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Brexit: New Evidence and Policy Perspectives*

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The United Kingdom's prospective exit from the European Union is one of the most significant events in UK political and economic life in a generation. It has the potential to generate profound effects on the UK and Europe for many years to come. Understandably, the issue has dominated the news and the popular debate for well over two years and is likely to do so for the foreseeable future. Estimates and predictions about the economic effects abound. But, at the time of writing, Brexit has yet to happen. And, since negotiations are ongoing, the details about many important issues remain uncertain or, at least, will continue to be negotiated and debated well after March 2019. Analysing the consequences of Brexit is no small order. The UK's relationship with the EU has been forged over many decades and is complex. Implementing Brexit is also, therefore, complex. Understanding the consequences and assessing the different policy alternatives will require an evolving research effort.

In this special issue of *Fiscal Studies*, we publish five new papers by researchers who are world experts in issues of immigration, trade, firm performance, industrial policy and the effects of uncertainty. There has been much focus on predicting the overall economic effects of Brexit. But, until Brexit occurs, it is hard to know what the future relationship will look like. The articles in this special issue do not attempt to provide overall forecasts about the economic costs and benefits of Brexit. Rather, in keeping with the traditions of *Fiscal Studies*, they focus on new empirical analysis, new data collection and an evaluation of different policy options. The authors examine

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five important, but by no means exhaustive, topics: the nature and effect of uncertainty on firms, the response of the stock market to Brexit so far and some specific issues regarding immigration, trade and industrial policy post-Brexit. The authors attempt to document the nature of the UK economy along these dimensions and its current relationship with the EU. Informed by this, several articles then analyse what the effects of different policy options might be. These papers are part of a wider research effort by a number of researchers and institutions to help inform the formation of public policy around Brexit.

Two articles in this special issue look at what effects Brexit might have had so far on firms and financial markets. It seems hard to argue that Brexit has not created some uncertainty about the UK's future relationship with the EU. What is more complex is measuring the nature of this uncertainty and establishing whether it might have an effect on the economy. *Nicholas Bloom, Philip Bunn, Scarlet Chen, Paul Mizen, Pawel Smietanka, Greg Thwaites and Garry Young* note that, in theory, uncertainty can affect firms' investment decisions today. For example, uncertainty may increase the incentive to delay investment decisions because it generates a rise in the real option value of waiting. Firms may be more cautious about investment decisions that are costly and hard to reverse. Uncertainty may also increase the risks associated with an investment project and financial backers may charge a risk premium when offering to finance a project. Bloom et al. note, however, that the uncertainty created by Brexit is quite unlike the economic or political uncertainty previously studied in the literature. This may limit the extent to which existing evidence can be easily applied to the Brexit debate. Bloom et al. tackle this using a new firm-level survey, the Decision Maker Panel. In the article, they assess the nature and degree of uncertainty created by Brexit and how it might be influencing firms. They find that Brexit has been an important source of uncertainty for around 40 per cent of UK businesses for most of the period since the referendum. This uncertainty has also, typically, been higher in industries more dependent on trade with the EU and on EU migrant labour. Businesses are also uncertain about the impact that Brexit will have on their sales, exports and costs over the longer term. For example, the paper notes that, in the August to October 2018 surveys, 'the average probability attached to Brexit eventually reducing sales was 39 per cent, with a 12 per cent chance of a positive impact. . . . Brexit was expected to reduce exports and increase labour costs on average'. Interestingly, at least until Summer 2018, there had not been much change in the uncertainties that businesses face, although uncertainty picked up in Autumn 2018.

To examine how market participants have interpreted the referendum vote and key Brexit announcements, *Holger Breinlich, Elsa Leromain, Dennis Novy, Thomas Sampson and Ahmed Usman* analyse reactions in the stock market. Their goal is to assess market expectations about Brexit and how Brexit announcements might have affected firms. They show that movements in stock prices after the referendum vote are best explained by variables related to firms' dependence on the UK market, their sensitivity to the economic cycle and their export status and reporting currency. The poor stock market performance of more exposed companies is highly persistent. Breinlich et al. interpret these results as evidence that initial stock market reactions to the referendum were mainly influenced by investors' expectations of an economic slowdown and by the consequences of the exchange rate depreciation. Analysing the stock market reactions to announcements at the Conservative party conference in October 2016 provides some evidence that firms in sectors with higher current EU import tariffs saw lower abnormal returns. The paper interprets this as evidence that investors expect higher future tariff barriers post-Brexit. In contrast, despite the prominence of immigration as a topic in the Brexit debate, it finds little evidence that reliance on EU immigrants across sectors explains sectoral stock market performance following the referendum result.

