The impact of Brexit on growth and the public finances

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This article provides an overview of the likely economic consequences for the United Kingdom of leaving the European Union. Drawing on a variety of sources espousing diverse analytic approaches, the evidence of an adverse economic effect from Brexit is shown to be persuasive. In the short term, the UK economy has underperformed since the beginning of 2017, although the labour market has been robust. Despite the anticipated savings from reduced payments to the EU budget, the UK’s public finances are likely to deteriorate because lower tax revenue will more than offset the direct savings. In the longer term, downside risks to the economy are expected to dominate.

Among the many unknowns about Brexit is quite how it will affect the economy, both of the UK and the EU27. There has also been speculation about whether it will constitute a ‘shock’ of sufficient magnitude to affect the global economy adversely, at a time when there are already concerns about a slowdown and a renewed risk of financial instability. To state the obvious at the outset, there is continuing ambiguity about what form the UK’s future economic relationship with the EU will take, and thus what to expect. However, there is a growing body of evidence about the adverse short-term effects of Brexit, with consequences for the public finances.

This paper looks at the economic impact of Brexit from a number of angles. It continues by looking at how economic analysis influenced the referendum. The following section considers the short-term consequences, including on the public finances, then the longer-term effects are briefly examined. Concluding comments complete the paper.

Economics around the referendum

Unsurprisingly, the costs and benefits of EU membership featured prominently in the discourse around the 2016 referendum. The notion of ‘project fear’ was at the heart of the
‘remain’ campaign, aimed at scaring voters by emphasising the economic costs of leaving the EU. A similar tactic had been employed (successfully) two years earlier in the Scottish independence referendum. One manifestation was the short-term projection published by the Treasury\(^1\) of an immediate slowdown in the economy, leading to rising unemployment, if the UK voted to leave. Similar warnings had been issued by, among others, the Bank of England and the IMF.

Economic analysis of the short-term consequences of Brexit has been controversial, partly because of the propensity of politicians to make unwarranted claims, based either on misrepresentation or selective use of analytic findings. This allowed unsustainable propositions to become widely believed. However, short-term forecasts and scenarios also suffer from the methodological challenge of coping with a change that is sudden, largely devoid of precedent on which to draw for assumptions, and a context in which rapid policy shifts may occur.

Moreover, Brexit happened (and still is happening) in stages, rather than being a single, discrete event. There was an initial shock from the referendum result, one outcome of which was a sharp fall in the exchange rate which, in turn, seemed to give a more immediate boost to the economy than might be expected from conventional analysis of devaluations.\(^2\) Nine months then elapsed before the UK triggered Article 50, notionally setting a date for leaving the EU at the end of March 2019, but the negotiations then introduced the notion of a transition during which the UK would, de facto, remain economically within the Union, even if politically ‘out’. The subsequent chaos round the parliamentary votes for the withdrawal deal and the extensions to the article 50 deadline added to the confusion.

It should, therefore, be no surprise that it has proved hard to capture the precise timing of different effects, all the more so when decision-makers have been unable to plot suitable courses. By contrast, economic analysis has been able to generate informative findings about longer-term effects. The dilemma is neatly captured in a comment in an Institute for Government report\(^3\): ‘economic theory and evidence provide a much stronger basis for making long-term projections than for making short-term forecasts’.

**The short term**

The resilience of the economy in the immediate aftermath of the referendum led to unashamed gloating from pro-Brexit commentators and had the longer-term effect of casting doubt on economic analyses, however reasonable and well-founded. The repercussions of this flawed effort to influence public opinion have continued to influence sentiment about how to appraise Brexit.

Yet, the UK growth rate manifestly deteriorated: from being the fastest growing of the G7 economies in the second semester of 2016, the UK became the slowest growing in 2017 when global conditions were favourable, and the slower growth has persisted in recent quarters. Despite the lacklustre growth, the labour market has been much more robust: total employment over this period has continued to rise and is now the highest ever, while unemployment has now fallen to the lowest rates since the early 1970s. There is, though something of a puzzle about labour productivity which has stagnated for a decade. Concerns about productivity arise in many other EU countries, but the UK is the outlier. Other problems include an external deficit which has lasted for several years and only slow improvements in the public finances.

