How will Brexit affect Tower Hamlets?

An assessment of the potential impacts of different Brexit scenarios on local businesses and residents

A report for Tower Hamlets Borough Council

CAPITAL ECONOMICS

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Grant Colquhoun, Marie-Louise Deshaires, Andrew Evans and Mark Pragnell

CAPITAL ECONOMICS

Registered in England, Registration No. 2484735.
VAT No. GB 198 2919 50

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Introduction

Capital Economics has been commissioned by Tower Hamlets Borough Council to research and report upon the potential impact of Brexit on its local businesses and communities.

In the 2016 the United Kingdom voted to leave the European Union and this was formalised when Britain triggered Article 50 in March 2017, giving two years to negotiate the exit. Over those two years negotiations between the parties has been ongoing but the outcome remains unclear. There are two parts to the negotiations: the terms of withdrawal and the future relationship.

At the time of writing a draft withdrawal agreement has been produced but it is unclear whether this will be formally agreed or ratified by parliament. If a withdrawal agreement is passed, a two year transition phase has been agreed to negotiate the terms of the future relationship, largely focussed on trading arrangements. If there is no agreement the United Kingdom will automatically leave the European Union on 29 March 2019.

This project and associated desk research and interviews commenced before publication of the text agreed between the United Kingdom government and the European Council. As such, the precise text of the agreement has not been analysed.

The deal secured for Brexit has implications for both the British economy and Tower Hamlets economy. In this report we have considered three possible scenarios:

- There is no deal and the United Kingdom leaves the European Union on 29 March 2019
- The proposed withdrawal agreement is agreed and a ‘Chequers style’ trading relationship is agreed over the next two years
- A withdrawal agreement of some form is agreed and a bespoke ‘Canada plus’ style trade arrangement is agreed over the next two years

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1. Summary report: Impacts, risks and opportunities for Tower Hamlets

Key findings and recommendations

Tower Hamlets is a significant economy

Tower Hamlets is a large and diverse borough, accounting for 1.6 per cent of the United Kingdom economy and providing a home to around 315,000 people. It spreads from Shoreditch and Aldgate in the west, to Bow and Poplar in the east, and encompasses the Isle of Dogs including Canary Wharf to the south.

Skills shortages is a key concern

The ability to recruit workers with appropriate skills is already a challenge for many businesses in Tower Hamlets. In general, London has a higher immigrant population and European Union nationals make up a higher share of the capital's workforce than elsewhere. This makes London boroughs more exposed to changes in immigration policy. Some sectors, such as hospitality, are particularly reliant on European Union workers for lower skilled roles, which are most likely those that will face significant restrictions if freedom of movement is ended. Other sectors, such as information and digital services, currently have a lower share of labour from the European Union, but regardless have some of the highest rates of hard to fill vacancies.

But freedom of movement is likely to end regardless

Skills shortages is a significant problem for many businesses in Tower Hamlets that needs to be addressed. However, the specific Brexit deal will likely have little impact in this regard because all three involve the end of free movement and British control over immigration policy. That means the extent to which Brexit helps or exacerbates the skills shortages will depend upon the government's future policy. The only outcome which would retain freedom of movement is if Britain stayed within the single market, which looks unlikely (although not impossible) at this point. In this case, however, movement of labour from non-European Union countries would continue to be restricted.

Tower Hamlets less exposed to barriers to trade in goods

Tower Hamlets is overwhelmingly a service based economy, with services accounting for 96 per cent of output in the borough. As such, Tower Hamlets is less exposed to any tariff or non-tariff barriers that increase the cost of goods trade with the European Union after Brexit. Furthermore, trade statistics show that local Tower Hamlets businesses that do trade are more likely to export or import goods from outside the European Union than the national average.

There will be supply chain impacts

This does not mean that there would be no impact on local businesses. Although few businesses import and export goods directly, their supply chains will involve goods originating from the Europe. Some key sectors in the borough, such as hospitality, retail and the public sector, are more exposed to these costs than others, such as financial and professional services.

A no deal would have the most impact on trade costs, with the potential imposition of tariffs on some goods from next year and the administrative costs of customs declarations and checks.

Key findings and recommendations

Canary Wharf is crucial to Tower Hamlets economy

Canary Wharf is international employment hub of financial and professional services. Almost half (46 per cent) of economic value generated in Tower Hamlets is from financial services and the vast majority of that activity is located in Canary Wharf. Canary Wharf is crucial to the Tower Hamlets economy. It employs around ten per cent of residents and generates business for local SMEs. In addition, it provides support to local public finances through section 106 contributions and uplifts in business rates.

Brexit poses significant risks and opportunities for financial services

Any impact on financial services is therefore important to Tower Hamlets and its communities. Financial services is one of the sectors that is most at risk from Brexit because of the likely loss of 'passporting' rights which currently allows financial service providers to sell to other European countries without having a presence there. This is particularly relevant for the banking sector where it is estimated that around one fifth of revenues are related to the access that the passport currently grants. This will likely lead to the loss of some banking activity as businesses relocate.

However, there are bigger opportunities for the finance sector than others if it is outside the scope of future European Union financial services regulations. It is possible that Britain can open up a 'regulatory gap' with the European Union, which will act to make the domestic market more attractive to foreign business. It is likely that passporting rights will be lost in whichever of our three Brexit scenarios were to transpire. The more important factor would be the negotiation of trade in services in the future agreement and whether that entails adherence to European regulations. This would appear to be more of a risk in a 'Chequers style' agreement.

Key findings and recommendations

This document provides an evidence base for Tower Hamlets Council and others to draw upon when developing future strategies and policies to help the communities of Tower Hamlets.

Our recommendations are:

- Ensure that the voice of the financial services industry is heard and that the sector's importance to the borough is recognised in national conversations about the future relationship with the European Union
- Address skills shortages which is critical to improving prosperity of the local population and supporting local businesses; this problem exists regardless of Brexit but a more restrictive immigration policy would exacerbate pressures on local businesses
- Be aware that some sectors are more exposed to the impacts of Brexit than others; financial services is a key concern and the hospitality, retail and public services sectors are most at risk from future immigration policy and also increased import costs
- Be mindful of the differential impacts between communities in the borough; Central Borough workers and residents working outside the borough are more exposed to lower value added industries which may be affected more by immigration policy and trade costs

Key findings for local areas

Tower Hamlets economy is far from uniform

Tower Hamlets has a diverse economy with significant differences and variations across its geographies. Given its size Canary Wharf can dominate statistics when looking at the borough and as such it is important to look more closely at different areas within the borough. For our analysis we have split the borough into four 'local areas' which are fairly well defined in terms of the nature of their economies.

