Chapter

21

Some people think that it [Brexit] is the end of the world. It's not. On the contrary, it's a massive opportunity for this country. (July 2016)

Our policy is having our cake and eating it. (September 2016)

Boris Johnson, British prime minister

Brexit: Problems and Prospects

Chapter Contents

The departure of the United Kingdom of Great Britain and Northern Ireland from the European Union is among the most momentous developments in the history of European economic integration – or disintegration in this case.

The trade-off that the UK made in leaving the EU is exactly the trade-off that prevented Switzerland, Norway and others from joining in the first place: sovereignty gains versus economic pains. The Swiss and Norwegians accepted that not joining would mean that they missed out on some economic gains, but their unique histories led them to judge that staying out was the better bargain. But it is important to note that the nature of the trade-off introduces an inevitable asymmetry in the treatment of the costs and benefits of Brexit.

The economic pain the UK is experience from reducing its integration with the EU is concrete and tangible, and thus easy to quantify. The gains from sovereignty are diffuse and intangible, and thus difficult to quantify. Appearing on *The Andrew Marr Show* on 15 February 2021, Dominic Raab, the British foreign secretary, claimed, 'I think if you take a 10-year view, as well as looking at the short-term risk, which is right to do, actually the growth opportunities in the future are going to come from emerging and developing economies around the world.' This is his way of saying there are gains from enhanced sovereignty, but they are diffuse and difficult to measure.

Because of this asymmetry, it is too early to form a full judgement on Brexit, but this chapter strives to present readers with a broad overview of Brexit, its historical background, political context, and quantifiable economic consequences. This is done by addressing a series of questions:

- Why is the UK leaving the EU?
- Who wanted to leave and why?
- What is in the Brexit deal?
- What are the economic consequences likely to be?
- Why were the Brexit talks so long, difficult and messy?

21.1 Why is the UK leaving the European Union?

On 23 June 2016, UK citizens were asked: 'Should the United Kingdom remain a member of the European Union or leave the European Union?' The possible answers were 'Remain a member of the European Union' or 'Leave the European Union'. Leave won.

21.1.1 Shockwaves and leadership crisis

This outcome was a shock. The value of the British currency, the pound, plummeted even before all votes were counted. 'Pound slumps to 31-year low following Brexit vote' was the morning headline of *The Guardian* newspaper. The London stock market index fell 9 per cent in the first ten minutes after opening.

The referendum's outcome was shocking in two additional ways. It made clear that the vote had settled only half the problem. It showed what citizens were against; not what they were for. It also revealed that the Leave campaign had no plan for what should come after the referendum.

The lack of a plan was not an oversight. Today, the British–EU relationship is defined by two agreements.

- The first is sometimes called the 'divorce agreement'. Technically, it is called the 'Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community'. As neither of the newly divorced couple was going to 'move out', they needed a second agreement.
- The second is sometimes called the 'cohabitation agreement'. Technically, this document is called the 'Trade and Cooperation Agreement' (TCA). It is an Association Agreement under EU law.

While the Leave-campaign leaders broadly agreed on what the divorce agreement should look like, they were deeply divided over the shape of the cohabitation agreement. Some wanted to continue with deep economic integration; others wanted an extreme break with the EU. They settled their differences before the referendum by agreeing that they would not present voters with a single plan for what came next.

The crux of the problem was simple. Taking the UK out of the EU after 45-plus years of deep economic integration would involve politically agonizing trade-offs between sovereignty and economic pain. The historical process of deepening European integration was a sequence of politically gut-wrenching trade-offs that reduced members' scope for unilateral action (sovereignty) in exchange for the economic benefits (economic gains) that came from closer economic integration.

The British prime minister leading the Brexit talks would have to relive all those trade-offs in reverse. Greater economic separation from the EU meant more economic pains, on the one hand, and more sovereignty gains on the other hand. While 'more sovereignty' sounded good in campaign slogans like 'Take Back Control', sovereignty provides few concrete benefits to citizens in the short run. One that is frequently mentioned – controlling immigration from EU nations – did not appear in the short run. It kicked in only four and a half years after the vote.

This sort of governance challenge – one with clear, short-run pains balanced against vague, long-run gains – ensured that whoever led Brexit would face years of political agony. As it turned out, none of the leaders of the Leave campaign stepped in to accept the governance challenge.

The result was an immediate crisis of leadership in the ruling Conservative Party. David Cameron, the sitting prime minister who had campaigned against Brexit, unexpectedly resigned at 8.20 in the morning after the Leave side won. Faced with the challenge of governing the UK through this minefield of economic losses, all the leaders of the Leave campaign were either pushed off the political stage or left the stage voluntarily. Ultimately, the minefield was left to Theresa May – a Conservative politician who had actually campaigned against Brexit. Political agony is indeed what she faced for two years.

21.1.2 Immediate economic consequences of leaving without a plan

Given the discord within her party, the new Prime Minister was unable to find consensus on what should come after Brexit. When asked about it, she repeatedly avoided the question by saying, 'Brexit means Brexit'. The lack of a plan worried financial markets. Understanding this requires a little background.

The EU's legal instrument governing the exit of EU members is Article 50 of the Lisbon Treaty. This states that the departing member must declare their intention to leave, but it does not require them to have a plan for what comes after exiting. The Article also sets a two-year clock for the exit negotiations. Membership would end – with or without an exit agreement – two years after the member announced that it wanted to leave. This countdown clock was designed to avoid never-ending talks (see Box 21.1). All this worried financial markets, because leaving without a plan for the post Brexit UK–EU relationship created massive uncertainty.

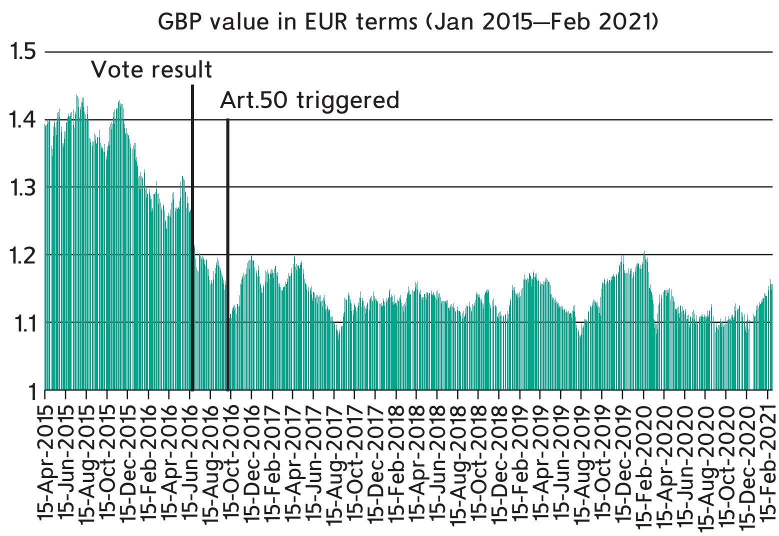
When Prime Minister May announced in Autumn 2016 that Britain would start the two-year exit clock without the Conservative Party having agreed a clear post-Brexit plan, the British currency dropped another 10 per cent against the euro (Figure 21.1, overleaf).

Box 21.1 Article 50 of the Lisbon Treaty

The legal instrument that governs the exit of an EU member (Article 50 of the Lisbon Treaty) stipulates that a nation start the process by announcing its intentions to leave. Prime Minister Theresa May did that on 29 March 2017. Once this was done, the parties had two years to negotiate a withdrawal agreement (the 'divorce'). Article 50 states that whether an agreement is reached or not, the leaving nation ceases to be a member after two years. The idea behind this deadline was to prevent a member from being interminably half in and half out. The Article, however, allows extensions if both sides agree. As we shall see below, two extensions were agreed – the second was until 31 January 2020, which is the day the UK stopped being a member of the EU.

Under the Lisbon Treaty rules, the nation that has left can request a new trade agreement with the EU in the same way that any nation in the world can request a trade agreement with the EU. This is the legal reason for why the UK relationship with the EU is today governed by two separate legal agreements.

Figure 21.1 The British currency's value against the euro, 2015 to 2021

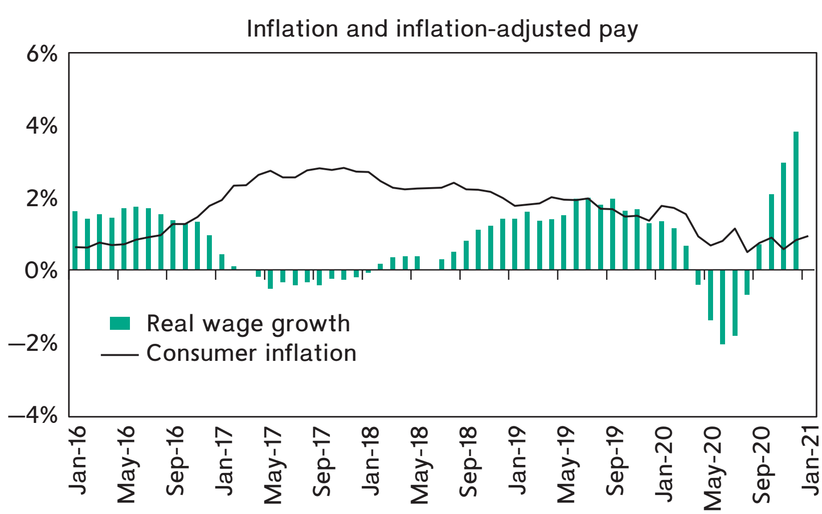


Source: Authors' elaboration of IMF online data, https://www.imf.org/en/Data; GBP (Great Britain Pound) is the standard abbreviation for the pound.

21.1.3 Immediate economic consequences

The pound's loss of value meant that the local prices of imported goods rose. The result was a noticeable pick-up in consumer inflation in Britain (Figure 21.2). Since British wages measured in pounds did not keep up with the higher prices, the purchasing power of British incomes fell.

