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Throwing the Baby out with the Bathwater: Brexit and the Economics of Disengaging from a Free Trade Association

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Abstract

For nearly six decades or more, international trade policy has been largely dictated by UN (now WTO) supervised rounds of mutual tariff reductions, starting with the Kennedy round in 1961. Initially attention was focused on tariffs as such, but more recently the scope has been extended to include services, investment, intellectual property rights, free trade associations, and sensitive issues like agricultural goods. As the negotiations became more complicated (and controversial), the speed at which new agreements were agreed slowed down markedly. It became popular to argue that bilateral deals, and then agreements that allowed the emerging trade associations to merge, would be a better way forward – in the hope that mergers between the larger associations would lead to free trade world-wide.

Instead, as the academic literature predicted, trading arrangements have gone in the opposite direction with economies withdrawing from established associations or violating old ones. This paper, by "reverse engineering" the costs of Brexit as an example, sets out and examines the costs and different ways a country might disengage itself from a trade association suspected to no longer be advantageous.

Keywords: Brexit; Free Trade Agreements; Exit Costs

1. Prologue and a Health Warning

Brexit, the process by which the UK will voluntarily surrender membership of the EU, is possibly the best example of a policy process that generates more heat than light that we have seen in decades. Faced with a threat to his government from his own party over the question of EU membership, and the fact that the nationalist UKIP party that was running in second place in many crucial Conservative seats, Prime Minister Cameron called a referendum on the issue in 2016. But no serious analysis of the economic arguments for or against EU membership, or evaluation of the likely economic outcomes, was offered during the referendum campaign -- or in the following two years when a new trade deal was to be negotiated with the EU. Now that the moment has come for Parliament to choose the way forward, the result appears to be political paralysis. The aim of this paper is to try to put the economic implications of Brexit into perspective and, by extension, the process of disengaging from free trade agreement or free trade zones more generally.

A careful reading of the UK government's proposals for a new deal of association with the EU gives the impression that everything comes down to a choice between two "no deals". There is discussion of the no deal case (leaving without any agreement with the EU) and of the government's preferred option which is a limited trade deal (but no specific arrangements for investment) with two restrictions – that the Irish border may be allowed to settle in the Irish Sea; and that the UK shall remain in an EU customs union till 2020 and likely beyond if no other arrangements are settled by December 2020. There are detailed discussions of the remaining budget contributions (separation fees) and the rights of EU citizens in the UK and UK citizens in the EU. However those two topics now appear agreed and no longer controversial. But there is no material on the trade and investment arrangements. In fact, a word search reveals only 7 mentions of trade, and they have nothing to do with future trade/investment arrange-ments. This "deal" therefore describes a transition out of the EU, but allows (or is intended to allow) the participants to forget that there are decisions to be taken within the transition period; and that making, or possibly failing to make, certain decisions now may rule out many of the preferred options after transition.

Using Brexit as exemplar, but recognising that the results generalise, this paper makes four basic points:

a) Disengaging from a Free Trade Association entails significant economic costs and losses in economic performance from reductions in trade. These costs will not be spread evenly across the economy; some sectors will be affected more than others, as is always the case when the pattern of trade alters. However, these costs may only apply in the short to medium term if the economy (and exchange rate in particular), adjust to restore competitiveness and develop new markets. This is because trade is a flow, not a stock.

b) Similarly, disengaging from a Free Trade Association will entail losses in investment: cross-border investment and of domestic investment that had been necessary to support the trade flows under the agreement. In the EU, cross-border investment has assumed special importance because it allows firms to exploit the EU's "passporting" arrangements[1]. The point here is investment develops the economy's productive capacity for the future, and is the gateway for incorporating new productivity techniques into the new capacity. Not only does that improve competitiveness; it creates the opportunity for future long term growth as the standard growth models show. Hence the loss of investment is likely to cause far greater long term damage than the immediate losses in trade. This is because productive capital (accumulated investment) is a stock, not a flow.

c) Various "compromise" models involving a degree of association or partial membership of a free trade zone exist. Mostly they involve administrative changes to how associated members may operate (for example, can the associated member influence the design of the rules of the trade zone?); or variations in the trade rules/tariffs applied to associated members (reduced tariffs, rules of origin, some freedom of movement of labour may remain). Each model has different advantages or disadvantages in terms of costs relative to full membership, in economic performance and in the distribution of those costs. The question then is: how do these costs or losses stack up against the losses of the outside option (no associated membership at all)? Examples of the best known compromise models are given below.

