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THE UK AFTER BREXIT

Brexit then, now, and in the future: Reflections and evaluations from 2016 to 2021

Abstract

On 23 June 2016, 52% of the British population voted to leave the European Union. This was the beginning of a long and bumpy road towards British sovereignty. More than 4.5 years of political shenanigans, parliamentary votes, and international negotiations, as well as several no-deal preparations, two general elections and two Prime Ministers later, the UK has left the EU and entered a new era on 1 January 2021 under the provisions of the Trade and Cooperation Agreement (TCA). This dossier is a collection of reflections and evaluations of the Brexit negotiations and their outcomes. It combines reprinted versions of contemporary Brexit analysis pieces (blog posts and academic articles) and novel, original postscripts and contributions.

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1. Brexit: a reflective timeline

On 1 January 2020 the UK fully exited the EU and entered a new era of political and economic independence. Both sides were keen to emphasise that the future relationship, guided by the Trade and Cooperation Agreement (TCA), will remain friendly and cooperative, as far as the new rules allow it.

The past four and a half years since the Brexit referendum in June 2016 were dominated by many changes in direction – both by politicians and commentators who, constantly readjusting to new political realities, tried to predict the next steps in the negotiations and potential future consequences for UK and EU citizens and businesses.

The period immediately before and after the referendum was led by a certain disbelief that the British would vote to leave the EU and that the UK government would follow up on this small win for Leave in the popular vote. Once the initial shock was digested, (economic) commentators chanted almost in unison about the obvious very close future relationship (a so-called "soft" Brexit, including Single Market and customs union membership) between the UK and the EU. By that time, however, Theresa May had already taken over the premiership and her iconic "Brexit means Brexit" slogan – clearly emphasising the hard red lines of migration control and suspension of ECJ jurisdiction – made evident that the UK was pursuing a much more independent path.

Yet, two years after the referendum the British leadership still seemed to be relatively unclear about how exactly this sovereign future should look – particularly with regards to the UK's economic and political relationship with the EU. In July 2018, when Ms. May invited her cabinet ministers to Chequers – the PM's famous country house – the "soft" Brexit options were dramatically reduced. The ensuing Brexit White Paper dropped any ambition to stay in the Single Market (after the EU had made clear that Single Market access was irrevocably paired with workers' freedom of movement) and instead focussed on the UK remaining in a free trade area for goods, governed by a "facilitated customs arrangement" (FCA) and brokering a CETA-style arrangement in all other areas.

As the EU rejected the White Paper, May's government was forced to renegotiate the agreement domestically, resulting in the publication of the Withdrawal Agreement – which was rejected by the House of Commons several times – and the Political Declaration. Countless government reshuffles, no-deal panics, Brexit extensions, parliamentary shenanigans, a general election, and a Conservative leadership contest later, Boris Johnson became the new prime minister in July 2019.

After yet another round of no-deal panics, yet another extension granted by the EU, and yet another general election – in which the Conservative party regained its parliamentary majority – Boris Johnson's amended version of the Withdrawal Agreement was accepted by the House of Commons in late-January 2020, allowing the UK's formal withdrawal from the EU on 31 January 2020.

The negotiations about the future relationship between the EU and the UK in the following 11 months were based on the Political Declarations which both parties had agreed on previously. Nevertheless, the negotiations, complicated by the outbreak and political consequences of Covid-19, again took a bumpy path – with a lot of back and forth on the issue of no-deal, level playing field and fisheries. Eventually, the UK's long and complicated journey to sovereignty was concluded with the agreement of the TCA on Christmas Eve 2020.

This dossier is a collection of reflections and evaluations of the Brexit negotiations and their outcomes. It combines reprinted versions of contemporary Brexit analysis pieces (blog posts and academic articles) with novel, original postscripts and contributions. Section 2 explains the early and late stages of the negotiations and gives an account of how the UK's and EU's strategies have evolved over time and adjusted to the prevalent political situation. Section 3 offers two articles on the labour market and financial regulation after Brexit (abstract and link to the original papers included) that resulted from an LSE "Commission on Brexit". Two of the authors of these articles have agreed to revisit the papers they wrote in early 2016 and evaluate how these analyses have stood the test of time in a postscript to the original pieces. Section 4 includes a 2018 blog post about the destiny of British manufacturing as well as an updated interpretation of the future challenges and opportunities for the UK's industrial path. Section 5 closes with some reflections about the impact of the TCA on the UK's service sector, its (likely detrimental) effect on the country's comparative advantage and future strategies to retain or regain the British strength in services.

2. Two level games: the EU-UK negotiations explained

In December 2016, PEACS's Bob Hancké posted a blog on EUROPP, which we reproduce here. His follow-up reflections on the progress of the negotiations between the EU and the UK, also first published on EUROPP in October 2020, are reprinted below.

2.1. Brexit, red lines, and the EU: The two-level game revisited

Three months before the UK was expected to trigger Article 50, **Bob Hancké** *already asked how successful the country will likely be in securing a favourable exit deal from the EU. He anticipated two major problems for the UK in its negotiation: that the rules of the game, as established by Article 50, are skewed toward the interests of the EU, and that the UK's approach of drawing 'red lines' is unlikely to be successful given the dynamics of the negotiation process.*

Judging by the Brexit debate in Britain, the UK will decide what deal it wants with the EU, what it negotiates and what it receives. Not a single day seems to pass without newspapers reporting on yet another way that the UK will redefine its relationship with the EU during and after Brexit: access to the Single Market, a bespoke deal, taking back control of the borders, passporting rights for financial services, just to name a few that are doing the rounds. It's as if the country is saying 'we decided to leave and we will also decide how we will do it'. End of conversation, as Tony Soprano used to say.

There are two big problems with this approach to Brexit. The first is simply that the procedure of Brexit, as captured in the famous Article 50, massively skews the process against the departing member state. Even if the EU is trying to be nice – as it should and as it more or less does – it calls the shots in the negotiations.

