Llywodraeth Cymru
Welsh Government

# Economic analysis of UK government's proposals for EU exit

Securing Wales' Future

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## Purpose and context

This short paper briefly reviews the results of the economic analysis that the UK Government has recently provided on the economic consequences of its preferred longer term arrangements for trade once the UK has left the European Union[1].

The UK Government's conclusions are compared with those of analysts at two respected research organisations, the National Institute for Economic and Social Research (NIESR)[2] and the Centre for Economic Policy (CEP) at the London School of Economics (and others)[3].

The paper also includes a brief summary of some key conclusions about possible shorter run effects of a "no deal" scenario as set out by the Office for Budget Responsibility (OBR)[4] and the Bank of England[5].

The longer run analysis assumes that any short run effects from a disorderly Brexit, even if severe, will be only temporary in nature and are therefore do not influence the results after 10-15 years. This may be optimistic in the worst case scenario.

The general approach adopted in the analysis that is reviewed here is one of assessing *what difference* new trade arrangements with the EU would be likely to make to economic outcomes, not one of forecasting what the outcomes facing the UK will actually be. Such a forecast would have to take account of wide range of other factors influencing the economy over the long term[6].

Even on this basis, assessing the economic effects of leaving the EU represents a major challenge.

There is a strong consensus amongst economists about the key principles, particularly:

- barriers to trade impose economic costs;
- distance itself is a barrier, and trade is generally more intensive with partners who are proximate both geographically and in terms of their stage of economic development;

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[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/759762/28_November_EU_Exit_-_Long-term_economic_analysis.pdf

[2] http://https//www.niesr.ac.uk/sites/default/files/publications/NIESR%20Report%20Brexit%20-%202018-11-26.pdf

[3] http://ukandeu.ac.uk/wp-content/uploads/2018/11/The-economic-consequences-of-Brexit.pdf

[4] https://obr.uk/docs/dlm_uploads/BrexitDiscussionWebVersion.pdf

[5] https://www.bankofengland.co.uk/-/media/boe/files/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability.pdf?la=en&hash=B5F6EDCDF90DCC10286FC0BC599D94CAB8735DFB

[6] The track record of such forecasts, sometimes termed "unconditional forecasts" is poor, reflecting inevitable uncertainty about the future. Making an evidence-based assessment of what difference a particular change might make, sometimes termed a "conditional forecast", remains challenging but is a fundamentally more feasible proposition.

- non-tariff barriers (including regulations, checks and even congestion) are in many cases at least as important as tariffs, and often more so.

However, assessing the extent to which additional barriers will arise under new trading arrangements, and still more quantifying their impact, is extremely difficult - not least because there is no precedent of a major economy leaving a large trading block.

A variety of techniques have been employed by analysts to assess and quantify such effects. These include formal modelling of different kinds and the synthesis of evidence from a range of empirical studies.

In view of the inevitable limitations of this kind of analysis, it is very important to recognise that quantified estimates of impact should be taken "in the round" as indicative of the potential scale of magnitude, and not seen as precise estimates.

It is beyond the scope of this short paper to review and assess the various methodological approaches and assessments of specific trade barriers that have been adopted within the analysis. However, the approaches and assessments adopted by the UK Government on these matters are broadly similar to those of the independent analysts included here and appear to reflect sound practice.

Importantly, the results of the UK Government's assessment of effects are also broadly in line with the independent analysis, with one important exception noted below.

**Longer term effects**

The tables below summarise key results from the UK Government's analysis of the longer run[7] economic impact of its preferred arrangements for trade with the EU (the "White paper" option) alongside its results for alternative options. The terminology adopted for the final option differs from that adopted by the UK Government for reasons set out below.

The UK Government has not analysed the combination of EEA membership, which effectively gives full access to EU single market, with participation in a customs union (so-called "Norway plus").

The table also include results from analysis of the preferred arrangements and the "no deal" alternative from the NIESR and the CEP.

