

# Preface

The historical referendum on European Union membership was the second such event to take place in the United Kingdom since 2014—when the Cameron government organized the Scottish independence referendum. In an obvious way, a referendum in a Western country invites all voters of the respective country to indicate their view on a critical topic and may be dubbed the ultimate expression of democratic decision-making. Thus, one should expect careful preparation on the side of government and a lively debate between the pro and con sides. At first sight, the British EU referendum of 2016 was indeed organized according to this logic, but upon closer inspection one can easily understand how unprofessional the information campaign of the Cameron government had actually been. Under normal circumstances, with the expected referendum standards applied, the outcome of the referendum would have been—as will be shown—52.1% in favor of Remain. The reality was decisively different for several reasons, as we shall see, with a 51.9% majority in favor of Brexit—a historical result on June 23 which one may argue represents a surprising and hardly legitimate decision for leaving the European Union: an accidental Brexit. That is the title of this book, and it is not easy to consider that the United Kingdom, with

the benefit of a history of hundreds of years of rational decision-making in many key economic and political fields, should be characterized by a Brexit majority which is not the result of a solid decision-making procedure. Supporters of the Leave campaign will have a different view, but the facts presented here cannot be dismissed. In the end, the readers—and the British people—will have to decide how convincing the arguments of the political economy analysis presented are.

For the world economy, the UK's final decision on EU membership is crucial as the UK represented about 2.3% of the global economy in 2015 (based on purchasing power parity real income data from the World Bank), the EU27 stood for 14.5% in the same year. As regards the EU, Brexit clearly means a weakening of the European Union as the UK accounts for about 18% of EU28 Gross Domestic Product (GDP); for the UK, it could mean that its share in world GDP will fall below 2% as we shall see. The long-term Brexit effects will mean a weaker UK, probably a weaker EU, and a US gaining enhanced access to London, but simultaneously losing influence in Brussels. China's global role will be reinforced beyond its 17.3% share in world income in 2015, notably ahead of the US with 15.7%.

In a nutshell, the subsequent analysis is not difficult to understand, but many important details can only be explained in the book's individual chapters. On June 23, 2016, a majority of British voters decided to leave the EU, and this historical decision is an interesting development in and of itself; for an international economist, however, this is not necessarily a starting point to write a thought-provoking book: even if one might argue that the Brexit vote was rather unexpected by many observers. Among the key drivers for this study were, as a first point, the disorderly nature of the referendum: with the Cameron government commissioning Her Majesty's Treasury to prepare a 200-page study on the long-term benefits of the British EU membership and the cost of a potential Brexit, respectively, but then not mentioning the key finding of a 10% income loss in the extensive government information brochure sent to all households—thus undermining any chance for Cameron's almost certain victory in the EU referendum. Who is responsible for this unprecedented “Treasury-gate” in London and other surprising developments? One rather strange element including confusing conjectures from the side of government was the anti-EU migration

debate, with immigration portrayed to be a large economic and fiscal burden for the UK. What about the facts that show the opposite and why did the Cameron government not present these key facts to the British population? Should a democratic government be interested in facts? What is the motivation for a government to use very misleading rhetoric? What made many British voters so concerned about immigration dynamics beyond the economic aspects—obviously, the fear of a rising number of refugees from Islamic countries played a role along with the perception that immigrants from countries with different religious and cultural backgrounds are not easily integrated in the Internet age in which certain young immigrants can come under the online influence of radical religious leaders based abroad (the integration of immigrants thus seems to become more difficult and the traditional tolerance of modern Western countries seems to be weakening: the open society could become mentally rather more closed in a period of globalization). A third element of the motivation for this book was the fact that the European Commission had organized neither a professional monitoring of the run-up to the historical UK referendum nor ensured that Mr. Juncker, President of the European Commission, gave a pro-EU speech in London or Birmingham; rather, the US President Obama gave a speech in which he supported the EU integration project in the British capital. What is wrong with the EU? Inefficient regional policies, over-regulation, a lack of leadership? More than this. A fourth element was the desire to understand whether or not the May government's promise to conclude new free trade treaties—after Brexit—would generate the high growth impulses promised; in 2016, the Leave campaign even created the impression that the UK could prosper as a free trade leader in a renewed Commonwealth. The answer to such promises is clear-cut. A fifth motivation concerns the apparently very low short-term negative output effects of the referendum, and this naturally leads to the question about the medium- and long-term effects of Brexit: could leaving the EU come at zero cost? Certainly not, and it will be explained why this is the case and also that the effects involve not only the UK, but also the EU27, the US, and hence the world economy in the long run.