Central borough more exposed to immigration restrictions

Job opportunities in the Central Borough area are dominated by the public sector, which currently provides over 50 per cent of the jobs. The next largest sectors are hospitality and retail respectively. This sectoral mix makes the area more exposed to restrictions on low skilled European Union immigration. It will also be more impacted by increases to the costs of trade in goods. Although not directly exposed to impacts on financial services businesses, the impact on Canary Wharf will affect the borough as a whole.

Impact on Canary Wharf dependent on financial services trade

With around 44 per cent of jobs in Canary Wharf in financial services, and the majority of the rest in related services, it is highly exposed to the impact on the financial services sector.

Isle of Dogs and South Poplar similarly exposed as Canary Wharf

Surrounding Canary Wharf, the economy of the Isle of Dogs and South Poplar is largely made up of services supporting the financial activity in their neighbouring area, such as building security, as well as a range of auxiliary financial and professional services.

The City Fringe is a diverse mix of businesses

The City Fringe is a mixed economy and has a range of key sectors, including public sector, financial and professional services, digital services, hospitality, retail, advertising and the media. Given its mix, it is particularly exposed to immigration restrictions and trade costs (particularly through hospitality and retail sectors) as well as being highly dependent on the financial services sectors of the City of London and Canary Wharf.

Key findings for local areas

Significant differences between local populations

Similarly to the business mix, Tower Hamlets has a broad mix of residents with different challenges and opportunities. Canary Wharf's resident population ranks comparatively well on skills levels, economic inactivity and unemployment rates. Meanwhile, the reverse is true for the Central Borough population where the share of resident population aged over sixteen with no qualifications is 23 per cent, almost three times the share in Canary Wharf. The City Fringe and Isle of Dogs populations rank somewhere in between these two on all the above metrics. Meanwhile, the female inactivity rate in Tower Hamlets is 37 per cent, significantly higher than the national average of 27 per cent.

Links between local areas are limited

Overall, 30 per cent of Tower Hamlets' residents work within the borough. However, this tends to be within their own local area. Only six per cent of Central Borough and City Fringe workers respectively work in Canary Wharf. Meanwhile, on the Isle of Dogs, 36 per cent of Canary Wharf residents work within the two local areas and 28 per cent of Isle of Dogs and South Poplar residents do likewise.

Residents tend to travel outside borough and have lower paid jobs

Overall, 70 per cent of residents in employment work outside the borough. Assessing the sectors in which residents work compared to Tower Hamlets jobs shows that there are a higher share working in lower value industries such as retail, wholesale, hospitality and the public sector. What's more, these jobs are disproportionately taken up by the ethnic minority population in Tower Hamlets.

Brexit provides opportunities and risks for these residents. On the one hand, a future immigration policy that restricts lower skilled workers could provide more opportunities for these workers and have a positive impact on wages. On the other hand businesses in these sectors tend to be more exposed to immigration restrictions and increased costs of trade, as well as tending to have smaller margins and therefore more at risk to changes in the macroeconomic environment. This could limit jobs growth and opportunities in these sectors.

There is also a large disparity in wages for those that work in the borough. We have estimated that average wages in Canary Wharf are double that of the Central Borough area.

Regardless of Brexit, improving skills is key

It is possible that immigration restrictions would provide more opportunities for local residents that aren't currently in employment. However, this does not address the underlying skills levels of residents. There are already job vacancies in these areas that aren't being filled by local residents.

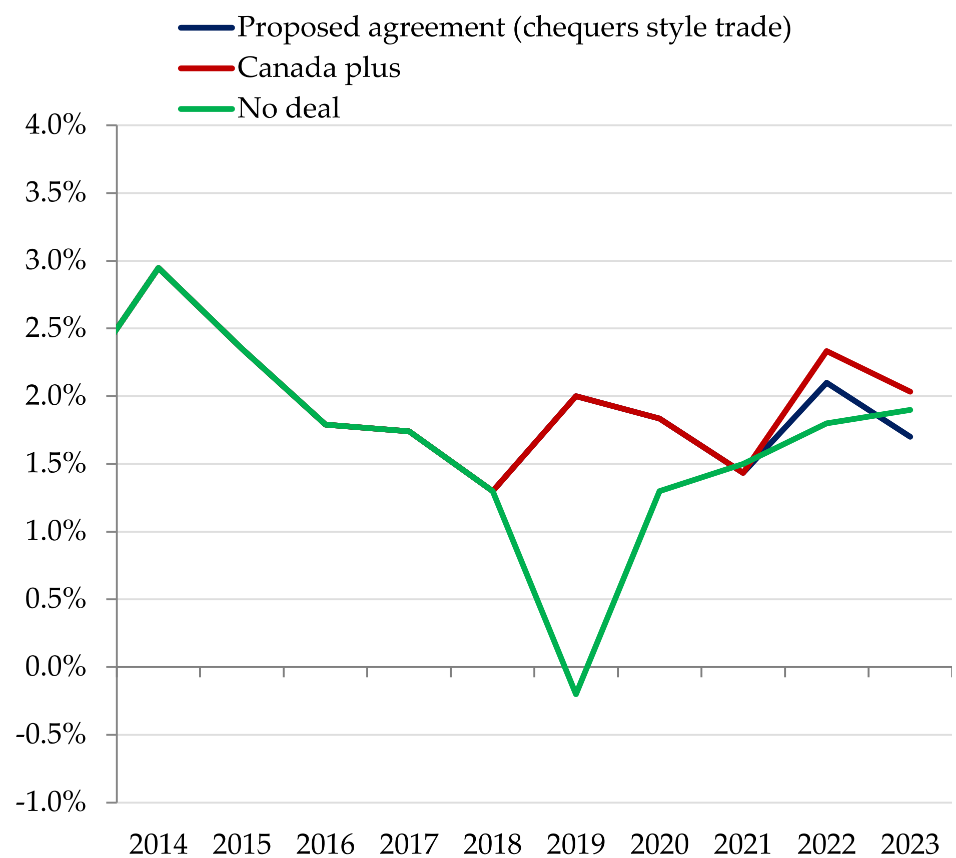
Macroeconomic impact and key issues

No deal would lead to small recession

The overall macro environment will affect all parts of the country, with Tower Hamlets no exception. In this regard over the next five years our forecasts suggest that a no deal outcome will be the worst outcome. The proposed agreement with a Chequers style trade deal and Canada Plus are the same for the next two years during the transition period. A Canada Plus style deal with a bespoke trade agreement will provide the most opportunity for growth after 2021 as we expect trade frictions and greater difficulty negotiating other free trade deals in the Chequers style plan.

