Why I Worry About Brexit

L. Alan Winters

Posted to the World Orders Forum: 16 March 2023

L. Alan Winters is Professor of Economics at the University of Sussex. He is Co-Director of the ESRC-funded Centre for Inclusive Trade Policy and Founding Director of the UK Trade Policy Observatory. He is a leading contributor to research and debate on Brexit and the UK's post-Brexit trade policy. He has formerly been Chief Economist at the UK Department for International Development (DFID), and Director of Research of the World Bank.

The brief for this essay was to 'explain what you view as the top three negative impacts Brexit has had on Britain's economic situation.' As a committed European, I felt spoilt for choice – the challenge was 'the top three' bit. As a scientist, on the other hand, I am acutely aware that it is too early to tell what the final outcome of Brexit will be and how difficult it is (and will be) to sort out Brexit effects from other economic shocks. However, some evidence is available and it seems to be getting clearer over time, so here goes. My three are:

- The disruption of international trade with the UK's closest market, the European Union (EU);
- The disruption of the UK science sector.
- The increased uncertainty that has curtailed investment, probably of all types – i.e. in tangible assets (which we can measure easily), in intangible assets (which are more complex to measure) and in what one might call 'other forward-looking activities' which do not figure in investment data at all, but nonetheless erode future economic performance.

In all three I will attempt to sketch the issue and the evidence so far.

International Trade

Despite occasional political claims to the contrary, it is almost universally agreed that Brexit has introduced significant frictions on trade with the EU, a large, rich and culturally similar economy on the British doorstep. The UK and EU economies are deeply interwoven and the EU accounts for approximately half of British trade. Although the EU raised restrictions on UK exports immediately it was able – 1st January 2021 – while the UK only dribbled its own restrictions and enforcement in gradually, the effect appears to have been greater on UK imports than exports. Using the UK's non-EU trade as a comparator colleagues estimate that while UK exports to the EU are broadly where one would expect, UK imports are around 28% lower!

The Trade and Cooperation Agreement (TCA) between the UK and the EU continues the tariff-free trade in goods that existed pre-Brexit, but makes it conditional in ways that were previously absent. The tariff-free concession for UK exports applies only to goods 'originating' in the UK; this excludes goods that contain major shares of inputs from third countries and even inputs from the EU if they have not received 'sufficient' processing in the UK. The situation is the same for EU exports to the UK (UK imports).

The problem is that some goods cannot, by their very nature, reach the necessary thresholds for obtaining 'origin', and that in other cases the costs of proving that they do so exceed the EU's 'regular' non-preferential tariff that applies if they do not. The result is that only 82% of eligible UK exports enter the EU tariff-free, while the figure for UK imports from the EU is 90%.

In addition, as everywhere, goods have to satisfy the importing countries' regulations. That they do so is taken as given for trade between EU members. Now, however, although the UK has barely deviated from EU standards, as a third country, it now has to prove that that is the case to enter the EU. In many cases this is trivial, but in plenty, it is not. (The position on UK imports is much easier – the UK for the most part just accepts that EU goods will meet its standards.)

The border frictions may not have significantly cut UK exports to the EU in aggregate, but they have re-structured it into larger consignments: the number of product-destination pairs traded with EU countries (i.e. counting exports of a product to France as different from an export of the same product to Belgium) has declined by around 30%. This, along with legion anecdotes, suggests that these administrative costs have hit smaller exporters hard, which is likely to render trade less flexible and responsive to economic incentives in future.

The UK also trades services internationally. Indeed, services account for about half of UK exports – a uniquely high share among major economies – and about 30% of imports. There are hints that services trade with the EU is doing slightly less well than with other countries, but this is far from conclusive. Whether such robustness will continue in future is an open question, however, because there is no doubt that the TCA has raised barriers to UK-EU services trade.

Comparing UK trade with EU and with non-EU countries offers a reasonable way of identifying the effects of Brexit, but it is arguably less significant economically than the evolution of UK exports and imports in total. John Springford suggests that by June 2022, UK total trade (exports plus imports) was about 13% lower than one would have expected in goods and about what one would expect in services. This was based on UK performance relative to a group of other countries selected statistically to best represent previous UK economic performance and economic structure.

More recently Sophie Hale and Emily Fry have compared UK performance with the other G7 countries up to the end of 2022. This suggests that UK services exports have performed exceptionally well since the start of the TCA (January 2021) but that goods exports were weak until the last half of 2022 when they jumped significantly. This re-assuring news must be qualified, however. The very recent goods improvement was substantially due to exports of precious metals (gold) to four countries that were rebuilding their foreign exchange reserves (and hence was clearly temporary), and the services strength reflected partly a statistical adjustment in 2022 and a favourable commodity composition effect whereby the UK is particularly strong in the sectors growing particularly fast as the world emerged from the pandemic. Removing gold and the statistical adjustment left the UK performance looking weak in goods and middling in services.

For imports, Hale and Fry find that the UK's import performance in goods was the worst in the G7. For services, however, I interpret their results as suggesting that services imports are pretty much at par (although they have a more pessimistic view).

