Quo vadis, Europe?
Economic Perspectives on Brexit

Vertretungsvorlesung „Außenhandelstheorie und -politik“
26. Januar 2017
• UK referendum vote last June poses a challenge for British and EU27 policy-makers

• lecture gives an overview on:
  • reasons that led to the referendum vote
  • alternatives how a Brexit could be organized
  • issues how Brexit will affect the remaining 27 EU states
  • how economists quantitatively evaluate the alternatives
  • the process of negotiations
I. What lead to the Brexit decision?

What were the factors leading to the referendum decision? (1/3)

• *increasing wage inequality* played an important role for the discontent (Dhingra 2016)

• *financial crisis* made things worse:
  • all workers suffered as avg. weekly earnings shrank by 1.8 percent from 2003 to 2014
  • the poorest did the worst: median earnings fell by 2.8 percent
  • mainly due to an increase of *working-age men w/o qualifications* that dropped out of the labor market
What were the factors leading to the referendum decision? (2/3)

- *underinvestments in public services*
  - particularly in *health care*: UK ranks 13th among the 15 original EU members in the percentage of GDP spent on health care
  - *fiscal austerity* post recession implied substantial welfare cuts for people living in poorer regions
- *minimum wage was too low to guaranty financial security:*
  - half of poor children in the country have parents who work but are nevertheless below the poverty line
  - GBP 5.05-5.80 for +22 year old between 2005 and 2009
What were the factors leading to the referendum decision? (3/3)

- **voters seeking revenge:**
  - declining industrial North feeling decoupled from London and the prosperous South and East of England
  - voted as though it were seeking revenge on an elite
I. What lead to the Brexit decision?

Evidence: Becker, Fetzer, Novy 2016

Abstract: [...] We analyze vote and turnout shares across 380 local authority areas in the United Kingdom. We find that fundamental characteristics of the voting population were key drivers of the Vote Leave share, in particular their age and education profiles, the historical importance of manufacturing employment as well as low income and high unemployment. [...] The severity of fiscal cuts, which largely reflect weak fundamentals, were also associated with Vote Leave. [...] Our results cast doubt on the notion that short-term campaigning events had a meaningful influence on the vote.
I. What lead to the Brexit decision?

Map of the Leave share from Becker, Fetzer, Novy 2016:
I. What lead to the Brexit decision?

Map of the share of 16-74 year-olds with no qualifications from Becker, Fetzer, Novy 2016:
I. What lead to the Brexit decision?

Is it fair to blame the EU? The EU as scapegoat for economic hardship (1/2)

EU membership reduced prices, increased real wages, and helped funding British public services (Dhingra 2016)

- lower trade barriers within EU → more competition → lower markups
  - Badinger 2007: markups for manufacturing goods across EU states fell from 38% to 28% between 1981 and 1999
- more varieties to choose from (or easier access to foreign products)
  - compare to the Krugman model we discussed in class
- lower price variation: within-EU price variation of household goods comparable to within-US price variation (Rogers 2007)
- export markets and FDI created job prospects
I. What lead to the Brexit decision?

Is it fair to blame the EU? The EU as scapegoat for economic hardship (2/2)

*Free movement of people was an important political issue*

- **net immigration**: over a third of the 8.5 million immigrants currently in the country hail from elsewhere in the EU
- voter concerns played an important role
- *no empirical evidence that intra-EU immigration harmed British citizens*
  - no effect on unemployment or wages after the Eastern European Enlargement
  - also no evidence that EU immigration exacerbated inequality
  - on the contrary: European immigrants pay more in taxes than they consume in government services (*net contributors*)
  - also no measurable effect of EU immigration on crime or theft
• despite the benefits of remaining within the EU, voters chose to leave it
• government must respect the voters decision

BUT:  
**How could / should Brexit be organized?**

Basically, there are 2 opposing alternatives on the table:
• a „soft“ Brexit
• a „hard“ Brexit
Option A: Soft Brexit (1/4)

