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Life after BREXIT: What are the UK's options outside the European Union?

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CEP's Brexit work is funded by the UK Economic and Social Research Council. As a whole the CEP, receives less than 5% of it's funding from the European Union. The EU funding is from the European Research Council for academic projects and not for general funding or consultancy.

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CEP BREXIT ANALYSIS

Life after Brexit: What are the UK's options outside the European Union?

- It is highly uncertain what the UK's future would look like outside the European Union (EU), which makes 'Brexit' a leap into the unknown. This report reviews the advantages and drawbacks of the most likely options.

- After Brexit, the EU would continue to be the world's largest market and the UK's biggest trading partner. A key question is what would happen to the three million EU citizens living in the UK and the two million UK citizens living in the EU?

- There are economic benefits from European integration, but obtaining these benefits comes at the political cost of giving up some sovereignty. Inside or outside the EU, this trade-off is inescapable.

- One option is 'doing a Norway' and joining the European Economic Area. This would minimise the trade costs of Brexit, but it would mean paying about 83% as much into the EU budget as the UK currently does. It would also require keeping current EU regulations (without having a seat at the table when the rules are decided).

- Another option is 'doing a Switzerland' and negotiating bilateral deals with the EU. Switzerland still faces regulation without representation and pays about 40% as much as the UK to be part of the single market in goods. But the Swiss have no agreement with the EU on free trade in services, an area where the UK is a major exporter.

- A further option is going it alone as a member of the World Trade Organization. This would give the UK more sovereignty at the price of less trade and a bigger fall in income, even if the UK were to abolish tariffs completely.

- Brexit would allow the UK to negotiate its own trade deals with non-EU countries. But as a small country, the UK would have less bargaining power than the EU. Canada's trade deals with the United States show that losing this bargaining power could be costly for the UK.

- To make an informed decision on the merits of leaving the EU, voters need to know more about what the UK government would do following Brexit.

- This is the first in a series of briefings analysing the economic costs and benefits of Brexit for the UK.

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Introduction

Suppose the UK votes to leave the European Union (EU): what happens next? Unfortunately, no one knows for sure.

A vote to remain in the EU is a vote to maintain the status quo. The new settlement that the government is negotiating with the EU leaves the UK's current economic and political relations with Europe broadly unchanged. But what happens in the aftermath of a vote to leave is more uncertain.

Leaving the EU would not mean that the UK could wash its hands of dealing with the rest of Europe. As Prime Minister David Cameron noted in his 2013 Bloomberg speech committing the Conservative Party to holding a referendum, 'If we leave the EU, we cannot of course leave Europe. It will remain for many years our biggest market, and forever our geographical neighbourhood' (Cameron, 2013).

Yet neither the government nor the campaign to leave the EU has put forward clear and concrete proposals for what comes after Brexit. In fact, the government has explicitly ruled out making contingency plans to cope with Brexit (Parker, 2015). To shed light on the possible aftermath of Brexit, this report outlines some of the options for the UK outside the EU and discusses the costs and benefits of each alternative.

Formal procedures for leaving the EU were introduced by the Lisbon Treaty, which came into force in 2009. A country wishing to leave the EU must notify the EU of its intention and this notification would trigger negotiations over a withdrawal agreement between the country and the remainder of the EU. The country would officially exit the EU on the date the withdrawal agreement came into effect or, if no agreement is reached, the country could leave two years after the date of notification.

What matters, of course, is the content of any withdrawal agreement. Several former colonies and overseas territories of European countries, such as Algeria in 1962 and Greenland in 1985, left the European Economic Community (EEC), the predecessor of the EU. But no independent European country has ever left the EEC or the EU. Therefore, there is no relevant precedent that can be used to understand the details of how the withdrawal process would work or to shed light on how the EU would treat the exiting country.

In the event of Brexit, the UK government and the EU would need to make decisions in five main areas.

First, what happens to the UK businesses and the two million UK citizens that are resident in the EU and to the EU businesses and the three million EU citizens that are resident in the UK? For example, would Britons living or working in the EU retain the same rights that they currently enjoy or would they be treated like migrants from outside the EU? Do migrants from the EU have the right to stay in the UK?

