The impact of a disorderly or no-deal Brexit
PBO Publication 8 of 2019

Introduction and context

The Note briefly outlines the impact of a disorderly Brexit on the Irish economy. It discusses both the potential economic and fiscal implications of a disorderly or 'no-deal' Brexit.

The nature of the future trading relationship between the EU and the UK remains unclear. The UK currently plans to leave the EU on 29 March 2019. To facilitate an orderly exit, the EU and the UK Government have provisionally agreed a Withdrawal Treaty and a Political Declaration on future EU-UK relations. The Withdrawal Treaty sets out a transition period during which EU law will continue to apply to the UK, a Protocol on Ireland and Northern Ireland (the ‘backstop’ solution) and a financial settlement.

The vote on the Withdrawal Treaty was defeated in the UK parliament on 15 January 2019. While dialogue between the EU and the UK Government may yet result in the Withdrawal Treaty being ratified by the European and UK parliaments, the default position is that on 29 March 2019 with no-deal in place, a ‘disorderly’ Brexit ensues.

Economic impact

A no-deal Brexit will have a detrimental impact on Irish economic activity. However, the scale of this impact is highly uncertain. While a no-deal Brexit will have an immediate impact, the timing and duration of most of its possible effects is unknown.

Table 1 summarises the results of modelling ‘no-deal’ scenarios on economic output (as measured by Gross Domestic Product by the Central Bank of Ireland, the ESRI and the Department of Finance). All three institutions use the macroeconomic COSMO model1 to simulate the economic effect of a no-deal Brexit in March 2019. However, they would apply different assumptions as to how a no-deal Brexit would affect certain parameters and indicators in the model.

The Central Bank estimates the most severe effect, with almost twice the effect in 2019 of the Department of Finance’s or the ESRI’s. However, the Central Bank still expects the economy to grow in 2019 and 2020 even with a disorderly or no-deal Brexit. The reason for this is, according to the Central Bank, that the economy has diverse activity in a range of sectors, strong domestic demand, and multiple trade relationships and these mitigate against some of the negative effects of Brexit.

Table 1 - Forecast of Brexit related reduction of GDP growth rate

<table>
<thead>
<tr>
<th></th>
<th>Central Bank</th>
<th>Department of Finance</th>
<th>ESRI2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short term (2019)</td>
<td>3 percentage points</td>
<td>1.5 percentage points</td>
<td>1.4 percentage points</td>
</tr>
<tr>
<td>Long term</td>
<td>6 percentage points</td>
<td>4.5 percentage points (by 2023)</td>
<td>3.8 percentage points (by 2027)</td>
</tr>
</tbody>
</table>


1 See Bergin et al. (2017) COSMO: A new Core Structural Model for Ireland.
2 The ESRI forecasted a reduction of 1.4 percentage points in GDP growth for 2019 under a move to WTO rules post-Brexit based an overall decrease of 3.8 percentage points in GDP by 2027 compared to a no Brexit baseline under the WTO scenario.

Key messages

- A no-deal Brexit will likely have an immediate and detrimental impact on the economy.
- The size of the economic impact in 2019 is unknown. Economic forecasters estimate that GDP growth will be 1.4 to 3 percentage points below what it would have been in an orderly Brexit.
- These estimates are highly uncertain and indicative as the model used has no history of this type of structural break in trading and regulatory relationships between advanced economies.
- Policy measures enacted by the Government and the European Commission may mitigate some of the impact.
- The fiscal impact of a no-deal Brexit will be significant, possibly resulting in a budget deficit from decreased tax revenue and increased government expenditure necessitated by a no-deal Brexit.
The Department of Finance scenario suggests that employment will be 55,000 lower in 2023 than their Budget 2019 forecast in the event of a no-deal Brexit. The unemployment rate would rise by 2 percentage points. This will result in loss of tax revenue and additional social payments. Neither the Central Bank nor the ESRI enumerate a figure for potential job losses.

Forecasting the impact of Brexit on the economy is very difficult as it is an unprecedented event (see Box 1). The estimates above are highly uncertain and indicative only as the model they are based on uses historical relationships between indicators that might break down or change dramatically in a no-deal Brexit.

Box 1: Macroeconomic models and structural breaks

Macroeconomic models use mathematical equations to relate different economic indicators to each other. The relationships that underlie these equations are estimated using economic theory and historical data. If an event occurs that changes historical relationships it may lead to a structural break in the model i.e. the model no longer accurately reflects the relationship.

Brexit is an unique event with no previous history or precedent in modern times which could be used to model the structural break that it represents. As Ivan Rodgers, former Permanent Representative of the UK to the EU, states "No developed country has left a trade bloc before, let alone in disorderly fashion, and let alone one [EU] which has become a lot more than a trade bloc".3

Therefore, forecasts based on current models will be limited. Furthermore, the structural break of Brexit will impact trade, consumption, investment, productivity, competitiveness, labour mobility, firms’ international interaction, the financial sector, regulatory and policy governance, etc. The multitude of issues involved and the interaction between the variables mean that their cumulative impact will be significant. The outcome that various economic forecasters estimate for a no-deal Brexit based on such models is tentative at best and based on their plausible assumptions of potential changes in the relationships. However, it is unlikely, given the scale of the structural break a no-deal Brexit represents, if all factors can be accounted for or all the assumptions made will be accurate.

