Brexit: A Cliff Edge or a Small Bump in the Road?

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Abstract

It is becoming increasingly accepted, not least by the Prime Minister and opposition leadership, that the negotiation of a comprehensive trade relationship with the EU is necessary to prevent the UK economy falling off a 'cliff edge'. This concern is shaping the UK's strategy towards negotiations with the EU and has provided at least part of the motivation for the UK to consider requesting a transition period to facilitate the Brexit process. But how accurate are these fears? What evidence is there for the existence of a 'cliff edge'? How disastrous would it be for the UK to revert to trading with the EU on the same basis as most other countries in the world, namely according to World Trade Organisation rules? This paper seeks to address these issues and it highlights a number of implications for policy makers which flow from understanding the available evidence a little more clearly.

Brexit - A Cliff Edge?

One of the widely accepted features of recent debate surrounding Brexit has been the suggestion that the agreement of a deep trade agreement with the European Union (EU) is necessary to prevent the UK economy from "an economic disaster" and falling off a 'cliff edge'.[i] The suggestion is that diminution of access to EU markets would impose a substantial cost upon the UK economy and therefore it is necessary to prioritise continued market access over other policy goals that could be achieved through Brexit. This is a proposition shared, to a greater or lesser extent, by leaders of all the main political parties and the CBI.[ii] Given the contentious nature of the European debate, this indicates an unusual degree of consensus amongst the political and business elite.

There are a number of consequences which flow from acceptance of the 'cliff edge' scenario. The first is the increased willingness of UK negotiators to make greater concessions in the ongoing negotiations with the EU. The second is the shift in government policy towards requesting an interim transition agreement with the EU in order to extend the period of negotiations beyond their initial two year deadline.

This emerging stance appears to be broadly welcomed by employer organisations, given their expressed concerns over the loss of preferential access to EU markets for UK goods and services. It would also shift government policy closer towards the 'Remainer' majority opinion within the UK parliament, which is perhaps inevitable given the government's lack of a parliamentary majority. It additionally helps to bridge the difference between the EU and UK negotiators over the financial settlement (often described as the 'divorce agreement'), due to the consequences of the UK remaining a net contributor to the EU budget for an additional two years, without the UK seeming to capitulate to EU demands on this point.

This approach is not, however, without profound consequences. The most obvious *quid pro quo* of a transitional agreement is the UK having to accept similar rules and regulations to those currently required by full membership. The most contentious aspect of this is the likely insistence from the EU that continued access to the single market requires the perpetuation of the free movement of capital and labour for the duration of this transition term. This would be a particular problem for the Prime Minister, given her previous statements in favour of a tighter immigration system.

A transition period also delays the ability for the UK to re-set regulations according to national rather than European priorities, and defers the ratification (or possibly even the negotiation) of new trade agreements with other nations. Moreover, whilst it is possible that a transitional agreement will reduce immediate uncertainty regarding the UK's new trade relationships with other countries, the fact that it prolongs this whole process may actually have the opposite effect. Finally, acceptance of a lengthy transition period has the potential to further undermine the status of politics and politicians for those who voted to withdraw from the EU given that, more than half a decade after what had been portrayed as a decisive vote, there would have been little substantive change on the ground.

Given the pivotal nature of the 'cliff edge' hypothesis, it is perhaps surprising that so little attention has been given to evaluating whether the failure to reach a close and deep trade agreement with the EU would in fact be economically disastrous. Or, to use the type of colloquial language that is often used to discuss such matters, whether 'no deal' would represent a "chaotic Brexit"[iii], or whether it would simply represent only a slight disruption of normal economic activity. Essentially, would it represent a 'cliff edge' or more of 'a slight bump in the road'. This paper seeks to briefly evaluate the available evidence in order to assess the likely implications.

Economic Models and their Predictions

It is often claimed that there is a broad consensus amongst economists that Brexit would prove damaging to the UK economy. Yet, out of the forty or so economic studies which have sought to predict likely economic impacts relating to Brexit, fully one third suggest either a net gain to the UK economy or that the cost-benefit is dependent upon the form of relationship ultimately agreed between the UK and the EU.[iv] Thus, whilst a majority of economic studies have forecast a net cost associated with Brexit, it is not accurate to describe this as unanimity.