The second is related to the dynamic of what political scientists call a two-level game, made famous by Robert Putnam many years ago. It refers to a setting in which international negotiations are embedded in domestic arrangements and vice versa. An EU member state can always claim that it would never be able to persuade its constituencies (citizens, MPs, or relevant interest groups) of the benefits of the prospective deal; for it to be accepted at home, it would need to be closer to that member state's preferred outcomes. The UK actually excelled in that game with its red line policy; for some it explains why the EU is much more of a neo-liberal system than we would expect given the socio-political proclivities of most of the member states of the EU.

In the run-up to negotiations with the EU, the UK is busy drawing red lines, much in the same way that it did when still a 'standard' member of the EU. That way of handling negotiations worked very well because of the particular mode of decision-making in the EU, which rewards recalcitrant members (technically called the joint-decision trap: the EU's decision-making system requires that more or less all member states have to agree to significant changes in modes of operation). As a result, a brilliantly ironic dynamic sets in, in which the most recalcitrant member ends up with more of what it wants out of the EU than the more enthusiastic members (yes, it does make you wonder why the UK wants to leave the EU if this is the case). Since negotiations usually end up where two can find common ground, it pays the recalcitrant member state to remain stubborn, thus reducing the place where everyone can agree to something that almost perfectly resembles its own agenda. It needs to keep its win-set of acceptable options small, in the knowledge that the others would rather negotiate a relatively weak deal than no deal.

Armed with that knowledge (and with, perhaps, a misplaced arrogance about going it alone in the turbulent world we live in), the UK draws up its plan for Brexit and seems to assume that the EU will take that as the parting shot. The EU may do that. Stranger things have happened in the past twelve months. But the EU is more likely to look at this as a psychodrama in which it doesn't really want to participate (that seems to be the prevailing mood elsewhere in Europe since David Cameron's fated call for a referendum).

Here's the idea: two-level game tactics, in which you reduce your win-set with a view to maximising the chances of your preferred option carrying the day, work if everyone prefers staying together over not finding a solution. This is known as a battle of the sexes game: John wants to go to the football game while Mary wants to go to the theatre, but both want to do something together rather than go alone. A battle of the sexes game is about the unequal distribution of outcomes when both want to cooperate. So, as long as the UK is in the EU, being a slightly recalcitrant member works in its favour because the rest of the EU wants a deal more than no deal.

While it works well as long as the UK wants to remain an EU member, the two-level game tactics backfire when you are negotiating leaving the EU. Drawing red lines when you don't want to cooperate anymore is massively counterproductive, even if you negotiate among equals but certainly if the other party controls the process. Since there is de facto no second level anymore – the UK has had its Brexit vote and, as Prime Minister Theresa May reminds us almost daily, Brexit means Brexit – the UK no longer is able to use that as a way of forcing other EU member states to inch closer to its preferred outcome. It is, indeed, much simpler to negotiate opt-outs during forty years of membership than opt-ins when leaving the EU.

2.2. The UK and the EU: Another two-level game

The prospects for a post-Brexit trade deal between the UK and the EU looked increasingly bleak following talks between EU leaders on 15 October 2020. **Bob Hancké** *attempted to make sense of the negotiations.*

Finally, the gloves are off. French president Macron, a bit more preoccupied with containing a new outbreak of Covid-19 than with Brexit, has turned the tables and told Boris Johnson to 'go whistle'. If the UK wants a Brexit agreement before the end of the year, it is going to have to accept the EU's conditions, *point final*. UK waters should remain open for EU (especially French) fishing boats, the UK should accept it will have to dynamically ratchet up environmental and social standards if it wants to trade with the EU, and state aid should be contained to the level acceptable within the bloc.

Ignore for a moment the outsized role that fish plays in this story (though more as an object than a subject – I bet some fish are hoping for a breakdown of the talks). If Macron had any sense of French history, he would understand the power of small but symbolic communities: for years, French farmers held reform of the CAP hostage because it would destroy the typical French relationship that the French (cuisine) has with the terroir. Ignore also the slightly hallucinating notion that the party of Margaret Thatcher insists on a free hand in doling out money to new (and old) industries both to safeguard livelihoods and to bask in the 'white heat of technology' again. What is truly interesting here is that the EU has now, supposedly, drawn its own red lines to face off those that the UK has drawn since the 2016 referendum.

A double two-level game

A few years ago, I analysed the Brexit strategy of the UK government (a bunch of red lines) as a misconceived two-level game (2LG): if you are no longer a part of the relationship, your 'and I want you to do this' style of negotiating has very little power, because there is no credible 'or else' that you can add or even imply. Invoking domestic constituencies as constraints in international negotiations to leverage the outcome in your favour only works if you display a fundamental commitment to the arrangement that you are trying to change. It's safe to say that the Brexit decision and the implementation since early 2017 killed that.

By making the EU's position as hard as this, we now effectively face a 'double 2LG', with hard red lines on both sides. I don't think I have ever seen this before: usually one of the parties is more committed, and thinks that any deal is better than no deal. So, we are living through a natural experiment. If both parties simultaneously reduce their win-set, the Venn diagram may suddenly end up with an empty overlapping intersection. A hard Brexit, the Australian option, name it what you will, heralds a collapse of trade talks, the end of friendly neighbourhood relations, and a weakening of both parties. That is a pretty steep price to pay for a handful of fish.

Or a chicken game?

Of course, the negotiations may have stopped being a 2LG a while ago. Imagine that Macron is difficult for other reasons than trying to resist the Anglo-Saxon aggressor (the parallels with Asterix the Gaul are a bit eery). Like everyone else, he is tired of the melodrama on the other side of the Channel, and corona is eating up a lot of the governing energy. By stating the obvious – trading with us, the largest Single Market in the world, means accepting our rules – Macron mobilises the power of the EU to force the UK to concede first.

