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Salvaging Brexit

The Right Way to Leave the EU

Swati Dhingra

On June 30, a week after the British public voted to leave the EU, Theresa May gave a speech launching her candidacy for prime minister in which she declared, "Brexit means Brexit." Her message was straightforward: even though she herself had supported remaining in the EU, she would not hesitate to implement the will of the voters. Yet months after assuming office, May has yet to answer crucial questions about what a British exit, or Brexit, would mean for trade, immigration, and financial services. It is still not at all obvious what Brexit will actually look like.

That's because the referendum has confronted the government with two distinct but related problems: how to leave the EU as painlessly as possible and how to reverse the years of economic neglect that have divided the country. Solving each will require hard choices, and whatever the politicians decide, some of their supporters will feel let down. With this in mind, they should prioritize prosperity over politics and defy radicals on both sides of the debate. Simply ignoring the referendum result would be politically untenable. But abruptly abandoning the single market, which guarantees the free movement of goods, services, and people, would cause widespread economic hardship.

The best path forward, then, is to strike a temporary deal to keep the United Kingdom in the single market—a deal similar to that which Norway enjoys. Such an arrangement would remove uncertainty among businesses over the United Kingdom's future relations with its biggest trade and investment partner and would buy time to work out a permanent settlement. Assuming it can be sold politically at home, such an interim solution should also prove palatable to the EU.

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But trade policy can achieve only so much. In order to respond to the grievances that led to the Brexit vote in the first place, the British government also needs to take big and immediate steps to restore economic equality and raise the country's potential for future growth. To that end, it should rebuild its creaking infrastructure and overstressed public health and educational systems. Only by targeting the underlying sources of economic anxiety can policymakers finally begin to heal a broken nation.

IT'S NOT EU, IT'S ME

In order to understand why the British people chose to leave the EU, it's necessary to understand what has happened to the British economy in the four decades since the country voted for membership in the European Economic Community. In 1975, two years after it acceded to the EEC, the United Kingdom held a referendum on continued membership. As in this year's vote, those who wanted to leave in 1975 claimed that doing so would lower prices, boost wages, and create jobs for British workers. A majority of the public rejected these claims, and 67 percent of voters chose to remain in the EEC. This time around, obviously, the result was different; only 48 percent opted to stay.

The shift in public opinion can be explained by the intervening increase in economic stress. Although the "leave" campaign's message in 2016 centered on the need to regain British sovereignty, curtail immigration, and stop contributing to the EU budget, many Britons used their votes to express anger at the country's political establishment and its failed economic policies instead. That shouldn't be surprising: even as the economy has grown, the gap between the top and the bottom has stretched wider and wider. In 1980, the top ten percent earned 2.7 times as much as the bottom ten percent; in 2013, the top ten percent took home 3.7 times as much. This is because, for decades, median wage growth has lagged behind average wage growth. In other words, the pie has grown, but workers have seen their slices grow far slower. The financial crisis only made things worse. From 2003 to 2014, all workers suffered as average weekly earnings shrank by 1.8 percent, but the poorest did the worst, as median earnings slid by 2.8 percent over that period. It's not enough to just blame the crisis, however. As far back as 2000, the share of working-age men without qualifications (having left school before the age of 16) who were not active in the labor force had reached 30 percent, compared with less than four percent two decades earlier. By April 2016, that figure stood at over 43 percent.

The state bears most of the blame for these problems. For years, it has underinvested in public services, eroded the power of trade unions, and failed to promote employment or raise wages. The national minimum wage remained low by international standards for decades, until a Labour government raised it in 1998. The result has been that for many in the United Kingdom, having a job is no guarantee of financial security. Half of poor children in the country have parents who work but are nevertheless below the poverty line.

In recent years, one of the worst examples of government underinvestment has been in health care. In 2010, the new coalition government of Prime Minister David Cameron pledged to protect the National Health Service from austerity. Despite this guarantee, however, health-care spending has grown by just 1.2 percent per year since 2010, compared with 3.7 percent between 1949 and 1979 and over 6.7 percent from 2007 to 2009, during the financial crisis. The United Kingdom now ranks 13th among the 15 original members of the EU in the percentage of GDP spent on health care. Cuts to the NHS' budget made in the name of efficiency have led to perverse policies, such as hiring expensive temporary staff to meet the shortfall in permanent employees. Remaining staff feel underpaid and overworked.

The British state bears most of the blame for the economic malaise.