Wide range of estimates and considerable uncertainty

HM Treasury recently published its own economic analysis of the long term impact of different Brexit deals. It assessed four scenarios including a ‘no deal’ scenario and a ‘Chequers proposal’ scenario. The analysis suggests that gross domestic product would be lower in 2035 under all scenarios. Unsurprisingly it suggests that the Chequers plan would yield the smallest loss and no deal the largest. These type of estimates always have a large margin of error and HM Treasury has a poor recent track record; even under their most optimistic scenario they forecast that a vote to leave the European Union in 2016 would lead to a recession. Although not directly comparable to our five year scenarios, we think they are a little too pessimistic about the fallout from a no deal Brexit, but a little too optimistic about the impact of a deal based around the Chequers plan. In part this is because they assign negligible benefits to new trade deals and regulatory flexibility, while underestimating the trade frictions under a Chequers style agreement.



Forecasts for annual percentage change in real gross domestic product, United Kingdom

Source: Thomson Reuters and Capital Economics

Macroeconomic impact and key issues

There are positives and negatives from each of the scenarios for the terms of exit from the European Union and the future relationship. These pros and cons apply nationally but the extent to which local economies are exposed to their impacts varies.

The key impacts that Tower Hamlets is overly exposed to relate to immigration and financial services. The impacts of changes to immigration are not dependent on the Brexit deal as all three of our scenarios would allow for an independent immigration policy.

Equally, all three of our scenarios involve the loss of passporting rights for financial services firms that are currently serving European Union markets under this scheme. The main difference between the scenarios would be the ability to tailor regulation for financial services, which could provide a competitive advantage in the future, as well as being able to forge trade deals with non-European Union countries. The no deal outcome would leave the United Kingdom free to do this from April 2019. In both the other scenarios things remain in the status quo during the transition phase. Thereafter we assume closer alignment of financial services regulation in the Chequers style deal.

Tower Hamlets is less exposed to impacts on trade in goods because there are few manufacturing businesses in the borough and few residents work in that sector. That is not to say there won't be an impact on some specific businesses and a wider knock-on impact through supply chains. However, it is less of a concern than elsewhere in the country. No deal would present the worst outcome with tariffs imposed, customs checks and likely delays at the border. Canada Plus would involve some costs of rules of origin and customs checks but these are likely to be manageable. The proposed agreement with a Chequers style trade agreement would involve costs of tracking imports and customs checks. It also involves adherence to product and other regulations which will make it harder to pursue other trade deals. This means it is less favourable than the Canada Plus deal.

Importance of potential Brexit impacts to Tower Hamlets
Loss of passporting rights
Adherence to EU financial regulations
Restrictive immigration policy
Uncertainty
Tariffs on imports
Payment of 'divorce bill'
Adherence to EU business regulations
Customs checks and declarations for EU trade
Rules of origin requirements on EU trade
Ability to negotiate trade in goods agreements with non-EU countries
Independent business regulations
Savings from EU budget contributions
Ability to negotiate trade in services agreements with non-EU countries
Independent financial services regulation

Local area summaries: Tower Hamlets

	Key impacts	Impact on Tower Hamlets businesses	Impact on Tower Hamlets residents
Macroeconomic conditions			
No deal	• Short recession and slow economic growth over next five years, increase in inflation	• Significant strain on businesses that will suffer from reduced demand and consumer spending	• Unemployment will rise significantly • Price increases will particularly hit those on lower incomes
Proposed agreement	• Steady economic growth over five years with slower growth at end of transition in 2021	• Fairly benign impact on consumer demand and business activity	• Limited impact on Tower Hamlets residents
Canada Plus	• Steady economic growth over five years with slower growth at end of transition in 2021 but scope for faster growth thereafter	• Fairly benign impact on consumer demand and business activity	• Limited impact on Tower Hamlets residents
Financial services			
No deal	• Loss of passporting rights and no transition period	• Loss of financial services activity and jobs • Longer term opportunity to establish greater competitive advantage and attract new financial services business	• Hit to financial sector will have knock-on impact on local economy
Proposed agreement	• Loss of passporting rights after transition and likely adherence to some regulations	• Loss of financial services activity and jobs • Limited upside if tied to European regulations	• Hit to financial sector will have knock-on impact on local economy
Canada Plus	• Loss of passporting rights but free of European Union regulations	• Loss of financial services activity and jobs • Limited upside if tied to European regulations	• Hit to financial sector will have knock-on impact on local economy

Local area summaries: Tower Hamlets

	Key impacts	Impact on Tower Hamlets businesses	Impact on Tower Hamlets residents
Immigration and skills			
No deal Proposed agreement Canada Plus	• Government will have freedom to design own immigration policy– likely to focus restrictions on low skilled workers	• Restrictions on low skilled workers will exacerbate skills shortages and see businesses unable to fill vacancies • Restrictions could push up wage costs, putting stress on local businesses bottom line	• Restrictions on lower skilled European Union immigration could present opportunities for local residents to fill jobs • Impact is likely to be limited given skills gaps already exist and skills levels in some areas of local population are poor
Trade policy			
No deal	• WTO tariffs imposed • Customs checks and declarations pushing up the cost of trade • Able to negotiate trade deals from 2019	• Tower Hamlets economy less exposed to increased trade costs • Businesses will face higher input costs as increased trade costs feed through their supply chains	• Prices of consumer goods will rise
Proposed agreement	• Tariff free trade • Costs to track imports • Unable to make trade deals until out of customs union	• Tower Hamlets economy less exposed to increased trade costs • Businesses will face higher input costs as increased trade costs feed through their supply chains	• Prices of consumer goods will rise modestly
Canada Plus	• Tariff free trade • Costs of rules of origin • Costs of customs checks • Free trade policy after transition	• Tower Hamlets economy less exposed to increased trade costs • Businesses will face higher input costs as increased trade costs feed through their supply chains	• Prices of consumer goods will rise modestly

Local area summaries: Central Borough

Largest sectors
Public sector (52%)
Wholesale and retail (10%)
Hospitality (5%)
Security and building services (4%)
Construction (3%)
Other significant clusters
Other professional services
Real estate activities
Media

Immigration and skills: High exposure to restrictive immigration policy

Wholesale/retail and construction, which are two of the biggest five sectors in Central Borough, are two of the three sectors most reliant on European Union workers. Meanwhile, the hospitality, retail and construction sectors all currently have a relatively high dependence on low skilled European Union workers, which are most at risk from a new immigration regime. What's more, an analysis of 'hard to fill vacancies' shows that skills gaps are particularly problematic in hospitality, construction and health, all of which are key sectors in Central Borough. Although data at the borough level aren't available, we also know that shares of European Union workers are higher in London than elsewhere.

