The cost of Brexit to trade? At least £850 per household, per year

blogs.lse.ac.uk/brexit/2016/03/19/the-cost-of-brexit-to-trade-at-least-850-per-household-per-year/

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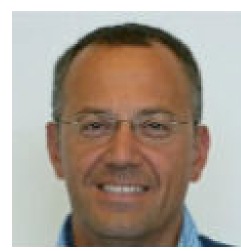
*In this extract from the LSE Centre for Economic Performance's second briefing paper on Brexit, (left to right) **Swati Dhingra, John van Reenen, Thomas Sampson and Gianmarco Ottaviano** conclude that – in the most optimistic scenario – UK income would drop by 1.3% (or £850 per household each year) if we left the EU. In a more pessimistic scenario, the drop would be 2.6%; it could even be up to 9.6%.*



The outcome of the UK's referendum on membership of the European Union will shape the future of the country's relationship with its largest trade partner – the EU. Membership of the EU has reduced trade costs between the UK and the rest of Europe. Most obviously, there is a customs union between EU members, which means that all tariff barriers have been removed within the EU, allowing for free trade in goods and services.

But equally important in reducing trade costs has been the reduction of non-tariff barriers resulting from the EU's continuing efforts to create a 'single market' within Europe. Nontariff barriers include a wide range of measures that raise the costs of trade such as border controls, rules of origin checks, cross-country differences in regulations over things like product standards and safety, and threats of anti-dumping.

Reductions in trade barriers have increased trade between the UK and the EU. Prior to the UK joining the European Economic Community (EEC) in 1973, around one third of UK trade was with the EEC. In 2014, the 27 other EU members accounted for 45% of the UK's exports and 53% of our imports (ONS, 2015). EU exports comprise 13% of UK national income.

A freight train passes through the countryside near the Welsh/English border. Photo: MicoloJ via a CC Attribution 2.0 Generic licence

Higher trade benefits UK consumers through lower prices and access to better goods and services. At the same time, the UK's workers and businesses benefit from new export opportunities that lead to higher sales and profits and allow the UK to specialise in industries in which it has a comparative advantage. Through these channels, increased trade raises output, incomes and living standards in the UK.

These standard 'static' effects of trade have been understood for many centuries since at least the work of David Ricardo. But in recent decades, studies of trade have revealed very large effects on wellbeing through other routes such as higher productivity and innovation.

How would Brexit affect the UK's trade, and what impact would this have on incomes in the UK? This briefing reports new estimates of how Brexit would affect UK living standards through trade (updating our earlier analysis in Ottaviano et al, 2014). We report a range of forecasts based on alternative estimation methods and different assumptions about how the UK's relationship with the EU would change following Brexit. We primarily focus on the narrow, static trade consequences of Brexit rather than other channels through which Brexit could affect the UK's economy, such as investment or migration.

Although it is always hard to assess what the economic future may bring and there are many uncertainties, we consistently find that by reducing trade, Brexit would lower UK living standards. Importantly, the fall in income per capita resulting from lower trade more than offsets any savings that the UK obtains from reduced fiscal contributions to the EU budget. Our baseline estimates imply that, after accounting for fiscal savings, the effect of Brexit is equivalent to a fall in UK income of between 1.3% and 2.6% – that is, a decline in average annual household income of between £850 and £1,700 per year.

Our baseline estimates come from a state-of-the-art static model of the global economy. We also present estimates using empirical evidence on the links between EU membership, trade and income. This 'reduced-form' approach captures the long-run effects of leaving the EU on productivity growth and leads to much higher estimates. In this case, we calculate that Brexit may reduce national income by between 6.3% and 9.5% – that is, about £4,200 to £6,400 per household per year.

The consequences of Brexit for UK trade and living standards

- The European Union (EU) is the UK's largest trade partner. Around a half of the UK's trade is with the EU. EU membership reduces trade costs between the UK and the EU. This makes goods and services cheaper for

UK consumers and allows UK businesses to export more.

- Leaving the EU ('Brexit') would lower trade between the UK and the EU because of higher tariff and non-tariff barriers to trade. In addition, the UK would benefit less from future market integration within the EU. The main economic benefit of leaving the EU would be a lower net contribution to the EU budget.
- Our analysis first quantifies the 'static' effects of Brexit on trade and income. In an 'optimistic' scenario, the UK (like Norway) obtains full access to the EU single market. We calculate this results in a 1.3% fall in average UK incomes (or £850 per household). In a 'pessimistic' scenario with larger increases in trade costs, Brexit lowers income by 2.6% (£1,700 per household).
- All EU countries lose income after Brexit. The overall GDP fall in the UK is £26 billion to £55 billion, about twice as big as the £12 billion to £28 billion income loss in the rest of the EU combined. Non-EU countries experience some smaller income gains.
- If the UK unilaterally removed all its tariffs on imports from the rest of the world after Brexit, UK incomes fall by 1% in the optimistic case and 2.3% in the pessimistic case.
- In the long run, reduced trade lowers productivity. Factoring in these effects substantially increases the costs of Brexit to a loss of 6.3% to 9.5% of GDP (about £4,200 to £6,400 per household).
- Being outside the EU means that the UK would not automatically benefit from future EU trade deals with other countries. This would mean missing out on the current US and Japanese deals, which are forecast to improve real incomes by 0.6%.
- After Brexit, would the UK obtain better trade deals with non-EU countries? It would not have to compromise so much with other EU states, but the UK would lose bargaining power as its economy makes up only 18% of the EU's 'single market'.
- It is unclear whether there are substantial regulatory benefits from Brexit. The UK already has one of the OECD's least regulated product and labour markets. 'Big ticket' savings are supposedly from abolition of the Renewable Energy Strategy and the Working Time Directive – both of which receive considerable domestic political support in the UK.

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 second briefing paper on the effects of leaving the EU, where detailed references can be found.

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