3 Rodgers, I. (2018) Brexit Speech at the University of Liverpool’s Heseltine Institute for Public Policy, Practice and Place.

Sources of economic impact

The overall economic impact in a no-deal or disorderly scenario is driven by a number of factors. These are discussed below.

Impact through trade

One of the key transmission mechanisms of a no-deal Brexit on the economy will be through the impact on trade. In a no-deal Brexit, trade between the EU and the UK will be subject to WTO rules and the resulting customs checks, regulatory checks4 and supply chain disruptions will act as significant barriers to trade. A number of Irish companies could be vulnerable to this trade disruption, many of whom are in labour intensive industries such as agri-food. The EU and Government may take steps to mitigate these effects but even with such measures there could be severe disruption in the immediate aftermath of a no-deal Brexit.

Table 2 shows the UK share of Irish imports and exports. The table illustrates how the UK is a significant trade partner for Ireland, particularly for goods imports and in the agri-food sector. Ireland records an overall trade surplus with the UK. However, this is due to the surplus in services and there is a trade deficit in physical goods.

Table 2 - UK share of Irish trade

<table>
<thead>
<tr>
<th></th>
<th>UK share of total Irish exports</th>
<th>UK share of total Irish imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods</td>
<td>11.4%</td>
<td>22.1%</td>
</tr>
<tr>
<td>Services</td>
<td>16.4%</td>
<td>9.3%</td>
</tr>
<tr>
<td>Agriculture/food</td>
<td>36%</td>
<td>40.3%</td>
</tr>
</tbody>
</table>


Note: Figures for Goods and Agriculture/food are for the first 11 months of 2018. Figures for Services is for 2017. Figures for Agriculture/food is for Great Britain (i.e. excludes Northern Ireland).

Trade with the UK will be affected by price changes driven by the imposition of tariffs and exchange rate movements. In the event of a no-deal it is likely that sterling will depreciate against the euro making Irish exports to the UK more expensive for UK customers. If tariffs are introduced at World Trade Organisation (WTO) rates, this will also increase the price of many Irish goods for UK customers. Tariffs are high in the agriculture sector, whereas in other

4 Regulatory checks will include agricultural, marine, health, environmental and plant health controls.
sectors tariffs tend to be lower and thus agri-food exports will be disproportionately affected. In addition, non-tariff barriers such as customs checks, regulatory differences and regulatory checks will impact exports.

Customs checks, regulatory checks and supply chain disruptions in the immediate aftermath of Brexit could disrupt and increase the cost of imports. In the event of no-deal Ireland would also have to impose the EU’s customs duties on UK imports, increasing the price of many goods. Counteracting these effects will be the likely depreciation of sterling and changing the sources of many goods (e.g. to EU based suppliers). The net price effect in the short term is hard to predict and it may not be uniform (i.e. prices in some goods especially food may increase due to tariffs whereas prices in other goods may fall in line with the exchange rate). In the medium to longer term less competition from UK suppliers could also impact on prices.

A 2017 paper by the Department of Finance concluded that the agri-food sector is particularly vulnerable to Brexit. This vulnerability arises as this sector is highly exposed to the UK economy and will be exposed to greater international competition in the UK market post-Brexit. Rural Ireland would be sensitive to any potential downturn in the agri-food sector. The implementation of WTO rules and tariffs in this sector will be complex and costly.

An important aspect of trade flows is the significance of raw material and intermediate inputs to the production of the final finished goods. For Ireland, a significant share of its exports rely on imported intermediate goods. Global, complex and time sensitive supply chains could come under intense pressure in a no-deal Brexit which could lead to a reduction in confidence in business to business and business to customers’ relationships.

In a no-deal Brexit, the issue of the Irish border and how trade across the border is handled. A no-deal Brexit could lead to Irish and UK border inspectors/customs officers on the Border, a decrease in economic activity in Northern Ireland and Ireland, and increase cross-border crime opportunities. Restoring the Northern Ireland Executive would bring more economic certainty to Northern Ireland. A no-deal Brexit may hamper the ongoing efforts to restore the Northern Ireland Assembly and its Executive.

Other potential economic impacts

There are other transmission mechanisms of Brexit besides pure trade effects. A no-deal Brexit could bring about changes in consumer sentiment in the domestic economy, which could result in reduced earnings, employment, consumption and investment. Consumption could also be reduced by higher prices from the trade effect of Brexit. A downward change in these key drivers of the economy could increase precautionary saving, risk aversion behaviour and policy uncertainty, depressing economic activity. SMEs could face financial strain as they have more limited capacity to quickly change their supply chains. This unpredictable environment could undermine confidence in the economy by customers and investors.