d) Generally, little detailed analysis has been devoted to the outside option of bilateral deals or a reversion to normal WTO trading rules (the default position). This is because a full reversion provides no benefits at all; and bilateral deals to improve on that turn out to be self-defeating in the sense that they may provide gains to start with, but the trade integration process will come to a halt when the bloc becomes large enough to act as a trade monopoly and the dominant players act as a coalition to set tariffs in such a way as to expropriate the gains generated for themselves (Krugman, 1989; Hughes Hallett and Primo Braga, 1994). So unless one is a dominant player in such a regime, there is no real incentive to continue as a member. Arguably, this is a lesson that the Trump administration has now been condemned to relearn.

The assessments made in this paper are confined to membership of the EU's Single Market and regular economic issues that arise naturally from the Brexit decision. They are not intended to address the other important cultural, environmental, legal or security aspects of EU membership that will arise in other contexts. This separation then implies two further points: i) that the lessons to be drawn from this analysis generalise to any case of a member withdrawing from a free trade deal; and ii) the list of special protections for certain sectors of the EU economy which the EU issued in lieu of a final agreement at the end of 2018 shows that there will be serious costs to both sides, the EU included, beyond just trade and budgetary losses. Disengagement is a two-way street in the same way as creating the free trade zone, if properly conducted, would have been a Pareto improvement in the first place.

2. Background

i) Any discussion of what detailed arrangements could or should be made between the UK and EU, or between the UK's constituent regions and either the UK or the EU, short of independence, depends on

[1] Passporting derives from the Single Market ruling that a firm licensed to do business in one member economy is licensed to do business in all. This allows EU producers to shrink their production to a single EU location (if they wish) and realize the scale economies that result. It also allows outsiders to establish a bridgehead position in one EU market and then trade in all of them from there. This is particularly valuable in component or assembly trades, or chain production processes where specialized and high productivity skills are involved.

the trading model that the UK government chooses to adopt with respect to the EU. This will necessarily remain unknown until a now delayed Parliamentary vote is taken in London. But on past experience this vote is not likely to pay much attention to a specific region's – Scotland for example – interests generally (jobs, investment, economic development) or specifically (e.g. natural resources, fishing rights).

ii) A number of models to replace the single market have been in discussion, but they all involve trying to achieve the near impossible feat of maintaining free EU market access (including for investment and passporting), while limiting the free movement of labour. This involves a difficult compromise: especially for the EU where the free movement of labour is a "fundamental freedom" that, if lost, would sit badly with the continued free movement of capital and investment that the UK values so highly. This explains why the negotiations have been so drawn out and difficult for both sides, and show so little room for compromise or improvement.

iii) The main contenders are the Norwegian model (stay in the Single Market, contribute to its costs but with no vote on its regulations); the Swiss model (bilateral free trade deals in selected sectors, allowing the UK the freedom to exploit her comparative advantages), stay out with bilateral free trade deals with the EU and other outsiders (not feasible so long as the UK has to remain in an EU customs union); a rules of origin approach much like NAFTA (cumbersome and hard to implement in industries whose inputs are mostly human capital, knowledge based, or skills based – financial services for example).

iv) A more explicit compromise would be to stay outside the EU but make bilateral free trade deals with the EU and outsiders to replace the Single Market without invoking WTO membership; or to stay inside with compromises on certain articles in the Single Market itself – for example, with quotas to replace the free movement of labour in return for concessions on aspects of EU membership outside the Single Market. This model has been proposed in the unofficial French-German "Continental Partnership" idea [Bruegel (2016a, b)].

v) The "no deal at all" option in which the UK leaves the EU without any agreement[2]. Under this option, the UK would progress to WTO membership in her own right. However all WTO members have to agree. Currently 7 countries, including the US, say they oppose UK membership. And even if that obstacle is overcome, the UK would have to accept the WTO's rules on international and bilateral free trade. The cost of the latter might be reduced by invoking the "most favoured nation" status between UK and EU, but how much benefit that would bring is not known.

