Assessing the economic implications of Brexit

Executive Summary
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In late February 2016 the UK prime minister, David Cameron, ended months of uncertainty by announcing that the referendum on the UK’s membership of the EU would be held just four months later, in June. Assuming a vote to leave, the government will face an intensive period of just two years in which to conclude a new deal covering trade and market access that will govern the UK’s relationship with the EU for, potentially, decades to come.

The implications of Brexit for the UK economy, business and consumers could be substantial and far-reaching. There are many possibilities for the kind of trade deal the government could seek to cut in the event of Brexit. Whichever trade settlement is adopted and whichever scenario comes to pass, there will be a long-term structural impact on the UK and EU economies. The UK is the Union’s second largest economy and almost half of all its overseas investment comes from the EU, as does a similar proportion of its export revenues. As such, business and investment decisions will be affected over both the short and long term. Consumers and the Exchequer too will feel the impact—with the government facing choices over how best to use the funds that are repatriated as a result of having to no longer contribute to the EU budget.

This research presents a comprehensive, rigorous and impartial assessment of the scale and nature of the impact of Brexit on the UK economy. It explores a range of scenarios based on alternative assumptions about the trade relationship that could be eventually negotiated between the UK and the EU, and how the UK government might react to its new-found policy freedom—taking account of the impact of regulatory, migration and fiscal policy choices on economic conditions. The findings are based on comprehensive a modelling exercise of nine potential scenarios using Oxford Economics’ Global Economic Model, the most widely used commercial model of its type in the world.

The results of the research suggest that the economic risks and opportunities presented by EU withdrawal are asymmetric. Any upside effects appear to be limited and the worst-case scenarios are far from disastrous. However, most scenarios would impose a significant long-term cost on the UK economy. The worst-case scenario that we model is associated with a decline of almost four percent in real GDP compared to a baseline of continued EU membership.

Best-case: Loss of 0.1% of GDP

Our results illustrate that the risks and opportunities presented by Brexit are asymmetric. The outcome of trade negotiations and the UK’s policy response will be decisive in determining the long-term economic impact.

Worst-case: Loss of 3.9% of GDP
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A second important finding is that the UK government’s subsequent policy response will be vital in determining the scale of the impact of Brexit. The government’s policy response could go in a number of directions, in relation to trade, migration, regulation and what to do with the fiscal windfall. Broadly, in the scenarios in which it adopts a more liberal, pro-business policy response—limited restrictions on the free movement of labour, more aggressive deregulation, a tax reduction agenda—the level of real GDP holds up better.

Regardless of the policy response, our results also indicate that the UK would be better off maintaining a preferential trading relationship with the EU rather than reverting to Most Favoured Nation (MFN) status. Scenarios in which the UK fails to agree such an arrangement lead to inferior economic outcomes, on average. This comes despite the enhanced regulatory and fiscal freedom associated with this option.

In certain scenarios, Brexit could impose significant costs on UK citizens and businesses. In the worst-case scenario, our results imply a loss of income per head of £1,000 by 2030 (in today’s prices). At the other end of the spectrum, the best-case of our modelled scenarios implies a small rise in income per head of £40 by 2030.

Across the board, all scenarios show a degree of trade destruction in which UK trade volumes fall as a share of GDP. This reflects the increased cost of trade between the UK and the EU, which, in turn, encourages firms and consumers, in both the UK and the rest of the EU to consume domestically-produced goods. The scale of the decline in both imports and exports varies considerably across scenarios. Exports fall by as much as 8.8 percent and imports by up to 9.4 percent in the worst-case scenario compared to a baseline of continued EU membership.

For businesses operating in the UK, the impact on investment could be marked. There is a very wide range of effects on business investment—in the worst-case scenario private sector business investment would be £21.1 billion (0.8 percent of GDP) lower in today’s money by 2030 compared to a baseline of continued EU membership. This is equivalent to each private sector organisation in the country investing over £4,000 less than it would otherwise have done. The extent to which investment declines broadly reflects how ‘business-friendly’ a given scenario is—where regulatory changes make domestic firms more competitive and migration controls are less stringent, investment holds up better.

Our modelling illustrates that the benefit that the government initially enjoys from the fiscal savings on contributions to the EU budget could be a false economy. In all scenarios, the government receives an initial fiscal boost of up to 0.5 percent of GDP. However, in some scenarios the extra fiscal space this offers in the short term is more than offset, over time, by the damage to the government’s revenue streams caused by worse demographics and lower productivity. In the worst-case scenario, the UK is forced to reduce spending by 1.7 percent of GDP by 2030—equivalent to half the fiscal tightening undertaken during the last Parliament—in order to retain its baseline fiscal position.

How different business sectors are affected will be determined by both the trade settlement and the government’s policy response, but certain sectors are more at risk. In general, the industrial sector (excluding extraction) is at greatest risk, with manufacturing and construction suffering the largest average contraction in our analysis. Among service sectors, our modelling suggests the financial services industry is most at risk.

Our modelling confirms that the economic implications of Brexit are much more significant for the UK than the rest of the world. Overall the impact on the rest of the EU is very modest. Ireland is found to be consistently the most vulnerable Member State, reflecting its stronger trade and investment ties with the UK. Real GDP in Ireland drops by up to 2.2 percent compared to baseline in the worst-case scenario. Our modelling indicates that Ireland would be particularly vulnerable to the UK failing to sign any type of preferential trade deal and reverting to MFN status, irrespective of the UK’s subsequent policy response.

This matters for the welfare of the UK population—income per head could fall by over £1,000 by 2030.

Best-case: Rise of income per person of £40
Worst-case: Fall of income per person of £1,000

Decisions made will be critical to determining businesses’ decisions over whether to invest and grow.

Best-case: Rise in business investment of £2.4 bn
Worst-case: Fall in business investment of £21.1 bn
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