The results are expressed relative to GDP. Given the broad-brush nature of the estimates these figures can also be taken as broadly indicative of the impact on people's incomes (and, approximately, on tax revenues).

The scenarios shown represent in turn:

[7] The UK government analysis provides showing expected effects after 15 years.

- A no deal scenario based on an assessment of average non-tariff barriers (NTBs) between countries trading on non-preferential World Trade Organization (WTO) terms and applying EU applied Most Favoured Nation (MFN) tariffs.
- A hypothetical Free Trade Agreement (FTA), with zero tariffs, reflecting average FTA non-tariff costs such as being outside the Customs Union and standard customs arrangements with the EU, regulatory barriers and other costs.
- An EEA-type scenario, which reflects being outside of the Customs Union and as such primarily reflects the costs of standard customs arrangements with the EU.
- The policy position set out by the UK Government in the July 2018 White Paper.
- "Realistic White Paper" – see below.

**Table1: GDP (% change)**

| | No deal /WTO | FTA-type | EEA-type* | White paper | "Realistic" White paper |
|---|---|---|---|---|---|
| UK Govt. | -9.3 | -6.7 | -1.4 | -2.5 | -3.9 |
| CEP** | -4.0 to -10.0 | n/a | n/a | n/a | -2.7 to -7.9 |
| NIESR*** | -5.5 | n/a | n/a | n/a | -3.9 |

**Table 2: GDP per head (% change)**

| | No deal/ WTO | FTA-type | EEA-type* | White Paper | "Realistic" White Paper |
|---|---|---|---|---|---|
| UK Govt. | -8.1 | -5.4 | -1.4 | -1.2 | -2.7 |
| CEP** | -3.5 to -8.7 | n/a | n/a | n/a | -1.9 to -5.5 |
| NIESR*** | -3.7 | n/a | n/a | n/a | -3.0 |

*assumes no change to migration
**lower figure excludes impact on productivity. CEP figure for GDP is estimated from reported results for GDP per head.
***NIESR also consider "Withdrawal deal plus Backstop": GDP -2.8%, GDP per head – 1.9%.

The tables show the forecast combined long run (10-15 year) effects of changes from both (reduced) trade and, except in the case of the EEA scenario, (reduced) migration.

The UK Government has also presented results for trade effects alone, assuming no change in migration policy. Unsurprisingly, these results show smaller reductions in total GDP, although the impact of the change on GDP per head is quite modest. These results are not shown here as they do not reflect the policy of the current UK Government and represent a seemingly unllikely combination of policy choices.

It is beyond the scope of this paper to review in detail all the assumptions made within the analysis on the nature and scale of new NTBs under each option.

However, comparison with the work of the NIESR and the CEP indicates that the "White Paper" scenario is clearly optimistic and arguably unrealistic as it assumes minimal additional NTBs between UK and the EU for goods and quite limited NTBs for services. The NIESR and the CEP have assessed that in practice the scenario would result in more significant increase in NTBs.

The UK Government has also modelled an option termed "White Paper plus 50% NTBs" as a sensitivity. This sensitivity reflects 50 per cent of the difference in NTBs between the White Paper scenario and the average FTA scenario. While obviously somewhat arbitrary this scenario appears more realistic and much closer in approach to the work of the NIESR and the CEP. It is therefore here termed the "Realistic" White Paper scenario.

The central estimates of the negative economic impact of this latter scenario compared to remaining in the EU are broadly consistent with the analysis undertaken by NIESR and CEP. In particular, the reduction in GDP per capita is 2.7%, similar to the NIESR and within the range estimated by the CEP[8].

The more realistic White Paper scenario is inferior to an EEA-type arrangement and would of course be still more inferior to EEA plus participation in a customs union – so-called "Norway plus" - which as noted above is not modelled.

