April 2015

Disunited Kingdom: Why 'Brexit' endangers Britain's poorer regions

By John Springford

CENTRE FOR EUROPEAN REFORM

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Summary

★ Britain is home to some of the richest and poorest regions in Western Europe, and the gap between their economic fortunes is widening.

★ There are several causes of this growing regional inequality. The number of jobs in manufacturing and heavy industry, long a source of well-paid employment in Britain's poorer regions, has been in decline for 40 years. The services jobs that have replaced them pay less well on average. And high-skilled people tend to move to prosperous cities while the low-skilled stay put.

★ A British exit from the EU risks making this regional inequality worse, because poorer regions of the UK are more dependent on exports to the EU than richer ones. Exports to the EU account for 15 per cent of private sector output in the North East of England, one of Britain's poorest regions, compared to 9 per cent in the South West of England and Scotland, two of its richer regions. And even with its sizeable financial services exports to the EU, London is among the less exposed.

★ There is a risk that the UK would be unable to conclude a free trade agreement with the EU after exit. The EU buys 45 per cent of UK exports, while the UK only buys 7 per cent of the other EU member-states' exports, giving the EU the upper hand in any negotiation over Brexit terms. Current alternatives to EU membership suggest that even a free trade agreement that covered only goods would come at the price of accepting free movement of labour: the Switzerland-EU bilateral treaties require it, for example. This might be too much for the British people to accept.

★ Without a free trade agreement, the UK could trade with the EU under World Trade Organisation rules. But the EU would apply tariffs to British goods. These would hit economic activity in poorer regions of the UK, where manufacturing tends to predominate, harder than richer ones.

★ While London's large financial and commercial services sector would be badly hit by a British exit from the EU, services make up less than one third of British exports, and services exports to non-EU markets have grown quickly over the course of the eurozone crisis. As a region, London would be among the less-affected regions.

★ In order to ensure that Brexit did not make regional inequality worse, Britain's government would have to secure as much access to the EU market as possible. The UK would need to sign up to free movement, EU budget contributions, and many of the EU's rules and standards. Since it would have next to no say over what those rules are, such an agreement would be worse than the status quo.

Introduction

London is the richest large city in Europe. Together with its commuter belt, the city's metropolitan area of 13.6 million people is home to Europe's largest collection of skilled people. Some other British cities – Bristol, Edinburgh, Manchester and Leeds, in particular – are prospering. But the UK is also home to some of the poorest regions in Western Europe.

The EU is slow to update its regional inequality statistics – the latest available is from 2011 – but the data serve to illustrate the point. That year, London's income was 181 per cent of the EU average, and England's South East, 111 per cent. However, Wales had an income of 74 per cent of the EU average, similar to Southern Spain (74 per cent), Slovakia (75) and Portugal (77). The North East of England and Northern Ireland came next on the list, at 78 per cent – slightly poorer than the Canary Islands and the Czech Republic. Given the depth of the depressions in Spain, Italy and Greece since 2011, the UK's economic periphery is now sure to rank higher than poorer parts of Southern Europe. But that is more down to the latter's decline than the former's rise. (The map on page 3 shows the UK's regions.)

If Britain holds a referendum on EU membership by 2017 – or the next time the Conservatives are in power – it will decide whether to leave the most comprehensive trade, investment and migration agreement between sovereign countries in the world. Yet the consequences of a British exit for the constituent countries and regions of the UK have received little attention.

Industries are not equally distributed across Britain, which would mean that an EU withdrawal would affect regions differently. The Scottish drinks industry – dominated, of course, by whisky – accounts for nearly one-sixth of Scotland's exports to the EU, for example. But the EU does not put tariffs on whisky from outside the Union, and under World Trade Organisation (WTO) rules, the EU would not be able to impose tariffs on Scotch after a British withdrawal, leaving the industry's access to the single market largely intact. On the other hand, cars and other transport equipment make up one-third of the North East of England's exports to the EU, largely thanks to the Nissan plant in Sunderland, and the EU's tariff on car imports is 10 per cent.

This prompts a series of questions. If the UK left the EU, which regions would suffer most? Would it damage Britain's poorer regions more than richer ones, making regional inequality worse? And how easy would it be for Britain to sign a free trade agreement with the EU that would minimise the regional economic impact? This policy brief is an attempt to answer these questions.