And it's not just health care where the government has failed. In 2010, the coalition government also reduced child benefits, a policy that researchers at the Institute for Fiscal Studies estimated would push an extra 200,000 children into poverty by 2016. Sure enough, the share of children living in relative poverty ticked up from 27 percent in 2011 to 29 percent in 2015, an increase of 300,000 children, even as the economy recovered.

The imposition of fiscal austerity after 2010 was the coup de grâce for many of the country's most deprived regions. London's poorer boroughs, England's forgotten seaside towns, and the declining industrial areas of northern England, the South Wales Valleys, and Glasgow have experienced the biggest declines in welfare payments over the last six years. In contrast, the more prosperous south and east of England have

England expects: in Portsmouth, once a major shipbuilding port, November 2013

STEFAN WERMUTH / REUTERS

seen only small spending reductions, since many of the cuts were to public spending that mostly benefited poor individuals. Reductions in disability benefits, housing-support payments, and unemployment assistance hurt most those areas that already had the highest shares of claimants.

DIDN'T WE ALMOST HAVE IT ALL

Real as the anger is, scapegoating the EU for British economic hardship is unfair. In fact, it's doubly so: not only is the British government responsible for the problem, but the EU has actually mitigated its impact. Forty years of data point to the overwhelming conclusion that EU membership reduced the price of goods, increased real wages, and helped fund British public services.

The EU did all this by reducing barriers to trade, which increased competition among firms and caused them to slash the markups they charged consumers. According to a study by the economist Harald Badinger, for example, markups for manufacturing goods across ten EU states fell from 38 percent to 28 percent of costs between 1981 and 1999. What's more, as markets integrated, consumers could more easily purchase products from other countries, which harmonized prices across borders. The economist John Rogers has shown that the local prices of dozens of household goods—from bread to wine to sweaters—converged dramatically between 1990 and 2001. By the end of that period, prices varied within the EU about as much as they did within the United States.

At the same time as the EU lowered prices, it also raised British workers' job prospects, since British businesses expanded production as they obtained cheaper access to European markets. According to researchers at the Institute for Fiscal Studies, this helped raise real wages in the United Kingdom and caused unemployment to fall by 0.7 percentage points between 1988 and 1999. Firms also intensified their research and development to respond to increased competition, which in turn increased overall economic productivity.

Another pillar of the EU, the free movement of people, has driven both economic growth and economic fear. Over the past four decades, workers from the poorer countries of Europe have flocked to the relatively prosperous United Kingdom—over a third of the 8.5 million immigrants currently in the country hail from elsewhere in the EU. Ever since the United Kingdom's accession to the EEC, many voters have feared that these immigrants would displace British workers. This concern played an important role in the June referendum: the higher an area's share of immigrants or the larger its recent increases in immigration, the more likely it was to vote to leave.

Economic hardship, inequality, and political alienation are not unique to the United Kingdom.

Yet immigration from other EU states has not actually harmed British citizens. Even after the EU expanded in the first decade of this century to include much of eastern Europe, there is no evidence that British-born workers experienced higher unemployment or lower wages in counties with above-average numbers of EU immigrants. Nor has EU immigration exacerbated inequality by harming less skilled workers, the segment most vulnerable to competition from immigrants. Changes in wages and joblessness for this group show little correlation with changes in EU immigration.

European immigrants have even been a boon to public finances, because they pay more in taxes than they consume in government services. Euroskeptics often accuse immigrants of robbing British citizens of places in schools and hospitals, but given immigrants' net contributions to such services, these deprivations are more accurately characterized as the result of chronic government underinvestment. Nor have immigrants from the EU undermined social stability: in 2013, researchers at the London School of Economics and University College London found that the large wave of economic immigrants from eastern Europe after the enlargement of the EU in 2004 did not lead to more violent crime or theft.

BREAKING UP IS HARD TO DO

Despite the benefits of staying in the EU, of course, voters chose to leave it, and now the government must respect their decision. But there are several different forms that the departure could take. The most sensible option would be a deal similar to Norway's, whereby the United Kingdom would remain a member of the single market by joining the European Economic Area, a group of all the EU members and three nonmember countries (Iceland, Liechtenstein, and Norway) that trade freely with the EU but do not participate in its political institutions. Under this arrangement, the costs of trade would still rise, since the United Kingdom would face some nontariff barriers that currently apply to the non-EU members of the EEA. To avoid duties, manufacturers would have to prove that their goods qualified as made in the United Kingdom, for example, a costly process thanks to increasingly complex global supply chains. The European Commission might also impose tariffs on British exports if it ruled that they were being sold to the EU below market price. In 2006, for example, Norwegian salmon exporters who received financial support from the Norwegian government incurred a 16 percent tariff. The United Kingdom would also lose the ability to influence future reductions in trade barriers, such as those the EU is considering in the service sector, which makes up a large part of the British economy. But by preserving access to the single market, this approach would minimize the losses from reduced trade and investment.