The negotiations thus seem to have morphed into a chicken game: two cars race toward each other and the one to veer first loses the contest. Both cars being of roughly the same size, there are only losers if no one veers. Yet what is perhaps not entirely understood in the UK is that this is not a standard chicken game with two more or less similar cars, but a situation where one party drives a large truck and the other a motorbike. That collision will not have symmetric effects, therefore. The EU is simply banking on the Johnson government seeing that too, coming to its senses, and accepting the EU's not entirely unreasonable demands.

A simple 2LG, actually

But what if something far more subtle is going on? Acting tough now, the EU actually offers the Johnson government a face-saving exit. The imposition of such hard (and, according to the British press, unpalatable) conditions implies that the road is open for a negotiation that will almost certainly look like a victory for the UK. Any EU concession it can now show to the audience back home will be portrayed as a Churchillian moment: the new Jerusalem will be built on the founding myth that 'we fought them in the tunnel'—the long, secret, 24/7 endgame negotiations.

Johnson has form in this regard: the deal he negotiated last year with the EU was, actually, from the UK's perspective a weaker deal than the one negotiated by his predecessor Theresa May and which he refused to countenance as a member of the cabinet at the time. Walking out of a room, waving a sheet of paper, shouting 'Brexit in our time' goes down well with the Eurosceptic press, of course, and the EU's hard stance assures that any success now will be seen as hard-fought.

Since the future is difficult to predict, as Mark Twain suggested, I won't place any bets on which of these logics is at play here – the double 2LG, the asymmetric chicken game, or the hidden simple 2LG. But the endgame is on, so much is clear.

3. Brexit perspectives: Then and now

In 2015, the European Institute of the LSE organised what we called the Commission on Brexit. The basic idea was to evaluate the key areas that the Brexit debate was engaging and went from immigration over business regulation to finance. For this PEACS dossier we have added the links to the publicly available versions of the articles on finance in the City of London and business and labour market regulation. Both of these areas were central in the debates in the UK on Brexit. Two of the authors of these articles have agreed to revisit the papers they wrote in early 2016 and evaluate how these analyses have stood the test of time in a postscript to the original pieces. We urge readers to visit the website with the original articles and read the new reflections here.

3.1. A bonfire of the regulations, or business as usual? The UK labour market and the Political Economy of Brexit

Due to copyright reasons and space constraints, we were unable to reprint the entire article. However, the publicly available abstract below gives a good overview of the article and sets the scene for the subsequent postscript, written by Bob Hancké. We also recommend reading the original article, which is accessible via the link included in the *About the author(s)* box.

Abstract
Employment and labour market regulation initially appeared as one of the solid red lines in the UK's renegotiation of the country's place in the EU. The basic argument is that the UK's more deregulated labour market would sit uneasily in the more organised models, based on statutory instruments or collective bargaining, found on the continent. While there is a legitimate problem here, EU employment regulations appear manageable from the point of view of business, while unions see them as important tools for socially responsible economic restructuring. Most of UK employment case law is now deeply entangled with EU law; labour market regulations have, on the whole, become part of the way of doing business in the Single Market; and a simple cost-benefit analysis appears impossible because some costs are not quantifiable and the costs of others are reduced when taken as a bundle. Labour unions agree that transposition of European law needs to be done taking into account local sensitivities, while internationally oriented companies do not see EU regulations on the whole as detrimental to business. Importantly, though, the costs and benefits of EU employment regulations are not symmetrically distributed across different companies: large companies are better able to reap the rewards and accommodate the costs of operating in the Single Market than smaller companies.

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The full article is available as an LSE e-print and was originally posted 14/03/2016 on LSE Research online:
http://eprints.lse.ac.uk/65714/1/Coulter_Bonfire%20of%20regulations_.pdf

3.2. Postscript: The cost of the bonfire

In our 2016 article on Brexit, Steve Coulter and I reported on discussions that we organised at the LSE between representatives of labour, business, and other experts in December 2015. The idea that guided us throughout the preparation of that discussion, as well as during the debates themselves, was that the UK had to a large extent honed its comparative advantage in the 40-plus years since joining the EU. Any change in the relationship with the EU, we assumed, would be organised around retaining that position in the international, EU-wide division of labour – a relative collapse of manufacturing (except for a few very high-end sectors), expressed in a substantial deficit in trade of goods, and a parallel surplus, especially in sophisticated services such as finance, law, auditing, consulting, advertising and architecture. From that perspective, leaving the EU not only made little economic sense because it would jeopardise these comparative advantages, but any Brexit was to be a 'soft' Brexit, securing access to the Single Market and remaining within the customs union, but without a say in the relevant regulations.

We, as authors, were not the only ones who thought this: without exception, every party in the discussions that we had in late 2015 agreed to a large extent, even the more 'small firm' oriented Institute of Directors. Furthermore, the representatives from the services sector, especially hospitality, pointed out that its sector would face dramatic labour shortages under severely restricted immigration regulations, and there was general consensus about keeping a flow of highly skilled but also low-skilled workers to staff the services sectors (and agriculture).

Much of the analysis around the referendum, both before and after, was therefore implicitly built on the idea that no UK government would jettison access to the Single Market, even if that came at the price of keeping labour markets open to immigrants and remaining subject to the ECJ over trade. In the days before June 2016, the Norway option, or the Swiss model, both rule-takers on product standards and immigration in exchange for access to the Single Market, were held up as a way of leaving the EU without paying a big price.

