

2019 UK GENERAL ELECTION BRIEFING: **THE ECONOMIC AND FISCAL IMPACT OF BREXIT**

Arno Hantsche and Garry Young
National Institute of Economic and Social Research (NIESR)

OVERVIEW

Brexit dominates political debate and divides opinion. The main political parties have different positions on this issue, ranging from cancelling Brexit (Liberal Democrats) to seeking a ‘clean-break’ (Brexit Party). The Prime Minister wants to ‘get Brexit done’ on the terms of the deal negotiated with the EU. This briefing focuses on:

- The economic impact that the decision to leave the European Union (EU) in the 2016 referendum has had so far
- The economic impact of different types of Brexit in the short and long run
- The fiscal implications of Brexit

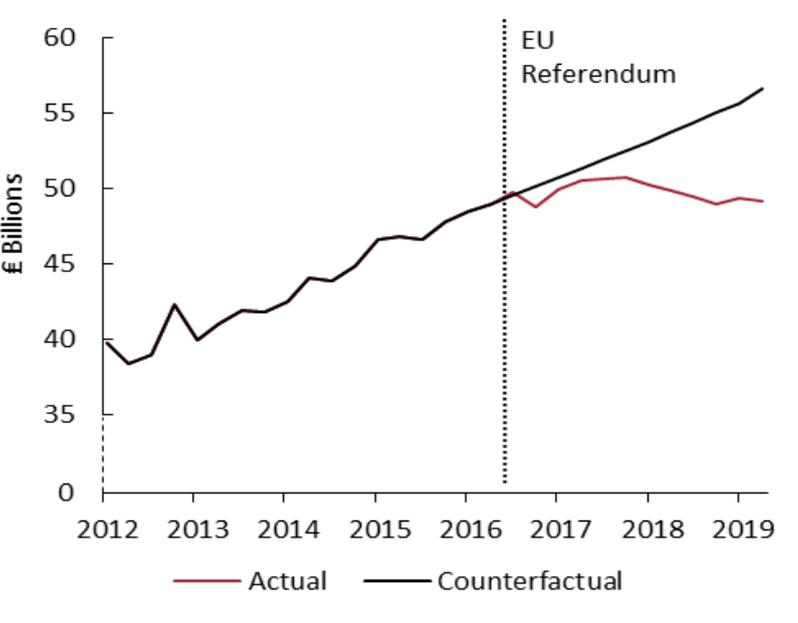
KEY TAKEAWAYS

- The decision to leave the European Union (EU) has already had a **material impact on UK economic activity**, with GDP now being around **2½ per cent smaller** than it would have been had the UK decided to stay in the EU. The **pound is 15 per cent lower** than in the run-up to the EU referendum, pushing up the prices of imported goods and services and so also contributing to lower living standards than if the UK had stayed in the EU.
- We estimate that the latest deal agreed between the government and the EU would result in **GDP being 3-4 per cent lower** in the long run than it would have been with continued EU membership. The effect is negative because leaving the EU will involve bigger trade barriers between the UK and its largest trading partner, lower migration from the EU, and lower productivity. A clean-break Brexit would hit **GDP by 5-6 per cent**.
- **Brexit is likely to worsen the public finances**. Despite saving around £10 billion per year on contributions to the EU budget, a smaller economy would mean that there would be a revenue shortfall of around **£20-40 bn per year in the long run**. We estimate that the revenue shortfall would average around **£4-12 bn per year in the next five-year Parliament**.

