The Consequences for the Northern Ireland Economy from a United Kingdom exit from the European Union

Briefing Note: CETI/OU, 2/15

March 2015

1. Background

The issue of the economic consequences of the United Kingdom (UK) leaving the European Union (EU), commonly known as a BREXIT, is a complex one to analyse. Proponents on both sides of the argument draw upon detailed evidence, much of which is not directly comparable. Examining evidence and arguments about the impact of a BREXIT at sub-national levels is more challenging. In the case of Northern Ireland, the consequences may be easier to delineate because it is the only part of the UK that has a contiguous border with another EU Member State. The crucial point in all these debates is that one is an attempting to analyse a future, and as yet uncertain, event the consequences of which may be profound. In this regard a series of counter-factuals are advanced based upon forecasts of future economic outturns.

For proponents of the UK's continuing membership of the EU[1] the following factors are key to their arguments:

- British trade and investment;
- Migration;
- The City of London;
- Regulation;
- The EU budget;

For the opponents of the UK's continuing membership of the EU, the issues are:

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[1] See Centre for European Reform (2014) *The economic consequences of leaving the EU The final report of the CER commission on the UK and the EU single market*, London: Centre for European Reform

- The relative decline of the EU's share of global trade as emerging becomes become advanced ones;
- The costs of regulation of EU membership which is estimated at between 6% and 25% of UK GDP[2] or £24.7bn[3], for the top 100 EU regulations;
- Combating the "myth" that 3 – 4 million jobs in the UK are directly related to EU membership and would be lost in the event of a BREXIT;
- Entering a global free trade area will increase benefits from trade and Foreign Direct Investment (FDI);

The proponents of EU membership use an analysis based on current data to estimate the positive benefits of continuing membership of the EU. The opponents, on the other hand, use counter-factuals and scenario analysis to support their case. Consequently, there is uncertainty around the range of "what ifs" implicit in the latter's assessment. What both sides share is trying to estimate transactions costs (administration costs) and opportunity costs (cost of alternatives/substitutes).

Hence, a number of the estimates of costs of staying or leaving are in this form of what can be termed 'funny money'. In regard to these types of costs, transactions costs are important for a territory like Northern Ireland in that these would rise significantly for cross-border trade and economic co-operation if a BREXIT occurred. Furthermore, the opportunity cost of improving cross-border infrastructure and thus connectivity could increase considerably.

Unravelling the economic impact upon Northern Ireland from the rest of the UK is challenging. The key factor is how smaller more devolved economies benefit from existing in a larger multilateral environment. Moreover, that these type of economies

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[2] Minford, P., Mahambare, V., and Nowell, E., Elgar, E. (2005): "Should Britain leave the EU? An economic analysis of a troubled relationship", in association with the Institute of Economic Affairs. London: Institute of Economic Affairs.

[3] Open Europe Briefing Note (2013): Top 100 EU regulations cost the UK economy £27.4 billion a year – and costs outweigh benefits in a quarter of cases: http://www.openeurope.org.uk/Article?id=14167

tend to create more sustainable growth and equity over the longer term[4] This conclusions underpinned by the Oates decentralisation theorem that states:

> *In multilevel governments, each level of government (including the central government) will maximise social and economic welfare within its own jurisdiction*.[5]

It is within the context of this evidence that the economic impact of a BREXIT on Northern Ireland can be examined.

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4 Centre for Cities(2014) *Cities Outlook 2014* . London: Centre for Cities.
Blöchliger H. and B.Égert (2013), Decentralisation and Economic Growth. Part 2: The Impact on Economic Activity, Productivity and Investment, *OECD Working Papers on Fiscal Federalism* , No.16, OECD Publishing.

5 Oates, W.E (2006) "On the Theory and Practice of Fiscal Decentralization" *IFIR Working Paper No. 2006-05* Maryland: University of Maryland.