3. Trade Losses from Leaving the Single Market on the UK side

Estimates have been made of the impact of Brexit on the UK, but few for Scotland. They produce UK losses of about 1% to 2% of GDP. These losses are about the same as reversing the *gains* estimated for membership of the single market when it was set up. The Cecchini report estimated gains of 5% in GDP over 5 years in 1992. The EU's post-mortem study in 2000 showed GDP gains of 1% by the time the Euro arrived. Later estimates put the figure at 2.15% of GDP in 2006, or 2.13% of GDP in 2014. For Scotland,

[2] This option is now limited by the motion adopted by the UK Parliament in early January 2019, that "no deal at all" cannot be part of the options offered to Parliament or negotiated with others by the UK government. That obviously restricts the government's freedom of action; but how much impact this would have in practice is not clear. It might be rescinded again in the future, and what do you do if the EU is unable to agree any other option?

the Fraser of Allender Institute has estimated the losses (gains lost) at about 2.8% of GDP or 80000 jobs. These gains will not have been distributed evenly of course; so the corresponding losses under Brexit will hit some sectors, such as manufacturing, much harder than others.

For the UK as a whole, the UK Treasury now estimates, rather late in the day, that UK GDP will be lower by 3.9% after 15 years (or ¼% each year on average) if the government's preferred plan is used; but 9.3% lower (0.62% each year) under no deal at all[3]. This is costly in terms of losses, given that it does not account for the investment and productivity increases foregone. Notably also the Treasury calculations do not evaluate any of the compromise models either.

The Scottish government figures for Scotland alone suggest losses of 7.4% after 12 years, or 0.62% per year: that is, half way between the government's proposal and the "no deal at all" solution. So Scotland would appear to be made worse off than the rest of the UK (rUK) if the UK were to crash out, although the damage would be less, even on UK Treasury figures, with any of the compromise arrangements currently ruled out (only 5% under a free trade association with the EU, 1% in a Norway type deal). Interestingly, the Treasury's argument is that these smaller losses would arise because Scotland is partly sheltered by the energy sector. I am not aware that London has in fact made any plans to devolve oil or gas revenues to provide any such financial sheltering. So it is not clear where this result is coming from. Nevertheless, the argument itself is of interest because it shows how easily the economic outcomes can shift with relatively small changes in the rules governing trade in any new association with the EU.

On these results, by 2030, the loss of productivity improvements will explain 60% of the losses between no deal and continued EU membership; restricted migration 26% of the difference, but new trade barriers and tariffs only 14% -- according to recent Scottish government (2018) estimates. Clearly the loss of investment and productivity gains are the major factors here and need to be recognised as such. Comparable figures for the UK are not available.

Finally, restricting net migration to zero is said to lower incomes by 5.4% per capita in the long term.

The reason why the trade impacts are not larger is that EU tariffs against outsiders average 2%-3%. Since the pound has depreciated 15% since the leave vote, the cost of UK exports to the EU has fallen. As a result, UK firms are now reporting increased business and the trade deficit is shrinking. However, imports also cost more (around 23% more so far) – raising the prospect of inflation. Since UK inflation is still within its 2%-3% target range, this is not a major problem. So, reversing the argument, there has been some downward pressure on prices across the EU as a whole, but rather small in its effect.

That said, the evaluations so far report the estimated trade effects ***only***. They do not look at the impact of lost investment and consequent losses in output and productivity growth. So there is a great deal to add to these estimates of Brexit costs. I am less optimistic that we can find a way to offset the combined losses without some kind of single market substitute or compromise, unless you judge the international trade rules of the WTO to be less restrictive than the EU's free market rules. They are clearly not, unless we can invoke a most favoured nation status. That part then represents the costs of a clean exit.

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[3] Figures calculated as of 2018 [see BBC (2018)]. The Scottish figures that follow are taken from Scottish Government (2018). It may seem odd to include the impacts of Brexit on a specific region. But those costs (or gains) are of importance here because they may persuade that region to reconsider or change their relationship with the national economy in question, especially if that national government has made an unfortunate or damaging choice when disengaging from the EU.

4. Trade Losses from the UK leaving the Single Market: the EU view

Not much can be decided about the future trade regime until the Article 50 process is complete (March 2019, with a transition period till the end of 2020). How much can be achieved within the remaining two-year time frame is unclear, although it is clear that both sides anticipate most of the design work will be done in the transition period. This amounts to substantial delay to the original Brexit timetable.

Why? First, there are strong incentives for the UK to delay negotiating: the longer the delay, the more the pressures in the EU to compromise build up. One can see that in the German employers' pressure for a single market scheme with work permits; worries that the Brexit slowdown puts the stability of Italian banks at risk; the movement to short time working in some German manufacturing plants; and the worries that the Dutch (for example) do not have the personnel, expertise or resources to set up a new customs system for their largest EU trading partner under a "no deal" scenario.