There is a presumption in international law that when treaty rights have been executed, those rights are unaffected by withdrawal from the treaty (House of Commons, 2013). This suggests that individuals and businesses that have taken advantage of the Single Market[1] to move either from the UK to the rest of the EU or in the opposite direction would probably be allowed to stay. But this outcome is not certain and would certainly be a subject addressed by any withdrawal agreement.

Second, how would UK law change following withdrawal from the EU? Currently, in areas where the UK has ceded sovereignty to the EU, such as regulation of the Single Market, UK law is shaped by decisions made at the EU level. EU legal decisions enter UK law in two ways. EU directives require member states to adopt policies or change laws to achieve the outcome specified by the directive. By contrast, when the EU issues a regulation, it immediately becomes law in all member states. Thus, directives are enacted through changes to UK law, while regulations have legal force only because the UK is part of the EU.

Consequently, if the UK leaves the EU, then laws that were passed to implement EU directives would be unaffected unless the government chooses to change them. But EU regulations would immediately lose legal force. Since EU regulations govern many important areas, such as food hygiene and safety, this would leave a gap in UK law.

To avoid this possibility, prior to leaving the EU, the government would need to pass legislation setting UK law in areas currently subject to EU regulations. Whether this legislation would simply transpose EU regulations into UK law or implement new regulatory policy is uncertain.

Leaving the EU would also mean that the UK ceased to be subject to the Charter of Fundamental Rights of the European Union. The government would need to decide whether any of the economic, social and political rights guaranteed to EU citizens under this Charter should be written into UK law.

Third, the UK government would need to decide what, if any, policies to adopt in areas that currently fall under the authority of the EU. Of particular importance would be the government’s regional and agricultural policies since these are the biggest components of the EU budget. Less wealthy areas of the UK, such as Northern Ireland and Wales, receive significant funding from the EU’s regional development programmes, which would cease following Brexit. Brexit would mean leaving the Common Agricultural Policy (CAP). The UK as a whole would benefit from this change (Philippidis and Hubbard, 2001), but unless the government introduced new agricultural subsidies, farmers would be among the big losers from Brexit.

In addition, the UK is the third largest recipient of EU research and innovation funding (Ugwumadu, 2013). Following Brexit, the government would need to decide whether to replace this funding. After leaving the EU, the government would also regain responsibility for issues such as competition policy and international trade negotiations, which are currently handled at the European level. There would be a cost of developing the competencies necessary to manage these areas, since the required skills do not currently exist within the UK civil service.

[1] The ‘Single Market’ is the name given to the integrated European economy created by removing economic barriers between EU member states. The Single Market is based on four freedoms: the freedoms of movement of goods, services, people and capital within the EU.

Fourth, would there be a transition period after the UK exits the EU during which the UK's rights and obligations as an EU member are phased out or would the change happen abruptly? A transition period would allow workers and companies that do business with the EU time to adjust to changes in laws, regulations and market access resulting from Brexit.

Fifth and probably most importantly, a withdrawal agreement would need to determine the future of the UK's relationship with the EU. Would free trade between the UK and the EU continue? Would free labour mobility between the UK and the EU continue? And would UK companies continue to have the right to establish subsidiaries and do business in the EU?

This report describes alternative post-Brexit futures for UK-EU relations and summarises the economic and political consequences of each option. It starts with the alternative that maximises economic integration between the UK and the EU and then moves to options with successively lower degrees of integration.

As will become clear, the key trade-off that the UK would face outside the EU would be the same trade-off that has always dominated the country's European policy. There are economic benefits from integration, but obtaining these benefits comes at the political cost of giving up sovereignty over certain decisions. Inside or outside the EU, this trade-off is inescapable.

The Norwegian model – joining the European Economic Area

The European Economic Area (EEA) was established in 1994 to give European countries that are not part of the EU a way to become members of the Single Market. The EEA comprises all members of the EU together with three non-EU countries: Iceland, Liechtenstein and Norway. Members of the EEA are part of the European Single Market and there is free movement of goods, services, people and capital within the EEA. Since EEA members are part of the Single Market, they must implement EU rules concerning the Single Market, including legislation regarding employment, consumer protection, environmental and competition policy.

EEA membership does not oblige countries to participate in monetary union, the EU's common foreign and security policy or the EU's justice and home affairs policies. EEA members also do not participate in the CAP. While there is free trade within the EEA, EEA members are not part of the EU's customs union, which means that they can set their own external tariff and conduct their own trade negotiations with countries outside the EU.