There is a consensus, of a sort, between the five most cited studies, from organisations such as the LSE, Treasury, OECD, IMF and NIESR – a fact that provoked a particularly memorable intervention by Michael Gove during the referendum campaign, concerning the accuracy of predictions made by these 'experts'. These studies predicted that Brexit was likely to have a negative impact upon the UK economy, and that, in addition, the magnitude of this negative impact was likely to be larger the looser any future trade relationship with the EU. The significance of these studies was magnified by the fact that their calculations were subsequently used as the basis for later reports produced by the CBI, the TUC and the Office for Budgetary Responsibility (OBR), rather than their producing their own independent analysis.

There are, however, two significant problems with their conclusions. The first is a little esoteric in that it stems from the particular type of simplifying assumptions that these five studies used as the basis for their calculations. All economic models of this type are based upon a range of assumptions concerning how the economy is supposed to work and how people and organisations are likely to react to different stimuli. Otherwise, the mathematics becomes frighteningly complex. However, to the extent that these assumptions fail to reflect the real world, then these models contain inbuilt inaccuracies within their very DNA. Without wishing to dwell upon the differences in emphasis between the different schools of thought within economics, it is the case that all five of these studies were based upon a similar (New Keynesian-New Monetarist) mainstream approach whose approximation to the real world is questionable. As a result, they tend to over-emphasise such factors as the importance of migration as a driver of growth, and downplay other factors such as the ability of economic policy intervention to influence expectations and hence the real economy.

The second problem with these studies concerns not only what they contain but what they omit. In economics terminology, the models suffer from missing variable bias which significantly skewed their findings. If an economist started with a blank sheet of paper, and sought to include as many variables as might be reasonably expected to be impacted by Brexit, they might come up with a list including both factors likely to be negatively impacted (i.e. trade with the EU, inward FDI from the EU, the quantity of net migration and the level of uncertainty arising from Brexit), and those likely to have a positive impact (i.e. greater potential for increasing trade with the rest of the world, inward FDI from outside Europe, Outward FDI, quality or productivity effects from targeted migration, the cost of regulation, exchange rate changes leading to greater competitiveness and government policy actions). Perhaps surprisingly, the five mainstream studies focused almost exclusively upon the variables from the first list and excluded most of those from the second. Not surprisingly, therefore, their predictions over-estimated likely costs and under-estimated likely benefits.

To try and place this into context, one more recent study, based upon post Keynesian assumptions as to how the economy actually works, predicted the likely economic impact of Brexit to be a net cost of around 1.5% of UK GDP.[1] If potential future benefits to be gained from new trade agreements and/or new regulatory or migration policies were included in a model of this type, the result would presumably either predict a rather modest medium term loss or slight gain depending upon whether these factors deliver significant or only marginal benefits.

[1] Gudgin, G., Coutts, K. and Gibson, N. (2017), The Macro-economic Impact of Brexit: Using the CBR Macroeconomic model of the UK economy (UKMOD), *Centre for Business Research Working Paper* No. 483. Available via: http://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp483revised.pdf.

The flaws in these models would not matter so much if commentators understood to treat their findings more circumspectly, since all were only a best estimate made of what was likely to happen if nothing changed. Similarly, it would matter less if studies undertaken more than a year ago had been superseded by more recent and more measured studies. However, to date, this has not been the case. Therefore, the best available economic predictions were developed according to a flawed approach, before the European referendum, and yet their conclusions are still influencing much that happens in the Brexit debate. It makes it more difficult for policy makers seeking to design appropriate reactions to manage the Brexit process, and for companies seeking to decide when or where to make investments. Indeed, the danger is that forecasts can themselves become self-fulfilling prophesies, as individual businesspeople or consumers react to predicted events and by their changed actions precipitate these same predicted outcomes.