It is worth reflecting why UK exports of goods to the non-EU world might be lower as a result of Brexit - there were, after all, no new restrictions. But the declines in imports suggest the UK may be dropping out of some European value chains and the decline in investment (see below) could be cutting productive potential. Indeed, the generalised uncertainty behind the investment data could also discourage firms from investing in the business of finding and developing new markets overseas, a real investment activity but not one that appears in the statistics.

Science

Brexit was not about science but Brexiteers and post-referendum governments made encouraging noises about science being at the heart of the UK economy. Why worry that it is not as simple as that? The dust has certainly not settled on post-Brexit science policy and much depends on policies that are currently under discussion. However, I am alarmed, and I should add that I attribute current policy discussions to Brexit because in the absence of Brexit most of them would not be happening.

By common consent, the UK's future as a prosperous economy depends on innovation; we will never support our current incomes on 'routine' tasks. 'Innovation' depends largely on research and development, be it in advanced manufacturing, skilled services or gaming applications. R&D is underpinned by excellent higher education, which, in turn, it requires vibrant viable research organisations and highly skilled people to staff them.

Brexit had direct consequences for the research ecosystem. First, it made immigration from Europe more difficult by eliminating the favourable treatment of EU citizens. They now face the expense and uncertainty of the immigration system, including the loss of assurance that they can remain in the UK unless they are granted permanent residence and then citizenship. UK costs of immigration are high and said to be among the highest in Europe – c.f. France. The new immigration regime has increased non-EU skilled immigration into the UK, and so offers an offset to these losses, but as just observed, it is expensive to penetrate and less certain than EU citizens had previously.

Second, by increasing the fees for EU university students in the UK (universities are no longer obliged not to discriminate between UK and EU citizens), it has halved the flow of potential skills from the EU. Third, and only indirectly due to Brexit, the UK Prime Minister is talking about cutting international student numbers in the UK, apparently totally innocent of the fact that such students substantially cross-subsidise both research and undergraduate provision for Brits. This 'Brexity' talk – favouring ideology over obvious economic harms – is not something one would have expected before 2016.

Finally, while the TCA negotiations agreed that the UK could become an associate member of the massive pan-EU Horizon Europe research programme, the EU put that on hold until the EU-UK dispute over the Northern Ireland Protocol was solved. In discussing recent progress on the latter – the Windsor Framework - the EU said it would take steps to negotiate the final details of admission immediately on the implementation of the Framework. Then, quite out of the blue, the Prime Minister wondered out loud whether that was what he really wanted. The science and higher education communities harboured no such doubts.

Investment

The referendum created great uncertainty about how Brexit would actually be implemented and compounded this with what one might only think of as a breakdown in political debate and normal policy-making procedures in the UK. The former uncertainty was resolved in 2020 with Boris Johnson's 'hard Brexit', which, as I have noted above, made trade with the UK's main market and supplier more difficult. The latter problem persisted, however, with continuing uncertainty over many regulations that the UK had to put in place once outside the EU, Johnson's habit of pursuing headlines rather than careful policy analysis and implementation and the continuing use of Brexit positions as the criterion for political promotion rather than competence. It was not surprising that enthusiasm for long-run investment in Britain declined.

No-one disputes that Business Investment in the UK flat-lined after the referendum, dipped substantially during the pandemic and has barely recovered to pre-pandemic levels by now – see here for example. This is in contrast to rising levels of investment, albeit with a marked business cycle, in previous decades and in contrast to experience in other major economies. To most economists, this constitutes evidence that Brexit has hit investment – see, most recently, comments by Jonathan Haskell (Twitter feed, 13th February; @haskelecon). It has been challenged by Graham Gudgin, however, who argues that Haskell's counterfactual is too optimistic – i.e. that flatlining was a 'rather better performance than might have been expected'.

This debate makes explicit an important methodological point: any *ex post* assessment of the effects of a policy depend wholly on the counterfactual: we know what happened with the policy but the challenge is to work out what would have happened without it. This is unknown and must be constructed on the basis of assumption. Counterfactuals cannot be proven, only argued. (This is true of the discussions above, only I did not make it quite so clear.)

Investment is extremely volatile and difficult to model, and I do not think we can yet reach an unambiguous conclusion on the counterfactual. However, while Gudgin makes valid points, I suspect he has overdone the weakness of the British economy in the absence of Brexit. He treats the huge dip in investment after the financial crisis as 'normal' because he factors it into what he uses as a 'normal' growth rate for investment; he also does not confront the fact that flatlining for six years is unusual behaviour, especially when the world economy is ticking along reasonably well, as it did over 2016-19.

Thus, while we do not have a good quantitative estimate, I think it is pretty clear that business investment has suffered since the referendum. In addition, I observe weak business confidence, the fact that some of the Brexit frictions are not yet fully implemented (e.g. the UK's own conformity assessment system and the registration system for chemicals), policy drift and some continuing perverse policy-making, such as the threat to abandon the entire regulatory structure inherited from the EU with not even enough time to review it. Thus overall, I fear that Brexit will turn out to have had a significant depressing effect on UK business investment, which is very bad news for an economy that traditionally invests less than most and is seeking to increase its growth rate.

To conclude, Brexit has posed many challenges to the British economy. The government, determined to prove that Brexit was a fine thing, has failed to engage with them. It is too early to tell where it will all come out, but the signs are far from encouraging.