Obtaining a Norwegian-style deal wouldn't be easy, however. For one thing, it would require joining the European Free Trade Association—composed of the three non-EU members of the EEA plus Switzerland—which might be unwilling to let the United Kingdom in. Norway has already said it might block British participation, as the relevant agreements have evolved over 20 years to reflect the needs of the association's current members. But Norway's opposition is not certain, and such a deal should prove more palatable to the EU than any other option, since if it were framed as a temporary measure, it would give the union time to think about how it will deal with emerging threats to the European project. The economic hardship, inequality, and political alienation that led to the Brexit vote are not unique to the United Kingdom; they are also present in France, Italy, and the Netherlands, any of which could soon face a similar campaign to leave. The EU must walk a fine line: if it is too soft on the United Kingdom, a host of other countries will want to renegotiate their positions in the EU, but if it is too harsh, it will further alienate anti-EU voters.

Perhaps a greater challenge would be getting the British public to accept the continued free movement of EU citizens, sure to be part of any Norwegian-style deal but a redline for many Britons in the leave camp. As a result, some prominent figures, including Rupert Harrison, former chair of the Council of Economic Advisers, have floated the idea of an "EEA minus" option. Such a deal would involve a comprehensive British-EU free-trade agreement similar to the Swiss-EU deal but, crucially, also restrictions on immigration. From the EU's perspective, however, this would be a nonstarter. Free movement of labor is the sine qua non of the EU, and the Swiss had to accept it in order to get deep access to the single market. Even after a referendum in 2014 in which the Swiss people voted to limit immigration from the EU, Brussels refused to let the country impose any limits on movement without losing all of its EU financial and trading rights. Besides, Switzerland's deals with the EU took over 20 years to negotiate, time the United Kingdom can ill afford. And to keep the club together, the EU cannot make leaving too easy.

Free movement of labor is the sine qua non of the EU.

The only path that would allow the United Kingdom to control immigration and free it from EU regulations and trade policy would be to exit the single market entirely, leaving the country with no comprehensive free-trade agreement with the rest of Europe. Were it to take this route, the United Kingdom would face harsh external tariffs, which, in an ironic twist, would hit hardest some of the areas that voted to leave.

To understand what's at stake, consider the northern industrial city of Sunderland, which voted for Brexit by a 22 percent margin. Sunderland is home to one of Nissan's most cost-efficient manufacturing plants, and last year, it began producing the company's newest luxury car, the Infiniti Q30. About half of British car exports currently go to the EU, which they can enter duty free. Should the United Kingdom leave the EU without a trade deal, it would be treated just like any other non-European trading partner, subject to the default World Trade Organization rules, under which the EU would charge its usual ten percent import tax on cars. No longer so attractive to Nissan, Sunderland could turn into Detroit.

Nissan isn't the only company facing this problem. In a 2014 survey, the Society of Motor Manufacturers and Traders, a British industry group, found that 70 percent of its members expected that leaving the EU would hurt their business in the medium or long term, and three-quarters felt that it would reduce foreign investment in the United Kingdom. History suggests that they're right: the British car industry spent a decade stuck in the slow lane until the country merged with the single market in 1973, allowing British manufacturers to get the same access as French and German ones.

To counter such gloomy predictions, the leave campaign set out grand visions of resuscitating trade within the Commonwealth or reorienting trade toward China or the United States. On the surface, these sound like great ideas, but nothing currently stops the United Kingdom from trading with those countries as a member of the single market. (Indeed, Germany does exactly that, and with great success.) Making up for the loss of membership in the single market would prove difficult, moreover, no matter how ambitious the new trade deals outside the EU were. For one thing, economists have long known that countries trade most with large, rich, nearby markets—and in the case of the United Kingdom, that's the EU. For another thing, trade agreements take many years to negotiate. And without the clout of the EU, British trade negotiators would find it far harder to defend the United Kingdom's interests against those of large countries such as China and the United States.

Besides, with tariffs at record lows, these deals have become less about reducing import duties and more about harmonizing regulations. Many countries outside the EU still lag far behind the United Kingdom in product and labor standards, and so bringing British rules in line with less stringent countries would prove politically difficult and often undesirable. In short, despite what the Brexiteers promised, abandoning the single market would do grave damage to the British economy.

