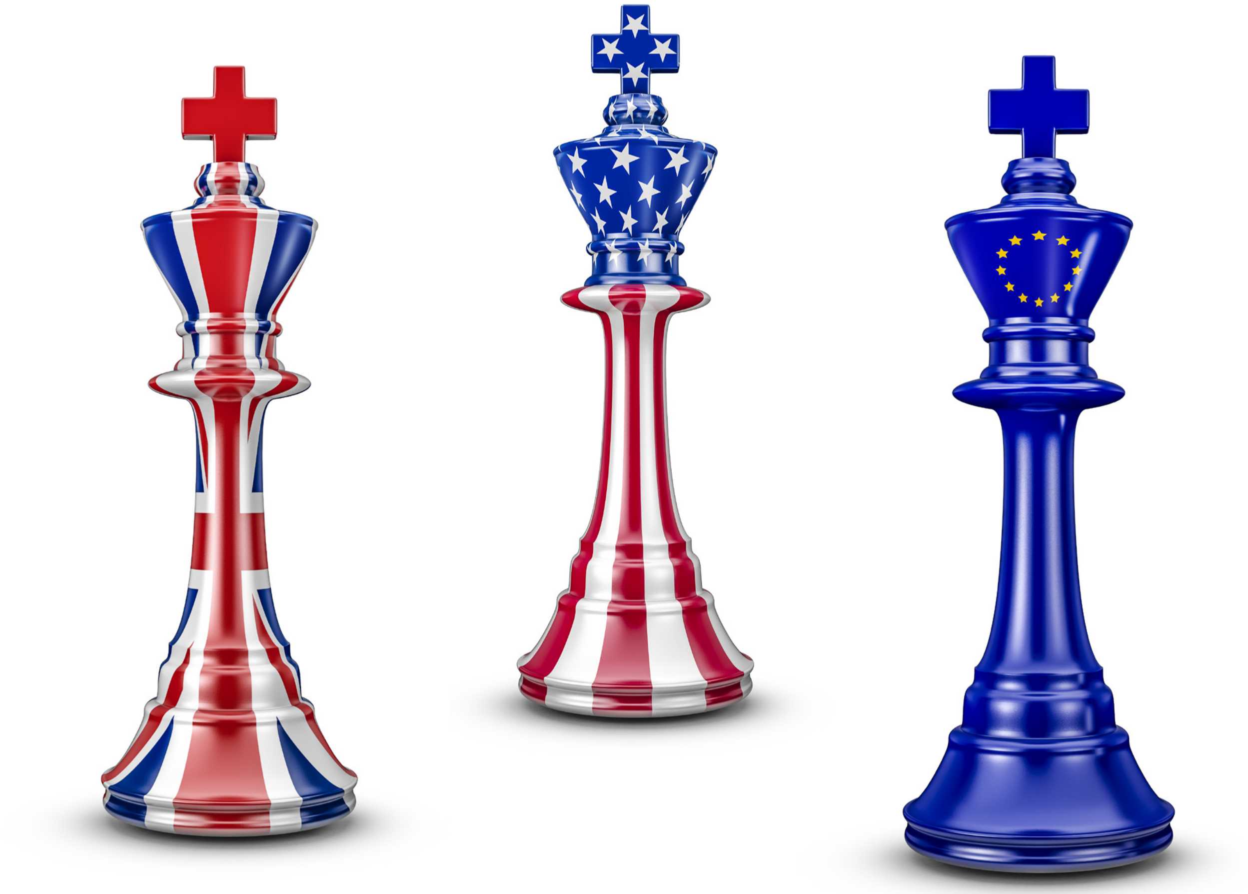

afterbrexit

Alternate forms of Brexit and their implications for the United Kingdom, the European Union and the United States

Summary

Charles P. Ries, Marco Hafner, Troy D. Smith, Frances G. Burwell, Daniel Egel, Eugeniu Han, Martin Stepanek and Howard J. Shatz

RAND EUROPE

For more information on this publication, visit www.rand.org/t/RR2200

Published by the RAND Corporation, Santa Monica, Calif., and Cambridge, UK

Summary

'Brexit means Brexit, and we will make a success of it!' has been the rallying cry of the British government since the 23 June 2016 referendum in the UK, in which a majority of citizens voted to leave the European Union. Yet, what does 'success' mean? The British government has put forward several different versions of the United Kingdom's future after it leaves the EU on 29 March 2019. In one scenario, the UK is a close partner of the EU, perhaps with access to the Single Market and part of a customs union following a 'soft Brexit'. In another, 'Global Britain' has opted for a 'hard Brexit' – outside both the Single Market and the Customs Union – but has negotiated a web of new trade agreements and established an independent influence around the world. Even now that the UK–EU negotiations have started, it is unclear which future the UK might choose, and whether that will be a path to success.

