

The Economics of Brexit

Scott Niederjohn, Ashley Harrison, and J.R. Clark

This essay will consider a number of interesting questions related to the Brexit vote. We will first examine, What is this European Union (EU)-operation that Britain is leaving? Using an economic perspective, Britain's decision to leave the EU will be evaluated based on its costs and benefits to the UK. The result of the vote (commonly referred to as Brexit) implies that the British people believed the costs of staying in the EU outweighed its benefits. What are these costs and benefits? Considering these current event questions through the lens of economics can help provide valuable insights for students.

What is the European Union?

The European Union—often known as the EU—is an economic and political partnership involving 28 European countries. It evolved from an agreement—originally between Germany, France, Belgium, Luxembourg, Italy, and the Netherlands—known as the European Coal and Steel Community. The partnership was forged out of a post-World War II environment focused on preserving peace on the European continent, with the idea that countries that trade together are more likely to avoid going to war with each other.

It has since become a “single market” in which goods, capital, and people move around freely, almost as if the member states were one country. It has its own currency, the euro (which is used by 19 of the member countries), its own parliament and its own rule-setting authority in a wide range of areas—including the environment, transportation, consumer rights, and even things such as mobile phone charges.

The European Union has three capital cities: Luxembourg City, Luxembourg; Strasbourg, France; and Brussels, Belgium. Brussels, however, is the true

center of the EU and hosts the Council of the European Union, European Commission, and a seat of the European Parliament. These three institutions are somewhat analogous to the executive branch, cabinet and legislative branch of American government. A European Court of Justice is based in Luxembourg City, and operates much like America's Supreme Court.

American students might find it convenient to imagine a fictional equivalent to the EU in North America. It might have its headquarters in Toronto, Canada. Rules and laws made by representatives from Canada, Mexico, and the United States would apply to all nations. People that are citizens of these three nations could choose to live, work, or retire in any of the other countries and receive all of the same benefits as citizens of those nations.

Why Leave?

Why did the British people choose to leave the UK by a margin of 52 percent to 48 percent? That is a complex question. Many felt that Britain's economy was being held back by the EU. They felt that Britain, as a vibrant, entrepreneurial,

and dynamic society, is hurt by being tied to “old Europe's” regulations and slow growth. Those leading the “leave” campaign felt the EU imposed too many rules on business and charged billions of pounds a year in membership fees for little in return. A common example of the “red tape” required by the EU is the “no bendy banana law” that classifies bananas by shape. Commission regulation 2257/94 identifies certain restrictions for fruits that producers have to conform to in order to sell their produce within the EU. The regulation states that bananas must be “free from malformation or abnormal curvature” and sets up a separate Class 2 for bananas that have full-on “defects of shape.” Many “leavers” also cited sovereignty and democracy as their objection to the EU. That is, they objected to rules being imposed upon the UK from Brussels rather than London.

Further, many wanted Britain to take back full control of its borders and reduce the number of people coming into the country to live or work. As mentioned earlier, one of the main principles of EU membership is “free movement,” which means you don't need to get a visa to go and live in another EU country. This obviously makes it impossible to control immigration from other EU countries. Many people moved from across Europe—and particularly from Eastern Europe—to the UK in response to its strong economy and, some argued, generous government benefits. This policy led many native-born people



Police are forced to separate demonstrators outside Downing Street where pro and anti Brexit supporters met during the March for Europe protest in London, Sep. 3, 2016. (Rex Features via AP Images)

to worry about losing their jobs to the influx of relatively less expensive labor from other countries, and some supporters of Brexit also raised concerns about possible terrorism. The EU's free movement of people potentially allows those that gain access to any country in Europe to come to the UK with little oversight.

Lastly, those that campaigned to leave also objected to the idea of "ever closer union" between EU member states, a stated goal of many of the original members. Some saw this as a move towards the creation of a "United States of Europe." While popular in many parts of continental Europe, such a concept has never gained much traction on an island nation with a proud history.

Why Stay?

The biggest concern and cost to the UK from Brexit is the loss of access to the European "single market." The single market is seen by many advocates as the EU's greatest achievement and one of the primary reasons the EU was set up in the first place. Many who advocated leaving the EU contend the UK can maintain single-market access after Brexit. However, experts suggest it would almost certainly come at the expense of accepting the free movement of people. This seems unlikely given how passionately those voting to leave felt about ending free movement.

In the EU free trade area, countries can trade with each other without paying tariffs. This truly allows the free movement

of goods, services, money and people within the European Union, as if it were a single country. In 2015, 44 percent of all UK exports went to countries in the EU's single market.