LONDON BRIDGE IS FALLING DOWN

Not only would striking a trade arrangement with the EU soften the blow of leaving; it would also give the United Kingdom the time and resources to get its own house in order. Over the past two decades, the fortunes of the wealthiest Britons have risen, while the poorest have been stuck in a cycle of falling wages and unfulfilling work. Geography has become destiny: London and the prosperous south and east of England feel increasingly like a different country from the declining industrial north. In the referendum, the latter voted as though it were seeking revenge on an elite it felt had forgotten it. Indeed, the lower the wage growth in a given region, the more likely its people were to vote to leave. Unfortunately, such votes were masochistic. The same regions that voted to leave are those that depend the most heavily on EU trade, investment, and transfers. Leave voters were also poorer and less educated than the average—the very group that will suffer more than most if the United Kingdom leaves the EU.

There are promising signs that May and her allies within the Conservative Party have recognized the scale of the problem. Since the vote, they have proposed a number of progressive policies, such as transferring funds from richer regions to poorer ones and giving workers representation on company boards. Although they would help, however, such changes would not go far enough. The United Kingdom needs to make a more fundamental shift away from its neoliberal ideology, which presumes that government efforts to promote growth never work and that balanced budgets are next to godliness, back to its earlier tradition of investing heavily in assets that raise long-term growth. Even the most ardent believers in the free market, including Germany and the United States, support their domestic industries—through public investment in research and development, for example—because they recognize that this kind of spending promotes future growth and economic equality.

Nothing illustrates what has gone wrong with the United Kingdom better than education. Today, poor British children perform worse in school than their richer classmates, and the correlation between socio-economic background and school performance, although present in every rich country, is stronger in the United Kingdom than in many others, including countries as varied as Greece, Russia, and Spain. This broken educational system not only stifles social mobility but also depresses labor productivity. To fix it, the government needs to find ways to recruit the best teachers and invest more in training them. At the same time, policymakers should make sure they are using the right yardstick when measuring success. Past attempts at educational reform have failed to improve social mobility, so the government should judge new proposals by how much they will improve the performance of children from disadvantaged backgrounds and not just based on average attainment. The silver lining of the referendum result is that, by highlighting the many places where social mobility is lowest, it appears to have created the political will for such policies.

Public investment in health care would also spur economic activity. Such moves have worked before: government regulation of prices in the NHS forced drug firms to innovate and encouraged competition from low-cost producers; support for biomedical research in public universities in the postwar era helped build a world-class pharmaceutical industry in the United Kingdom. Stepping up health-care spending would not only improve public health but also generate jobs in industries linked to health care and improve corporate bottom lines by creating a healthier work force.

Unfortunately, the vote to leave was masochistic.

The United Kingdom's problems aren't limited to education and health care, however; the country also spends less on infrastructure than most other rich nations. Many of its roads, houses, and power grids were built in the 1960s and 1970s and are now coming to the ends of their useful lives. The electrical system has deteriorated to the point that earlier this year, the country's energy regulator warned that power shortages could be coming. Investing in infrastructure now would create jobs and lay the foundations for future growth, just as it did for the United States during the Great Depression, when such spending put millions of Americans to work improving the roads and laying the sewer pipes and other equipment that enabled the country's subsequent recovery.

Finally, the British government should ramp up its investments in innovation, focusing on firms that have high growth potential. Innovation produces social benefits—technological advances that can be used in other sectors, for example—beyond the returns to private investors, so it deserves government support. Yet the British government spends much less on promoting innovation than do the governments of France, Germany, and the United States. Since such spending makes workers more efficient, it's no surprise that labor productivity in the United Kingdom is seven to 39 percent lower than it is in those countries.

The British government also does too little to encourage investment in small and medium-sized enterprises, diverting private investments away from young businesses and toward safer activities such as real estate. Smaller companies form the backbone of the British economy, providing 60 percent of private-sector jobs and generating high returns relative to the support they receive. Yet private commercial investors tend to think in the short term and are reluctant to support such businesses, especially during recessions. It wasn't until 2012 that the government attempted to help by setting up the British Business Bank to lend to these firms. And even now, the bank's total lending remains small compared with that of similar facilities in the United States. The government should dramatically scale up the bank's operations.

None of these ideas are radical. But for them to work, politicians must be willing to spend dramatically more than in the past; a few percent of national income will not do the trick.

The Brexit vote has handed the country a gargantuan challenge, and no response to it will satisfy everyone. But if the British government can maintain access to the single market and invest in education, public health, infrastructure, and innovation, then it will contain the immediate damage and may even begin restoring prosperity and hope in the country's forgotten places.