

# What might be the Economic Effects of Brexit?

**John Van Reenen**

**Professor of Economics, LSE & CEP Director**

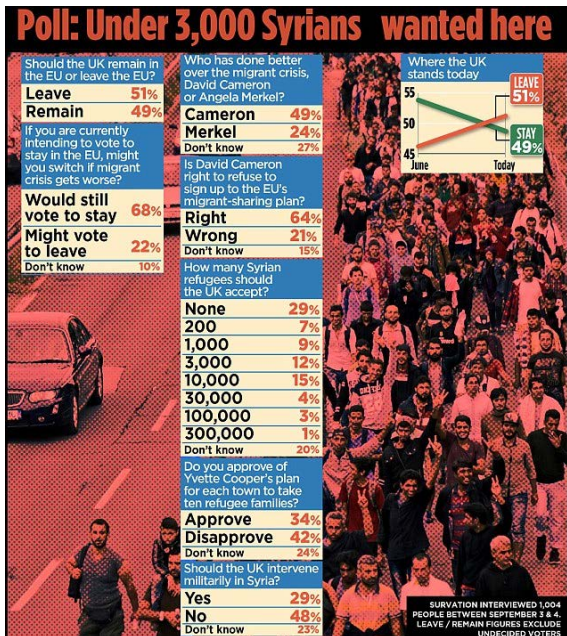
**Draws extensively on joint work with Swati Dhingra, Gianmarco Ottaviano, Tom Sampson**

**FCO, London  
September 2015**

# Background

- In-Out Referendum by end of 2017 (PM pledge Jan 2013)
- Polls evenly split (51%-49% Mail on Sunday, 5/9/13)

<http://www.dailymail.co.uk/news/article-3223674/Britain-wants-quit-Europe-Shock-new-poll-s-ahead-time-Cameron-prepares-face->



## WHAT THEY DON'T SAY ABOUT THE COMMON MARKET!

Some people complain that membership of the Common Market would cost the British housewife more.

