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A CONSEPTUAL APPROACH TO THE IMPLICATIONS OF BREXIT ON THE SOCIAL-ECONOMIC ASPECTS INTO THE UK AND THE EUROPEAN UNION

***Dr. Stamatis Kontsas**

Adjunct Professor, Technological Education Institute of Western Macedonia

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ABSTRACT

The purpose of this paper is to examine the effects of Brexit on social-economic aspects into UK and the European Union as well. It is mentioned that for the first time in a generation there is a serious prospect of a member state leaving the European Union. In Britain, the Conservative government, led by Prime Minister David Cameron, is committed to holding an in-out referendum by the end of 2017. If the UK leaves the EU the impact would depend on the new relationship between the UK and the EU. We consider five models. The impact of Brexit through the trade and investment channels would be most severe in the UK. Regulatory divergence would increase over time, affecting trade volumes and reducing the attractiveness of the UK for investment. This would impact on European businesses invested or trading in the UK and supply chains involving UK firms, but the magnitude depends on the specific Brexit model and is impossible to predict.
Brexit would impact on the position of both the UK and the EU in the world. In economic terms this would be most evident in trade policy. While the UK would likely be free to strike new trade deals based on domestic priorities it would have less leverage and be a lower priority than the EU for other countries.

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INTRODUCTION

The overall macroeconomic impact of Brexit is hard to quantify. This is because there are several unknowns and macro models do not capture many channels through which Brexit would impact on the economy. The majority of published studies find the impact on the UK would be negative and significant. The impact on the rest of the EU would be smaller, although no comprehensive macroeconomic estimate has been published. If the UK votes to leave then the government would have two years to negotiate a withdrawal agreement under Article 50 of the EU Treaty. The government itself would be weakened and the PM may be forced to resign. This would add to the uncertainty surrounding the long and complex process leading to Brexit. Overall, the evidence does not suggest this has been at the expense of trade with non-EU states, but this may be a factor in individual protected sectors, such as agriculture, footwear and clothing. Costs for consumers might fall in these sectors, but rise overall. Under either a Swiss-style accord or an FTA-based relationship the UK would negotiate the terms of access for specific sectors, including the standards and regulations that apply in those sectors.

****Corresponding author: Dr. Stamatis Kontsas***
Adjunct Professor, Technological Education Institute of Western Macedonia

The EU tradition of harmonization rather than mutual recognition means the choice for the UK is likely to be either to adopt EU standards or for firms to bear the cost of meeting two sets of standards. The UK would be less able to influence the future development of the single market, particularly in services where regulatory barriers remain significant and where full liberalization could add 7% to UK GDP. (http://www.qbeeurope.com/documents/research/What%20Brexit%20means%20for%20business.pdf, 15/11/2016).

Brexit Models and the Social –Economic Structure

The impact of Brexit depends on the relationship with the EU that follows. Five distinct models are set out below. What is most beneficial politically, in terms of policy independence, is also the most damaging economically. This is the Brexit paradox. The most likely models are the Swiss or the FTA-based approaches. (http://www.cfr.org/councilofcouncils/global_memos/p37922, 15/11/2016). The UK joins the European Economic Area and maintains full access to the single market, but must adopt EU standards and regulations with little influence over these. The UK still makes a substantial contribution to the EU budget and is unable to impose immigration restrictions.

Verdict: does not address UK political problems with the EU
Turkish-style customs union

Internal tariff barriers are avoided, with the UK adopting many EU product market regulations, but sector coverage of the customs union is incomplete. The UK is required to implement EU external tariffs, without influence or guaranteed access to third markets. (http://www.cfr.org/councilofcouncils/ global_memos/p37922, 15/11/2016)

Verdict: a bad compromise for the UK
FTA-based approach

The UK is free to agree FTAs independently and the UK's relationship with the EU is itself governed by an FTA. Tariff barriers are unlikely, but as with all FTAs the UK will need to trade off depth –which means agreeing common standards and regulation –with independence.

