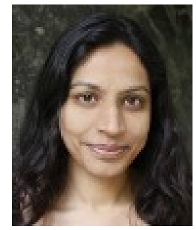
What kind of relationship with the EU is best for the UK economy post-Brexit?

blogs.lse.ac.uk/europpblog/2016/08/09/what-kind-of-relationship-with-the-eu-is-best-for-the-uk-economy-post-brexit/

09/08/2016

The UK has voted to leave the EU, but not in favour of any specific alternative to EU membership. This poses a challenge for UK policy makers and the new Prime Minister. What should the UK's relations with the EU be, following Brexit? The UK should join the EEA and remain part of the single market, write **Swati Dhingra** *and* **Thomas Sampson**.



It is naïve to expect economic considerations will be the only factor that determines what relationship the UK eventually seeks with the EU, or what deal the EU is willing to grant the UK. If the UK government's objective were to obtain the highest possible standard of living for UK citizens it would never invoke Article 50 of the Treaty of Lisbon and start the Brexit process. But if Brexit must happen, it is useful to understand which option would do least harm to the UK economically. This option can then serve as a benchmark for evaluating the trade-offs required to obtain political objectives such as limits on immigration and 'taking back control'.

The UK's Options

There are many models available for the UK: join the European Economic Association and remain part of the Single Market like Norway; negotiate bilateral deals providing partial access to the Single Market like Switzerland; sign a free trade agreement with the EU like Canada, or; trade with the EU under World Trade Organisation (WTO) rules as the United States currently does. Research on the economic consequences of Brexit clearly shows that the costs would be lowest under the first option – joining the EEA and remaining part of the Single Market.

Economic Reasons for Choosing the EEA

To explain why the EEA is the least bad option we can consider the consequences of Brexit along four dimensions: trade, investment, immigration and regulation. Trade makes countries better off by allowing them to specialise according to their comparative advantage, providing access to new and cheaper imported goods and increasing competition between producers. Leaving the EU will hurt the UK economy by increasing trade barriers between the UK and the EU, but joining the EEA would lead to lower trade barriers than any of the alternative options.

As a member of the EEA, the UK would remain part of the European Single Market meaning there would be no tariffs or other new border measures on UK-EU trade. In addition, the UK would continue to adopt all the EU's economic regulation keeping non-tariff barriers between the UK and the EU at a lower level than if the UK leaves the Single Market and starts to diverge from EU regulatory standards. After joining the EEA the UK would no longer be part of the EU Customs Union meaning it would face some new non-tariff barriers on its trade with the EU, such as rules of origin and the threat of anti-dumping duties. However, it would also be free to seek its own trade deals with the rest of the world.

Analysing the trade effects of Brexit, Dhingra et al. (2016a) find the EEA option is equivalent to a 1.3% fall in the UK's income per capita, while the WTO option is twice as costly leading to a 2.6% decline. Importantly these estimates also net out post-Brexit changes in how much the UK pays into the EU budget. As an EEA member the UK would continue to contribute to the EU budget, but based on how much Norway pays, its contributions would be around 17% lower. Dhingra et al's analysis shows that the costs of Brexit come mainly from higher non-tariff barriers not from changes in tariffs. This illustrates why a traditional free trade agreement that focuses only on reducing tariffs is not a good alternative to EU membership.

Foreign direct investment (FDI) directly raises output and employment, but also has indirect benefits through the transfer of new technologies and managerial know-how. Bruno et al.(2016) estimate EU membership increases FDI inflows by around one-quarter compared to either having a free trade agreement with the EU or trading with the EU under WTO rules. The UK is the third largest recipient of FDI in the world. One of the reasons the UK is an attractive destination for FDI is that firms which invest in the UK have free access to all other EU markets, so they can use the UK as an export platform for exporting to the EU.