2. Impact on UK Economy

The EU has a falling share of the world's population (7%): total GDP (25%); but, rising social costs (50%) due to ageing and demographics. In respect of the development of the European Single Market (ESM) and its components:

1. From 1995 to 2008, EU GDP was 5% higher because of the creation of the ESM[6].
2. Full implementation of the Service Directive would increase EU GDP by 2.3%[7].
3. Completing the Digital SM could raise EU GDP by 4%[8].

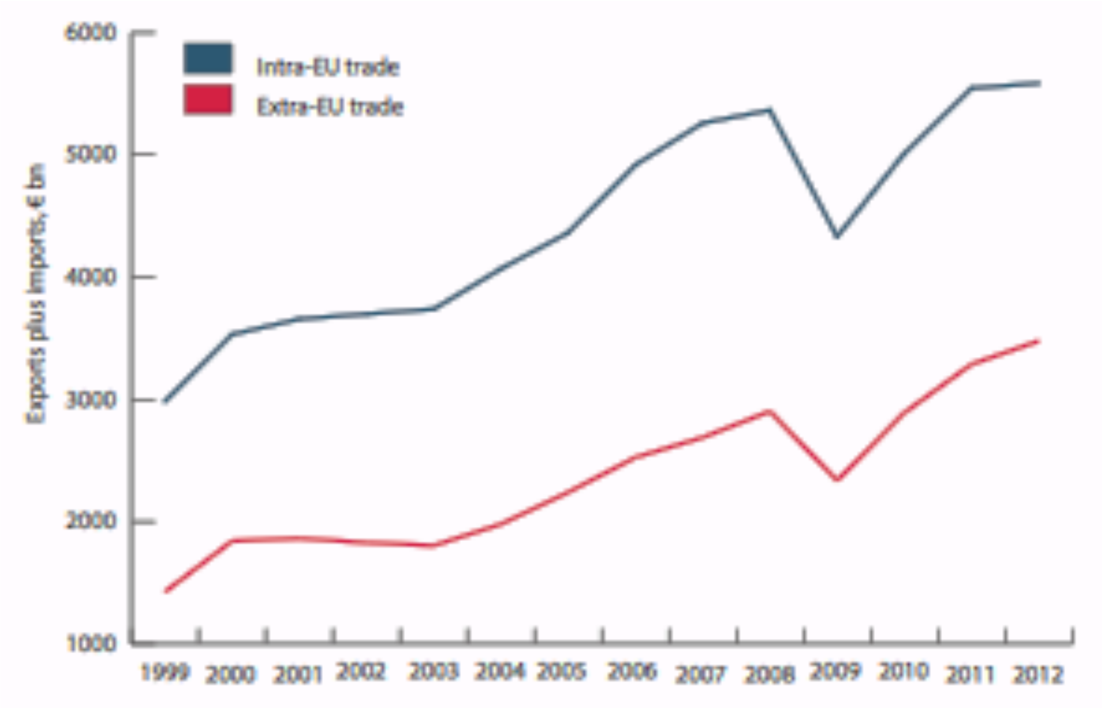
In respect of the UK, it accounts for 12% of its population and 15% of its GDP. Given the comparative demographics of the UK, its economic impact is likely to grow over time. Moreover, given the role of services and e-commerce in the composition of the British economy, the completion of the components of the SEM will also enhance its GDP. The following factors reflect the current importance of the EU to the UK economy.

- A BREXIT would lead to a 1 to 3% reduction in UK GDP with the ESM[9];
- The Eurosceptic Institute of Economic Affairs estimates that leaving the EU would lead to an impact on UK GDP of -2.6% and +1.1% of GDP, with a best estimate of +0.1%[10];
- According to the National Institute of Economic and Social Research a BREXIT would result in a permanent reduction in UK GDP of $2^1/_4$%[11].