The other three articles in this special issue examine important aspects of the current relationship between the UK and the EU and assess some post-Brexit policy options.

Jonathan Wadsworth focuses on the labour market and immigration. He first examines key patterns and changes in the UK labour market around the referendum vote. The paper argues that there is little evidence of a relationship between EU immigration and the employment or wage outcomes of UK-born residents. For example, it presents evidence using variation across local authorities and notes that these findings also mirror a large body of wider academic work. The paper then considers the current role of EU migrants in the UK, reporting that they are more likely to be employed than the UK-born population and are more likely to be net contributors to fiscal revenues. There is also heterogeneity across regions and sectors. Some 48 per cent of EU inhabitants live in London and the South-East, and EU migrants do feature prominently in a few sectors, with the highest proportions typically in low-wage, high-labour-turnover sectors (for example, hotels, domestic help and food manufacturing). Employers in these sectors may face hiring difficulties post-Brexit, although many of the existing EU workforce would still be eligible to remain in the UK. Any effects are likely to be incremental rather than immediate. Informed by this evidence, the paper features a detailed discussion of the immigration policy options post-Brexit. It considers the ability of the government to hit its net migration target after Brexit; the pros and cons of occupation-based entry shortage schemes versus individual worker-based schemes; whether a shortage list should include the vocational sector in addition to graduate-level jobs; the interaction of immigration policy and welfare policy; the work status of EU students and family members of resident EU individuals; area-based schemes; and the desirability of imposing costs on firms when hiring from abroad.

Pieter IJtsma, Peter Levell, Bart Los and Marcel Timmer examine an important aspect of the trade debate. Modern international trade is complex and the paper highlights that the UK operates in a network of global value chains. Countries import and export unfinished components and business services to produce final goods and services which are then exported elsewhere. For example, IJtsma et al. note that '14.5 per cent of UK value added that is ultimately consumed in China is first exported in the form of intermediate inputs to producers in the EU'. Using detailed input–output data from the World Input–Output Database (WIOD), the authors examine how Brexit might affect the UK's position in these global value chains. The paper has a number of important results. First, it is often argued that one of the benefits of leaving the EU Customs Union would be that the UK could improve the competitiveness of UK exporters by reducing tariffs on imported inputs. IJtsma et al. show that, in fact, the gains are likely to be small. This is because the foreign value added content in UK exports is relatively low and because the tariffs currently imposed by the EU on intermediate goods imported from outside the EU are also relatively small. Some sectors would be affected more than others, however. Second, the paper also shows that from 2000 to 2014, the UK has become increasingly specialised in exporting services. This means that membership of the Customs Union, or access to the Single Market for *goods*, would only offset any negative effects of Brexit to a limited extent. Third, a loss of access to EU markets may discourage UK firms from participating in value chains with nodes in the EU, which currently export significant amounts to China and other fast-growing economies. These costs should therefore be subtracted from any benefits obtained through new trade agreements.

Finally, *Nicholas Crafts* considers the post-Brexit options for the UK's industrial policy. Much has been written about the UK's poor productivity performance over the last decade. There are good reasons to review the UK's supply-side policies. As a result, some have been arguing for a more interventionist industrial policy. Since the 1970s, and until the recent Great Recession, industrial strategies have been somewhat out of fashion. But, in recent years, UK governments of all parties have considered policy options in this space. Moreover, the challenges and opportunities presented by Brexit may provide an impetus to revise UK industrial policy and competition policy. Crafts notes that hard (but not soft) Brexit could allow much more scope for selective industrial policy as the UK may no longer be subject to the EU's state-aid and competition policies (which preclude many forms of selective industrial policy). Indeed, some have argued that this could be a benefit of a hard Brexit. Crafts analyses this proposal and draws on the experience of the 1970s as a case study. He concludes that, in the past, selective industrial policies have generally not been successful at promoting better productivity performance. The paper argues that one advantage of a softer Brexit would be that these types of policy interventions would be constrained. Instead, Crafts argues, other policy reforms, including changes to education, innovation and infrastructure policy, are desirable and possible with any kind of Brexit.

These papers provide an initial look at the effects of Brexit so far, consider the UK's current relationship with the EU and examine the policy implications along important dimensions such as trade, the labour market and industrial policy. The full implications of Brexit for UK public policy may only become apparent over time and after a future relationship with the EU is agreed. New and detailed research will be required to help inform policymaking about the economic consequences of Brexit, whatever form it may take. The articles in this special issue hopefully contribute to this goal.