The economic case for a Brexit

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What effect would a Brexit have on the UK's economy? **Kent Matthews** *gives three reasons why Britain leaving the EU may have a positive economic impact for the country. He argues that a Brexit would reduce prices, free businesses from over-zealous regulations, and allow the UK to redirect the money it currently pays into the EU budget toward more pressing priorities.*

The most compelling arguments for a Brexit are not necessarily economic ones. The matter of sovereignty, rule by bureaucracy, and the democratic deficit are all much more powerful arguments for the leave campaign. But an economic argument does exist, and on balance it also favours a Brexit.

The first step in outlining this case is to dispense with the argument that access to the single market trumps all arguments for an exit. The remain campaign contends that not being part of the EU will close the UK off from the single market in some capacity. In reality, the single market is a protectionist customs union that places sizeable tariff barriers around manufactures and agriculture. Together these two sectors only account for about 11% of UK GDP. However, there is no EU trade barrier on services which accounts for nearly 80% of the UK economy.

But before we look at the potential costs for UK manufacturing we need to be aware of some facts. First, the UK exports less goods to the rest of the EU than it imports from the EU. The trade deficit with the rest of the EU in goods was £85.3bn in 2015, compared with a deficit of £20.7bn with the non-EU. Furthermore, our trade deficit with the rest of the EU has been widening since 2008, while our deficit with the rest of the world has fallen during the same period.

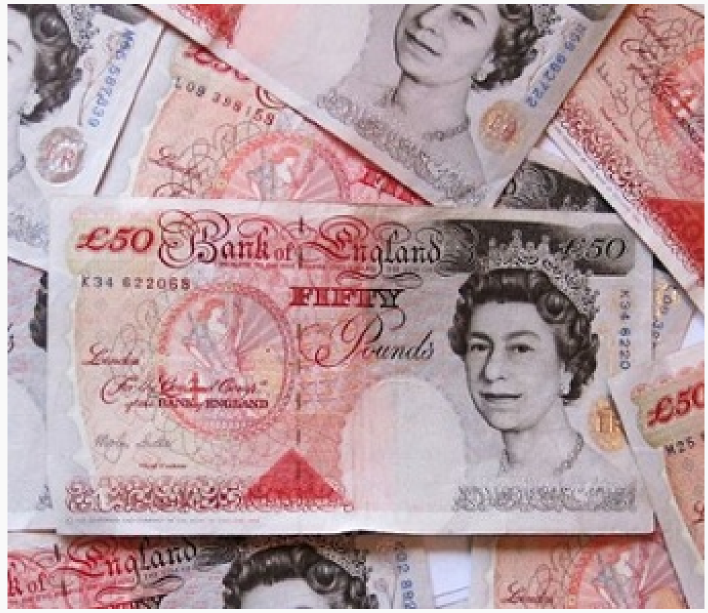
Second, contrary to what is popularly believed, Germany is not our biggest export market. While it is true that 44 percent of our exports go to the EU, it follows that 56 percent of our exports are to non-EU countries. Our biggest single goods export market in 2015 was the United States (15%), followed by Germany (10%), Switzerland (7%) and China (6%). Imports from the EU account for 53 percent of total goods imports and Germany is the single biggest country that makes up 15 percent of the total. Finally, we had a surplus of £30bn with our trade in services across Europe in 2014, while the top 5 countries in the EU's services trade were in surplus by £8bn.

The point in these facts is that as far as the single market is concerned, tariffs on UK goods exports will also damage the rest of the EU's exports to the UK and as they export more to us than the other way round, the stakes are high. It would pay both parties to agree on trade arrangements that are not damaging to trade. But with trade in services, where the UK has an enormous comparative advantage, the single market leaves it unaffected.

Three economic arguments for Brexit

There are three key economic arguments for Brexit: a trade argument, an argument concerning regulation, and an argument focused on distribution. In the first case, the EU places protective barriers around manufacturing and agriculture, but leaves services largely unaffected. Inside the EU, the prices of manufacturing and agricultural products are higher than world market prices. But tariff barriers are not the whole story, various non-tariff barriers also exist that are difficult to quantify.

Research by Patrick Minford and others has quantified the joint effect of tariff and non-tariff barriers, estimating a 20% premium on world prices. As such, almost any trade agreement with the EU that reduces the import prices of protected goods will be an improvement. Suppose the extreme case is simply to 'walk away' and impose no retaliatory tariffs on EU imports. Minford and his colleagues estimate that general prices will fall by 8% in this scenario and economic welfare will increase by 4% of GDP. Manufacturing would diminish as the protective tariffs bite, but this will also release resources to the competitive services sector that will expand.