Trade in goods: Medium exposure increased trade costs

Overall, Tower Hamlets is less exposed to trade barriers because it is a service based economy with a small manufacturing sector. However, this does not mean that it isn't exposed at all. Public sector and hospitality businesses, which make up almost 60 per cent of employment in the area, are two of the most exposed sectors to the feed through of higher input costs as a result of trade barriers.

Financial services: Medium exposure to restrictions on financial services trade

The key concern related to trade in services is the finance sector. There is little financial services activity located in the Central Borough area but the business community will feel the knock-on impacts of any impacts on the large financial sector in Tower Hamlets. This is likely to be less pronounced than other areas of the borough because it is home to the lowest share of Canary Wharf workers.

Business regulation: Low exposure to changes in business regulation

The small manufacturing base in the area means that any changes to product standards regulation will be small. Some businesses in the Central Borough area could benefit in the long term if there was a broader deregulation of the labour market, but this is unlikely to occur.

Local area summaries: Central Borough

	Level of risk	Level of opportunity	Proposed agreement	Canada plus	No deal	Summary
Immigration and skills	High risk	Low opportunity	• Independent immigration policy	• Independent immigration policy	• Independent immigration policy	• No difference between Brexit deals
Trade in goods	Medium risk	Low opportunity	• Unable to make trade deals until out of customs union • Costs to track imports • No tariffs • Free trade policy eventually	• Costs of rules of origin • Costs of customs checks • Free trade policy • No tariffs	• WTO tariffs • Costs of customs checks	• No deal likely to be worst outcome especially in short/medium term • Canada Plus
Financial services	Medium risk	Medium opportunity	• Likely loss of passporting	• Likely loss of passporting	• Likely loss of passporting	• No difference between Brexit deals
Regulation	Low risk	Low opportunity	• Adherence to 'common standards' • Possible adherence to financial regulations with no input	• Some adherence to regulations in return for free trade	• Regulatory freedom	• Financial services regulation is key, which more likely to be aligned in proposed agreement scenario
Macroeconomic environment	Medium risk	Medium risk	• Steady growth, a little lower than Canada Plus post 2021	• Steady growth	• Recession in 2019	• No deal will have largest impact on macroeconomy over next five years

Local area summaries: Canary Wharf

Largest sectors	
Finance	33.8%
Finance auxiliary activities	10.6%
Legal and accounting	10.6%
Security and building services	9.4%
Computer programming and information services	7.3%

Immigration and skills: Low exposure to restrictive immigration policy

Financial and professional services are less exposed to restrictive policy on low to mid skilled European workers because more of the jobs in these sectors are classified as highly skilled. We estimate that only 0.6 per cent of financial services jobs are currently occupied by low to low-mid skilled European workers compared to say, hospitality, where this figure is nearly twelve per cent. Overall, eight per cent of the workforce in financial and business services are from the European Union, with a higher share of twelve per cent coming from outside the European Union. That is not to say that there are not any risk of exacerbating skills shortages, but it is lower than other areas.

Trade in goods: Low exposure increased trade costs

Overall, Tower Hamlets is less exposed to trade barriers because it is a service based economy with a small manufacturing sector. This is particularly true in Canary Wharf which is dominated by financial and professional services. These are two of the sectors that are least exposed to the feed through of higher trade costs because their spending on goods is comparatively low.

Financial services: High exposure to restrictions on financial services trade

The key concern for Canary Wharf is trade in financial services, which makes up the bulk of its activity. The loss of 'passporting' rights will mean that some financial services providers will find that they will not be able to provide financial services to clients in the single market as they do today. Only around one fifth of the financial services industry is estimated to be subject to passporting requirements currently, but these are focussed on the banking sector which is prominent in Canary Wharf. Some firms may choose to set up subsidiaries in relevant locations elsewhere which will increase their costs and see some activity lost. Others may choose to relocate larger portions of their business.

Business regulation: High exposure to changes in business regulation

Being outside European Union financial services regulation does provide an opportunity for London to become a lower regulatory environment and gain a competitive advantage over European counterparts. This could see positive growth in financial services and relocation of activities into London.

Local area summaries: Canary Wharf

	Level of risk	Level of opportunity	Proposed agreement	Canada plus	No deal	Summary
Immigration and skills	Low risk	Low opportunity	• Independent immigration policy	• Independent immigration policy	• Independent immigration policy	• No difference between Brexit deals
Trade in goods	Low risk	Low opportunity	• Unable to make trade deals until out of customs union • Costs to track imports • No tariffs • Free trade policy eventually	• Costs of rules of origin • Costs of customs checks • Free trade policy • No tariffs	• WTO tariffs • Costs of customs checks	• No deal likely to be worst outcome especially in short/medium term
Financial services	High risk	High opportunity	• Likely loss of passporting	• Likely loss of passporting	• Likely loss of passporting	• No difference between Brexit deals
Regulation	High risk	Low opportunity	• Adherence to 'common standards' • Possible adherence to financial regulations with no input	• Some adherence to regulations in return for free trade	• Regulatory freedom	• Financial services regulation is key, which more likely to be aligned in proposed agreement scenario
Macroeconomic environment	Medium risk	Medium risk	• Steady growth, a little lower than Canada Plus post 2021	• Steady growth	• Recession in 2019	• No deal will have largest impact on macroeconomy over next five years

Local area summaries: Isle of Dogs and South Poplar

Largest sectors	
Security and building services	12.1%
Public sector	11.5%
Finance auxiliary activities	11.0%
Computer programming and Information services	9.3%
Office administration/ business support	8.5%
Legal and accounting	8.4%
Other significant clusters	
Travel agency	
Telecommunications	

Immigration and skills: Low exposure to restrictive immigration policy

Spillover from Canary Wharf means the key sectors Financial and professional services are less exposed to restrictive policy on low to mid skilled European workers because more of the jobs in these sectors are classified as highly skilled. We estimate that only 0.6 per cent of financial services jobs are currently occupied by low to low-mid skilled European workers compared to say, hospitality, where this figure is nearly twelve per cent. Overall, eight per cent of the workforce in financial and business services are from the European Union, with a higher share of twelve per cent coming from outside the European Union. That is not to say that there are not any risk of exacerbating skills shortages, but it is lower than other areas.