Whether Brexit is successful will depend a great deal on the economic implications of leaving the EU and whether trade agreements with others might fuel the UK's economic growth. Yet our modelling suggests the 'hard Brexit' options frequently discussed in the press can be expected to cause a significant loss of growth, with the 'no deal' scenario making the UK 4.9 per cent poorer in 2029 than if it had remained in the EU. Staying in the Single Market or the Customs Union certainly alleviates that decline in growth, but these 'soft Brexit' options are still worse economically than staying in the EU. Recently, the possibility of a transition period has gained favour in both London and Brussels. This option is slightly better, assuming the UK stays temporarily in the Single Market and Customs Union, but only because it delays the real decisions and their effects. The loss of growth cannot be made up by negotiating free trade agreements (FTAs) with other partners either, including the United States. Such agreements would compensate only somewhat for the loss of trade and investment with the UK's main market, the EU. Indeed, the most beneficial FTA for the UK would be one with the EU, and the best overall outcome would be a trilateral UK–EU–US FTA, similar to the Transatlantic Trade and Investment Partnership (TTIP), itself now in hiatus.

> Whether Brexit is successful will depend a great deal on the economic implications of leaving the EU and whether trade agreements with others might fuel the UK's economic growth.

Which version of Brexit the UK is able to choose will depend largely on its negotiations with the EU. This will be a complex set of talks involving multiple issues, and if game theory is any guide, the UK will face an uphill struggle. The UK must disentangle its current ties with the EU, while

also negotiating arrangements for a future UK–EU relationship. Both sides have declared their intent to have a positive partnership, but if discussions over the divorce arrangements and future accord are negotiated consecutively rather than concurrently, the British are at a definite disadvantage. Similarly, the two-year deadline very much favours the EU, especially since all 27 member states must approve any extension. Both sides face serious internal divisions and must find ways of satisfying internal constituencies to maintain consensus. Since the EU has a political incentive to demonstrate that the UK is worse off as a result of leaving the EU (so as to discourage other departures), and some in the UK believe the costs of 'no deal' are low, there is a real risk that the parties – even while seeking to cooperate – will find themselves struggling to reach any agreement. Unfortunately for the UK, 'no deal' – or, indeed, any of the 'hard Brexit' scenarios – is the worst situation for the future, with significant losses in terms of economic growth.

> Unfortunately for the UK, 'no deal' – or, indeed, any of the 'hard Brexit' scenarios – is the worst situation for the future, with significant losses in terms of economic growth.

Issues for negotiation

In Theresa May's 29 March 2017 letter triggering Article 50 of the Lisbon Treaty and thus beginning the Brexit process, the British government made clear that the UK would not try to stay in the Single Market, but instead would seek a free trade agreement with the EU. Moreover, it requested that issues related to departing the EU be negotiated concurrently with the arrangements for the future relationship between the two parties. The EU, however, responded with a phased approach involving three separate negotiations: one on the terms of the UK's exit, a second to establish a framework for a future relationship, and a third to establish any necessary transitional arrangements. The EU also held that 'sufficient progress' would have to be made in finalising the exit accord before formal talks on the future relationship could start. Since all 27 remaining member states would have to approve any extension of the two-year negotiating mandate, this procedure alone would give the EU leverage on the substance of the exit provisions being discussed. The EU's chief negotiator, Michel Barnier, cautioned that the real deadline could be as early as October 2018, because of the need for European Parliament approval before the European Council could accept the arrangement.

The first-phase exit negotiations involve the following issues:

Rights of citizens. A new arrangement must be agreed to secure the rights of millions of EU citizens living in the UK and UK citizens living in the EU.

Financial settlement. The UK will have financial obligations to settle as it leaves the EU, given its multi-year commitments to certain EU agencies and programmes. As the negotiations began, the EU was signalling that the UK may need to make payments of as much as €100bn in total, while Theresa May, in a speech in Florence in September 2017 offered only €20bn.

Northern Ireland. Both parties are determined to preserve the stability of Northern Ireland, based on the Good Friday Agreement. But with Northern Ireland leaving the EU, some form of border must be established with the Republic of Ireland.