While finalizing the preface at the University College London and in a café close to St. Paul's Cathedral on March 3, 2017, I contemplated the first drastic foreign policy and trade policy changes associated

with Trump's victory in the presidential elections in the United States. Considering the information from Washington DC, Brussels, Berlin, Paris, and London through a theoretical economic lens, there was indeed an important question that to some extent is explored in this book: can the Global Britain project of the May government—with emphasis on free trade and free capital flows plus economic stability—really work in a situation characterized by the sudden weakening of the international institutional architecture with global international organizations such as the World Trade Organization and the Bank for International Settlements being actively dismantled by a protectionist and anti-multilateral Trump's administration—which Prime Minister May has deliberately chosen to be the UK's preferred partner? The book is also ultimately concerned with necessary EU reforms, including an overhaul of the Eurozone, the candidate countries for which are still chosen on the basis of the so-called convergence criteria, but not on the basis of the complementarily important optimum currency area literature. This is unwise, and not modifying the EU catalogue of Eurozone admission criteria would be irresponsible. As regards the speed of necessary EU reforms, one should not have the illusion that slow adjustments will work to stabilize the EU since with Brexit, the Trump victory in the US and the ongoing growth of China, there are at least three dynamics which require reforms to simultaneously be energetic and careful. The 2017 EU Commission's White Paper on the Future of the EU is not very convincing here. While it is true that EU integration problems are quite difficult, for every disease there is a cure.

There is also the new question of whether or not people in EU countries would support innovative elements of European integration and whether or not pent-up problems within the EU could be resolved? How will EU member countries react to the twin challenges of Brexit and Mr. Trump's election victory in the US? Given the fact that a majority of elderly voters in the UK are against British EU membership—according to exit polls after the referendum—and taking into account the graying of the EU's other societies, will it suffice to mobilize more young people in EU countries to express public support for the European integration project? What are the key benefits of a “neo-EU” that would be more in line with the challenges of the twenty-first

century and that could expect a broad majority in all countries of the EU? What could help to maintain EU integration as a role model for other regional integration schemes—and what implications does the new phenomenon of disintegration (assuming Brexit will be implemented in 2019) have for Europe, the US, and the world economy? The analytical challenge of a broader UK–EU27–US perspective on certain issues is not easy, but in the twenty-first century, no international analysis of economic dynamics is complete without considering the role of China in the politico-economic adjustment process. As regards the latter, only a few thoughts can be developed here, but in some fields, even a trilateral view of US, Europe, and Asia is important.

The June 2016 British referendum was a historical event, despite actually being the second EU referendum to be held in the United Kingdom, the first, in 1975, resulted in a clear pro-EU majority. For many observers, the result was rather unexpected, and it brought about a rapid change in the government of the UK, with Theresa May becoming the new Prime Minister. This was followed just a few months later by the also rather surprising success of Donald Trump in the US presidential election. One of the first actions of the newly-elected President Trump was to declare that the US would withdraw from the Trans-Pacific Partnership (TPP), a Pacific-area free trade agreement concluded by 12 countries—including Japan, Australia, Vietnam, Mexico, and Canada—Trump had already threatened that he would also withdraw from the North American Free Trade Agreement (NAFTA) and was eager to engage in only bilateral trade negotiations in the future. With the UK leaving the European Union, and the US moving away from TPP and NAFTA, the two leading historical, liberal, Western economies, which were world powers in the nineteenth and twentieth centuries, have now become leaders of disintegration. Strangely enough, the Australian Prime Minister has suggested that the US should remain a part of the TPP project—or the 11 partner countries might consider asking China to come on board. With the election of Trump and the Brexit referendum, the Western world and indeed the wider global community have changed enormously. Interestingly, the protectionist Mr. Trump received Mrs. May as the first international visitor after his inauguration. Prime Minister May is the leader of British global trade

liberalization—she presented her country as the Global Britain in her Brexit speech of January 17, 2017—suggesting the referendum had given her a pro-globalization mission.

