

Brexit and the Future of Globalization?

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Abstract

Alongside the victory of Donald Trump in the 2016 US elections, Britain's vote to leave the European Union ("Brexit") in June 2016 reflects a global upsurge in populism. I find that under all plausible scenarios Brexit will make the average UK household poorer than the alternative of remaining in the European Union. The welfare loss is larger if the UK leaves the Single Market (a "hard Brexit) and larger still (6% to 9% of GDP) when the dynamic effects of productivity losses are factored in. This damage hits the poor as much as the rich and is unlikely to be offset by new trade deals which cannot replicate the sustained reduction in non-tariff barriers that the Single Market has engineered.

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I. Introduction: The Beginning of a New History?

The great English historian Eric Hobsbawm remarked in his book the “Age of Extremes” that it was easy for Western Europeans to believe in progress at the start of the Twentieth Century. There had been no major war involving all the European powers for almost 100 years. Sustained economic growth, widening democracy and globalization seemed to have risen in tandem. This naïve optimism was annihilated in the horrors of the first half of the Twentieth Century where rampant nationalism caused two catastrophic wars, economic depression and collapse of the global trading order.

Out of this destruction, the new foundations for globalization were underwritten by American hegemony. And by the end of the Twentieth Century, even former socialist economies had re-joined the global trading order.

Fundamentally, the view long-held by economists that trade was a win-win had been broadly accepted. This consensus over the benefits of trade, foreign direct investment and migration were underpinned by supra-national organizations such as NATO, the WTO and the EU.

How different things seem today, just 17 years later.

In the wake of the Global Financial Crisis, populist revolts have sprung up all over the world. In some respects, they reached their apogee last year in Brexit – Britain’s fateful decision to leave the EU – and in the election of Donald Trump, an avowed economic nationalist. Of course, there are similar movements in other countries – Poland and Hungary, Le Pen in France, the AfD in Germany and so on. And populism is not monopolized by the right of the political spectrum – think of Podemos in Spain, Syriza in Greece and more recently the rise of Jeremy Corbyn in Britain.

The underlying motivation behind much of the populist wrath has been an explicit rejection of globalization. It’s “us” - the heroic locals vs. “them” - the foreign globals. Rather than seeing that there is a mutual benefit from playing by commonly agreed international rules, globalization is seen simply as a zero sum game where we lose and foreign exporters, foreign immigrants and foreign investors win.

II. Brexit

I am going to look at these issues through Brexit-tinged lenses. Before doing my personal Brexit to MIT last year, I was Director of the [Center for Economic Performance](#) at the LSE for 13 years. Since 2013, we have been doing extensive research into what might be the long-term economic impact of Brexit.

This meant that I had the dubious privilege of being heavily involved in the Brexit debate, such as it was. I travelled up and down the country from my hometown of Carlisle to being livestreamed on top of [London Double Decker](#) bus talking with Grime Rapper, Big Narstie. And I had frequent media debates, most memorably when I and my fellow travelers were branded “[Nazi Scientists](#)” by Michael Gove, then Minister of Justice (who’s now in charge of the Environment) for questioning his judgement that Brexit would be a great economic success.

II.A The Simple Guide to Brexit Economics

Assessing the economic impact of Brexit is on one level incredibly simple. The EU has been able to radically reduce trade costs between its 28 Member States. This is only partly through reduced tariffs: it has been mainly through reducing non-tariff barriers. The Single Market is a mechanism for having common regulations so that goods and services can be traded easily throughout the bloc of half a billion people. This is facilitated, of course, by the free movement of labor which is particularly beneficial for services.

The Single Market is a work in progress, but its historical success in raising trade levels amongst its members is not in serious doubt.

So when the UK does leave, it will inevitably face higher trade costs with the rest of the EU compared to staying in. Since the UK will remain geographically close to the EU (even Boris Johnson can’t shift plate tectonics), Britain will suffer increased costs with countries it will continue trading with. High continued trade is a result of the “gravity” relationship which is perhaps the most robust fact of the economics of empirical trade. It is simply the observation that countries who are geographically close trade more with each other than those who are geographically distant.

The reduced amount of fiscal transfers from London to Brussels is peanuts by comparison with this trade loss.

So the real issue of Brexit economics is not whether there will be a cost, but rather how big this cost will be and how much the damage from less trade can be limited.