[6] Boltho, A. and B. Eichengreen (2008). The Economic Impact of European Integration. *CEPR Discussion* Paper 6820
[7] Open Europe (2013). *How to reignite the EU's services market and boost growth by EUR 300 bn*. London: Open Europe.
[8] See H.M. Government (2013) *UK Review of the Balance of Competences between the United Kingdom and the European Union. The Single Market*, London: Cabinet Office.
[9] Deutsche Bank Research (2103) *A future in the EU? Reconciling the 'Brexit' debate with a more modern EU*, Frankfurt: Deutsche Bank.
[10] Masefield, I. (2014) *A Blueprint for Britain: Openness not Isolation* IEA Brexit Prize, London: Institute of Economic Affairs.
[11] Pain, G. and Young, G. (2004) 'The macroeconomic impact of UK withdrawal from the EU', *Economic Modelling*, 21, pp. 387–408

The scale of the UK's economy integration in the EU (and with possibly large direct costs of exiting) can be seen in the growth of trade and FDI. As shown in Figure 2.1 in the first instance/

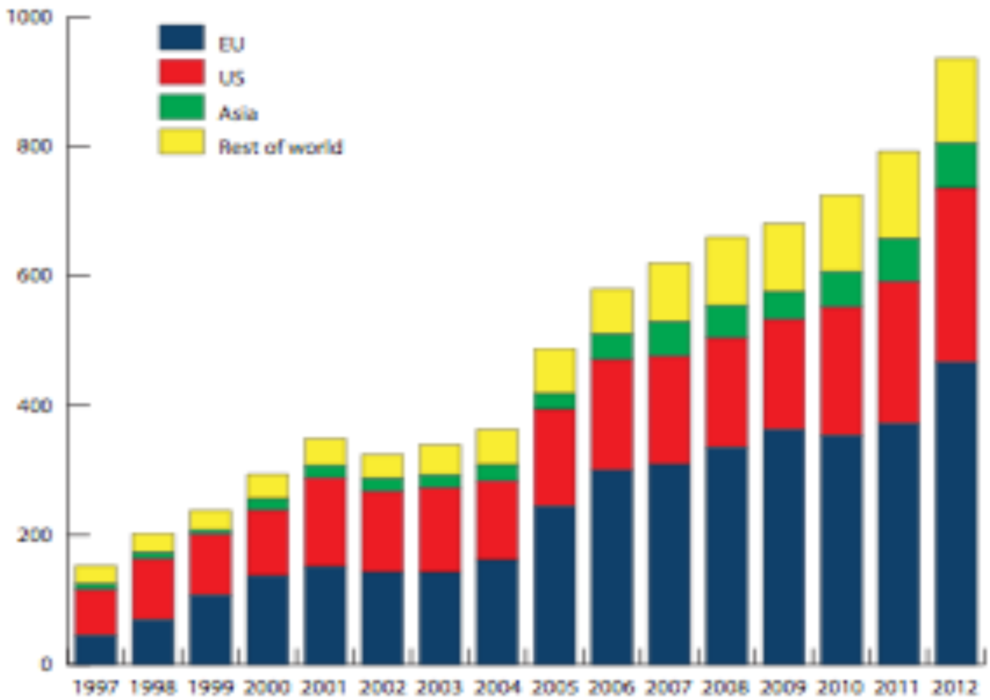
Figure 2.1: Trade between Member- States of the EU and between the EU and the Rest of the World



Source: EUROSTAT (2013)

This figure shows the growth of trade in the EU with intra-EU trade growth at 5.4% per annum. Intra-EU trade data should come with a caveat that much of it is intra-firm. That is, intra - firm trade corresponds to international flows of goods and services between parent companies and their affiliates or among these affiliates, as opposed to arm's length trade which is trade between unrelated parties (inter- firm trade). Intra-firm trade is the consequence of activities of multinational enterprises (MNEs) that move goods and services across borders during the production process and provide final products to customers through their foreign affiliates. For example, the same MNEs in the car industry in the EU transfer large amounts of intermediate and final goods across national border. Intra-firm trade in services accounts for 57% of EU trade. The important point is the link between intra-firm trade and FDI particularly in a globally open economy like the UK. The composition of inward FDI to the UK is given in Figure 2.2.