EEA members effectively pay a fee to be part of the Single Market. They do this by contributing to the EU's regional development funds and contributing to the costs of the EU programmes in which they participate. In 2011, Norway's contribution to the EU budget was £106 per capita, only 17% lower than the UK's net contribution of £128 per capita (House of Commons, 2013). Becoming part of the EEA would not generate substantial fiscal savings for the UK government.

Joining the EEA would allow the UK to remain part of the Single Market while not participating in other forms of European integration. An important finding of research on the economic consequences of leaving the EU is that although Brexit would harm the UK's economy through reduced trade, the cost is smaller when the UK remains more economically integrated with the EU (Ottaviano et al, 2014). Consequently, EEA membership is an appealing option for those attracted by the economic benefits of the EU, but who are not in favour of 'ever closer union'.

There are other downsides to joining the EEA in addition to the membership fee and the need to follow EU regulations. While EEA members belong to the Single Market, they are not part of the deeper integration that occurs within the EU. For example, as an EEA member Norway does not belong to the EU's customs union. This means Norwegian exports must satisfy 'rules of origin' requirements to enter the EU duty-free.[2]

With the growing complexity of global supply chains, verifying a product's origin has become increasingly costly. If the UK joined the EEA, part of this cost would be borne by UK firms. Exporters would have to limit their use of inputs imported from outside the EU to meet the EU's rules of origin (Stewart-Brown and Bungay, 2012). The EU can also use anti-dumping measures to restrict imports from EEA countries, as occurred in 2006 when the EU imposed a 16% tariff on imports of Norwegian salmon. Campos et al (2015) find that Norway's failure to undertake the deeper integration pursued by EU countries has lowered Norway's productivity.

While these consequences of EEA membership would increase the cost of doing business with the EU, the more important drawbacks of adopting the Norwegian model would be political. Non-EU members of the EEA must accept and implement EU legislation governing the Single Market without having any part in deciding the legislation. The rules of the Single Market are set by the EU not the EEA.

By leaving the EU to join the EEA, the UK would give up its influence over all EU decision-making, including how to govern the Single Market. In this sense joining the EEA entails giving up even more sovereignty than being part of the EU. EEA members must agree to implement legislation that they have no say in deciding.

For a relatively large country such as the UK, which is accustomed to having a prominent voice in European and world affairs, this is likely to be a difficult position to accept. For example, the government would have no opportunity to block proposals that it believed harmed the UK's national interest or to drive forward policies it generally supports, such as further liberalisation of trade in services. If a vote to leave the EU is interpreted as a vote against giving up UK sovereignty to the EU, then joining the EEA could easily be construed as a betrayal of the spirit of the outcome of the referendum.

The Swiss model – bilateral treaties

Switzerland is not a member of the EU or the EEA. Instead, it has negotiated a series of bilateral treaties governing its relations with the EU. Usually, each treaty provides for Switzerland to participate in a particular EU policy or programme. For example, among many others, there are treaties covering insurance, air traffic, pensions and fraud prevention. Switzerland is also a member of the European Free Trade Association (EFTA), which provides for free trade with the EU in all non-agricultural goods.

[2] 'Rules of origin' are used to determine whether a product originated in a free trade area and is eligible to enter a market duty-free. The precise specifications of rules of origin are complex and variable, but typically to benefit from free trade a product must undergo a certain level of processing within a country that belongs to the free trade area, or a certain proportion of its value-added must come from within the free trade area.

The bilateral treaty approach allows Switzerland the flexibility to choose the EU initiatives in which it wishes to participate. Through EFTA membership and an agreement covering technical barriers to trade, Switzerland has achieved a similar level of goods market integration with the EU as EEA countries.

Currently, there is also free movement of people between Switzerland and the EU, although in February 2014, Switzerland voted in a referendum to impose restrictions on immigration from the EU that would violate its agreement with the EU on free movement of people. It remains to be seen whether or how the Swiss government will implement this vote and what will be the consequences for Swiss-EU relations.

Switzerland and the EU have not reached a comprehensive agreement covering trade in services. Consequently, Switzerland is not part of the Single Market for services and Swiss financial institutions often serve the EU market through subsidiaries based in London.