Growing apart

Britain's regional inequality has worsened sharply in recent years. Between 1998 and 2007, London's private sector output grew a full percentage point faster (4.1 per cent) a year than the rest of the UK (3 per cent). Since 2008, the divergence has been even more marked, with the poorest regions having the worst of the recession: Northern Ireland's private sector shrank by nearly 1.5 per cent a year between 2008 and 2013, while London's grew by 1.4 per cent.

There are several reasons for this growing divide. London and the South East have always been Britain's wealthiest regions, but they have pulled away over the last 40 years. One cause is 'sorting': more highly skilled people and those with more capital or entrepreneurial zeal tend to move to more successful cities. This is reinforced by the fact that low-skilled people are less likely than the high-skilled to move between regions.[1] Another is the economic benefits of living near other people – the reason why cities arose in the first place. There are more job opportunities living in or near a city, where people and businesses can more easily specialise, use technology and become more productive – the foundation of economic growth. Cornwall and West Wales are so poor partly because they are so far from the UK's more successful cities.

But the main reason has been the UK's de-industrialisation, which most affected South Wales, the West of Scotland, parts of Northern England and the Midlands, because heavy industry and manufacturing were concentrated there. Manufacturing output is now 5 per cent lower in real terms than it was in 1997 – while manufacturing employment almost halved from 4.3 million in 1997 to 2.6 million in 2013. The combination of a slight decline in output and fast productivity growth, as labour has been increasingly replaced by machinery, has led to heavy job losses.

Since output in the UK's services sector has grown by 54 per cent since 1997,[2] it is legitimate to ask why manufacturing's decline matters. Both the left and the right in British politics have shown a tendency to romanticise manufacturing and other types of

1: Tony Champion and Ian Shuttleworth, 'Are we becoming more migratory? An analysis of internal migration 1971-2011', ONS, November 2013.

2: 'Manufacturing: Statistics and policy', House of Commons Library, November 2014.

industrial work, which, after all, often consist of repetitive manual tasks. But manufacturing jobs are better in some ways. Pay is slightly better: median full-time annual pay is £27,763, against £26,879 in services. And manufacturing also has a more equal distribution of pay than services: the bottom 10 per cent of manufacturing workers get £15,675 – £1,300 more than the bottom 10 per cent of services workers.[3] This difference is explained by the fact that developing economies have won an ever larger share of low-paid manufacturing work, leaving more productive and higher-paying firms in Britain.