European Court of Justice. The question of the ECJ's role in adjudicating disputes between the EU and UK post-Brexit has been very sensitive politically. The EU has argued that the ECJ should have jurisdiction over post-Brexit disputes on citizens' rights as well as other matters. But this is extremely difficult politically, especially for the current British government, which has campaigned on regaining British sovereignty from the ECJ.

Even if 'substantial progress' is made on these exit issues, and negotiations on the future relationship begin, the process could easily extend well beyond the two-year, March 2019 deadline, causing the UK to end up with an inadvertent 'no deal'. To prevent such a scenario, the parties are likely to negotiate a transition accord, so that there can be adequate safeguards as they proceed to focus on a new trade agreement and customs arrangement. While a transition agreement is certainly not the worst outcome for the UK, it will only temporarily postpone the economic costs of Brexit, and uncertainty about the final outcome would remain. In effect, a transition arrangement merely delays many of the vital decisions about trade and customs arrangements that will make an enormous difference to the UK's future economic health. Moreover, since a transitional arrangement would affect incentives for both parties to complete final arrangements, it may turn out to be as difficult to negotiate as any final accord.

Priorities of the negotiating parties

Brexit marks the first time a developed country has sought to leave a major international institution without a military defeat or political revolution. Superficially, the talks are bilateral, with the UK and the EU27 as the two parties involved. In reality, both have significant internal constituencies, each with their own potential to block a successful resolution of the negotiations. Whether these internal actors will hold together throughout the exit process is far from clear. The June 2017 election in the UK left its government more divided than ever, at least in the short term, and reduced the Prime Minister's ability to keep everyone in line.

The UK government seeks four main outcomes from its departure from the EU: the ability to impose restrictions on freedom of movement of EU citizens in the UK, freedom from ECJ jurisdiction, as much free and open trade as possible and the smallest possible financial settlement with the EU. But different parties in the UK, and even within the ruling Conservative party, have distinct priorities. In particular, concern over migration to Britain by citizens of other EU member states played a central role in attracting support for Brexit during the referendum, and continues to be a high priority for one faction of the pro-Leave camp that demands the re-establishment of British sovereignty. Along with controlling freedom of movement, advocates of this perspective want to stop what they view as 'meddling' by Brussels, and escape the jurisdiction of the ECJ. A second group, while also favouring Brexit, emphasises the importance of free markets, trade and an outward perspective. This group believes that the UK can secure better access to world

> The UK government seeks four main outcomes from its departure from the EU: the ability to impose restrictions on freedom of movement of EU citizens in the UK, freedom from ECJ jurisdiction, as much free and open trade as possible and the smallest possible financial settlement with the EU.

markets on its own rather than relying on the European Commission to negotiate FTAs with trading partners. The group's adherents advocate a relatively internationalist approach, aiming for a low-tariff trade deal with the EU that does not prevent the UK negotiating trade and economic deals with other global markets.

The EU has so far maintained a steady consensus during the early stages of the Brexit negotiations. While that unity may come under strain over time, as EU member states seek to use the process to secure objectives on issues far removed from Brexit, for now the EU negotiators and member states have been consistent in identifying their core objectives: to have the UK as a close partner, to have any deal based on a balance of rights and obligations, to preserve the integrity of the Single Market and the four freedoms, and to ensure that a non-member does not have the same benefits as members. This last objective is particularly important, as it is seen as discouraging any other possible exits.

EU negotiators and member states have been consistent in identifying their core objectives: to have the UK as a close partner, to have any deal based on a balance of rights and obligations, to preserve the integrity of the Single Market and the four freedoms, and to ensure that a non-member does not have the same benefits as members.

There are several fault lines in the EU's position that could emerge. These include the diverging interests of the countries that use the euro currency and those that do not, as well as the diverging interests of those countries that are net contributors to the EU budget and those that are net recipients. Interests could also diverge on regional bases: northern European countries may seek the maximum possible free movement of goods while trying to lure the financial industry from London to their countries, southern European countries may focus on securing a high financial settlement from the UK and preserving agricultural and fisheries policies, and eastern European countries may seek strong protections for their citizens currently in the UK. These differing priorities may come into play as trade-offs are made.