The UK acts as a land bridge to the continent for a share of Irish exports, which existing economic models might fail to capture. A no-deal Brexit could see a shift in transportation patterns with more goods moving directly between Ireland and the continent. This can be already seen in a recent agreement between the Irish and French ports’ associations aiming to increase capacity on existing sea routes between Ireland and France. A change in transport patterns might increase time pressures in the supply chain and/or result in price increases. There could be an increased cost to the Government, businesses and consumers if additional investment in transport facilities to the continent is required.

A no-deal Brexit will have an immediate economic impact however there are uncertainties about the timing and duration of this shock to the economy. In the months immediately after a no-deal Brexit, there might be contingency plans to reduce the burden of non-tariff barriers. Policy and legal pressures, events and/or scandals (e.g. fraud/smuggling/defective goods), and the development of customs and regulatory compliance capacity will likely drive a stricter regime in the long run. Furthermore, trade deals by the UK with non-EU countries could result in more competition facing Irish exporters who sell in the UK market, for instance, Irish agri-food products could be out-priced in the UK market by American or Southern American products.

The overall long-term effect of a no-deal Brexit will depend on if there is a subsequent trade agreement after such a Brexit. The terms and timing of any trading and regulatory regime eventually agreed between the UK and the EU may

6 Customs control are not exclusive to border areas but non-border checks are more resource-intensive and less efficient (LSE (2019) What no-deal really means for customs on the Northern Irish border).
mitigate some of the initial damage from a no-deal Brexit. There are some positive opportunities for economic development arising from Brexit. UK businesses may invest in Ireland in order to access European markets. Ireland may attract other foreign direct investment that would not have materialised without Brexit. This could be particular pertinent for the financial sector and the issue of passport rights for financial firms. Furthermore, a no-deal Brexit will drive diversification of Irish trade and potentially could make Ireland less reliant on the UK market, particularly for the agri-food sector. However, these effects would materialise in the longer term and may require significant investment.

Fiscal impact

If economic growth is negatively affected by a no-deal Brexit, there will be consequences for the fiscal balance. Lower economic growth will also reduce employment, income, profits and consumption below what is currently expected. This would result in less tax revenue and additional expenditure, for example unemployment payments and associated benefits (i.e. medical cards, housing), given no policy change in tax and expenditure.

There will be changes to tax and revenue as a result of a no-deal Brexit. There could be a decrease in income and VAT payments if there is a downturn in the economy with the corresponding reduction in earnings and employment. Revenue from customs duty could significantly increase from Brexit but this mostly contributes to the EU Budget, not the national budget.

Under the Department of Finance scenario discussed earlier, the general government balance would become a deficit of 0.2 per cent in 2019 and this would increase to a deficit of 0.5 per cent in 2020, with further increases in the deficit to 2023. According to Professor John Fitzgerald an economic model developed by ESRI suggests that a no-deal Brexit would result in a budget deficit of between one and two percentage points of GDP in 2019 and 2020.9

The risk of a no-deal Brexit to public finances is influenced by pre-Brexit fiscal policy. The forecasts for Budget 2019 are based on the assumption of a transition period involving little change to current trading relations between the EU and the UK. In Budget 2019, €92 million in additional expenditure was allocated to be spent on new Brexit related measures.10 In the event of a no-deal Brexit, additional expenditure over what is currently allocated on Brexit specific measures will be likely.

Allowing tax revenue to fall and expenditure to rise automatically in a slowdown (i.e. counter-cyclical fiscal policy) may be merited in a no-deal Brexit depending on the severity of the resulting slowdown. However, the large nominal level of Ireland’s Government debt may put limits on the amount that can be borrowed for such a fiscal response. EU fiscal rules which have proved to be pro-cyclical for Ireland may also be a constraint.

There are some positive aspects for public finances arising from a no-deal Brexit. There could be increased revenue from corporation and income tax if Ireland receives high value FDI, particularly from the financial sector, as a result of a no-deal Brexit.

The PBO, amongst others including IFAC, have raised concerns about large increases in Government expenditure based on potentially unsustainable tax revenues. An economic shock from a no-deal Brexit leading to a deterioration in the deficit highlights the fragility of the public finances.

Disclaimer: This document has been prepared by the Parliamentary Budget Office (PBO) in accordance with its functions under the Houses of the Oireachtas Commission Act 2003 (as amended) for use by the Members of the Houses of the Oireachtas to aid them in their parliamentary duties. It is not intended to be either comprehensive or definitive. The PBO may remove, vary or amend any information contained therein at any time without prior notice. The PBO accepts no responsibility for any references or links to or the content of any information maintained by third parties. Staff of the PBO are available to discuss the contents of these papers with Members and their staff, but cannot enter into discussions with members of the general public or external organisations.

Contact: pbo@oireachtas.ie
Go to our webpage: www.oireachtas.ie/pbo
Publication Date: 14 February 2019