

## **BREXIT IS AN UNDERRATED RISK**

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THE BREXIT REFERENDUM is up for grabs, for either side. Probably, two thirds of British voters have not yet made up their minds. The probability of success for the “Leave” campaign supporting the UK’s withdrawal from the European Union is currently significantly underestimated. Based on a recent round of colloquia I attended in Europe and the U.S., I had a clear perception that the Leave camp’s current chances of victory are significantly higher than the standard 33-38% estimate by official polls. My sense is that the Leave supporters are much closer to the 50% threshold, or maybe even higher.

The public is split almost down the middle between Leave and “Remain.” Many don’t know which way they will vote. Core support for neither Leave nor Remain amounts to more than 20% of the public. Voters who are currently undecided about the referendum will therefore determine its result. Women in particular seem as yet unaligned, and they may determine the final outcome. Certain sections of the voting public, particularly the younger voters, are leaning toward the Remain camp, but they do not seem too interested in actually showing up at polling stations.

In this policy brief, I will try to synthesize the bones of contention. The first section briefly summarizes the standard background information on Brexit. If you are already familiar with the basic tenets, you can jump to the following sections, where I will present some of the findings I gathered from the colloquia I attended.

### **The History of the Referendum**

The referendum will be a chance for voters to provide a definitive answer to a question that has hung over British politics for a generation. Membership in the European Union has been a topic of debate in the United Kingdom since the country joined the European Economic Community in 1973. In January 2013, the leader of the Tory party, David Cameron, promised that, should the Conservatives win a parliamentary majority in the 2015 general election, the UK Government would negotiate more favorable arrangements for continuing British membership in the EU, before holding a referendum on whether the UK should remain in or leave the EU. The EU referendum is now scheduled to take place on 23 June 2016. The

referendum question that will appear on ballots will be: “Should the United Kingdom remain a member of the European Union or leave the European Union?”

In accordance with a Conservative Party manifesto commitment, the legal basis for a referendum was established via the passage of the European Union Referendum Act of 2015 by the British Parliament. The standard representation of the original positions that led to the calling of the referendum runs as follows: most of those who were in favor of a British withdrawal from the European Union argued that being a member of the EU undermines Parliamentary sovereignty, while those in favor of membership argued that, in a world with many levels of supranational organizations, any theoretical loss of sovereignty is more than compensated by the benefits of membership in the EU. Those that support withdrawal maintain that Brexit would allow the UK to better control immigration, conduct its own trade negotiations, and free it from what they believe to be unnecessary EU regulations and bureaucracy. Those in favor of remaining in the EU argue that leaving the EU would have significant economic costs, diminish the UK's influence over world affairs, jeopardize national security by reducing access to common European criminal databases, and result in trade barriers between the UK and the EU.

On 20 February 2016, Cameron announced that the Government would advise the British people to vote for the United Kingdom remaining in the European Union. This marked the official launch of the campaign.

The Treaty of Lisbon, which came into force on 1 December 2009, introduced a procedure for a member state to voluntarily withdraw from the EU for the first time. This is specified in Article 50 of the Treaty on European Union, which states that a member state may notify the European Council that it wishes to withdraw, upon which withdrawal negotiations begin. If no other agreement is reached, the treaty would cease to apply to the withdrawing state two years after such notification.

### **Economy or Immigration?**

The composition of the Brexit positions has become more radical over time. The main issues raised by the campaigns are that, by withdrawing from Europe, the British economy would be unshackled—firms would no longer be suffocated by EU overregulation, the number of immigrants drawing on public subsidies would eventually subside, and the United Kingdom would regain full control of its borders. In sum, the two battlegrounds upon which the two campaigns are waged are economy and immigration. The economic costs of Brexit have become key to the Remain campaign, while immigration has become the pivotal issue for the Leave campaign.

The economic issue raised by the Remain camp hinges on the risk that Britain may not benefit from free trade if it left the EU. Trade, differently from what happens in many other countries, is still a very popular goal for the British population. As for the argument that the economy would benefit once unshackled from European regulation, this runs against evidence that productivity growth in the UK has been increasing at a lower rate than in other more highly regulated European countries such as Germany and Spain. Since London can make use of many opt-outs, it does not suffer from European regulations as much as other countries. Consequently, the British productivity disease appears homemade.

The Leave position is *prima facie* stronger on immigration. In the UK, there are around 3 million EU citizens, representing 6% of the working population. This number practically tripled in the last decade. The increasing supply of foreign workers is suspected to cause

harsh competition, particularly for the low income range of British jobs. The Leave campaign has grown popular by brandishing the argument that European migrants steal jobs and receive huge benefits from public funds. In 1975, at the first referendum on joining the European Community, the people's stance on immigration was a very weak predictor of the vote. Now, it has become a very strong one.