As with the EEA countries, Switzerland has almost no influence over the design of the EU programmes in which it participates. It makes an in or out choice, but has no ability to shape the content of the programmes. The treaties require Switzerland to implement policies and legislation set by the EU.

In this sense, Switzerland also trades integration for sovereignty and for the most part, Switzerland has chosen to remain relatively closely integrated with the EU by accepting most EU economic regulation. Like the EEA countries, Switzerland makes a financial contribution to the EU to cover regional funding and the costs of the programmes in which it participates. Switzerland's contribution in recent years has averaged around £53 per capita, 60% lower than the UK's net contribution per capita (House of Commons, 2013).

Adopting the Swiss model following Brexit could be appealing if the UK is looking for an 'à la carte' approach to European integration. But there are drawbacks. The EU would be under no obligation to serve the UK everything on the menu, which means that the Swiss model would not provide the same guarantee of market access that EU or EEA membership offer. For example, whether the UK could reach an agreement with the EU to participate in the Single Market in services is uncertain and exclusion from the Single Market would be detrimental to the UK's ability to export financial and business services to the EU.

Overall, it is likely that the Swiss model would result in less economic integration between the UK and the EU than EEA membership, leading to higher economic costs of Brexit. The Swiss model would also entail giving up some sovereignty, since the UK would no longer have a say in EU decision-making, but would have to adopt EU legislation to participate in the Single Market.

Re-joining the European Free Trade Association

Following the Norwegian or Swiss models would allow the UK to remain economically integrated with the rest of Europe and to participate in at least some parts of the Single Market. But a vote in favour of Brexit could lead the UK to seek a more decisive break with the EU. When the UK opted out of joining the EEC in 1957, it founded EFTA as an alternative. EFTA is a free trade area covering all non-agricultural goods. EFTA also has free trade agreements with the EU and numerous other countries.

Re-joining EFTA would guarantee UK goods tariff-free access to the EU and ensure the UK did not impose tariffs on goods imported from the EU. But it would not provide for free movement of people or free trade in services between the UK and the EU. Since the UK would not belong to the Single Market, re-joining EFTA would also probably result in a gradual divergence between economic regulation in the UK and the EU. This would increase 'non-tariff barriers' to trade between the UK and the EU.[3]

Ottaviano et al (2014) estimate the costs of Brexit to the UK economy would come primarily from increases in non-tariff barriers between the UK and the EU, not from changes in tariffs. This suggests there would be an economic price to pay for joining EFTA.

In 1960, when EFTA came into being, reducing tariffs was the primary goal of efforts to lower trade costs and promote international economic integration. But the success of the World Trade Organization (WTO), the EU and other regional and bilateral trade agreements in lowering tariffs has shifted the focus of today's trade negotiations – such as the Transatlantic Trade and Investment Partnership (TTIP) – towards non-tariff barriers and trade in services and capital. EFTA is not designed to promote integration in these areas. Consequently, all EFTA members have either left to join the EU or sought greater integration with the EU through other channels.

At present, the members of EFTA are Iceland, Liechtenstein, Norway and Switzerland. All these countries are either members of the EEA (Iceland, Liechtenstein and Norway) or have their own bilateral agreements with the EU (Switzerland). Unless the UK wishes to opt out of all forms of economic integration except tariff removal, re-joining EFTA is not a stand-alone solution to the problem of what should follow Brexit.

World Trade Organization – the fallback option?

Suppose the UK leaves the EU without putting in place any of the alternative arrangements discussed above. Then the country's trade with both the EU and almost all the rest of the world would be governed by the WTO. As of 2015, the WTO has 161 members comprising all major economies and most minor ones. Under WTO rules, each member must grant the same 'most favoured nation' (MFN) market access, including charging the same tariffs, to all other WTO members. The only exceptions to this principle are that countries can choose to enter into free trade agreements such as the EU or EFTA and can give preferential market access to developing countries.

As a WTO member, the UK's exports to the EU and other WTO members would be subject to the importing countries' MFN tariffs. Compared with EU or EFTA membership, this would raise the cost of exporting to the EU for UK firms (Ottaviano et al, 2014). The UK's services trade would also be subject to WTO rules. Since the WTO has made far less progress than the EU in liberalising trade in services, this would mean reduced access to EU markets for UK service producers.