II.B Putting numbers on the costs and benefits of Brexit

Our academic work has tried to quantify the economic impact of Brexit. The most rigorous way to do this is by using a structural model of the economy – a Computable General Equilibrium Model. We build a standard “global value chain” model which allows for trade in intermediate goods and services across all sectors and all countries.

In implementing this analysis, a key question is what kind of deal Britain will strike with the EU after the conclusion of the Article 50 process in 2019.

The least damaging scenario is a so-called “soft Brexit” where the UK stays in the Single Market. In this scenario the UK would be like Norway, a member of the European Economic Area. There are still some costs like customs check and Rules of Origin requirements which have to be factored in. The fiscal saving is very small because Norway pays an “entry fee” which is equivalent to about 83% of what the UK currently pays on a per capita basis.

Putting these together, we estimate that a soft Brexit would cost about 1.3% in lost income [see Exhibit 1], or \$1,100 per household.

The main political problem with a soft Brexit is that this would mean accepting free movement of labor. It also means accepting the rules of the Single Market without having a vote on what these are. “Pay with No Say” as Richard Baldwin likes to quip.

At the other end of the spectrum is a “hard Brexit” where the UK trades under WTO rules, like the US or Japan. This would mean paying tariffs as well as facing higher non-tariff barriers. There is a bigger net fiscal saving.

On net, we calculate that a hard Brexit would double Britain’s welfare losses to 2.7%.

Although Britain loses most, all European countries lose economically from Brexit with those more closely connected to the UK through trade links, like Ireland, losing relatively more [Exhibit 2].

Many other “in-between” scenarios can be modelled such as the Swiss case of scores of bilateral deals or the recent Canadian comprehensive free trade deal. There remain losses in all the scenarios we looked at ranging between 1% and 3%.

One instructive alternative scenario is “Unilateral Trade Liberalization”. This was promulgated by the free market wing of the [pro-Leave movement](#). Here, the UK trades under WTO rules like hard Brexit, but simply abolishes all its import tariffs.

Given the general anti-globalization mood in the UK, this does not appear to be a very likely policy. Nevertheless, we modelled this and found it does reduce the costs of Brexit. However, the offset is under a third of a percentage point - so the costs of hard Brexit falls from 2.7% to 2.4%. The reason for this is that rising trade costs after Brexit will primarily come from non-tariff barriers. Since the UK will inevitably continue trading with the EU due to the law of trade gravity, this means that we will have fewer exports and imports.

Supporters of Unilateral Trade Liberalization claim vast welfare gains because they assume countries just purchase from the lowest cost producer whether that’s in France or Fiji. But this ignores the reality of trade in differentiated products.

II.C Dynamic effects of trade magnify the harm

A more serious problem is that our approach is static, like all workhorse quantitative trade models. But there is a wealth of empirical evidence from “natural experiments” of trade liberalizations that trade stimulates higher productivity through many other mechanisms than just specialization to comparative advantage such as greater competition, higher quality intermediate inputs, larger market size, reallocation away from less productive firms and so on. There has also been an explosion of theoretical models to help understand these effects, although none of them are well enough developed to calibrate with the empirical rigor we can bring to the static analysis.

What we can do, however, is to lean on empirical “reduced form” studies to assess these dynamic effects. In particular there are a large number of empirical studies of what has happened to trade

when countries have joined different forms of trade arrangements such as the EU. The results of these empirical studies, built on the gravity equation, show large increases of trade due to joining the EU. Such studies suggest that UK-EU trade will be depressed by about a quarter after Brexit which actually matches up pretty well with what we find from the static structural model.

We then combine these trade losses with natural experiments using exogenous falls in trade cost such as Feyrer's (2009) study of opening up of land and air transportation routes. These look directly at the GDP effects of changing trade costs.

In GDP terms these estimates imply losses of income of 6.3% to 9.6%, tripling the losses from the static model.

One reason for these much larger losses is that Brexit is likely to have a chilling effect on [foreign investment](#) into the UK. FDI has many productivity benefits in terms of bringing in tougher competition, new technologies and managerial know-how. Financial services, which bring in a lot of cash to the UK, is likely to be particularly hard hit by being outside the Single Market.

III. Offsetting Factors?

Are there offsetting factors to reverse our conclusions on the negative effects on Brexit?