Brexit and game theory

Game theory offers some important insights into the Brexit negotiations. In particular, it makes clear that the structure and timing of the negotiations present real challenges to the UK. Specifically, game theory provides the following insights:

- **The structure of the game is crucial**. It is to the EU's advantage that talks over the exit arrangements and the future relationship occur consecutively, so that the prospect of a future trade agreement – a British priority – can provide leverage in securing UK agreement to EU exit terms, including the financial settlement. For the UK, however, it would be much more beneficial if the talks were conducted concurrently, so that it could obtain benefits in exchange for concessions made, and better sell the resulting package to the British people.
- **Both sides face serious internal divisions and coalition maintenance will be costly**. The EU understands that its interests depend on staying united behind a coordinated strategy. As a result, EU institutions and 'core' countries may even be willing to make concessions to other member states on internal EU matters in order to ensure the continued consensus on Brexit.

Divisions within the UK, and especially within the Conservative party, weaken the UK negotiating position. These divisions have only intensified following the June 2017 general election, and there is the prospect of a leadership struggle in the near future.

- **Given the complexity of the negotiations, the parties should be careful about the language they use with domestic constituencies, and seek to avoid limiting their options**. Both parties have signalled certain elements of their negotiating position, and both are making their position papers public. While such transparency can be beneficial, it can also make it more difficult to concede points in the negotiations later.
- **The two-year negotiating deadline puts the UK in a weaker position**. If there is no resolution by March 2019 and no agreement by the EU27 to continue talks, a suspension or ending of the negotiations would harm the UK much more than the EU. A transition period may provide more flexibility for both parties, but would also come with some domestic cost in the UK if it prolongs free movement of EU citizens and ECJ jurisdiction – and in any case a transition agreement may be almost as difficult to negotiate as the final arrangement.
- **Flexibility on both sides will be needed to avoid an outcome where both parties lose**. As long as each party views the pay-offs differently – with the EU winning only if the UK is seen to lose and the UK believing that the costs of 'no deal' are low – there will be few incentives to coordinate in order to avoid harm.

Finally, adding additional actors to this game, such as the United States, may further complicate the situation, especially since US objectives and interests remain ambiguous.

The economic effects of Brexit

> Any option that involves leaving the Single Market and the Customs Union will have a significant negative effect on future UK economic growth.

Whether Brexit is judged a success or not will depend to some degree on its economic impact. Much of the British debate has focused on whether the UK should leave the EU Single Market and Customs Union. Given that trade with the EU has gone from being 33 per cent of total UK trade in 1973 to almost 60 per cent in 2014, any disruption to the UK–EU trading partnership will have consequences. Indeed, any option that involves leaving the Single Market and the Customs Union will have a significant negative effect on future UK economic growth. Out of eight different scenarios evaluated for their impact on UK trade and GDP, some of those most discussed in the press have the harshest outcomes.

Five scenarios fall within the category of 'hard Brexit', as they involve the UK leaving both the EU Single Market and the Customs Union:

Baseline Scenario 1 – WTO rules. If the UK leaves the EU without any arrangements in place ('falling off the cliff' or 'no deal'), then its trade with the EU and the rest of the world would be governed by WTO bound tariff schedules. The UK would be able to set its own tariffs and establish its own regulatory standards, although any divergence from EU standards would increase non-tariff barriers (NTBs). This is the most costly outcome for the UK, reducing future GDP (compared to full EU membership) by about 4.9 per cent, or $140bn, over 10 years.[1] The loss to the EU in this scenario is relatively minor, about 0.7 per cent of GDP.

Scenario 2 – UK–EU FTA. In this case, tariffs would stay at zero, but UK exports to the EU would have to satisfy some rules of origin requirements, and customs measures would increase compared to current Single Market membership. NTBs are also assumed to increase gradually over time as UK regulations and standards diverge from those of the EU. This is definitely better for both the UK (an improvement of 3.0 percentage points of GDP over Scenario 1) and the EU (an improvement of 0.5 percentage points) than falling back to WTO rules, although, as in all scenarios, the impact is far less for the EU than the UK.

Scenario 3 – A trilateral UK–EU–US arrangement (TTIP). In this case, a UK–EU FTA is supplemented by a trade agreement with the United States that eliminates tariffs on goods and agriculture and reduces NTBs substantially. This is the most beneficial outcome, not only for the UK, but also for its partners. Compared to Scenario 1, UK GDP would increase by $202bn (7.1 percentage points of GDP).