Figure 21.2 British real earnings and price inflation, January 2016 to December 2020

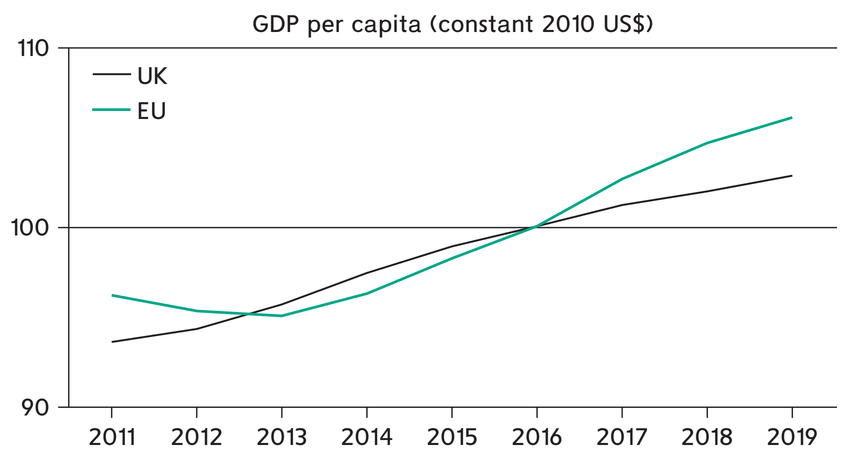


Source: Authors' elaboration of ONS online data. Wages are real average weekly earnings, total pay, seasonally adjusted, 3-month average. Inflation is from the CPIH series, all items.

As Figure 21.2 shows, the growth in real earnings (i.e. workers' incomes adjusted for purchasing power) started slipping from the date of the Brexit vote and turned negative for most of 2017 as inflation picked up. Earnings growth returned to normal for most of 2018 and 2019 but dived and then jumped in 2020. The jump at the end of 2020, according to Britain's statistical office (the Office of National Statics, ONS) was 'increasingly being driven by compositional effects of a fall in the number and proportion of lower-paid employee jobs'. This coincided with many EU citizens leaving Britain in 2020 – many of whom had low-paid work in pubs, hotels, restaurants and the like. Furthermore, the pandemic destroyed many low-paid jobs. The real earnings of other workers did not rise, but the average did, because fewer low-paid workers were counted when computing the average.

Overall income growth of the British economy has been slower than that of the EU since about 2013. The Brexit vote seems to have made matters worse, as Figure 21.3 shows. The EU experienced a recession following the 2009–11 euro crisis (see the dip in the EU GDP per capita line). Britain avoided the crisis and the recession but since then the EU economy has grown faster than the UK economy. Per capita incomes in Britain are now lower than the average EU income and growing more slowly. There is some hint in the data that the UK's under-performance on growth got worse after 2016 (but this could also be due to other factors). Sophisticated statistical analysis suggests that UK growth has slowed since Brexit compared to what it would have been otherwise (Born et al., 2019).

Figure 21.3 British and EU real per capita income growth, 2011–2019



Source: Authors' elaboration of public data from World DataBank, World Bank. To highlight the divergence in trends, the data is rebased so that both series equal 100 in 2016.

The profound changes that Brexit will bring to the UK economy and its relationship with the EU are just now starting to take effect. The economic difficulties documented above all stem from economic actors anticipating the changes to come. The future is unknowable, so we cannot say for sure that Brexit will be economically painful. The evidence to date, however, makes it quite difficult to argue that Brexit will provide abundant gains to British citizens.

21.2 Who wanted to 'Leave' and why?

It might seem odd to readers that we look at who voted 'Leave' without first looking at what Brexit means today. But it is not. When the British cast their votes in 2016, no one had a clear idea of where the country was heading. Different politicians made different promises to voters about what Brexit would mean. It is important to keep this firmly in mind when thinking about voters' intentions and motives in 2016 – and how opinions have evolved since.

About 72 per cent of eligible voters cast a ballot in the EU referendum. About 52 per cent of these chose Leave. According to a poll conducted on the day of the vote (Ashcroft, 2016), the young and employed preferred to Remain:

- 73 per cent of 18 to 24-year-olds voted Remain
- 60 per cent of over-65s voted Leave
- A majority of those with jobs voted Remain
- A majority of those without jobs or retired voted Leave.

21.2.1 Not a vote along party lines

This was not a vote along party lines. Among the Leave voters, 40 per cent declared themselves as Conservatives (also known as Tories) and 20 per cent as supporters of the Labour Party. Among the Remain voters, 30 per cent said they were Tories and 40 per cent said they were Labour-leaning voters. The only clear voting by party affiliation was that of the single-issue UK Independence Party (UKIP) which contributed about a quarter of all Leave voters.

There was also a great deal of difference between the two groups in terms of how serious they thought the decision was. Among the Remain voters, 77 per cent thought 'the decision we make in the referendum could have disastrous consequences for us as a country if we get it wrong'. Among the Leave voters, 69 per cent thought the decision 'might make us a bit better or worse off as a country, but there probably isn't much in it either way'.

The 2016 vote split the country along geographical lines as well. Northern Ireland and Scotland preferred to remain, but the English and Welsh wanted to go. London also voted to stay by a margin of 59.9 per cent to 41.1 per cent. On the morning of the result, the deputy leader of the Labour Party, Tom Watson, said: 'We end this referendum more divided than when we started it.'

Statistical analysis by Becker et al. (2017) shows that fundamental characteristics of the voting population were key drivers of the Vote Leave share by voting district. The key variables were voters' education level, their district's historical dependence on manufacturing, and the level of unemployment. At the ward level within cities, deprivation in terms of education, income and employment was important in predicting the Leave vote share. Importantly, it was not about immigration as is often claimed. The study finds that exposure to the EU in terms of immigration and trade provides relatively little explanatory power for the referendum vote.

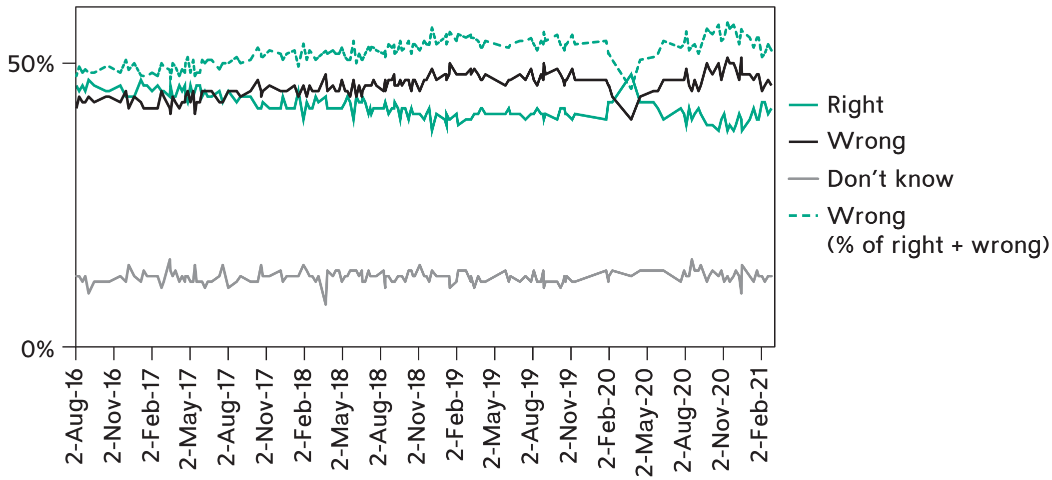
Since the Brexit process has lasted for so long and revealed so much new information about the actual difficulties and opportunities Britain faces outside the EU, public opinion has shifted. As Figure 21.4 shows, since the end of 2017 surveys conducted by YouGov (a global public opinion and data company) suggest that a rising share of voters think that the Leave decision was a mistake. The share saying that they thought it was a mistake is not consistently above 50 per cent, but excluding the 'don't know' respondents, there has been a consistent majority thinking it was wrong since mid-2017.

21.3 What is in the Brexit deal?

Brexit is something that is both very clear and something that is very muddled. Clear since the trade deal that now links the UK and EU is a completely standard free trade agreement. It means goods traded across the EU–UK border will remain tariff-free and quota-free (subject, however, to new customs and regulatory checks that have raised costs and created delays). The free moment of people has ceased. The messy part comes from the fact the two economies are deeply integrated in ways that go far beyond trade in goods and immigration. Cross-border flows of services, data and investment are not covered by the current trade agreement. Many issues were left to be settled by future negotiations.

The situation in which Britain finds itself in 2021 is defined by two agreements, as mentioned above. They are sometimes described by evocative names: the 'divorce document', or Withdrawal Agreement, and the 'cohabitation deal', or new trade agreement. As mentioned, the technical name for the first is the 'Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the

Figure 21.4 In hindsight, do you think Britain was right or wrong to vote to leave the EU?



Source: Authors' elaboration of public data from https://whatukthinks.org/eu/opinion-polls/uk-poll-results/

European Union and the European Atomic Energy Community'. It is an international Treaty signed on 24 January 2020. A week later, the UK was no longer a member of the EU. The EU28 became the EU27.

A 'cohabitation deal' was necessary to establish a new relationship between the UK and the EU27, but in the meantime, Britain was inside the EU in all but name. To avoid sudden changes that might be reversed by the subsequent 'cohabitation deal', the Withdrawal Agreement committed the UK and the EU to a 'transition period' (the UK government preferred the name 'implementation period') for 11 months. During this time the EU treated the UK as if it were still a member, but one that had no right to participate in decision making.

The cohabitation document, formally known as the 'EU-UK Trade and Cooperation Agreement', came into effect on 1 January 2021. What is in these deals?

21.3.1 Withdrawal Agreement

This was the trickiest part of Brexit – the one that led to an amazing sequence of political events in Britain (see Section 21.5). Despite that, its content is rather simple to describe. There are four keys elements:

1. *Citizens' rights:* The Withdrawal Agreement (WA) safeguards – for life – the acquired rights of EU and UK citizens and their family members who moved to the UK and EU Member States before Brexit. This established rights for about 4 million EU citizens living in the UK and 1 million British nationals living in EU27 nations. The provisions ensure that they can stay and continue their lives with little disruption.
2. *Financial provisions:* The WA commits Britain to meeting all the financial commitments it made as a member of the EU and defines the obligations. The WA does not set out a fixed amount that Britain has to pay to the EU; it agrees principles upon which the payments will be based. The UK Parliament estimated that the settlement would eventually cost the UK about £30 billion.
3. *Separation issues:* It ensures the orderly winding-down of arrangements made when the UK as a member. This covers such things as continued protection for intellectual property and the orderly conclusion of cases involving police and judicial cooperation. Establishing a dispute settlement mechanism was also part of this.
4. *The Northern Ireland Protocol.*

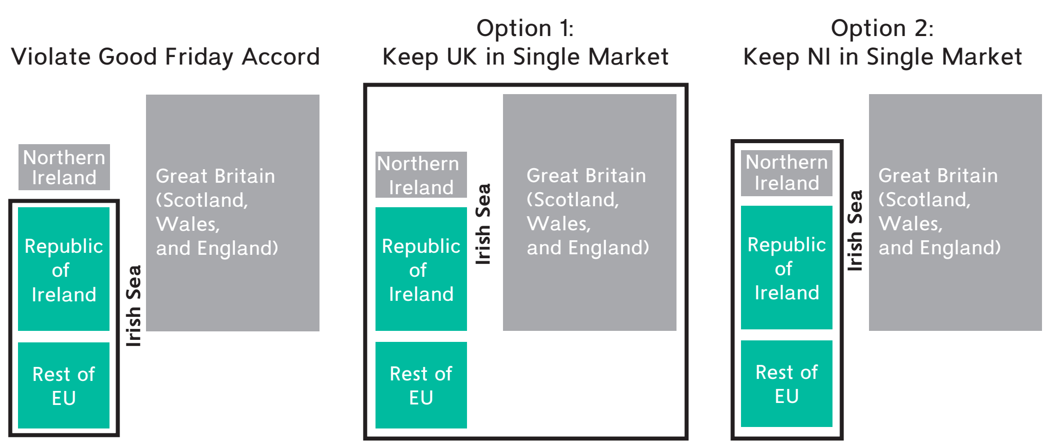
Northern Ireland Protocol

The provisions that caused the most political difficulties for the UK government concerned an issue that very few voters or campaigners on either side had anticipated as being of outstanding importance. This is not to say it was an unknown problem. British citizens in Northern Ireland appreciated the problems Brexit would pose for their corner of the UK. The issue was one of the reasons that a majority of citizens in Northern Ireland voted 'Remain' in the 2016 referendum (55.8 per cent Remain against 44.2 per cent Leave).