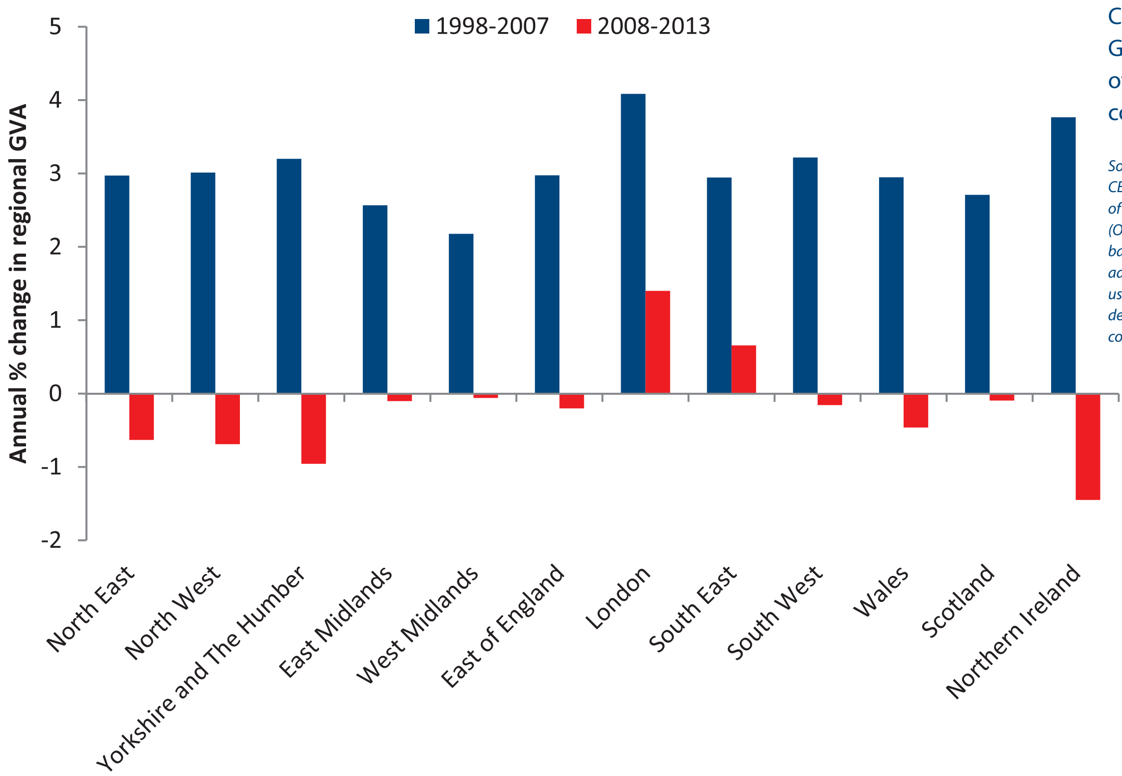

Chart 1: Growth rates of regional conomies

Source: CER analysis of Office of National Statistics (ONS), workplace-based gross value added data (adjusted using the ONS's GDP deflator to achieve constant prices)

3: ONS, Annual Survey of Hours and Earnings, 2014. Median gross pay for a full-time job.

Thinking through Brexit risks

The UK is highly likely to hold a referendum on EU membership – either by the end of 2017, if the Conservatives win the May 2015 election, or when the party is next in power. Would withdrawal from the EU harm some regions more than others by damaging manufacturing? That would depend on what sort of trade agreement, if any, the UK can negotiate with the EU after exit.

There are very good reasons to think that Brexit would be costly – even if we cannot know how costly. Most economists who are not ideologically opposed to the EU agree as much. This is because of the negative impact of reduced foreign direct investment[4] and increased costs of trade – through tariffs or non-tariff barriers, or both – with Britain's largest trade partner.[5] However, since the terms of a divorce are unknowable in advance, the magnitude of the costs are uncertain. But the demands that the EU makes of non-members seeking access to its market offer us some guide to the EU's red lines in a Brexit negotiation.

If Britain wanted full access to the single market, perhaps through membership of the European Economic Area, it would have to sign up to all of the rules of the single market – and accept free movement of labour. It would have to pay budgetary contributions, and it would have almost no ability to influence EU rules.[6] Looser relationships, like the Swiss web of bilateral treaties or the Turkish membership of the EU customs union, still require those countries to sign up to the majority of the EU single market's regulations and directives. And the EU has forced the Swiss to accept EU immigrants in exchange for access to goods markets. These models of association with the EU show that Britain could choose freedom from EU rules, but it would have less access to the single market if it did so.

It is not possible to know with any sort of precision where a UK-EU relationship agreement would lie on this sovereignty-access spectrum. Many argue that while the UK would win access to goods markets, it would be more difficult to find agreement on services.[7] This is because the UK runs a large trade deficit in goods with the rest of the EU, and a large surplus in services. Hence, these commentators consider the idea that the EU member-states would impose tariffs on British goods to be unrealistic, since they would be keen to maintain access themselves.[8]

But there are good reasons to think that a free trade agreement might not be achieved. The remaining EU countries might seek to punish Britain, to deter others from pursuing the same strategy. From the other member-states' perspective, Britain would be trying to leave the EU and opt back into the single market, but without free movement, the shared rulebook or budget contributions. Allowing such a move might encourage other countries to cherry-pick in the same way, endangering Europe's economic integration. Any deal would have to be approved by qualified majority voting by the Council and by a simple majority in the European Parliament, and so would have to be acceptable to both institutions – in which, since it would be on the way out, Britain would have no voice.

> *"There are good reasons to think that a post-Brexit free trade agreement might not be achieved."*

Moreover, it is easy to overstate the importance of the UK market to the other member-states, who buy 45 per cent of British exports, while Britain only buys 7 per cent of theirs.[9] This would give the EU the stronger hand in negotiations, and it would be likely to insist that the UK signed up to the free movement of labour, as well as single market rules and budget contributions, in exchange for goods market access (this, after all, is the price that Switzerland has been made to pay). Since immigration is the biggest cause of British hostility to the EU, this might put an end to a prospective deal.

What follows is an attempt to identify which regions would lose out most from Brexit, on the assumption that no free trade agreement is struck. In this scenario, the UK would fully leave the EU's orbit and trade under WTO rules, thus obtaining the maximum regulatory sovereignty. When taking decisions under conditions of uncertainty, as the UK will do if it holds a referendum on EU membership, it makes sense to consider this worst-case scenario, especially when the scenario is plausible.