Verdict: possible, but it all depends on the deal
Swiss-style bilateral accords

The UK and the EU agree a set of bilateral accords which govern UK access to the single market in specific sectors. Concern in Brussels about cherry picking may limit the sectors. The UK becomes a follower of regulation in the sectors covered, but negotiates FTAs separately.

Verdict: possible, but may not be attractive to the EU
MFN-based approach

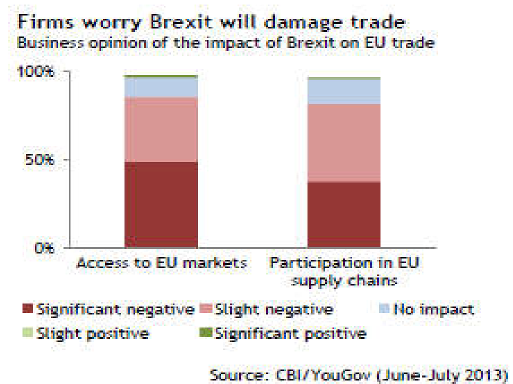
No need to agree common standards and regulation, but at the expense of facing the EU's common external tariff, which damages UK trade with the EU in goods as well as services. Non-tariff barriers may emerge over time to damage trade in services in particular.

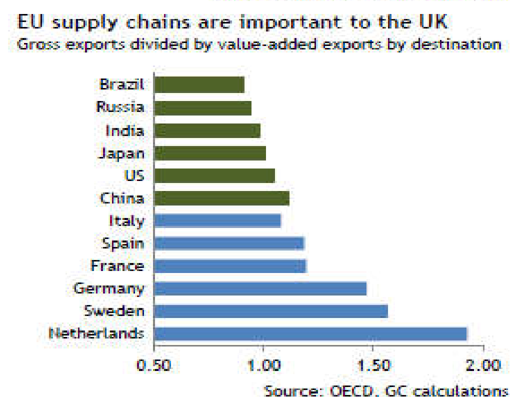
Verdict: inconsistent with the UK's liberal approach to trade.
Brexit will only happen if a majority votes to leave the EU in a referendum. The outcome is highly uncertain as there are many unknowns including the timing of the vote and the outcome of the renegotiation. If Brexit happens it will be a long and protracted process. While some points on the road are fixed, others are not, creating additional uncertainty. The new Conservative government has promised an in-out referendum by the end of 2017 after renegotiating the terms of the UK's membership. A referendum bill is likely to be passed by the British parliament later this year. This will specify the process but not the actual date for a referendum. The bill proposes the question that will be put to the British electorate: "Should the United Kingdom remain a member of the European Union?" (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016).

The Conservative renegotiation priorities are vague. David Cameron says he wants more controls on immigration from new member states, limits on benefits for immigrants, more powers for national parliaments to block EU legislation, less red tape, faster trade deals, power returned to member states and an end to "ever closer union". His ambiguity is partly tactical as he does not want to show his hand. The referendum date could be brought forward to 2016 if Cameron judges this is politically advantageous. Cameron is highly likely to support and in effect lead the 'Yes' campaign. The majority of the political establishment and British business will also support this. But the Conservative Party and the cabinet will be split, with a large faction supporting the 'No' campaign, along with some opposition MPs and large parts of the media. (https://www.bloomberg.com/news/articles/2016-08-16/u-k-advised-to-focus-on-u-s-china-in-post-brexit-trade-deals, 15/ 11/2016)