The provisions taken together are called the Northern Ireland Protocol. This part of the WA institutes a legally binding solution that avoids a hard border on the island. Why is that so important? The Protocol protects the all-island economy, the Good Friday Agreement, and cohesion of the EU Single Market. Understanding the need for each of these and the political difficulties it created requires some background.

Ireland was part of the United Kingdom from 1801. Following a bitter war of independence (1919–21), the southern counties seceded from the United Kingdom. The 1921 agreement ended armed conflict on the island, but violence erupted again in the 1960s with rioting and deaths in the Northern Ireland towns of Londonderry and Belfast. British troops were brought in but underground armed groups, the Irish Republican Army (on the Catholic side), and paramilitary groups (on the Protestant side) continued terrorist attacks. The conflicts persisted into the 1990s. Thousands died.

Figure 21.5 Choices faced on the Northern Ireland issue



Source: Authors' elaboration.

The European Single Market allowed 'borderless trade' in the sense that trucks, cars, and trains could cross frontiers without stopping for customs formalities. This indirectly facilitated peace in Ireland. Because of the Single Market there was no physical manifestations of a land border on the island of Ireland. The Single Market also guaranteed that all Irish from all counties had equal economic rights in all other counties. Given these two new facts on the ground, the conflict that had raged for decades ceased to make sense. The island remained divided into two countries but with the Single Market, each side could plausibly claim that they had achieved their goals – or close enough to make further loss of life senseless. The Good Friday Agreement was the official name of the accord reached in 1998 and ratified by a popular vote held island-wide on 22 May 1998. Peace has reigned since.

Brexit threatened this peace by raising the possibility of restoring a land border between Northern Ireland and the Republic of Ireland – thus disrupting the unity of the island-wide economy (left panel in Figure 21.5). The fourth and most controversial element of the Withdrawal Agreement established a baseline that ensures that the island-wide economy remains integrated and that no physical border will be rebuilt.

The politically tricky part of the Ireland provisions in the WA is that it forced difficult choices on the parties. One part of the problem is apparent in the formal name for the country: the United Kingdom of Great Britain and Northern Ireland. Great Britain is the union of England, Scotland and Wales. The United Kingdom broadens this out to include Northern Ireland. If Great Britain and Northern Ireland were to leave the EU Single Market, then barriers would have to go up between the southern and northern counties on the island of Ireland. If Northern Ireland were to stay in the Single Market, barriers would have to go up between Great Britain and Northern Ireland.

In other words, there were only two viable ways of continuing the economic integration of the whole island: Option 1: the whole of the UK stays in the Single Market (middle panel of the figure), thus eliminating the need for a Single Market boundary between Northern Ireland and the rest of Great Britain. Option 2: Northern Ireland stays in the Single Market (breaking the cohesion of Britain's internal market along the Irish Sea, right panel of the figure).

The reality of the choice was not quite as stark as this. The complexity of Single Market regulations and the rather modest flow of goods between Northern Ireland and the rest of the UK meant that some exceptions to the Single Market rules could be tolerated as they would have very little effect. Moreover, politicians on both sides of the negotiating table were willing to paper over some difficulties and this allowed them some wiggle room between Option 1 and Option 2. But laying out the choice starkly makes it easy to understand why Northern Ireland caused so much trouble for Brexit. There was an unavoidable choice between a completely economically united UK, and a fully unified Single Market on the island of Ireland.

The hard-line Brexiteers in the Conservative Party completely and consistently rejected option 1 (all of UK stays in the Single Market). Option 2 (only Northern Ireland stays in the Single Market) was rejected by Prime Minister Theresa May. May's insistence on a version of Option 1 is why her version of the Withdrawal Agreement was rejected by her own party. And it is why she had to resign in May 2019.

A version of Option 2 is what was ultimately agreed by Prime Minister Boris Johnson, but only after he held a general election in which Conservatives won a resounding mandate. This aspect of the Withdrawal Agreement has already caused tension between the UK and the EU and is likely to be an enduring source of problems.

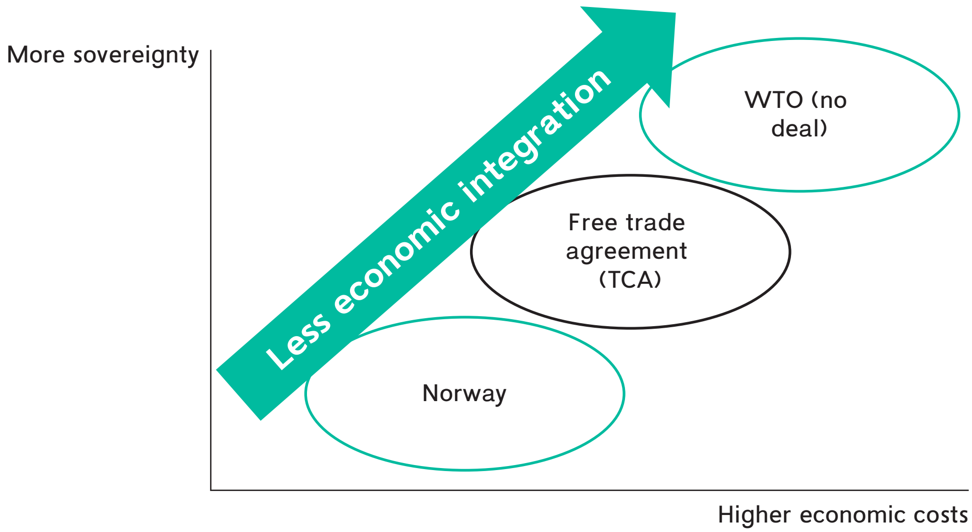
21.3.2 What were the options for the cohabitation deal?

Britain faced three basic options for the 'cohabitation deal'. Each presented a different combination of sovereignty gains and economic pains. The options are presented in order of rising sovereignty gained and economics costs paid. First is the 'Norway option', which entails almost full participation in the Single Market, where this means free movement of goods, services, capital and people. It also involves making contributions to the EU budget and participating in EU programmes for students (e.g. Erasmus) and researchers. Norway, and other members of the European Economic Area (Iceland and Liechtenstein) operate with this deal. Switzerland has a deal that is very close to it, but with slightly higher sovereignty and slightly higher economic costs.

Second is the 'Canada option', which means free trade in most industrial goods and some liberalization of services and investment flows, but no passporting and no automatic right for Brits to work in the EU or for EU citizens to work in Britain. This is essentially the deal Britain ended up with in the TCA. The third was the 'WTO option'. This would have seen the imposition of tariffs against UK goods and a rise in barriers to UK service exports. During much of the negotiations under Prime Minister Johnson, this was referred to as a 'no deal' Brexit. It would have led to important disruptions of trade – especially international supply chains in industries such as autos. The fact that it would have caused great harm on both sides of the EU-UK border was used by Johnson as leverage during the negotiations. He hoped that the threat of inflicting such pain (on the EU) and enduring such pain (in the UK) would strengthen his hand in the TCA talks.

This option would be highly disruptive to the UK economy. It would have faced about a sixth of UK exports to the EU27 with tariffs exceeding 7 per cent. Importantly, this would have included motor cars,

Figure 21.6 Options for the remarriage deal



Source: Authors' elaboration.

which would have had to pay a tariff of 10 per cent. Such tariffs would surely induce large parts of the UK car industry to 'vote with their feet' for the Single Market by moving to the EU.

Were there other options? Before the referendum and in the initial phases of the Brexit talks, some Leave campaigners claimed that the UK could negotiate a deal that had the best parts (from the UK's perspective) of the Norway option and the Canada option. For example, John Redwood, a Member of Parliament for the Conservative Party who Reuters described as 'an intellectual leader of the Brexiteers' told Reuters in July 2016: 'Ideally we just keep tariff-free trade and passporting and all the other arrangements we have at the moment.' Passporting here refers to the guaranteed access to the EU market for UK-based financial firms – one part of the Single Market that has greatly benefitted Britain, given the importance of services in its export mix. He went on to assert, 'I think it is very likely we will keep that because I think they want them as much as we want them.'

As four and a half years of negotiations, two changes of prime ministers showed, the EU was not willing to let the UK have a special deal. The real problem is that each EU member would like to pick and choose among the Single Market rights and obligations. But allowing this would break the cohesion of the Single Market and thus undermine its contribution to EU economic prosperity. Given that individual members cannot pick and choose, it was politically impossible for the EU to offer such a deal to a non-member. The group of EU national leaders, the European Council, stated this clearly, right from the start of negotiations and maintained the position throughout.

21.3.3 The new EU–UK trade deal

The 'cohabitation deal' puts the United Kingdom outside the Single Market and outside the EU's Customs Union. It thus gives the UK the ability to set separate regulations and tariffs with third nations while keeping tariffs on EU-UK bilateral trade at zero. It is basically a classic but not very ambitious free trade agreement that allows tariff-free and quota-free trade in goods but little beyond that. There is little of 'mutual recognition' that avoids regulatory barriers and only modest commitments to free trade in services.

This chapter is being written in the Spring of 2021 when the British newspaper headlines are filled with stories of long delays and big drops in exports from the UK to EU. These are due to paperwork and regulatory checks that arose from the UK's departure from the EU's Single Market (on 31 January 2021).

