Should the UK stay in the EEA after Brexit?

*This revised version of Anthony Scholefield's briefing note can also be downloaded as a pdf **here**.*

We don't start with a 'clean sheet'

If we were considering ideal future trading arrangements for the UK from the basis of a clean sheet, it would probably not be sensible for the UK to join the European Economic Area [EEA]. However, the decision to remain in the EEA is quite different from a decision to join the EEA from outside.

Today, the UK does not face a clean sheet. The UK has been in the EEA for 26 years (40 years in the EU) and its trade has developed in this environment. Following the decision to leave the EU the question of whether to change trading arrangements is only one of a number of political decisions the government has to take.

Background

The background fact to be borne in mind is that a huge part of the UK's export trade has always been with Europe. According to Professor Ashworth, in his '*Economic History of England,* about 40% of UK gross goods exports in the mid-nineteenth century went to Europe.

The definition of 'Europe' in the nineteenth century was different from the EU of today, of course, and included the Russian Empire but, notably, excluded Ireland

Free Trade Agreements

The underlying rationale of any trading agreement is not free trade but an increase of trade between the participants at the expense of third party countries. Indeed, a ‘free trade’ agreement is a contradiction in terms. It will also usually benefit producers at the expense of consumers in the participating countries. But the point is that such ‘agreements’ cause trade to flow in certain ways which are not ‘free trade’ but once actioned have costs when they are dismantled.

Political advantages of staying in the EEA

It is very important to consider that staying in the EEA will massively reduce the political upheaval and workload of the government organising Brexit, reassure business, achieve a degree of national unity and make it easier to negotiate on other matters with the EU which will favour this scenario. It also reverses the burden of responsibility for causing a breakdown in negotiations. Finally, it offers a secure refuge (the UK already being in the EEA) should the talks break down. For the EU also, the political upheaval and workload is minimised. It is always good negotiating strategy to consider the difficulties of your opposite numbers. If, after experience, it does not work, the UK can leave the EEA by giving 12 months’ notice. Therefore, there are political reasons to remain in the EEA.

There is also the need to balance the costs of disruption against the calculation of the net benefits and disbenefits of the EEA membership. At present, no such cost/benefit analysis exists, which is an essential preliminary to negotiation. It is possible to recall the exhaustive studies by the Swiss government before their referendum on joining the EEA.

Theory of Trade

There are two unspoken assumptions about the advantages of trade as put forward by the conventional economic wisdom:

‘Any trade is good trade’

‘All trade is of equal value’

Therefore, bulking up trade is ‘a good thing’.

However, the political economists of the nineteenth century recognised there was more to it than the above two assumptions.

John Stuart Mill included the question of the different profitability of different types of trade and which party got the most benefit in his study entitled *‘Essays on Some Unsettled Questions of Political Economy’* in 1848. The particular question of the profitability of various trades is still ‘unsettled’ but ground-breaking work has been done by the OECD and WTO in focussing on trade as a value added phenomenon rather than just gross trade statistics. The OECD/WTO joint paper entitled *‘Trade in Value-Added: concepts, methodologies and challenges’*, sets out the intellectual case for viewing trade through the lens of value-added rather than gross figures.

One significant example, which has been widely referred to in the literature is the case of the Apple I-phone, which is assembled in China and whose ex-factory price appears as exports in Chinese trade statistics. Estimates are that only 8% of the ex-factory price accrues to the Chinese assembler with 92% being spent on imported components and thus showing up in Chinese import statistics and then again in the Chinese export statistics as part of the Apple phone.

Another interesting area arises in the case of the UK where Switzerland in 2014 became the UK’s fifth biggest export market and, in December 2015, was actually the UK’s single biggest export market (£4293 million of exports, according to UK Overseas Trade Statistics, December 2015) and twice the size of the German market. Much of this export trade was non-monetary gold which, of course, is not produced in the UK. Therefore, the value added to national factors of production in both these examples is very small.

Plainly, therefore, trade is not an undifferentiated item. All trade is not of equal value. Some trading is more profitable than other trading. Simply increasing exports of any type is not an adequate policy.

Profitability of Trade

Profitability of trade for a national economy is dependent on value being added so the factors of production, such as labour and capital, get increased returns after buying in necessary supplies to effect increased exports. Therefore there is a hierarchy of added value in trading activities. Simply bulking up gross exports is meaningless.

Generally the most profitable areas of trade from the point of view of the national economy are in services or manufactured goods with a high skill content because they involve very little imports or have a high added-value content. In these examples the gross revenue flows through as very high added value. At the other end of the spectrum are re-exports of raw materials or precious metals with very little added value.

UK gross services exports have recently approximately overtaken UK gross goods exports when considering UK overall trade outside the EU. However, the percentage of UK exports to the EU which relates to services is much lower than in UK trade outside the EU.

