THE ECONOMIC IMPACT OF PRIME MINISTER JOHNSON'S NEW BREXIT DEAL

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On 17 October 2019, the UK government and its EU counterparts concluded a renegotiation of the previous withdrawal agreement and political declaration which sets out the framework for their future relationship. The government hoped that this would enable the UK to leave the EU on 31 October 2019 and then, after a transition period lasting to the end of 2020, trade with the EU under a free trade agreement (FTA) while negotiating new trading arrangements with other countries.

This box sets out estimates of the economic effects of the deal on the basis that an FTA is in place at the beginning of 2021. On this basis, we estimate that in the long run the UK economy would be 3½ per cent smaller under the new deal compared to continued EU membership. The estimated effect is very uncertain. It is similar to our estimate of the deal proposed by Mrs May's government (Hantzsche, Kara and Young, 2018) because both involve an exit from the EU's single market and customs union. It is at the lower end of the range of estimates provided by UK in a Changing Europe (2019) in their analysis of Prime Minister Johnson's Brexit proposals. It is also somewhat smaller than the 4.9 per cent loss of GDP estimated in the government's published analysis of the effect of an average FTA (HM Government, 2018). The Chancellor has declined to update the government's analysis.[1]

However, there is significant doubt that it will be possible to have an FTA in place by the beginning of 2021. Many trade experts expect it to take much longer to agree, citing the length of time the EU has taken to negotiate and implement other FTAs. This opens the way for continuing uncertainty, especially the risk that the UK reverts to World Trade Organisation (WTO) rules at least for a time at the end of the transition period.

Modelling the Prime Minister's new deal

The main difference between Prime Minister Johnson's deal and that of Mrs May's government relates to the treatment of Northern Ireland. In the protocol on Ireland/Northern Ireland of the withdrawal agreement the whole-UK backstop has been replaced by a Northern Ireland-specific solution. The whole-UK backstop in the old agreement was put in place to ensure frictionless trade could continue without a hard border on the island of Ireland or in the Irish Sea between Northern Ireland and Great Britain until technological solutions were available to facilitate customs checks without border infrastructure. This was to be achieved by establishing a temporary customs union between the UK and the EU. Under the new agreement, the whole of the UK will no longer form a customs union with the EU. Northern Ireland will remain part of a customs territory with the UK but goods moving from Great Britain to Northern Ireland will be subject to customs and regulatory checks, with exceptions applied to goods that are not at risk of being moved on to Ireland and the European Union. Consent with Northern Ireland-specific rules will periodically have to be granted by the Northern Ireland Assembly.[2]

In practice, the absence of a whole-UK backstop and the dual tariff regime that will operate in Northern Ireland mean that Great Britain would be able to enter a different trading relationship with the EU sooner than under the May deal. The political declaration setting out the framework for future UK-EU trade is largely unchanged, with the ambition of operating a type of FTA. This implies leaving the European customs union and single market. For goods trade, the parties no longer envisage "a trading relationship […] that is as close as possible". The relevant passage in the political declaration has been replaced by "an ambitious trading relationship […] on the basis of a Free Trade Agreement".[3] References to level playing field arrangements have been watered down allowing for somewhat greater regulatory divergence between the EU and Great Britain, and thus higher barriers to trade.

In our analysis of the previous government's Brexit deal (Hantzsche *et al.*, 2018), we interpreted the government's ultimate preferred outcome to be a standard free trade agreement, similar to those observed elsewhere, rather than the close relationship that the original political declaration allowed. This is clearer in the revised declaration. Despite the name, trade typically does not move 'freely' under FTAs and UK businesses will experience many more frictions

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in trading with the EU than they do now. These frictions include non-tariff barriers such as customs and rules of origin requirements, regulatory burdens and barriers to market entry such as the loss of passporting in financial services. The extent of these non-tariff barriers to trade will be determined in the next stage of Brexit negotiations. In modelling the economic impact of Prime Minister Johnson's deal, we apply the same methodological approach as our earlier assessment of an FTA (Hantzsche *et al*., 2018). First, we analyse what will change as a result of leaving the EU and of setting up a free trade agreement between the UK and the EU instead. Second, we look at how these changes would feed through the economy using our global macroeconomic model NiGEM. NiGEM is regularly being used and updated by public and private sector institutions around the world for similar scenario analyses lending particular credibility to our model estimates.