4: Garry Pain and Nigel Young, 'The macroeconomic impact of UK withdrawal from the EU', *Economic Modelling*, 2004.
5: Gianmarco Ottaviano and others, 'Brexit or Fixit? The trade and welfare effects of leaving the European Union', London School of Economics CEP Policy Analysis, May 2014.
6: For a full discursion of the implications of EEA membership, see Centre for European Reform Commission, 'The economic consequences of leaving the EU', June 2014.
7: See, for example, Daniel Hannan, 'EU Brexit would turn UK from "bad tenants" to "good neighbours"', Parliament Magazine, December 2014; Open Europe, 'How would the UK's key export sectors fare under Brexit?', March 2015.
8: Open Europe and Ciuriak Consulting, 'What if..? The consequences, challenges and opportunities facing Britain outside the EU', March 2015.
9: Based on ONS, 'United Kingdom balance of payments', and European Commission/Haver Analytics data, 2013. The UK receives 19 per cent of the EU's extra-EU exports. But the relevant statistic here is the UK's share of combined intra- and extra-EU exports. This is because each member-state has to agree to a deal, and would consider what proportion of their total exports would be at risk if no deal were reached.

Which regions would suffer most?

Three manufacturing sectors produce the majority of UK goods exports to the EU: vehicles, machinery and components; chemicals and pharmaceuticals; and fuel. These industries are more important to some regions than others. Ultimately, the fact that these industries clump together in some regions means that the costs of a British exit would be unevenly shared (see Chart 2).

One cluster of car companies is in the South East, which is home to a Ford engine plant, as well as Honda, Vauxhall and Mini factories. The West Midlands has Jaguar Landrover, a BMW engine plant, Toyota and Bentley. The South West's aerospace cluster of Rolls Royce, Airbus, Agusta Westland and GKN provides over half of its exports to the EU. In the East of England, the North East, North West and South East, pharmaceuticals plants are important exporters. Gas exports to Ireland and the continent, through pipelines and LNG terminals, are booked as regional exports for Wales, Scotland, the East of England and North West of England. But the jobs producing that gas are largely in Scotland.

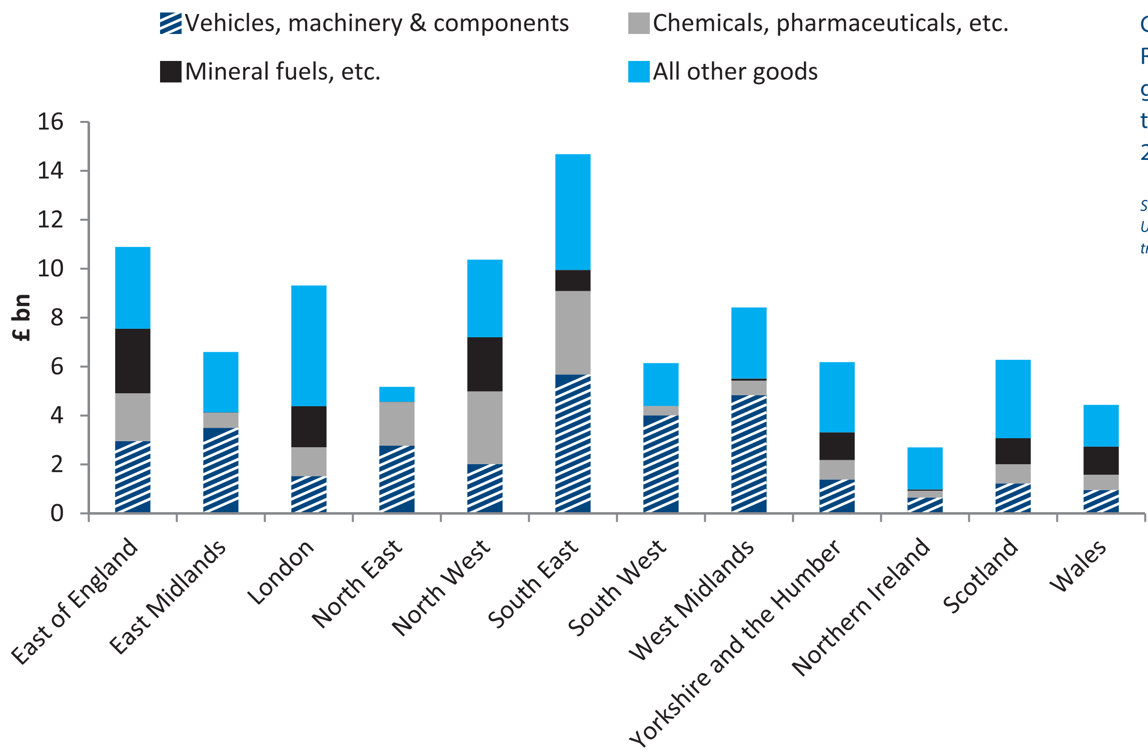

Chart 2: Regional goods exports to the EU, 2013[10]

