

The economic impact of 'Brexit'

A paper discussing the United Kingdom's relationship with Europe and the impact of 'Brexit' on the British economy



Executive summary

Capital Economics has been commissioned by Woodford Investment Management to examine the United Kingdom's relationship with Europe and the impact of 'Brexit' on the British economy. A referendum is due to be held before the end of 2017 but it looks increasingly likely that it will occur before the end of 2016. The latest set of opinion polls suggests an extremely tight vote but this could easily change due to, for example, another escalation in the Greek crisis, further rises in net migration from Europe or an escalation of the refugee crisis. In addition, the nature and extent of any renegotiation of the terms of British membership could also be important in determining the referendum outcome.

Our report covers the economic impacts of the most important elements of the Brexit debate.

Immigration

Annual net migration from Europe has more than doubled since 2012, reaching 183,000 in March 2015. Immigration from the European Union is currently boosting the workforce by around 0.5% a year. This has helped support the economy's ability to grow without pushing up wage growth and inflation, keeping interest rates lower for longer.

Whether the United Kingdom gains any powers to restrict immigration from Europe will depend on its future relationship with the European Union. If Britain wanted to retain full access to the single market, it may have to keep the free movement of labour between the United Kingdom and the Union. But this is unlikely. Policy is far more likely to change to restrict the number of low skilled workers entering the country and shift towards attracting more highly skilled workers. This would be a potential headache for low-wage sectors heavily dependent on migrant labour, such as agriculture, but could benefit other sectors with a shortage of highly skilled labour. Overall, policy would shift to be more specifically designed for Britain's migration requirements. *(See Chapter 2.)*

Trade and manufacturing

Official trade statistics show that the European Union is the destination for about half of all British goods exports. The trading links are bigger if we include the countries that the United Kingdom trades freely with because they have a free trade agreement with the European Union. These agreements mean that 63% of Britain's goods exports are linked to European Union membership.

It is highly probable that a favourable trade agreement would be reached after Brexit as there are advantages for both sides in continuing a close commercial arrangement. But the worst-case scenario, in which Britain faces tariffs under 'most-favoured nation' rules, is certainly no disaster. Exporters would face some additional costs, such as complying with the European Union's rules of origin, if they were outside the single market. However, these factors would be an inconvenience rather than a major barrier to trade. In addition, fears that exporters would be left high and dry the day after the Brexit vote are unfounded. Under the Lisbon Treaty, a country leaving the European Union has two years in which to negotiate a withdrawal agreement.

In addition, falling tariffs, the decline in manufacturing and Europe's diminishing importance in the global economy mean we doubt that even the absence of a trade deal with the European Union would hurt the United Kingdom's overall exports materially. The benefits of being in the European Union are smaller than they were a few decades ago, when a Brexit would have been a far bigger deal. However, the effects will vary across sectors. Brexit would give Britain a crucial opportunity by allowing it to broker its own trade deals with non-European Union countries; indeed Britain could even have a unilateral free trade policy. Non-European Union countries may find negotiating with Britain easier and quicker than dealing with the European Union's bureaucratic machine, as Switzerland has shown.

The production sectors in the economy face a more uncertain outcome than services. The range of potential outcomes is more variable as production sectors are more dependent on whether or not the United Kingdom agrees a trading agreement with the European Union – and the nature of any such agreement. The possibility of tariffs on goods exports to the European Union gives greater downside potential, while the opportunity to open up trade with other countries or to increase the sector's competitiveness through greater competition or cheaper inputs gives it more upside potential.

Contrary to the claims of many authors and commentators, it is probable that the impacts of Brexit on trade would be relatively small. Moreover, it is certainly possible that leaving the European Union would leave the external sector better off in the long run, if Britain could use its new found freedom to negotiate its own trading arrangements to good effect. *(See Chapter 3.)*

Financial services and the City

Financial services have more to lose immediately after a European Union exit than most other sectors of the economy. Even in the best case, in which passporting rights were preserved, the United Kingdom would still lose influence over the single market's rules. The City would probably be hurt in the short term, but it would not spell disaster. The City's competitive advantage is founded on more than just

unfettered access to the single market. A European Union exit would enable the United Kingdom to broker trade deals with emerging markets that could pay dividends for the financial services sector in the long run. *(See Chapter 4.)*

Regulation, innovation and productivity

Brexit is only likely to have a limited impact on Britain's productivity. The major potential for improvement comes from increased business investment which shows little connection with political developments. Estimates that axing European Union regulations would save Britain a lot of money exaggerate the true picture as the United Kingdom would still choose to implement many of them. It would also need to implement the union's regulations to continue to export easily to the single market. Reduced regulation might give a small boost to productivity but wouldn't be a game-changer. *(See Chapter 5.)*

Foreign investment

Concerns about a drying up of foreign direct investment if Britain votes to leave the European Union are somewhat overblown. Access to the single market is not the only reason that firms invest in Britain. Other advantages to investing here should ensure that foreign firms continue to want a foothold in the country. It is likely Britain would remain a haven for foreign direct investment flows even if it was outside of the European Union. Of course, we could see a period of weak foreign direct investment inflows as the United Kingdom's new relationship is renegotiated. However, if Britain is able to obtain favourable terms, then foreign direct investment would probably recoup this lost ground. *(See Chapter 6.)*

Public sector

The British government could save about £10bn per year on its contributions to the European Union's budget if the country left the bloc. This figure could be higher if either the British rebate was to be threatened in the years ahead or Brexit was to result in overall faster economic growth.

On the other hand, a little economic disruption and lower migration as a result of Brexit could offset these savings. The government might also continue to make some contributions to the union if it wanted to preserve single market access, it might need to compensate sectors of the economy and specific regions that currently benefit from European Union handouts and it may have to sacrifice customs duties income to strike new trade deals with countries outside Europe.

We expect that Brexit would benefit the public finances, but not to a huge degree. *(See Chapter 7.)*

Consumption and property market

It seems clear that the City is the part of the British property market that has most to lose if the United Kingdom opts to leave the European Union. It is certainly possible to tell a story in which the damage done could be considerable, but the role of the financial services sector in holding up the property market is probably overstated, leading us to believe that any negative impacts will be small, certainly at a macroeconomic level.

We anticipate that the impacts on the property market overall and on aggregate consumption in the economy will be limited. In the case of the latter, they may well be positive due to beneficial effects from independent policymaking on immigration, trade and regulation, as well as savings to the exchequer (which may then be disbursed in the form of lower taxes). *(See Chapter 8.)*

Overall

Although the impact of Brexit on the British economy is uncertain, we doubt that Britain's long-term economic outlook hinges on it. Things have changed a lot since 1973, when joining the European Economic Community was a big deal for the United Kingdom. There are arguably much more important issues now, such as whether productivity will recover. The shortfall in British productivity relative to its pre-crisis trend is still over 10%, so regaining that lost ground would offset even the most negative of estimates of Brexit on the economy. Based on assessing the evidence, we conclude that:

- The more extreme claims made about the costs and benefits of Brexit for the British economy are wide of the mark and lacking in evidential bases
- It is plausible that Brexit could have a modest negative impact on growth and job creation. But it is slightly more plausible that the net impacts will be modestly positive. This is a strong conclusion when compared with some studies
- There are potential net benefits in the areas of a more tailored immigration policy, the freedom to make trade deals, moderately lower levels of regulation and savings to the public purse. In each of these areas, we do not believe that the benefits of Brexit would be huge, but they are likely to be positive
- Meanwhile, costs in terms of financial services, foreign direct investment and impacts on London property markets are more likely to be short-term and there are longer-term opportunities from Brexit even in these areas
- It is not likely that any particular region or regions of the country would be more adversely affected by Brexit than the country overall. Likewise, we do find support for the notion that Brexit would benefit some sectors more than others, but the range of outcomes for production / manufacturing industries is probably wider than for services

We continue to think that the United Kingdom's economic prospects are good whether inside or outside the European Union. Britain has pulled ahead of the European Union in recent years, and we expect that gap to widen over the next few years regardless of whether Brexit occurs.

Table 1: Sources of possible gains and losses from Brexit

Gains	Losses
Less regulation	Possible tariffs on exports to the European Union
Savings on European Union contributions	Loss of access to the single market
Ability to strike new trade deals	Damage to the City
Skills-based migration policy	Drop in investment caused by uncertainty

BREXIT IN NUMBERS

Although the impact of Brexit on the British economy is uncertain, we doubt that Britain's long-term economic outlook hinges on it.
Capital Economics, 2016

183,000
0.5%

Policy change will restrict low-skilled workers coming to the UK, impacting sectors such as agriculture – but it could result in an increase in the number of highly-skilled migrant workers.

50%
53%↓

Small impact as some tariffs have fallen over the past two decades. Increased negotiating powers will help offset higher costs for food, drink and car producers.

£33bn
52,000

Estimates that axing EU regulators will save the UK a lot of money are exaggerated. It would give a small boost to productivity but no game changer.

£19.4bn
£10bn

Negative in short term but not a disaster. City's competitive advantage not solely down to single market access and could open up long-term opportunity.

46%
28%

Britain to remain a safe haven for foreign investment in the longer term. Weaker investment in the short term as new tariffs are negotiated but once in place, losses could start to be recouped.

£10.4bn
£20bn

Brexit would benefit the UK, but not to a huge degree – economic disruption and lower migration could offset some savings.

15%
50%

Easy to create a doom-case scenario but scientific, professional and technical services driving London office creation – not financial services as often perceived.

Source: Capital Economics

IMMIGRATION

Net migration has more than doubled to 183,000 a year since 2012. Migrants boost the UK's workforce by 0.5% a year.



TRADE

Each year the EU is the destination of about half of all British goods exports. EU tariffs for manufacturing goods have more than halved since the 1990s.



REGULATION

Red tape on EU's 100 most expensive legislations costs £33bn a year. There were 52,000 legislations made by EU members between 2000-13.



FINANCIAL SERVICES AND THE CITY

Exports of financial services to the EU was £19.4bn in 2013 (latest figures). Loss of passporting rights could see those exports halve to around £10bn.



FOREIGN INVESTMENT

The EU accounted for 46% of the UK's stock of inward investment in 2013. 28% - UK's share of all investment into Europe in 2014.



PUBLIC SECTOR

Annual cost of EU membership to the UK's public finances is £10.4bn. EU migrants contributed £20bn to the UK's public finances between 2001-11.



PROPERTY MARKET

City property values estimated to fall by up to 15% on Brexit. Scientific and technical services sector account for 50% of London's office-based job creation.



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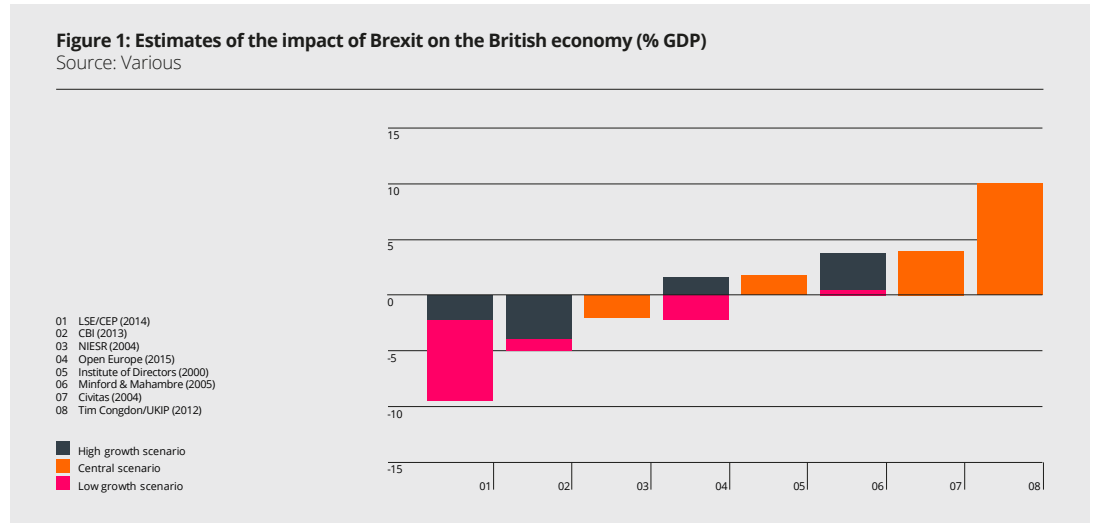
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1. Introduction

In this section, we review the studies that have previously estimated the impact of Brexit on the United Kingdom economy.

Leaving the European Union is a substantial step for any member state to take. The decision is in many ways a social, cultural and political one, but it is also one which carries economic implications.

The United Kingdom's potential decision to leave the European Union, or 'Brexit', has consumed much debate. The magnitude of the economic costs and benefits of Brexit cannot be known with certainty before the event. As a result, a range of estimates have given differing scales and even directions of the impacts. (See Figure 1.)