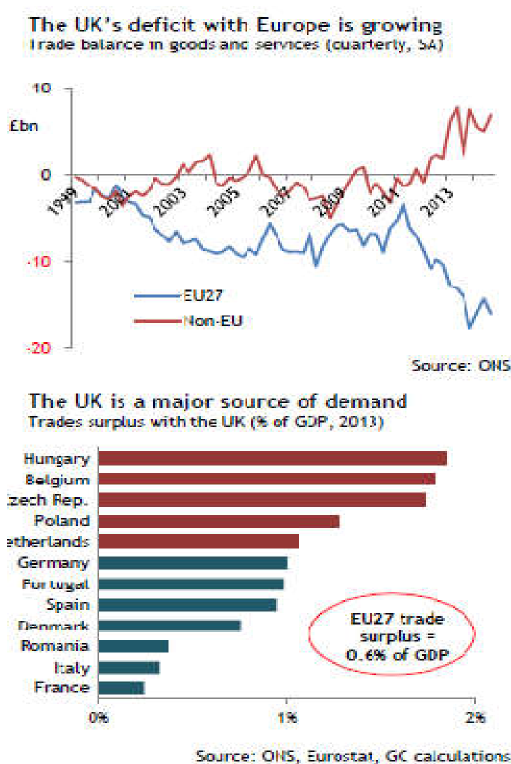
Trade and Industrial Disclosures within Europe

The impact on UK trade with Europe will depend on the relationship between the UK and the EU after Brexit. In the most likely scenarios –either the Swiss model, or an FTA-based relationship –regulatory divergence that adds to the cost of trade is likely to increase over time, damaging bilateral trade volumes and the UK's position in European supply chains. The costs will be borne by consumers as well as businesses. EU membership is estimated to have boosted British goods trade with other member states by 55%, equal to £130bn in 2013. (http://www.qbeeurope.com/ documents/ research/ What%20Brexit%20means%20for%20business.pdf, 15/11/ 2016). The single market provides opportunities for economies of scale, competition and innovation, which enhance productivity and which would be hard to replicate fully through trade outside Europe. There is a strong relationship between exporting and productivity: between 1996 and 2004 the productivity growth for UK exporters was 1.3%, compared to 0.8% for non-exporters. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/ Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016). Supply chains are becoming more important for competitiveness, but tend to be geographically concentrated. About half of EU imports to the UK are intermediates. The high ratio of trade in gross relative to value-added terms suggests that much UK trade with Europe is connected to supply chains. (https://www.global-counsel.co.uk/ sites/default/files/special-reports/downloads/ Global%20 Counsel_Impact_of_Brexit.pdf, 15/11/2016).





Post-Brexit outcomes which reduce trade or increase the cost of trade between the UK and the rest of Europe will be damaging for both sides. The EU is a more important trade partner for the UK than the UK is for the EU. But UK demand is very important in macro terms for many EU countries. The UK runs large bilateral deficits against several member states. (http://www.cfr.org/councilofcouncils/global_memos/p37922, 15/11/2016). The UK accounts for just one sixth of the EU economy. One-tenth of EU exports are to the UK, whereas half of UK exports are to the EU. However, the imbalance in the trade relationship is such that the UK is an important source of demand for the rest of the EU. The UK's trade deficit with the rest of the EU has grown substantially in recent years and was €66bn in 2013, the equivalent of 0.6% of the GDP of the EU27 countries. In value terms the trade surpluses with the UK are concentrated in a small number of countries, notably Germany, which exported €78bn to the UK in 2013 and imported €50bn. (http://www.cfr.org/councilofcouncils/global_memos/p37922, 15/11/2016). However, as a percent of GDP the trade surplus with the UK is important many countries. This exceeds 1% of GDP in the Netherlands, Poland, Czech Republic, Belgium, Hungary, Latvia, Lithuania and Slovakia.(8) Only a few EU countries run a trade deficit with the UK, notably Ireland at 6.2% of GDP in 2013.(9)But the UK is an extremely important bilateral trading partner with many Irish firms exporting into UK supply chains. UK companies are relatively upstream in global supply chains, compared to companies in other European countries. The importance of the UK in international supply chains is particularly concentrated in a small number of sectors. In 2009 the UK exported almost $54bn of business and financial services into the supply chains of other countries, with companies in other EU countries accounting for a large proportion. In the same year the UK exported over $30bn of mining and chemical products and over $20bn in the transport, telecom, and wholesale and retail sectors into international supply chains. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20 Counsel_Impact_of_Brexit.pdf,15/11/2016)