- *a deal similar to Norway’s:*
  - UK would *remain a member of the single market* by joining the **European Economic Area** (group of all the EU members and 3 nonmember countries Iceland, Liechtenstein, Norway)
  - but *no participation in EU political institutions*
  - *a rather “deep” trade agreement*
  - *costs of trade would still rise:*
    - UK would face some **nontariff barriers** currently applying to the non-EU members of the EEA: manufacturers have to prove that goods qualified as “made in the UK” (challenging; complex GVCs)
Option A: Soft Brexit (2/4)

- *costs of trade would still rise continued* ...:
  - European Commission *might also impose tariffs* on British exports if it ruled that they were being *sold to the EU below market price*
    - example: Norwegian salmon exporters with financial support from the Norwegian government incurred a 16% tariff rate
  - *UK would lose the ability to influence future reductions in trade barriers*
    - such as those the EU is considering in the service sector
II. Breaking Up: Organizing Brexit

Option A: Soft Brexit (3/4)

Is it easy to get a Norwegian deal for the UK?

- **no because it would require joining the European Free Trade Association**
  - composed of the three non-EU members of the EEA + Switzerland
  - might be unwilling to let the United Kingdom in

- **yes because it would also benefit the EU**
  - might be framed as a temporary measure
  - buys time to think about how to deal with emerging threats to the European project
Option A: Soft Brexit (4/4)

- **political economy game:**
  - if EU is too soft → other countries might want to renegotiate their position within the EU
  - if the EU is too harsh → harder British reintegration process, further alienate anti-EU voters

- **challenges for the Norwegian deal:**
  - British public has to accept the free movement of EU citizens
  - “EEU-minus” option is a no-go from the EU perspective
  - was also impossible for Switzerland (even after the Swiss 2014 referendum)
II. Breaking Up: Organizing Brexit

Option B: Hard Brexit (1/2)

- **UK regains control:**
  - over immigration
  - be free from EU regulations and EU trade policy
- **requires exiting from the single market**
  - no comprehensive free-trade agreement with the rest of Europe
  - tariffs could be raised up to MFN status tariffs
    - example (from Dhingra 2016): city of Sunderland voted for Brexit by a 22 percent margin; home to one of Nissan’s most cost-efficient manufacturing plants
  - about half of British car exports currently go to the EU
  - MFN tariff on cars would be approx. 10%
Option B: Hard Brexit (2/2)

- *leave campaign set out visions of trade deals within the Commonwealth or China or the US*
  - nothing stops the UK from doing that from within the single market (as Germany does)
How will Brexit affect the remaining 27 EU member states?

- *within-EU variation in the costs and benefits of a “soft” versus “hard” Brexit*
- *for decades, Europe was about integration:*
  - following the British referendum, the main issue now is **disintegration**
  - “prevailing view of European integration was the ‘bicycle principle’: you must keep moving forwards; if you stop, you fall off. Cycling backwards is arguably much more difficult.”

- What are the perspectives of a Brexit on:
  - trade, FDI, financial services, labor mobility, EU budget contributions?
How will Brexit affect the remaining 27 EU member states?

Trade is not always the big issue:

- *UK market important for some countries, not so much for others*
- *sometimes “indirect trade” often matters more:*
  - global value chains
  - UK is net importer of industrials and net exporter of services: depends on a country’s position in the GVC
- *conversely, the UK is a relatively small market for the EU27 as a whole, though not for all individual countries*
How will Brexit affect the remaining 27 EU member states? Trade is not always the big issue (Table from VoxEU 2016):