Second, the complexity of negotiating replacement arrangements (where London lacks the necessary expertise and the EU lacks the focus) means that it almost certainly cannot be done in the 2 years allowed. From the UK point of view, better to delay the Article 50 process till a good part of the design of the agreement that needs to follow has been done. This means the UK needs to make known her concerns early in the process, to avoid being presented with a fait accompli. But this has not happened.

Gaming the system in the name of creating a transition arrangement before a final agreement can be reached, particularly over the question of where the Northern Ireland border for trade purposes shall be placed (evident in the disagreements over the correct interpretation of a previously agreed "backstop" arrangement) has inevitably made this process more tortuous and the costs involved larger than they need have been.

There are also incentives on the EU side to dilute the pressures triggered by Brexit, to make space to create agreement on the future form of the EU from within, and to allow financial pressures created by the UK's withdrawal to subside. The extra costs generated by the *Markets in Financial Instruments and Derivatives Initiative-2* is one example, more expensive financial services/financing imposed by breaking up the existing financial markets is another. Fragmented liquidity, reduced access to financing, shallower or narrower financial markets, and a loss in the ability to pool financing or currency risks, is a third. This imposes costs on everyone (consumers and businesses alike) in the EU or UK, but mostly on the EU side given the depth and greater scope of the UK financial markets. For example, the OECD (2018) forecasts Dutch exports could fall 17% under a "no deal" Brexit. It is also estimated that the EU as a whole would need additional financing margins of €77bn just to back the same volume of trades as undertaken today. Disengagement really is a two way street. It is not surprising that the emergence of the Continental Partnership idea from the EU side has indicated a desire for a degree of compromise. But, again, no firm proposals have materialised – perhaps because the EU is still unclear what it wants to achieve with a new association agreement, aside from limiting damage to the European integration movement.

5. Investment is the Key Element.

Investment spending plays three key roles. First it builds capacity: the ability to produce competitively in the future. The specific quantity spent therefore has a magnified effect on output and employment going forward; and investment lost through Brexit would have a likewise magnified effect in lost output and growth. It is hard to put numbers on this since we lack detailed investment data, e.g. for Scotland. But we can make estimates: grossing up the figures for public investment in the same proportion as the UK shows that ***new*** investment runs at around 3.3% of GDP, a little over half the UK rate (6%). On these numbers, Scotland can ill afford further losses in investment from Brexit, whether due to a slowdown or to lost passporting.

Second, an inability to passport your services/goods into the EU could be very damaging to investment spending. For obvious reasons we have no data on how much Scottish investment is made to facilitate passporting. But given that 15.3% of Scottish exports go to the EU (ex-UK), and 63.8% to rUK (about 70% is passported on), the loss of passporting rights directly or via the UK would mean a loss of more than 16% in investment. Scottish government figures are more sanguine (7.7%, or between 6.3% and 9% lost over 12 years), the difference being that the loss of passporting exports through rUK is not included.[4]

Third, and most important, investment is the way productivity growth enters into the economy. In fact, productivity growth is the only source for *permanent* increases in growth and employment (Scotland's working population is static or shrinking). Hence lost investment for Brexit reasons would inflict greater long-run damage to the Scottish economy than the current weak investment performance because the capacity to incorporate new productivity gains would shrink.

6. The link to productivity growth

As an example: Scotland has labour productivity which is 3% lower than the UK. Yet wages are roughly 6% lower. This implies that unit labour costs are 3% lower in Scotland. However, overall production costs per unit are not lower since otherwise the Scottish economy would have grown faster than the rUK. It has not. Growth has been consistently slower by ½%-1% per year than in the rUK. Hence total factor productivity (meaning the way in which the inputs to production are combined) must be lower in Scotland. Scots work harder than their counterparts, but to less effect because cheaper labour has been substituted for capital and productivity increases. In cases such as these, a sensible policy would be to adopt a two-pronged approach: a general drive to increase total factor productivity with improved technology, capital deepening, better work practices; plus policies that shift the industry mix towards the high productivity activities and those with specialised services, skills, and (internal or external) economies of scale. In short, we need more investment in order to exploit trade and Scotland's comparative advantages more; not less as will happen under any Brexit deal.