Foreign Direct Investment Weights and Measures

The UK is the largest recipient of FDI in the EU. Brexit could reduce the attractiveness of the UK as a gateway to Europe. It could also lead to a reduction in investment from the rest of the EU, which is the biggest source of FDI in the UK. It may become harder to attract corporate HQs. The EU was the source of 46% of the stock of FDI in the UK in 2013. This dependence has fallen somewhat in recent years, with the EU share down from 53% in 2009. (http://www.cfr.org/councilofcouncils/global_memos/p37922,15/11/2016). The UK has many advantages that would be unaffected by Brexit such as language, light regulation and deep capital markets. Even so, the UK may struggle to attract as much new investment following Brexit. Other locations inside the EU are likely to be more attractive for marginal investment decisions. A poll of British firms suggests the impact of Brexit will be damaging not only to FDI, but also to the investment intentions of UK firms, with 29% more saying it will have a negative than a positive impact. (http://www.cfr.org/councilofcouncils/global_memos/p37922, 15/11/2016) However, the EU features low down the list of important factors according to a separate poll, with fewer than 1% of firms saying the UK needs to focus on access to the European market to remain a major global destination for investment. Opinions are likely to vary across sectors. Investment in vehicle production, for example, appears particularly dependent on the single market, both for sales and due to long European supply chains. Half of all European headquarters of non-EU firms are in the UK, with the UK hosting more HQs than Germany, France, Switzerland and the Netherlands put together. (http://www.cfr.org/councilofcouncils/global_memos/p37922, 15/11/2016).

This could become harder following Brexit given the favorable tax treatment available to member states through the Parent-Subsidiary Directive. The UK would either need to negotiate third-country treatment under the directive or a series of new double taxation agreements with member states. That would take a considerable amount of time. Many large European corporate are heavily invested in the UK and the commercial logic for this investment could be affected by Brexit. The cost of adjustment for European corporate could be considerable. The UK may seek to compete more aggressively for investment by undercutting the EU on taxation and the business environment. FDI in the UK from the EU comes disproportionately from a small number of host countries, including France, Germany, Spain and Ireland, although the picture is distorted by FDI routed through third countries, such as the Netherlands and Luxembourg. The EU share of FDI is much higher in the energy, retail and wholesale trade, transportation and manufacturing sectors than it is in financial and professional services. (http://www.cfr.org/ councilofcouncils/global_memos/p37922, 15/11/2016). The success of the UK in attracting FDI projects and jobs creates opportunities and risks for other EU countries if the UK leaves the EU. Whether they can seize the opportunity depends on how they respond to the loss of UK competitiveness that Brexit would likely represent.

One particular challenge would be to attract European headquarters for multinationals away from the UK, but this will depend as much on the business environment in individual European countries. The UK would almost certainly seek ways to restore the competitiveness of the FDI offer. The UK might

attempt to 'undercut' the EU further on social regulation and taxation, but probably not on environmental legislation. The risk to the EU is of the UK acting 'like Ireland' but over ten times bigger and largely liberated by the constraints and obligations of EM membership. This could impact in one of two ways in the rest of the EU. It could distort location choices and draw investment away from the rest of Europe over time. Or it could benefit firms elsewhere in the EU to the extent that it puts pressure on their governments to be more liberal and to take steps to improve the environment for investment. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016)

A Financial Services Framewok Analysis

Established advantages and agglomeration effects mean the UK has a strong competitive edge that would be hard to dislodge. However, existing EU regulations would make it harder for London to serve European markets, particularly for retail products and in euro trading. Business could move. Under the Swiss or FTA models the UK must negotiate access to EU markets in financial services. The EU only allows access to countries with equivalent regulations. The approach currently varies across directives. No access is allowed in some areas, such as UCITS (undertakings for collective investment in transferable securities). The logic is that retail consumers need additional protection. By contrast, the EU takes a flexible approach to wholesale banking, where equivalence is defined largely by reference to international standards. This matters for the UK given its dominance in wholesale banking. In many other directives the EU takes an intermediate approach. For example, the EU evaluates the equivalence of insurance regulation 'line-by-line' under Solvency II, although the impact is softened by transitional arrangements. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20 Counsel_Impact_of_Brexit.pdf, 15/11/2016).