Source: UK Trade Info, regional trade statistics

While Chart 2 shows where leading export sectors are located, it does not show how important EU exports are to regional economies. The South East is the UK's most populous region, so it is not surprising that it is the largest exporter to the EU. One way to measure the importance of goods exports to the EU to a particular region is to express their value as a proportion of regional gross value added (GVA) – the latter being a measure of private sector output in a particular region – which is shown in Chart 3.

The horizontal axis of the chart shows how much of each region's output is exported to the EU. On the far right is the North East – its exceptional dependence on exports to the EU reflects the importance of the Nissan car factory and its suppliers of components on the Tyne and Wear.

On the far left is London, where most exports are services, not goods. The vertical axis of the chart shows GVA per head – a measure of labour productivity, and hence the prosperity of the region. Manufacturing constitutes a larger proportion of economic activity in poorer regions because land and housing are cheaper, and so living costs and wages are therefore lower. This leaves poorer regions more exposed to EU demand.[11]

This means that these regions would lose out most if, upon withdrawal, the trading relationship between Britain and the EU reverted to WTO rules. The EU's 'most-favoured nation' (MFN) tariff would apply to its imports from Britain.[12] Higher tariffs would, of course, reduce exports and investment in the sectors concerned.

10: All data are from 2013, the last year with complete regional trade statistics, unless otherwise specified.

11: The correlation coefficient of the chart is -0.76.

12: Under WTO rules, after a British exit, the EU could not punish Britain by raising tariffs above the lowest rate that it currently charges on goods from other countries.

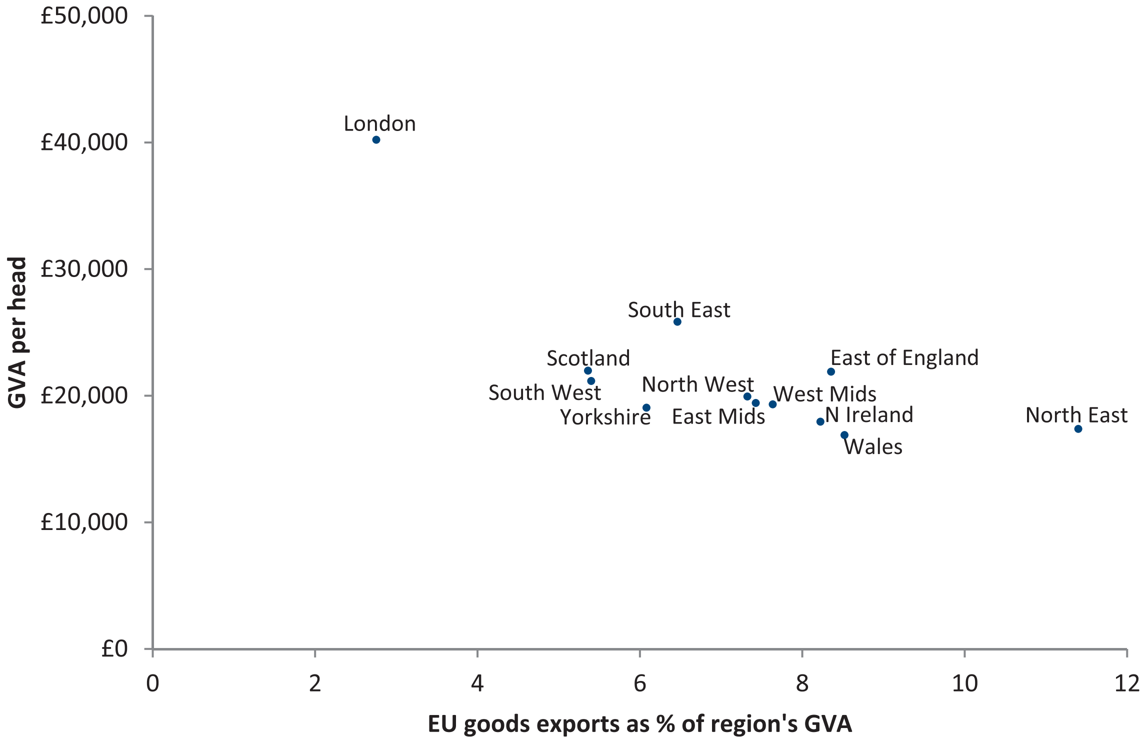

Chart 3: Goods exports: richer and poorer regions' exposure to EU demand

Source: UK Trade Info, regional trade statistics and ONS, regional income-based GVA data