7. Investing in productivity growth

Digging deeper, Scotland ranks highly on R&D and innovation in the public sector – principally in higher education sector – but does less well in business and industry. In fact business R&D spending runs at half the UK rate. And most of it is done by US, Scottish and EU owned firms: very little by UK based firms, a clear "branch office" problem. In figures, 53% is done by US firms, 25% by Scottish owned firms, 16% by EU firms and only 3% by UK owned firms. At the same time, 8% of firms in Scotland by value added are US owned, 31% are non-UK and 61% are UK owned. Taken together, this means that UK based firms undertake just 5% of the R&D or innovation spending, per unit value added, of non-UK firms. This

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[4] The Scottish government figures for investment lost look more likely to be correct: given annual growth rates 1% slower than in rUK, and an incremental capital-output ratio of 2.5, we should expect an investment loss of 7¼%.

general argument then generalises to the UK as a whole. The simplest strategy, then, would be to find ways to bring high productivity activities to the local economy by investing in productivity growth and by encouraging foreign trade and ownership in order to make UK markets and UK firms more contestable (raising competitive pressures). Again the opposite of what Brexit itself would bring. Instead of which, it appears that (by 2030) 60% of the loss of output/jobs under no deal vs. EU membership would be due to an emerging productivity gap; 26% from the loss of migration, but only 14% from trade barriers and market access issues that have taken up so much of the negotiators' time.

One additional point: a possible Brexit cost, in economic performance rather than scientific prowess, would be a loss of research funding and scope (whether from the EU or internally) where the UK does hold a world-wide comparative advantage.

8. The Costs of a Productivity Slowdown

There is very little work in the existing literature that would allow us to estimate the impact of the loss in productivity growth that one might expect from Brexit. This is because the only estimates that exist (for example from the Treasury, or the Fraser Institute report) measure the impact of productivity losses arbitrarily imposed from the outside, rather than from losses that we would expect to be *induced* (endogenously) by the Brexit process itself; ***and*** because the productivity losses have been imposed on labour productivity when, in view of sections 6 and 7 above, they should have been obtained from the effects on investment and total factor productivity. Nevertheless, imposing an arbitrary 5% loss in prod-uctivity (the Treasury's assumption), leads to a very large negative shock on top of any trade losses. That confirms the general argument in the last two sections.

9. Conclusion: could the UK fit into a replacement single market arrangement?

The reality is that, short of crashing out with no deal at all, the UK will have to accept whatever post-EU arrangements are agreed with the EU Commission. On the face of it, the Swiss option should probably have found most favour in London. This would have distinct advantages if the bilateral market access agreements are made in areas where the UK has comparative advantage: principally financial services, but also in energy services, technical services, biotechnology, digital industries, downstream petroleum and chemical products, precision engineering, pharmaceuticals and medical technology, high quality food, drink and clothing. All this depends on being able to negotiate and agree bilateral deals in the sectors concerned, including crucially passporting and defining watertight limits to what activities and pass-porting can be regarded as being legitimately "within sector". It is not clear if this can or would be done satisfactorily under current arrangements.

A better alternative might be the Continental Partnership format, as proposed in an unofficial French-German-Brussels initiative, in which the UK's Single Market membership (hence free trade, free market access) is preserved as it is. But the free movement of labour is suspended, to be controlled instead by a system of quotas or work permits, in return for limited forms of joint regulation – enough to allow passporting – plus a joint say in common single market policies and a degree of joint decision making in some other areas of the EU. That implies a voice, but not necessarily a vote, on setting EU rules. To make this a reality, there would have to be contributions to the European budget – at a reduced level compared to regular EU members – and the application of European law to certain defined activities. The details of such a scheme need to be worked out. But it is likely to be superior for the UK because it retains access to the Single Market, and the freedom to play to the UK's comparative advantages, while respecting the vote to leave the current EU arrangement as it now is. A work permit system for labour migration could be regulated to direct resources and expertise to where the UK has its comparative advantages. Unfortunately the combination of divided politics and a strangely lackadaisical attitude to a proper analysis of the merits and demerits of the different trading schemes available post-exit have not allowed this to happen or even be considered.

If arrangements of this kind were to be adopted, it would be in the UK's interest to ensure that the labour movement clause is controlled by a work permit scheme rather than a system of overall UK quotas. This way, the UK could retain an ability to boost certain sectors of the economy, rather than go along with whatever comes out of the general EU agreement.

In contrast to all this, staying outside with across-the-board free trade deals with the EU and others on a bilateral basis would have little value since the economy would remain linked to EU markets and the threat of coalition behaviour by EU firms with little investment in productivity or comparative advantage as the UK's only real defence.

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