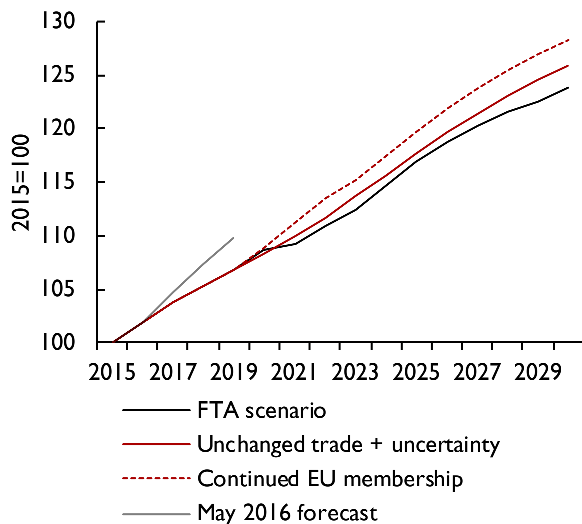
As a result of leaving the EU customs union and single market, UK-EU goods trade is assumed to be lower by 40 per cent, and UK-EU services trade is lower by 60 per cent relative to continued EU membership. These effects are assumed to build up gradually over time after the end of a transition period in 2021. The UK would be free to restrict immigration more than under EU membership leading us to assume a reduction in net migration of 50,000 people per year. Foreign direct investment is assumed to be lower by over 20 per cent. As a result of reduced EU trade and competition, we assume that productivity would be lower by 1.3 per cent in the long run. Leaving the European customs union would also provide the UK with flexibility to negotiate free trade agreements with the rest of the world. Following Ebell (2017), we assume that agreements with main Anglosphere trading partners (USA, Canada, Australia, New Zealand) bolster bilateral goods trade by around 25 per cent.

Macroeconomic impact

We estimate that as a result of higher barriers to goods and services trade and restrictions to migration, the economy would be 3½ per cent smaller under Johnson's deal (FTA scenario) compared to continued membership in the EU customs union and single market.

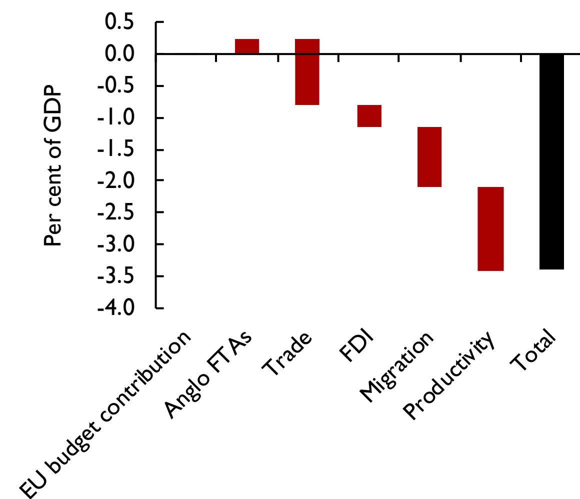
Figure 1 shows a number of illustrative macroeconomic scenarios including the GDP forecast NIESR published before the 2016 EU referendum under the assumption of a vote to remain. On that forecast, GDP would have been around 2½ per cent higher at the end of 2019 than now appears likely. This is similar to estimates of the impact of Brexit on the UK economy so far by the IMF, Born *et al*. (2019) and the Centre for European Reform (Springford, 2019).

Figure 1. GDP impact of Brexit



Source: NIESR, NiGEM simulation.

Figure 2. The impact of a free trade agreement on UK GDP by impact channel (per cent difference relative to continued EU membership 10 years out)



Source: NIESR, NiGEM simulation.

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Figure 1 also shows our main-case forecast scenario and a continued EU membership scenario that estimates how much higher output would be from now on if the uncertainty associated with Brexit dissipated and the UK remained in the EU customs union and single market (this is similar to the 'stay' scenario in Hantzsche *et al*., 2018).
In the FTA scenario, in which output is 3½ per cent smaller under the new deal than under continued EU membership, output is also about 1½ per cent below our main-case forecast scenario reflecting the combined effect of a worse trading relationship with the EU (taking 3½ per cent off GDP) offset by the effect of lower uncertainty (adding about 2 per cent on).

Figure 2 breaks down the total long-run impact into contributions from different modelling assumptions. The negative impact is driven predominantly by barriers to trade and migration as well as weaker productivity growth, by far offsetting the economic benefit of negotiating free trade agreements with non-EU partners of 0.2 per cent of GDP.

Table 1. Long-run economic impact of different types of Brexit (per cent difference relative to continued EU membership)

	GDP	GDP per capita
Unchanged trade + uncertainty (main case)	–2.0%	–2.0%
Customs union (whole-UK backstop by PM May)	–3.0%	–2.1%
FTA (NI-only arrangement by PM Johnson)	–3.5%	–2.6%
No deal	–5.6%	–3.8%

Source: NIESR, NiGEM simulation.