Which regions would suffer most from higher tariffs? By applying the EU's current tariff rates to British regions' goods exports to the EU, one can estimate the total value of the tariffs that each region would have to pay. Chart 4 shows that the poorest regions of the UK would feel the most pain. The North East would see tariffs of £197 million applied to its exports. That amounts to 0.43 per cent of its private sector output. This may not sound much, but since the tariffs would be so concentrated in a particular sector – car manufacturing – it could have a significant impact on export sales, leading to a dramatically greater loss of output than 0.43 per cent. It would also damage future investment in the automotive sector. The tariffs applied to the South East would be largest in absolute terms – £472 million – but that amounts to only 0.11 per cent of its output. London, the UK's richest region, would feel much less pain than others.

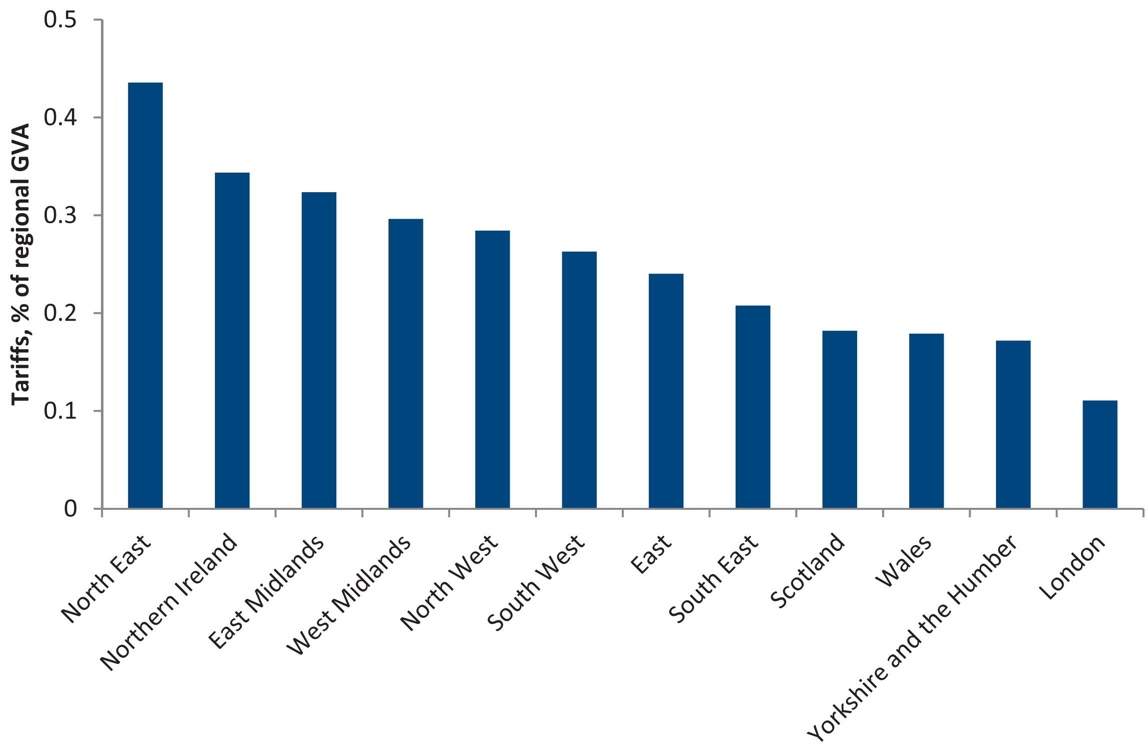

Chart 4: Who loses from EU tariffs?

Source: UK Trade Info, regional trade statistics and World Trade Organisation tariff database

These figures provide some sense of the risk to the regions' goods exporters. But services account for nearly a third of UK exports, because the City of London is a world-leading financial and commercial services centre. The EU does not impose tariffs on services imports, but it is likely to restrict London firms' access to European services markets after a British withdrawal. At first sight, this suggests that the impact of Brexit might be more evenly shared between London, its commuter belt and poorer regions. But this is not the case: Chart 5 shows an estimate of services exports to the EU, as a proportion of that region's GVA: while London's services exports to the EU make up 8 per cent of its output, its goods sector is tiny, and so London only climbs from least exposed to EU demand to fourth least.