Figure 2.2: **The origin of foreign direct investment to the UK**



source: Centre for European Reform (2014)

The EU's share of world inward FDI declined from 45% in 2001 to 18% in 2012 rising again to 20% in 2013[12]. This decline has been accompanied by an increase in outward FDI to emerging economies as they have been the dominant source of global growth in the last decade. As both the EU has expanded and emerging economies, like China, develop into advanced ones, inward FDI to many regions of the EU is likely to rise. Furthermore, the role Global Value Chains (GVCs), in which the different stages of the production process are located across different countries, have grown in importance.International production, trade, services and investments are increasingly organised within GVCs. Globalisation motivates companies to restructure their operations internationally through outsourcing and offshoring of activities through FDI. But there is a countervailing tendency that may increase inward FDI to the EU in that the growth of GVCs encourage re-shoring back to a home base as the dynamics of the global economy evolve.

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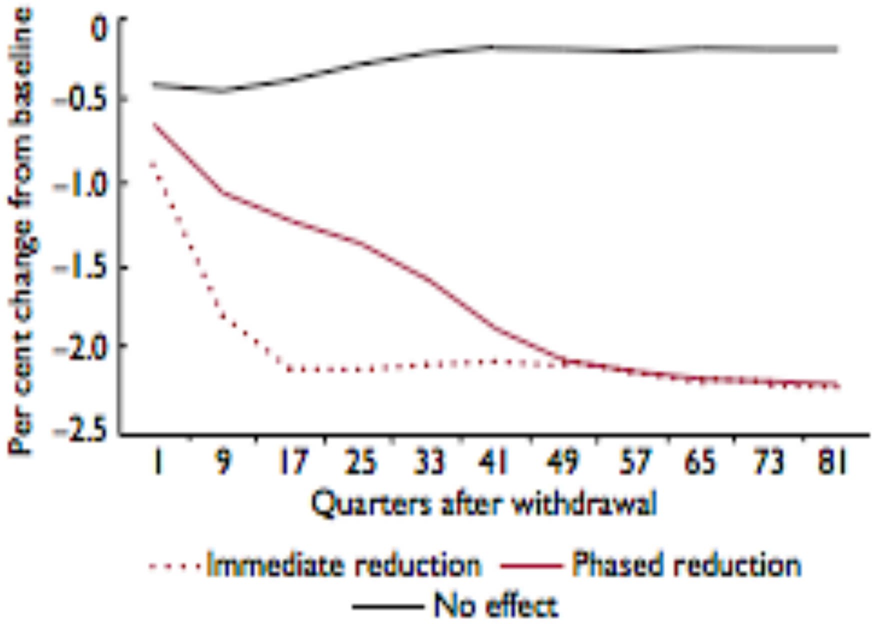
[12] Ernst and Young (2014) *EY's attractiveness survey Europe 2014 Back in the game*, London: Ernst and Young.

The impact on FDI is the weakest part of the arguments made by supporters of a BREXIT in that they admit that the greatest uncertainty surrounds this key factor. The impact is shown in Figure 2.3 that shows the percentage decline in FDI over time as a

Figure 2.3: The impact on real GDP of different FDI assumptions (per cent)



source: Pain and Young (2004)[13]

result of a BREXIT. The relationship between trade (particularly cross-border) and FDI is an important consideration for Northern Ireland, particularly in the light of proposed control over the rate of corporation tax in order to stimulate FDI. Being located as a potential site of increased FDI within the EU remains advantageous for economic territories like Northern Ireland. Withdrawal from the EU would thus affect devolved nations and regions that are sites of FDI.