The surprise to many was not only the referendum outcome in itself, but the fact that a 'hard' Brexit suddenly made an appearance in the debate, promoted from a fringe point of view to one of the possible key planks of government policy – and quickly becoming the default position. Where we were initially quite sanguine with regard to the effect of Brexit on the regulatory framework for business and the labour market (and therefore also quite sceptical about the perceived benefits of leaving the EU), the debate took a largely unforeseen turn, which upset many of our assumptions. If the UK was willing to blow up the bridge that tied it to the Single Market, all bets were off – and at times in the autumn of 2020, it certainly seemed as if that scenario was playing out. How else to make sense of negotiations in which the short-term interests of the fishing industry appeared to trump all of manufacturing, much of higher education and research, services and, yes, Harrods and Fortnum and Mason.

In the end calmer minds prevailed, and to this day it is unclear if the May and Johnson governments made a massive mistake calling the EU's bluff, or if it was a calculated move to force the EU into accepting better terms for the UK. The latter failed: against the (or, at least, our) odds, the Brexit deal upholds the free flow of goods and restricts the export of services. The assumption that the UK would temper its desire for Brexit with a realistic sense of how and what to trade was simply wrong. And with us, the socio-economic interest groups in the country – most trade unions and the different employers' organisations – were left out in the cold.

That said, our analysis of a relatively modest adjustment in the regulatory frameworks for business, if any adjustment at all, remains more or less valid. The key approach in the Brexit agreement is that of regulatory alignment in exchange for access to the Single Market – exporting to the EU is only permitted if the UK makes things according to roughly equivalent regulatory standards, including social and environmental. In fact, the inputs into the exported products also have to meet these standards, which broadly precludes a 'bazaar' economy, which relabels goods from less regulated jurisdictions as 'Made in the UK' – a significant dent in the buccaneering Brexit that many on the right of the Conservative Party held up as the ideal outcome. The regular update of that equivalence, therefore, ensures that UK and EU products will remain what they were before 1 January 2021: roughly similar products, made under roughly similar conditions. From the point of view of large firms and trade unions, therefore, things will be very similar in future: a constant conflict about wages and working conditions but without existential problems for either, or at least not as long as they can trade with the EU.

Small firms may see things differently: because they export substantially less to the EU, they have made some significant (de-)regulatory gains. As long as their products do not constitute a significant part of exported products made by others further down the supply chain, they are, within the loose confines of UK law, more or less allowed to do what they want.

But these processes are not static: How exactly that will play out is anyone's guess at the moment. Construction companies, for example, may face a labour shortage, which should push up wages, but in exchange they are no longer bound by EU regulations on working time, health and safety, and working conditions more generally (since they do not export their products), which will, all other things equal, have the opposite effect on wages. Yet at the same time it is not entirely obvious how firm those benefits of Brexit will remain for small companies – the first construction worker to fall off a scaffolding after Brexit will be displayed as a victim on the front pages of the same tabloids that lamented the stifling impact of EU safety regulations, as one of our colleagues suggested during our discussions in 2015. The response, after a suitably convened Royal Commission chaired by a (perhaps now unemployed) City grandee, might well be a stealthy introduction of the very health and safety rules from which the country managed to escape a few weeks ago.

Yet in the high-end services sector, where Britain had an undisputed comparative advantage, the shoe actually already pinches. The Financial Times reported that during the first week of trading in 2021, £6bn per day was diverted to other financial centres in Europe, and that many financial operators had set up an EU office for their European clients, linking up with London staff over the phone for meetings. It is far from clear how sustainable this arrangement is in the long run. Employees in Europe can easily acquire the skills that the City was famous for (and probably already have done so). From a competitive point of view, the strength of London as a financial centre has probably always been less the stellar abilities of its employees and more the sheer scale and the associated network externalities with one massive but very local labour market. If the latter is the case, then any significant transfer of activity to the continent will ultimately also undermine that network advantage.

Usually, such a shift would take a long time, especially if activities are highly entrenched: as long as London remains the relatively largest player in Europe, even if Frankfurt or Paris were to grow in size. Imagine a world in which Frankfurt gets 30% of the market, Paris 20% and a few smaller players combined another 10%; London would easily remain the largest financial centre and, from that position, export to the rest of Europe. And as long as London remains the largest financial centre, the pull to remain in London is very powerful.

While it is way too early to say how this will play out, there are good reasons to be very concerned. The sudden shift of financial trades to the continent on the first Brexit working day, the fact that many UK banks have set up more than cosmetic operations on the continent, and the not insignificant political desire to keep the euro's financial hub in the E(M)U herald a significant acceleration of the demise of London as a European financial centre. And once that happens, its labour market will become increasingly less attractive, with negative effects on not just its 'financial' labour market but also the satellite services that developed alongside, such as law, consulting and auditing. The way down may be just as fast as the way up was after the Big Bang in the mid-1980s.

And that brings us full circle – but through the looking glass, where everything is upside down. We assumed in early 2016 that the UK would fight hard for its comparative advantages in a tightly integrated Single Market. That would have implied a much softer Brexit than what was agreed in late December 2020, a departure in which the UK left the EU but remained close. It would have retained the right to trade goods without local content rules and, most importantly, retained a central role in finance and its corollary industries. Instead, the EU can export freely to the UK (and vice versa, of course, but the UK's trade deficit suggests that those are slim pickings), while the export of sophisticated services (including higher education) is dramatically curtailed. 'I have a feeling we're not in Kansas anymore…'.

3.3. Financial centre and monetary outsider: how precarious is the UK's position in the EU?

Due to copyright reasons and space constraints, we were unable to reprint the entire article. However, the publicly available abstract below gives a good overview of the article and sets the scene for the subsequent postscript, written by Waltraud Schelkle. We also recommend reading the original article, which is accessible via the link included in the *About the author(s)* box.

Abstract
The UK's negotiating position in the area of 'economic governance' started from the assumption that there is a deep dividing line between insiders and outsiders of the 'Eurozone'. To protect the outsiders, the UK government did not ask for a veto but a safeguard mechanism that can postpone a decision in the euro area. This is exactly what David Cameron achieved in the negotiations with Council President Tusk. The article explains why the UK demands were so modest. Key is the peculiar situation of the UK being the major financial centre for a currency union to which it does not belong. Hence, the UK taxpayer needs protection from the City and EU membership has helped to provide this. There is not much else a UK government could ask for.