Trade in goods: Low exposure increased trade costs

Spillover from Canary Wharf means the key sectors are mostly financial and professional services or activities supporting these industries. As in Canary Wharf, this means that businesses have relatively low exposure to increased trade costs. Exceptions to this are the public sector and telecommunications businesses, which are more exposed to increased input costs.

Financial services: High exposure to restrictions on financial services trade

The impact on financial services poses significant risks to the financial services businesses located in the Isle of Dogs and the supporting industries.

Business regulation: High exposure to changes in business regulation

Being outside European Union financial services regulation does provide an opportunity for London to become a lower regulatory environment and gain a competitive advantage over European counterparts. A boon for financial services in Canary Wharf would spread to the Isle of Dogs and the support services it provides.

Local area summaries: Isle of Dogs and South Poplar

	Level of risk	Level of opportunity	Proposed agreement	Canada plus	No deal	Summary
Immigration and skills	Low risk	Low opportunity	• Independent immigration policy	• Independent immigration policy	• Independent immigration policy	• No difference between Brexit deals
Trade in goods	Low risk	Low opportunity	• Unable to make trade deals until out of customs union • Costs to track imports • No tariffs • Free trade policy eventually	• Costs of rules of origin • Costs of customs checks • Free trade policy • No tariffs	• WTO tariffs • Costs of customs checks	• No deal likely to be worst outcome especially in short/medium term
Financial services	High risk	High opportunity	• Likely loss of passporting	• Likely loss of passporting	• Likely loss of passporting	• No difference between Brexit deals
Regulation	High risk	Low opportunity	• Adherence to 'common standards' • Possible adherence to financial regulations with no input	• Some adherence to regulations in return for free trade	• Regulatory freedom	• Financial services regulation is key, which more likely to be aligned in proposed agreement scenario
Macroeconomic environment	Medium risk	Medium risk	• Steady growth, a little lower than Canada Plus post 2021	• Steady growth	• Recession in 2019	• No deal will have largest impact on macroeconomy over next five years

Local area summaries: City Fringe

Largest sectors	
Public sector	13.5%
Finance	11.8%
Computer programming and Information services	8.9%
Hospitality	8.6%
Legal and accounting services	7.4%
Wholesale and retail	7.4%
Other significant clusters	
Advertising	
Media	

Immigration and skills: Medium exposure to restrictive immigration policy

The City Fringe is a mixed economy and has a range of key sectors, including public sector, financial and professional services, digital services, hospitality, retail, advertising and the media. These sectors currently rely on European Union workers to different degrees. Hospitality and retail businesses have large a share of (particularly low skilled) European migrant workers, and are highly exposed to immigration restrictions. Meanwhile, financial and professional services are less exposed. Information services and hospitality services have been identified as one of the sectors most affected by skills shortages currently.

Trade in goods: Medium exposure increased trade costs

Overall, Tower Hamlets is less exposed to trade barriers because it is a service based economy with a small manufacturing sector. The City Fringe has significant hospitality and retail sectors which have greater exposure to the impact of higher import costs than other sectors.

Financial services: High exposure to restrictions on financial services trade

As well as having a significant number of financial services businesses, many of the hospitality and retail businesses are dependent on the prosperity of the financial services industry. This is because of the City Fringe's close proximity to the City of London.

Business regulation: High exposure to changes in business regulation

Being outside European Union financial services regulation does provide an opportunity for London to become a lower regulatory environment and gain a competitive advantage over European counterparts. A boon for financial services in the City of London would spread to City Fringe.

Local area summaries: City Fringe

	Level of risk	Level of opportunity	Proposed agreement	Canada plus	No deal	Summary
Immigration and skills	Medium risk	Low opportunity	• Independent immigration policy	• Independent immigration policy	• Independent immigration policy	• No difference between Brexit deals
Trade in goods	Medium risk	Low opportunity	• Unable to make trade deals until out of customs union • Costs to track imports • No tariffs • Free trade policy eventually	• Costs of rules of origin • Costs of customs checks • Free trade policy • No tariffs	• WTO tariffs • Costs of customs checks	• No deal likely to be worst outcome especially in short/medium term
Financial services	High risk	Medium opportunity	• Likely loss of passporting	• Likely loss of passporting	• Likely loss of passporting	• No difference between Brexit deals
Regulation	High risk	Medium opportunity	• Adherence to 'common standards' • Possible adherence to financial regulations with no input	• Some adherence to regulations in return for free trade	• Regulatory freedom	• Financial services regulation is key, which more likely to be aligned in proposed agreement scenario
Macroeconomic environment	Medium risk	Medium risk	• Steady growth, a little lower than Canada Plus post 2021	• Steady growth	• Recession in 2019	• No deal will have largest impact on macroeconomy over next five years

Insights from local businesses

In order to supplement the quantitative analysis we conducted 30 interviews with businesses in the borough. The objective of these interviews was to gather the views of local business about the challenges and opportunities that Brexit presents, as well as impacts that they have already seen on their businesses since the referendum vote in 2016.

Our aim was to interview a sample of businesses that was as representative as possible of the business community in Tower Hamlets. To do this, we drew up target lists that split companies by size, location and sector. The companies we interviewed ranged from sole traders to multinational companies, including businesses from all parts of the borough.

The interviews were conducted between 24 October and 23 November 2018.

Skills

Impacts since referendum

Regulations

Customer markets

Supply chains

Support from the council

Insights from local businesses

The most commonly cited concern of Tower Hamlets businesses interviewed related to Brexit was the impact on being able to hire appropriately skilled workers. The key points from our interviews on skills were:

- For over half of the businesses interviewed a shortage of skilled staff is already a significant burden, regardless of Brexit
- Nearly all of the businesses interviewed had some European Union employees, with the average across the sample around twenty per cent
- A common fear is that restrictive immigration policies could worsen the, already poor, availability of workers
- Businesses cited increased wages as a concern if there is a reduction in the labour pool but more pressing an actual inability to fill vacancies
- Some businesses have already seen European nationals leave and there is evidence that European employees have been thinking about whether or not to stay in the United Kingdom due to a greater feeling of insecurity
- Some sectors that are traditionally seen as 'lower skilled' are particularly worried that a targeted immigration policy after Brexit will make it harder for them to recruit
- Most interviewees felt any restrictions on immigration would be damaging to their business