[3] 'Non-tariff barriers' is a catch-all term referring to any measure that raises the costs of trade but does not take the form of a tariff. It covers everything from quantitative trade restrictions such as import licensing to border costs of complying with customs procedures and behind the border costs caused by regulatory or product standard differences across countries. The EU Single Market has reduced non-tariff barriers between member states by removing customs procedures and harmonising regulations and product standards.

The WTO has no provisions for free movement of labour, so under this scenario, free labour mobility between the UK and the EU would cease. But free movement of capital between the UK and EU would probably continue, as the EU prohibits restrictions on capital mobility not only within the EU, but also with countries outside the EU.

After leaving the EU, the UK would no longer be bound by the EU's common external tariff, but would be free to set its own MFN tariffs on imports. As a starting point, the UK would be most likely to inherit the EU's tariff commitments, but it could then choose to reduce its import tariffs below EU levels to lower import costs for UK consumers and firms and increase the competition faced by UK businesses.

But since the average tariff charged on imports to the EU is only 1% (World Bank, 2015), there is limited scope for further tariff reductions. There is also limited scope to lower non-tariff barriers through unilateral action since reducing non-tariff barriers often requires harmonising policies, regulations or product standards across countries, which requires international agreement.

The pay-off for the lack of economic integration would be greater political sovereignty. Being outside the Single Market would enable the UK government to set economic policy and regulatory standards without taking account of the preferences of other EU members. But any divergence in regulation between the UK and the EU would still act as a non-tariff barrier to trade and raise the cost of doing business with Europe.

Overall, it is uncertain how leaving the Single Market would affect the UK's economic policies and regulations and whether any changes would be beneficial. The OECD has found that, even as a member of the Single Market, the UK's labour and product markets are substantially less regulated and more flexible than those of other EU countries (Koske et al, 2015).

In fact, the UK's labour and product markets exhibit similar levels of flexibility to Canada and the United States and are much less regulated than those of non-EU countries such as Norway and Switzerland. This shows that the Single Market does provide scope for countries to adapt economic regulations to suit national preferences.

Table 1 summarises the costs and benefits of the alternative paths the UK could follow after leaving the EU.

Looking away from Europe

EU members have a common trade policy and are represented by the EU in all international trade negotiations. After Brexit, the UK would become an independent player in trade negotiations. This means that the country would not only need to determine its future economic relations with the EU, but also with the rest of the world. Instead of entering into new agreements with the EU following Brexit, the UK could opt to seek closer integration with countries outside Europe.

Table 1: Options for the UK outside the EU

	Pros	Cons
EEA – the Norway model	○ Belong to the Single Market. ○ Able to negotiate trade deals independently of the EU.	○ Required to implement Single Market policies, but have no representation in setting the rules of the Single Market. ○ Must comply with rules of origin for exports to the EU and subject to EU anti-dumping measures. ○ Must contribute to the EU budget.
Bilateral agreements – the Swiss model	○ Free trade in goods and free movement of people with the EU. ○ Able to negotiate trade deals independently of the EU. ○ A la carte approach permits opting out of EU programmes on a case-by-case basis.	○ Bilateral agreements require Switzerland to adopt EU rules, but Swiss have no representation in EU decision making. ○ No agreement with the EU on trade in services. ○ Pay a fee to participate in EU programmes, but contribution likely to be lower than if in EEA.
EFTA	○ Free trade in goods with the EU. ○ Able to negotiate trade deals independently of the EU. ○ Not required to adopt EU economic policies and regulations. ○ No obligation to contribute to the EU budget.	○ No freedom of movement of people with the EU. ○ No right of access to EU markets for service providers. ○ Goods exported to the EU must meet EU product standards.
WTO	○ Able to negotiate trade deals independently of the EU. ○ Not required to adopt EU economic policies and regulations. ○ No obligation to contribute to the EU budget.	○ Trade with EU subject to MFN tariffs and any non-tariff barriers that comply with WTO agreements. ○ No freedom of movement of people with the EU. ○ No right of access to EU markets for service providers. ○ Goods exported to the EU must meet EU product standards.