Trade in goods – free trade but outside the Customs Union

Exports in both directions will continue to enter tariff-free (as they have been for over 40 years), but since the UK left the EU's Customs Union, the two-way trade will be subject to new regulatory barriers that raise the cost of trading with and doing business in the EU27. It is useful to think the new barriers are related to the UK's departure from the Customs Union on one hand, and departure from the Single Market on the other.

Having left the Customs Union, the UK is free to strike free trade agreements with third countries, like the USA. But if the UK charges no tariff on imports from the USA, and the EU charges no tariff on imports from the UK, the possibility of 'tariff evasion' arises. Without strict rules defining which goods are actually made in the UK, US automakers could evade the EU's tariff on US cars by exporting the cars to the UK and immediately re-exporting them to the EU.

The rules necessary to prevent this tariff cheating have the self-explanatory name of 'rules of origin'. Decades of experience and abundant empirical work have shown that these rules are costly for firms in the UK and the EU. These costs – which did not exist before Brexit – will hinder bilateral trade in goods. The rules of origin for cars are particularly stringent. UK-made gasoline and diesel vehicles must have at least 55 per cent British or EU content to escape the EU's tariffs.

Having left the Single Market, the UK is free to set its own regulations and standards. It also means that British products will face new barriers in EU27 markets. One aspect of the Single Market that facilitates trade is so-called 'mutual recognition' (see discussion in Chapter 1) of product standards. In practice this saves manufacturers the time and costs of having their products tested and certified as meeting product standards in their customers' markets. As a member of the Single Market, UK manufacturers could certify once (for the UK market) and sell everywhere in the EU. The cohabitation deal does not include an agreement on mutual recognition so UK regulatory bodies cannot certify products as meeting EU standards and regulation. Again, this faces UK and EU exporters with costs and delays that did not exist before. The ultimate importance of these new barriers is unclear, but they have resulted in a significant drop in EU–UK trade in the first months of 2021.

Financial services – no firm commitment to free access

The UK has a marked comparative advantage in financial services and indeed London is one of the most prominent financial service centres in the world. Despite this, the Conservative governments negotiating Brexit gave no priority to the sector. The existing trade agreement contains only vague language and a commitment to continuing discussions.

Trade barriers in financial services mostly take the form of regulations that restrict which financial services can be sold in the EU or UK markets. When the UK was inside the Single Market, firms located in London had an automatic right to sell services anywhere in the EU, and conduct business on behalf of clients located anywhere in the EU. The idea was that since the UK was inside the Single Market's regulatory system, there was no need to check that UK financial rules were sufficient to protect EU consumers. Now that the UK is outside the Single Market, UK-based firms no longer have that automatic right. To reacquire those rights, the EU has unilaterally to grant the UK 'equivalence', which means that the EU recognizes the UK's regulatory system and rules as equivalent to those of the EU.

The two sides are discussing the possibility of the EU granting an 'equivalence ruling', that would allow UK-based firms to sell financial services into the EU market, but these are not really negotiations. Under EU law, it is the European Commission that is in charge of granting equivalence and they do it based on their evaluation of the regulations in the non-member (in this case the EU). As of early 2021, the Commission has not granted equivalence, so UK based firms have lost some access to the EU market. Due to this, a number of financial institutions have shifted activity to inside the EU27 – especially Amsterdam, Dublin, Frankfurt and Paris.

Rules on a regulatory 'level playing field'

One claim that was repeatedly made by pro-Brexit politicians was that Brexit would allow Britain to remove costly EU regulation and thus increase the attractiveness of the UK as a production base compared to the EU. To avoid competition based on lax rules, the TCA contains provisions that limit this possibility. They are called 'level playing field' provisions.

The need for such rules stem from a unique starting point. Since the UK was in the EU since 1973, they begin the new relationship with largely harmonized regulations and profoundly integrated markets that were built on the regulatory convergence. The TCA provides means of controlling future divergences.

Divergent trends could change competitive conditions and the EU feared that the UK would seek to improve its competitive position against EU27 firms via lax standards while continuing to enjoy tariff-free access to EU markets. The provisions cover issues such as competition policy, state aids, behaviour of state-owned enterprises, and taxation as well as labour, social and environment standards. As part of this, the TCA establishes a mechanism – the 'rebalancing mechanism' – that allows both sides to impose tariffs if regulatory divergences put businesses on either side at an unfair disadvantage.

Subsidies to companies – state aids in EU parlance – are also subject to a disciplining device. EU firms can challenge state aids awarded to their UK competitors in Britain's national courts, and UK companies enjoy equivalent rights in the EU. There is also an urgent action provision that allows either side to unilaterally impose tariffs to counter trade-distorting subsidies. The strictest and most detailed level-playing-field rules concern social and labour standards, and environmental objectives such as climate policy.

Fishing

While only a tiny part of the UK and EU economies, Prime Minister Boris Johnson's government elevated fishing negotiations into a headline dispute. It became an emblem for how 'taking back control' could be used to promote the interest of British firms and workers.

As an EU member, the UK fishing fleet was subject to the Common Fisheries Policy. This allowed EU fishing boats a catch quota in UK waters. Under the TCA, the UK fishing fleet gets to keep its previous quota and is allocated a quarter of the quota previously allocated to non-UK boats. In exchange for cooperation on fishing quotas, the two parties grant each other duty free market access. After a few years, the deal will be revisited.

Professional services

As Single Market members, UK professionals enjoy widespread mutual recognition of their professional qualifications in the EU and the UK reciprocated. With the TCA, the automaticity disappears. Practically, this means that doctors, nurses, dentists, pharmacists, vets, engineers and architects will have to have their qualifications recognized in each EU nation they wish to practise in.

Agriculture

Trade in farm goods will enjoy zero-tariff and zero-quota treatment across the border, but this does not mean there will be free trade. The lack of mutual recognition means that strict sanitary rules will be enforced immediately. This will create new hurdles at the border.

An example of such barriers briefly made British headlines in February 2021 when British exports of live shellfish (oysters, clams and mussels) started to be treated the same as those from any other non-EU nation. As member, Britain participated in the formulation and embraced the rules that ban live shellfish from non-members. When these were applied to British exports, the UK requested an exception that they had not negotiated in the TCA. The EU refused. A story in the *Financial Times* on 11 February 2021 quoted an EU official as saying: 'There will be no new export health certificate at the end of April for any third country, including the UK. British exports have to fulfil the rules applied to a third country.'

Specifically, the EU has a blanket ban on the import of live shellfish that are caught in waters that are considered as being of 'class B' cleanliness. This covers shellfish caught in waters off Wales and the south-west of England, but not Scotland whose waters are in 'class A'.

21.4 What are the long-term economic consequences of Brexit?

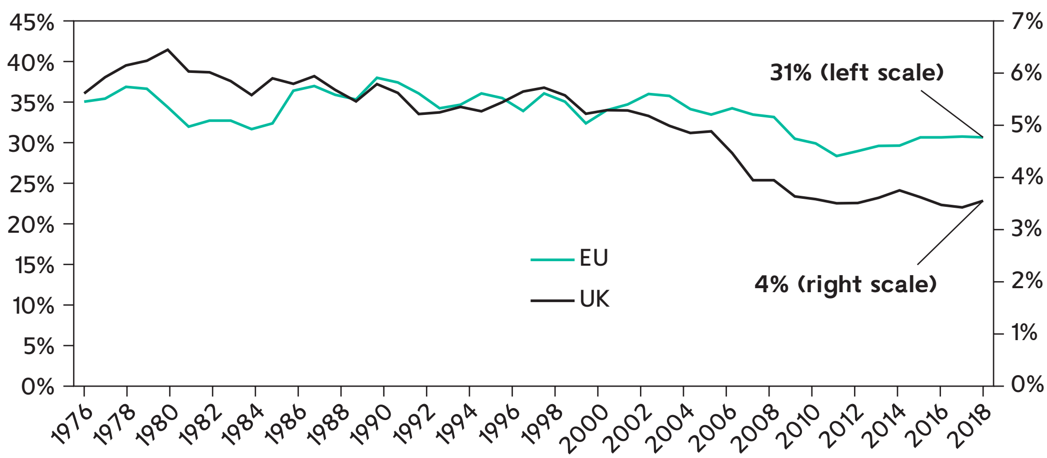
Britain is heavily integrated with the EU27, but given the enormous size difference, the integration is very asymmetric. This section looks at the economic consequences of Brexit. It starts with a quick review of Britain's economic position in the world, and the economic relationship with the EU27.

21.4.1 Conditioning facts: Britain's economic position in the world

The UK is a medium-sized economy by world standards. Its share of world GDP is 3 per cent (measured at market prices and exchange rates). That makes it the 6th largest individual economy in the world behind USA, China, Japan, Germany and India, when looking at individual nations. The EU27, however, is very much a united economy and it is very much larger; about six times larger in terms of total output (i.e. GDP).

The size asymmetry is even greater when it comes to trade. In terms of world exports, Britain is dwarfed by the main trading powers – China (11 per cent), the EU27 (31 per cent), and the USA (10 per cent). As Figure 21.7 shows, the EU's share was fairly steady at about 35 per cent until the early 2000s when it declined to about 31 per cent. The UK's world share, by contrast, declined continuously since the 1970s with a noticeable acceleration from the early 2000s.

Figure 21.7 UK and EU share of world exports of goods and services, 1976–2019



Notes: Exports are 'Exports of goods and services (current US$)'. The EU exports include trade within the bloc since UK exporters compete with EU exporters inside and outside the EU.

Source: Authors' elaboration of public data from World DataBank, World Bank.

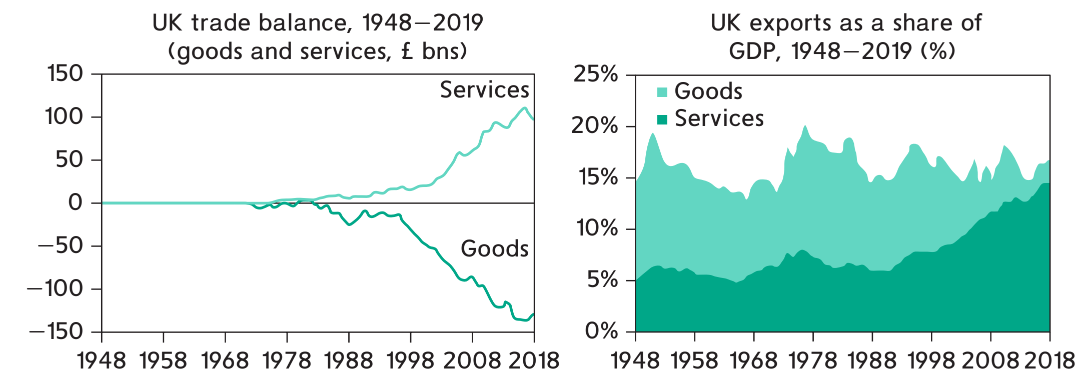
An important aspect of Britain's trade reality is its dependence on service exports. As the left panel of Figure 21.8 (overleaf) shows, the country is a net exporter of services and has been since the 1970s. The fact that it exports more services than it imports is evidence that it is competitive in services. The trends show that this competitive edge has been growing steadily. By contrast, it does not have a 'revealed comparative advantage' in goods since it imports a value of goods that exceeds its exports of goods. Again, on the evidence, this competitive disadvantage has been getting stronger since the 1970s.

