COVID-19, Brexit and the opportunity for a sustainable recovery

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3

The establishment of a new trading relationship between the UK and the EU takes place in times of unprecedented economic disruption due to the COVID-19 crisis. Before the crisis, the UK government set out a vision for reform which focused on improving living standards across the UK. It has since reiterated this commitment to such policies. These include so-called 'levelling up' policies, aimed at improving productivity across the different regions of the UK and achieving the green transition, through infrastructure investment. And they include addressing yawning social problems, such as the acute housing shortage and the dreadful shortcomings in social care.

Vast social inequalities, underinvestment in public services and slow progress on the green transition remain huge challenges, as before. It is in this context that the exit from the Brexit transition period is taking place.

The Institute for Public Policy Research (IPPR) has argued that a fair and sustainable recovery from the COVID-19 crisis is indeed possible. It should be built on public investment that fosters the green transition,[1] a reversal of crippling cuts to public services and a drive to address regional inequalities.[2] The government's overall economic success will be judged by how it tackles these challenges within the context of the pandemic.

The establishment of a new relationship with the EU will interact with these policy initiatives and could play a supportive role. At the same time, the crisis adds to the need to ensure that the transition to a new relationship is smooth, well-designed and minimises uncertainty for people and businesses.

Brexit in times of coronavirus

Brexit and its economic implications will take place in an economy severely weakened by COVID-19. Even before this crisis struck, the UK was experiencing low growth and a decade of stagnant living standards that had left many behind. The decade following the 2008 financial crisis was marked by stagnant productivity growth. This meant that although unemployment reached its lowest level in four decades (below 4%), there was barely any real wage growth. Most regions of the country never saw their living standards return to the levels before the 2008 financial crisis.

A 'no deal' outcome remains a possibility. However, there is also scope for compromise, for instance, in areas of environment and climate change, labour and social standards, and taxation.

The pandemic is exacerbating these trends. As elsewhere, the coronavirus has had a disastrous effect on the UK's economy and labour market. The economy is on life support, with more than 8 million workers' wages being funded by the government – almost a third of the labour force. Unemployment is likely to increase by over 2 million. If social distancing restrictions continue in the second half of the year, even if partially, redundancies may well be higher still. The groups most affected by this tend to be those earning low wages, ethnic minorities as well as young people.

The government's migration plan will have a significant impact on the UK's labour market – particularly on low-paid sectors that currently rely on EU migrants.

The government's response so far has averted some of the crisis' worst consequences, including an even larger rise in layoffs. However, all eyes are now on the coming policy decisions that will shape the recovery. Will the government make good on its promise to invest and "spread opportunity to every corner of the UK," as the Prime Minister claims?[3] Vast social inequalities, underinvestment in public services and slow progress on the green transition remain huge challenges, as before. It is in this context that the exit from the Brexit transition period is taking place.

The economic impacts of Brexit

Even though the UK has left the EU and is currently in the transition phase, the shape of their future relationship is still hugely uncertain. As the quid pro quo for a tariff- and quota-free deal, the EU has made clear its expectation of a level

playing field for trade. This includes an agreement on areas like state aid and competition policy, taxation, environmental protections, and labour and social standards.

IPPR analysis suggests that, given the UK's red lines, there will be many challenges in negotiating such a level playing field and, so far, little progress has been made. Therefore, a 'no deal' outcome remains a possibility. However, there is also scope for compromise, for instance, in areas of environment and climate change, labour and social standards, and taxation.[4]

Any forward-looking economic assessment will thus remain highly uncertain given that important policy decisions are yet to be made. The Office for Budget Responsibility (OBR) – the UK's public finances watchdog – highlights that economic activity is about 2% lower in 2020 than what it would have been in the absence of Brexit.[5] This is mainly explained by lower business investment following the referendum. The OBR says this drag on growth constitutes about a third of the negative impact, with the rest still to come, assuming future trade barriers will be similar to those of a 'typical free trade agreement'. The exact size of this impact will depend on the outcome of the negotiations. And negative growth effects from increased trade barriers could be offset by pro-growth policy choices, as outlined in the final section of this chapter.

Brexit should be tailored to promote the government's objectives to 'level up' the left-behind regions of the country, improve living standards across the board and drive the green transition.

Before considering policy options, the remainder of this section considers in more detail how different sectors, income groups and regions might be affected by Brexit.