<table>
<thead>
<tr>
<th>Country</th>
<th>Exports to the UK</th>
<th>Exports from the UK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>€ billions</td>
<td>% of exporter’s ODP</td>
</tr>
<tr>
<td>Austria</td>
<td>4.36</td>
<td>1.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>31.74</td>
<td>7.3</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.59</td>
<td>1.7</td>
</tr>
<tr>
<td>Croatia</td>
<td>0.21</td>
<td>0.9</td>
</tr>
<tr>
<td>Cyprus</td>
<td>0.12</td>
<td>4.3</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>7.53</td>
<td>4.5</td>
</tr>
<tr>
<td>Denmark</td>
<td>5.37</td>
<td>3.3</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.33</td>
<td>2.2</td>
</tr>
<tr>
<td>Finland</td>
<td>2.78</td>
<td>1.9</td>
</tr>
<tr>
<td>France</td>
<td>32.13</td>
<td>2.1</td>
</tr>
<tr>
<td>Germany</td>
<td>89.25</td>
<td>3.5</td>
</tr>
<tr>
<td>Greece</td>
<td>1.08</td>
<td>1.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.58</td>
<td>3.7</td>
</tr>
<tr>
<td>Ireland</td>
<td>15.28</td>
<td>14.1</td>
</tr>
<tr>
<td>Italy</td>
<td>21.46</td>
<td>1.6</td>
</tr>
<tr>
<td>Latvia</td>
<td>0.54</td>
<td>2.9</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1.03</td>
<td>3.4</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0.74</td>
<td>10.1</td>
</tr>
<tr>
<td>Malta</td>
<td>0.15</td>
<td>9.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>47.42</td>
<td>7.6</td>
</tr>
<tr>
<td>Poland</td>
<td>12.06</td>
<td>3.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.35</td>
<td>2.7</td>
</tr>
<tr>
<td>Romania</td>
<td>2.38</td>
<td>1.8</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>3.76</td>
<td>5.2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.54</td>
<td>1.5</td>
</tr>
<tr>
<td>Spain</td>
<td>18.72</td>
<td>2.4</td>
</tr>
<tr>
<td>Sweden</td>
<td>9.07</td>
<td>3.2</td>
</tr>
</tbody>
</table>
How will Brexit affect the remaining 27 EU member states? Does FDI matter? Sometimes:

- *tax evasion FDI*
  - Luxembourg, Ireland and the Netherlands receive from and send to the UK considerable amounts of FDI
  - part of that could be driven by intra-European tax optimization
  - maybe not so great for the other EU27 members
- *global value chains:*
  - for some of the largest countries (France, Germany, Spain) FDI from Britain largely exceeds FDI to Britain
  - British firms subcontract production to these countries
  - important objective to support these types of FDI in the future
How will Brexit affect the remaining 27 EU member states? Does FDI matter? Sometimes (Table from VoxEU 2016):

<table>
<thead>
<tr>
<th>Country</th>
<th>Accumulated investment in the UK</th>
<th>Accumulated investment by the UK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>€ billion</td>
<td>% of investor’s GDP</td>
</tr>
<tr>
<td>Austria</td>
<td>2.97</td>
<td>0.87</td>
</tr>
<tr>
<td>Belgium</td>
<td>31.8</td>
<td>7.93</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.01</td>
<td>0.02</td>
</tr>
<tr>
<td>Croatia</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Cyprus</td>
<td>4.61</td>
<td>26.5</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>Denmark</td>
<td>8.37</td>
<td>3.21</td>
</tr>
<tr>
<td>Estonia</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Finland</td>
<td>1.85</td>
<td>0.90</td>
</tr>
<tr>
<td>France</td>
<td>94.3</td>
<td>4.41</td>
</tr>
<tr>
<td>Germany</td>
<td>62.1</td>
<td>2.13</td>
</tr>
<tr>
<td>Greece</td>
<td>0.24</td>
<td>0.14</td>
</tr>
<tr>
<td>Hungary</td>
<td>-0.01</td>
<td>-0.01</td>
</tr>
<tr>
<td>Ireland</td>
<td>17.0</td>
<td>0.82</td>
</tr>
<tr>
<td>Italy</td>
<td>5.51</td>
<td>0.34</td>
</tr>
<tr>
<td>Latvia</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Lithuania</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>97.8</td>
<td>200</td>
</tr>
<tr>
<td>Malta</td>
<td>7.92</td>
<td>9.70</td>
</tr>
<tr>
<td>Netherlands</td>
<td>21.8</td>
<td>32.9</td>
</tr>
<tr>
<td>Poland</td>
<td>0.14</td>
<td>0.03</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.53</td>
<td>0.34</td>
</tr>
<tr>
<td>Romania</td>
<td>0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>Slovakia</td>
<td>0.00</td>
<td>0.01</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.01</td>
<td>0.03</td>
</tr>
<tr>
<td>Spain</td>
<td>56.7</td>
<td>5.44</td>
</tr>
<tr>
<td>Sweden</td>
<td>12.0</td>
<td>2.77</td>
</tr>
</tbody>
</table>
How will Brexit affect the remaining 27 EU member states?