Table 1 compares the economic impact of Prime Minister Johnson's deal to other possible post-Brexit trading relationships, all relative to continued EU membership. A customs union arrangement would reduce GDP by around 3 per cent in the long run. The impact on the economy would be similar if the whole-UK backstop negotiated by Mrs May's government applied permanently. While goods trade would face fewer frictions than under the latest deal, services trade would be similarly affected by leaving the regulatory framework of the EU single market (see also Hantzsche and Young, 2019).

The impact of a permanent no-deal situation, in which the UK would trade on WTO terms with the EU indefinitely, is larger than of the described FTA scenario.

A smaller economy than otherwise also means that tax revenue would be lower under the proposed FTA deal. We estimate that government revenue would be lower by around 2½ per cent in the long run, or £26 billion per year in 2016 prices. The shortfall relative to a closer economic relationship with the EU would have to be met by raising tax rates, increased public borrowing or reduced spending, or a combination of all of these options.

Regional impact

Drawing on multisector trade analyses (Dhingra, Machin and Overman, 2017; Mion and Ponattu, 2019), we estimate the impact of the proposed deal on regional economies. All parts of the UK are set to be poorer with the deal, compared to continued EU membership.

While the impact across regions is very similar, areas of the country most heavily dependent on EU trade would see somewhat larger effects, like North Eastern Scotland, Kent and Surrey, East and West Sussex and East Anglia.

The regional impact also depends on the local industry mix. The production sector would be affected by customs and health and safety checks. Trade in services would be affected by leaving the regulatory framework of the EU single market. Linkages between sectors and global value chains mean that contraction in sectors with a high exposure to trade will be propagated to all domestic sectors and regions to some extent. Similarly, reduced spending power of workers would be dispersed across the country, for instance by commuting workers in London and the South East.

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Table 2. Regional impact of the FTA deal (per cent difference relative to continued EU membership)

Region	GDP difference	Region	GDP difference
North Eastern Scotland	–4.2	South Western Scotland	–3.5
Kent	–3.8	Inner London – West	–3.5
Surrey, East and West Sussex	–3.8	East Wales	–3.5
East Anglia	–3.8	North Yorkshire	–3.5
Hampshire and Isle of Wight	–3.8	Leicestershire, Rutland and Northamptonshire	–3.4
Bedfordshire and Hertfordshire	–3.7	Outer London – East and North East	–3.4
Essex	–3.7	Cornwall and Isles of Scilly	–3.4
Gloucestershire, Wiltshire and Bath/Bristol area	–3.7	Derbyshire and Nottinghamshire	–3.4
Berkshire, Buckinghamshire and Oxfordshire	–3.7	West Wales and The Valleys	–3.4
Inner London – East	–3.7	South Yorkshire	–3.4
Cheshire	–3.6	West Midlands	–3.4
Outer London – South	–3.6	Lancashire	–3.3
Dorset and Somerset	–3.6	Herefordshire, Worcestershire and Warwickshire	–3.3
Tees Valley and Durham	–3.6	Shropshire and Staffordshire	–3.3
Devon	–3.6	East Yorkshire and Northern Lincolnshire	–3.3
Eastern Scotland	–3.6	Lincolnshire	–3.3
Merseyside	–3.6	Northern Ireland	–3.3
Northumberland and Tyne and Wear	–3.6	Highlands and Islands	–3.1
West Yorkshire	–3.5	Cumbria	–3.1
Greater Manchester	–3.5	Outer London – West and North West	–3.0

Source: NIESR estimates.

Regions reliant on public expenditure, like South Yorkshire, West Wales and the Valleys, would be affected if government revenue shortfalls led to lower regional spending.

Areas with a large share of high-skilled workers employed in services sectors, like London, may find it easier to adjust and switch from producing financial services to other high value added services while other regions will face a slower adjustment process that requires retraining and reskilling of workers and changes to economic structures. If labour mobility is high, workers will move to sectors and regions with higher pay and more jobs, further propagating the economic impact of the deal.

NOTES

1 Letter from Sajid Javid to Catherine McKinnell MP, interim chair of Treasury Select Committee.
2 European Commission, revised protocol on Ireland and Northern Ireland included in the Withdrawal Agreement, 17 October 2019. See also Institute for Government, Brexit deal: the Northern Ireland protocol, 17 October 2019.
3 European Commission, revised political declaration, 17 October 2019. See also Institute for Government, Brexit deal: political declaration on future UK-EU relationship, 17 October 2019.

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