Insights from local businesses

Uncertainty was commonly cited as a frustration of Tower Hamlets businesses and some have seen this lead to a fall in business activity over the past two years. The key points from our interviews on impacts and planning since referendum were:

- Uncertainty was cited as a key frustration; businesses want to know what the deal is before they can decide how to mitigate any impacts
- Many businesses are concerned about Brexit but given high uncertainty few had made specific plans, particularly in smaller companies
- One company reduced their planning period from five years to two years because of Brexit uncertainty
- The referendum vote in 2016 lead to an immediate fall in business for some companies, particularly in consumer sectors, where businesses felt that people were being more cautious due to uncertainty around economic conditions; falls in revenue of up to 30 per cent reported in some cases
- Some companies, particularly high value service companies, have opened new offices in Europe, changed entity structures and moved staff out of London
- Some companies have started marketing to new customer markets to mitigate any impacts on its current markets including the financial sector and tourists
- A small number of companies were confident that their business would not be affected by Brexit

Insights from local businesses

A few companies cited potential benefits from being outside European Union regulations, but in general local businesses thought they would see little change in their regulatory environment. The key points from our interviews on regulation were:

- Few companies could identify current regulations that they would like to change after Brexit
- Some financial services companies have a more complicated process through Brexit to ensure they can continue to operate in the United Kingdom/European Union
- A small number of companies thought there were potential upsides of a lighter regulatory regime after Brexit

Insights from local businesses

One of the key themes that emerged from our interviews was that many local Tower Hamlets businesses are dependent on the prosperity of financial and professional services and the commercial property market. The key points from our interviews on customer markets were:

- Significant shares of revenues came from London and in particular the financial and professional services sectors, be it through business to business purchases or spending on hospitality or retail services in the local area
- Several companies noted that their business was affected by the level of activity in the commercial property market and were concerned about London becoming a less attractive location for international businesses and foreign investment
- On the whole, for those companies that sold to European clients, businesses did not foresee any significant impact from Brexit on this part of their business; given most are service based activities, they do not foresee any additional trading difficulties than currently exist
- Tourists are important to some of the consumer focused companies and there was concern that the perception of London as a good place to visit would fall after Brexit
- Exchange rate volatility was important to the internationally trading companies, with some citing a fall in sterling as a potential positive as it was after the referendum
- Several companies highlighted the opportunity to picking up business from any company that decides to relocate or goes out of business, as well as opportunities for new businesses (for example service firms set up to deal with more complicated administration if there are additional barriers to trade)

Insights from local businesses

In general, because of the nature of Tower Hamlets businesses, most felt that they were not overly exposed to rising trade costs. However, any increase is seen as a negative. The key points from our interviews on supply chains were:

- Professional service firms are not overly exposed to increased trade costs with the European Union
- Rising input costs was a large concern for around five businesses in our sample which import significant goods from the European Union
- Some local businesses said that even a relatively small increase in input costs could lead to staff cuts or even business closures
- For these businesses, their view was that alternative suppliers were not available locally (or in the United Kingdom) or were prohibitively expensive
- One company noted that that if some consumer businesses closed in the area there would be a knock-on impact as the vibrancy of the Tower Hamlets area is key to its appeal
- Several companies noted that they were concerned about exchange rate volatility; the benefit they would see from a fall in the exchange rate to sell would be offset by rising import costs

Insights from local businesses

We asked the local business community what they think the council could do to support them and mitigate any potential negative impacts from Brexit.

The responses included:

- Reduce business rates in order to support businesses that could be affected by rising costs
- Promote the importance of European Union workers to the local economy to ensure that workers do not leave because they feel unappreciated
- Improve skills in the area. Businesses in a wide range of sectors are struggling to fill vacancies currently. They are not concerned with where workers come from but any help the council can provide in improving skills would be advantageous
- Provide help and advice to smaller businesses about the logistics of international trade so they can take advantage of opportunities if there are new trade deals put in place
- Provide a strong voice on the importance of sectors that are traditionally overlooked or seen as 'low value'
- Ensure local restrictions aren't imposed that could damage the vibrancy of the area

2. Structure of the Tower Hamlets economy

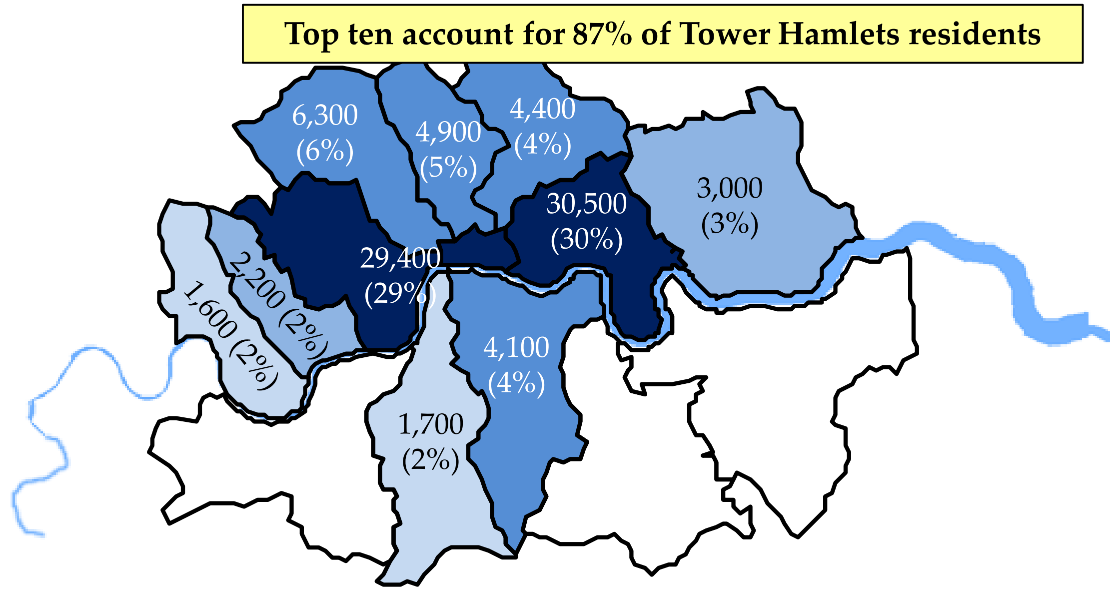
Thirty per cent of residents work in Tower Hamlets

Most residents work outside the borough

Data from the census, which is the latest available on commuting patterns, show that just under one third of Tower Hamlets residents aged over sixteen and in employment also work in the borough. The majority work in other inner London boroughs, in particular Westminster and the City, which provides jobs for almost 30,000 (29%) of Tower Hamlets workers.