The right panel of the figure shows how different the trends have been for goods versus services. That is to say, the share of goods exports in British output (as measured by GDP) has remained fairly steady for decades, but the share of service exports has risen steadily since the late 1980s. This fact suggests that the failure of the government to negotiate better access for UK services into the EU market will have negative consequences in the future.

21.4.2 Conditioning facts: Britain's economic relationship with the EU27

A little less than half of British exports are purchased by EU nations, taking goods and services together. As Figure 21.9 shows, the share of which is made up by services has been rising steadily and is now about 40 per cent of the total.

Figure 21.8 UK trade in goods versus services, 1948–2018



Source: Office of National Statistics, UK government.

Figure 21.9 UK total exports to EU (£ millions, right axis), and services share of total (%, left axis), 1999–2019

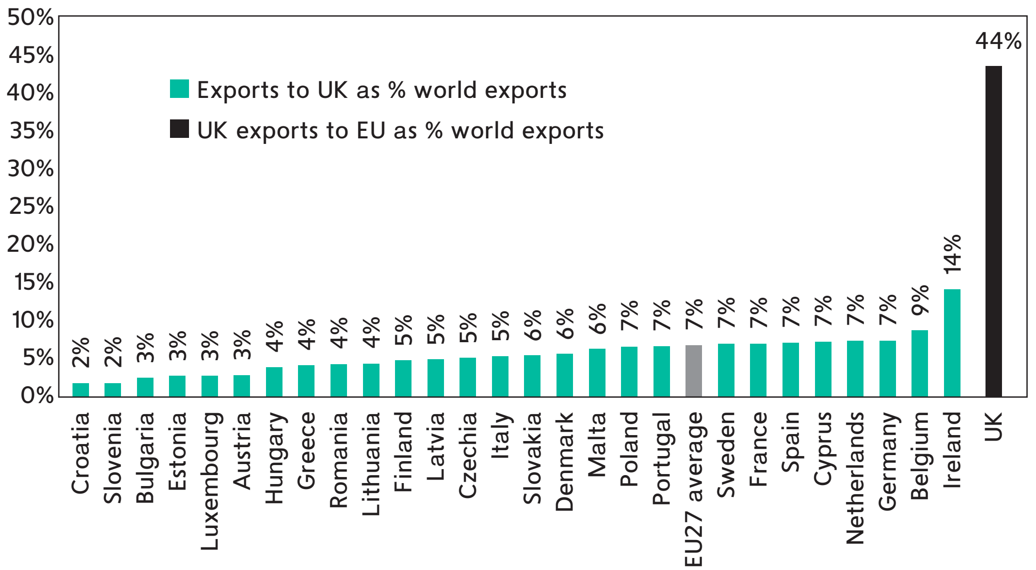
Source: Office of National Statistics, UK government.

When it comes to the economic impact of Brexit on the UK versus the economic impact on the EU, it is important to look at the two-way mutual dependence. When thinking about how much the UK needs the EU market and how much the EU needs the UK market, bilateral trade flows are important. We look at the EU27 as a whole since from a trade policy perspective the EU27 acts as one – on tariffs since it is a customs union, and on regulation and most other openness policies – including services – since it is a Single Market.

So how much does the UK rely on the EU27 market for its exports? And how much does the EU27 rely on the UK market? The answer, shown in Figure 21.10, is that the dependence is extremely asymmetric. The EU market is critical to the UK's export success, while the UK market is only a minor consideration for most EU nations. In total, the UK market only amounted to about 7 per cent of all EU27 exports. For Britain, the situation is completely reversed. The number is seven times higher. Specifically, the EU is Britain's predominant market accounting for 47 per cent of all its export sales.

This extreme asymmetry in export dependency is one of the reasons that the UK had so little negotiating leverage with the EU between 2016 and the end of 2020 when the final deal – that is, the 'cohabitation agreement' – was struck (technically known as the Trade and Cooperation Agreement, or TCA for short). There is an important subtlety here. Since the EU makes its decisions cooperatively, it is not the average position that matters, it is the position of the majority of members. From this voting-on-trade-policy angle, it is important to note that for 14 of 27 members, the UK market accounts for 5 per cent or less of their total exports. Even for Ireland, which is a natural trading partner given its proximity and historical ties, the figure is only 14 per cent. This political economy reality meant that the threat of a sudden disruption of trade (which would have happened if the TCA had not been agreed at the last minute) weighed much more heavily on Britain than it did on the EU members.

Figure 21.10 EU nation exports to UK as share of their total exports and UK exports to EU27 as share of its total exports (2015)



Source: Authors' elaboration of public data from World DataBank, World Bank.

21.4.3 Estimates of the economic impacts of Brexit

There are many estimates of the long-term impact of Brexit on the UK economy.

These ask the simple question: How much larger or smaller will the UK economy be after Brexit compared to what it would be if it had remained in the EU?

Since the cohabitation deal was only settled on 24 December 2020, the studies have to estimate the impact of the three main variants discussed above, namely staying inside the Single Market (the so-called Norway or European Economic Area (EEA) option), the Free Trade Agreement option (which is what was actually chosen in the end), and the World Trade Organization options (the so-called 'crashing out option'). These options are ranked in order of increasing gain in economic sovereignty.

As expected, different researchers arrive at different answers since they use different economic approaches and make somewhat different assumptions about exactly what the three options would mean about trade barriers in the future.

Despite the differences, the studies paint a remarkably consistent picture:

- All three options would result in economic losses for the UK.
- There is a clear trade-off between sovereignty and economics; the higher is the sovereignty gain, the higher is the estimated economic loss.

The various estimates are shown in Table 21.1. Focusing on the middle column as this is close to the 'cohabitation deal' that was agreed in December 2020 (the TCA), we see that estimated loses in UK income by 2030 range from quite small, –0.8 per cent to reasonably large, –12.5 per cent. Only time will tell which of these is closer to the truth, but the losses and slower growth that the UK has already experienced in anticipation of Brexit (see Figures 21.2 and 21.3), it would seem that the losses will be substantial.

Table 21.1 Estimates of the long-term impact of Brexit on GDP, relative to remaining in the EU

	Cohabitation deal option considered:		
	EEA	FTA	WTO
Rabobank	−10	−12.5	−18
CEP dynamic	−6.3		−9.5
CPB static		−3.4	−4.1
CPB dynamic		−5.9	−8.7
Treasury	−3.8	−6.2	−7.5
HMG	−1.6	−4.8	−7.7
RAND	−1.7	−1.9	−4.9
NIESR	−1.8	−2.1	−3.2
Oxford Economics		−2.7	−4.6
PwC		−1.2	−3.5
CEP static	−1.3		−2.7
Ciuriak	−1		−2.8
Bertelsmann	−0.6		−3.8
Open Europe		−0.8	−2.2

Note: Most of the estimates show the change in the level of UK GDP in 2030; see Tetlow and Stojanovic (2018) for details and references. CEP = Centre for Economic Performance, CPB = Netherlands Bureau for Economic Policy Analysis, HMG = HM Government, NIESR = National Institute of Economic and Social Research.

Source: Authors' elaboration of Tetlow and Stojanovic (2018) Figure 1.

Importantly, the estimates do not take account of the possibility that the newly gained sovereignty will be used by the current and future governments to undertake pro-growth policies that they were unable to do as EU members. Indeed, Prime Minister Boris Johnson declaimed, 'this moment is finally upon us and now is the time to seize it', on the day the UK Parliament formally approved the TCA. Commenting on this, an editorial of the *Financial Times* newspaper on 3 January 2021 noted, 'for all the slogans of the past five years, Boris Johnson's government has never defined a coherent vision for what to do with the new freedoms Brexit offers'. This may not be due to a lack of political initiative; it could reflect the very limited expansion of *economic* space that comes with the Brexit-boost in sovereignty.

All lists of pro-growth policies involve improvement of education and training opportunities and promoting research and development. Such policies, however, were not hindered by EU membership. Another possible long-term gain (in terms aggregate GDP) might come from de-regulation that deviates significantly from the EU's Single Market regulations. This road, however, is limited by the 'level playing field' provisions in the TCA. If the UK embraces tax cuts and regulations that undermine the competitiveness of EU firms inside the UK, the TCA allows the EU to counter by imposing tariffs against UK exports to the EU.

The only concrete plans for using the new-found sovereignty over trade policy involves signing free trade agreements with third nations. There is a hope that this will stimulate new exports. There are two problems with this line of reasoning. First, it is not clear why the UK had to depart from the EU in order to take advantage of rapid growth in Asia. UK exports to the region have been growing faster than average during the past two decades even while UK was an EU member. Second, the EU already has free trade agreements with some of the UK partners and is negotiating agreements with others. Of the UK's top 25 export destinations (which includes all the market that absorb at least 1 per cent of UK exports today), 13 are EU members. For these destinations, Brexit has worsened access for UK-based firms. Another eight partners already had free trade agreements with the EU, so Brexit would have meant a loss of free trade access that the UK has had to renegotiate with the eight partners.

The remaining UK partners include the US (20.5 per cent of UK exports), China (4.4 per cent of UK exports), India (1.1 per cent), and Australia (1.7 per cent of UK exports). For these, Britain may be able to negotiate better access than they would have had as EU members.

21.5 Why were the Brexit negotiations so long, difficult and messy?

To outsiders, the Brexit process looked like a complete mess. Two changes of prime ministers, two general elections, two supreme court rulings of unconstitutional actions by the prime ministers, a UK government charged with 'contempt of parliament' by its own parliament, and much more. Steven Erlanger, the chief diplomatic correspondent in Europe for the *New York Times*, described it as 'messy and self-destructive'. Rosa Balfour, a senior fellow at the German Marshall Fund in Brussels said Britain had 'gotten itself into a right old mess, making itself ridiculous to its European partners'.