Revised thinking about stagnating productivity being a permanent shift, rather than an aberration following the financial crisis of a decade ago, led the OBR (the UK budgetary ‘watchdog’) to alter its assumptions about the underlying growth potential of the economy. It is now assumed to be 1.5%, down from the 2.5 rate assumed previously.\(^4\) A plausible explanation is the low rate of investment, now languishing at the bottom end of the G7 league table. Indeed, the latest business investment data show a further fall in business investment in the last quarter.

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4. <https://www.ft.com/content/e0ae58a6-cf95-11e7-9dbb-291a884dd8c6>
of 2018. A commentary in the statistical release is pointed: ‘this is the fourth consecutive quarter-on-quarter fall in business investment and the first time this has happened since the economic downturn of 2008 to 2009.’ Ironically, given its salience in the referendum rhetoric, a decline in the net inflow of EU workers may also have contributed to slower growth by limiting the supply of more skilled labour. Moreover, as a recent assessment by Chris Giles of the Financial Times reveals, the track-record of many independent forecasters on the effects of the referendum result has been quite impressive. He notes the UK economy has grown by 1.5 percentage points less than had been forecast by the Bank of England prior to the referendum, in May 2016, despite faster global growth which would have been expected to boost the UK. Giles also mentions how more politically motivated assessments – he cites the overly pessimistic Treasury projections and the highly optimistic ones generated by the group of Economists for Brexit – have been shown to be less accurate.

Research by John Springford for the Centre for European Reform, using a technique of calibrating UK economic performance to that of peer economies (‘doppelgangers’), suggests UK GDP is now 2.5 percentage points lower than it would have been had the referendum result been for ‘remain’. Similar work by Goldman Sachs on modelling the impact of different short-term scenarios emphasises the scope for the UK to recover if it remains in the EU, with most of the losses of the post-referendum period likely to be recouped. Their finding also highlight the discrepancy between the UK and the EU in the event of no deal being the outcome: for the UK, there would be a sharp loss of confidence, a steep fall in the exchange rate and a GDP loss of up to 5.5%, whereas for the EU it would be a 1% loss.

Uncertainty engendered by the exit negotiations has played a part, deterring investment and leading some corporations – especially in the financial and business services sector – to relocate certain business units in EU27 countries. Hitherto, this has been a trickle, rather than a flood, but some recent analyse from the City of London have become more alarming. Thus one estimate points to nearly GBP 1 trillion of financial assets having left the UK. This recent study by New Financial found that 275 financial companies had moved activity away from London to other EU financial centres.

Asset managers have favoured Dublin, while investment banks have preferred Frankfurt, with moves to Paris, Luxembourg and Amsterdam also occurring. While relatively few UK jobs have so far been lost – the think tank estimates some 5,000 – the analysis also suggests that there is much more to follow.

Although the study also concludes ‘there is no question that London will remain the dominant financial centre in Europe for the foreseeable future’, it points out that the £800 billion in assets displaced from the banking sector is 10% of the UK total. If this trend continues, it is likely to diminish the UK trade surplus in financial services and reduce UK influence in financial regulation. This matters, because the financial sector has a triple significance for the UK: it is a source of economic activity and jobs; it makes a substantial contribution to net exports; and it is an important source of tax revenue.

In the manufacturing sector, Japanese inward investors have expressed their dismay about not just the prospect of barriers to exporting to the EU27, but also highlighted the deleterious effects on supply networks organised on just-in-time principles. The car industry, a success story of recent decades because of the impact of FDI, is particularly vulnerable because of fears of tariffs if the UK exits the customs union.

A less obvious impact of Brexit is the social tensions it has fomented and the prospect of damage to social cohesion. The likely regional incidence of Brexit is also at issue in a country in which the dominance of London is already a cause of imbalance in the economy. London has hardly any manufacturing, but

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5 https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/businessinvestment/octobertodecember2018revisedresults
6 https://www.ft.com/content/534e108a-4651-11e9-b168-96a37d002cd3
8 https://uk.reuters.com/article/uk-britain-eu-goldmansachs/brexit-has-cost-britain-nearly-2-5-percent-of-gdp-goldman-sachs-idUKKCN1RD1T8
9 https://newfinancial.org/the-impact-of-brexit-on-the-city/
a very prominent financial and business services sector, whereas parts of middle and northern England have concentrations of industries dependent on exports to continental Europe. The evidence on the likely regional impacts is mixed and sometimes contradictory, depending on how Brexit is assumed to affect the sectors of activity crucial to local or regional economies. An early study by Dhingra, Machin and Overman⁠¹⁰ predicts the most negative effects will be in localities in the South of England and in urban areas – including London – and notes the irony that most of the worst affected areas also voted for Brexit. However, researchers at the University of Birmingham⁠¹¹ find the most negative effects in North East England, while London will be less affected. This work expects financial services to be less hit.

