CENTRE FOR EUROPEAN REFORM

Why a hard Brexit looks likely

by John Springford

Recent data suggests that the Brexit vote will not cause a recession. This, coupled with the fact that British voters rejected two important principles of the EU, makes a single market exit all but certain.

Last week, Number 10 repudiated the remarks of David Davis, the Brexit minister, who said that "if a requirement of [single market] membership is giving up control of our borders, I think that makes it very improbable [that the UK will remain in it]". Theresa May's spokeswoman said that Davis was merely "setting out his opinion". But May herself has said that the British people "do not want free movement to continue as it has in the past", and Number 10 has said that a new immigration system should "ensure that the right to decide who comes to the country resides with the government". An end to the free movement of labour would force the UK to leave the single market. And economic developments since the Brexit vote suggest that such an exit is politically deliverable.

Initial post-referendum data pointed towards a recession. But the August purchasing managers' indices – surveys of companies' output, sales, orders and employment levels, which offer speedy (but incomplete) evidence of economic activity – bounced back. The Bank of England has further lowered interest rates and restarted quantitative easing. The Chancellor of the Exchequer, Philip Hammond, told the House of Lords last week that he planned to boost infrastructure spending in order to deliver a "short-term demand stimulus" in his budget statement in November. This is the right thing to do.

The Centre for European Reform has always said that the long-term economic consequences of the vote are what matter – and that they are very likely to be negative. But they will show up in a slower rate of growth both before and after barriers to trade, investment and migration have risen, which may be in 2019. With luck, barriers could rise gradually, if the UK and EU can agree on a way for a trade agreement to come into force as the UK leaves the EU. But if there is no recession, it means that Remainers' arguments on the economics will be more easily dismissed by the government and pro-Brexit media. And Brexiters will deploy other arguments to explain the slower rate of growth – an ageing population and a generalised slowdown in the rate of productivity growth across the OECD – or they will say that the British economy is growing faster than country X or country Y, so what is all the fuss about?

If the UK ends up with a bilateral trade agreement instead of single market membership, the cost will be significant: Oxford Economics puts it at between 0.75 and 3 per cent of GDP, depending on how comprehensive the trade deal is and how open the UK remains to immigration. These are big numbers in economic policy terms – the only supply-side policy that might achieve an equivalent boost to national income would be radical planning reform. But Brexit is not an event but a process of disintegration. As long as there is no sudden crisis, Brexit voters will believe that its absence justifies their decision.

Many Remainers argue that the electorate did not vote for a particular form of Brexit. But they did vote against two fundamental principles of the single market. First, they voted to end the free movement of low-skilled labour. Second, persuaded by Vote Leave's 'take back control' message, they voted to end the supremacy of EU over British law, and the jurisdiction of the European Court of Justice (ECJ).

A single market exit will be costly for British services firms. The UK has a comparative advantage in high-value added services, which rely on the single market principles of non-discrimination and freedom of establishment, enshrined in EU law and enforced by ECJ judgements, to sell across the EU. For their part, Poland and the other newer member-states have a comparative advantage as a site for manufacturing, largely 'offshored' from Germany, and in low-value added services. Free movement is the only way that most such services – in construction, retail and so forth – can be traded, as construction workers and baristas cannot provide their services remotely. Poland will be unwilling to allow UK services companies to take market share while its citizens are denied equivalent opportunities in Britain.

Given the vote, UK trade with the EU will probably be governed by a bilateral trade agreement, but there are good reasons to be pessimistic that it will be nearly as comprehensive as the single market. The EU's institutions provide a political process for updating regulations as markets evolve or market failures are identified, and these regulations minimise the barriers to trade between the member-states. Bilateral trade agreements, on the other hand, are more static, as they mostly deal with traditional barriers to trade, such as tariffs and quotas, and less with regulations or other 'behind-the-border' discriminatory measures. New institutions could be created within a trade agreement to allow regulatory co-operation to continue: colleges of regulators in different economic sectors could agree that UK regulations were equivalent to those of the EU. This is what happens – to a much more limited degree than in the EU – in the NAFTA agreement and in the Canada-EU trade agreement, if it is ratified. And the regulatory preferences of the UK and the EU-27 are not as different as many Brexiters argue.

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But it would be far from straightforward. Any 'living' free trade agreement would require political institutions designed to negotiate compromises between the EU and the UK to ensure that regulations were equivalent, and the EU would insist that it had the final say. If the EU gave UK firms access to the single market on the basis of equivalence, that would be a much bigger concession than the UK giving EU firms similar access to the much smaller UK market. The UK would therefore have to offer something in addition: the EU determining whether the UK's rules were equivalent, as well as a financial contribution to the EU or free movement of people. Disagreements about financial regulation, transactions taxes, bankers' pay and incentives, and the City's role as a bridgehead for non-European banks to access EU markets would become more fraught. And there are differences on chemicals, GMOs, data sharing and more.

A new free trade agreement with UK-EU institutions to enforce regulatory equivalence looks remarkably like the Swiss deal with the EU, in which joint committees ensure that Swiss legislation accords with EU law. The Swiss deal only provides goods access, with services largely excluded. And for that, the Swiss have been forced to accept the free movement of people.

The EU is unlikely to offer Britain better access to its services markets – and equivalent goods access – than Switzerland without free movement or budget contributions. And without acute economic pain that is clearly attributable to Brexit, Britain's politicians will find it impossible to defy the electorate's demand to 'take back control', whatever the chronic damage to the economy.

John Springford
Senior research fellow, CER