The Role of the Financial Services Sector:

- **passporting rights matter**
  - i.e. the right to operate in all other EU countries
- **economies of scale and agglomeration matter, too**
  - banks started to move jobs towards Frankfurt, Dublin and Paris
  - these places also expect to benefit from an end to passporting rights for the UK
- **heavy within EU competition to attract the financial services sector from London**
How will Brexit affect the remaining 27 EU member states?

Labour Mobility matters:

• some countries are net receivers of EU migrants while others are net issuers
  • immigrants can come from the EU or from the rest of the world
  • the mix is very different from one country to another

• role of the Schengen agreement
  • once immigrants are registered in any EU country, people are more or less free to move to other EU countries (with exceptions and opt-outs from the Schengen agreement)
How will Brexit affect the remaining 27 EU member states?

Contributions to the EU budget:

- countries that are net recipient of EU funds worry about the implications of Brexit
- the UK has been a net contributor
  - its withdrawal will reduce net transfers to a number of countries
  - however: most contributions come from the largest countries
  - these do not even consider payments to the EU to be an important issue
How can economists quantitatively evaluate the alternatives? (1/2)

- idea: compare trade deals according to their deepness
  - EU has the deepest trade deals
  - soft Brexit would come close to such a deep trade deal
  - compare how deep and not-so-deep deals affect UK trade
- World Bank study by Mulabdic et al. 2017:

<table>
<thead>
<tr>
<th></th>
<th>&quot;Norway&quot; scenario</th>
<th>&quot;average PTA&quot; scenario</th>
<th>&quot;no-agreement&quot; scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods</td>
<td>-12%</td>
<td>-38%</td>
<td>-50%</td>
</tr>
<tr>
<td>Services</td>
<td>-16%</td>
<td>-48%</td>
<td>-62%</td>
</tr>
<tr>
<td>Domestic Value Added</td>
<td>-6%</td>
<td>-20%</td>
<td>-28%</td>
</tr>
<tr>
<td>GVC forward linkages</td>
<td>-5%</td>
<td>-18%</td>
<td>-26%</td>
</tr>
<tr>
<td>GVC backward linkages</td>
<td>-7%</td>
<td>-25%</td>
<td>-34%</td>
</tr>
</tbody>
</table>
How can economists quantitatively evaluate the alternatives? (2/2)

- **idea: model UK-EU relationship in terms of 2 channels – trade and fiscal contributions:**
  - include trade in goods and services, finals and intermediate inputs
  - estimate a gravity equation
- study by Dhingra et al. 2016:
  - ‘pessimistic’ scenario and ‘optimistic’ scenario about speed of EU integration in the future
  - percentage changes in UK income per capita:

<table>
<thead>
<tr>
<th></th>
<th>Optimistic</th>
<th>Pessimistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade effects</td>
<td>-1.37%</td>
<td>-2.92%</td>
</tr>
<tr>
<td>Fiscal benefit</td>
<td>0.09%</td>
<td>0.31%</td>
</tr>
<tr>
<td>Total change in income per capita</td>
<td>-1.28%</td>
<td>-2.61%</td>
</tr>
</tbody>
</table>
UK and EU27 negotiations

- highly complex: hundreds of thousands of pieces of legislation
- basically 2 negotiations:
  - divorce proceedings will start when Britain invokes Article 50 (by the end of March 2017); proceedings are required not to exceed two years, unless prolonged by a unanimous decision
  - negotiate aspects of the future relationship between the UK and the EU as a whole
    - EU27 currently does not intend to start the second negotiation before the first one is concluded
  - each EU27 government must first negotiate on a national level; then a consensus on EU level needs to be found
Thank you for your interest and attention!
• Dhingra, S. 2016. Salvaging Brexit. The right way to leave the EU. Foreign Affairs.