Scenario 4 – UK–US FTA. Both the UK and US governments have indicated their willingness to negotiate a bilateral accord, and it is assumed that such a deal would reduce tariffs on goods and agriculture, as well as some services barriers. UK–US NTBs would also be reduced, although this might have the impact of raising UK–EU NTBs, if the UK moves towards US standards. This option benefits both parties (UK GDP 2.4 percentage points better than Scenario 1; US GDP 0.2 percentage points better), although it is not as beneficial to the UK as an FTA with the EU. The United States benefits far less than the UK, perhaps giving it leverage (though less interest) in the talks. The EU, lacking an FTA with either the UK or the United States, would be slightly worse off in this scenario compared to the baseline (minus 0.1 percentage points), as a result of trade diversion.

Scenario 5 – UK–EU transitional zero-tariff arrangement. The previous scenarios assume that to avoid Scenario 1 – falling back on WTO rules – it looks increasingly likely that the UK and EU might negotiate a transitional arrangement in which both parties apply zero tariffs on goods for an interim period. Both have indicated that the transition must be for a limited time; we have assumed it would be in place for four years before a UK–EU FTA was agreed. The outcome in this case is better than Scenario 1: the transitional agreement leaves UK GDP 2.8 percentage points better than Scenario 1, and the EU 0.4

1 Throughout the report US Dollar is used as currency. Using the 2017 (January to October) average US Dollar exchange rates provided by the OECD (https://data.oecd.org/conversion/exchange-rates.htm), the suggested exchange rates are as follows: $1 to £0.782; $1 to €0.895.

percentage points better off. But the long-term economic impact will very much depend on the type of final deal agreed.

An additional three scenarios (none of which are currently being explored by the UK government) examine the possible consequence of what are known as ‘soft Brexit’ outcomes, in which the UK stays within either the EU Single Market or the Customs Union:

Scenario 6 – The Norwegian model. In this scenario, the UK stays in the European Economic Area, with access to the EU Single Market, but leaves the Customs Union. The UK would have to comply with EU rules on free movement of goods, services, capital and people, which would be politically difficult in the UK. It would be able to pursue its own independent trade policy, but would face rules of origin and other NTBs in trade with the EU, and would have to accept EU regulations and contribute to the EU budget, despite being excluded from the decision-making process. This option brings a slightly better economic outcome for the UK, with GDP 3.2 percentage points better than Scenario 1 (WTO rules). But it is also slightly better economically than either an FTA with the EU (Scenario 2), or with the United States (Scenario 4).

Scenario 7 – The Swiss model. In this case, the UK would stay in the Single Market, but only for goods, not services. The UK–EU goods trade would continue to be tariff-free. But NTBs on trade in services would rise relatively sharply to WTO bound levels. As in Scenario 6, the UK would also be required to contribute to the EU budget and adhere to EU regulations and standards (as Switzerland is obliged to do). Because of the important role of services in EU–UK trade, this scenario, while making UK GDP 2.5 percentage points better than the Scenario 1 baseline, turns out to be worse for the UK than the Norwegian model (Scenario 6) or the UK–EU FTA (Scenario 2).

Scenario 8 – Customs union covering goods. The two previous scenarios assume that the UK would exit the EU Customs Union so that it could independently negotiate FTAs with other countries. But another option is to maintain a customs union with the EU, but only for goods, not services, while leaving the Single Market. This would restrict the UK’s ability to act independently, but would ensure trade with the EU took place free of tariffs and some NTBs, even though NTBs on services would rise. The economic impact on the UK is slightly better than an FTA with the EU (3.1 percentage points better than Scenario 1), but not quite as beneficial economically as the Norwegian model (Scenario 6).

A key element in the UK’s economic relationship with the EU and the United States is that of foreign direct investment (FDI). The UK is one of the largest investors in the United States and vice versa, and many US companies invest in the UK in part because it offers open access to the EU. Research suggests that EU membership has a positive and significant effect on FDI, boosting inflows by 28 per cent and FDI stocks by 34 per cent. Even for non-members, signing a comprehensive FTA with the EU boosts inwards investment sharply. But there is much uncertainty about how a re-imposition of trade barriers might affect FDI, as the situation is so unusual. Our research indicates that a fallback to WTO rules (Scenario 1) would reduce EU FDI inflow into the UK by about $7.8bn. If the UK signs a comprehensive FTA with the EU, investment from the EU would fall by $3.4bn – a reduction of about 9 per cent from EU membership investment levels. Signing an FTA with the United States would add about $3.2bn in FDI inflows for the UK from our baseline scenario, making up about one-third of investment lost due to termination of EU membership. The best option would be to conclude a three-way UK–EU–US trade agreement, but the likely investment inflows from that arrangement still do not make up for the total investment impact of leaving the EU.