While London maintained its status as one of the world's most important financial centers during two world wars and the Great Depression, some argue that "The City" will suffer under Brexit. London's role as a financial center is threatened primarily over the fear that much of the euro-dominated business is likely to move to Paris or Frankfurt. Many large London-based banks have already forecasted job losses if the single market isn't maintained.

Immediately following the unexpected Brexit vote, the British pound slumped

and the UK's FTSE stock market dropped substantially. The Bank of England responded with a decision to cut interest rates from 0.5 percent to 0.25 percent—a record low and the first rate cut since 2009. Most economic indicators have proven resilient to Brexit and the UK economy continues to lead Europe in terms of economic growth and low unemployment. Yet the pound's slump has continued, and the currency remains near a 30-year low with the U.S. dollar. In addition, Britain lost its top AAA credit rating following Brexit, meaning the cost of government borrowing will be higher in the future.

Another issue affecting both the UK and the EU is the status of British citizens living in EU countries and Europeans living in Britain. With Brexit, it is uncertain whether they must return to their home countries. Most expect this issue to be resolved in the negotiations that follow Brexit; however, a resolution isn't certain at this point.

Perhaps the biggest issues Brexit exposed were those associated with Scotland and Northern Ireland. England voted strongly for Brexit, by 53.4 percent to 46.6 percent, as did Wales, with "Leave" getting 52.5 percent of the vote and "Remain" 47.5 percent. However, Scotland and Northern Ireland both supported staying in the EU. Scotland voted "Remain" by 62 percent to 38 percent, while Northern Ireland voted "Remain" by 55.8 percent to 44.2 percent. In 2014, Scotland had held a referendum to consider leaving the United Kingdom and those choosing to stay in the union prevailed by about 55 percent to 45 percent. Given Scotland's overwhelming preference in both votes to stay in the EU, there are already rumblings about another vote for Scottish independence.

The situation in Northern Ireland is similar, but perhaps with even higher stakes, than in Scotland. After many years of violence called "The Troubles" between those sympathetic to the Irish Republic (now Ireland) and "Unionists"

(often Protestants sympathetic to the British crown), tensions have eased in recent years. The Brexit vote has the potential to reopen these wounds, as a hard border between Ireland and Northern Ireland would seem to be required once Northern Ireland isn't part of the European Union.

What, from Europe's perspective, are the costs of Brexit? Put simply, the European Union loses its second largest economy. It also loses the continent's financial capital in London and the nation that provides the strongest voice for free trade and a more market-oriented economic policy. In addition, the UK is Europe's largest spender on military and defense in absolute terms as well as a percentage of GDP. The European Union is clearly a weaker and less influential body without the presence of the United Kingdom.

The Exit Process

For the UK to leave the EU it must invoke an agreement called Article 50 of the Lisbon Treaty which gives the parties two years to agree on the terms of the split. Prime Minister Theresa May has said she intends to trigger this process with the aim of exiting by the summer of 2019, depending on the precise timetable agreed upon during the negotiations.

Once negotiations officially begin, a clearer idea of what kind of deal the UK will seek from the EU on trade and immigration will emerge. The government will also enact a Great Repeal Bill which will end the primacy of EU law in the UK. It will incorporate EU legislation into UK law, after which the government will decide which parts to retain or change.

A court challenge to Theresa May's right to trigger the Article 50 process without getting the backing of Parliament was successful in the British High Court, and caused some delays in starting the Article 50 process. The May administration, however, subsequently secured the support of the British Parliament for starting the process.

The Path Forward for the United Kingdom and Europe

The current debate within the UK revolves around the question of a "hard" or "soft" Brexit. These terms are increasingly being used in discussions focusing on the terms of the UK's departure from the EU. At one extreme, "hard" Brexit could involve the UK refusing to compromise on issues like the free movement of people in order to maintain access to the EU single market. At the other end of the scale, a "soft" Brexit might follow a path similar to Norway, which is a member of the single market and has to accept the free movement of people as a result.

Many businesses have warned against a "hard" Brexit as a serious risk to the UK economy. However, many who voted for Brexit did so, at least partly, in an effort to end the free movement of people into the UK from around Europe. This is precisely what makes these negotiations so complicated. There is no strict definition of "hard" and "soft" exit, but they are used to refer to the closeness of the UK's relationship with the EU post-Brexit, to be worked out in the negotiations.

EU negotiators seem reticent to give the UK access to the single market without accepting the free movement of people. In many ways, the remaining EU nations seem determined to make an example of Britain for fear that if the UK negotiates too good a deal, other nations will vote to leave the union too. There are already rumblings and political parties focusing on an exit from the EU in France and The Netherlands. Recent speeches by Prime Minister May suggest that the UK is planning to pursue something more similar to a "hard" Brexit. They will leave the EU, not accept free movement of people into Britain, and then start from scratch re-negotiating a free trade agreement with Europe.