One view is that only the rich will bear the pain of Brexit. Looking at the distributional effects we find that far from being born just by the wealthy, the pain from Brexit is shared [democratically](#) across households of different income levels [Exhibit 3]. Loosening ties with a group of nations with similar skill levels will not help prop up wages of the less educated. And despite all the rhetoric, EU [immigrants](#) are on average younger, more educated, more likely to work and less likely to claim welfare benefits than native born Britons. Hence, reducing their numbers to the "tens of thousands" as promised by the current government will hurt the [public finances](#) and do nothing serious to help pay, jobs or inequality [Exhibits 4 and 5].

Will the UK will be able to strike more and better trade deals with the rest of the world without the shackles of the EU? It is unlikely. First, the terms of any trade deal are likely to be worse, since the UK is under a fifth of the GDP of the EU and so has weaker bargaining power.

Second, the issue with modern trade deals is not just getting rid of tariffs. It is the painful negotiations of agreeing regulations over investment, occupation licensing and product standards,

especially in services. This requires compromise and rules and some loss of sovereignty which is inevitable when doing deals.

And third, the question is whether the UK future deals can surpass the access to non-EU markets it obtains through both the current deals *and* any future deals the EU strikes with other countries.

IV. What Brexit reveals about the popular will

What swung the Brexit vote was the disaffected northern heartlands, the white working class bedrock of the Labour Party. As with Trump's rust belt ex-Democrats, these are people who feel left behind economically, socially and politically by modern Britain. Median real wages in the UK are still 5% below what they were a decade ago, prior to the Global Financial Crisis. This is a worse wage performance than even the inter-war period. People are justifiably angry and Brexit was a way to express their discontent. Many of them have been falsely convinced that their woes are due to immigration, despite the fact that wages were rising pre-2008 when immigration was going up just as fast.

But immigrants are globalization made flesh and are a convenient punching bag for the failures of financial regulation that propelled the crisis.

V. Conclusion: What's the Upshot?

Currently, the UK is in a truly chaotic state. The election has left the conservative government without a majority. Without leadership and with the hardest negotiation the country has had to face in decades, Britain is a poster child for how populism can cripple the decision making process. We have to hope that somehow the country shakes itself into realizing the immense task that lies ahead. Even better would be to at least offer citizens a choice over what deal is eventually struck.

The historical problem Britain faces is that the fruits of economic growth, born from embracing globalization, have been very unequally shared over the last four decades. Those in the top third (especially top 1%) of the income distribution have benefited much more than the middle and the bottom. This can only go on for so long. When the crisis hit and political leaders stumbled, the nation howled and in my view, committed an act of great economic self-harm.

A similar story could be told of the US. Growing inequality and polarization over decades finally led to the election of an avowed proponent of narrow economic nationalism. To a greater extent

than the UK, President Trump is skeptical of international deals on trade, climate and even the military, such as NATO.

Currently, Britain and America are doing more to disrupt than defend free trade. Will the mantle now be being passed to others in France, Germany, Japan and maybe even China?

All we can hope is that this is a pause in the progress towards peaceful economic integration rather than an abrupt and permanent reversal.

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More material is available on <http://cep.lse.ac.uk/BREXIT/>

Exhibit 1: Income losses after Brexit for average UK household, Structural Model

<u>Panel A: Optimistic Soft Brexit Scenario</u>	
<i>Total Welfare Change</i>	-1.34%
<i>Income change per household</i>	-£893

<u>Panel B: Pessimistic Hard Brexit Scenario</u>	
<i>Total Welfare Change</i>	-2.66%
<i>Income change per household</i>	-£1,773