Higher tariff or non-tariff barriers between the UK and the EU would reduce the advantages of investing in the UK. EEA membership is the best alternative from the perspective of FDI because it would lead to smaller increases in trade barriers than any other option. Particularly important are 'passporting rights' which allow financial institutions operating and regulated in the UK to do business throughout the Single Market. Passporting rights have played an important role in allowing the UK to dominate the European market for financial services. All EEA members have passporting rights, but no country outside the EEA does (Dhingra et al 2016b).

Turning to immigration, EEA membership requires agreeing to free movement of labour with other EU and EEA countries. While immigration from the EU is politically unpopular in the UK, research has failed to find any robust evidence that immigration has hurt the UK economy (Dhingra et al 2016c). In fact, there may be benefits from obtaining access to a wider pool of skills. Limiting immigration into the UK would also mean accepting new restrictions on emigration from the UK to the EU, which would reduce the opportunities for UK citizens to live and work in other EU countries. Finally, it is important to remember that EU immigrants are net contributors to the UK government's budget (Dustmann and Frattini 2014). Consequently, reducing immigration would increase the UK's fiscal deficit.

Since EEA members are part of the Single Market, they must adopt the EU's economic regulations. But EEA members that are not also part of the EU do not have a vote on what the regulations are. Therefore, leaving the EU to join the EEA would reduce the UK's control over economic regulation. By contrast, trading with the EU under a free trade agreement or WTO rules would give the UK greater control over economic regulation.

However, there are two reasons why EEA membership is still the better economic option. First, EU and EEA members have ample scope to tailor their implementation of EU regulations to reflect their national interests. OECD measures of product and labour market flexibility show the UK has similar levels of flexibility to the US and Canada, while most other EU members have more rigid economies. Consequently, the potential benefits from regulatory changes in the UK are likely to be small. Second, common regulatory standards across members of the Single Market are what keeps non-tariff barriers low which increases the gains from trade. Overall, the costs of reduced control over economic regulation are lower than the benefits of regulatory harmonisation.

Conclusions

Economically, none of the options facing the UK are preferable to staying in the EU. But joining the EEA and remaining part of the Single Market is the best available option as it would minimise the disruption to the status quo and keep the UK closely integrated with the rest of Europe.

Given the importance the new UK government, and at least part of the UK public, attach to imposing controls on immigration from the EU, the EEA option may not be politically viable. But this only highlights that the government's political objectives have economic costs. The question the UK must address as it debates the aftermath of Brexit is whether these costs are a price worth paying.

Please read our comments policy before commenting.

Note: This blog first appeared at LSE Business Review Blog, and it draws on work published in the VoxEU ebook Brexit Beckons: Thinking ahead of leading economists, and Life after BREXIT: What are the UK's options outside *the European Union?, Brexit Analysis 01 of LSE's Centre for Economic Performance (CEP). It gives the views of the authors, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics. Featured image credit: Steve Eason (CC-BY-SA-2.0)*

Shortened URL for this post: **http://bit.ly/2aLb5lp**

About the authors

Swati Dhingra is an Assistant Professor at the Department of Economics at LSE. Before joining LSE, Swati completed a PhD at the University of Wisconsin-Madison and was a fellow at Princeton University. Her research interests are international economics, globalisation and industrial policy. Her work has been published in top economic journals including *The American Economic Review*. She is Associate Editor of the *Journal of International Economics*, and was awarded the FIW Young Economist Award and the Chair Jacquemin Award by the European Trade Study Group for her work on firms and globalisation. Swati is a member of the Globalisation group at the LSE's Centre for Economic Performance, and has made regular contributions to work on economic policy.

Thomas Sampson is an Assistant Professor in the Department of Economics at LSE. He holds a PhD in Economics from Harvard University and an MSc in Econometrics and Mathematical Economics (with distinction) from LSE. He has worked as a consultant to the World Bank, a fellow of the Bank of Papua New Guinea and other organisations. He has published papers in a number of leading academic journals. His research interests are in international trade, growth and development.

-