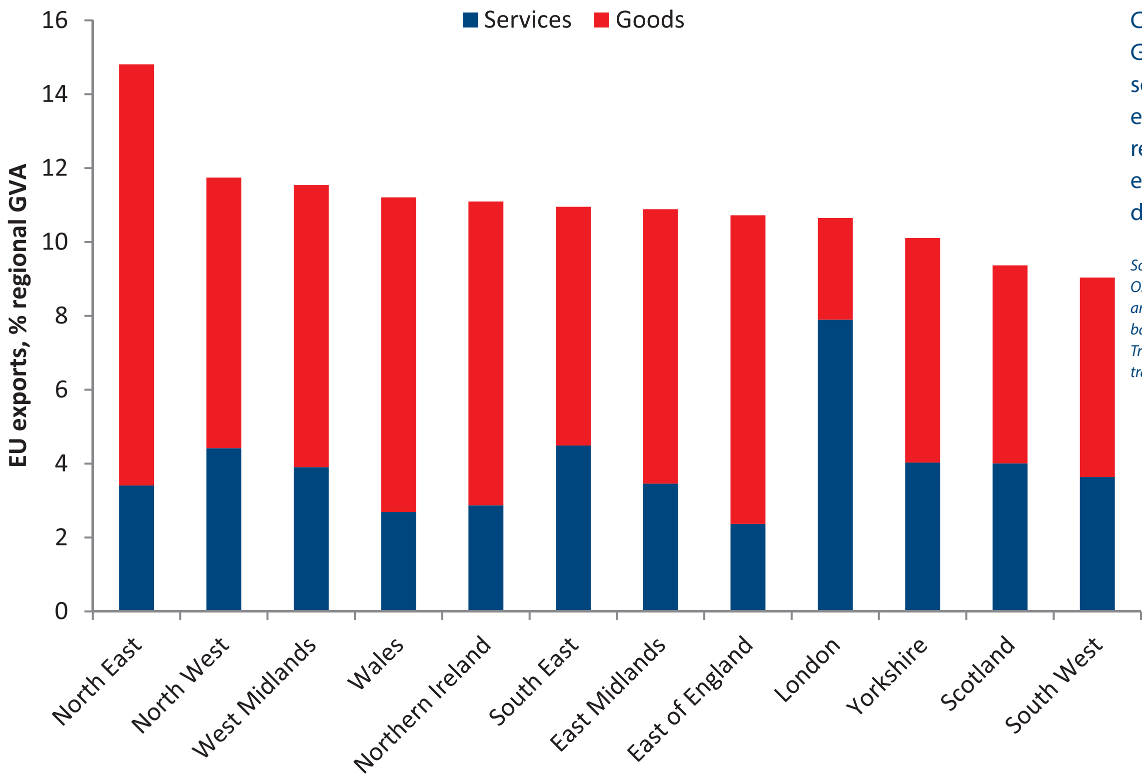

Chart 5: Goods and services exports: regions' exposure to EU demand[13]

Source: ONS, Pink Book 2014 and regional income-based GVA data; UK Trade Info, regional trade statistics

Some of the City of London's activities could see considerable losses. The eurozone would repatriate euro-denominated trading and clearing. Banks based outside the EU find it difficult to sell investment products to consumers. Non-European banks who 'passport' into the EU through London might move some operations to Dublin, Paris or Frankfurt. But overall, the City would probably find it easy to diversify into other markets: exports to the EU now only make up 35 per cent of total services exports, since non-European exports have been growing more quickly since the eurozone crisis began in 2010.

Of course, it is difficult to calculate the precise impact of increased trade costs on regions' exports to the EU, should the UK leave. Some manufacturers might manage to absorb the increased costs by making efficiency gains. Others might try to compensate by increasing sales to other parts of the world. But tariffs and other trade barriers would cut EU demand for UK exports. And they would disrupt complex supply chains: much of Britain's trade with the EU is in intermediate goods by multinationals. UK-based companies would find it more difficult to redirect trade away from Europe than those based in the EU, who could find suppliers elsewhere in the single market. Regions with manufacturing sectors that make up a large proportion of their economies look to be most at risk, and since these tend to be poorer, an exit from the EU risks making Britain an even more unequal place.

Ironically, the regions that have most to lose tend to be the most eurosceptic. Chart 6 shows that regions whose economies are more exposed to EU demand tend to be more in favour of leaving the EU (although the correlation is only a moderate one). The North East stands out: exports to the EU make up 14.8 per cent of its private sector output, far higher than other regions – yet its residents consistently favour withdrawal.