Therefore, in principle, UK trade with the rest of the world generates greater added value per unit and, consequently, greater returns to labour and capital than the UK’s trade with the EU. For this reason, a clean sheet consideration would not favour joining the Single Market where services exports are weak whether because of greater competition or restrictive practices.

Paul Samuelson and ‘over trading’

So some trade is more profitable than other trade. But we can go further than that in critiquing the conventional wisdom that all trade is good, following the line of argument put forward by Paul Samuelson, the most influential ‘liberal’ economist of the post-war generation, in a revolutionary paper just before he died.

This was entitled *‘Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization’,* 2004.

In this work he questions the alleged benefits of ‘more trade in modern conditions’.

The kernel of his argument was that trade is beneficial to start with but can cease to be beneficial when shifts in capital and skills make it hard for a country to compete in its supposed (Ricardian) superior productivity industries. Having already given up its supposed (Ricardian) inferior productivity industries, it is faced with a retreat to national autarky to balance its payments situation. At some point the disruptive effects of trade outweighs the benefits. In effect, Samuelson is enlarging on a long-standing critique of the theory of comparative advantage. This is that trade advantages do not stand still. England had comparative advantage in the cotton industry in the nineteenth century and over-concentrated on this industry. In the twentieth century, other countries with cheaper labour out-competed the English cotton industry. In the terminal phase, after 1945, the cotton industry even imported cheap labour from Asia to try to maintain competitiveness but was unable to do so.

So, concentration on what is presently a trade where there is comparative advantage is not necessarily an advantage in the long-term.

The Supply Chains

It is estimated that a majority of trade in manufactured goods takes place within supply chains, co-ordinated by major corporations and worked through legal subsidiaries, associates or clusters of component and assembly suppliers.

These supply chains have adjusted themselves, for good or bad, to working within the EEA.

To leave the EEA would be to disrupt these supply chains, at least in the European Area. There is exactly the same situation which was experienced in the agricultural sphere when the UK joined the EU and the food and raw materials exports of Latin America and Australasia, which were geared to the requirements of the British market, were heavily disrupted.

Weighing up the Balance

The decision to remain in the EEA, however, is quite different from a decision to join the EEA.

UK trade with the Rest of the World appears more profitable than trade with the EEA.

However, once settled inside the Single Market, the argument for not disrupting supply chains is a major issue, counterbalanced by the clear fact that trade with the EEA in services is not proportionate to their role in trade with the Rest of the World and the endless prevarication about removing the barriers to services trade in the EEA.

If the warnings of Paul Samuelson are correct, seeking extra gross trade from supposedly superior productivity activities is not beneficial in itself in the long run. Better is to ensure a balance of manufacturing and service activity with, to be sure, an emphasis on what appears to be superior productivity industries but with particular emphasis on new industries.

Hidden Costs of Trade

Of course, a deeper analysis of the benefits of trade would need to address issues connected with the social or financing costs of trade. It is widely noted, in the case of EU membership, that there is a substantial budgetary cost for British taxpayers for the trading arrangements with the EU as they stand now. (This budgetary cost would be massively reduced by a move from full EU to simple EEA membership.)

A further point is that trade secured by the use of extra factors of production, rather than use of existent national factors, should be strictly analysed for cost. Many advocates of bulking up trade are also advocates of the importation of capital and labour rather than utilising existent capital and labour. These advocates belong to a kind of '*deus ex machina*' school of economics where problems can be solved by outside actors.

Extra factor inputs are not costless. For example, in the UK foreign owners of UK assets can receive dividends tax free while UK owners pay income tax. Of course, these dividends are also negative. This is, therefore, an outright subsidy to foreign capital. Similarly, the provision of extra labour through migrants require massive social and economic capital such as buildings, roads, hospitals, schools, etc. to be paid for by natives either by taxation or by displacement of capital investments from supporting native workers to meeting the needs of migrants. Additionally, there are two further costs in the UK as regards foreign labour. The way the income tax system is set up now means very few low income workers pay any tax (many of these are migrants) despite being heavy users of public-financed capital investment and of public services. So, both foreign capital and foreign workers are subsidised by the British tax system.

Additionally, many migrant workers make substantial remittances to their home countries. These remittances are a dead loss to UK national income.

These extra costs should be considered when looking at the purported benefits of increased trade dependent on introducing extra factors of production.

Summing up

As a basic starting point, cost/benefit analyses are needed in two areas:

1. What are the net benefits and disbenefits of EEA membership vis-à-vis, say, WTO stand-alone trade?

What are the costs of disruption of leaving the EEA?

1. Where is any trade with the EEA which is lost going to be replaced?