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The full article is available as an LSE e-print and was originally posted 14/03/2016 on LSE Research online:
http://eprints.lse.ac.uk/65708/1/Schelkle_Financial centre_2016.pdf

3.4. Postscript: The unwanted deregulation of the City

In my 2016 article on Brexit, I reported on discussions at a roundtable that the European Institute organised at the LSE between representatives of financial businesses, and financial and legal experts in December 2015. The possibility of a referendum outcome that would decide in favour of Brexit was discussed. But everybody expected that any UK government would fight hard to secure a favourable third-country regime, so-called equivalence, for its most competitive sector that actually generates a trade surplus. This, I argued, was not only in the interest of this politically well-plugged in sector, but in the self-interest of any UK government. Being a member of the EU allowed Britain to influence Single Market regulation in financial services in the way it deemed favourable to its economic interests, but also to hide behind EU compromises if it did not want to give in to demands for lighter regulation at the risk of the UK taxpayer.

What the Johnson government actually got for the financial industry is what many in the City consider 'effectively a "no-deal Brexit"'. All we know for now is that the actual post-Brexit agreement for financial services will be finalised by March 2021. Also, the UK authorities have agreed to accept the equivalence of EU businesses in 28 areas, such as investment firms and credit rating agencies, because Treasury Secretary Sunak admitted that it is in the UK's own interest. But the EU has not reciprocated in the 59 areas where it claims the right to issue equivalence decisions. Prime Minister Johnson has already admitted, in parliament and even before the deadline for a financial services trade agreement, that the government has not achieved as much as it wanted in financial services.

His Treasury Secretary thought of compensation for what looks for now as having achieved nothing. Rishi Sunak promised a "Big Bang 2.0" in "a candid interview" with a media outlet for City insiders. In other words, a revamp of Margaret Thatcher's deregulation drive that liberalised and legalised Eurodollar markets, did away with interest rate regulations and captive markets for government bonds. Solvency II, the short-hand for EU legislation of the insurance industry, is also mentioned as a target of deregulation.

But the world in which this would be enthusiastically welcomed is no more. Eurodollar markets – or generally financial markets dealing in currencies outside their jurisdiction – are awash with liquidity due to interest rates kept at the zero lower bound thanks to central bank interventions and they voluntarily buy government bonds as safe assets, which to guarantee central banks have obviously committed. The Chancellor, who is obviously used to bringing good news about government largesse in dire times, must have been disappointed this time round. A City Network convened by the FT used its publicity to let the government know that it is not interested deregulation but re-regulation, as Anne Richards from Fidelity International was quoted. The chief executive of The CityUK, which represents its interests, echoed what his predecessor had said five years ago at the LSE Roundtable: "The UK did a superb job of getting its voice heard on the regulatory debate in the EU. [..] As such, it's not a surprise that the UK industry is broadly content with the regulation that we've just onshored — the UK was, after all, the main architect." In the LSE Roundtable, experts on insurance regulation similarly argued that the UK industry is content with Solvency II. UK insurance firms were in particular prepared for the arduous capital requirements of this Directive. The UK was always in favour of regulation through capital requirements because its deep capital markets make them easy to fulfil.

This brings me back to the original message of the argument in *Political Quarterly*. As different Prime Ministers as David Cameron and Theresa May understood, the financial industry is not an unmixed blessing for the UK. Yes, it is a high-end financial sector with well-paying jobs and yields a sizeable share of income tax revenue. But in return, the UK taxpayer is on the hook for repeated rescues of this sector. We also find still that representatives of the financial industry are aware that high standards of regulation and capacity to absorb losses are desirable. Be it because this provides a competitive advantage in a world where clients have become sensitive to the soundness of the counterpart. It may also be the case because the financial industry may be wary of the regulatory cycles that were on display over the last decade. Easing now raises the spectre of tightening later. Whatever the reasons, it is noticeable that the Johnson government seems to be singularly unable of reading the interests of businesses it wants to serve. Instead, it promises to live a past that few see as relevant. But then, this is the story of Brexit in a nutshell.

4. The future of British manufacturing

In July 2018, PEACS's Bob Hancké posted a blog on EUROPP, which we reproduce here, followed by a new, original, postscript reflecting on the argument in that article from the vantage point of a post-Brexit 2021.

4.1. Made in the UK: Brexit and manufacturing revisited

In July 2018, **Bob Hancké** *pointed out the domestic economic effects of Brexit are dynamic, not static. While some industries will be devastated by Brexit, resources may switch to other areas which, in theory, could thrive. But for this to happen, the UK needs to revamp its industrial supply chains, which are dependent on close links to European manufacturers that will be hampered by a hard Brexit.*

The prevailing line on Brexit and the UK manufacturing runs [in 2018] roughly like this: unless free trade in goods survives the EU-UK talks – something that looks increasingly unlikely – industry will quickly pack its bags and decamp to locations on the continent from where it can continue to produce, export and import without tariffs. The noises coming from some of the bigger manufacturing companies in the UK, such as Airbus, BMW and Nissan, leave little doubt about the urgency that these large companies associate with the free trade element in Brexit. Before long, Brexit UK will be an industrial desert – which, according to some senior government ministers it already is anyway (so why bother?).

A quite nuanced recent article in The Guardian takes issue with this line of thinking and examines the problem from a more dynamic perspective. It correctly points out that investment horizons usually cover the better part of a decade: in the car industry, for example, models change moderately every five years, give or take a year, and airplanes fly on an even longer cycle. Up-front investments have to be written off, preferably over a large number of units, which produces a significant level of inertia. The article concludes that after Brexit, UK manufacturing will slowly wilt: R&D will gradually be shipped overseas and future investment will be diverted as well, with the expected effect on British manufacturing. The birthplace of modern industry would become a manufacturing-free zone. This is certainly a very plausible scenario, given where we are now with the talks between the EU and the UK going nowhere. But my nagging sense is that it is one of two possible scenarios – and the other one has at least as big a chance, given the medium-term constraints for companies if we take this logic further.