Future Trade Options

There are a wide variety of potential future trading relationships that could be forged between the UK and the EU. Each has its own advantages and drawbacks. Whilst any eventual agreement is almost bound to be a bespoke arrangement, there are a number of existing models or options which inform the choices available to policy makers in seeking to forge this future relationship. These are, in essence:

i. Full membership of the EU – the current status quo, which could only be pursued by either ignoring the European referendum result or holding a second referendum and hoping this result would overturn the previous decision. This course of action has been advocated by the Liberal Democrats and former Prime Minister Tony Blair.

ii. Apply for membership of the European Free Trade Agreement (EFTA) and through this membership of the European Economic Area (EEA). This would maintain UK access to the EU single market whilst allowing the UK to forge trade agreements elsewhere in the world, but at the cost of continued compliance with EU rules and regulations (without the ability to influence these rules), acceptance of the freedom of movement, having to introduce rule of origin mechanisms and a requirement to make continuing budgetary contributions to the EU. This is often termed the Norway model.

iii. Negotiate a customs union with the EU. This effectively takes the UK back to EU membership conditions before the advent of the single market in 1993. This option would ensure free trade in goods without customs costs, but at the cost of having to accept the EU’s common external tariff and hence the UK could not negotiate its own trade deals with the rest of the world. There would likely be some budgetary contribution required for market access, but there would be no requirement to accept the free movement of capital and labour, and it is unlikely that this option would include other aspects of EU membership, such as membership of the common agricultural and fisheries policies that have proved so damaging to the UK. Turkey currently has a customs union agreement of this type with the EU.

iv. Negotiate a free trade agreement (FTA) with the EU, in the same way as Canada, South Korea or Switzerland, albeit that the latter chose to do so through multiple bilateral agreements rather than one comprehensive FTA. The areas covered by the agreement would enjoy free (tariff free) trade in goods and *some* services, and the UK would be free to make its own trade agreements with the rest of the world, at the cost of accepting rules of origin regulations. There would be no budgetary contribution to the EU and no requirement to accept EU rules and regulations, albeit that exporters would have to follow equivalent standards if they wished their goods to be accepted into a foreign market, in the same way as currently is the case exporting elsewhere across the globe.

v. Failure to negotiate a mutually satisfactory agreement with the EU would lead to the UK trading according to World Trade Organisation (WTO) rules. This would involve tariffs being levied upon much UK-EU trade, although the magnitude of these would be limited by most favoured nation rules. As with the FTA option, there would be no restrictions upon forging trade deals, no budgetary cost and no requirement to accept EU rules and regulations, albeit that rules of origin would need to be specified and exporters comply with equivalent standards pertaining within their target market(s).

A brief review of these options highlights the fact that there is a policy trade-off between market access and policy flexibility when considering the various trading arrangements that could be negotiated between the UK and the EU. Whilst EEA and customs union arrangements would promote closer trade ties to the EU, they would equally have the effect of reducing the freedom of manoeuvre that would otherwise be associated with FTA or WTO forms of Brexit. It is a pity that none of the economic studies undertaken to date have sought to rigorously test the relative merits of this trade-off to determine which of these choices would be preferable. Instead, by focusing more narrowly upon questions of trade and how Brexit will impact upon existing economic relations with the EU, the mainstream studies concluded that the closer and deeper the trade relationship with the EU the lower the net economic costs arising from Brexit. The WTO or 'no deal' option, by contrast, was predicted to have the highest net costs.

One of the justifications behind preferential trade agreements is to reduce the costs of trade and thereby facilitate further trade expansion. Hence, it is not surprising that a study focused almost entirely upon how existing patterns of trade will change, should tariffs be re-imposed, is likely to predict net economic costs. However, that is to only consider half of the balance sheet. The other has to reflect any potential gains that may arise from such a change in trading patterns. Moreover, given that approximately 60% of current UK exports (and around half total trade) occurs outside of the EU, and that most of this takes place under WTO rules, it is important, when making a judgement on the preference for different trade options with the EU, in briefly reprising how this trade occurs.