Some studies show negative impacts of varying degrees. The Centre for Economic Performance at the London School of Economics estimates that the United Kingdom leaving the European Union and joining the European Free Trade Association will reduce British GDP by at least 2.2% in its optimistic scenario, and between 6.3% and 9.5% in its pessimistic one.¹ The Confederation of British Industry estimates that the net benefit to the United Kingdom stemming from European Union membership is somewhere in the region of 4 to 5% of Britain's GDP, or between £62bn and £78bn per year.² The National Institute of Economic and Social Research estimated that withdrawal from the European Union would permanently lower the British economy's level of output by 2.25% below what it would otherwise have been.³

Other studies paint a more mixed picture. Open Europe estimates that, if the United Kingdom embraced protectionism in the wake of a Brexit, this could cost 2.2% of GDP by 2030. By contrast, if it followed a path of economic openness, Britain could outperform the European Union. In that case, Brexit could add at least 1.6% to national income by 2030.⁴

There are also some positive assessments of Brexit's economic impact. In 2000, the Institute of Directors estimated the cost of British membership of the European Union to be 1.75% of GDP. Leaving would eliminate this cost.⁵ Patrick Minford and Vidya Mahabre identified the ongoing costs of British membership and additional substantial potential future costs of harmonisation, pension sharing and euro membership, estimating these as equivalent to between 3.2% and 3.7% of GDP. Finding no appreciable countervailing benefits from membership, they offered this as the potential scale of benefit from Brexit.⁶ Civitas estimated the current recurring annual direct net cost to the United Kingdom of European Union membership as between approximately three and 5% of GDP, with a 'most likely' figure of 4%.⁷ Tim Congdon, on behalf of the United Kingdom Independence Party, has estimated that Britain's membership of the European Union costs it an amount equivalent to 10% of its GDP. This is primarily driven by costs of regulation – 5.0% of national income – and the costs of resource misallocation – 3.25%.⁸

The terms of departure and whether or not the United Kingdom negotiates an agreement with the European Union governing the future relationship will determine the magnitude and direction of the impacts of Brexit. Currently the United Kingdom is part of the single market, with free movement of goods, services, people and capital within the European Union's border. It is likely that Brexit would change this.

Our report assesses the potential impact of Brexit on key issues that would be affected by Britain's future relationship with the European Union and the rest of the world, including immigration and the labour market, trade and the manufacturing industry, financial services and the City of London, regulation, innovation and productivity, foreign investment, public sector finances and consumption and the property market. The United Kingdom is in the process of renegotiating the existing terms of its

membership of the union and the outcome of this will affect the relative magnitude of Brexit. For this report we examine the implications of Brexit against the existing terms of membership as the outcome of these negotiations is still uncertain – but it appears that any changes will not be significant.

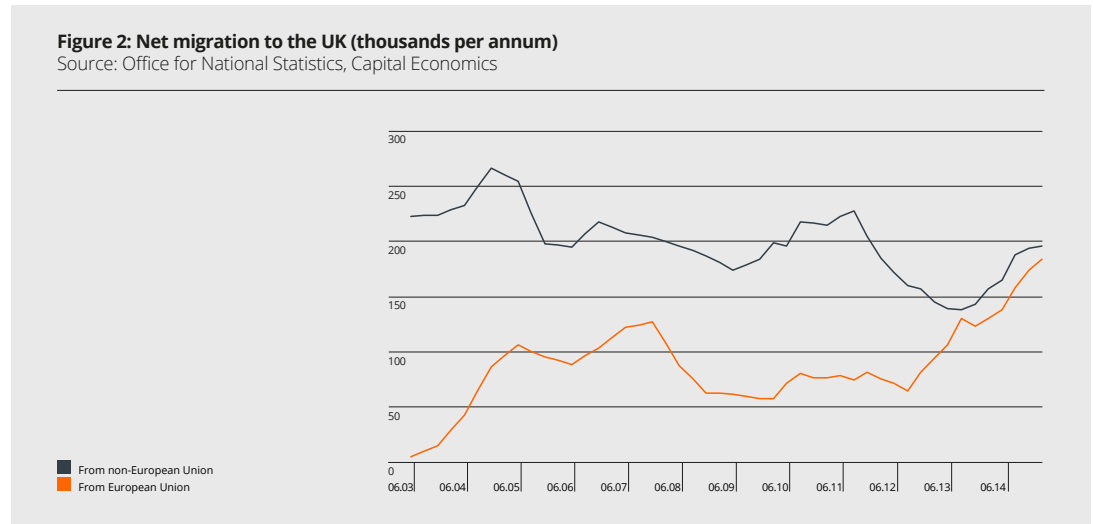
- ¹ Swati Dhingra, Gianmarco Ottaviano and Thomas Sampson, *Should we stay or should we go? The economic consequences of leaving the EU* (The London School of Economics and Political Science, London), 2015
- ² Confederation of British Industry, *Our global future* (Confederation of British Industry, London), 2013
- ³ Nigel Pain and Garry Young, 'The macroeconomic impact of UK withdrawal from the EU', *Economic Modelling*, Vol. 21, 2004. pp 387-408
- ⁴ Stephen Booth, Christopher Howarth, Mats Persson, Raoul Ruparel and Pawel Swidlicki, *What if...? The consequences, challenges & opportunities facing Britain outside EU* (Open Europe, London), 2015
- ⁵ Graeme Leach, *EU membership – what's the bottom line?* (Institute of Directors, London), 2000
- ⁶ Patrick Minford, Vidya Mahambare and Eric Nowell, *Should Britain leave the EU?* (Edward Elgar, Cheltenham), 2005
- ⁷ Ian Milne, *A cost too far?* (Civitas, London), 2004
- ⁸ Tim Congdon, *How much does the European Union cost Britain?* (Tim Congdon), 2012

2. Immigration

In this section, we look at the impact of Brexit on immigration. First, we assess the contribution of European Union membership to Britain's labour force. Second, we consider the impact of Brexit on immigration and the likely economic implications of these changes.

2.1 European Union migrants and the British labour force

Annual net migration from the European Union rose to significant levels of approximately 100,000 people per annum following the accession of countries in eastern Europe to the union in 2004. It has more than doubled since 2012, reaching 183,000 in March 2015. (See Figure 2.)



Most migrants from the European Union come to the United Kingdom to work, boosting the workforce by around 0.5% a year in 2015.⁹ This supports the economy's ability to grow without pushing up wage growth and inflation, keeping interest rates lower for longer.

2.2. The impact of Brexit on immigration

It is plausible that immigration policy may not change substantially after Brexit. Whether the United Kingdom gains any powers to restrict immigration from Europe will depend on its future relationship with the European Union. If Britain wanted to retain full access to the single market, it may have to keep the free movement of labour between the United Kingdom and the union. However, it is unlikely that Britain would sign up to such a deal, given that concerns about migration would probably have been one of the main reasons for a vote to leave.

Nevertheless, even if the United Kingdom were free to impose restrictions, it is questionable how effective these would be in the near term. There could be a "rush for the border" ahead of the restrictions, resulting in a surge in migration in the short term. European Union migrants already in Britain would almost certainly be given leave to stay, just as British citizens living in Europe could remain there. Furthermore, if European Union migrants already in the United Kingdom knew that it would be hard to get back in if they left, they might stay longer than they otherwise would have. Emigration out of Britain could fall alongside a rise in immigration, perhaps leaving net migration little changed or even higher in the short term.

In the medium term, net migration from European Union countries would almost certainly fall if Britain was outside the single market, reducing the growth rate of the British labour force (though the extent of the fall would obviously depend on the new arrangements put in place). This may lead to upward pressure on wages and inflation, benefiting some workers but to the detriment of some employers.

Most importantly, the government would gain the ability to implement a different migration policy, with criteria probably set according to people's skills and professions, rather than where they come from. Accordingly, the quality of migrant labour could rise, boosting Britain's productivity performance and plugging labour shortages in specific sectors.

Migration policy is not the only way in which Brexit would impact the labour market. The United Kingdom would be freed from many of the European Union's restrictive regulations (such as the Agency Workers' Directive, which gives temporary workers the rights of full-time workers). This boost to the overall flexibility of the labour market could offset some of the cost to firms from lower migration.

2.3 Summary: A more tailored immigration policy

It is likely that, after Brexit, Britain would not agree to the free movement of labour with the European Union. Policy would change to restrict the number of low skilled workers entering the country and shift towards attracting more highly skilled workers (including from outside the European Union). This would

be a potential headache for low-wage sectors heavily dependent on migrant labour, such as agriculture, but could benefit other sectors with a shortage of highly skilled labour. Overall, policy would shift to be more specifically designed for Britain's migration requirements.

⁹ *Calculations using tables from the data section of Office for National Statistics, Migration Statistics Quarterly Report, August 2015 (Office for National Statistics, London), 2015*

¹⁰ *The Office for National Statistics estimates that closer to 46% of goods exports go to the European Union. Many of the United Kingdom's exports that pass through the ports of Antwerp and Rotterdam, and are counted as exports to the European Union, are bound for re-export outside it. The trade statistics show that 7.9% of Britain's goods exports go to the Netherlands and 4.3% to Belgium / Luxembourg, but the true figures of exports with these countries as the final destination will be lower than this. Office for National Statistics, How important is the European Union to UK trade and investment? (Office for National Statistics, Newport), 2015*

3. Trade and the manufacturing industry

In this section, we examine the likely impact of Brexit on the United Kingdom's international trade. First, we examine Britain's current trade links with the European Union. Second, we consider what sort of trading relationship might follow Brexit. Third, we assess the costs of leaving the single market. Fourth, we consider the impact of no post-Brexit trading agreement on trade and on different sectors. Finally, we explore the potential benefits of Brexit to trade.

3.1. Britain's trade links with the European Union

The United Kingdom's trade links with the European Union are considerable. Official trade statistics show that the European Union is the destination of about half of all British goods exports.¹⁰ The share is a little lower if services exports are included too but is still a sizeable 45%. Given that total exports account for 30.5% of British output, this means that the value of all goods and services exports to the European Union are equal to 14% of the overall United Kingdom economy.

The trading links are bigger if we include the more than 60 countries that the United Kingdom trades freely with because they have a free trade agreement with the European Union. These include Switzerland, South Africa and Turkey. Taking into account Britain's exports to these countries means that 63% of its goods exports are linked to European Union membership. (See Figure 3.)

The manufacturing sector of the economy is heavily reliant on exporting, but growth in the services share of the economy has left manufacturing accounting for an ever smaller share of the United Kingdom's output. (See Figure 4.)

Figure 3: British goods export values by destination (% of total, 2014)

Source: International Monetary Fund Direction of Trade Statistics, Thomson Datastream, Capital Economics

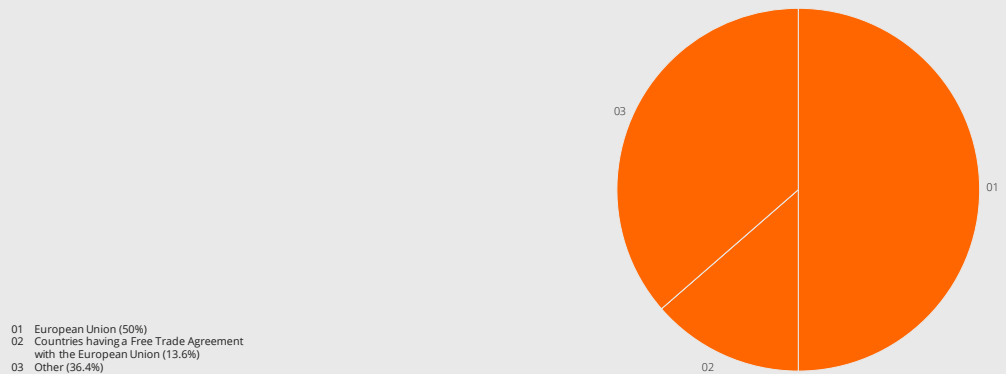
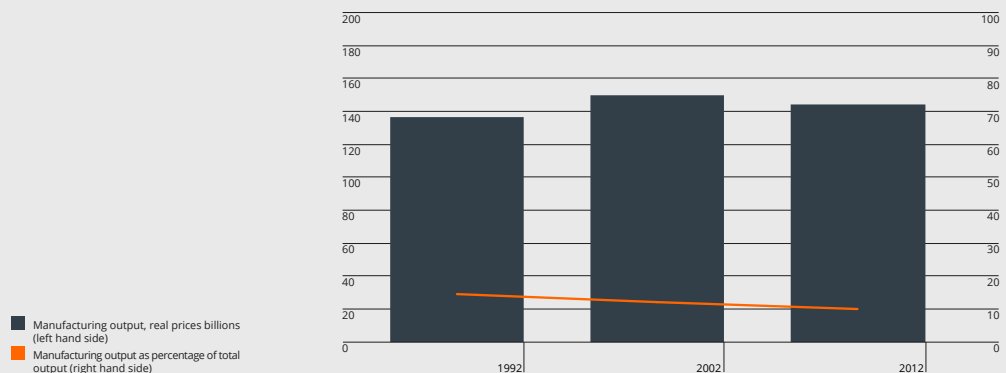


Figure 4: Manufacturing output in the UK

Source: Office for National Statistics, Capital Economics

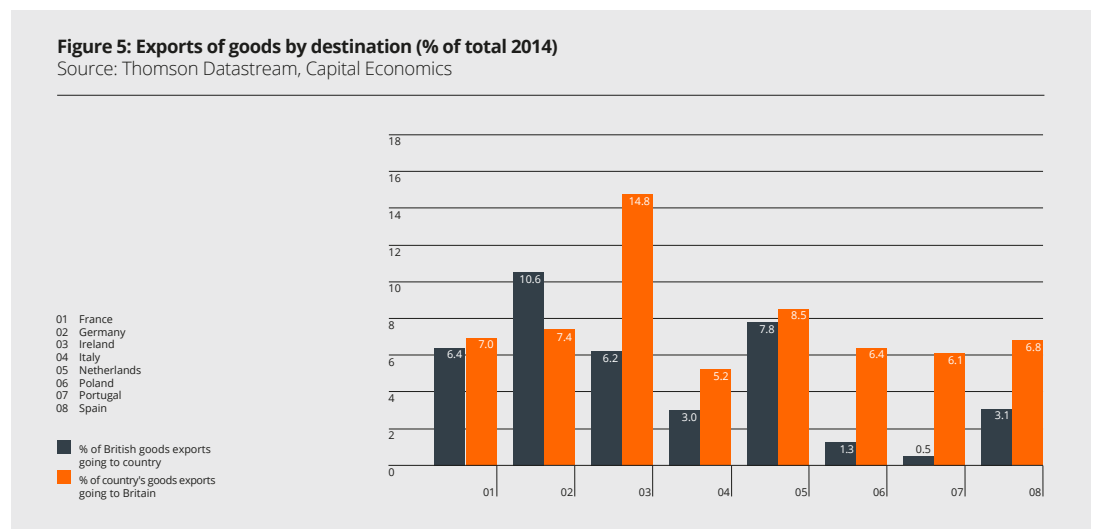


3.2 Strong chance of a trade agreement

The chances are high that a favourable trade agreement could be reached after Brexit, as there are advantages for both sides in continuing a close commercial arrangement. Not only is the European Union important to the United Kingdom's trade position, British markets are important to the rest of the European Union.