The question of the legitimacy of the 2016 referendum is one issue, the other big question is to what extent Parliament will be involved. The Supreme Court in London has decided that authorization to trigger Article 50 of the Treaty of the European Union—and thus to declare the UK's intention to leave the EU—will need majority support in Parliament; Mrs. May initially wanted to write her exit letter without prior consent from Parliament. The Supreme Court's decision does not strengthen Mrs. May's position, and her decision to visit the White House in January 2017 might also raise some doubts: does the country of David Ricardo and Adam Smith, the pioneering free trade economists, really want to take sides with the neo-protectionist Donald Trump whose international economic policy agenda is so strange?

As the new Prime Minister, Theresa May emphasized in her speech in January 2017 that her government aims at a 'hard' Brexit, which means leaving not only the EU and the single market, but also saying no to a customs union that would require the UK and the EU27 to impose joint import tariffs. Instead, future economic relations between the EU and the United Kingdom should be framed within a bilateral free trade treaty; and not much time is left for achieving a political deal between London and Brussels. The pro-Brexit majority in the referendum came as rather a surprise to many observers, but as is shown in this study, this majority was in fact contrived, since the Cameron government in its 16-page information brochure, which was sent to all households, did not mention the Treasury's finding that leaving the European Union would bring a real income loss of 10%. Had British voters been aware of this important fact, the result—according to standard UK popularity functions—would actually have been a 52% majority in favor of Remain. Thus, one may conclude that there is no legitimacy behind Brexit unless one considers the government's suppressing of crucial information for voters a natural element of politics. It can be argued that a disorderly referendum should not be the basis for a historical political change.

Strangely, the Treasury study was presented to the public just a week after the government had sent out the info brochure to households in England. As the Brexit majority is artificial, one may argue that many of the conclusions drawn from the referendum are to some extent rather far-fetched. One could also ask why a Parliament that knows about the very dubious circumstances surrounding the referendum would follow the spurious result of said referendum.

The world owes British philosophy and scientific development a debt of gratitude for the modern approach of science which is based on observation, modeling, and empirical studies. All this dates back to the sixteenth century and Sir Francis Bacon who was an influential English philosopher, statesman, jurist, scientist, and author—he also served as Attorney General and Lord Chancellor of England. In his judicial approach to reality, Bacon called on scientists and indeed others to not only come up with new ideas and conjectures, but to always show supporting evidence for conjectures made; self-deception was to be avoided, carefully observing the facts and reality, respectively, should help in gathering the critical evidence required. Scientists and politicians who mislead themselves or others would not be held in high esteem by Francis Bacon, nor do they respect the old school of empirical methodology developed in the United Kingdom. Against this background of modern progress from 1700 to 2000, the run-up to the British referendum of 2016 looks particularly strange.

Some observers of the referendum have argued that immigration was a key issue for voters and a determinant of their behavior, but this is indeed only partly true as expert analysis suggests. Did EU immigration really represent a critical burden on the UK for many years prior to the referendum? Perceived developments and newspaper reports in the tabloid press is one thing, statistical facts and the careful analysis of experts is quite another. The Organisation for Economic Co-operation and Development (OECD), a professional international organization, has shown that the EU immigrants' participation rate in the UK labor market has exceeded the British average and that immigration has actually created a surplus for the government budget; a Bank of England Staff Paper based on careful empirical research finds that immigration has put significant downward wage pressure on one category only in the labor market—unskilled

workers in the services sector. The annual UK population growth rate from EU immigration amounted to only 0.2%, and all this amounted to an excessive burden for the world's fifth largest economy?

For decades, the EU has combined the liberalization of markets with a growing global trade and investment flow orientation, plus social policy. What the adequate balance of these elements should be has been viewed in very different ways in various EU countries. The UK supported the development of the EU single market—an institutional innovation which was successful enough to encourage the ten Association of Southeast Asian Nations (ASEAN) countries to start their own single market in 2015/16. The liberalization approach of the Western world, which has inspired so many regions in the global economy to follow steps toward the opening-up of markets and increased competition, is now facing a double stress test since both Brexit and the election of Donald Trump in the US stand for new approaches that contradict the traditional models of Western success. By leaving the EU, the UK will have less liberal trade and capital flows than before, while in the US, President Trump made trade protectionism and barriers to foreign direct investment (FDI) outflows a hallmark of his election campaign. As Mrs. May, arguing in favor of a Global Britain, has declared her strong interest in cooperating with Mr. Trump's protectionist government, there will be a new transatlantic political odd couple.