The WTO Option

WTO rules prevent trade discrimination such that the access provided by one country (or group of countries, such as the EU) to another 'most favoured nation', has to be available to all other WTO members. In practice, this means that tariffs imposed on UK goods cannot be any higher than those imposed on other trading nations. The exception to this is if a nation has negotiated a preferential trade agreement, such as a customs union or free trade agreement (FTA), with the EU. Accordingly, should the UK revert to trading with the EU according to the WTO scenario, then the level of tariffs likely to be faced by UK exporters are reasonably well known in advance. These range from high levels averaging around 22.3% for agricultural goods to around 2% for non-agricultural goods.[2]

Given that a significant minority of goods are traded tariff-free, the trade-weighted tariff facing UK exporters is likely to only add between 2-3% to their cost base *on average*, which is a sum easily absorbed by UK exporters as it lies within the monthly fluctuations of a floating currency. However, since the tariff cost would fall disproportionately upon certain industries, such as car production, chemicals, tobacco, clothing, together with food and beverages, which might face tariffs of around 4-8%, it might be advisable for the UK government to seek to use a proportion of budgetary savings arising from Brexit to compensate producers in these sectors. This might occur through a combination of research grants and training subsidies, aiming at enhancing the productivity of these industries whilst simultaneously compensating them for the rise in costs caused by tariffs. Early formulation of this type of industrial policy assistance would prove helpful in mitigating uncertainty faced by producers in these sectors and unlock otherwise deferred investment decisions.

The imposition of tariffs upon UK export goods is the most significant disadvantage arising out of trading according to WTO rules. However, there are also non-tariff barriers (NTBs), such as health and technical barriers on the one hand, which impose legal restrictions upon certain characteristics of goods

[2] World Bank (2015), *MFN (Most Favourite Nation) tariff rate 1988 - 2014*. Available via: http://data.worldbank.org/indicator/TM.TAX.MRCH.WM.AR.ZS?locations=EU; World Data Bank (2016), Tariff rate series. World Development Indicators.

or services, to administrative regulations which impose a delay or other costs upon trade, thereby reducing the volume traded. NTBs are likely to impose a higher cost upon exporters than formal tariff forms of protectionism, albeit that their significance has been recorded as reducing across the globe over time. It is therefore probable that the combined effect of tariff and NTBs is likely to have a much smaller impact upon the competitiveness of UK exporters than the boost provided by the post-referendum devaluation of sterling.

It is also the case that, in all circumstances other than full participation in the single market (through joining the EEA), UK exporters are likely to experience some degree of NTBs in their dealings with the EU. These are likely to be less intrusive if the UK negotiates a customs union agreement or comprehensive FTA with the EU, but because regulations and standards would not need to be identical but only *equivalent* under other forms of trading scheme, there would be scope for bureaucratic delays to occur. Hence, whilst the WTO option may experience more NTBs than under other preferential trade arrangements with the EU, it would be unlikely that it would be the only scenario where these would occur.

Trading according to WTO rules does not only incur costs, however, but it has a number of advantages in relation to other potential trade options. For example, compared to EEA membership, where the UK would have to abide by current EU rules on the free movement of labour and regulations across all trade-related matters, the UK would have none of these restrictions under the WTO option. Similarly, whereas the UK would be constrained to accept the common external tariff within a customs union arrangement, under a FTA or WTO arrangements the UK would be free to negotiate its own trade agreements with any other country across the globe as it would wish. In addition, whilst the UK is likely to have to make financial contributions to the EU as part of the EEA or customs union options, this would not apply to any FTA or WTO alternatives. Thus, the WTO option maximises the policy flexibility that could be utilised by UK policy makers following the completion of Brexit, but at the cost of incurring additional trade-related costs. The final judgement concerning the advisability of this scenario depends upon a careful consideration of *both costs and benefits* of this approach, rather than simply the former.

Implications for Policy Formation

There are a number of implications that arise for policy makers from the brief argument presented in this paper.

The first is that the UK government need to make an informed judgement concerning the relative merits of continued access to EU markets against the potential for future gains arising from having greater policy flexibility. In essence, they must consider the short term gains arising from safeguarding existing economic activity in relation to trade with the EU against longer term potential benefits. The latter include the ability to negotiate other trade agreements across the globe, modify regulations to better suit the UK economy, design a new migration system better fitting national labour requirements and pursuing a series of measures intended to raise the efficiency and competitiveness of UK producers.