Indeed, the low level of NTBs within the UK Governments' preferred White Paper scenario means that its performance approaches what would be expected from EEA membership plus participation in a customs union, hence its' relatively good performance is what would be expected.

Under all scenarios there is a negative long run economic effect. This means that GDP will be lower than it would have been had the UK stayed in the EU – it is neither a prediction about the actual level of GDP nor a prediction that GDP will fall.

The scale of the negative effects is broadly proportionate to the degree of additional friction being introduced into trade with the EU. This is entirely consistent with what would be expected from the general, and largely uncontested, economic principles set out above.

The analysis also shows that economic benefits from new FTAs made possible under the White Paper or under "No Deal" would be minimal compared to the losses associated with leaving the EU[9]. Again, this is unsurprising given the economic

[8] The lower figure from CEP includes no productivity effects and the higher figure a wider, but less certain, range of productivity effects than either NIESR or the UK Government.
[9] Some previous work which has examined the beneficial effects of new trade deals for the EU as a whole has indicated larger positive effects. However, the results are not comparable because they were intended to show the maximum potential benefit, assuming all NTBs were eliminated (which is

principles set out above as many new FTAs are with countries that are not geographically proximal to the UK.

The country and regional analysis undertake by the UK Government indicates that the negative economic impact on Wales under the more realistic White Paper scenario could be a little less than on the UK as a whole. This results from the nature of the NTBs assumed in this scenario, which are greater for services than for goods. However, the difference in the level of impact on Wales and the UK are minor and, given the uncertainties of the modelling, should be given little credence.

Previous independent studies which have looked at the country and regional effects within the UK have found differing results depending in part on whether additional NTBs are assessed to impact more severely on goods or services.

In general, however, the close integration of the economy in Wales with the wider UK, and past experience, suggests that, over the longer run, negative effects are likely to be of broadly similar orders of magnitude[10].

**Short to medium term effects**

Both the OBR and the Bank of England have considered potential short to medium term effects. Here the range of potential scenarios is very wide, as the trajectory taken by the economy could reflect both extreme reactions by consumers and businesses to unpredictable political events and the nature and extent of any mitigation undertaken by the UK Government[11].

In respect of assessing the impact of such short term effects of a disorderly exit the OBR stressed the lack of any relevant precedent while explicitly noting that the 'Three-Day Week' introduced in early 1974 was associated with a fall in output of a little under 3 per cent that quarter, so it may be reasonable to expect very large short to medium term negative effects from "no deal".

The Bank of England has also considered a range of short term scenarios. The most negative ones, which it considers unlikely "worst case" scenarios, are termed "disruptive" and "disorderly". GDP is between 7 ¾ per cent and 10 per cent lower than in May 2016 by end 2023. This is a more severe contraction than experienced in the recession that started in 2008.

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probably unrealistic). In addition, the EU is a much larger market than is the UK, so the scope to exploit some of the gains from trade is also greater.

[10] This is of course not to say that all sectors or businesses in Wales will be affected in a similar way, particularly over the short to medium term. The Welsh Government has published research examining the potential impact on business in Wales: https://gov.wales/docs/det/publications/180202-eu-transition-and-economic-prospects-for-large-and-medium-sized-firms-in-wales-en.pdf

[11] The required scale of any mitigation could be very large. For example, in Wales alone, new bank lending to SMEs approaches £1billion a year.

On the other hand, under a “close” economic partnership between the UK and EU (including comprehensive arrangements for free trade in goods and some trade in in business and financial services) by end 2023 GDP could be 1 ¾ per cent higher than forecast in the November 2018 Inflation Report (though still lower than expected in March 2016, before the referendum).

A “less close” partnership (with customs checks and greater barriers to trade) could result in GDP being ¾ per cent lower than forecast.

Again, there is no particular reason to suppose that such effects would be higher or lower in Wales than the UK as whole, though of course a differential response is entirely possible if particular sectors or business are affected in a different way.