[13] ibid

3. Economic Consequences for Northern Ireland

Attempting to disaggregate the impact of a BREXIT to the level of the economy of Northern Ireland is challenging. An inference can be made about this impact from growth and unemployment rates. The trend rate of growth of the Northern Ireland economy is about a third lower compare to that of the UK[14]. The comparative unemployment rate of about is about twice that of the UK as a whole. Thus, if the median forecast for the impact on UK GDP from a BREXIT is around 2% lower then we could expect trend total GDP to be 3% lower in Northern Ireland. Similarly, we would expect trend total unemployment in to increase by a proportionate amount. The drivers for these changes would be primarily the impact of reduced cross-border trade and economic co-operation; FDI; and a loss of EU economic development funding programmes. In the case of less FDI, the spillovers effects of higher productivity, training and skills and more importantly derived demand for domestic production, tradable and non-tradable services would decrease.

3.1 Cross-Border Trade and Economic Co-operation

The UK is the largest trading partner of the Republic of Ireland (ROI) accounting for 17% of its exports. Given the contiguous land border and that since the Good Friday Agreement has led to more cross-border trade and economic co-operation, the relationship of Northern Ireland to the rest of the EU has been strengthened. This rising trend in trade is shown in Figure 3.1 below. One can see a rising trend in the North to South series (allowing for the global dip associated with the 2007 financial crisis), showing the increasing importance of the ROI as a market for output of the Northern Ireland economy. The relationship between trade flows and FDI is a well-established one[15]. In the case of cross-border economic co-operation the latter is an important

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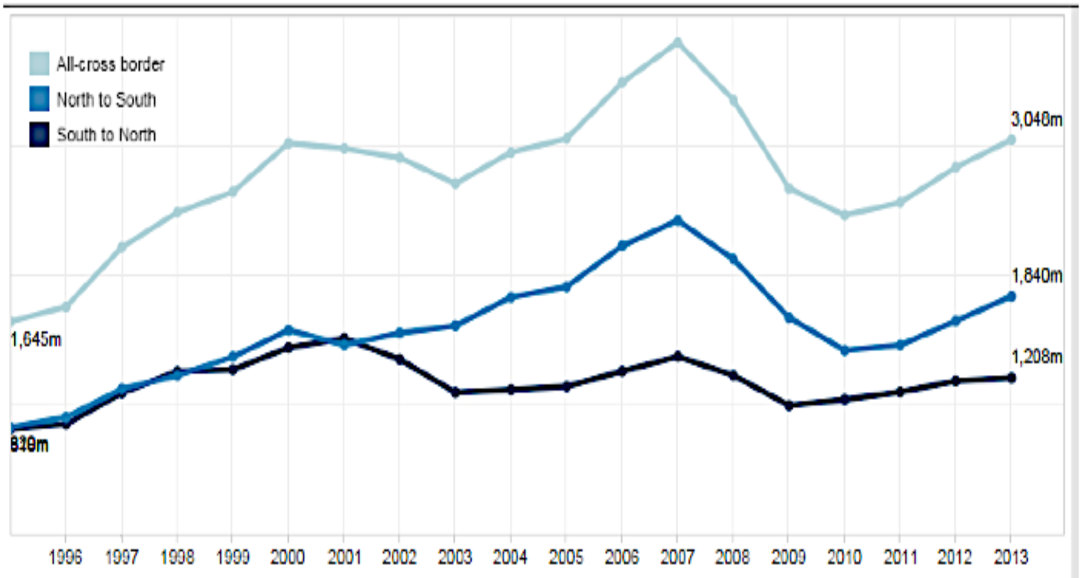
[14] NICEP (2014) *Outlook Autumn 2014* Northern Ireland Centre for Economic Policy, Coleraine: Ulster Business School

[15] Fontagné, L. (1999), "Foreign Direct Investment and International Trade: Complements or Substitutes?", *OECD Science, Technology and Industry Working Papers*, 1999/03, OECD Publishing. http://dx.doi.org/10.1787/788565713012.

driver, with spillovers effects, in the form of service activities and employment. arising out of the from the growth of the key strategic sectors.