After Tower Hamlets and Westminster and the City, the largest employers of Tower Hamlets residents are Camden, Islington and Hackney, providing 6,300, 4,900 and 4,400 jobs respectively.

In total the top ten boroughs in terms of work destinations for residents account for 87 per cent of Tower Hamlets workers.



Top ten commuting destinations (number of Tower Hamlets residents working in local authority)

Sources: Capital Economics and Office for National Statistics

Inter-borough commuting is limited

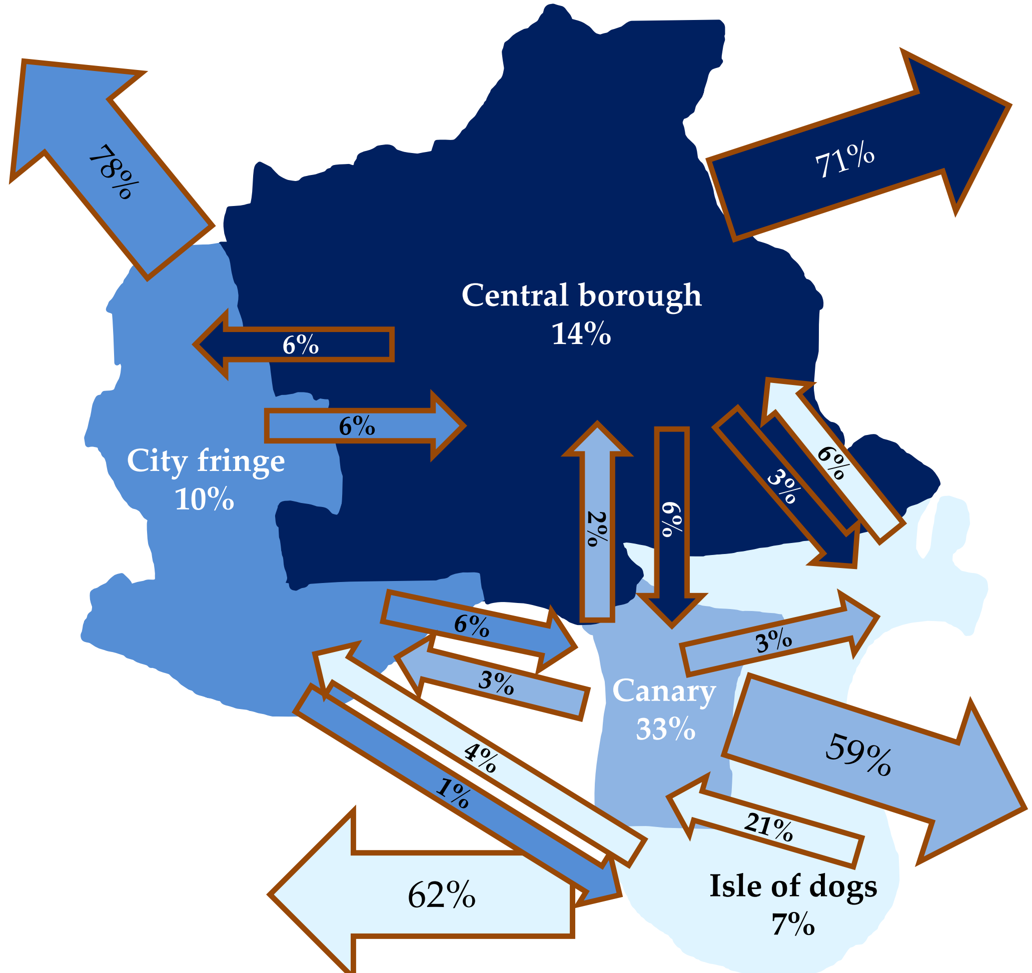
Isle of dogs population is most locally employed

Among the four areas of Tower Hamlets, Isle of dogs is the one with the highest share of their population working in the borough (38 per cent). In contrast, 78 per cent of the population in the city fringe and 71 per cent of Central Borough work outside Tower Hamlets.

Isle of dogs to Canary Wharf is largest inter-borough connection

Canary Wharf employs 21 per cent of Isle of dogs residents and has the highest share of resident population living and working in the same area (33 per cent).

The links between the other areas of the borough are limited. Only six per cent of City Fringe and Central Borough residents work in Canary Wharf. Equally, only six per cent of Central Borough residents work in the City Fringe.



Commuting patterns of Tower Hamlets four economic areas

Sources: Capital Economics and Office for National Statistics

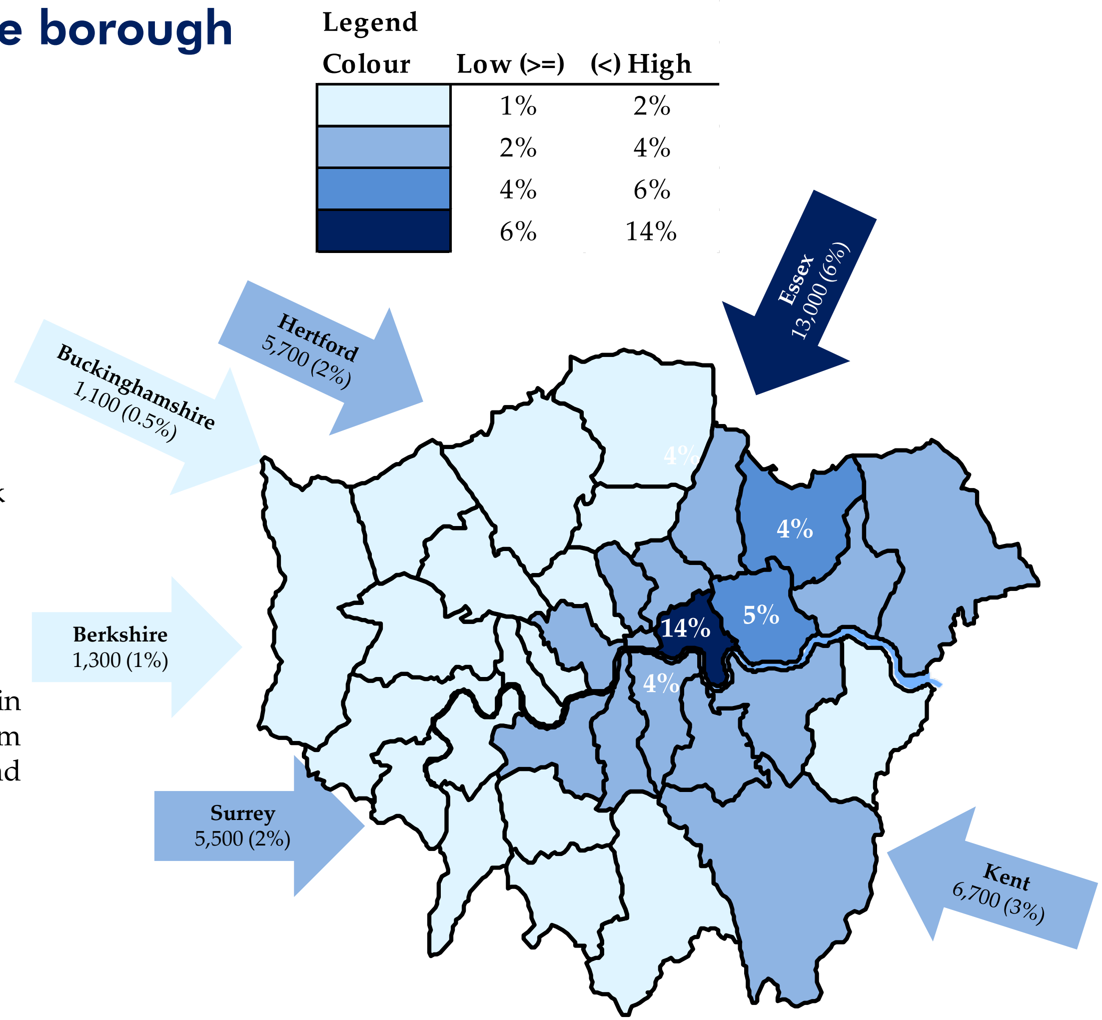
86 per cent of workers live outside the borough

