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Brexit: Lessons from history

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Joining the EU raised the level of UK real GDP significantly. This column suggests that leaving the EU will very probably have a negative effect on UK GDP, but history does not tell us how strong this effect will be. However, history does suggest that the notion that there will be a faster rate of long-run trend growth facilitated by Brexit is not persuasive. The obstacles to better supply-side policy are, as ever, to be found in Westminster not in Brussels.

The voters have opted for Brexit. It seems that the UK will soon leave the EU, having been a member since 1973. This is despite warnings from many economists that such a decision would probably entail very significant economic costs, not only in the short run during the transition period but also in the long run through a permanently lower level of income and productivity (Table 1). On the other side, claims are made that, freed from the constraints imposed by EU membership, economic policy reforms can deliver a faster rate of economic growth so that, at least in the long run, the UK economy will benefit from Brexit.

Table 1 Long-run impact of Brexit on level of real GDP (%)

LSE	-7.9
HM Treasury	-3.8 to -7.5
NIESR	-7.8

Source: adapted from Ebell and Warren (2016).

It has been widely noted that after the UK joined the EU its relative growth performance compared with France and Germany showed a sustained improvement (Table 2). Some have interpreted this, at least in part, as a result of EU membership, but Eurosceptics tend to attribute it to the economic policies pursued by the Thatcher governments during the 1980s and largely sustained by subsequent Labour administrations.

Table 2 Rates of growth (% per year)

	Real GDP/person	**Real GDP/hour worked**
1950-1973		
France	4.02	5.29
Germany	5.00	5.91
UK	2.42	2.81
US	2.45	2.57
1973-1995		
France	1.65	2.67
Germany	1.76	2.86
UK	1.76	2.40
US	1.81	1.27
1995-2007		
France	1.75	1.75
Germany	1.56	1.70
UK	2.55	2.17
US	2.16	2.21

Source: The Conference Board (2015)

Trade effects after the UK's 1973 membership

Gravity models of trade indicate that the EU has been highly effective in raising trade volumes, presumably because it has reduced trade costs more than is typical of trade agreements and achieved a relatively deep level of economic integration. Using the results in Baier *et al*. (2008), I estimate that leaving EFTA and joining the EU raised total UK trade by 21.1% by 1988 (Crafts 2016), and that this might be expected to have increased the level of UK GDP by 10.6% based on an assumed elasticity of 0.5 between trade volumes and income (Feyrer 2009). An alternative approach using a synthetic counterfactuals methodology finds that EU accession raised GDP by 8.6% after 10 years (Campos *et al*. 2014).

Four points should be noted about these estimates.

- First, they are much higher than even optimists predicted at the time of joining (Table 3) because they capture 'dynamic effects'.
- Second, a key transmission mechanism was through the impact on productivity of increased competition, which was an antidote to bad management and dysfunctional industrial relations (Crafts 2012); at least through the 1986 Single Market Act, EU membership was an integral part of the Thatcher reforms.
- Third, the benefits of membership far outweighed any reasonable estimate of the membership fee entailed by net budgetary transfers and the Common Agricultural Policy, which amounted to less than 1% of GDP.
- Fourth, the impact was on the level of GDP not the trend rate of growth; it is domestic supply-side policies that matter for long-run growth.

Table 3 Estimates of impact of UK accession to the EU (% GDP)

Ex ante (1)	-1.2
Ex ante (2)	0.6
Ex post (1)	8.6
Ex post (2)	10.6

Sources: Ex-ante (1): Miller (1971); Ex-Ante (2): Josling (1971) and Williamson (1971); Ex-Post (1): Campos *et al*. (2014); Ex-Ante (2): Crafts (2016).

Estimates of the long-run impact of Brexit (cf. Table 1) typically use variants of the method described above to calculate its effect on trade and then to work out the implied impact on GDP. The idea is to use historical evidence to predict the future. However, this must be regarded as a doubtful procedure because there are no gravity model estimates relating to ex-members of the EU, whose trade flows may well differ from those of 'never-members'. Moreover, insofar as the main impact on productivity originally worked through increased competition, exit from the EU may not reverse much of this given that the UK now has a much more effective competition policy and the economy is no longer mired in its problems of the 1970s.

The proximate sources of growth can be found in rates of increase of factor inputs, including capital, human capital, and hours worked, and of the productivity of those inputs. At a deeper level, economics highlights the importance of micro-foundations of growth in terms of the key role played by the incentive structures which inform decisions to invest, to innovate, and to adopt new technology, and which depend on institutions and policy. Obviously, there are a large number of supply-side policies that affect growth performance. These include areas such as competition, education, infrastructure, innovation, regulation, and taxation. Moreover, even for EU members, to a large extent these are very largely under the control of national governments.

The source of today's economic policy failings

Even though relative UK growth performance improved prior to the Global Crisis, there have been long-standing failings in supply-side policy (Crafts 2015). The most obvious is in innovation policy, which is reflected in a low level of R&D (Frontier Economics 2014), but education (Hanushek and Woessmann 2012), infrastructure (LSE Growth Commission 2013), land-use planning regulation (Cheshire and Hilber 2008), and the tax system (Mirrlees *et al*. 2011) also give significant cause for concern, while British capital markets remain notably short-termist with a bias against long-term investment (Davies *et al*. 2014).

Although Eurosceptics complain about the costs of EU-imposed regulations, it should be recognised that the UK has persistently been able to maintain very light levels of regulation in terms of key OECD indicators such as product market regulation (PMR) and employment protection legislation (EPL), for which high scores have been shown to have significant detrimental effects (Barnes *et al*. 2011). In 2013, the UK had a PMR score of 1.09 and an EPL score of 1.12, the second and third lowest in the OECD, respectively. Moreover, it is noticeable that the regulations which it might be politically feasible to remove in the event of Brexit do not include anything that might make a significant difference to productivity performance (Booth *et al*. 2015).

If Brexit could make possible radical changes to policies that affect the growth rate, then an economic case in favour might be made. Is this an omission in the studies considered in Table 1? After all, as was noted earlier, there is much that could be done to improve UK supply-side policy, for example, in the areas of education, infrastructure, innovation, and the tax system. However, reforms are not precluded by EU membership.

Concluding remark: Westminster is holding Britain back, not Brussels

The obstacles to better policy lie in Westminster not Brussels, and are related to British politics rather than constraints imposed by the EU. Whereas 40 years ago, entry into the EU did help to improve supply-side policy by strengthening competition, today there is no problem area to which Brexit is required to provide an answer.

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