Let's spell out this slightly more positive scenario. Most assembly plants, for cars, aerospace parts or white goods, have a minimum shelf life of ten years or more – lest the owner is willing to take a massive loss on the investment. Now, most companies with plants in Britain are not very rich companies. Renault-Nissan, Airbus and BMW certainly do well, but not to the extent that they can simply write off losses related to plant closures: the investment itself, the redundancies (and foregone training costs), the collapse of supplier networks which might be echoed by problems in the home plants and the reputational costs. In fact, it is hard to imagine many large manufacturing companies that can take such a blow; their profits and cash reserves are too low for such a shock, and if they could take it, they would almost certainly starve other operations of much-needed investment. Closing a plant in Britain is not a good idea.

Assuming that most of these operations remain open as manufacturing plants for the foreseeable future, what about the parts supplied by other companies that go into the final product? Modern cars, for example, are essentially combinations of complex systems manufactured by companies that many of us have never heard of, bolted together in the final assembly plants that sport the badge. Ditto for most other industries, where vertical disintegration has reduced the value added that Bauknecht itself put into its induction stove, Zanussi in its refrigerators or Magimix in its mixers. For the car industry, more than 75% of the value added, often approaching 90%, is produced outside and bought in. This changes the second part of the Brexit 'should I stay or should I go' question.

Concentrate on the car industry: about half the parts in an average car cross the Channel a few times before they end up in the final product. This is a simple effect of the fact that industries have a tendency to cluster in relatively well-specified regions because others are there who produce public goods such as skills and general technological know-how: southern Germany, Switzerland, northern Italy, Catalonia, Flanders, southern Denmark, etc. About a year ago, The Guardian followed the crankshaft in the Mini assembled in Oxford on its journey from stand-alone part to completed car and discovered that it crossed the Channel three times – and then once more in the finished product for a customer in Germany or France. If each of these crossings incurs a 10%

tariff, the car will become, say, 30% more expensive. Not an easy cost to absorb in a competitive industry. If the German luxury brands would find it hard to accommodate that, imagine what it would mean for mass producers with their razor-thin margins.

If, under a relatively hard Brexit, the final assembly plants stay, no other sustainable option remains for them, therefore, than to reconstitute local supply chains. Instead of crossing the Channel three times, the crankshaft could cross the Thames twice, not incur any tariffs along the way and become part of a Mini to be exported. That exported car might still be taxed more than today, but probably not that much, since more BMWs are sold in the UK than Minis in the EU; it would cut down on paperwork and possible delays that upset the now industry-standard (but very fragile) just-in-time production systems where parts are delivered when needed and not in large batches once a week or so; and it saves the company a multitude of other tangible and intangible costs.

The combination of these two possibilities changes the Brexit equation dramatically, at least for manufacturing. Instead of a looming apocalypse, re-industrialisation of those regions that house a sophisticated, advanced manufacturing sector becomes a possibility. The economics of the manufacturing sectors, with their long time horizons and fragmented production systems, nudge them there. But economics alone is not enough – else we wouldn't even be considering Brexit. It will also require a reconfiguration of different parts of the value chain; an industrial policy to organise technology transfer; a regional policy to develop support systems including Chambers of Commerce, local development agencies and broad associations of stakeholders; and the development of sophisticated training systems for both engineering skills and shop-floor workers. Business alone cannot organise these for a variety of reasons, ranging from simple inability to complex collective action problems associated with the production of public goods. And some sectors, especially those where a reintegration of supply chains is difficult, may go to the wall as the inevitable consequence of a hard Brexit: it is hard to imagine textiles, ceramics or cutlery to survive a tariff wall. All this helps understand the mild Brexit panic in business circles. But government can provide the necessary help here, and it should do so.

4.2. Reflections on 'Made in the UK: Brexit and manufacturing revisited'

Now that we have a Brexit deal under the guise of the Trade and Cooperation Agreement (TCA), agreed on 24 December 2020, we no longer have to gaze into a crystal ball to evaluate the future of manufacturing in the UK – or at least less so than we did in 2018, when the article above was written. Only a few weeks into the official post-EU period, many UK businesses are still trying to come to terms with the new arrangements, which seem to impose rather significant transaction costs: paperwork, red tape, unclear, unknown and undeclared restrictions turn exports for many small businesses from a highly lucrative into a loss-making activity, possibly jeopardising their survival.

But the good news for the manufacturing sector in the UK (and therefore also a slither of hope for my argument) is that goods will be more or less freely traded between the UK and the EU. That contradicts one of the assumptions in the analysis of UK manufacturing, which was based on a hard Brexit with many obstacles to trade in goods.

In fact, assuming the problems of small exporters can be accommodated, only the Rules of Origin (RoO) requirements seem to throw up important new barriers to trade. Whereas before 1 January 2021 any product legally made in the UK could be sold anywhere in the UK, from this month on the UK needs to prove that a large proportion of the value of parts were themselves produced in the UK or the EU to allow free trade in the final product. The required percentage for material originating in the EU or UK varies by product, but will be at least 50% after an initial transition period. This is obviously very important for sectors such as the automobile industry: the crankshaft example from 2018 would, aggregated over all parts, increase the price of the Mini Cooper by an estimated 30-40%; that is now not going to happen, since most car parts are already produced in the EU and can cross borders without incurring tariffs.