Figure 3.1: Cross-Border Trade (1995 – 2013 € m)



source: InterTrade Ireland (2014)

The ROI has also had a successful history in attracting FDI,. Overall FDI fell from 23.9% of Irish GDP in 2009 to 10.5% in 2011 but rebounded to 19.4% in 2012. The sectors most represented in inward FDI are life sciences, ICT, international financial services, content & engineering as well as mobile projects from Irish food multinationals. The demonstration effect of a successful record of inward FDI (70% of total employment in FDI related activities is accounted for by US firms) in sectors that correspond to those promoted in the Northern Ireland Economic Strategy can act as a stimulus to cross-border activities. These sectors that are being promoted in Northern Irelands are known as the MATRIX sectors are:

- Telecommunications & ICT;
- Life & Health Sciences
- Agrifood;
- Advanced Materials;
- Advanced Engineering

These sectors underpin the policy of developing cross-border innovation centres builds upon and reinforces the demonstration effect of FDI in the ROI. The current relative characteristics in respect of the cross-border regions are shown in Table 3.1 below

Table 3.1: Snapshot of the rationale and relevance for cross-border collaboration
(Ireland and Northern Ireland in bold)

Driver	Explanation	Relevance for cross-border co-operation
Economies of scale	Combine resources for efficiency of investment, larger labour markets or access to wider business and knowledge networks to increase critical mass; often used to overcome peripherality	Strong **Moderate** Weak Not present
Political recognition	Increase the recognition and strengths of areas that are far from capitals to better negotiate and compete for resources from higher levels of government	Strong Moderate **Weak** Not present
Complementarities	Build on diversity of assets in terms of research, technology and economic base, as well as supply chain linkages	Strong **Moderate** Weak Not present
Branding	Increase internal recognition of the cross-border area as well as its external attractiveness to firms and skilled labour	Strong **Moderate** Weak Not present
Border challenges	Address the day-to-day challenges associated with flows of people, goods and services (including public services) across the border	Strong Moderate **Weak** Not present

Note: The assessment of relevance relates to the actual relevance in current cross-border collaboration, not necessarily to the potential relevance.

source: Nauwelaers, C. Maguire, K. and Marsan, G.A. (2013)[16]

The authors has also constructed a table of the relative strength of policy levers to promote cross-border co-operation. The crucial point they make, however, the level of transactions costs because of a lack of regulatory harmonisation. It follows that a BREXIT would significantly increase these costs and act as a disincentive to further economic co-operation and development. This point is returned to below.

3.2 Foreign Direct Investment in Northern Ireland

The Northern Ireland has had a sustained record of attracting FDI. The decision by policy makers to press for a reduction in the rate of corporation tax, allied to stimulating

[16] Nauwelaers, C., K. Maguire and Marsan, G.A. (2013), "The Case of Ireland-Northern Ireland (United Kingdom) – Regions and Innovation: Collaborating Across Borders", *OECD Regional Development Working Papers*, 2013/20, OECD Publishing. http://dx.doi.org/10.1787/5k3xv0llxhmr-en

inward FDI for the MTRIX sectors should strengthen this position. Key sectors that are attractive to global FDI has been identified by *FDI Intelligence* who point out that Northern Ireland has some way to go to match the sectoral balance of the ROI to take advantage of this demand[17]. The overall relative position for Northern Ireland in respect of different levels of value-added is shown in Table 3.2.