How did British policymaking arrive at such a dismal state? The explanation comes in the form of a real-life morality play that has enough twists to fill a two-season Netflix political thriller.

It begins with a huge political gamble.

21.5.1 Cameron gambles EU membership for the sake of party politics (and loses)

Facing a difficult general election in 2015 and a party that was deeply divided on European issues, Conservative Party leader David Cameron quieted the pro- and anti-Europe factions by promising to put the question directly to British voters in a referendum.

It was a two-part gamble. The first was that the Conservatives would win the election. The second was that he could go to Brussels, renegotiate the terms of British membership, and then win the referendum (Cameron was strongly pro-EU membership). If he won, the gamble would give Cameron intra-party peace for a few years, and he could carry on with the policies he really cared about. If he lost, Britain was in for the most radical economic policy change his country had seen in two generations, but he could resign and hand the mess over to the Eurosceptics in his party.

The gamble was not without precedence. Faced with a Labour Party that was deeply divided over European issues in the 1970s, Labour leader Harold Wilson placed an almost identical bet to keep his party together and his country inside the EU. Wilson won both parts of the gamble. Labour won the general election. In 1975, he renegotiated the terms of British membership that had been struck by a Conservative government in 1972 and held a referendum. Wilson, who was pro-Europe, won a resounding victory in the referendum. Two-thirds voted to stay in, and that included a majority in every district of the country apart from a few Scottish islands. The Europe issue was put to sleep for decades. That surely was the outcome David Cameron was gambling for.

Informed insiders, opinion polls and the financial market all believed Cameron would win his second bet. He did not. It is hard to say why so many got it wrong. Jen Kirbyjen, writing on Vox.com in January 2020, lists some reasons: 'Taking back control. Populism. Immigration fears. Better trade deals. English nationalism. Anger at the political establishment. Deindustrialization. Misinformation. Russian interference – whatever the combination reasons, spoken or unspoken, 17.4 million people voted to Leave.'

The 2016 vote split the country along geographical, generational and educational lines. Scotland voted Remain, thus reviving talk of Scotland leaving the UK. London also voted to stay by a wide margin as did Northern Ireland. Wales went for Leave. The generations were divided. Almost three-fourth of voters between 18 and 24 voted Remain; 60 per cent of those over 65 voted Leave. On the morning of the result, the deputy leader of the Labour Party, Tom Watson, said 'We end this referendum more divided than when we started it.'

Cameron resigned the morning after the vote. The two main leaders of the Leave campaign, Conservative politicians Boris Johnson and his right-hand man, Michael Gove, held a victory press conference that morning. By that time, the pound had nosedived overnight, and the London stock market had crashed 9 per cent in the first 10 minutes of trading. *The Guardian* newspaper described the men as looking 'shell-shocked . . . Their short speeches were funereal in tone, no smiles.' You can easily find photos and videos online and judge for yourself what their mood was after this epic victory for their cause. Johnson was widely expected to become prime minister.

And then came a classic Netflix twist. Michael Gove turned on Boris Johnson in what Politico called 'A very British betrayal'. Johnson withdrew his name. A few days later, the Conservative Party turned on Gove, forcing him to withdraw. In the end, there was only one name in the contest. Within days, Theresa May was leader of the Conservative Party and prime minister of the UK.

There was enough drama here for a whole Netflix season, but it proved to be just the pilot episode.

21.5.2 Theresa May gambles for Brexit against party control (and loses control)

Prime Minister May's first and most pressing task was to find a plan for Brexit that would attract wide support within her own party. This was always going to be difficult. Even the leaders of pro-Brexit campaign could not agree what trading relationship Britain should have with the EU after leaving.

Inconsistent statements based on misunderstandings of the EU or wishful thinking were rife even after the vote. No one exemplified this better than Leave-campaign leader Boris Johnson.

On the morning after the vote, 26 June 2016, Johnson claimed post-Brexit relationships would involve three inconsistent things: continuing British access to the Single Market, ending British compliance with Single Market regulatory harmonization and European Court of Justice (ECJ) oversight, and ending free movement of EU citizens into Britain.[1] The following day, an EU diplomat quoted by *The Guardian* newspaper, pointed out the inconsistency: 'It is a pipe dream. You cannot have full access to the single market and not accept its rules.'

The Single Market consists of four freedoms – free movement of goods, services, people, and capital – and regulatory coherence overseen by the ECJ is one of its essential pillars. In reality, Britain had to choose between Single Market access to the EU's enormous market, on the one hand, and ending free immigration and enforced regulatory coherence, on the other. Britain could not choose both – a fact that Johnson surely knew or should have known. Johnson was asking British citizens to do what the White Queen instructed Alice to do in *Alice in Wonderland;* to believe 'as many as six impossible things before breakfast'.

As prime minister, Theresa May did not have the luxury of playing make-believe. She had to negotiate a Brexit deal with the EU. She had to make hard choices and line up political support for them inside the UK parliament.

As a supporter of Remain, May faced scepticism from Tory Eurosceptics. This did not help with her search for consensus on a plan for Brexit. It took eight months for her to finally publish her plan for Brexit (the Brexit White Paper). To put it generously, her plan was ambiguously worded and avoided the hard choices. More frankly, it embraced Johnson's tactic of wishful thinking and double talk. For example, it said the UK would be leaving the Single Market, but it said the UK would be staying in the Single Market for some things. It said the UK would be leaving the EU's Customs Union, but it said it would be using

[1] *Daily Telegraph* newspaper column by Boris Johnson, 'I cannot stress too much that Britain is part of Europe – and always will be', 26 June 2016.

unproven technology to allow it to act as if it were in the Customs Union. The precise plans for Northern Ireland were unclear.

To get around her inability to gain support for any clear plan in the UK parliament, the prime minister placed a risky bet. Her gamble, like Cameron's, had two parts.

- First, create an 'ultimatum' for the UK parliament by pulling the irreversible 'Brexit trigger' even though the UK had no clear, broadly agreed plan for the divorce deal or cohabitation deal. She did this on 29 March 2017, so the ultimatum would have to be exercised on 29 March 2019.

The idea behind this ultimatum requires a bit of background. The EU's legal instrument governing exits (Article 50 of the Lisbon Treaty) sets a two-year clock for exit negotiations. Membership would end – with or without an exit agreement – two years after the member announced that it wanted to leave. This was designed to avoid a member being interminably half-in and half-out.

Given this, starting the Brexit clock created a cliff edge, or ultimatum on 29 July 2019. The prime minister would negotiate the best deal possible with the EU and then face her divided party with a 'my deal or no deal' choice so close to the cliff edge that it would, in essence, be an ultimatum. Counting on common sense, she must have supposed that a majority of members of parliament would choose to avoid crashing out of the EU – an outcome that was widely assumed to be disastrous economically.

- Second, she called a General Election in the hopes of strengthening her negotiating position within her own party.

She had inherited the narrow parliamentary majority that David Cameron had won in the 2015 general election. The narrowness of the majority gave veto power to the most extreme pro-Brexit faction in her party. She gambled that a new election would dilute their power.

She lost both bets. The second one immediately; the first one eventually.

The gamble goes wrong

The June 2017 election was a disaster for the prime minister. She ended with minority government supported by a tiny party with extreme views on Brexit – the Northern Irish Democratic Unionist Party (DUP). *The Economist* magazine described the DUP as a party 'rooted in conservative and ultra-conservative forms of Christianity'. The party arose during the Protestant-Catholic violence that the Good Friday Agreement had ended. Its founder, Ian Paisley, was a leading voice on the Protestant side back then. This meant that the prime minister now had two groups in her coalition with extremely uncompromising views – and both of them had veto power over her decisions.

Although it was not at first apparent, it turned out that including the DUP transformed the Brexit puzzle from something that was difficult into something that was impossible. The DUP refused option 2 from Figure 21.5, or anything like it that put the boundary of the EU Single Market in the Irish Sea (thus raising barriers between Northern Ireland and the UK's internal market). The Eurosceptics refused option 1 from Figure 3.1, or any deal that left England inside the EU's Single Market. The EU refused any deal that put the EU's Single Market boundary between Ireland and Northern Ireland. All options were off the table, but it would take another year before this reality revealed itself.

The second part of Theresa May's bet also went horribly wrong, but not all at once. Her legislative strategy seems to have assumed that she could prevent the UK parliament from holding a meaningful vote on her Brexit deal (i.e. a vote that could force the prime minister to renegotiate with the EU). It also assumed that the cliff-edge nature of the end of British membership would force the quarrelling factions to face up to the hard choices. Both assumptions turned out to be false.

In the autumn of 2016, a British court ruled that the government's legislative strategy was unconstitutional; parliament would have to get a meaningful vote on the eventual Brexit deal. May's government appealed the ruling, but the UK's supreme court backed it. This meant that May would indeed have to choose a plan that attracted support from both DUP and the Eurosceptics.

The second assumption also proved false when, on the eve of the cliff-edge date, parliament instructed May to request an extension. She did, and the EU granted it. Her premiership ended soon afterwards, but that is getting ahead of the story.

This was the end of season 1 of the imaginary Netflix series. Like all good Netflix series, it ended with the hero facing a seemingly insurmountable challenge. Having lost her parliamentary majority, Theresa May started Brexit talks with the EU.

21.5.3 UK–EU Brexit talks begin

While the UK's position was intentionally obfuscated to maintain domestic coherence, the EU's position was clear, unified and remained consistent through the talks. Following standard EU practices, the European Council – the body made up of the leaders of all EU members (excluding UK in this instance) – adopted 'negotiating directives', which you can easily find on the web. These set out the framework for the talks and the EU's goals.

Based on the EU's law (Article 50), the EU directive called for the talks to be structured in two phases and this is indeed how the talks proceeded. The first phase was to settle the main exit problems – none of which were particularly tricky. Anticipating future problems over Northern Ireland (which did in fact arise), the EU also insisted that phase one settle the Northern Ireland question. The solution would have to be permanent, legally binding, and consistent with the EU's two redlines: maintenance of the cohesion of the EU's Single Market – so Ireland had to be in the Single Market – and safeguarding the Good Friday Agreement – so Northern Ireland had to be in the Single Market.

The talks proceeded in a timely manner. By December 2017, the UK and the EU concluded that sufficient progress had been made on the phase one issues (the divorce agreement) to allow the talks to move on to phase two issues (political discussions about the cohabitation deal). Article 50 states that the actual cohabitation talks could not begin until after the member had left (so they would be treated as any other non-member country). Thus phase two was aimed at negotiating a 'political declaration' on what the eventual, post-exit relationship would look like.