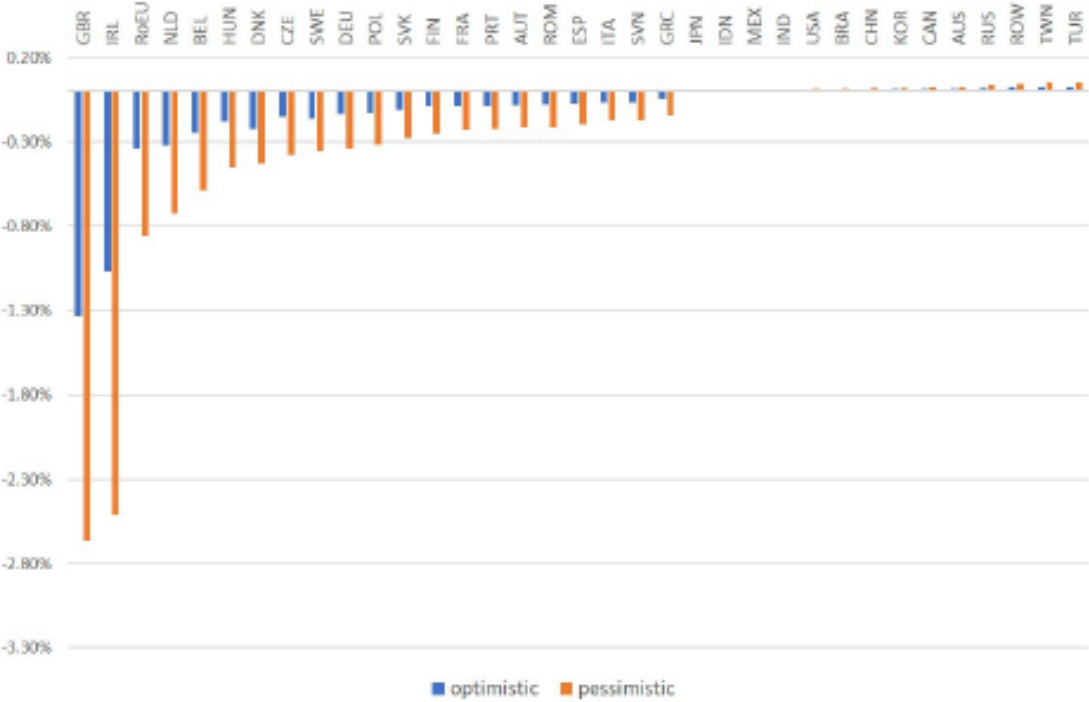
Notes: Counterfactuals changes in welfare, measured by consumption equivalent as specified by equation (5) with $\rho = 0.96$. Fiscal benefit information comes from HM Treasury (2013). EU is defined as EU 28 minus the UK and Croatia.

Panel A shows an optimistic scenario where UK could negotiate a deal like Norway and tariffs remain zero. But non-tariff barriers increase to 1/4th of the reducible barriers faced by US exporters to the EU (2.77% increase). Further, the UK does not benefit from further integration of EU where non-tariff barriers will fall 20% faster than in the rest of the world (5.63% lower in 10 years). For the fiscal effect, we assume that UK could save 17% from the fiscal contribution to the EU (same as Norway) which is 0.09% of UK GDP.

Panel B shows a pessimistic scenario where the UK and EU impose MFN tariffs on each other (see Table 1). Non-tariff barriers increase to 3/4th of the reducible barriers faced by US exporters to the EU (8.31% increase). Further, the UK is excluded from further integration of EU where non-tariff barriers will fall 40% faster than in the rest of the world (12.65% lower in 10 years). For the fiscal effect, we assume that the UK saves more on fiscal contribution to EU budget which is 0.31% of UK GDP.

Source: Dhingra et al (2017)

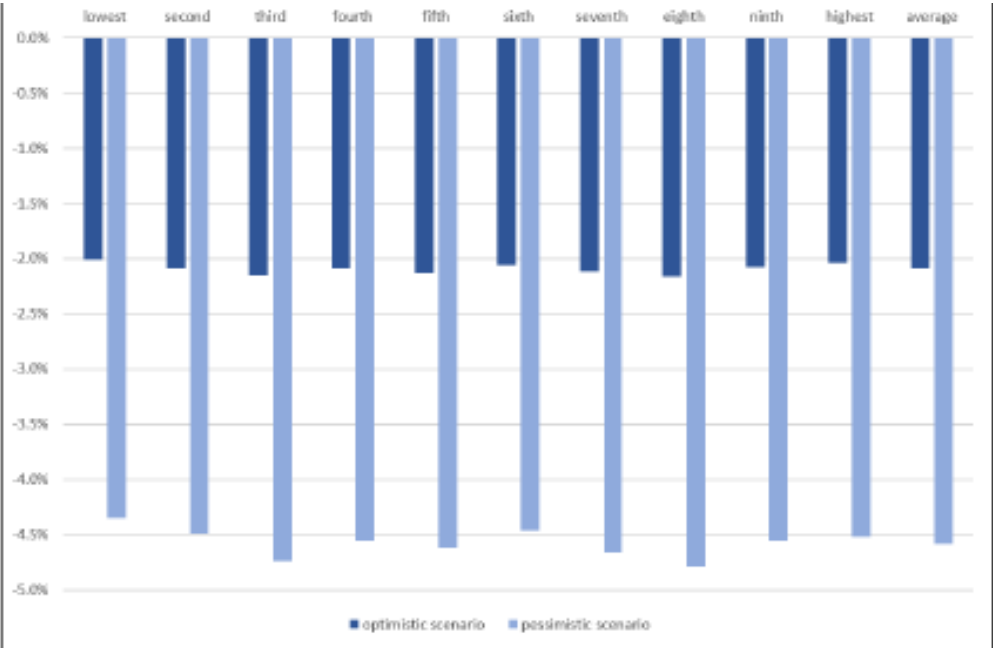
Exhibit 2: Income losses after Brexit for average household by country, Structural Model