Admittedly, if we take the European Union as a whole, the 18% of its exports that go to the United Kingdom is small compared to the 50% of Britain's exports that go to the rest of the European Union. However, the picture is different if we look at the largest individual economies within the European Union and Ireland (given its particular relevance for Britain). With the exception of Germany, Britain is a more important market for the biggest European Union economies than they are for the United Kingdom. (See Figure 5.)

Given the scale of trade interdependence between the United Kingdom and the European Union's members, and the advantages of maintaining a close commercial arrangement, there would be little to be gained on either side from hostile trade relations after Brexit. Indeed, given that the European Union is currently negotiating free trade agreements with countries that are much less important to it from a trading point of view, it would be odd if it did not try to reach an agreement with the United Kingdom. Similarly, there is no reason to think that Britain would not be able to negotiate new trade deals with those countries that it currently has free trade agreements with via the European Union.



What's more, fears that exporters would be left high and dry the day after the Brexit vote are unfounded. Under Article 50 of the Treaty on European Union, a country leaving the European Union has two years in which to negotiate a withdrawal agreement, before the Treaties cease to apply to that country. During that two-year negotiation period, the United Kingdom would still effectively be in the European Union with unfettered access to the single market.

3.3 Cost of losing access to the single market

The European single market is more than a free trade agreement without tariffs. Goods can move freely because all members adhere to common regulatory requirements and technical standards. In addition, the single market provides for the free movement of services, capital and people.

Britain could in effect remain part of the single market by becoming a member of the European Economic Area. Norway, Iceland and Liechtenstein are outside the European Union, but in the European Economic Area. Meanwhile the Swiss, who are members of the European Free Trade Association but not the European Economic Area, have established free trading relations with the European Union and access to the single market through a series of bilateral agreements. Although their trade with the bloc is subject to Brussels' 'rules of origins' regulations, both Norway and Switzerland have the freedom to determine their own trade policy and arrangements with third party countries. (See Figure 6 and Figure 7.)

The option of remaining in the European Economic Area (like Norway) seems an undesirable one in the event of Brexit. The whole point of leaving the European Union would be to gain substantial extra freedoms – which in that case would not be possible. At the same time, some of the United Kingdom's influence over the European Union would be lost. The Swiss option is more plausible but would be subject to tough negotiations.

Figure 6: Summary of Norwegian arrangements with the EU

Source: EEA Review Committee, *Outside and Inside: Norway's agreements with the EU* (unofficial translation) (General Secretariat of the Council of the European Union, Brussels), 2012, Capital Economics

<p>EEA* (Free movement of goods, services, people and capital)</p> <ul style="list-style-type: none"> - Employment and social policy - Consumer protection - Product standards - Company law - Competition and state aid 	<p>Schengen (Free passport area)</p> <ul style="list-style-type: none"> - Cross-boarder police cooperation 	<p>Separate agreements</p> <ul style="list-style-type: none"> - Justice and home affairs - Security policy - Defence - Energy and climate change measures 	<p>Not adopted legislation related to</p> <ul style="list-style-type: none"> - Common agricultural policy - Common fisheries policy - External trade - Direct and indirect taxation
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Figure 7: Summary of Swiss arrangements with the EU

Source: Integration Office FDFA/FDEA, *Bilateral agreements Switzerland-EU* (Integration Office FDFA/FDEA, Bern), 2009, Capital Economics

<p>Free trade agreement (1972)</p> <ul style="list-style-type: none"> - Free movement of industrial products 	<p>Bilateral I (1999)</p> <ul style="list-style-type: none"> - Free movement of persons - Technical trade barriers - Public procurement - Research programmes - Agriculture 	<p>Bilaterals II (2004)</p> <ul style="list-style-type: none"> - Schengen and Dublin agreement - Taxation of savings - Harmonisation of statistics - Environment 	<p>Not adopted legislation related to</p> <ul style="list-style-type: none"> - Common agricultural policy - Common fisheries policy - External trade - Direct and indirect taxation - Freedom of movement of services - Employment and social policies
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Assuming Britain does not remain in the single market, then even if the United Kingdom managed to negotiate a free trade agreement, exporters would face additional costs in selling into the European Union. These would include extra costs of clearing customs and the administrative costs of complying with the European Union's rules of origin.¹¹ They might also face other non-tariff barriers, such as quotas. They would also still need to adhere to European product standards in order to export freely to the union. To avoid producing some goods in one way to meet European Union standards, and others in another way, firms would presumably just continue to comply with most current regulations.

However, these factors would be an inconvenience rather than a major barrier to trade. The important fact is that other countries, such as the United States, manage to export successfully to the European Union despite facing these barriers. What's more, the single market does not appear to have given Britain that much of an advantage in exporting to the rest of the union over countries that are outside the single market in recent years. Between 1993 and 2011, the United Kingdom was only the 28th fastest growing exporter to the other eleven founding members of the single market.¹² Similarly, it is easy to forget that the United Kingdom successfully sends half of its exports to countries that are not in the European Union despite, for example, incurring the costs of clearing customs to do so.

¹¹ *These set a limit on the proportion of the inputs into a good that can come from outside the European Union in order for it to get tariff-free access. British exporters currently do not need to worry about rules of origin when selling into the European Union. Outside it, however, firms would need to keep track of the components going into a good. Given that these can be sourced from many different countries, this could require a large amount of paperwork, particularly for small firms. That said, they may be collecting this information already anyway.*

¹² *Michael Burrage, Where's the insider advantage? (Civitas, London), 2014*

Furthermore, those parts of the economy that do not export to the European Union (and make up the vast majority, 85%, of Britain's GDP) would benefit from their freedom from European Union rules and regulations, with which they currently have to comply. With the single market as it stands, the United Kingdom needs to apply European Union regulations to the whole of the economy, even though only 14% of its output is exported to the European Union. So, for example, the National Health Service must

comply with the Working Time Directive and retailers are affected by the Agency Workers' Directive. Nevertheless, the benefits of getting rid of European Union regulations should not be overstated as Britain would probably want to keep many of them anyway.

Another potential cost to leaving the single market is that, even if a free trade agreement was secured, the United Kingdom would miss the chance to drive forward, and benefit from, efforts to complete the single market in services. Such an extension would involve more harmonisation of product standards in services, reducing the fragmentation of regulatory systems for services across the European Union and stopping discrimination against service providers in other countries – an example would be special online offers only being available to people browsing the internet in certain countries.

It is often argued that Britain would help itself more by staying in the European Union to drive these reforms forward. The United Kingdom's comparative advantage these days primarily lies in services, rather than manufactured goods. But claims that Britain would benefit disproportionately from the completion of the single market in services are arguably overdone. Although the United Kingdom has a trade surplus on services with the European Union, Britain's total services exports are equivalent to 12% of its GDP – the same proportion as European Union services exports as a share of European Union output. If the United Kingdom did stand to benefit disproportionately from further services liberalisation, that could in itself be a reason why it has so far had limited success in getting the rest of the European Union to prioritise such reforms. It is not clear that that will change.

3.4. Worst-case scenario

The worst-case Brexit scenario would be one in which the United Kingdom failed to negotiate a free trade agreement with the European Union. Such an outcome might result from the Union playing hard ball in order to discourage any other members from leaving or, alternatively, Brussels might demand too high a price – such as the continued free movement of labour – for Britain to agree.

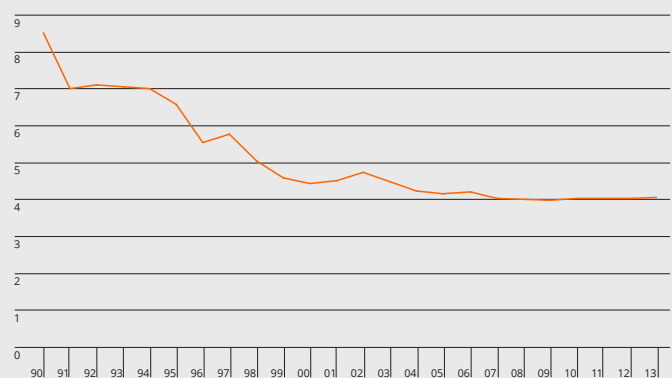
Nevertheless, even in that pessimistic case, the losses for British trade or manufacturing industry would not be catastrophic. If it transpired, British exports to the European Union would face the latter's common external tariff. This is sometimes called the 'World Trade Organization option', as the United Kingdom's trade with Europe would be governed by the 'most-favoured nation' rules.¹³ Britain would be subject to the same tariff as the European Union charges other non-member countries, without any discrimination against the United Kingdom.

However, there have been three key developments over the past few years which mean that this would be a far smaller concern than it would have been in the past.

First, tariffs have fallen substantially as part of a world-wide trend towards reducing trade barriers. As part of this, the average European Union most-favoured nation tariff on manufactured goods has fallen to just 4%. That compares to over 8% at the start of the 1990s. According to Business for Britain (the pro-Brexit group which concedes that leaving could carry a cost, but a manageable one), the average effective tariff, based on the specific mix of goods and services that the United Kingdom sells to the European Union, would be a touch higher, but still only 4.4%. (See Figure 8.)

Figure 8: EU most-favoured nation average tariff on manufactured goods (%)

Source: World Bank, Capital Economics

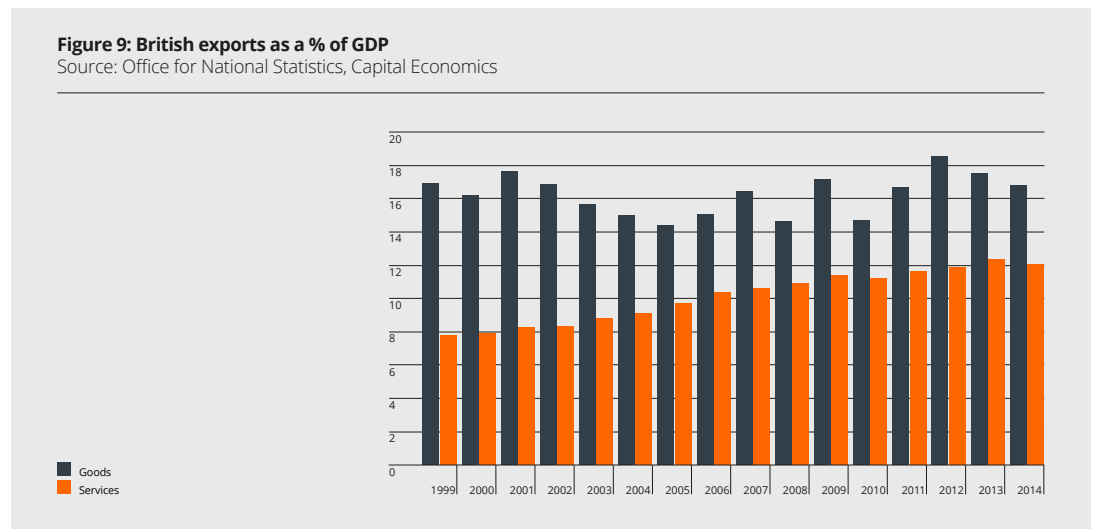


¹³ World Trade Organization, *Understanding the WTO: Principles of the trading system* (World Trade Organization, Geneva), 2015

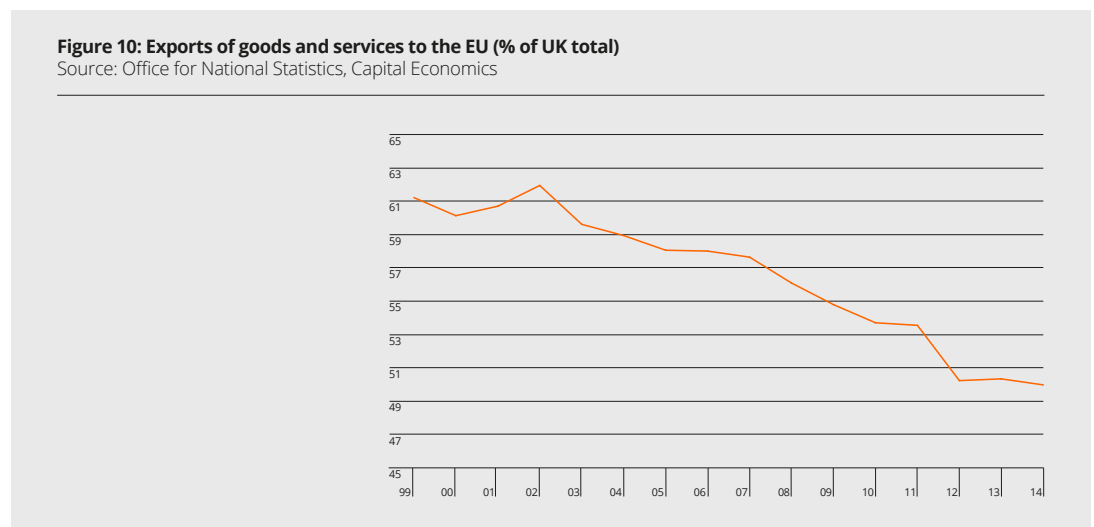
These costs would be well within the normal range of exchange rate movements; sterling (in trade-weighted terms) has appreciated by 12% over the past two years and by around 5% since the beginning of the 2015.¹⁴ The United Kingdom could, of course, impose its own tariffs on imports from the European Union in return. But an escalation of trade barriers would clearly leave all parties worse off in the end. Indeed, Britain announcing that it would put up its own tariffs would only be in its interests if it persuaded the European Union to back down, leading to no tariffs on either side. But if the European Union steadfastly stuck to its decision to raise tariffs, then it would be in the United Kingdom's best interests to nonetheless maintain its own free trade position vis-à-vis the European Union.