In March 2018, the EU and UK published a draft of the divorce deal, which came to be called the Withdrawal Agreement. Both sides agreed that they needed to soon produce a legally binding version. Only 75 per cent of the draft Withdrawal Agreement was agreed, and as the remaining 25 per cent included all the most difficult issues, the wishful thinking and double talk could continue until the final version was published. That took seven months.

When the legal text was published in November 2018, the trouble began immediately. The UK's lead negotiator, devoted Brexiteer Dominic Raab, resigned in protest.

The trouble begins in the UK parliament

The Withdrawal Agreement included many uncontroversial elements on budget matters, intellectual property rights, and so on. It also included a legally binding, permanent solution to the Northern Ireland problem in the form of the 'Northern Ireland Protocol'. The Withdrawal Agreement was to be a binding international treaty between the UK and EU, so the Protocol would have the force of international law. The Protocol did not specify what the solution would be. It provided a fallback solution (also called a 'backstop') in case the UK and EU could not agree a better solution before the transition to non-members was completed.

For non-lawyers, it is hard to truly comprehend what Treaty text really means, so May's government asked the UK's Attorney General to clarify the legal implications of the Protocol under UK law. The result – a letter from the Attorney General to Prime Minister May – turned out to be political dynamite. The prime minister refused to let the UK parliament read it. In reaction, the UK parliament found the UK government in 'contempt of parliament'. Contempt of parliament means the person or persons have deliberately and knowingly obstructed the will of parliament. This action forced May to hand over the letter. And that, in turn, proved to be the beginning of the end for May.

The letter revealed that the Protocol, were it to come into operation:

- Would be binding on the UK and it would be permanent
- That the boundary of the Single Market would lie in the Irish Sea (option 2 in Figure 21.5)
- That despite being out of the Single Market, the UK would have to observe a range of EU regulatory obligations.

The second point violated the DUP's red line. The third point arguably violated the Eurosceptics' red line. While it would take a few months of political intrigue and plotline twists, these implications meant that the Withdrawal Agreement would not be approved by the UK parliament. Nevertheless, the EU side approved the Withdrawal Agreement.

Brexit becomes reversible – final episode of season 2

Another Netflix-like thickening of the plotline came when the European Court of Justice ruled that the UK could renounce Brexit and stay as a member if it chose to do so. The case was brought before the European Union's highest court by Scottish politicians who sought legal clarity on the question of whether Britain could unilaterally revoke its exit decision. As the BBC explained on the day of the ruling: 'They believed that if the ruling went in their favour, it could pave the way for an alternative option to Brexit, such as another referendum.' This was in December 2018.

As parliament was widely expected to reject the Withdrawal Agreement, the EU court ruling opened the door to a possibility that horrified Brexiteers. One solution to a deadlocked parliament might have been to hold another referendum asking British citizens to choose whether they wanted to stay in the EU or exit under the conditions laid out in the Withdrawal Agreement. Faced with this, Prime Minister May delayed the parliamentary vote on the Withdrawal Agreement.

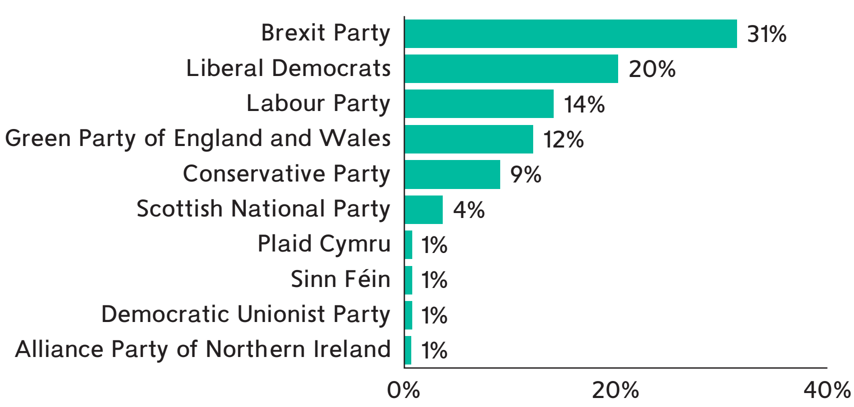
With the 29 March 2019 cliff edge looming, the UK parliament reconvened in January. Over the period of a few weeks, it rejected all possible solutions to the Brexit problem. It rejected the possibility of exiting without a Withdrawal Agreement, so no-deal Brexit (also called 'crashing out') was off the table. It twice rejected the Withdrawal Agreement in two 'meaningful votes'.

It then directed the prime minister to seek an extension of the 29 March Brexit deadline and the EU granted an extension. Subsequently, the government essentially lost control of the debate and parliament held a series of 'indicative votes' to see if any conceivable alternative to the deal in Theresa May's version of the Withdrawal Agreement would attract a majority of support among members of parliament. None of them did.

The third and final vote against Prime Minister May's Withdrawal Agreement came on the exact date that was supposed to be the cliff edge that would force a decision. May had completely lost her gamble. But she did not give up.

Having found insufficient support in her own party, the prime minister discussed compromises with the opposition leader, Jeremy Corbyn, that might win support. As history would have it, that was not to be. The imaginary Netflix drama had one more twist before the end of season 2.

Figure 21.11 Results of European Parliament elections in UK, 23 May 2019 (vote shares)



Source: Authors' elaboration of online available data, https://www.europarl.europa.eu/unitedkingdom/en/european-elections/uk_meps.html

The Brexit extension meant that the UK was still in the EU on the date of European Parliament election. This, in turn, meant that Britain was required by EU and British law to hold the election. The campaign becomes something of a second referendum on Brexit. The various parties – including the Conservatives – put their Brexit plans to the voters and the voters sent a clear message.

The governing Conservative Party was humiliated, and the opposition Labour Party was shamed. The leading vote winner, by far, was a newly founded, single-issue party – the Brexit Party. The runner up was the only other party that had maintained a consistent stance on Brexit – the Liberal Democrats who were staunchly anti-Brexit. See Figure 21.11 for details of the election results.

The next day, Prime Minister May announced her resignation. In one of the most ironic twists in the long Brexit saga, it is the EU democratic process that finally brought clarity to Britain's Brexit quandary.

This melodramatic finale brought season 2 to a close. Season 3 opened with one of the peripheral characters taking centre stage. The opening scene created an ominous atmosphere.

21.5.4 Boris Johnson gambles twice (loses one, wins one)

Boris Johnson became prime minister on 24 July 2019, fully committed to 'getting Brexit done'. The trouble is that he faced two stark realities.

- First, the cliff edge for leaving the EU was now 31 October 2019.
- Second, he was facing the same parliament Theresa May faced.

This parliament had just proved that they: (1) were not willing to pass the Withdrawal Agreement as it stood; (2) were unable to find a majority behind any conceivable renegotiated version of the Withdrawal Agreement; (3) were not willing to exit without a deal; but (4) were willing to request extensions.

In the face of this predicament, the UK parliament went for a six-week summer recess.

The Brexit 'speed chess' begins; the 'prorogue bet' is placed

The various Brexit factions presumably spent the summer scheming up next moves and countermoves. Prime Minister Johnson talked to a few EU leaders, but new negotiations went nowhere. When parliament returned on 3 September, the world witnessed a rapid-fire sequence of extraordinary events.

On the first day back, Johnson's government lost control of the parliament. A coalition of Labour and renegade Tory MPs started a process to tie Johnson's hands so that the UK could not crash out of the EU without a deal.

Specifically, the parliament started its elaborate legislative process on the so-called Benn Act (after Labour MP Hillary Benn). This would force the prime minister to do one of three things:

- Get a withdrawal agreement passed by the 31 October Brexit cliff edge
- Get MPs to pass a motion agreeing to a no-deal Brexit, or
- Write to the EU requesting a three-month extension of the cliff edge. The act even included the text of the letter that Johnson would have to send to the EU requesting the extension.

Johnson's countermove was to ask parliament to approve a new election. Parliament's countermove was to say 'no' and then to pass the Benn Act.

Johnson's countermove was truly historic. The prime minister convinced the Queen to 'prorogue' parliament on 9 September. This was to shut down parliament until 14 October, just days before the 31 October cliff edge. The prorogue would have restored the ultimatum that Theresa May had tried to establish. It meant that the UK parliament would have to either pass Johnson's deal, or crash out of the EU without a deal as there would not be time for a renegotiation with the EU. Johnson, in essence, was using the Queen's constitutional power to get back to Theresa May's strategy of preventing the UK parliament from having any meaningful input into the Brexit deal. Not everyone thought this respected Britain's democratic procedures.

The Speaker of the House (the title for the parliament's powerful referee), John Bercow, reacted immediately: 'However it is dressed up, it is blindingly obvious that the purpose of prorogation now would be to stop Parliament debating Brexit and performing its duty in shaping a course for the country . . . Shutting down Parliament would be an offence against the democratic process and the rights of Parliamentarians as the people's elected representatives.'

Two weeks later, on 24 September, the UK Supreme Court agreed with the Speaker. It ruled that Johnson's advice to the Queen was unlawful. They asserted that it would frustrate parliament from carrying out its constitutional functions without reasonable justification. Parliament resumed business the next day.

These were truly astounding events – the supreme court judged that the prime minister had given unlawful advice to the Queen, and then the Queen's prorogation was negated. But the events did shake things up. They broke the logjam created by Johnson's hard-line opposition to Theresa May's Withdrawal Agreement. Long bilateral talks between Johnson and Ireland's leader (Taoiseach) yielded key concessions that led to the UK and EU agreeing a new Withdrawal Agreement just in time for the 17–18 October summit of EU national leaders (European Council). With this agreement in hand, Johnson tried one more time to prevent the UK parliament from having more than a yes-no say.

When 19 October rolled around and Prime Minister Johnson had not accomplished either of the first two options in the Benn Act, he grudgingly sent the extension request to the EU President. 'Grudgingly' here means that he sent a photocopy of the letter that British law required him to send. He did not sign the letter, but he did send along a signed personal letter asking the EU President not to grant the extension.

The EU ignored Johnson's personal letter and granted the extension the UK parliament had requested (to 31 January 2020). Johnson had lost his prorogue gamble.

Johnson's second gamble pays off

With another three months to settle the Brexit quandary, Johnson called for fresh elections in December 2019 and parliament agreed. He was betting that the spirit that came through in the May 2019 European parliamentary elections would strengthen his parliamentary majority enough to get his new deal approved by the parliament. His gamble paid off handsomely.

The Conservatives won a crushing victory in the December 2019 elections; the Labour Party was simply crushed. The outcome completely realigned the British political world. Johnson had a strong personal mandate to 'get Brexit done'. Labour Party leader Corbyn resigned, and the DUP no longer had a veto over the Withdrawal Agreement. Johnson had a large outright majority of seats.