For example, the UK could propose a free trade area among Commonwealth countries or could attempt to join Canada, Mexico and the United States as a member of the North American Free Trade Agreement (NAFTA). Of course, the EU is also working to dismantle trade barriers with the rest of the world, such as through the TTIP agreement currently being negotiated with the United States. It is uncertain whether leaving the EU would enable the UK to negotiate more and better trade agreements than it can as part of the EU.

Even without the UK, the EU is the world's second largest exporter behind China and the world's second largest importer behind the United States. This makes the EU a desirable trade partner and gives the EU an important voice in trade negotiations. Since the UK is a much smaller market than the EU, the country alone would have less bargaining power in international trade negotiations than the EU currently has.

On the other hand, Brexit would enable the UK to seek trade agreements tailored to the interests of UK businesses and consumers rather than having to make compromises to meet the needs of other EU countries.

Whether the benefits from greater autonomy in trade negotiations would outweigh the costs from reduced bargaining power is hard to predict, but some insight into how the UK may fare following Brexit can be gained by looking at the experience of Canada – another medium-sized developed economy in close proximity to a much larger market.

Under NAFTA, there is free trade between Canada, Mexico and the United States, but one of the costs of obtaining access to the US market is adoption of the provisions of the 'investment state dispute settlement' (ISDS). ISDS clauses are almost always included in US trade agreements (Poulsen et al, 2013) and they allow US investors to bring claims directly against the Canadian government (and vice versa). By contrast, under the WTO's dispute settlement mechanism, investors must go through their home government to bring a claim against another country.

Cases brought against Canada under the ISDS have covered issues such as the decision to introduce plain packaging of tobacco products and 'anti-graft' rules that would restrict companies convicted of corruption from receiving government contracts. This has raised concerns that ISDS clauses provide too much protection to foreign investors and effectively curtail national sovereignty.

There is also evidence that US firms are better able to take advantage of ISDS provisions than Canadian firms. The United States has won all of the 11 decided cases that it has initiated under the ISDS, while Canada has won seven of its 13 decided cases (CCPA, 2015).

The scope of ISDS provisions is a key point of contention in the TTIP negotiations between the United States and the EU. The EU has sufficient bargaining power to push back against rules designed to advance the interests of US firms. It is unlikely that the UK alone would have similar leverage.

Reducing trade barriers between the UK and the rest of the world is a laudable aim and would be likely to increase trade and raise UK income. But it is not an adequate replacement for EU membership. The best-known fact in international economics is that international trade and investment fall substantially with distance (Head and Mayer, 2014). Doubling the distance between two countries roughly halves the trade between them. The UK is much closer geographically to the EU than to other large economies such as the United States or China and, therefore, it is not surprising that roughly half of the UK's trade is with the EU (Ottaviano et al, 2014).

Put another way, it is geography rather than policy that makes the EU the UK's most important economic partner. Simply reorienting the focus of the UK's trade policy away from Europe will not change this underlying reality. Whatever agreements are reached with countries outside Europe, the most important decision facing the government following Brexit would still be the future of the UK's relations with the EU.

Conclusions

A vote in favour of Brexit will fire the starting gun on a two-year renegotiation of the UK's place in Europe and the world. If the UK opts to cut ties with the rest of Europe, this renegotiation could fundamentally change the political, economic and legal foundations of UK life that have built up since the country joined the EU in 1973. Alternatively, if the UK chooses to remain part of the EEA, the economic and legal changes would be much smaller.

During the renegotiation, the UK would face an unavoidable trade-off between economic benefits and political sovereignty. The UK benefits from closer economic integration with the EU, but the price for this integration is allowing the EU control over some areas of policy. Leaving the EU will not free the UK from this fundamental trade-off.

At present, there is no consensus within the government or the public over what should follow Brexit. This reflects the fact that all of the alternatives to EU membership have their own drawbacks and would impose costs on the UK economy. To make an informed decision about the merits of Brexit, voters need to know as much as possible about what Brexit would mean.

To date, neither the Conservative government nor the Labour opposition have released proposals for the UK's future if the country votes to leave the EU. Just as the parties put forward policy manifestos in the run-up to an election, they should publish their plans for a post-Brexit world before the referendum. The alternative scenarios discussed in this report embody very different visions of the UK's future place in the world. The country's voters have the right to know what they are choosing between when they enter the polling booth.

February 2016

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