In summary, no single short-term effect is paramount, but the accumulation of smaller effects could be significant for the UK economy. There is, however, a consensus about the likely adverse consequences of an acrimonious, no-deal exit by the UK, especially if it disrupts routine cross-border activities. There has been widespread speculation in the British media about flights being grounded, medication for cancer treatment being held up, long queues at the ports and a plethora of other problems. Some of these claims are exaggerated, but they also disguise a hidden cost of Brexit arising from preparations by both public and private actors to guard against the disruption stemming from a no-deal Brexit.

The public finances

The effect of Brexit on the UK’s public finances will depend on opposing factors. There will, first, be a direct benefit to the UK from lowering its payments into the EU budget. Although the longstanding British rebate has meant that the UK generally makes the smallest contribution to ‘Brussels’, as a proportion of GDP, of any Member State, it is still a substantial sum, reaching €15-17 billion in recent years. EU spending in the UK, principally for direct payments to farmers, provides some offset, but the net contribution is still of the order of €10-12 billion per annum. Long-term, this is a potential saving to British tax-payers of the order of 0.4% of GDP.

However, if the UK economy grows more slowly as a result of Brexit, there is likely to be deterioration in the public finances. According to the Office for Budget Responsibility in its autumn 2018 assessment of the economy, the annual deterioration since the 2016 referendum, has been greater than the net payment to the EU, although much of this is attributable to building slower productivity growth into the projections. Tax revenue as a proportion of GDP has been around 37% in recent years which, for an economy of roughly £2 billion means that every percentage point of additional GDP translates into revenue of £7.4 billion.

Springford’s findings⁠¹² emphasise the loss to the public finances which he estimates has now reached £19 billion per year – more than the highly influential, though greatly exaggerated, windfall gain claimed by the ‘leave’ campaigns. It is important to stress, too, that these are likely to be permanent losses, because it would take above average growth for a number of years for the short-term hit to the economy to be reversed.

The longer-term

In an overview of existing studies, the Institute for Government⁠¹³ finds only one which anticipates any macroeconomic gains from Brexit, but also notes the considerable range of negative outcomes, depending on the assumptions underlying the research. The one outlier, by Economists for Free Trade⁠¹⁴, derives much of the projected gain from opportunities for deregulation, an assumption heavily criticised by other contributors. Five dimensions are arguably relevant in assessing the future UK-EU relationship:

- Diminished access to the EU market because of tariffs or other constraints on exports of goods, or regulatory divergence affecting services trade. The latter is likely to weigh more heavily because successive rounds of trade liberalisation have left tariffs much reduced,
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although current US policy could change the parameters.

- Opportunities to strike new trading arrangements with other partners, but it is not as simple as just agreeing new deals, because the UK already has access to such deals struck by the EU and will not have the same bargaining clout acting on its own.

- Developments in flows of factors of production. There will be at least some rebalancing of migratory flows away from EU nationals, and some scope for a shift to other nationalities. Direct investment flows will also be affected, for example by deterring third country investors concerned to invest in the UK as gateway to the EU single market.

- Macroeconomic developments affecting key variables such as the exchange rate or country risk in credit markets.

- The scope for changing the UK regulatory regime to one which is more closely attuned to UK preferences and interests. This will be tempered by the need to conform to international standards, and may require the UK to make strategic choices about whether to stick with the EU model, shift to that of the US or attempt some sort of go-it-alone approach. Ivan Rogers, the former UK Ambassador to the EU who resigned shortly after Article 50 was triggered, has been very explicit in this regard.\(^\text{15}\) He points out that the overwhelming majority of exporting companies are ‘alarmed at the prospect of being excluded from the key private sector standard setting bodies, which sit outside the EU structures, but only have national members from within the EU and EEA’. The key implication is that notional power to regulate, is not the same as effective sovereignty.

A government internal assessment, only published at the insistence of the House of Commons Brexit Committee\(^\text{16}\), concluded that the UK economy would be worst off under WTO terms, somewhat better if it had a free trade agreement with the EU and least affected if it had a closer, EEA style arrangement. These findings largely accord with mainstream academic studies using a variety of analytic approaches. The UK government also conducted a longer term analysis\(^\text{17}\), published just prior to the initial agreement between the UK and the EU of the withdrawal deal.