Table 3.2: Comparison of value-added of FDI into Northern Ireland, UK and ROI

Value added	% of FDI projects attracted (2006 -10)			% of new jobs attracted (2006 -10)		
	NI	UK	ROI	NI	UK	ROI
Very High	44.3	39.4	46.7	37.3	20.4	41.6
High	12.1	15.8	16.1	16.5	16.8	11.2
Medium	14.1	18.0	15.8	10.5	13.4	18.9
Low	16.8	17.5	16.9	6.0	36.1	19.8
Very Low	12.8	9.2	4.5	29.7	13.4	8.5

source: FDI Intelligence (2012)

It is apparent that Northern Ireland comparatively holds its own in most categories, with the exception of very low-value-added jobs attracted. This may be because of it being a relatively late starter compared to the rest of the UK and the ROI. But, many of these types of jobs are in business and financial services that are an important part of the labour markets and income in most advanced economies.

The importance of widening and deepening the attractiveness of the MATRIX sectors to FDI is clearly crucial. Achieving this objective is also tied to the UK continuing membership of the EU, particularly because of the strategic importance of Northern Ireland's cross-border co-operation. The ROI economy has a demonstrably successful record in attracting FDI from companies seeking to access the rest of the EU's markets. The importance of Northern Ireland as a site for FDI within the EU, particularly for those companies from the emerging market is partially demonstrated in Table 3.3 that shows a sample of the performance of Northern Ireland's top 20 companies and their origin.

[17] FDI Intelligence (2012) *Improving the Quality of Foreign Direct Investment to Northern Ireland,* London: Global Insight Financial Times

Table 3.3: Sample of Northern Irelands Top 20 Companies (2013)

Company	Employment	Turnover (£m)	Activity	Origin
1. Moy Park	10914	1089.6	Food Processing	Brazil
3 Bombardier	4990	492.8	Aerospace	Canada
5 Four Seasons Health	4710	97.1	Nursing & Care Homes	NI
8 Dunbia	3300	701.0	Food Processing	NI
10. Catepillar	2923	771.4	Capital equipment	US
11. Alma Group	2917	275.5	Pharmaceuticals	US
13 Resource (NI)	2538	35.3	Business support services	ROI
16. First Source Solutions	2293	55.9	Business support services	India
18. Ulster Bank	2185	n/a	Banking	UK
19 Teleperformance	2010	32.5	Business support services	France
20. Allstate (NI)			IT/Insurance	

source: Belfast Telegraph (2014)[18]

Outside of the targeted sectors there are number, however, of growing economic activities that also stimulate FDI. These include culture; sport; and, tourism all of which are underpinned by creative industries and are also important in cross-border economic co-operation. Evidence of the importance s identified in the *Innovation Strategy for Northern Ireland 2014-2025*[19] and a number of EU-funded projects[20]. Moreover, the awarding of *The European City of Culture to* Derry/Londonderry in 2013 has stimulated these activities in respect of their impact in the city's cross-border hinterland, current budget challenges notwithstanding[21]. Connected to these apparently subsidiary activities is the question of infrastructure and connectivity, within Northern Ireland, with rest of the UK and the EU, as well as cross the border with the ROI. In this regard, air traffic, broadband and energy utilities are strategically crucial as the economy seeks

[18] *Northern Ireland's top 100 companies 2013 - Moy Park rules the roost* Belfast: Belfast Telegraph. 8/09/14 http://www.belfasttelegraph.co.uk/business/top-100-companies/

[19] Northern Ireland Executive (2014) *Innovate NI: Innovation Strategy for Northern Ireland 2014-2025* Belfast: Northern Ireland Executive.

[20] See: The MIDAS project: Cross-border cluster of creative industries, Panteia and Partners (2008), *Ex-Post Evaluation – INTERREG III 2000-2006 – PROGRAMME: INTERREG III A Ireland-Northern Ireland*, report to the European Commission.

[21] The Guardian (2013) *How Derry's year as UK city of culture reawakened the voice of idealism*. London: The Guardian 29/12/13 http://www.theguardian.com/uk-news/2013/dec/29/derry-city-of-culture-reawakened-idealism

to be a more globally attractive site for FDI and associated economic development. What is also apparent in respect of the argument set out in this section is the role of EU funding to support economic development in Northern Ireland.