The impact of the decision to leave the EU on the economy so far

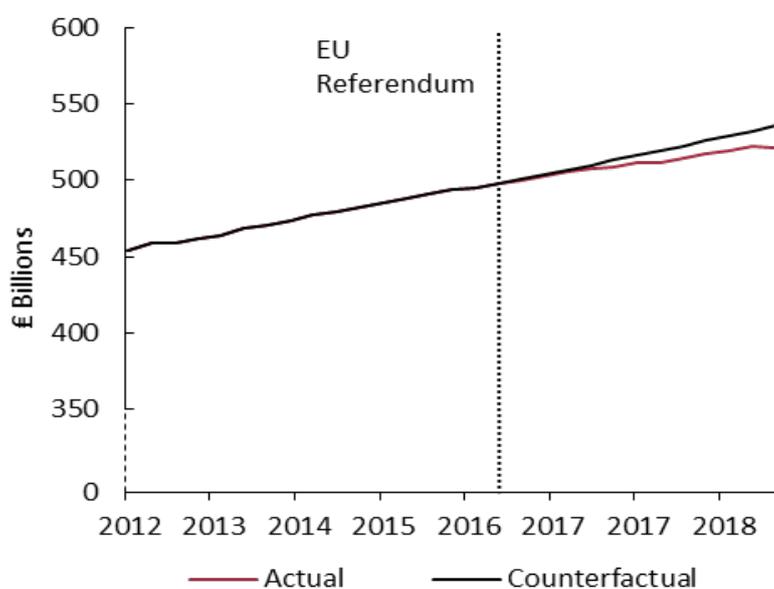
- **Business investment** is estimated to be **around 15 per cent lower** than it would have been had it not been for the 2016 Brexit vote (Figure 1). This is due to the uncertainty that the decision to leave the EU created. This uncertainty has led businesses to postpone investment until they know more about the new relationship with the EU.ⁱ
- Brexit has also contributed to the **prolonged weakness in UK productivity growth**. Demand has increasingly been met by employing more workers rather than investing in capital goods as investments cannot easily be reversed. In addition, management time has been diverted towards no deal planning.ⁱⁱ
- The **level of GDP is estimated to be around 2½ per cent lower** than otherwise, reflecting lower investment and productivity (Figure 2). This is despite measured economic activity being somewhat boosted by Brexit-related contingency planning and stockpiling that had little positive effect on welfare.

Figure 1. Quarterly business investment: actual and post-referendum counterfactual



Source: NIESR.

Figure 2. Quarterly GDP: actual and post-referendum counterfactual



Source: NIESR.

- The value of the **pound** has been sensitive to news about Brexit. The pound has depreciated by 15 per cent in effective terms since its pre-referendum peak in November 2015. The depreciation contributed to higher import prices and a rise the cost of living. Import prices have risen by 10.9 per cent in the thirty-nine months since the EU referendum, whereas they fell by 7 per cent in the thirty-nine months leading up to it.

The economic impact of Brexit in the short and long run

- The economic outlook depends critically on the **nature of the future trading relationship** between the UK and EU.
- **Various different forms of Brexit** are currently being discussed (Table 1), ranging from continued EU membership (as favoured by the Liberal Democrats) to no deal (as favoured by the Brexit Party). Other options include a UK-EU customs union and the deal agreed between the Prime Minister and the EU.
- Brexit-related **uncertainty is unlikely to lift any time soon**: a free trade agreement or customs union with the EU would be difficult to negotiate within a one-year transition period, revoking Article 50 in order to remain in the EU would likely involve discussions about the future position of the UK in the EU, while no deal would generate very high levels of uncertainty about future trade relations and migration.

Table 1. Short- and long-run effects of Brexit

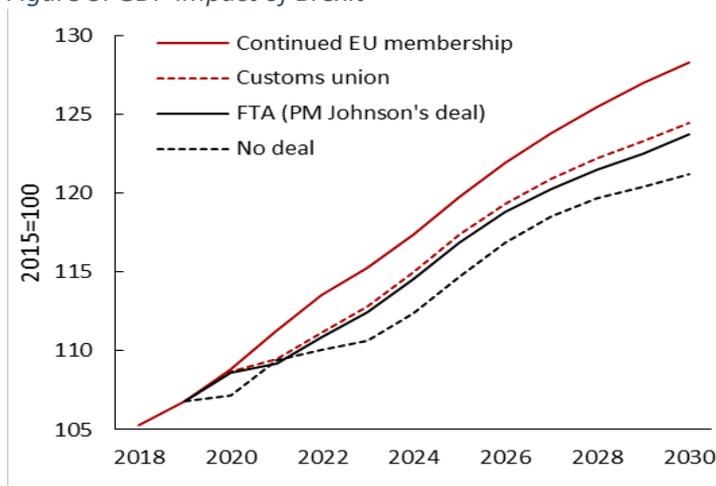
TYPE OF BREXIT	SHORT RUN (2019-2024 PARLIAMENT)	LONG RUN (10 YEARS OUT)
CONTINUED EU MEMBERSHIP (REVOKE ARTICLE 50)	Elevated uncertainty	No change to UK-EU trade barriers and migration
UK-EU CUSTOMS UNION	Elevated uncertainty, GDP impact*: -1.6% (£30 bn/year)	GDP impact*: -3% (£60 bn/year)
UK-EU FTA (PM JOHNSON'S DEAL)	Elevated uncertainty, GDP impact*: -1.8% (£40 bn/year)	GDP impact*: -3-4% (£70 bn/year)
NO DEAL (TRADE ON WTO TERMS)	Very high uncertainty, GDP impact*: -2.9% (£60 bn/year)	GDP impact*: -5-6% (£120 bn/year)

Source: NIESR, NiGEM simulation.