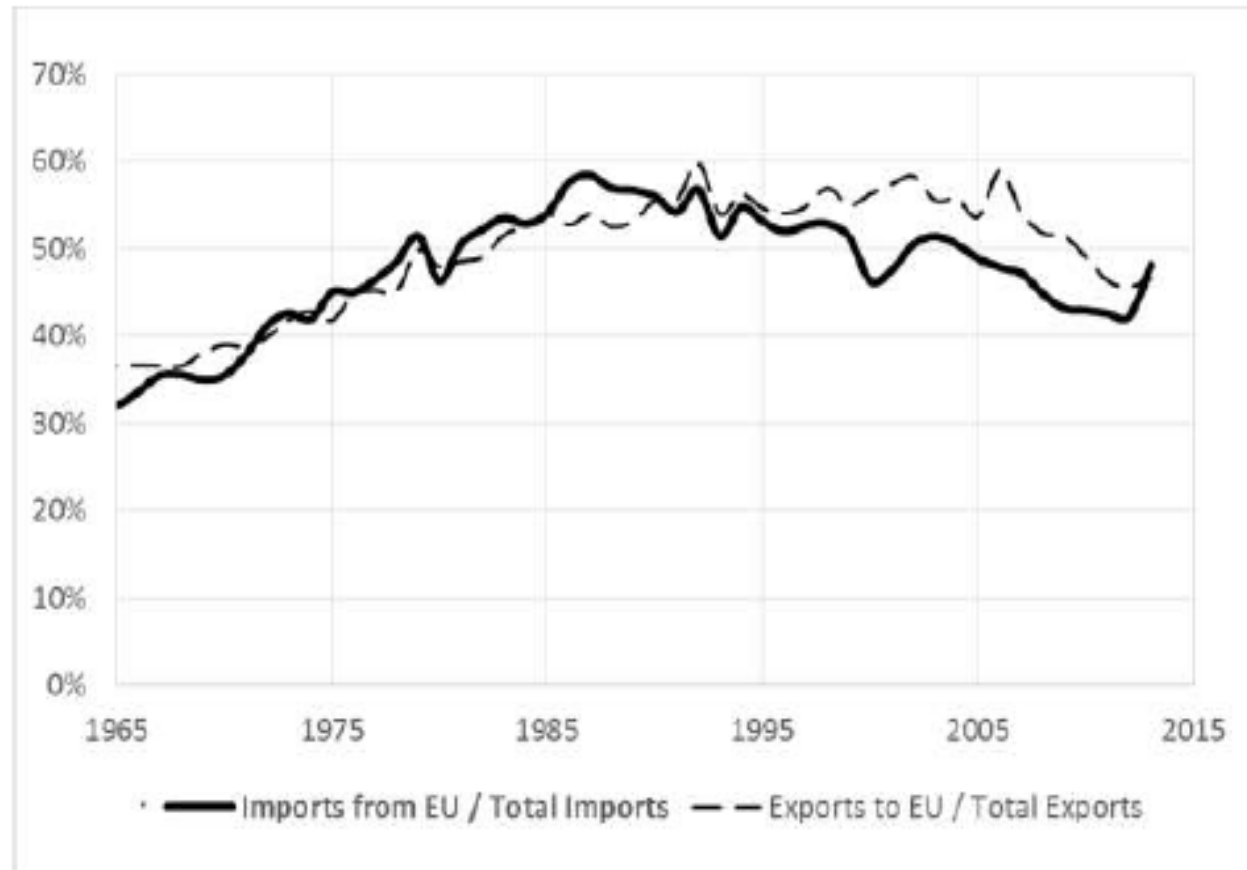


What they don't say is how much greater will be the prospects for her husband to earn more – the economic advantages leading to greater wealth for Britain and more money in wage packets.

Some people say the cost of food will rise substantially if Britain joins. What they don't say is that the additional rise in living costs is likely to be under  $\frac{1}{2}$  per cent a year for five years.

Some people say that membership would make life tough on families. What they don't say is that standards of living in all Common Market countries have been rising much faster than in Britain – in some cases, almost three times as fast.

# EU still our major trade partner (non-EU is 25% of world GDP, yet our trade is twice this proportion)



*Notes: Data covers trade with Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and Sweden.*

# The main Issues

- Net Fiscal transfers ~0.53% of GDP (HMT). Depends on deal – e.g. EEA vs Switzerland
- **Trade**
- Foreign Direct Investment
- Immigration
- Regulation
- Psychological benefits of “Sovereignty”

# **Trade**

Foreign Direct Investment

Immigration

Regulation

# Trade Effects

- Benefits of trade
  - Lower prices, more varieties
  - Specialisation in areas of comparative advantage
  - Competition
  - Innovation & productivity growth
- How would trade change with EU & non-EU relative to counter-factual?
- What would the new level of tariffs & non-tariff barriers
- A forward looking question: how much would the UK lose/gain from not being part of the ongoing deepening of the internal market?
  - Service liberalization, future trade deals

# Calculating the costs of greater trade barriers

(Ottaviano et al, 2014, <http://cep.lse.ac.uk/pubs/download/pa016.pdf>)

- Conventional static trade model which focuses on benefits of specializing in areas of comparative advantage
  - 35 sectors
  - 40 major countries in the world
  - Estimate relationships in model
  - Simulate what happens to welfare as UK-EU trade barriers **change**
- Takes into account how things change – e.g. If EU-UK trade barriers rise, UK trade with other countries *increases*

# Calculating the costs of greater trade barriers (Ottaviano et al, 2014)

- Simulate model under two main scenarios:
  - ***Optimistic*** (UK like EFTA;  $\frac{1}{4}$  of non-tariff barriers; future barriers within EU fall 20% than RoW)
  - ***Pessimistic*** (MFN tariffs;  $\frac{2}{3}$  of non-tariff barriers; future barriers within EU fall 40% than RoW)



**Table 1: Estimates of the welfare changes if UK leaves EU**

| <u>Welfare Changes due to UK Withdrawal from the EU</u>   |               |
|---|---------------|
| <i>Optimistic Scenario (0% Tariffs)</i>                   | % of GDP      |
| Due to Increase in EU/UK Tradable Tariffs (0%)            | 0%            |
| Due to Increase in EU/UK Non-Tariff Barriers (+2.01%)     | -0.4%         |
| Due to Future Falls in EU/UK Non-Tariff Barriers (-5.68%) | -1.26%        |
| Due to Fiscal Benefit                                     | +0.53%        |
| <i>Total Welfare Change</i>                               | <i>-1.13%</i> |

Notes: Welfare measured by change in real consumption in the UK.

Source: Ottaviano et al, 2014.