A striking statement in a document meant to underpin government policy is: ‘higher barriers to UK-EU trade would be expected to result in greater economic costs’. Noting that the sectoral effects will be very varied, estimates of some of the trade costs are quite pronounced, depending on the scenario examined – see Table 1, which shows the range of likely additional costs. While the uncertainty about the effects of Brexit is evident from the wide range in many of the estimates, it is noteworthy that they all emerge as costs, not potential benefits.

### Table 1. Costs by sector under different scenarios (% of value of trade compared with status quo)

<table>
<thead>
<tr>
<th>Sector</th>
<th>No deal</th>
<th>Theresa May deal</th>
<th>EEA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufactures</td>
<td>9-17</td>
<td>0-1</td>
<td>3-7</td>
</tr>
<tr>
<td>Agri-food</td>
<td>29-42</td>
<td>1</td>
<td>4-9</td>
</tr>
<tr>
<td>Services</td>
<td>5-18</td>
<td>4-12</td>
<td>1-4</td>
</tr>
<tr>
<td>Financial services</td>
<td>4-22</td>
<td>2-9</td>
<td>4-22</td>
</tr>
<tr>
<td>Network industries</td>
<td>3-15</td>
<td>0-2</td>
<td>1-8</td>
</tr>
</tbody>
</table>

*Source: UK Government\(^\text{18}\)*

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\(^\text{15}\) https://policyscotland.gla.ac.uk/blog-sir-ivan-rogers-speech-text-in-full/


\(^\text{18}\) Op cit.
Conclusions

After initially proving more resilient than some had expected, the UK economy slowed in the aftermath of the 2016 referendum result and is projected to grow at a slower rate than if the result had been ‘remain’. The effect is not dramatic, although because, at the time of writing, the UK had neither exited the EU nor arrived at a clear definition of its future relationship with the bloc, there is as yet no hard evidence on how Brexit will affect the economy.

The central message from mainstream economic analyses is, nevertheless, both plausible and negative: the greater the barriers between the UK and the EU27, the bigger the relative losses for the economy. More worrying for the British economy is the interplay between the direct effects of Brexit and longer run trends. Lower potential growth could, for example, become lower still if Brexit deters skilled immigrants or growth enhancing inward investment.

Commenting on the various concerns about the global economic outlook, the OECD observes ‘Brexit is also an immediate downside risk. We have already seen a clear dent in the growth rate of investment in the UK since the Brexit referendum. And the costs of a no-deal would be significant. According to our estimates, it could amount to 2% of GDP for the United Kingdom by 2020 already’.19

These findings have a number of implications:

• The economic impact on Brexit on the UK will be felt in diverse ways and over different time scales, but these have an unfortunate tendency to be conflated in much of the public debate. As a result, the separation, notably between transitional and permanent effects, has been blurred.

• The transitional effects range from the settlement of accounts with the EU to the costs of adaptation, with the latter borne by private agents as well as the public sector. Permanent costs are likely to be reduced growth from diminished access to export markets and less robust public finances.

• Uncertainty has been a feature not only of the negotiations, but also of the decision-making by economic actors, contributing to the adverse economic impact. In particular, the fall-off in business investment can be seen as a direct result of Brexit.

• Although the UK is predominantly a service sector economy, the effects of Brexit on certain key manufacturing industries will be important. Those locked into complex supply chains could easily see quite extensive disruption.

• Longer-term, the UK economy could change towards deregulation, but it is far from obvious this would be acceptable to UK citizens. The early, muted threat of ‘Singapore on the North Sea’ if the UK does not obtain a satisfactory deal rapidly disappeared when confronted with the political realities of negotiation. Nor was it what people voted for in the referendum.

• No single economic consequence of Brexit, on its own, would be critical, but when cumulated, the effects could be quite marked, recognising how many are intrinsically negative.

• Overall the risks are nearly all on the downside, including for the global economy.

Economically, Brexit is not just a gamble offering unattractive odds, but also one that could have negative political repercussions. From the standpoint of economic analysis, it makes little sense.

About the author

Iain Begg is a Professorial Research Fellow at the European Institute and Co-Director of the Dahrendorf Forum, London School of Economics and Political Science. His main research focus is on the political economy of European integration and EU economic governance. His recent projects include studies on the economic and fiscal consequences of Brexit, the governance of European economic and social policy, evaluation of EU cohesion policy and reform of the EU budget.