Notes: * relative to continued EU membership.

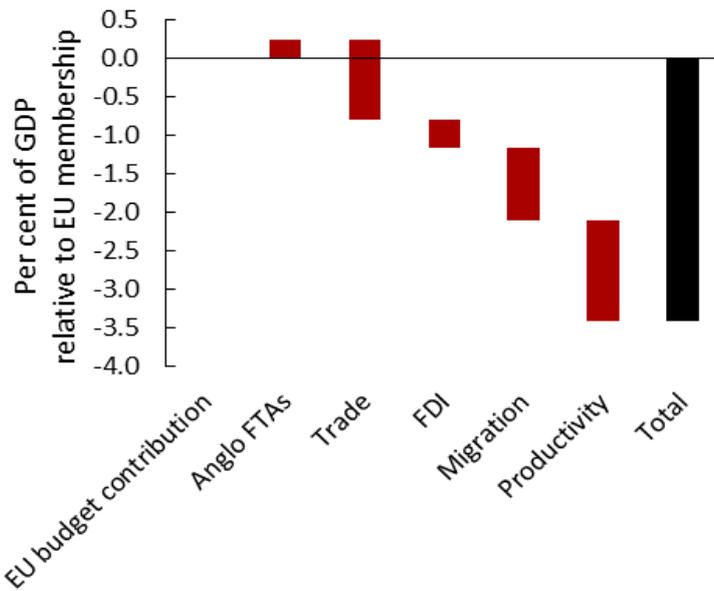
- While the level of economic output (GDP) is expected to grow in all scenarios, there will be differences **depending on future barriers to trade and migration** (table 1 and figure 3). So, for example, leaving the EU on the terms of the Prime Minister's deal would result in the economy being smaller by around 2 per cent on average over the next Parliament and by 3-4 per cent in the long run (by 2030). These estimates are uncertain in size but not direction.
- The **economic benefits of Brexit do not outweigh the economic costs**: The economic benefit of recovering EU financial contributions and of being able to negotiate free trade agreements with non-EU partners in the **FTA scenario** (PM Johnson's deal) are more than offset by the costs of trading frictions, reduced inward investment, less net migration and the impact of Brexit on productivity (Figure 4).
- **Services trade** would face similar frictions in a **UK-EU customs union** as in an FTA. This is because of regulatory barriers that would be put in place if the UK left the European single market. **Goods trade** would benefit from the absence of customs and rules of origin requirements in a customs union but still face regulatory barriers, like safety checks and quality requirements.

Figure 3. GDP impact of Brexit



Source: NIESR, NiGEM simulation.