Nevertheless, those countries which have a free trade agreement with the European Union generally have higher tariffs than 4%. For example, the United Kingdom would face an effective tariff to Egypt of 35%. However, Britain should be able to negotiate its own agreements with those countries. Even if not, the countries with the highest tariffs are generally small markets for the United Kingdom.

The second key development is that manufacturing has fallen substantially as a share of the British economy (and of course, European Union tariffs would apply only to goods, not services). Manufacturing has fallen from over 20% of GDP in the mid-1990s to less than 10% now. While the services exports as a share of output have been rising, goods exports as a share of output have been broadly stable (fluctuating around an average of 16% since 1999). (See Figure 9.)



The third development is that Europe has become less important, as an export market, for the United Kingdom. The share of Britain's exports of goods and services that go to the European Union has been on a downward trend over the past decade or two; the current 45% share is down from 55% in 1999. This is despite expanding membership of the European Union over the same period. (See Figure 10.)



We account for the impact of enlargement by focusing on the share of British goods exports (the data on services is limited) going to the fourteen other countries that formed the European Union before its expansion into eastern Europe in 2004. The initial period after the United Kingdom joined the European Economic Community in 1973 saw a period of strong growth in trade; the share of British goods exports to those members of the union rose from around 30% to a peak of 46% in 1999. In spite of further European integration, that share has largely flat lined, or perhaps fallen modestly, since then. This

indicates that even increasing legislative integration with the European Union has not been able to offset the latter's declining relative importance for British goods exports. (See Figure 11.)

As a result of these three factors – falling tariffs, the decline in manufacturing and Europe's diminishing importance – we doubt that even the absence of a trade deal with the European Union would hurt the United Kingdom's overall exports materially. The benefits of being in the European Union are smaller than they were a few decades ago, when a Brexit would have been a far bigger deal.

However, this won't be the case for all sectors or regions. The average tariff that could potentially be imposed by the European Union under most-favoured nation rules is 4%, but this varies across sectors and food and drink product sectors would be hardest hit. In addition, the car industry would suffer from a 10% tariff on cars and a 5% tariff on imported components. (See Figure 12.)

Figure 11: British goods exports to EU 14 (% of total)

Source: Office for National Statistics, Capital Economics. Note: We only show data for goods as data for services are more limited

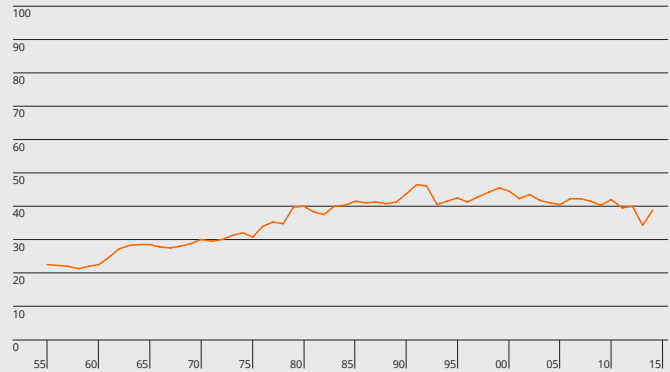
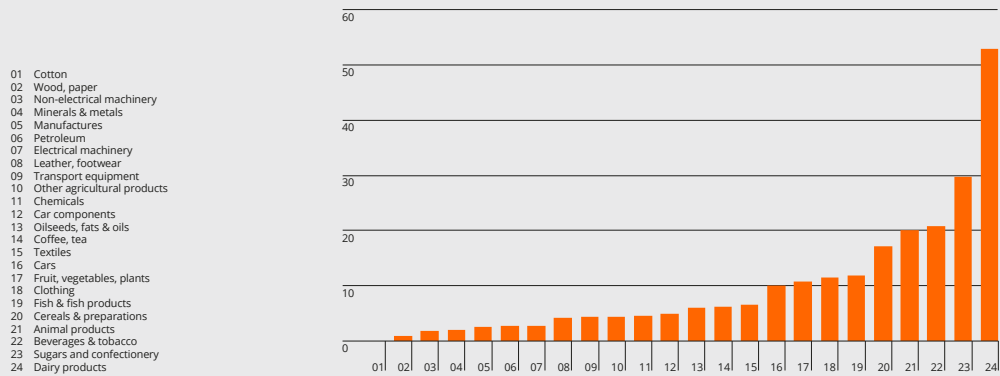


Figure 12: EU tariffs by selected sectors (% 2013)

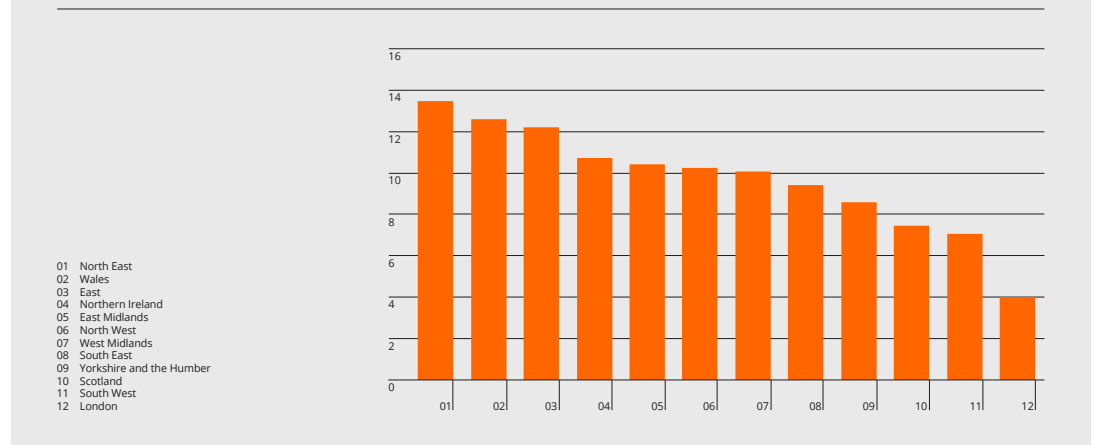
Source: World Trade Organization, Capital Economics



Meanwhile, it does not appear to be the case that any one region or regions is particularly exposed to Brexit through having a disproportionately strong goods trading relationship with the European Union. Wales, the North East and the Eastern regions are somewhat more exposed than other parts of the country, whilst Scotland, the south of England generally and London in particular are less prone to any goods tariffs. The data do not suggest that Northern Ireland would be particularly adversely affected, in spite of its land border with the Republic of Ireland. (See Figure 13.)

Figure 13: Goods exports to the EU (% of gross value added 2013)

Source: Office for National Statistics, Thomson Datastream, Capital Economics



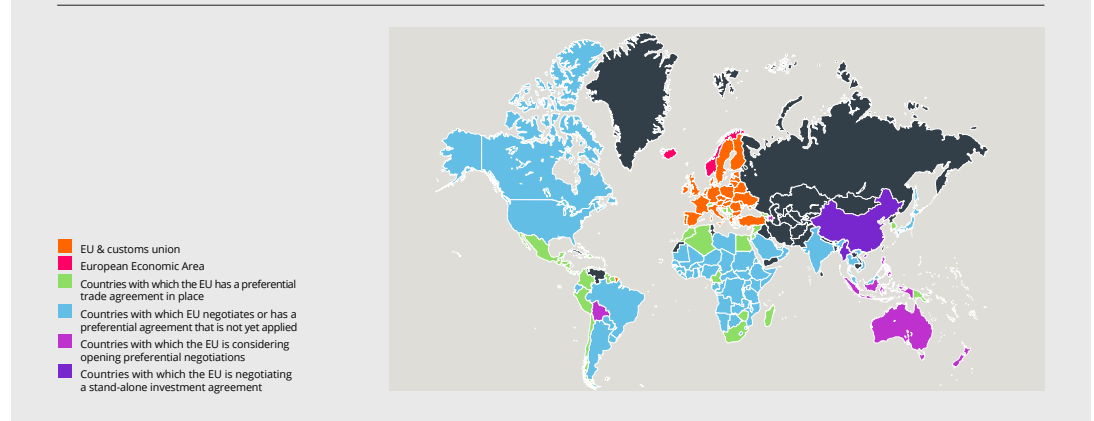
The government may choose to use the £10bn savings from its contributions to the European Union budget to compensate the hardest hit sectors (including some manufacturing industries) and regions, at least in the short term. The extra costs which British exporters would pay in higher tariffs would be less than the savings the United Kingdom would make on its contributions to the European Union – making it feasible for the government to compensate the losers from Brexit, at least in the short term. In the long term, the British economy is flexible enough for there to be a reallocation of resources from industries that are made less competitive by Brexit to those that become more competitive.

3.5. The benefits of leaving

Even if Britain’s overall trade with Europe did suffer, it is quite easy to imagine these losses being offset over the long term by the opportunities, created by leaving the European Union, to boost trade with other countries. In recent years, export growth for the United Kingdom has, in the main, come from outside the European Union. Over the coming years, economic growth is likely to be much stronger in the rest of the world than in the European Union. Brexit would therefore give Britain a crucial opportunity by allowing it to broker its own trade deals with non-European Union countries. This is not currently possible under European Union membership, as any trade negotiations can only be carried out for the Union as a whole. There remain large areas of the world with which the European Union has not reached a free trade agreement. (See Figure 14.)

Figure 14: EU trade agreements with third party countries

Source: European Commission, EU Trade relations world wide – a map (European Commission, Brussels), 2012 (accessed 26/11/2015) and Capital Economics



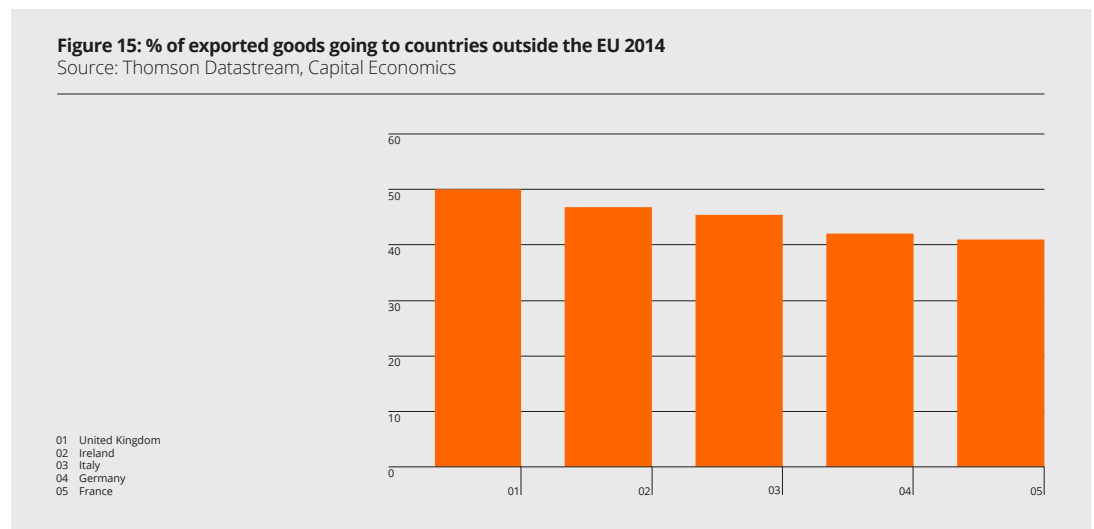
The United Kingdom would be able to reduce the tariffs on imported goods from those countries to below European Union levels; indeed Britain could even have a unilateral free trade policy. This would boost consumers’ real incomes and spur competition, as domestic producers competed with cheaper imports. Cheaper imported components would help the United Kingdom’s exports to become more

¹⁴ Bank of England’s sterling effective exchange rate index

competitive in turn and help boost manufacturing industry. Britain would, in exchange for lowering its import tariffs, be able to negotiate easier access to overseas markets.