While Mrs. May's speeches often seem to follow the spirit of Adam Smith, who published his famous book on Economics in 1776, the year of US independence, Mr. Trump's speeches echo a very different approach that sometimes sounds like Mercantilism, the politico-economic ideology of the early eighteenth century that brought international conflicts through the obsession of many countries to all achieve a current account surplus which, of course, is logically impossible.

The EU needs to reform regardless of the result of a British referendum (including of a potential second referendum in 2018). While some EU approaches were useful, other policy elements were doubtful, e.g., overregulation in many fields—but not in financial markets and banking, respectively. This book makes various suggestions for EU reforms, and it also presents some fresh thoughts on how the historically decisive Transatlantic Banking Crisis could be overcome in a



sustained manner—a topic that is of key interest to both European and North American readers. This analysis discusses whether or not Brexit is the starting point of a protracted politico-economic crisis in Europe and whether or not major changes in transatlantic relations should be expected from Brexit dynamics. The study shows that Brexit does not mean simply moving back to a situation akin to pre-1973 and undoing part of the free trade networks in Europe.

As a European economist with good links to both leading British and US universities and to many international organizations, I have tried to put key pieces of information on Brexit together—and I certainly agree that in the end, it is for the British voters to decide for or against EU membership. At the same time, I should like to argue that it is only fair to present critical reflections on a debate which is historical but often not careful enough to take into account the key facts. Political systems and government in Western democracies have always had a tendency to respond to certain political movements and to not only rely on hard facts, statistics, or expert views. Rarely, however, have OECD countries' governments had much success when reality is largely ignored. Here, the EU28 has a broad responsibility not only for European economic and political dynamics but for global developments as well. It is hoped that this book will contribute some enlightenment to a confusing Brexit debate in Europe and beyond and it is clear that the EU28 has broad responsibility not only for European economic and political dynamics but for global developments as well.

Many observers of Great Britain would surely agree with the estimation that the country, which is known for being rich in tradition, the source of many important inventions, historic achievements, an advanced political system, and a high level of economic dynamism worldwide, is perceived as a leading light in Western Europe and as a shining example of democracy. However, this makes the massive policy failures in the run-up to the referendum on EU membership on June 23, all the more incredible. One may anticipate that Brexit will take place in early 2019—indeed it would have to take place before spring 2019 since elections to the European Parliament will take place at that time. Whether or not Scotland will then seek to hold a new independence referendum and break away from the UK is an open question. However, one cannot rule out that there will be a second referendum

on British EU membership—and the result might be in favor of Remain. This, in turn, would bring new adjustment costs to the United Kingdom. The announcement of the President of the EU Commission, Jean-Claude Juncker, not to stand for a potential future re-election, as he is afraid that the Brexit negotiation will lead to further EU disintegration, is a signal that there are considerable tensions among the EU27 which could yet break apart. This statement, of February 2017, is an indication of a lack of EU leadership. The view expressed by Mr. Juncker, in an interview with a German radio station, that “the other EU 27 don’t know it yet, but the Brits know very well how they can tackle this...They could promise country A this, country B that and country C something else and the end game is that there is not a united European front”) stands in stark contrast to the expectations of Prime Minister May as expressed in her Brexit Speech on January 17, 2017, in Lancaster House, when she said “I know that this—and the other reasons Britain took such a decision—is not always well understood among our friends and allies in Europe. And I know many fear that this might herald the beginning of a greater unraveling of the EU. But let me be clear: I do not want that to happen. It would not be in the best interests of Britain. It remains overwhelmingly and compellingly in Britain’s national interest that the EU should succeed”.

My first research activities with British colleagues—from Hertford College/Oxford University—began in the 1990s and were focused on the energy and telecommunications sectors, fields which were deregulated in the United Kingdom early and sensibly, faster than was the case in other EU countries. Further, EU-related research projects followed (which included colleagues from the University of Birmingham and, later, the University College London), and British economists and indeed foreign economists at British universities, respectively, certainly enjoy a high level of respect across the globe. It would be most regrettable if this kind of cooperation with colleagues from these universities should, in the longer term, be made more difficult due to Brexit.

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Paul J.J. Welfens

President of the European Institute for International  
Economic Relations (EIIW) at the University of Wuppertal  
And

IZA Research Fellow, Bonn and Non-resident Senior  
Research Scholar at AICGS/Johns Hopkins University, Washington DC  
And

Alfred Grosser Professorship 2007/2008  
Sciences Po, Paris

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