Demographic analysis shows that older people who resent immigration and consider it a very unpleasant change in their social fabric would vote for withdrawing from Europe, while younger Brits would do the opposite. The Remain camp has not done much in this regard and tends to use the immigration question only as a bargaining chip that allows the country to be granted freedom of trade in the EU Single Market. In fact, part of the strength of the UK economy over the last 15 years has been the inflow of qualified young workers that rarely coincide with the standard image of poor migrants reaping social benefits from British taxpayers. Around London, there are currently 700,000 French and 500,000 Italians that have secondary education or higher, who sometimes are key to the functioning of hospitality and financial services, as well as other high value activities.

However, a rational assessment of the arguments over Brexit has been superseded by heated political rhetoric. Referenda tend to be very useful when they stick to the subject, and they tend to go awry when they become a vehicle for protest or political frustration. There is much reason to believe that the Brexit referendum has assumed a meta-meaning for public protest. One piece of evidence is that the laborious negotiations that Prime Minister David Cameron conducted with the European Union in February have not changed anybody's mind. This was mainly because the negotiations did not touch immigration—the most politically sensitive of the Brexit arguments—since Angela Merkel clearly stated that the free movement of people was not negotiable and actually was not on the agenda at all.

The main strategic argument has thus centered on securing a profitable arrangement after the Leave camp's success at the Brexit referendum. In fact, the UK's subsequent relationship with the remaining EU members could take several forms. A research paper presented to the UK Parliament proposed a number of alternatives to membership that would continue to allow access to the EU internal market. These include remaining in the European Economic Area (EEA) as a European Free Trade Association (EFTA) member, or negotiating bilateral terms along the Swiss model with a series of interdependent sectoral agreements. Were the UK to join the European Economic Area as an EFTA member, it would have to abide by EU internal market legislation without being able to vote on its content. However, the EU is required to conduct extensive consultations with non-EU members beforehand via its many committees and cooperative bodies. The EEA Agreement (EU and EFTA members except Switzerland) does not cover Common Agriculture and Fisheries Policies, Customs Union, Common Trade Policy, Common Foreign and Security Policy, direct and indirect Taxation, and Police and Judicial Co-operation in Criminal Matters, leaving EFTA members free to set their own policies in these areas; however, EFTA countries are required to contribute to the EU budget in exchange for access to the internal market.

Most of the discussion thus hinges on replicating the Swiss arrangement. However, a special weakness puts the UK in an awkward position. The UK has a large trade deficit with the rest of the European Union—its exports to the EU correspond to 13% of its GDP while its imports reach 16-17%. Should London leave the EU, it might find itself in need of a number of bilateral trade agreements with the EU's individual countries which, being creditors, would put them in a stronger negotiating position.

Moreover, EU members may be tempted to punish London in case the Leave camp wins. In that case, EU heads of governments who already suffer under the pressure of Eurosceptics at home might wish to show that countries adopting an anti-European leadership are destined for a dreadful end. In order to prove it, they may want to give British negotiators a hard time. Punishing the UK to prevent other countries from following could be justified by some advances in political integration, while blaming the UK as a dragging anchor that had slowed down Europe ever since Margaret Thatcher came to the fore.

Inevitably, the negotiations would hinge on the role of the City, which is not particularly popular in the UK outside of London. It is common to hear in financial milieus that many non-British banks would move sections of their activity outside the UK, probably not the headquarters but the trading activities for a temporary period of around two years, after which they will decide on whether to abandon London. Article 50 of the European Treaty prescribes a two-year period for the completion of exit negotiations starting from the moment when a country officially submits its intention to leave. In that period, the temptation for other governments to attract financial business is likely to become irresistible. British banks are aware of the threat and are actually supporting the Remain campaign. On the other hand, hedge funds are eager to unshackle the burdensome regulation imposed by the new BRRD EU regulation on speculative finance and are heavily funding the Leave campaign.

### **The Consequences of a Leave**

Some see Brexit as a self-induced financial wound that is already showing its scars through higher interest rate spreads and unstable currency markets. The UK is already deemed riskier than it once was. Increased volatility might cause a weakening of the pound sterling that could force the central bank to raise interest rates. Instability would reverberate throughout Europe with unpredictable consequences. Political instability in the UK would create further uncertainty and higher financial risks.

There is no doubt that, in the event of a Leave victory, David Cameron would not survive the week. It would not only be a humbling defeat for the prime minister who called the referendum, but the outcome would put Cameron in the impossible position of negotiating the consequent agreement with the EU after campaigning for staying in the EU. Cameron might be rapidly replaced by Boris Johnson or someone else, but political and financial instability might swiftly tarnish the party of a victorious Leave and make the new British, anti-European government actually scramble to make up with Europe.