Some opponents of Brexit argue that countries would not want to bother negotiating trade agreements with Britain on its own, given the United Kingdom's small size (just 2.5% of global output). But negotiating with Britain would almost certainly be easier and quicker than dealing with the European Union's bureaucratic machine. Switzerland, which is not a member and is smaller than the United Kingdom, has had more success establishing free trade agreements than the European Union.¹⁶

Admittedly, the global fall in tariffs in recent years means potential gains from free trade have fallen. The European Union is already in the process of negotiating new free trade deals with a number of other countries, such as the United States and Japan. Indeed, as the European Union completes more of these deals, the benefits of the United Kingdom leaving will ebb. But Britain could negotiate its own deals with these countries; it could even join other free trade agreements, such as the North American Free Trade Association. It would still have scope to strike new deals with countries with which the European Union does not have immediate plans to open up trade. This may be of particular benefit to Britain and its manufacturing industry, as its external sector is more dependent on markets outside the European Union than other members. Half of the United Kingdom's goods exports go outside the European Union, while, in Germany, the figure is 42% and, in France, 41%. (See Figure 15.)



Striking new trade deals and, in turn, opening up fast growing markets outside Europe and improving the competitiveness of Britain's manufacturing industry and goods exports would be likely to help rebalance the economy away from its current reliance on services. In 2014, Britain had a goods deficit of £121.2bn and a surplus on its services trade of £85.9bn. Hence, services play a disproportionate role in supporting Britain's trade account. Boosting exports of goods could help in strengthening the United Kingdom's current account and creating a well-balanced economy.

3.6. Summary: An opportunity to boost trade

Fears over the threat of Brexit to trade and resultant employment are often overdone, with some pretty big figures being bandied around regarding the potential loss to the British economy. The most striking – and most inaccurate – is that three to four million jobs, i.e. the number of people employed in exporting goods and services to the European Union, could be lost through Brexit.¹⁷ Given that this assumes that all exports to the Union would cease if the United Kingdom was to leave, it is a wild overstatement.

We would not go so far as to say that Brexit would definitely be a good thing for British trade and its manufacturing and services industries. That would depend on a host of factors we do not yet know (and in some cases may never know), including: the outcome of negotiations about the United Kingdom's new trading relationship with the European Union; the future economic growth of the Union versus other markets; the success of the European Union in implementing new free trade agreements with other countries; and how successful Britain could be at pushing for the completion of the single market in services if it stayed in the European Union.

¹⁵ Bank of England's sterling effective exchange rate index *Business for Britain, Change, or go (Business for Britain, London), 2015*

¹⁶ Switzerland's free trade agreement with China entered into force on 1 July 2014. State Secretariat for Economic Affairs SECO, Factsheet: Free Trade Agreement between Switzerland and China (State Secretariat for Economic Affairs SECO, Bern), 2014

¹⁷ For example the then Deputy Prime Minister Nick Clegg made the claim that "three million ... jobs rely directly on our participation and role and place in what is after all the world's largest borderless single market" in an interview on the Today programme on BBC Radio 4 on 31 October 2011.

Nevertheless, contrary to the claims of many authors and commentators, it is probable that the impacts of Brexit on trade would be relatively small. Even in the worst case scenario, adverse effects are likely to be largely confined to those sectors, mainly food production, that could be subject to a meaningful tariff under World Trade Organization rules. Moreover, it is certainly possible that leaving the European Union would leave the external sector better off in the long run if Britain could use its new found freedom to negotiate its own trading arrangements to good effect.

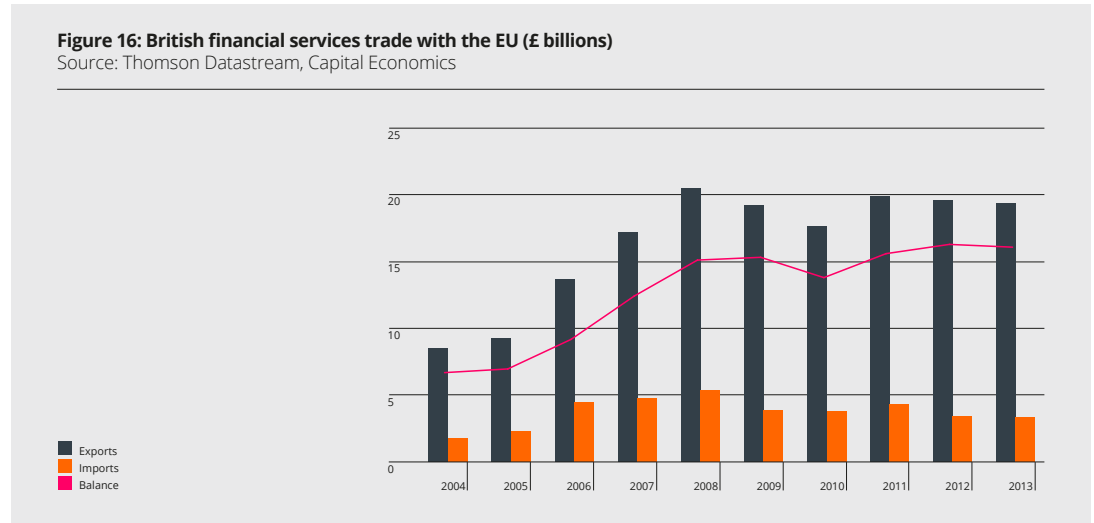
The production sectors in the economy face a more uncertain outcome than services. The range of potential outcomes is more variable as production sectors are more dependent on whether or not the United Kingdom agrees a trading agreement with the European Union – and the nature of any such agreement. The possibility of tariffs on goods exports to the European Union gives greater downside potential, while the opportunity to open up trade with other countries or to increase the sector's competitiveness through greater competition or cheaper inputs gives it more upside potential.

4. Financial services and the City

In this section, we look at the probable consequences of Brexit for financial services and the City of London. First, we examine the economic contribution of Britain's financial services exports to the European Union. Second, we assess how a new policy regime might negatively impact on these exports post-Brexit. Third, we consider how this regime could benefit the prospects for British exports.

4.1. The importance of financial services exports

In 2013 (the latest year for which data are available), exports of financial services to the European Union amounted to £19.4bn; imports were £3.3bn. The resulting £16.1bn surplus was the equivalent of 0.9% of British GDP. (See Figure 16.)



4.2. A threat to financial services exports

Although there are no tariffs on financial services, leaving the European Union could lose Britain its “passporting rights”. These allow British-based institutions to sell into the rest of the European Union without having a branch there. Similarly, banks in, say, the United States can locate in the United Kingdom and sell to the European Union without setting up there.¹⁸

There is major uncertainty over how important this issue is. Losing these rights could mean that banks would just have to set up a brass plate subsidiary in the European Union to process business essentially still done in London. But it is also possible that it would prompt the United Kingdom to lose large amounts of business to the European Union.

One way to potentially measure the value of these passporting rights is to compare the European Union's intake of British financial services exports with that of other countries. While Britain's exports of financial services to the rest of the European Union account for 0.2% of the latter's output, that share falls to just 0.1% for exports to the United States, 0.08% to Japan and 0.06% to Canada. Much of this geographical pattern is not down to European Union membership but can instead be explained by time zones – i.e. it is much easier to sell wholesale financial services (such as investment banking) into markets on the same time zones. Nevertheless, without passporting rights, it is conceivable that exports of financial services to the European Union could fall by half, or about £10 billion.

To avoid this, the United Kingdom could preserve its single market access and passporting rights if it remained in the European Economic Area. But this could still hurt the City, as Britain would have to adopt all European Union financial rules and many other regulations but would lose its ability to influence and / or block any damaging ones. The European Union could even deliberately undermine the City in order to win business for Frankfurt and Paris.

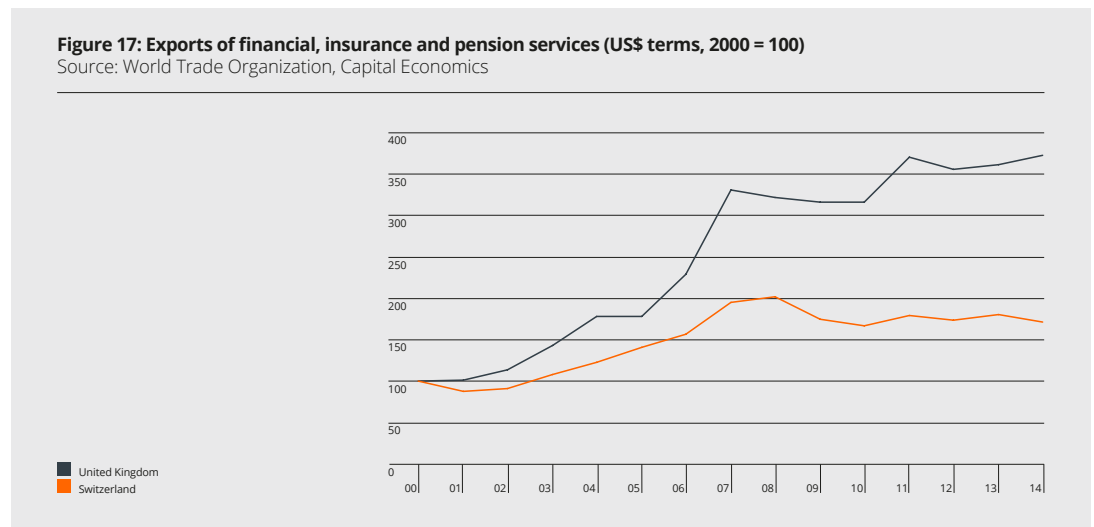
Of course, the United Kingdom's current influence has not stopped the European Union from passing some regulations Britain did not want to adopt. In 2013, the United Kingdom failed to stop the introduction of a cap on bankers' bonuses.¹⁹ It was also unsuccessful in 2012 in preventing the European Union from introducing new restrictions on short selling.²⁰ But Britain was successful in overturning a European Central Bank decision to force clearing houses settling euro-denominated contracts to relocate to the euro-zone. The United Kingdom has also helped to stop the financial transactions tax proposed by core euro-zone economies being implemented across the whole European Union.

¹⁸ Bank of England, *Passporting* (Bank of England, London), 2015

¹⁹ BBC News, *Osborne stands alone as EU backs bonus cap* (BBC News, London), 2013

²⁰ BBC News, *EU court rebuffs UK legal challenge to short-selling law* (BBC News, London), 2014

If Britain did not want to stay in the European Economic Area, it could still negotiate bilateral trade agreements with the European Union, as Switzerland has done. But Swiss banks do not have passporting rights and so operate their European investment banking businesses through subsidiaries in London. This may help to explain why Swiss exports of financial services have performed worse than British exports over the last fifteen years, despite the outperformance of the Swiss financial sector as a whole. (See Figure 17.)



It is unlikely that the United Kingdom would get a deal with the European Union as good as Switzerland's. The Swiss negotiated their deal when they were planning to join the European Union; there would be less goodwill for a country leaving it. Although Britain could retaliate with its own barriers to trade in financial services, it has much more to lose given the disparity in trade. Indeed, financial services are the part of the economy where trade negotiations probably stand the smallest chance of success.

Meanwhile, non-European Economic Area institutions may soon face bigger barriers to providing financial services within the European Union when the Markets in Financial Instruments Directive II rules are introduced in January 2017.²¹ In essence, these rules force non-European Economic Area providers of financial services to have equivalent levels of regulation in their home country before doing business across the European Union.

So, Britain's financial services exports to the European Union would probably be hit by Brexit. In addition, it would be wrong to assume that leaving the European Union would result in less regulation on the City. The British government has shown more zeal for regulation than its continental peers recently. Unlike those in other European Union countries, Britain's banks will be required to ring fence their retail banks from their commercial banks from 2019.²² The Bank of England's stress tests were tougher than the European Banking Authority's last year.²³

4.3. The opportunity for financial services exports post-Brexit

There is a decent chance that the City would still prosper if the United Kingdom left the European Union. London's pre-eminent position as a global financial centre predates the single market. The City possesses intrinsic advantages, including Britain's legal system, the English language, a convenient time zone perfectly placed between the working hours of Asia and New York, openness to immigrants, a large pool of skilled labour and a critical mass of expertise in support services such as accounting and law.

And even if exports to Europe did suffer, these losses could be offset over the long term by the greater opportunities to boost trade with non-European Union countries. Brexit would free the United Kingdom from the rules of the European Union's Common Commercial Policy, which prevents it from negotiating bilateral trade deals with other countries.

This potential for growth in trade with countries outside Europe applies to all exports but is perhaps more pertinent for financial services. In particular, there seems to be considerable scope for Britain to increase financial services exports to China and Hong Kong. They currently amount to just 2% of the United Kingdom's total financial services exports, even though China is the world's second largest economy (though, as noted above, the time zone differences may act as a barrier). Indeed, Switzerland brokered a trade deal with China in 2014 that has reduced non-tariff barriers to its financial firms.²⁴ (See Figure 18.)

At the same time, though, some other European Union countries, such as Germany, do not seem to have been hindered greatly by their inability to strike bilateral deals. Germany's exports of financial services have grown faster than the United States' and at a much faster rate than those of Switzerland or Britain since 2001. But we do not know how German exports might have fared had it been able to negotiate its

own deals and it is too soon to see the benefits of the Swiss-China deal. (See Figure 19.) Additionally, should Britain be successful in expanding financial services exports, it should be noted that this could shift Britain's overall sectoral balance towards services further still.