US interests

Brexit will have a significant effect on US political and economic interests, especially in Europe. That impact will be mostly negative, although there is still much that is uncertain. It is also unclear which stances the United States might adopt to be most effective in advancing US interests.

The most important potential effect of Brexit on US interests could be through its impact on European cohesion.

The most important potential effect of Brexit on US interests could be through its impact on European cohesion. The United States has long seen an integrated Europe as supporting the security, prosperity and stability of European allies, and thus benefiting the United States. Brexit brings a risk of eroding that cohesion, although it could also reinforce the cohesion of the remaining EU27. But even if Brexit ends up strengthening the remainder of the EU, the United States will miss the influence and global perspective that the UK has brought to the EU decision-making process. In the development of EU defence policy, for example, the UK aim was often to ensure that EU measures did not undermine NATO and the strong transatlantic partnership.

The stresses of the Brexit process could also reopen old political disputes. In particular, the United States has a strong interest in preserving the stability created in Northern Ireland by the Good Friday Agreement, and would not welcome any negative fallout from Brexit. New tensions between Spain and the UK over Gibraltar would also not be in US interests, especially since US Navy ships, based in Spain, regularly use facilities in that territory. Nor would the United States benefit if Brexit leads to EU divisions over Russia policy, including sanctions. As an EU member, the UK has been a steady advocate for a more effective EU foreign policy, and although the EU is certainly likely to continue growing its international role post-Brexit, the lack of British input may lead to approaches more distinct from US preferences.

Brexit also presents some economic risk for the United States, although with more uncertainty. If the UK fails to sign a comprehensive FTA with the EU and reverts to WTO rules, the substantial economic penalty on UK GDP may affect US businesses in the UK and possibly UK investment in the United States. It should be noted, however, that while the UK is the largest investor in the United States, UK-owned firms only comprise a very small part of the US economy, and any 'Brexit effect' in this dimension is likely to be negligible. Of course, the UK may succeed in negotiating an FTA with the United States, but our research indicates that even a UK–US FTA would have little macro impact on the US economy.

Brexit could also have some secondary economic effects that negatively affect US interests: for example, a weakened economy may reduce the UK's capability to fund its defence forces, including anticipated purchases of American defence equipment, with negative consequences for US defence firms. US financial firms could also find themselves having to move out of London to preserve access to the EU market, with some additional costs. But the biggest economic impact is likely to be the loss of the UK's voice in setting EU economic policy. The UK has long advocated a more free-market approach than others in Europe, and British Members of the European Parliament have been influential in areas of financial regulation, digital policy and privacy rules, among others. An EU without the UK may be more willing to create barriers for non-EU companies, to the detriment of US companies and the American economy.

While Brexit presents primarily negative consequences for the United States, in some cases Washington may find that the UK out of the EU would be a more willing ally, in both political and economic matters, as it seeks to find its new place in the world. It may align itself with US international initiatives and regulatory approaches, even possibly against those of the EU. But the greatest consequence of Brexit for US interests will be the uncertainty that it brings in many arenas.

A note about our Brexit calculator

Accompanying this study is an online calculator, allowing users to alter key assumptions in order to understand their significance or create other scenarios for examination as negotiations proceed. This calculator can be found at https://www.rand.org/randeurope/research/projects/brexit-economic-implications/calculator.html.

The quantitative estimates reported in this Summary, and the main body of the report, differ slightly from the estimates reported in RAND's online Brexit calculator. As a specific example, the Summary reports that GDP would fall by 4.9 per cent in the WTO rules scenario, while the online calculator reports an estimated fall in GDP of 4 per cent.

This discrepancy is a consequence of two differences between the report and the calculator. First, as the online calculator is designed to rapidly calculate the economic implications of user-designed Brexit scenarios, the analytical approach is necessarily simplified. The estimates in the report are derived from a computationally intensive general equilibrium model, which provides more precise estimates of the economic effects, while the calculator produces first-order approximations of these same results using a partial equilibrium approach. Second, while the main results in this Summary include only trade-related economic effects, the calculator allows users to also include the economic effects of Brexit-related changes in foreign direct investment (FDI). Third, while the main results in this Summary and the main body of the report include both the predicted effects from changes in immediate trade costs and changes in trade costs over time (i.e. due to regulatory divergence), the calculator includes the effects from changes in immediate trade costs alone. Finally, in addition to the percentage loss in GDP over a ten-year time period, the calculator reports a set of other effects, such as the predicted percentage of growth foregone, and changes in the levels of trade and foreign direct investment.