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The Economics of a Brexit

Now that the results of Prime Minister David Cameron's negotiations with the EU are known and the date for the UK's referendum to remain or leave has been set for 23 June 2016, it is time to clarify the consequences of this seemingly simple choice: in or out.

The economics of European integration is a well-trodden path, with major research undertaken in the 1980s and 1990s on the emerging single market and monetary union. Interesting as those studies were, they appeared better when presented *ex ante* than in the cold light of *ex post* events. In addition, there is of course the huge literature on the impact of trade agreements, usually with CGE modelling in support, but these pose the same problems of *ex post* evaluation.

In the Brexit hypothesis, a calculation would have to compare the membership status quo with the conditions of non-membership. But here already the complications begin in a big way. What would non-membership look like?

The "remain" choice (Plan A) is fully known, consisting of the status quo, as marginally improved under Cameron's four points. These improvements could only be marginal, because basically the UK is "in" what it likes and already "out" of what it does not like. For the economist, the status quo has not significantly changed.

But Plan B, or the terms of secession, is in the immortal words of Sherlock Holmes "the dog that did not bark". The "leave" choice is unknown territory, beyond vague statements like regaining freedom from Brussels and being able to engage in freer trade with the world at large. A recent CEPS study has attempted to do some homework that the secessionists have been unable or have not wanted to do in which three hypothetical Plan Bs are sketched.[1]

Plan B.1 corresponds to one popular sentiment in the UK, to get out simply and fast, with a clean break on Day 1. This would mean scrapping all EU law, including all of its international agreements, and would thus create initially a huge legal void that would be unthinkably catastrophic for the economy, such that no British government would conceivably do this. Consequently, there can be no quick clean break, and there is no need to model it. The only point of including it is to inform those who have not thought about the question seriously.

Plan B.2 consists of quitting politically while staying within the single market by joining Norway and others in the European Economic Area and thus minimising economic disruption. This could be workable, since the mechanisms already exist and have been tested. The problem is that this would leave the UK in the position of what some have dubbed "no say, still pay". As an economic proposition, this would seem at first sight to initiate virtually no changes to the UK's economic policy settings and therefore have zero economic impact. However, it is not that simple, since all of the EU's preferential trade agreements would cease to apply and would take years to reconstitute on a bilateral basis.

Plan B.3 is the more plausible scenario. In it, the UK tries to negotiate the best possible deals with the EU and its international trading partners. This, however, becomes a very messy prospect, with years of negotiation lying ahead in a climate of uncertainty over the outcome. The UK's preferred deal with the EU would presumably include an end to the

1 M. Emerson (ed.): Britain's Future in Europe – The known Plan A to remain or the unknown Plan B to leave, Brussels and London 2016, CEPS and Rowman & Littlefield.

free movement of people but would at the same time try to retain maximum continued access to the EU market for goods and services. In addition, the secessionists argue that the UK should be able to make bigger, better and faster free trade deals with the rest of the world. Both of these prospects are problematic.

The EU can be expected to object to a "cherry-picking" approach. Secessionists tend to argue that since the EU has a trade surplus with the UK, it would be keen to conclude a friendly free-trade deal. This is an illusion that fails to understand the likely EU response. The EU would be anxious to avoid the impression that secession from the EU would be an easy and costless proposition for any other member state that might be tempted to follow suit. It would not agree to embark on a re-run of the so-called Swiss model, i.e. to open a sequence of negotiations of sector-specific packages of deals, taking the easiest ones first. EU member states would also be tempted by the opportunity to gain advantages in commercial competition over all three of the "crown jewels" of the UK economy, namely the preeminent position of the City in financial markets, its strength in international service markets more broadly and its rank as the preferred location for foreign investment aimed at the EU market. The EU could be expected to play a tough game in negotiations and would be in no hurry to end the uncertainty.

Moreover, the idea of the UK replacing the EU's international free trade deals with something better and faster is also an illusion. The secessionists say that the UK should regain its freedom to make its own free trade agreements with the rest of the world. This fails to recognise that the EU already has, or is negotiating, preferential trade agreements with virtually the whole of the world, with only a few important exceptions that the UK would be unlikely to pursue alone. The default position of WTO-MFN terms of trade with the rest of the world would be a major setback for the objective of attaining maximum free trade globally. To negotiate a new set of deals would be a highly complex affair that would take years and years to complete. Two categories of deals would need to be addressed.

First would be the EU's existing free trade deals, which would cease to apply to the UK. Recent deals, such as those with Korea and Canada, are now typically deeper than simple FTAs, and they consequently take many years to negotiate and then ratify. Second would be the trade deals that the EU is currently negotiating, including with the US, Japan and India. The US has already said it would not be interested in a bilateral deal with the UK, especially while its TTIP negotiations with the EU continue. Other countries will similarly give priority to the EU.

For any modelling of the economic consequences of Plan B.3, one would assume that on Day 1 of secession there would be an initial increase in trade barriers back to WTO-MFN terms with countries with which the EU has preferential trade agreements. There could then be an assumed time path of many years for getting back towards the current status quo. For the EU's ongoing free trade negotiations with the US, Japan and India, the UK would suffer some years of competitive disadvantage over the time needed to catch up. For the UK's deal with the EU itself, one might assume a resumption of tariff-free trade but less than full internal market treatment, with the big uncertainty being how much less.

The conventional task for economic analysis would thus be to assess the costs of an initial negative shock as trade barriers would be increased, followed by the gradual negotiation of a fresh set of bilateral free trade agreements over a transition period of many years. The less conventional task would be to assess the cost of years of strategic uncertainty, which the EU would be in no hurry to dispel. The claims by secessionists that the UK could get better and faster free trade deals with the rest of the world than the EU can is simplistic wishful thinking.

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