The Swiss experience highlights the risks to the UK. They have equivalence under AIFMD, are being assessed under Solvency II and will try under MIFID. But they have failed under EMIR, ostensibly due to capital requirements, but with a suspicion that the real problem is Swiss immigration policy.

The UK is the leader in euro-denominated wholesale banking, but Euro zone countries and institutions want this activity to move to the Euro zone and be overseen by the ECB. This would be much more likely following Brexit, as the UK would no longer be protected by ECJ enforcement of single market rules. The UK might also suffer an opportunity cost from being absent from future liberalizing initiatives such as Capital Markets Union, which could open up new markets in areas such as securitization and covered bonds. (https://www.global-counsel.co.uk/sites/default/files/special-reports/ downloads/ Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016).

The impact in the UK would be felt beyond London in financial centers such as Edinburgh, Leeds and Glasgow, as well as in the Crown dependencies. Brexit may impact on the location, liquidity and cost of financial services in Europe if it undermines London's competitive position. This would be costly for businesses and households across Europe. Most large European banks have major operations in London which would be costly to relocate. Only a small number of financial centers elsewhere may benefit. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/ Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016).

The UK is highly integrated into the European financial system. Total UK claims on the EU15 alone are $880bn with most of the credit to households and firms, but some also to governments and interbank lending. European bank exposure to the UK is even greater at $1.7tn in total. It would be costly for European banks to relocate wholesale banking activity away from London. London is not just a European financial centre –it is an international centre with a dominant position in many product areas. However, London's international position could be damaged if large amounts of European business migrate following Brexit. There is a risk that some business, particularly more mobile activity such as derivatives, may leave Europe altogether. The most likely beneficiaries in the EU are Paris, Frankfurt, Amsterdam and Dublin. But they cannot replicate overnight the advantages of the London 'ecosystem' supporting financial services, including skilled staff, legal services and market infrastructure. Competition between them borne out of new barriers to trade with London would be disruptive and costly. Businesses in Europe would lose due to higher charges, poorer products and less liquidity. European corporate would, for example, find it more inconvenient and costly to raise capital in London, which currently provides a one-stop shop. (https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/ Global%20Counsel_Impact_of_Brexit.pdf,15/11/2016). Brexit would likely change the balance of financial regulatory debates in Europe. The UK now takes a more interventionist and risk-averse approach to regulation. Even so, the UK largely avoids politically-motivated interventions. Initiatives such as the Financial Transactions Tax and the cap on banker bonuses would have found an easier passage in an EU without the UK. (https://www.global-counsel.co.uk/sites/default/ files/special-reports/downloads/ Global%20Counsel_Impact_of_Brexit.pdf, 15/11/2016).

Concluding Remarks

A referendum on Brexit is now certain. While the outcome is far from a foregone conclusion, a vote for Britain to leave the EU is very possible. The impact of Brexit on British businesses, the UK economy and wider British interests would be severe and felt across multiple channels. Both the path and the endpoint, in terms of the new relationship between the UK and the rest of the EU, would be uncertain, compounding the costs to the UK. The direct impact on the rest of the EU would also be significant. The export, supply chain, investment and policy interests of many large corporate would be adversely affected, but perhaps the single biggest impact will be on the cost of raising finance in Europe which is likely to increase.

Brexit would have a wider political impact on the EU, both by disrupting internal political dynamics and because of the risk of political contagion if the 'proof of concept' of leaving the EU encourages disintegrative forces in other member states. Europe would also lose esteem and influence around the world. Member states would be affected in different ways and to different extents. This will most likely influence ways in which states are willing to engage and accommodate the UK during the pre-referendum negotiation. All member states would, however, feel the impact of Brexit, both politically and economically.

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