

## **Brexit: a natural experiment for the EU**

Wednesday Briefing No. 8

*The Wednesday Briefing is a weekly free-market commentary on topical economic issues by our Head of Research, Diego Zuluaga. You can subscribe to the Wednesday Briefing by e-mailing Greta Gietz at [greta.gietz@epicenternetwork.eu](mailto:greta.gietz@epicenternetwork.eu).*

Last week, the unexpected – though certainly not the improbable – happened and the UK voted to leave the European Union. The ensuing uncertainty has so far met with gloom in financial markets, with the pound slumping to levels unseen since the 1980s, and key benchmarks around Europe registering record losses. Spain's Ibex 35, for instance, saw the biggest one-day drop in its history on Friday.

Little is known about what Britain's new status vis-à-vis the remainder of the EU will be in future. Indeed, important disagreements are already simmering both within the victorious Leave camp in the UK and among key Member States such as Germany, Italy and France. The consensus in Britain seems to be to extricate itself from any political implications of EU membership, whilst retaining as much of the economic links – Single Market membership above all – with the free movement of people in limbo.

Whilst it is clear that swift and liberal trading arrangements would be best suited to the economic interests of both parties, it would be unwise to discount the importance for Germany and other Member States to drive a tougher bargain *pour ne pas encourager les autres*. Importantly, any renegotiation with the UK will take place alongside changes of EU structures to stem centrifugal forces in other countries, notably France, the Netherlands and the non-euro Member States.

The competing pressures and interests at play, and the unstable global economic and political environment in which changes will be negotiated, suggest it is foolish to try and make forecasts of the final outcome so early on. Instead, it is worth pondering a separate but meaningful impact of Brexit on the rest of Europe. Specifically, the value of Britain's departure as what economists call a 'natural experiment' in economic policy change.

Natural experiments compare the outcomes of a randomly selected experimental group, to which a particular treatment is applied, to those of the control group. The expectation is that, because both groups are similar except for the application of the treatment in question, any discrepancy in outcomes between them can be attributed to the treatment. This is what is roughly attempted when testing new drugs.

Natural experiments are hard to come by in economics because events rarely happen in isolation. Almost every economic policy change will be accompanied by other changes, whether exogenous such as an oil supply glut, or endogenous such as additional reforms above and beyond the policy change which one wishes to examine. It is therefore difficult to disentangle how much of the observed effects is attributable to the 'treatment' one is analysing, and how much to other factors.

This is no less true in the case of Brexit. The political shock of Britain's departure from the EU is already rippling through to other economies. Furthermore, it is likely that the direction of policy in the UK will change with a new government and new circumstances. Finally, all of these developments are taking place in a context of slowing global growth, amid uncertainty about the coming U.S. presidential elections and the future of the Eurozone.

Nevertheless, what happens in coming decades will help us to answer the question: can a country do better after leaving the EU? Indeed, we can perform an even more granular analysis and seek to establish in which policy areas the greater policy flexibility and decentralisation which comes with departure might outweigh the cost of losing the EU's four freedoms and its constitutional barriers against bad government policy. Let us therefore look at some key policy areas which will be affected by a Brexit and speculate what sort of change we might see in the UK over the medium term.

### **Common Fisheries Policy**

This is one area where the UK is likely to see considerable change after Brexit. The management of fisheries became an EU competence almost by accident, when the Common Agricultural Policy was introduced and fish stocks were defined as agricultural resources. According to most analyses, the CFP has been [ineffective, bureaucratic and harmful](#). It has magnified rather than mitigated the 'tragedy of the commons' which leads to overfishing, by enshrining the principle of equal access by fishing fleets from any Member State into the waters of other Member States.

Both fish landings and the fishing fleet in the UK have been on a path of steady decline for decades. Indeed, fisheries provided one of the more emotionally and intellectually compelling arguments for Brexit, and were profusely cited by the Leave camp for that purpose. Departure from the EU will enable Britain to return fisheries management to the local level, which can enforce collective property rights and thus ensure more sustainable management of fish stocks. Developments in this sphere after Brexit can be expected to be positive on net.

## Common Agricultural Policy

The CAP has also been actively denounced by Brexiteers as a relic from the past and a waste of money. Indeed, the CAP absorbs 40 per cent of the EU budget and is [preventing European farming](#) from growing in average farm size, modernising production and investing in sustainable intensification technologies. But pro-Leave campaigners insisted throughout the campaign that farming subsidies would be maintained after Brexit, and [already the UK farmers' lobby is putting pressure](#) on policymakers to guarantee that everything will stay the same. No change there in the foreseeable future.