Conclusion

The famous British economist John Maynard Keynes is best known for his ideas regarding stimulus spending.

However, some of his other ideas on nations' choices may yet prove to be relevant regarding the United Kingdom's exit from the European Union.

Another strand of Keynes's work is not as well known. In 1919, he published *The Economic Consequences of the Peace*. Keynes was a strong advocate for a more generous peace offer to Germany than was imposed under the Treaty of Versailles. He had argued for a plan to *rebuild* Europe after World War I with the goal to integrate a peaceful Germany into the world economy, rather than punish her with unpayable war reparations. Keynes, in fact, was a major player in the 1944 Bretton Woods negotiations and his ideas were highly influential in the eventual design of the successful Marshall Plan and the later formation of the European Union.

Given the costs the UK paid both economically and in human life fighting two wars in Europe, its decision this past June to leave the European Union seems puzzling and has created much uncertainty about the future relationship between the UK and its continental European neighbors.

Looking at this decision through the lens of economics would suggest that voters in the UK perceived that the costs of EU membership outweighed its benefits. The costs include direct payments to Brussels totaling billions of pounds per year and EU regulations that likely also place indirect costs upon the UK economy. In addition, the acceptance of the EU's free movement of people provision was perceived as the cause for large numbers of immigrants from around Europe relocating to Britain. The benefits to the UK primarily revolve around participation in the EU's single market allowing for free trade between the member states. Those who supported the "Leave" vote likely believe the UK can keep its membership in the single market while eliminating the parts of the EU viewed as costly. While this is possible, it looks increasingly likely that Europe will take a hard stance with the UK to dissuade other

states from following the UK's path; however, the events will prove to be interesting to the student of economics.

References

1. Keynes, John Maynard. *The Economic Consequences of the Peace*. 1919. Library of Economics and Liberty. www.econlib.org/library/YPDBooks/Keynes/kynsCP.html
2. European Union Delegation to the United States: www.euintheus.org/resources-learning/

SCOTT NIEDERJOHN is Professor of Economics and Director of the Center for Economic Education at Lakeland University in Sheboygan, Wisconsin.

ASHLEY HARRISON is Assistant Director of the Center for Economic Education at The University of Tennessee at Chattanooga.

J.R. CLARK is Probasco Distinguished Chair of Free Enterprise at The University of Tennessee at Chattanooga.

Classroom Application: The Economics of Brexit

In preparations for classroom discussion, ask students to read the article "The Economics of Brexit" and brainstorm answers to the following questions using economic principles. Or you may structure this exercise as a mock hearing before the British High Court, in which the judges are querying the parties about the potential consequences of Brexit.

What do you think would be the best outcome for the United Kingdom following Brexit? *Students might suggest that the best outcome would be if the U.K. could maintain access to the single market while also achieving limits on the free movement of people (immigration) from Europe.*

What do you think would be the best outcome for the European Union following Brexit? *The EU would be stronger if it can maintain the U.K. in the single market as well as close cooperation in other areas. However, an ideal outcome for the EU also allows for the free movement of Europeans into the U.K. to live and work.*

Identify the economic concepts illustrated by the Brexit vote? *Trade, free trade, immigration, costs and benefits.*

Applying economic concepts, what does the final relationship of the UK and EU look like three years from now? *This is a complicated question that many are interested in. If Article 50 is invoked, then the U.K. would want to minimize the costs of Brexit—reduce/eliminate free movement of people, while extracting the greatest benefits—maintain free trade policy. However, the EU would likely desire the opposite outcome, and also make an example out of the UK to prevent other nations from leaving the EU. Based upon incomplete information regarding both parties, they are likely to make choices to increase their individual benefits that do not produce the economic optimal result.*

What incentives might other nations have if the UK negotiates a great free trade deal without free movement of people? *The EU is sensitive to this question as other nations within the bloc have political parties arguing for their countries to exit the EU. If the U.K. is "rewarded" for leaving (they get a better deal out of the EU than in it) this might provide the impetus for others to leave. Economists often refer to this concept as moral hazard and the EU members have publicly stated they will not allow such a result to happen.*

Other Teacher Resources

A good set of lessons is published by the Delegation of the European Union to the United States: www.euintheus.org/resources-learning/academic-resources/eu-lesson-plans-and-teaching-material/european-union-lesson-plans-secondary-level/

Your class might enjoy this video which explains the complexities of the European Union: www.youtube.com/watch?v=O37yJBFrfq