Figure 18: British financial services exports by destination (% share of total 2013)

Source: World Trade Organization, Capital Economics

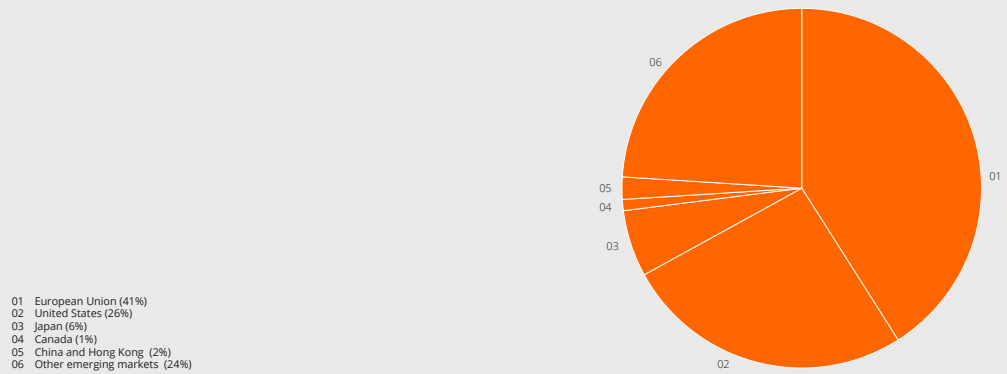
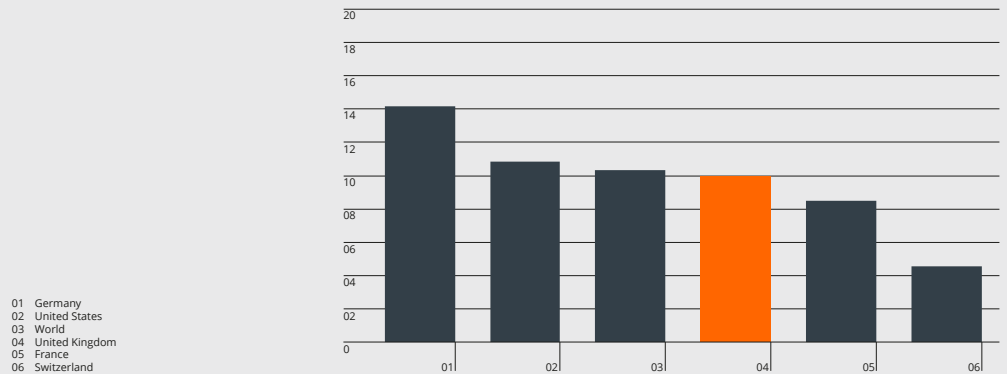


Figure 19: Exports of financial, insurance & pension services (average % y-o-y change, US\$ current prices 2001-14)

Source: World Trade Organization, Capital Economics



4.4. Summary: A short-term threat but a long-term opportunity

Overall, financial services have more to lose immediately after a European Union exit than most other sectors of the economy. Even in the best case scenario, in which passporting rights were preserved, the United Kingdom would still lose influence over the single market's rules. The City would probably be hurt in the short term, but it would not spell disaster. The City's competitive advantage is founded on more than just unfettered access to the single market. A European Union exit would enable the United Kingdom to broker trade deals with emerging markets that could pay dividends for the financial services sector in the long run.

²¹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

²² Prudential Regulation Authority, *The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities* (Prudential Regulation Authority, London), 2015

²³ Giles Williams and Clive Briault, *Stress tests: another way to impose higher capital requirements* (KPMG, London), 2014

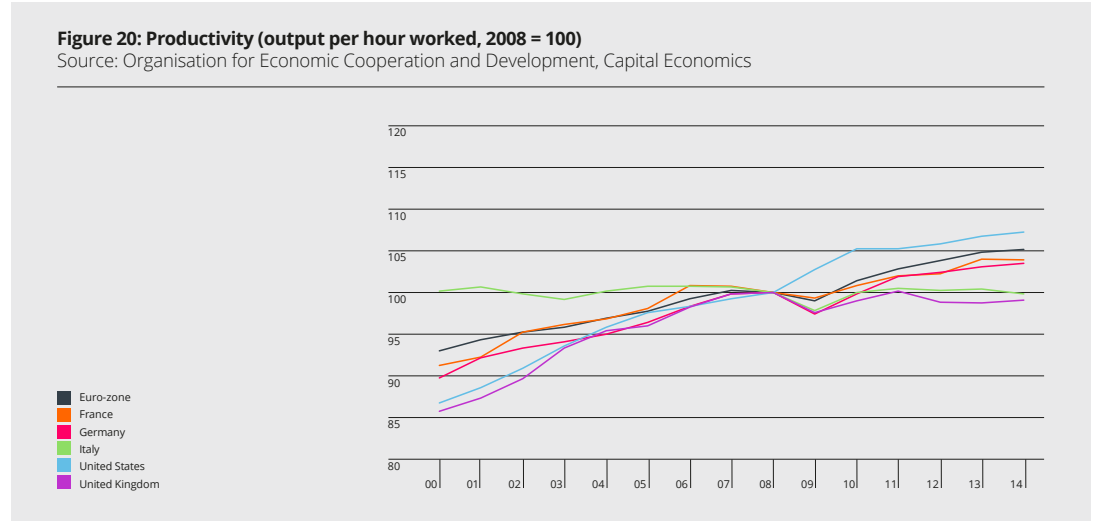
²⁴ State Secretariat for Economic Affairs SECO, *Factsheet: Free Trade Agreement between Switzerland and China* (State Secretariat for Economic Affairs SECO, Bern), 2014

5. Regulation, innovation and productivity

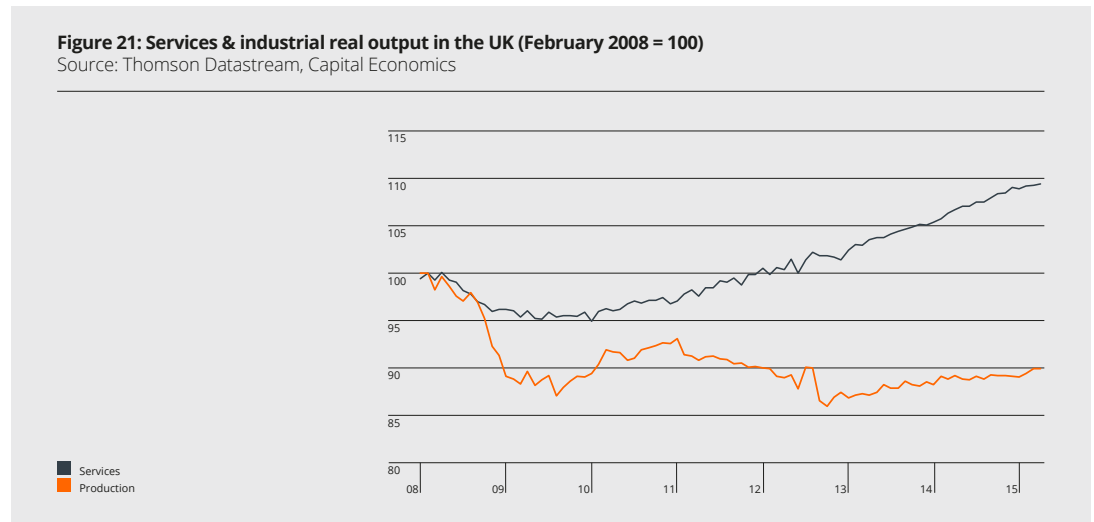
In this section, we look at the probable impact of Brexit on the United Kingdom's productivity and its regulatory environment. First, we assess Britain's productivity. Second, we examine how membership of the European Union affects the regulatory environment and how Brexit might change this. Third, we consider the implications of Brexit for productivity.

5.1. British productivity

Against a positive economic backdrop in recent quarters, one blot on the British economy's copybook has been the continuing dismal performance of productivity. Output per hour worked remains below its pre-crisis peak and productivity growth has been substantially weaker than in the United States and other large European countries over the same period. (See Figure 20.)



It is difficult to blame membership of the European Union for this productivity weakness and there are two principal factors lying behind it. First, it has, in part, been driven by the divergent performances of the services and industrial sectors. While services output is now back above its pre-crisis peak, industrial output still remains well below it. (See Figure 21.)



Given the relatively labour intensive nature of the services sector, the scope for rises in productivity may be more limited than in other parts of the economy. So the outperformance of services may presage permanently weaker productivity growth.

A second factor that has weighed on productivity is weak business investment. Following a fall of 22% after the financial crisis, it took until 2014 to recover to pre-crisis levels. Weak business investment implies slower growth in capital and hence output per worker.

5.2. Britain, the European Union and regulation

One of the perennial concerns raised in the debate around British membership of the European Union is that of regulation – so-called ‘red tape’. At present, European Union regulations have to be applied across the whole British economy, even though only 14% of its output is exported there. The National Health Service must comply with the Working Time Directive and retailers with the Agency Workers’ Directive. The impact of the 100 most costly European Union regulations for British business has been estimated at £33bn annually.²⁵

Superficially, it would seem there is much scope for benefits in the field of regulation post-Brexit. Even if the United Kingdom still had to comply with European Union regulations in those sectors wanting to export there, it could reduce regulations in the 85% of the economy that does not. Membership of the European Economic Area – the ‘Norway option’ – would provide the United Kingdom with greater flexibility than at present but would still impose considerable constraints. There is a debate as to how significant these would be, with various statistics being put forward. On the one hand, between 2000 and 2013, for example, the European Union enacted 52,000 pieces of legislation. At the same time, Norway adopted just 4,700 – 9% – of them.²⁶ On the other hand, the Norwegian government has estimated that Norway has adopted roughly three-quarters of European Union legislation.²⁷ The implication is that Norway does not have to adopt many European Union laws, but does have to comply with the more significant and important ones. Overall, if Britain pursued this option, there would be likely to be some additional room for manoeuvre, which may help to boost productivity.

That said, the benefits of getting rid of European Union regulations can be overstated. After all, Britain would probably want to keep many of them anyway. As we noted in section three, British governments have shown more zeal for financial services regulation than other European countries recently.

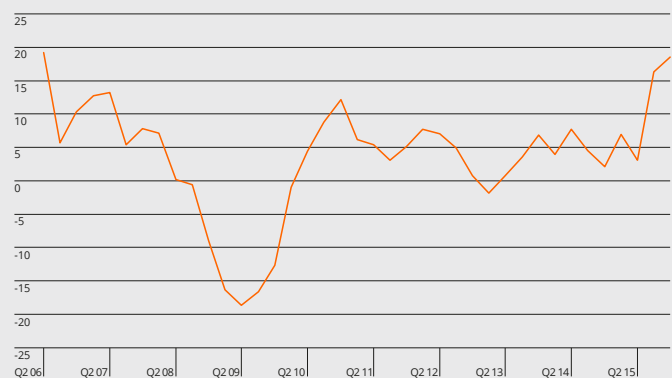
5.3. The implications of Brexit for productivity

Due to Britain’s domestic penchant for enhanced regulation, the scope for radical reform of the regulatory environment to enhance productivity following Brexit is limited and its impact on Britain’s sectoral balance could even be harmful. British manufacturers might face a more difficult export outlook in important European markets but services would be relatively impervious to this. The ratio of British output from services and industry could be distorted even further in favour of the former if the financial services sector benefits more from new trading opportunities with emerging economies than the manufacturing or industrial sectors. This would create a difficult environment for productivity growth.

With respect to business investment, recent changes in this seem unconnected with uncertainty surrounding Britain’s continued membership of the European Union. As in the case of the Scottish referendum, business investment demonstrates little apparent sensitivity to these political considerations. Much would depend on businesses’ perceptions of the United Kingdom’s economic prospects post-Brexit. If these looked good, investment could be expected to rise. If not, then it would continue to stagnate. This, however, would be the case with or without Brexit. (See Figure 22.)

Figure 22: UK real business investment (% y-o-y change)

Source: Thomson Datastream, Capital Economics



There are two further issues which could arise from Brexit. First, given that foreign multinationals tend to be productivity-enhancing, bringing with them new technologies and management practices, a fall in foreign direct investment into Britain could be damaging for the country’s productivity outlook. Second, an immigration policy which allowed the United Kingdom to choose migrants on the basis of their skills rather than simply on the country they come from, would allow it to select higher skilled, more productive workers.

²⁵ *Open Europe, Top 100 EU rules cost Britain £33.3bn (Open Europe, London), 2015*

²⁶ *Kathrine Kleveland, ‘Actually Mr Cameron, we Norwegians are happy, rich and free outside the EU’, The Telegraph, 29 October 2015*

²⁷ *Unofficial translation of ‘Outside and inside: Norway’s agreements with the European Union’, Official Norwegian Reports, NOU 2012:2*

5.4. Summary: Benefits from Brexit, but not a game-changer

Brexit is only likely to have a limited impact on Britain's productivity. The major potential for improvements comes from increased business investment, which shows little connection with these political developments. Estimates that axing European Union regulations would save Britain a lot of money exaggerate the true picture, as the United Kingdom would still choose to implement a lot of them. It would also need to implement the Union's regulations to continue to export easily to the single market. Reduced regulation might give a small boost to productivity but wouldn't be a huge boon.

6 Foreign investment

In this section, we look at the likely impact of Brexit on foreign direct investment into the United Kingdom. First, we outline the scale of investment into Britain from the European Union. Second, we explore the probable legal and regulatory environment for foreign investment following Brexit and its likely impact on flows of foreign direct investment.

6.1. The European Union's investment in Britain

The European Union is an important source of foreign direct investment for the British economy. In 2013 (the latest year for which data are available), the European Union accounted for 46% of the United Kingdom's stock of inward foreign direct investment and its share of the overall stock of foreign direct investment has been fairly stable over the past decade. However, inflows of foreign direct investment from European Union countries have been slowing over recent years and more investment has been flowing in from non-member countries. (See Figure 23 and Figure 24.)