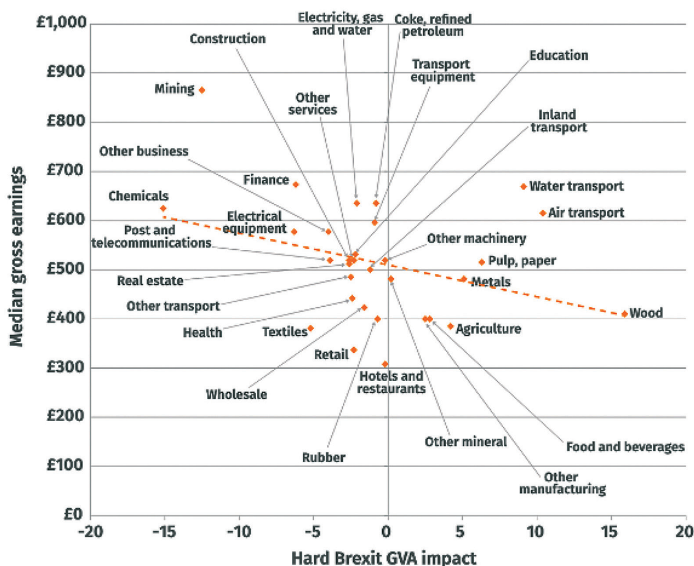
SECTORAL IMPACTS

A Brexit-related increase in trade barriers is likely to negatively affect sectors like finance, mining, chemicals and electrical equipment – they could have a negative impact of more than 5% on their gross value added (GVA) (see figure, page 24). These sectors tend to have relatively higher wages, and indeed Brexit might affect high-income sectors somewhat more in general. Nevertheless, some low-paid sectors (e.g. textiles) will likely suffer, too. On the other hand, some sectors, such as agriculture, and food and beverages, could benefit from Brexit in terms of their GVA.

Distributional impacts will likely vary also within sectors. Low-paid workers might be most at risk of Brexit-related impacts, even in sectors that are on average well-paid. For instance, lower-paid or less senior staff members in firms considering downsizing or relocating due to Brexit may be at greater risk of redundancy.

Higher-income sectors are somewhat more likely to be negatively affected by Brexit

Source: Morris (2018)[6]



MIGRATION-RELATED IMPACTS

The UK government announced in February 2020 its plan for a new 'points-based' immigration regime following the transition phase. IPPR analysis finds that 69% of EU migrants currently working in the UK would be ineligible for a skilled work visa if these future immigration rules were to apply to them. This is because, based on their occupation and earnings, they would not have enough points to secure a skilled work visa.[7]

This suggests that the government's migration plan will have a significant impact on the UK's labour market – particularly on low-paid sectors that currently rely on EU migrants. The social care and health care systems are already experiencing a workforce crisis, but these new immigration measures are likely to complicate recruitment further. The hospitality industry will also find it particularly difficult to recruit EU workers under the new system.

PRICE-RELATED IMPACTS

Higher trade barriers resulting from the new trading relationship could mean increased prices for imported goods. Building on analysis by Breinlich *et al.*,[8] the IPPR finds that the price impact (as a share of income) could be relatively similar across income groups. Overall, prices could increase between 1.5% and 3.5% across income groups, depending on the 'softness' or 'hardness' of the new trading relationship.[9]

The manner in which potential price increases affects different income groups will vary, however. For instance, poorer households spend a greater proportion of their income on food (i.e. a product group with high price impacts as a result of Brexit). Meanwhile, richer households are more likely to spend a greater proportion of their income on transport (i.e. another product group with a high price impact, in part because of the predicted rise in the price of imported cars).

Some of these price rises could be offset by cheaper goods from elsewhere through tariff reductions if new trade deals were negotiated with non-EU trading partners. However, the overall effect of this is estimated to be relatively small.

REGIONAL IMPACTS

Brexit will likely have widely varying regional impacts. At first glance, EU withdrawal will impact local authorities in London and the South East the most. This is because these areas have the highest concentration of people employed in the services sector, particularly financial services and business activities.

However, using a different set of indicators and focusing on exports changes this picture, with regions outside London significantly more affected. For instance, Northern Ireland exports the vast majority of its food, live animals and material manufactures to the EU given the land border with the Republic of Ireland. East Wales, in turn, has a high share of exports to the EU in machinery and transport equipment, given that it contains a number of major European export hubs, such as Toyota's Deeside Engine Plant and Airbus' Broughton manufacturing site.[10]

In general, going beyond a high-level sector analysis and considering value chains, there is evidence that regions outside London will be hit the hardest. Looking at trade exposure through value chains, Chen *et al.* find that regions most exposed to EU trade are, in fact, the Midlands and Northern England, rather than London or Scotland.[11] London and Scotland – with their more skilled workforce – could also be expected to adapt to the new post-Brexit reality more quickly than others.