3.3 EU economic development funding for Northern Ireland

It is apparent that the performance of the Northern Ireland economy has been underpinned by funding support from the EU. As shown in Table 3.4, under the last programming period, support accounted for about 8.4% of annual GDP across a range of activities of which nearly 2/3rds is accounted for by agriculture.

Table 3.4: EU Funding to Northern Ireland (2007 -13) £m

Agriculture & Fisheries		**Other programmes & Initiatives**	
Single Farm Payment	1290	PEACE III	180
NI Rural Development Fund	330	Regional Competitiveness & Employment Objective (European Regional Development Fund element)	307
European Fisheries Fund	18	Regional Competitiveness & Employment Objective (European Social Fund element)	165
		INTERREG IV4	77
		International Fund for Ireland	60
Total	1638	Total	789
Grand Total (2007 -2103)			**2427**

source: European Commission (2014)

The programme for the 2014 – 2020 is central to the Northern Ireland Economic and Innovation Strategies and the achievement of the objectives within them. This funding stream also further integrates the Northern Ireland economy with others in the EU, that also allows a greater degree of discretion over its development, particularly in regard to underpinning cross-border economic co-operation and growth in FDI. In the event of a BREXIT, these funding streams would no longer be available. Furthermore, if the UK government chose to exit the EU but remain a member of the European Economic Area (like Norway for example) it would have access to EU markets but would continue to fund economic assistance without decision-making powers over its destination.

4. In the End it's the Politics

There is a banal cliché that states that "politics determines economics and economics determine politics". In the event of a BREXIT the two discourses merge. The alternatives open to a UK government in this event are:

- A revival of the European Free Trade Area (EFTA) with the UK as a member;
- European Economic Area (EEA) access to EU markets, contributing to EU budgets but no control over decisions-making;
- EEA membership but also signing up to Free Trade Agreements (FTAs) with other countries of groups of countries (for example Switzerland);
- A Customs Union with EU with a access to a range of EU tariff-free markets (for example, Turkey);
- "Anglosphere": the UK joins the North American Free Trade Area (NFATA) and negotiates FTAs with English-speaking former Commonwealth countries.

All have varying degrees of uncertainty attached to them but the crucial point is the very large transactions costs associated with a BREXIT. In the case of Northern Ireland these costs would be significant in respect of:

- The logic of harmonising corporation tax with that of the ROI is undermined with accompanying budgetary and transactions costs rising significantly;
- The cost of cross-border trade and economic co-operation would rise and would managing risk of any cross-border infrastructure projects;
- As a site for FDI to access EU markets, Northern Ireland could lose ground on its neighbour as the ROI becomes a more favourable location for emerging economies;
- The regulations concerning transatlantic air traffic are negotiated at the EU level that could be detrimental to growth of international connectivity with Northern Ireland;

- The ending of EU economic development funding could result in a reversal of economic decentralisation.

It is apparent that the crisis in the Eurozone has generated support for populist political demanding political reform across the EU. Geo-political uncertainty in the EU's Eastern borders reinforces this demand. The completing of the ESM and an institutional solution to the economic imbalances created within the Eurozone would go a long way to reviving the growth trajectory of the EU. The UK derives significant advantages from not being a member of the Eurozone, but is in step with many other EU Member States in seeking reform of the EUto the benefit of all citizens.

In this changing policy environment, the Northern Ireland economy may benefit in that after the next UK election there is likely to be some form of a new constitutional settlement in the form of greater devolution of economic powers. The harmonisation of corporation tax with that of that the ROI changes the relative costs of doing business in Northern Ireland, exchange rate differentials notwithstanding. It is also the starting point in having more discretion over its economic policy. Given its special position in regard to the ROI and the rest of the EU, the large transactions costs of uncertainty surrounding a BREXIT may be too large to bear.

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March 2015