But that implies a few important things for the points I made in 2018. First, and addressing the core of the argument, the new Brexit arrangement is very unlikely to lead to a revival of UK manufacturing, at least not in traditional sectors. For a variety of reasons, some of which I will detail below, automobile manufacturers may still be facing tough choices about their past investments in the UK – the economics of investment in car manufacturing have not changed in the past three years – but they seem to have accepted that the costs of remaining in the UK and produce at full capacity are too high, and have decided to slowly write off the losses. Nissan and Honda have already announced capacity reductions, and BMW is likely to do the same for the Mini factory near Oxford. In addition, it is unlikely that newcomers would choose the UK, now outside the EU, as a production site: Why exactly Elon Musk selected Brandenburg for the new (European) TESLA factory may be unclear, but Brexit surely must have mattered in the calculations of the company.

Technological shifts in the industry do not help. There is a rumour doing the rounds in the industry that continental factories will be converted into plants for electric vehicles (not quite as simple as making EVs on an existing assembly line, as we discussed in our PEACS dossier in December 2020) and that UK plants will remain producers of vehicles propelled by internal combustion engines. While that will secure the short-term future of the industry in Britain, it also guarantees its demise in the medium term, precisely because that transition is not very simple. If traditional engines will be prohibited for sale in the EU (and the UK) within a decade as planned, these plants are obsolete, not least because the geography of new production will be fixed without the UK at the table. The future may be uncertain, but it is not entirely unknowable.

Brexit and Covid-19, then, have accelerated this dynamic. The pandemic made companies hedge their bets, as Honda's recent announcement of a partial closure of the Swindon plants demonstrates. That could be overcome as a cyclical problem, but Brexit will seal the fate of both old and new investment in complex manufacturing sectors. Companies often located in the UK because of the English language, the deregulated labour market, and the permissive business environment. Important as these advantages may be, Brexit trumps them all. When the UK is no longer an entry port into the EU's Single Market, the main competitive advantage in the race for FDI disappears. And with that the hope for a revival of traditional manufacturing in the UK (given where we are now, a manufacturing future based on science- and technology future would make more sense; however, the soft and hard obstacles to educational and scientific exchange in the TCA do not bode well for that option). Time to acknowledge that there always was another, far more dire scenario lurking under the relatively optimistic one that I explored in 2018. Now we know more about how and when that might prevail.

5. The future of British (high-end) services

The UK economy is predominantly reliant on services and some celebrated the recently concluded Trade and Cooperation Agreement (TCA) between the EU and the UK as a success for the industry. However, while better than a no-deal scenario, **Laurenz Mathei** *argues that the TCA actually introduces rather harsh conditions for UK service suppliers and presents them with a regime that is far away from the Single Market environment they have been used to in the recent decades of EU membership. A wide array of market access and non-tariff barriers (NTBs) will inevitably diminish British services exports to the EU. In conjunction with a potentially reduced inflow of both high-skilled workers from the EU and foreign direct investment (FDI), this could undermine the UK's comparative advantage. The UK can now try to find and apply advantages of its regained sovereignty, renegotiate the TCA, or just live with it – though none of the options are free of costs.*

The UK is a services economy…

For a long time, the UK has been Europe's poster child when it comes to the provision of services. In 2019, the services industry accounted for 80% of the total UK economic output (Gross Value Added), or around 30 million jobs. This includes a wide array of sectors including finance, legal and business services, transport, information and communication technology (ICT), medical and social care, creative, hospitality, environmental, and other non-tradeable services.

But services are also crucial for the UK's trade balance. While the British export more goods than services, their services export ratio dwarfs other European nations. In 2018, services exports in the UK accounted for 46% of all exports, but only for 34% in France and a mere 17% in Germany. Additionally, while the UK had a trade deficit in goods, it ran a substantial surplus of £28bn in services.

…but the TCA does actually very little for services exporters

After what felt like an eternity for many – though compared to other EU free trade agreements (FTAs) the negotiations were rather rapid – the UK and the EU have agreed on the terms of the TCA on Christmas Eve of 2020. Long-awaited and often-reported presents included among others a deal on tariff-free goods trade as well as agreement on the hot topic of fishery. But what did Father Christmas bring for the British services industry?

The short answer is: probably not enough, as financial and non-financial services will suffer from an increase in NTBs and reduced access to the European market. Additionally, the complexity of the new rules creates uncertainty which can only be resolved by a costly and time-intensive study of the agreement and the supplementary rules in the 27 different EU member states. For many (small) traders, lacking the appropriate understanding of the TCA, this will mean that they either continue to export as usual and run the risk of being fined or they might stop trading at all. Let us now try to unpack these NTBs and see how they will affect the diverse range of companies and independent professionals that are grouped under the umbrella of the UK's services industry.

Market access

Market access is probably the most fundamental right any UK service provider requires to cater the Single Market. Similar to the CETA deal between Canada and the EU, the TCA's services chapter follows a so-called negative list approach. This means that – per default – all sectors that are in scope of the chapter (audio-visual services, for instance, are always excluded) are covered by the trade liberalisation. However, this approach usually also features large appendices that include so-called reservations, i.e. exceptions from the commitment to liberalising market access. In the TCA they take up a whopping 211 pages, which makes up 17% (!) of the whole 1241-page long agreement. The trading partners – in the case of the EU that means the Commission and every individual member state – can use these reservations to (partly) opt-out of opening up their sectors.

One important additional technical detail is that usually the services chapter covers all non-financial services, while a separate chapter covers the agreement on financial services. Though the EU has signalled that the UK might be granted financial market access (or “equivalence”), this was largely excluded from the deal and Brussels doesn’t seem to be in a rush with the decision. Among the non-financial services sectors covered by the TCA, the legal services industry is probably the hardest hit. One of the most protected sectors in Europe, all EU members have taken at least one reservation regarding the services and/or investment liberalisation in legal services. The strictest reservations in this industry include EEA/EU residency (commercial presence) and/or nationality requirements.