Notes: The figure plots the welfare loss by country for the optimistic and pessimistic scenario. Assumptions are the same as the notes to Table 3. We assume that the other EU countries have to fill the budget hole left by the UK proportionally to their GDP. This brings them a net fiscal loss of 0.015% in the optimistic case and 0.051% in the pessimistic case. The list of countries can be found in Table A.1.

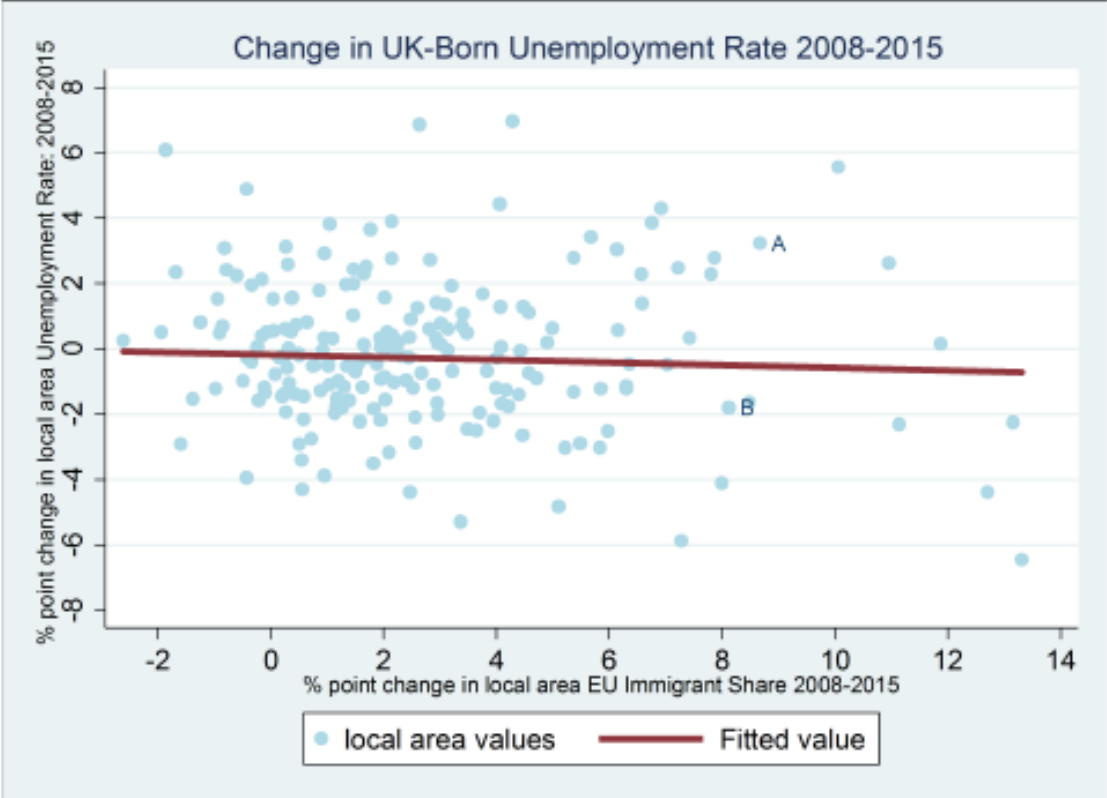
Source: Dhingra et al (2017)