Figure 23: Stock of foreign direct investment in the UK (£bn nominal)

Source: Office for National Statistics, Capital Economics

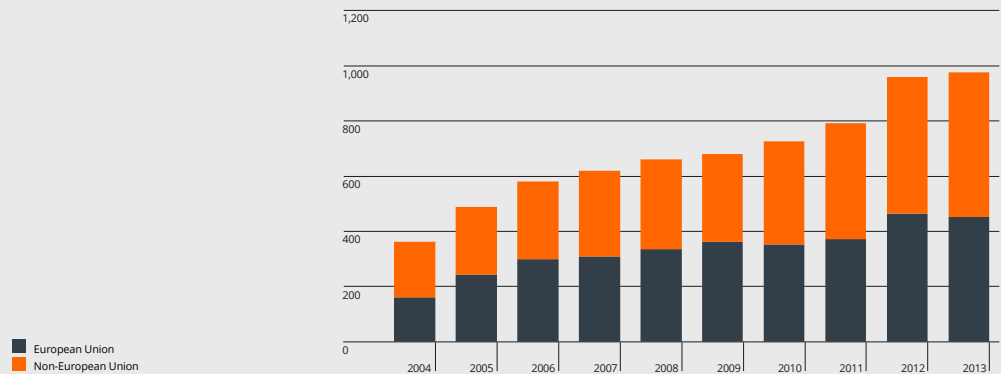
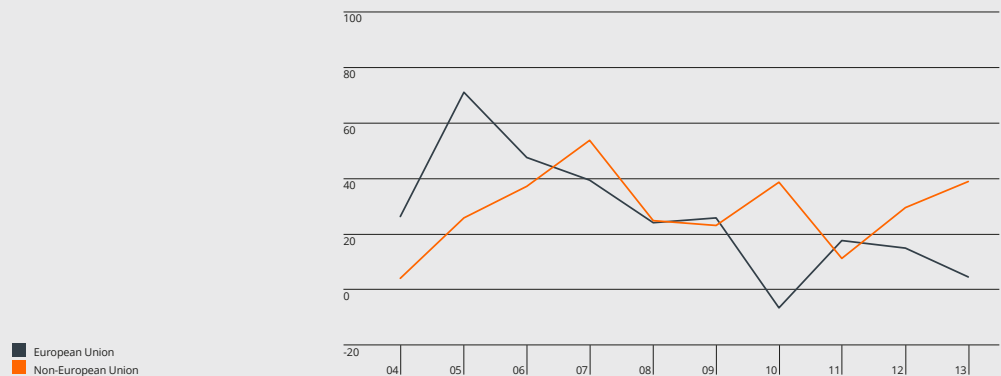


Figure 24: Foreign direct investment inflows into the UK (£bn nominal)

Source: Office for National Statistics, Capital Economics



6.2. Implications for attracting foreign investment

Firms and investors in many non-European Union countries have been using Britain as a gateway to Europe, benefitting from the zero-tariff environment and free movement of labour and capital. Accordingly, the main fear here seems to be that, if the United Kingdom voted to leave, foreign direct investment inflows would dry up and parent companies may even close-up shop and move production or offices elsewhere. In addition, given that foreign multinationals tend to be productivity-enhancing, bringing with them new technologies and management practices, a drying up of this investment into Britain could be damaging for the country's long-term potential.

These fears tend to focus on investment in manufacturing industries (such as car production) but foreign investment includes not only financing for physical plants and machinery but also less tangible financial investments. In fact, it is once again the financial sector that appears to have the most to lose from Brexit, at least in the short term: around a third of inward foreign direct investment by non-European Union countries in the United Kingdom is accounted for by financial services.

Nevertheless, we think that these concerns are overblown. They are predicated on the assumption that, on leaving the European Union, Britain would be hit with a swathe of harsh tariffs which would make it costly to export to member countries. But, as we have already determined, tariffs on exports to the European Union remain generally low for non-member countries. Moreover, these fears don't take into account the fact that firms choose to invest in Britain for a myriad of reasons, not just for its access to the single market, and that they do not just invest in projects for the production of physical goods.²⁸

In the World Bank's Doing Business survey (which assesses countries according to the ease of doing business in them), Britain ranks highly in areas such as attaining credit, dealing with construction permits and protecting minority investors.²⁹ What's more, the United Kingdom benefits from good transport connections, a welcoming political environment, a strong rule of law and the English language. This helps to explain why Britain has been more successful than other European Union countries in attracting inward foreign direct investment, capturing 28% of all investment into (European Union and non-European Union) Europe in 2014.³⁰

6.3. Summary: Initial disruption then business as usual

We could see a period of weaker foreign direct investment inflows as the United Kingdom's new relationship, including the tariff structures, is renegotiated. But if (an admittedly uncertain "if") Britain is able to obtain favourable terms, foreign direct investment would probably recoup this lost ground.

Consequently, concerns about a drying up of foreign direct investment if Britain votes to leave the European Union are somewhat overblown. Access to the single market is not the only reason that firms invest in Britain. Other advantages to investing here should ensure that foreign firms continue to want a foothold in the country. Accordingly, we still think that Britain would remain a haven for foreign direct investment flows even if it was outside the European Union.

²⁸ Office for National Statistics' Foreign direct investment involving UK companies 2013 Inward Reference Tables

²⁹ The World Bank Group, *Doing Business 2016* (The World Bank Group, Washington), 2015

³⁰ fDi Intelligence, *The fDi report 2015* (The Financial Times Ltd, London), 2015

7. Public sector

In this section, we examine the probable impact of Brexit on Britain's public finances. First, we look at Britain's current contributions to the European Union. Second, we explore Britain's likely fiscal relationship with the European Union after Brexit.

7.1. The United Kingdom's contributions to the European Union

There are different ways of examining Britain's financial contributions to the European Union. In 2014/15, the United Kingdom paid a standard £13.7 billion contribution, based on the size of its economy, to the European Union, plus an additional £2.3bn payment because each country must contribute a share of Value Added Tax receipts to the bloc. It received back £4.8bn through the British rebate and a £0.8bn fee for collecting duties on the European Union's behalf – all adding up to a cost to the public finances of £10.4bn.

Some people prefer to quote the gross contribution, which, in addition to the above, also includes the £3bn of customs duties that Britain collects for the European Union and would get to keep if it left (although, if the United Kingdom used Brexit to increase its free trade with other countries, these customs duties would be reduced or disappear). Others prefer to take off the £4.4bn of funds disbursed by the European Union to British firms and households, for example via the Common Agricultural Policy. After all, the Government would probably reimburse at least some of those losing such European Union funds in the event of Brexit. Accounting for these two items leaves a net contribution of £9.1bn, though the 'true' cost of membership to the public purse may range from £6.1bn to £13.4bn, depending on whether these two items are included. (See Table 2.)

Table 2: British contributions to the European Union

	£billion in 2014/2015
Gross National Income based contribution	13.7
Plus Value Added Tax receipts	+2.3
Minus British rebate	-4.8
Minus fee for collecting duties	-0.8
= Contribution included in public finances	=10.4
Plus customs duties	+3.0
= Gross contribution	=13.4
Minus European Union funds (e.g. Common Agricultural Policy)	-4.4
= Net contribution	=9.1
Minus customs duties	-3.0
= 'Free trade' net contribution	=6.1

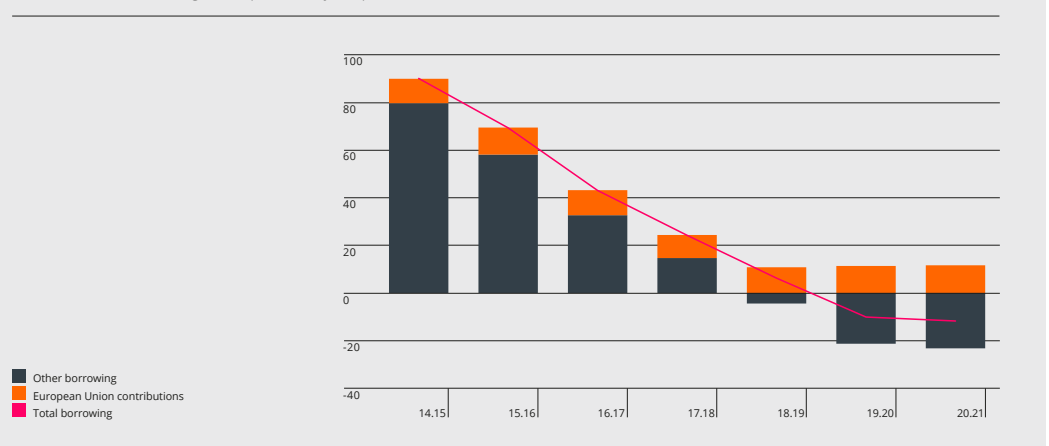
Sources: Office for Budget Responsibility and Capital Economics

7.2 Britain's financial relationship with the European Union post-Brexit

Exiting the European Union would directly save the exchequer in the order of £10bn a year (the contribution to public finances included in Table 2), cutting about one seventh off this year's public sector net borrowing forecast of £70 billion.³¹ The Office for Budget Responsibility expects Britain's contribution to rise further by 2020 and it is therefore possible to project the savings that would result if Brexit was to occur over the next few years.³² This assumes that the United Kingdom still receives its rebate, which was agreed in 1984 when Britain was one of the poorer members. The rebate now looks less defensible and may come under threat in future negotiations on the European Union's next seven-year budget if Britain remains a member. If the rebate was reduced, the savings would be greater. (See Figure 25.)

Figure 25: Projected public sector net borrowing and EU contributions (£bn nominal)

Source: Office for Budget Responsibility, Capital Economics



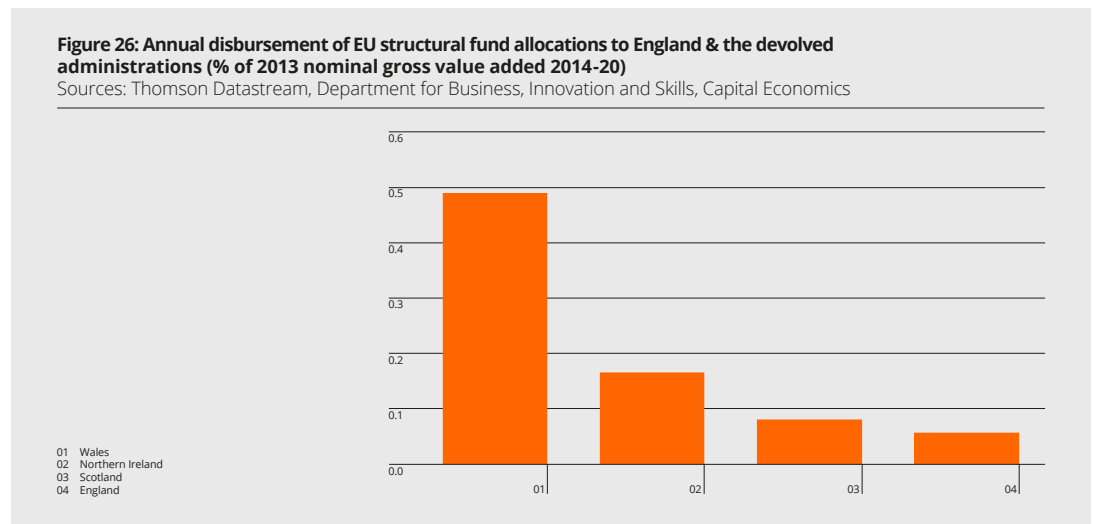
There are, however, a number of sensitivities around this central forecast. Firstly, these savings could easily be eradicated if Brexit had an adverse impact on the economy, even if it was quite a small one. The Office for Budget Responsibility's rule of thumb suggests that it would only take a 0.8% permanent reduction in the level of output for public borrowing to be £10bn higher than it would otherwise be.³³ Equally, though, if Brexit boosted the economy, the savings would be even bigger.

Secondly, the United Kingdom might still need to contribute to the European Union's budget. To be in the European Economic Area, Norway pays a contribution based on the size of its economy. Estimates of how much Britain would pay for a Norway-style arrangement vary but it is estimated that contributions would be at least 56% of current levels³⁴ and may only fall by 17%.³⁵

Thirdly, if the United Kingdom left the European Economic Area, it might need to compensate exporters if no free trade agreement was reached and the European Union imposed its Common External Tariff. The government may also find itself in a position where it needs to compensate businesses for a loss of access to European Union structural funds, such as the European Regional Development Fund. These would be small amounts; in Wales, for example, structural funds will disburse the equivalent of almost 0.5% of annual gross value added between 2014 and 2020.³⁶ (See Figure 26.)

Fourthly, the potential for Britain to receive the revenues currently lost to the European Union in customs duties will be reduced if the United Kingdom is successful in negotiating low or zero duty arrangements with other countries via new free trade agreements. Of course, it could be expected that such deals will yield net benefits for the economy but it should be noted that they will come at a cost to the public finances.

Finally, the public finances could be further affected if Brexit resulted in lower net migration. Estimates vary but one study showed that European immigrants who arrived in Britain since 2000 made net contributions to the public finances of more than £20bn between 2001 and 2011.³⁷ The Office for Budget Responsibility estimates that, in a low net migration scenario (of 105,000 annually), the ratio of debt to GDP will be twenty percentage points higher in 50 years' time than if migration were 165,000 a year.³⁸



7.3. Summary: Cost-savings from Brexit

The British government could save about £10bn per year on its contributions to the European Union's budget if the country left the bloc. This figure could be higher if either the British rebate was to be threatened in the years ahead or Brexit was to result in overall faster economic growth.

