech/yellen20160606a.htm.

Figure 1

Impact of Brexit on GDP in different regions by 2018



(a) Ireland, the Netherlands, Norway and Switzerland.
(b) Austria, Belgium, Denmark, Finland, France, Germany, Greece, Spain and Sweden.
(c) Czech Republic, Estonia, Hungary, Italy, Latvia, Lithuania, Poland, Portugal, the Slovak Republic and Slovenia.
Source: OECD (2016).

Public finances

The departure of Britain will mean a reduction of up to the full UK gross contribution to the budget, depending on whether the future relationship between Britain and rEU includes some continuing financial contribution, as with the EFTA countries. To put it in perspective, the loss of the British gross, post-rebate contribution is equivalent to most of the budget for line 1a, 'Competitiveness for growth and jobs', or to around a third of the budget for Cohesion Policy.

From this UK contribution, some spending from EU programmes accrues to Britain, such that the net contribution is lower, but the loss of the UK payment would still leave a big hole to be filled, prompting an obvious question: will the other net contributors agree to pay more, or will today's net recipients be obliged to accept less. Formally, the EU's spending plans are embodied in the Medium-Term Financial Framework (MFF) in which the agreed expenditure determines how much Member States have to contribute. Unless the current MFF is over-ridden, the net contributors (not least Germany) will face a higher bill for the EU at a time when this could prove politically awkward.

However, these direct effects will be relatively trivial if the wider economic effect of Brexit is adverse. Lower GDP means, *ceteris paribus,* lower public revenues and higher demands on public spending, not just in Britain but also in rEU, suggesting a plausible lose-lose economic scenario, dominating the direct effects of EU budget changes.

A word on Scotland

There has been speculation about a possible break-up of Britain because of the very strong support for remain in Scotland and, to a lesser extent, Northern Ireland. The Scottish Nationalists face a trilemma. They have a clear political opportunity afforded by the message that England has taken the Scots out of a Europe to which they want to belong and the possibility that resistance to rapid Scottish accession to the EU would be muted. At the same time, it is questionable whether enough of the 55 percent of Scottish electorate who voted against Scottish independence in September 2014 will have changed their minds, despite the subsequent electoral success of the nationalists.

The third issue is the economy and its implication for the public finances. In the 2014 Scottish referendum, a weakness of the 'yes' campaign was that it was unclear what currency arrangement would ensue from independence and there were doubts about the public finances. Since then the steep fall in the oil price has slashed revenue from oil on which an independent Scotland would rely, to the extent that an independent Scotland today would face a dangerously high deficit and maybe even a bailout.

Assessment

Despite the polls showing how tight the vote was likely to be, not only was the result generally regarded as a surprise, but it was also clear that there was no real plan for what happened next. There has been much debate about Article 50 of the Lisbon Treaty, the provision that enables a country to leave the EU. It has to be triggered by the Member State seeking to exit and, although there have been evident signs of impatience in Brussels (and in a number of national capitals) that it did not happen immediately, there is little the EU institutions can do to accelerate it. With the caveat that in the current febrile political context the unexpected has become the normal, making any prediction hazardous, the signals emanating from Westminster, both from Theresa May and David Davis, the Minister she has appointed to pursue Brexit are that Britain will not invoke Article 50 before the end of 2016.

Financial volatility has already been evident since the referendum vote, adding to a slowdown identified by the IMF prior to the vote in property transactions and prompting the Bank of England at its July 2016 rate-setting meeting to signal monetary easing later in the summer. For rEU, some adverse effects are already surfacing, not least the extent of the pressure on Italian banks. It could be argued that their problem of non-performing loans was always going to have to be confronted and that it has little to do with the pro-Brexit vote. However, the erosion of confidence associated with the uncertainty about what happens next manifestly has not helped.

Paradoxes abound in the Brexit decision. A first is the general agreement that the UK economy has recovered better than most from the great recession in 2008, despite being so closely tied to the EU. In addition, the UK economy has achieved something of a turnaround since joining in 1973, with the implication that membership has been good for the economy, although a standard retort from the 'leave' side is that the success of the British economy is due not to EU membership, but to the extensive supply-side reforms of the Thatcher era.

Second, the EU has, in several respects shifted its preferences very much towards those of Britain and, to their dismay, away from those of countries like France. The single market, better regulation and a global outlook are all watchwords for what Britain wants, and federal ambitions have waned, making it all the more odd that this country has chosen to leave now. A further paradox is that areas which have benefitted from EU membership – including the parts of Wales and England in receipt of the highest flows from EU Cohesion Policy – have proved to be hostile.

Yet another paradox is that hostility to migrants – one of the key themes of the 'leave' campaign – is not well correlated with where migrants are concentrated. London, with a high migrant share, voted strongly to remain, while many parts of *l'angleterre profonde* where there are few migrants voted to leave. Equally, in certain localities where low-skilled migrants are numerous, such as Boston in the East English county of Lincolnshire, opposition to migrants was a critical reason for high votes to leave. The explanation can be simply stated: migrants crowd-out locals in accessing public services and are blamed for depressing wages at the bottom end of the wage distribution. These phenomena are strong negatives for those who see themselves as losers from globalisation/economic integration.

For the EU as a whole, constitutional and political issues arise as a result of the UK decision, as well as the direct economic consequences. The challenge can be framed in stark terms: will Brexit be the catalyst for an unravelling of the European integration project, or, with the removal of a member that has long been the awkward partner, an opportunity to move forwards. In this regard, an underlying question is whether it is time to move on from the old debate between more or less Europe. Jean-Claude Juncker, in his 2015 state of the union speech,[13] remarked that "our European Union is not in a good state". He went on to say, somewhat delphically, "there is not enough Europe in this Union. And there is not enough Union in this Union".

In some domains, he is correct: for the Eurozone to function effectively, it will require increased integration, notably in relation to many of the proposals for fiscal and political union raised in the Five Presidents' Report. Thus far, these plans have been side-lined and discordant views are being expressed by Europe's two presidents (Juncker and Tusk), as well as national leaders about the wisdom of new integrative steps. A further paradox is, though, that they will have to be confronted before long if the EMU is to be completed. However, in other respects, the 'federal Europe' project was yesterday's and it is more probable that the Union of the future will increasingly take the form of differentiated integration (Schimmelfennig and Winzen 2014). This may be the true legacy of Brexit.

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[13] http://ec.europa.eu/news/2015/09/20150909_2_en.htm.