In the absence of a series of economic studies which use different methodological approaches to attempt to quantify these factors in a cost-benefit analysis, such judgement will inevitably be subjective. Nevertheless, it hinges upon the weight given to the ability for Brexit to facilitate a different form of economic policy being introduced in the UK, and the degree to which such reforms and interventions are credited with the potential to make a significant difference to UK productivity and performance. Those who adopt an essentially new classical, efficient market perspective, will be more sceptical that such policy flexibility can deliver significant future benefits. By contrast, those adopting a more Keynesian economic viewpoint, will be considerably more confident that a more active policy framework, if intelligently formulated, can have a favourable medium term impact.

A second implication, arising from this paper, concerns the need to accelerate planning for a post-Brexit future. There is certainly a rational case for a mutually advantageous agreement, to be forged between the EU and the UK, around free trade in goods and some services. However, despite significant concessions thus far being made by the UK negotiating team, in terms of financial payments (the 'Brexit bill') and the suggestion of applying for a transition agreement at the end of the Article 50 process, the outcome of these negotiations remains highly uncertain. Indeed, Former Greek Finance Minister Yanis Varoufakis, who recently experienced a series of negotiations with the EU, has argued that the process was designed to fail and, moreover, it would be the "greatest nightmare" for the EU bureaucracy if negotiations with the UK reached a mutually advantageous resolution.[v]

Irrespective of whether Varoufakis proves to be correct or not, the point remains that the UK needs to make more rapid progress in developing a credible alternative ('plan B') in case the negotiations break down or that any final resolution proves to be undesirable to the individual member states all of whom will need to ratify the agreement for it to take effect. Moreover, successful negotiators need to convince their counterparts that there will be consequences if agreement is not reached. This does not have to be delivered in terms of a threat, but it does have to be perceived by the other parties as credible.

This requires two elements: firstly, for the UK to accelerate its preparations for a post-Brexit future, and secondly, to agree a preferable fall-back position should the favoured future trading option with the EU prove to be difficult or impossible to negotiate.

In terms of the former, this requires faster progress in finalising new customs arrangements to manage trade between the UK and the EU which potentially may occur outside of current customs union arrangement. This would involve using the existing Customs Handling of Import and Export Freight (CHIEF) system that currently manages UK trade with the rest of the world. The quantity of checks and interventions would inevitably increase and would require the construction of new facilities to accommodate this additional work, in addition to the recruitment and training of new customs officials. The system would potentially have to include provision for the introduction of a requirement for traders to identify the place of origin of the proportion of their exported good or service (by value), in order to prevent import-exporters unfairly circumventing tariff barriers.

Business regulation is another area where Brexit may deliver potential benefits for the UK economy, as rules are better tailored to national rather than EU circumstances. This is likely to be a medium term project, with regulatory changes introduced over time. Nevertheless, there should be a more rapid introduction of certain regulatory changes, such as exempting smaller firms who do not engage with exporting activity from at least a proportion of former EU-designed regulations.

Similarly, if government intends to use Brexit to introduce a more selective migration system, then this needs to be developed more rapidly, so that businesses can be consulted in advance of implementation to avoid unintended disruption.

There is a need to agree a comprehensive agricultural and fisheries policy for the UK, consistent with high levels of environmental protection but providing a level of support to producers required to maintain food security and the maintenance of the countryside. Access to national waters needs to be negotiated with other interested parties under the jurisdiction of the UN Convention on the Law of the Sea and measures taken to rebuild UK fishing stocks should this result in a significant increase in the UK's share of the total allowable catch from UK territorial waters.

Finally, in order to ensure that Brexit provides opportunities as well as costs for the UK business community, a comprehensive and more active form of industrial policy is required. This should aim to rejuvenate UK infrastructure, support research and innovation, to increase the skill levels amongst the workforce and to support investment in specific sectors deemed to have the greatest potential for future expansion. The government have made a number of tentative steps in this direction, but their measures remain woefully insufficient at present.

In addition to post-Brexit planning, the UK needs to develop a 'plan B' scenario that secures general agreement across the UK, such that any failure to agree a future mutually beneficial relationship with the EU in full and on schedule does not lead to significant problems. Varoufakis suggests that one option would be for the UK to circumvent the negotiation period by immediately applying for membership of the EEA. This would maintain market access in the short term but would delay the adjustment of the UK economy to a post-Brexit future. It would, however, necessitate the continued acceptance of current EU rules and regulations, including the free movement of capital and labour, and it would limit future policy flexibility to restructure the UK economy in a different and potentially more effective way. It would, however, make it easier for any future administration to seek to reverse the Brexit process.