Overall, though, the likelihood is that the savings will be somewhat less than £10bn because there are a number of factors that could reduce them. A little economic disruption and lower migration as a result of Brexit could offset them. The government might also continue to make some contributions to the Union if it wanted to preserve single market access, it might need to compensate sectors of the economy and specific regions that currently benefit from European Union handouts and it may have to sacrifice customs duties income to strike new trade deals with countries outside Europe.

We expect that Brexit will benefit the public finances, but not to a huge degree.

³³ Office for Budget Responsibility, 'Cyclically adjusting the public finances', Office for Budget Responsibility Working Paper No.3, 2012

³⁴ Confederation of British Industry, *Our global future* (Confederation of British Industry, London), 2013

³⁵ Gavin Thompson and Daniel Harari, 'The economic impact of EU membership on the UK', House of Commons Briefing papers, SN06730, 2013

³⁶ We assume that funds are disbursed evenly across the period from 2014 to 2020.

³⁷ Christian Dustmann and Tommaso Frattini, 'The fiscal effects of immigration to the UK', *The Economic Journal*, Volume 124, Number 582, pp593- 643, 2014

³⁸ Office for Budget Responsibility, *Fiscal sustainability report* (Office for Budget Responsibility, London), 2015

8. Consumption and the property market

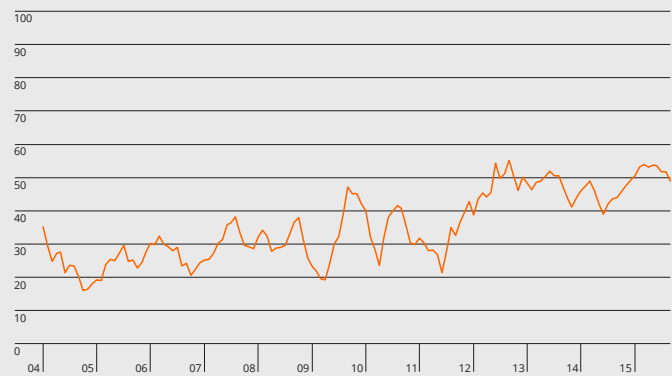
In this section, we look at the likely effects of Brexit on consumption and the British property market. We start by focussing on the property market impacts. First, we look at the concern that Brexit could harm Britain's status as a commercial gateway to Europe, negatively impacting property markets. Second, we examine whether Brexit would adversely affect property demand through damaging the City of London. Finally, we bring together the property market analysis with our assessments of the other macroeconomic impacts of Brexit to evaluate the impact on aggregate consumption.

8.1. Foreign direct investment and the British property market after Brexit

If Britain lost its free access to the single market, there is a worry that that this could rapidly change the country's status as a commercial gateway to the rest of Europe, with adverse consequences for both occupier and property investment markets. If demand from overseas buyers did drop following Brexit, the impact on the market could be significant. After all, by value, overseas buyers have accounted for roughly half of all transactions in the British commercial property market over the past few years. (See Figure 27)

Figure 27: Purchases of British commercial property by overseas buyers (% of total by value)

Source: Property Archive, Capital Economics



However, if we are right that overall foreign direct investment flows will hold up rather better than is sometimes suggested, there is little reason why those same factors would not continue to support the demand for British property. After all, most purchases of commercial property in the United Kingdom by overseas buyers are for investment rather than for operational purposes.

Factors such as the legal system and the language, as well as the size, liquidity and transparency of the British market are not a function of our European Union membership. Therefore, unless the majority of buyers took issue with our view that Brexit would not harm the United Kingdom's underlying economic growth prospects, it is hard to see why property investment would suddenly slump.

8.2. The City, the property market and Brexit

There is more reason for concern over the impact of Brexit on the City of London and, subsequently, the British property market. The argument here is that Brexit could damage the City, by forcing institutions to re-locate to the continent. In that scenario, vacancy rates could rise and the premium commanded by Central London office space could shrink.

It seems likely that leaving the European Union would hit the health of the City and it is plausible that a number of overseas institutions would close or scale back their London operations, putting a dent in occupier demand. That drop in demand could come at an unfortunate point in the development cycle. Over the next few years, the office development pipeline in central London is likely to run ahead of recent rates of net absorption, with the bulk of that surplus space destined for the City. A sharp drop in demand could see vacancy rates spike higher and rental values start to fall. (See Figure 28.)

If that was to happen it is possible that investors might begin to reassess the price premium commanded by City office space. A rolling five-year average of the difference between City office yields and the yields for regional office markets shows that this premium has been growing steadily over the past twenty years – it has more than doubled over that period. (See Figure 29.)

If investors felt that the City had been permanently damaged by the United Kingdom's departure from the European Union, a jump of between 50 and 100 basis points in City office yields, knocking 8% to 15% off capital values, would not seem implausible.

Figure 28: Indicators of office demand and supply in London (millions of square feet, annual averages 2011-15 pipeline 2015-19 expectations)

Source: CBRE, Knight Frank, Capital Economics' estimates

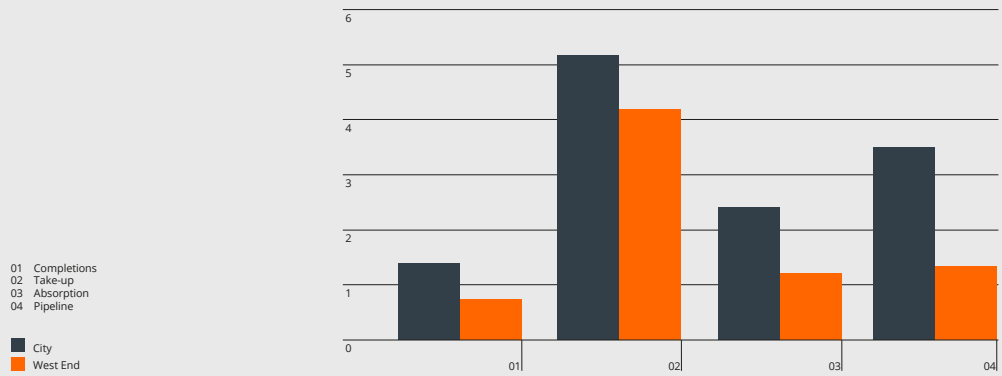
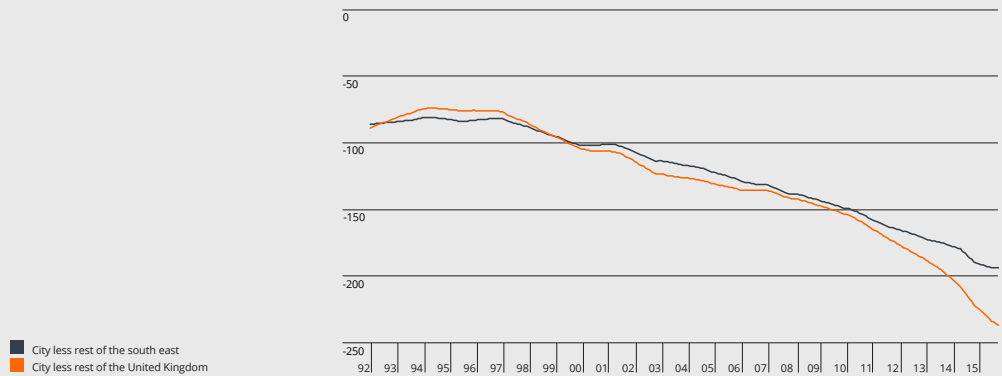


Figure 29: Gap between City and regional office yields (5yr rolling average, basis points)

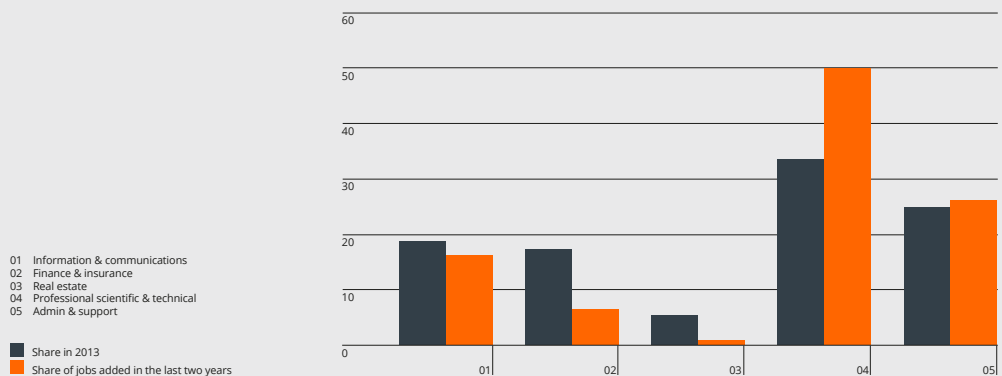
Source: IPD, Capital Economics



However, agency sources suggest that financial services firms have not been the key driver of central London office take-up in recent years, even in the City. Employment data point to a similar conclusion. Within London, financial services account for roughly 16% of the stock of office-based jobs. But over the past two years, they accounted for only 6% of the new jobs created. Instead, it is professional, scientific and technical services that have been driving London office job creation. (See Figure 30.)

Figure 30: % of London office-based jobs by sub-sector (latest = Q2 2015)

Source: Office for National Statistics, Capital Economics



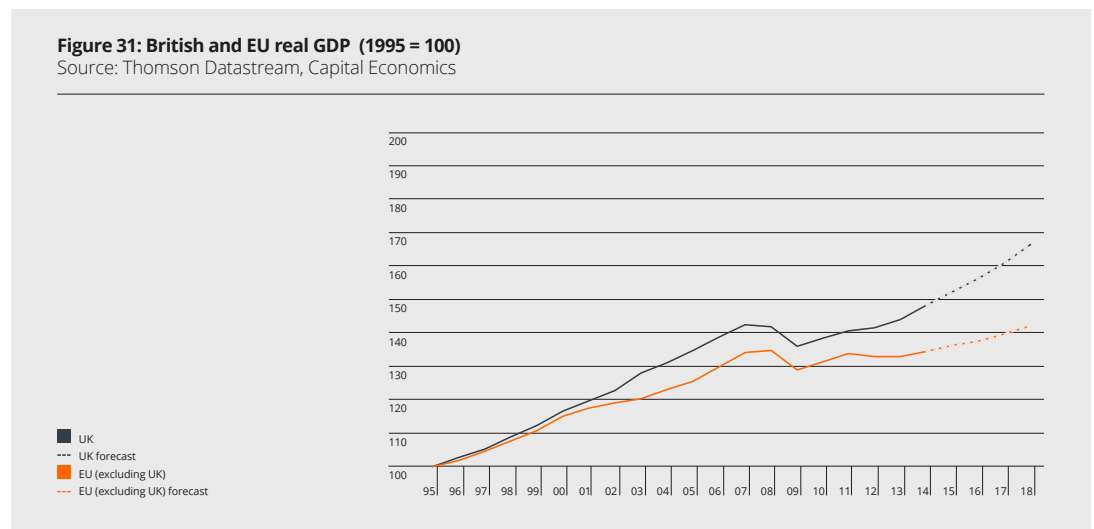
Moreover, the City office vacancy rate currently sits at just 5.0%, some 3.5 percentage points below its long-term average. It is therefore quite possible that occupier demand has been held back in recent quarters by a shortage of suitable space. If that is the case then, even if demand from financial services firms was to fall, increased demand from other sectors could help to mitigate the overall impact on vacancy rates and rents.

8.3. Brexit, the British economy and consumption

It is argued that leaving the European Union would damage property markets and the macro-economy, resulting in lower consumption.

Based on our analysis in sections one to six, we are, on balance, sceptical of the more extreme claims made about the costs and benefits of Brexit for the British economy. It is plausible that Brexit could have a modest negative impact on growth and job creation. However, it is slightly more plausible that the net impact would be modestly positive. There are potential net benefits in the areas of a more tailored immigration policy, the freedom to make trade deals, moderately lower levels of regulation and savings to the public purse. In each of these areas, we do not believe that benefits of Brexit would be huge but they are likely to be positive. Meanwhile, costs in terms of financial services and foreign direct investment are more likely to be short-term and there are longer-term opportunities from Brexit even in these areas. In this chapter, we have seen that that there may be a limited impact on the level of occupier demand for property, mainly via the City of London channel.

Overall, the resultant effects on consumption could well be positive and are certainly not likely to be large. We continue to think that the United Kingdom's economic prospects are good whether inside or outside the European Union. Britain has pulled ahead of the European Union in recent years, and we expect that gap to widen over the next few. (See Figure 31.)



8.4. Summary: Small property downsides, small consumption upsides

It seems clear that the City is the part of the British property market that has most to lose if the United Kingdom opts to leave the European Union. It is certainly possible to tell a story in which the damage done could be considerable but the role of the financial services sector in holding up the property market is probably overstated, leading us to believe that any negative impacts will be small, certainly at a macroeconomic level.

We anticipate that the impacts on the property market overall and on aggregate consumption in the economy will be limited. In the case of the latter, they may well be positive due to beneficial effects from independent policymaking on immigration, trade and regulation, as well as savings to the exchequer (which may then be disbursed in the form of lower taxes).

Ultimately the issue is likely to hinge crucially on the terms that the United Kingdom can negotiate in the event that it does decide to leave. In turn, that may well depend on how the government's attempts to negotiate European Union reform are received over the next few months and how fearful leaders on the continent are that if Britain was to vote to leave that could set an unwelcome precedent for others.

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