## Financial regulation

London is the world's leading financial centre, and the financial services industry represents nearly 10 per cent of UK GDP and two million highly-paid jobs. The opportunity for Brexit to "liberate" the financial sector from constraining EU regulations thus formed another plank in the Leave campaign's arguments.

However, it is unlikely that the much-vaunted deregulation of financial services will materialise post-Brexit, for a number of reasons. First of all, although the EU plays a significant role in the design and implementation of financial sector rules, the reality is that most legislation on this front is determined on an international level, through bodies such as the Bank for International Settlements (which sets the Basel capital and liquidity requirements) and the Financial Services Board.

Additionally, it is unrealistic to suggest that the climate of opinion on financial regulation is materially less hostile in Britain than in the EU as a whole. Antipathy towards bankers following the 2008 bailouts, coupled with media-driven outrage at high executive pay, means policy will probably shift less than is assumed by some. Thirdly, the nature of the UK's financial sector, for which Europe represents a sizable portion of business, suggests functional equivalence of regulation will have to be sought to preserve London's leading position.

## Trade and globalisation

Another central plank of the pro-Brexit case was Britain's inability to increase its trade relations with third countries whilst remaining part of the EU. This argument is somewhat fallacious because it suggests EU membership somehow meant the UK could not properly trade with third countries, when in fact the United States is its biggest export market. Moreover, China is Germany's fourth-largest trading partner [with annual trade volumes of €163bn](#), suggesting EU membership is not a powerful barrier to foreign trade.

Nevertheless, it is true that Brexit will allow the UK to pursue trade deals independently, without having to wrestle with 28 separate – and sometimes conflicting – sets of interests. To that extent, Brexit will make it easier to negotiate new trade terms. However, all of this is taking place in an environment of increasing trade barriers – [on a rate of 21 per month worldwide](#), according to the WTO – and with public opinion moving against globalisation. As part of the EU, the UK was one of the most pro-trade members of one of the key pro-trade blocs in the world. The negative consequences for EU trade policy and for global trade from the UK's departure could therefore outweigh the positive effects from independence.

## Migration policy

To their credit, many free-market Brexiteers expressed – though perhaps not loudly enough – a wish to have a relatively liberal migration policy post-Brexit. This is important because the UK's 2.9 million residents alone contribute £20bn to public coffers, and billions more to the private sector as consumers and as complements to other workers.

The consensus at this stage appears to be the creation of a points system – similar to Australia's – according to which the government will decide which foreign workers are suitable and needed by the British economy each year. It is, quite evidently, the equivalent for migration of central planning, and will likely have [similarly bad consequences](#) and thus be worse than the existing policy.

A post-Brexit UK should maintain EU freedom of movement and combine it with liberalisation of migration policy with regard to the rest of the world. But that is unlikely to take place in the current policy environment.

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Some free-market proponents of Brexit have claimed that Britain's departure from the EU is an opportunity for the UK to become a more liberal, globalist economy. This is inaccurate. The UK's economic challenges – a housing shortage, government overspending, a deficient healthcare system – are of a domestic nature and it is here that free-market reforms would bring about significant improvements. But these could have been achieved regardless of the outcome of the Brexit vote.

Here's hoping that Brexit will bring about more liberal outcomes in all of the areas above, and that the EU will learn from the UK experience as it decides what Member States should and should not do jointly in future. But as we can see, there is no guarantee that either the UK or the EU will end up more free and prosperous than they would have been together. Far from it.

**Further reading:**

Booth, Philip, and Ryan Bourne. [“Making the pieces fit: reforming Britain’s relationship with the EU.”](#) Current Controversies Paper No. 52. London: Institute of Economic Affairs, 2016.

Rickard, Séan. [“Prospects for a reformed agricultural policy.”](#) In *Breaking up is hard to do: Britain and Europe’s dysfunctional relationship*, ed. Patrick Minford and J.R. Shackleton. London: Institute of Economic Affairs, 2016.

Tingle, Rachel J. [“Freedom for fisheries?”](#) In *Breaking up is hard to do*.

Zuluaga, Diego. [“Blazing trails in a post-Brexit Europe.”](#) EPICENTER Wednesday Briefing 7, 22 June 2016.