An alternative form of 'plan B' would be to revert to the fall-back position as originally articulated by the Prime Minister in January 2017, namely that "no deal for Britain is better than a bad deal for Britain"[vi]. In essence, if it proved to be too difficult to reach the type of comprehensive FTA with the EU that includes key services in addition to tariff free trade in goods, then the UK would prefer to trade according to WTO rules than be subject to a one-sided trade relationship with its near neighbours.

This could form part of the negotiating position for the UK team. To be effective it would have to be believable, and hence accelerating the post-Brexit preparations are an essential feature of this approach. However, given how prone political discussions are to inauspicious leaks, the stated preference that the UK would prefer to revert to trading with the EU via WTO rules rather than accept an unbalanced and unfair trade deal with the EU must be reflected in reality. An empty threat is little use if a negotiators bluff is called. Hence the importance of understanding what the economic evidence does and does not tell us about the likely implications of following the WTO option. Nevertheless, consideration of trading according to WTO rules is a more viable alternative than to be used simply as a bargaining ploy.

The argument made in this paper is that there would undoubtedly be certain costs associated with 'no deal' reliance upon WTO rules, not least the imposition of tariffs and NTBs on UK exports to the EU. This would raise costs for exporters albeit that, since the trade-weighted tariff rate is estimated as little more than 2% by such august bodies as UNCTAD and the World Bank, any increase in costs for non-agricultural exporters is likely to be far more modest than the benefit they have already internalised from a more competitive exchange rate since the European referendum. A more active industrial policy could facilitate further productivity and performance gains amongst UK producers, offsetting some or all of these costs over time. The WTO option would also have the secondary effect of reducing the UK's large trade deficit with the EU, with resultant economic benefits. It may also encourage UK exporters to seek out alternative market opportunities in faster growth areas of the world.

Thus, whilst a comprehensive FTA would be the preferred option for this author, reverting to trading by WTO rules does not appear likely to result in the damaging economic scenario that many commentators seem to suggest. Rather than 'no deal' resulting in the UK economy 'falling off a cliff edge', a more accurate metaphor might be that it might experience a small bump in the road. Indeed, it may offer greater potential for reshaping the UK economy over time, rather than tying it more closely to the EU for short term advantage.

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[i] Peter Mandelson, Today programme, BBC Radio 4, 20 October 2017.
[ii] Pitas, C. (2017), *May says EU repeal bill best way to avoid Brexit 'cliff edge'*, Reuters, 2 September 2017. Available via: https://uk.reuters.com/article/uk-britain-eu-may/may-says-eu-repeal-bill-best-way-to-avoid-brexit-cliff-edge-idUKKCN1BD0UY. Accessed 4 January 2018; Sandle, P. (2017), *Labour backs soft Brexit, putting pressure on May*, Reuters, 26 August 2017. Available via: https://uk.reuters.com/article/uk-britain-eu-labour/labour-backs-soft-brexit-putting-pressure-on-may-idUKKCN1B60QO. Accessed 4 January 2018; Fairburn, C. (2017), *Avoiding the Brexit cliff edge*, Business Voice, 18 September 2017. Available via: http://www.cbi.org.uk/businessvoice/latest/avoiding-the-brexit-cliff-edge/. Accessed 4 January 2018.
[iii] Menon, A., Barnard, C. and Portes, J. (2017), *The UK in a Changing Europe*. Available via: http://ukandeu.ac.uk/research-papers/cost-of-no-deal/. Accessed 31 October 2017.
[iv] Whyman, P.B. and Petrescu, A.I. (2017), *The Economics of Brexit*, Palgrave, Basingstoke, 35-40.

[v] Yanis Varoufakis, Today Programme, BBC Radio 4, 19 October 2017; Yanis Varoufakis, Bloomberg, 29 November 2017.

[vi] Speech by Prime Minister Theresa May, *The government's negotiating objectives for exiting the EU*, 17 January 2017. Available via: https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech. Accessed 11 November 2017.