Did the Treasury get it right? Putting a figure on the cost of a Brexit

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*The Treasury has released a report which analyses the economic impact of leaving the EU and estimates that it could lead to a 6.2% fall in GDP (£4,300 per household). In a briefing paper for the LSE's Centre for Economic Performance, **Swati Dhingra, Gianmarco Ottaviano, Thomas Sampson** and **John van Reenen** analyse the report and conclude it is a serious contribution to the debate. Their major criticism is that the Treasury have been overly cautious in their assumptions for their central case (a negotiated bilateral agreement, like the Canadian trade deal) and the true long-run costs of a Brexit are likely to be higher than they estimate. In this extract, they address some of the criticisms made of the Treasury's analysis.*

Is forecasting so far out impossible?

Many Leave commentators have attacked the Report by saying it is impossible to forecast events so far in the future. Although the Report is pitched as what will be GDP in 15 years' time, it is important to realise that this is an analysis rather than a forecast. The Report is in essence saying how much poorer the UK is likely to be because of a Brexit. Current forecasts of the global economy could be too pessimistic as technological change may pick up. Or they might be too optimistic if China has a debt meltdown. But whatever happens, we can consider what will be the state of the UK economy relative to these outcomes. And the Report is essentially saying that whatever unexpected events happen in the world, the UK is likely be considerably poorer than it would have been if it remained in the EU.

Fiscal transfer

The Report does not focus on net fiscal transfers to the EU. As we have argued, these are not likely to be large enough to outweigh the economic losses as the transfer is about 0.31% of GDP. In the case of the EEA, there is likely to be a continued large transfer (Norway pays in 88% of what the UK does on a per capita basis) and similarly large transfers are made even in looser arrangements (for example, 40% in the Swiss case).

Benefits of cutting 'red tape'

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The Report argues there is unlikely to be much of an effect from changes in regulation following a Brexit, as the UK is already one of the most lightly regulated countries in the developed world. This is the same conclusion that we reach. Although the UK Government's Impact Assessment finds that the benefits of most regulations derived from EU laws have outweighed their costs, Booth et al (2015) point to 56 regulations where costs outweigh the benefits. Crafts (2016) estimates that the cost of these regulations is 0.9% of the UK's GDP. But many of these regulations implement policies that the UK government is committed to following inside or outside the EU. For example, half of the total cost comes from just two policies: the Renewable Energy Strategy; and the Working Time Directive. Scrapping these regulations would mean abandoning the UK's renewable energy targets and removing rights such as the entitlement to 20 days paid annual leave. And even if the regulatory costs of EU membership were 0.9% of GDP and there was the political will to abolish these regulations, this figure is substantially smaller than the GDP decline forecast in the Report.

'Look globally and strike great trade deals'

Another criticism is that the document ignores the possibility that after a Brexit, the UK will reorient its trade towards faster-growing economies such as China, India and the United States. The UK actively promote trade with these countries now, but it cannot strike trade deals with them alone. When negotiating post-Brexit trade deals, the UK would not need to compromise with other EU countries. On the other hand, the UK would have to take on the cost of hiring civil servants to rebuild its capacity to undertake trade negotiations which can take decades. More importantly, since the UK is under a fifth of the economic size of the EU single market it would have less bargaining power in trade negotiations than the EU does. And being outside the EU would mean it no longer automatically accessed the benefits from the EU's trade deals, such as the current ones being negotiated with the US and Japan worth around 0.6% of GDP. It beggars belief that these putative trade deals would be on so much better terms than the existing and future deals that the EU has negotiated, that they would outweigh the larger loss of trade and investment identified in the Report.

'Leaving the EU will shield us from its decline'

Some critics believe that the EU is about to collapse and the UK will be shielded from the fall out by jumping from the sinking ship. It is true that the EU (like the UK) has become a smaller part of the world economy over the last two decades. But this is not because the EU has not grown – it has simply not grown as fast as the rising economies such as China or India. Given the geographical fact that we are a neighbour to Europe, developments in the EU block will always have a major effect on the UK. Throwing up masses of trade barriers with the EU (which Brexit supporters claim they will not do) will 'shield' us only in the sense it would decouple us from our major economic partners.

Conclusions

Forecasting the economic consequences of Brexit is a difficult challenge and all estimates will be subject to a degree of uncertainty. But our overall assessment is that the Treasury Report is a credible analysis, which, for the most part, uses the best available estimation methods. Our main criticism is that they have taken overly cautious assumptions which will tend to underestimate the economic costs of Brexit. Their headline forecast that Brexit would reduce long-run UK GDP by 6.2% in the baseline case is broadly consistent with our previous work and many other independent estimates. For example, our dynamic estimates of the cost of Brexit indicate a GDP loss of 6.3% to 9.5% in the case of moving from the EU to EFTA. Treasury estimates are at the lower end of this range. The Treasury's findings reinforce the academic and business consensus that a Brexit would make the UK significantly poorer. The Report is a serious contribution to the debate.

Reference

Crafts, N. (2016) 'The Growth Effects of EU Membership for the UK: A Review of the Evidence', University of Warwick mimeo.

This post represents the views of the authors and not those of BrexitVote, nor the LSE. It is an extract from the LSE Centre for Economic Performance's fourth briefing paper on the effects of leaving the EU.

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