Exhibit 3: The income losses after Brexit are not mainly born by richer households



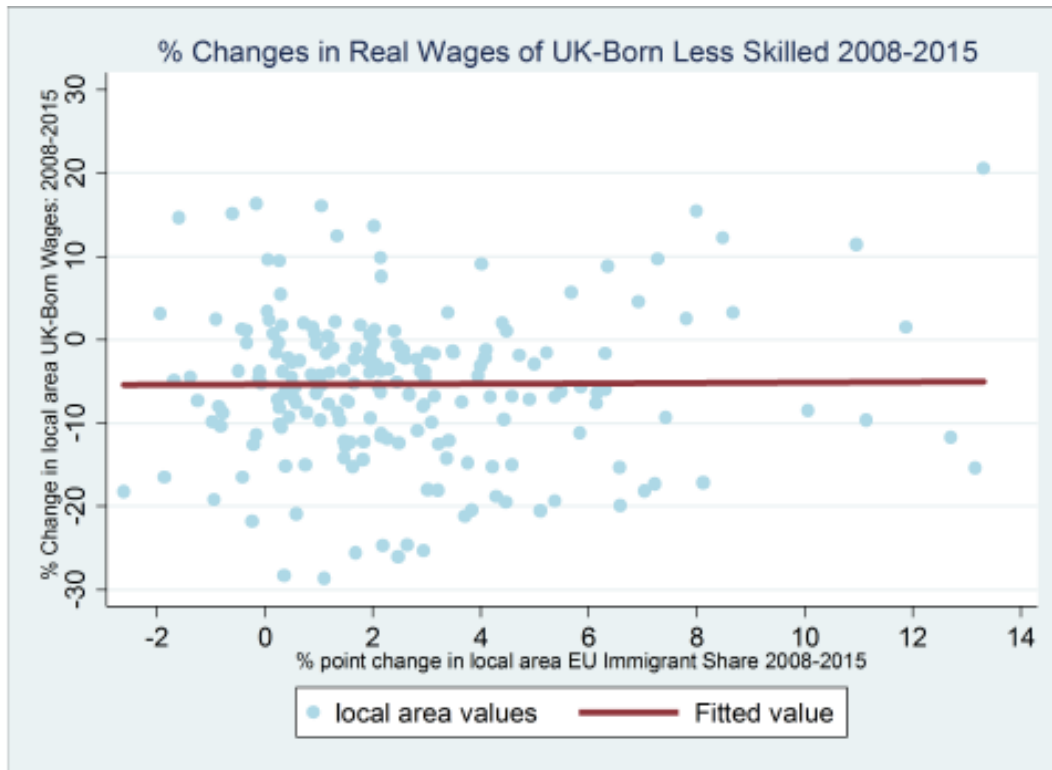
Source: Breinlich, Dhingra, Sampson, and Van Reenen (2016), Labour Force Survey.
Notes: Predicted real income losses based on the present model, as calculated by Breinlich, Dhingra, Sampson, and Van Reenen (2016). See Table A2 in their paper in the Annex for the exact percentage changes for each income decile.

Exhibit 4: Large increases in EU immigration have not significantly harmed the jobs UK-born workers



Source: Wadsworth, Dhingra, Ottaviano, and Van Reenen (2016), Labour Force Survey.
Notes: Each dot represents a UK local authority. The solid line is the predicted “best fit” from a regression of changes in unemployment on the change in share of EU immigrants in each UK local authority. These are weighted by the sample population in each area. Slope of this line is -0.04 with standard error of 0.05, statistically insignificantly different from zero.

Exhibit 5: Large increases in EU immigration have not significantly harmed the wages of less skilled UK-born workers



Source: Wadsworth, Dhingra, Ottaviano, and Van Reenen (2016), Labour Force Survey.
Notes: Each dot represents a UK local authority. The solid line is the predicted “best fit” from a regression of local authority percentage changes in the wages of the less skilled on the change in share of EU immigrants. These are weighted by the sample population in each area. Slope of this line is 0.02 with standard error of 0.21, statistically insignificantly different from zero. Less skilled is defined by those who left school at 16 or earlier.