**Table 1: Estimates of the welfare changes if UK leaves EU from trade cost, STATIC**

| Welfare Changes due to UK Withdrawal from the EU           |               |
|--|---------------|
| <i>Optimistic Scenario (0% Tariffs)</i>                    |               |
|  | % of GDP      |
| Due to Increase in EU/UK Tradable Tariffs (0%)             | 0%            |
| Due to Increase in EU/UK Non-Tariff Barriers (+2.01%)      | -0.4%         |
| Due to Future Falls in EU/UK Non-Tariff Barriers (-5.68%)  | -1.26%        |
| Due to Fiscal Benefit                                      | +0.53%        |
| <b><i>Total Welfare Change</i></b>                         | <b>-1.13%</b> |
| <i>Pessimistic Scenario (MFN Tariffs)</i>                  |               |
| Due to Increase in EU/UK Tradable Tariffs (MFN EU Tariffs) | -0.14%        |
| Due to Increase in EU/UK Non-Tariff Barriers (+5.37%)      | -0.93%        |
| Due to Future Falls in EU/UK Non-Tariff Barriers (-10.54%) | -2.55%        |
| Due to Fiscal Benefit                                      | +0.53%        |
| <b><i>Total Welfare Change</i></b>                         | <b>-3.09%</b> |

Notes: Welfare measured by change in real consumption in the UK.

Source: Ottaviano et al, 2014.

# Extensions to basic model

- Leaves out effects due to competition, selection, scale & varieties
- Ignores any **dynamic** benefits of trade via productivity & innovation (<http://www.voxeu.org/article/who-s-afraid-big-bad-dragon-how-chinese-trade-boosts-european-innovation>)
  - Major advances in “Big Admin Data” over last decade show that these are BIG
  - Look at actual trade liberalisations & EU history (Baier et al, 2008; Feyrer, 2009).
  - Quantitative analysis suggests a **doubling or tripling** of static effects (Sampson, 2014; Bloom et al, 2015)
- Incorporate these using past empirical evidence

**Table 2: Estimates of the welfare changes if UK leaves EU from trade cost, STATIC + DYNAMIC**

|   |                |
|---|----------------|
| <u>Implied changes in UK incomes from leaving the EU and joining the EFTA</u> |                |
| Implied change in UK's bilateral with EU                                      | -25%           |
| Implied change in per capita income in the UK                                 | -6.3% to -9.5% |

Notes: Welfare measured by change in real consumption in the UK.

Source: Ottaviano et al, 2014.

# Future trade agreements

- Nothing stops UK from promoting trade with Asia & Africa
- Wouldn't have to "pool" our preferences with EU who have different preferences
- BUT much weaker bargaining power as offer of access to UK markets tiny compared to EU wide market

Trade

**Foreign Direct Investment**

Immigration

Regulation

# FDI

- Strong evidence that FDI brings large benefits directly and via spillovers (e.g. technology & management)
- After Brexit, UK less attractive location because access to rest of EU markets is now weaker
- Magnitude of this effect hard to quantify, but Head & Mayer (2015) look at car industry. Calculate Brexit would mean ~12% loss of car production in UK

Trade

Foreign Direct Investment

**Immigration**

Regulation



**Table 3: Growth in immigrant share has no effect on unemployment**



*Source: Annual Population Survey*

# Immigration

- Immigration has positive effects similar to trade
- May be additional dynamic effects on productivity especially as EU immigrants to UK on average better educated
- Fiscal effect positive (Dustmann & Frattini, 2014). immigrants work more, use less benefits & more educated than natives (~£15bn from EEA)
- But what about negative effects on domestic labour markets? Wadsworth (2015) summary (<http://cep.lse.ac.uk/pubs/download/ea019.pdf>) No negative impacts on:
  - Native Jobs
  - Native Wages (maybe small negative on bottom 20% and increase in middle 40%-80%)
  - Public services (e.g. Polish students & schools)

Trade

Foreign Direct Investment

Immigration

**Regulation**

# Regulation

- Obtaining equal access to EU requires adopting same product and service regulations
- Labour market regulations.
  - Can cause losses of welfare (e.g. French evidence)
  - But UK already has one of most flexible labour laws in OECD. Gains from relaxing more likely to be miniscule
  - <http://blogs.lse.ac.uk/politicsandpolicy/evidence-based-policy-beecroft-van-reenen/>

# Conclusions

- Need to refine models of how trade has welfare impacts
- Incorporate other effects that are harder to model (dynamics, FDI, immigration, etc.)
- But current estimates suggest serious losses for little gain

# Some Further reading

- [http://cep.lse.ac.uk/pubs/download/pa016\\_tech.pdf](http://cep.lse.ac.uk/pubs/download/pa016_tech.pdf)