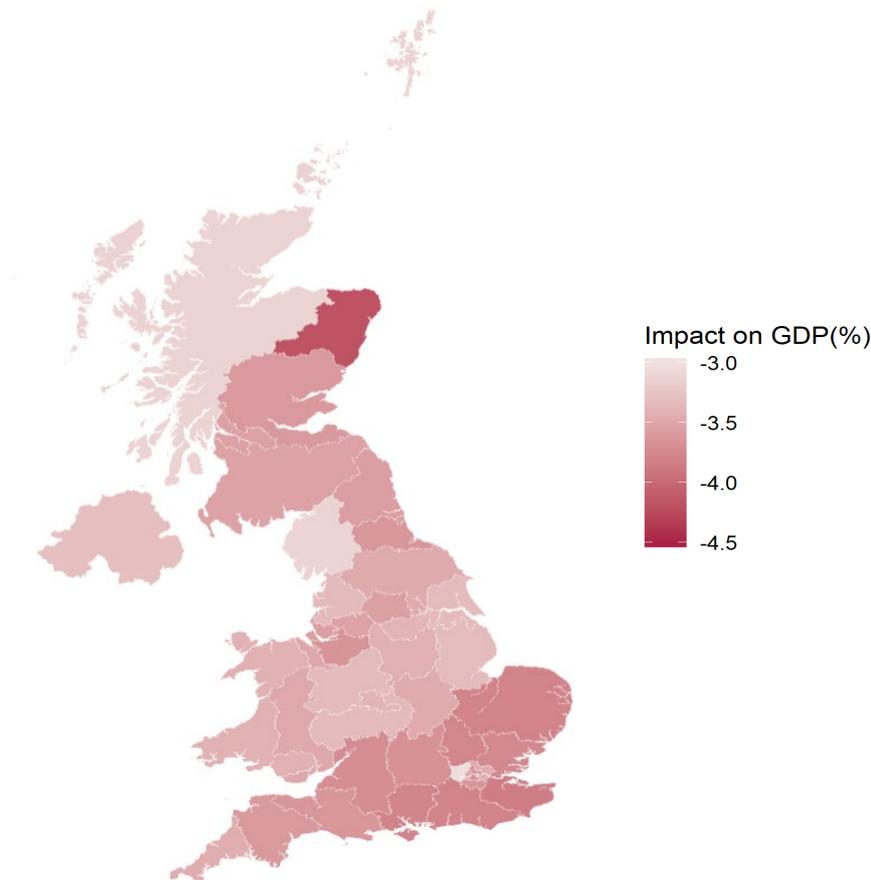
Figure 4. Impact of an FTA by channel



Source: NIESR, NiGEM simulation

- **All regions of the UK are set to be less prosperous under Brexit**, compared to continued EU membership (Figure 5). The regional impact depends on the intensity of EU trade, the local industry mix, linkages with the rest of the country through value chains and commuting workers, and the reliance on public funding.

Figure 5. Regional impact of a UK-EU Free Trade Agreement



Sources: NIESR, NiGEM simulation.

The fiscal implications of Brexit

- The short-term fiscal implications of Brexit are relatively small and overshadowed by the spending and taxation promises of the major political parties.
- Any form of Brexit will leave the economy smaller than it would have been had the UK remained in the EU. This means that **tax revenue will be smaller** than it would otherwise have been. In the short term, i.e. the next Parliament, revenue losses relative to the counterfactual of continued EU membership **materialise slowly** as barriers to trade will only bind after the end of a transition period and build up over time as regulation in the UK and the EU diverges. Initial revenue shortfalls are also partly offset by higher inflation which flatters the tax intake.
- Estimates of the effect of different forms of Brexit on tax revenue are shown in the first column of table 2. So, for example, leaving on the terms of the Prime Minister’s deal will result in tax revenue being lower by about £10 billion per year in the next Parliament and by about £30 billion in the long term (by 2030).
- In the other direction, funds will be released by no longer having to contribute to the EU budget and these can be **recycled into domestic government spending**. But the amount that can be recycled is relatively small in the short term because, under the terms of the ‘divorce bill’, the UK is due to continue to make payments for its outstanding commitments to the EU. If the UK leaves under the terms of the Prime Minister’s deal the amount available to be recycled averages £6 billion per year in the next Parliament and £11 billion per year in the long run (middle column of table 2).
- The net revenue shortfall of leaving the EU on the terms of the Prime Minister’s deal is estimated at £4 billion per year in the next Parliament and just under £20 billion per year in the long term. To put this in context, the 2017-18 annual budget of the Department for Transport was £20 bn. Any net revenue shortfall will have to be met through **higher borrowing, higher tax rates** or a **combination of both**.
- **Lower net migration** and a smaller population compared to staying in the EU would imply **somewhat smaller public expenditure needs**, but these are not accounted for in table 2.

Table 2. 2020-24 impact of Brexit on government revenue (£ billion, 2016 prices per annum)

	TOTAL REVENUE SHORTFALL	REALLOCATED EU BUDGET CONTRIBUTIONS [§]	NET REVENUE SHORTFALL
UK-EU CUSTOMS UNION	-7.5 (-26.2)	2.4 (5.5)	-5.1 (-20.7)
UK-EU FTA	-9.9	6.0	-4.0
(PM JOHNSON’S DEAL)	(-28.7)	(11.0)	(-17.7)
NO DEAL	-18.4	6.0	-12.5
(TRADE ON WTO TERMS)	(-47.7)	(11.0)	(-36.7)

Source: NIESR, NiGEM simulation.

Note: annual average, relative to EU membership, £ billion, 2016 prices, impact ten years out in brackets.

§ Net saving on EU contributions after taking account of ‘divorce’ bill. In the UK-EU customs union case, it is assumed that the UK continues to make some contribution to EU programmes such as Horizon 2020.

ⁱ See NIESR's [Prospects for the UK Economy](#), November 2019.

ⁱⁱ See also Bloom et al. (2019), [The impact of Brexit on UK firms](#).