This differential regional impact may make the government's plans to raise productivity in all parts of the country more difficult.

The policy opportunity

Brexit should be tailored to promote the government's objectives to 'level up' the left-behind regions of the country, improve living standards across the board and drive the green transition.[12] It should be built around three pillars: a broad-based industrial strategy, and investing in the UK's social infrastructure and a green recovery.

First, the UK requires an ambitious investment stimulus aimed at improving productivity growth in sectors that are traditionally considered high- and lower-tech. The government has declared its ambition to increase infrastructure investment and research and development expenditure for high-tech industries and manufacturing. But investments and support initiatives should also focus on service-oriented sectors, such as education, health and social care. This response must be tailored to the needs of the post-pandemic labour market.

Second, the government needs to foster investment in 'social infrastructure' that generates economic *and* social value. In the 21st century, an important source of economic value will be generated through networks and the exchange of ideas. Such growth requires people to meet, exchange and create. At the same time, the rise of the service sector means that delivery is increasingly local. In other words, much growth is generated through people convening in economic clusters. Fostering this type of growth has the dual advantage of raising growth while also

strengthening communities. World-class local public services are a crucial piece of social infrastructure to enable this. Severe cuts to such services over the last decade thus need to be reversed. This can be further advanced by championing common forms of ownership and local employment through placemaking strategies.

Third, public investments should be used to steer the economy onto a green growth trajectory. Such investment can incentivise the private sector to make green investments. Each pound the government uses to, for instance, support low-carbon housing or sustainable transport can 'crowd in' a multiple of that in private investment. In the long term, such investments pay off for the economy as a whole. To make such crowding-in work, careful targeting and impact assessment of public investment is needed. Its aim must be to fully decarbonise buildings, transport, industry and the power sector by 2050.[13]

In sum, sustainable recovery from the COVID-19 crisis is possible. The government should ensure that its Brexit policy supports, rather than hinders, this. It will need to support a broad-based investment stimulus to allow an upscaling of the country's social infrastructure, and deliver the green transition swiftly.

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2. Raikes, Luke; Arianna Giovannini and Bianca Getzel (2019), "Divided and connected: Regional inequalities in the North, the UK and the developed world", Manchester: The Institute for Public Policy Research North.
3. Johnson, Boris, "Let's unite this country", *Twitter*, @BorisJohnson, 15 December 2019.
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5. Office for Budget Responsibility (2020), "Economic and Fiscal Outlook – March 2020", London.
6. Morris, Marley (2018), "An equal exit? The distributional consequences of leaving the EU", London: The Institute for Public Policy Research, p.8.
7. Morris, Marley; David Wastell and Robin Harvey, "Immigration plans analysis: Two thirds of current EU migrants in health and care sector would have been found ineligible", The Institute for Public Policy Research, 19 February 2020.
8. Breinlich, Holger; Elsa Leromain; Dennis Novy and Thomas Sampson (2017), "The Brexit vote, inflation, and UK living standards", London: Centre for Economic Performance.
9. Morris (2018), *op.cit.*
10. *Ibid.*
11. Chen, Wen; Bart Los; Philip McCann; Raquel Ortega-Argilés; Mark Thissen and Frank van Oort (2018), "The continental divide? Economic exposure to Brexit in regions and countries on both sides of The Channel", *Papers in Regional Science*, Volume 97, Issue 1, pp.25-54.
12. The UK's industrial strategy is unlikely to clash with EU state aid rules; they do not prevent an active industrial policy. Instead, the EU allows state aid to be directed towards a range of key progressive priorities, such as regional development, environmental protection and support for small businesses. It restricts state aid when public money is wasted, and pan-European inequalities exacerbated. Moreover, EU rules do not prevent nationalisation and explicitly allow for public ownership in the rail industry and other areas of the economy. The evidence suggests that the UK has spent far less on state aid than most EU countries. Morris, Marley and Tom Kibasi (2019), "State aid rules and Brexit", London: The Institute for Public Policy Research.
13. Murphy and Jung (2020), *op.cit.*