Mutual recognition of professional qualifications

However, the buck doesn’t stop here. Not unlike many goods being subject to a quality check, some service suppliers operate in regulated professions. Usually these are sectors where the provision of the service has to comply with certain standards so as to minimise the risk of any unforeseen adverse consequences. In the EU – under a procedure called the mutual recognition of professional qualifications (MRPQ) – a qualification obtained in one member state is automatically recognised in any other EU country. The TCA unfortunately doesn’t include this automatic recognition of qualifications. While for FTA insiders this is unsurprising (CETA doesn’t include these provisions either), it has important consequences for UK service providers who want to cater the EU market.

Take again the example of legal services. A French lawyer, having passed the French bar exams, is free to advise a German client on domestic and EU law. While a British lawyer with the equivalent UK qualification is essentially banned from providing legal advice in the Single Market unless she acquires these qualifications again in an EU member state. Effectively, this is what has happened in the past few years: many British lawyers obtained an Irish legal qualification and registered with the local bar to be able to practice after EU Exit. But it’s more than just legal services. Professional qualifications – and the lack of their recognition – also affect medical staff (such as doctors, nurses, or pharmacists), architects, engineers, accountants and many more.

Business travel and service supply abroad

Yet another area of concern regards the provision of services in the territory of the client, or Mode 4 of services supply as the WTO General Agreement on Trade in Services (GATS) calls it. While British holidaymakers can freely travel to the EU and stay in the Schengen area for 90 days out of a 180-day period, service providers might face visa and/or work permit requirements. The most important areas for service suppliers to look out for are rules for business visitors, contractual service suppliers, and independent professionals.

Under the TCA, a number of work-related trips are defined as business visitor activities, including meetings and consultations, research and design, marketing research, training seminars, trade fairs and exhibitions, sales, purchasing, after-sales or after-lease services (only if the services contract is incidental to the sale or lease of a good), commercial transactions, tourism personnel activities, and translation and interpretation services. For these activities, UK service providers will not be required to produce a visa or work permit upon entry if they don't stay in the Schengen area for more than 90 days in a six-month period. For all other services that are scheduled under the provisions for contractual service suppliers and independent professionals, member states impose a variety of rules including visas, work permits, and economic needs tests. The costs and time associated with obtaining all required permits is significant and could become particularly problematic for small exporting firms and independent professionals. Just imagine a music group touring through the EU having to get all necessary documents for each individual member state.

Data adequacy

A further complication arises from the fact that the EU has strict rules for the conditions under which personal data of EU citizens can be stored and processed. By extension, this means that a non-member state must be afforded data adequacy to store and process data of EU customers but potentially also of employees living in the EU. Along with the TCA, the UK secured a positive data adequacy decision from the EU Commission. However, this right has been limited to 6 months. After this period, the decision will be unilaterally reassessed by the Commission. As this affects all British businesses that exchange personal data with the EU (services and manufacturing alike, though exporters more than others), securing an indefinite data adequacy extension should be an immediate priority objective for the UK government.

What does this mean for the UK's comparative advantage?
The UK exports more services than any other European nation – the bulk of which are financial and professional business services. The City of London has been the centre of the European financial market for decades. The large volume of financial services trade has also attracted other firms, such as legal or consulting companies, which provide auxiliary professional business services. The sheer density of these high-end service suppliers and the associated network effects have been the foundation of the UK's large comparative advantage.

However, with the UK being locked out of the EU market in some services sectors and facing large NTBs in others, many of these (often international) companies might move a significant portion of their operations to countries on the continent. In fact, a lot of this movement has already occurred in the period preceding the conclusion of the TCA. If this trend continues in the future, the City's comparative advantage might erode. It could also take a hit if, due to a tightened immigration regime, the UK becomes a less attractive destination for highly-skilled European workers. Though some of this could be offset by the settlement status offered to those EU citizens who were UK residents before Brexit and an increase in immigration from non-EU countries.

Lastly, the UK could become less attractive as a destination for FDI by multinational companies which have previously used the UK with its business-friendly regulation as a springboard to access the Single Market. A recent study found that EU membership leads to about 60% higher FDI investment into the host economy from outside the EU, and around 50% higher intra-EU FDI. FDI is usually also connected to an increase in productivity in the host economy; losing it might hence have additional repercussions on the UK's competitive advantage.

What can the UK do to stay in the (services) game?
All is not lost in the land of services. The TCA includes 19 specialised committees – sitting under a ministerial level joint partnership council – which cover almost every aspect of the agreement and can suggest (marginal) changes to the deal. It is unlikely that the UK or the EU will want to amend the deal immediately and as long as the British hard red lines on migration and ECJ jurisdiction stand (which is likely over the short- to medium-term) significant changes to services market access will be hard to obtain. However, additional provisions on MRPQ, for example, are possible, though they will only make sense in sectors where UK service providers are allowed to access EU markets already.

In theory, the UK could also utilise its newly gained sovereignty to deregulate the services industry in an effort to increase competitiveness. However, Downing Street should tread carefully, as any moves that the EU could interpret as tilting the level playing field could have costly consequences. For instance, Brussels could argue that deregulated (and thus cheaper) services inputs into British manufacturing represent an unfair advantage to UK manufacturers, potentially leading to the reintroduction of tariffs. Even more relevant, any sudden moves away from current regulations could negatively influence the EU's decisions about financial equivalence and data adequacy.

Lastly, UK services providers can, of course, just try to live with the situation and look for loopholes to continue their operations with EU clients. As the FT reported recently, some financial firms have already implemented a hub-and-spokes model where for every (online) meeting with an EU client, a London-based product specialist is joined by an EU-based core client contact. While technically not illegal – though some of these practices have already been called out by EU watchdogs – it will remain to be seen if this is a cost-effective strategy. In any case, London is likely to retain much of its strength as a centre for financial and professional business services, but anybody who is under the illusion that the UK services industry will not incur significant costs in new era of free trade might want to think again.

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