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In this exercise it is assumed that agriculture would continue to be supported by the government to stay at the same size, however this would be a worst case scenario. Faced with possible retaliatory tariffs on EU exports to the UK, a better deal would allow manufacturing to continue to trade freely in the EU. The current agreement gives manufacturing free entry to the EU but at the cost of high import prices. The alternative is to negotiate an agreement with the EU that is favourable to manufacturing for both parties and simply continue to trade under WTO rules with the rest of the world as we currently do, without individual trade agreements. Therefore, the only trade agreement we need to have is with the EU and it is not necessary, as has been suggested, to negotiate multiple trade agreements with all other trade blocs.

The second economic argument relates to the regulatory zeal of the European Commission that has placed numerous and unnecessary burdens on businesses. The rules and regulations of the single market relate to the 44 percent of exports to the EU. This is less than 15% of GDP but all those regulations apply to the remaining 85% of the economy. There are four areas of regulation, as identified by Tim Congdon.

First, the EU has been at the forefront in pronouncing the dangers of global warming and has forced member states to replace low-cost energy sources with high-cost energy sources. The result has been to drive up costs in the steel and heavy industries, with the crisis in the steel industry being one of the outcomes. Second, the ‘social chapter’ and the creation of social legislation have again added to the costs of business which is estimated to cost 1% of GDP.

Third, financial regulation has passed from the UK to EU bodies which threaten the most profitable square mile of London as a financial centre. According to the 2014, UK Government competency review on financial services, ‘Over the last ten years, there has been a roughly ten-fold increase in the volume of EU law on financial services’.

Fourth, there are a huge number of regulations that ban substances and manage processes that is part of the harmonisation drive of the single market. Regulation creates allocative distortions that affect output, productivity and employment. The acquis communautaire is 170,000 pages long and that is particularly costly for the SME sector.

Of course it can be argued that trying to evaluate the costs of regulation comes up against the counterfactual that perhaps the regulations adopted by the UK government would be even more draconian than what the EU imposes. While this argument is difficult to counter it is unlikely that the UK government would actively hamper business in this way, but anyway there is a democratic process that can define the degree of ‘business friendliness’ which is skewed within the EU.

Finally, we come to the distribution argument. The EU provides funds to agriculture, scientific research, universities and many other recipients in the promotion of its wider objectives of a more integrated and socially cohesive Europe. What is important to understand is that it is not the EU but the UK taxpayer that ultimately provides these funds.

In 2014 the gross contribution by the UK to the EU budget was £18.8 billion. Subtracting the rebate (‘abatement’) of

£4.4 billion left a total contribution after the rebate of £14.4 billion. Subtracting a further £4.6 billion for UK recipients leaves a net contribution in 2014 of £9.8 billion. HM Treasury estimates that the net contribution in 2015 will have been £8.5 billion (more than twice the number in 2009) and forecasts that this will rise to £11.1 billion in 2016. The net contribution by the UK to the EU has been rising systematically in real terms since 1973.

Now a well-established principle in welfare economics is that if the gainers can compensate the losers in any cost-benefit calculation then there is a net welfare improvement. What is important to realise is that as a net payer to the EU budget the UK is well able to compensate the losers in a post Brexit world. However, price support systems and subsidies, as in the Common Agricultural Policy, result in a misallocation of resources. The removal of the price support payments will have the additional benefits of lowering prices to consumers.

From a political economy standpoint the gainers (the UK consumer) may want to compensate the losers (farmers). But that leaves two important questions. First, how should the gainers compensate the losers, and second can the UK government credibly commit to compensating these losers? Regarding the first question, the least distortionary method of compensation is to provide a lump-sum subsidy that will leave production decisions unaffected by interventions. This would simply be a means of cushioning the financial impact on those recipients who have grown dependent on funds disbursed by the EU.

The second question is harder. There is no credible way a future government can pre-commit to spending the Brexit-dividend in the way the EU currently does. This is particularly so as much of the EU spending may be inefficient, not allocated to the right areas, for the right reasons. It may be politically defensible to promise the losers in the short term that they will be protected but in the longer term this will have to be balanced against how the resources may be better used. Each lobby group would make their case to government which in a democratic world will be balanced against the greater good. That is how democracy works.

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