13: The ONS does not collect data on regions' services exports. These were estimated by taking the aggregate value of UK services industries' exports to the EU and apportioning them to regions by their share of each industry's gross value added.

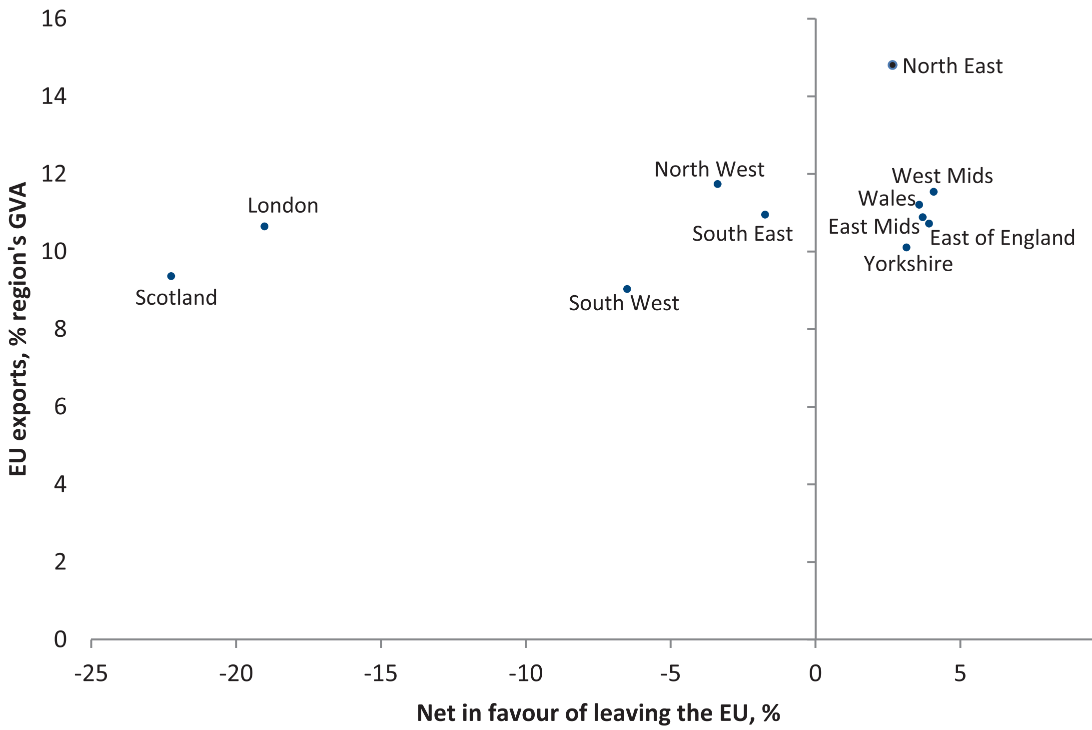

Chart 6: Regions most exposed to EU demand are more eurosceptic

Source: ONS, and an average of Survation, TNS, YouGov, ComRes and Ipsos Mori polls which asked people their voting intention in a referendum, between January 2014 and February 2015. Correlation co-efficient: 0.47

Conclusion

Opponents of EU membership claim that a free trade area in goods could be easily negotiated, citing the fact that the UK runs a trade deficit with the rest of the EU. But there are many reasons to doubt this: the proportion of the EU's exports bought by the UK is far smaller than the the proportion of the UK's exports that go to the Union, which would make the EU the more powerful player in negotiations over market access. The EU would certainly seek to prevent the UK from cherry-picking some aspects of the single market (goods and services) while opting out of others (migration). Furthermore, other models of association with the EU require countries to sign up to most of the EU's rulebook while having little say over it. The UK would probably have to sacrifice a good deal of sovereignty, and let in EU migrants, in order to maintain access even to goods markets.

To protect the manufacturing sector – especially the automobile, aerospace and chemicals industries – and to prevent EU withdrawal from making Britain's regional inequality worse, the government would have to do what is necessary to maximise market access. This would probably mean Britain having to sign up to large parts of the EU's corpus of regulation, allow free movement of labour and pay substantial budget contributions – all in exchange for a dramatic loss of influence in the EU's institutions.

The British Parliament might not agree to such a deal – nor the British people, for that matter, many of whom believe that EU withdrawal will lead to an escape from the perceived burdens of membership. This evidence should prompt them, particularly in the UK's poorer regions, to reconsider the risks.

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