From here it was smooth sailing. The Withdrawal Agreement glided through the EU and UK democratic procedures without a hitch and the UK was out on 31 January 2020.

21.6 Concluding remarks

Given the deep economic integration that exists between Great Britain and the EU27, and given the long list of economic and political factors that were not fully resolved by the Brexit agreements, the concerns that plagued the Brexit process will surely continue to plague the current leaders of the EU and the UK. The aim of this chapter is to help readers understand why Brexit was so difficult, so meaningful, and so likely to affect the two economies in the years ahead.

One word that has not popped up is 'Covid-19'. This was discussed in Chapter 20 but it is worth saying that the cohabitation agreement negotiations were probably much easier than the divorce agreement – they lasted less than a year – at least in part because everyone was preoccupied with the pandemic. Brexit difficulties may once again fill the headlines as the pandemic fades. To put it differently, the last season of our imaginary Netflix drama ended with a flourish, but there was nothing in the final episode to rule out another season of political drama. This chapter will surely need to be updated next year!

21.7 Annex: Brexit's historical roots

Brexit is something that is both very new and very old. New since it became fully effective in January 2021. Old since many of the students reading this chapter would have been in secondary school when the June 2016 referendum happened. Even older since the parents of the readers would have been in secondary school when the first Brexit referendum was held in 1974. And perhaps even older than that since their grandparents would have lived through pro- and anti-Europe discussions in the 1950s. This section provides the historical background to Brexit. This is essential since we really do not know where Brexit is going, and understanding the past is the best guide to thinking about the future.

21.7.1 British exceptionalism

The sentiment of British exceptionalism – which was very much part of the Brexit movement – is longstanding but not ancient. For thousands of years, Britain was culturally, linguistically, and economically part of Europe (Box 21.2).

The first real Brexit occurred in the 1500s when Henry VIII – who was a staunch Catholic – and Catholicism was a unifying force in Europe. He was not against Catholicism. He just objected to the Pope being in charge of English Catholicism. He split with the Pope and was excommunicated for it.

British exceptionalism accelerated in the 18th century as it experienced the Industrial Revolution sooner and faster than the rest of Europe, thus becoming the economic envy of all of Europe. The distinctions deepened as it missed the transformative impact that the French Revolution had on the Continent. The second layer of exceptionalism was piled on during Britain's 19th-century rise to global superpower status.

The 20th-century decline in Britain's superpower status was compensated by its experience in World War II. As Charles Grant put it: 'Britain's relatively glorious role in the Second World War plays a potent role in nourishing Euroscepticism . . . British popular culture is still heavily focused on the Second World War as the country's "finest hour" . . . Virtually every other major European nation has something to be ashamed of in that war,' he claims.

This attitude of superiority surfaced strongly among older British voters during the 2016 referendum as it had been front and centre in the first British debates over membership. In the 1960s, former Prime Minister Clement Attlee said, when asked about joining the EEC6, 'I seem to remember that we spent a lot of blood and treasure during the War rescuing four of them from the other two.'

Box 21.2 Britain's ancient European roots

Iron Age Britain shared Celtic culture and language with much of Western Europe. Twenty-first century traces of this commonality are found in the Gaelic language groups in Ireland, Wales, Cornwall, Scotland and France. The commonality continued as Rome conquered most of the Western Celtic regions. Rome's rule north of the Alps lasted a few centuries – long enough for its urban civilization and language to leave a shared, indelible mark on Britain and indeed most of the Western and Southern European nations that are now part of the EU. When the Romans withdrew in the 5th century, all West European Roman territories were invaded by Germanic or Central European peoples. The Angles, Jutes, Saxons and Vikings invaded the British Isles just as the Franks invaded France, and the Goths invaded Italy, Spain and Portugal.

Several centuries later, in 1066, Britain was occupied and unified by Vikings who had embraced French culture – the Normans. French became the language of the English ruling class and it is why today's English so often has two words for the same thing – one with a French root, for example pork, and one with a Germanic root, namely, swine. (The upper class ate the meat, hence the French name, while the lower class raised the meat, hence the Germanic name.) For centuries after the Norman invasion, Britain was very much a part of feudal Europe. The Hundred Years' War (1337–1453), for example, was fought in part over an English claim to the French throne.

Source: Cunliffe (2008).

21.7.2 Post-war Euroscepticism switches from left to right

Today, Euroscepticism is mostly associated with the right flank of the Conservative Party. But as the 2016 vote results showed, Brexit was not a left-versus-right issue. At least part of the messiness of Brexit was caused by the deeply ambiguous personal views of Jeremy Corbyn – the Labour Party leader during much of it. It is thus useful to look back how the Eurosceptic crown passed from the Labour Party to the Conservative Party.

Back when left meant left and right meant right

It is hard for today's readers to comprehend how massive the political differences were between the British parties during the late 1940s and 1950s (and indeed the right and left parties in most European countries).

- The Conservative Party was pro-market and pro-US, or at least anti-Soviet.

The right-wing of the Conservative Party thought of imperialism as a good thing. They thought it most important to maintain trade with the colonies and dominions of the British Empire.

- The Labour Party was anti-capitalist and much less pro-US.

Right up until 1995, the constitution of Britain's Labour Party embraced the Marxist goal of nationalizing all the means of production. All factories along with all railroads, all energy and all communication companies were to be nationalized. An anti-EEC stance was part of this. The 1983 Labour Party manifesto, for example, committed Labour to exiting from the EEC as the Community would constraint the party's 'radical, socialist policies for reviving the British economy'. A majority of Labour voters and the left-wing branch of the Labour leadership were devoted to unilateral nuclear disarmament by the UK in the middle of the Cold War. The Labour leader during the first part of the Brexit saga, Jeremy Corbyn, believed deeply in both goals, and he argued for the UK leaving NATO.[2]

The one thing the parties agreed in the early 1950s was that Great Britain should stay out of European integration initiatives. European integration in the 1940s and 1950s was pushed by people who believed that deep economic and political federalism was the way to avoid World War III and build a bulwark against communism. These were led by 'The Six' (France, Germany, Italy, the Netherlands, Belgium and Luxembourg). The initiatives, which include the European Coal and Steel Community (ECSC), entailed far too large a loss of sovereignty for the UK's taste. For Labour, the loss would have been the ability to change Britain into a socialist economy. For Conservatives, the loss would have been unacceptable as a general matter but especially since it would mean disrupting Imperial trade patterns. For both political parties, and indeed most British citizens, the idea of pooling sovereignty with The Six ran counter to a strongly held belief in British exceptionalism. This exceptionalism is still very much alive today and central to Brexit and its aftermath.

As facts changed on the ground, however, British attitudes transformed.

Britain joins the European Economic Community

By the late 1950s, when today's EU – then called the European Economic Community – was taking shape, the ground had shifted for Britain in two ways. Britain's superpower status had evaporated in the shadow of US-Soviet rivalry (the 1956 Suez Crisis was the watershed), and the Continental economies were booming while Britain's economy was struggling.

When 'The Six' started the process of creating the forerunner of today's EU, the European Economic Community (EEC), Britain partook in the preliminary meetings but dropped out as they were not interested in economic integration that was as deep as was being discussed. The ground, however, shifted again.

Charles de Gaulle – a staunch defender of national sovereignty – won the 1958 French Presidential election. Although he did not revoke the Treaty of Rome (signed in 1957), he reversed the view on sovereignty. Instead of economic integration being the cost of achieving political integration, political integration became the cost of securing the gains from economic integration. This was an approach Britain could live with. De Gaulle's tempering of EEC supranationality, and the Soviet Union's crushing of democracy in Central Europe changed both Labour and Conservative attitudes. The fact that some of the Continental economies were growing twice as fast as Britain was also telling.

In the end, it was a Conservative prime minister, Harold Macmillan, who put in Britain's first application to the EEC. Although it meant abandoning Imperial trade policies, he believed that continuing to stay out of Europe would harm the UK's economy. Labour leaders were more prominently anti-Europe at the time – as membership would constrain their ability to shift Britain to a socialist system. De Gaulle, however, postponed the debate in Britain by vetoing the first two UK membership applications.

[2] Parkin, Frank (1968) *Middle Class Radicalism: The Social Bases of the Campaign for Nuclear Disarmament*, Manchester University Press, Manchester, p. 39.

The third UK application, made after de Gaulle left the political stage, was put in by another Conservative leader, Edward Heath. It succeeded in 1973. Labour was profoundly split on the membership issue, but Heath had the majority he needed to get membership approved by the British parliament. By the 1970s, Conservative's supporters in the business world were far more focused on European markets and production partners than on trade with the Commonwealth nations (most of which were ex-colonies by 1973).

Euroscepticism switches from mainly a Labour issue to mainly a Tory issue

As the 1970s turned to the 1980s and the 1980s to the 1990s, the mantle of Euroscepticism passed from hard-left Labour to hard-right Conservatives. The failure of Soviet communism undermined the most radical of Labour's economic policy ideas just as the acceleration of European integration heightened Conservative's fears of supranationality.

A pair of speeches in 1988 provide a convenient turning point for the switchover. The first was by the ultra-federalist Commission President, Jacques Delors; the second was by Margaret Thatcher who was vigorously pursuing pro-market policies that are sometimes called 'neoliberalism'. In his speech, Delors argued that Britain's labour movement should embrace a 'uniquely European model of society} and support the commission in building a 'platform of guaranteed social rights'. Europe, in other words, would be a way to slow or reverse the Thatcherite weakening of British unions' power in particular and neoliberalism in general.

Thatcher's riposte came 12 days later in her famous Bruges speech. She claimed that European integration beyond the Single Market would 'introduce collectivism and corporatism' and 'concentrate power at the centre of a European conglomerate'. 'We have not successfully rolled back the frontiers of the state in Britain,' she stated, 'only to see them reimposed at European level, with a European super-state exercising a new dominance from Brussels'.

The Bruges speech became a rallying point for Conservative Eurosceptics. Thatcher was ousted by her own party, but intra party fights over Europe dogged her successor, John Majors. The intra-Tory war was still raging when a very pro-European leader, Tony Blair, took the reins of the Labour Party in 1994 and crushed the Conservatives in the 1997 elections. Blair's successor, Gordon Brown, was as pro-European but had steered the country clear of Eurozone membership when he was Chancellor under Blair. All the while, the Conservatives were led by strongly anti-EU leaders who fanned the flames of intra-party warfare over the issue. Elements on the party's right wing began talking and writing about Britain leaving the EU.

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