Only around fourteen per cent live in the borough

Around fourteen per cent of Tower Hamlet workers live and work in the borough. Residents in nearby boroughs of Newham and Redbridge represent five and four per cent respectively of Tower Hamlets' working population.

Most of Tower Hamlets' workers come from London

In total, just under 80 per cent of Tower Hamlets' workforce lives in a London borough. That means a little over 20 per cent comes from outside London, with commuters from Essex (six per cent) and Kent (three per cent) making up the largest share of those.



Share of Tower Hamlets workers by place of residence

Sources: Capital Economics and Office for National Statistics

Spread of workers differs between employment centres

City fringe workers are fairly spread across the region of London

Around 77 per cent of City fringe workers live in London. Among those, twelve per cent live in the borough of Tower Hamlets while five and four per cent are resident in Hackney and Newham respectively. The majority are based in boroughs on the east side of the city.

Looking at counties outside London, Essex accounts for the highest share of people working in the City fringe of London with a share of six per cent.

Canary Wharf's workforce is most widely spread

People travel from further afield to work in the high value jobs of Canary Wharf.

Residents from Tower Hamlets account for only ten per cent of Canary Wharf jobs, the lowest of the four local areas. There are also more significant in-flows of workers from outside London. Commuters from Essex (six per cent), Kent (four per cent), Surrey (four per cent) and Hertfordshire (three per cent) make up seventeen per cent of Canary Wharf's workforce.

Isle of dogs workers living in London mainly come from eastern boroughs

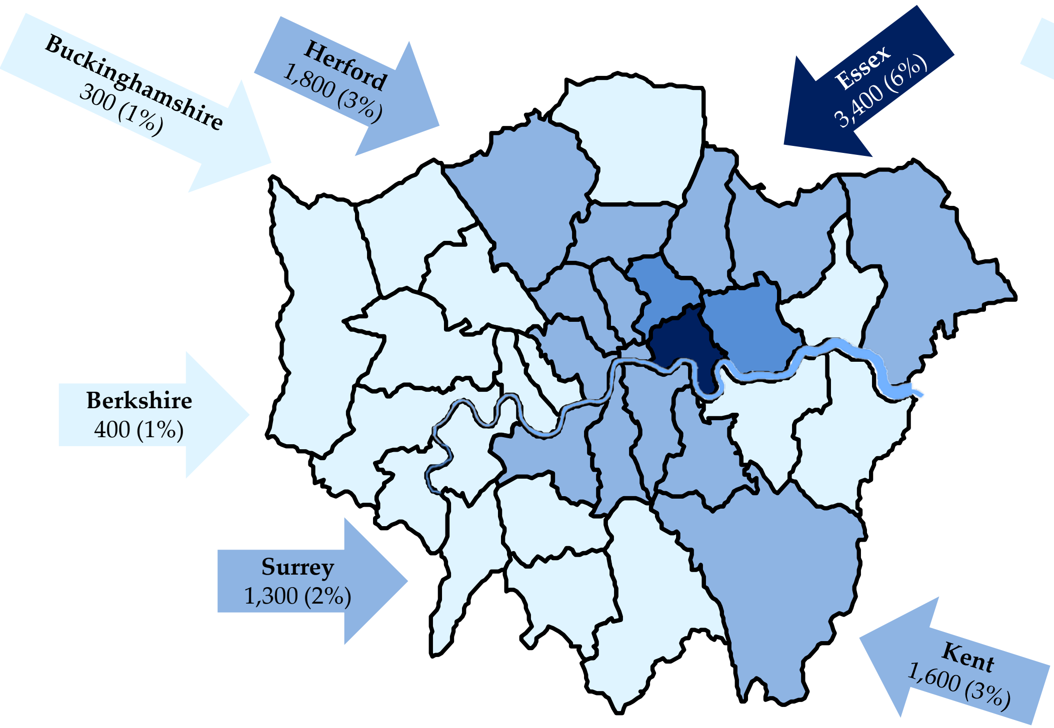
Tower Hamlets residents comprise seventeen per cent of the Isle of Dogs (excluding Canary Wharf) workforce, while neighbouring Newham borough accounts for a further eight per cent in Newham and six per cent in Redbridge. The workforce is concentrated in London's eastern boroughs.

The share of commuters from outside the capital is similar to the City Fringe and Canary Wharf at around 23 per cent.

Central Borough has a more local workforce

Around 28 per cent of Central Borough's workforce is resident in Tower Hamlets. Meanwhile, just thirteen per cent of the workforce come from outside London compared to over twenty per cent in the other areas of the borough. Over ten per cent of the workforce live in neighbouring Newham.

Share of City Fringe workers by location of residence



Legend

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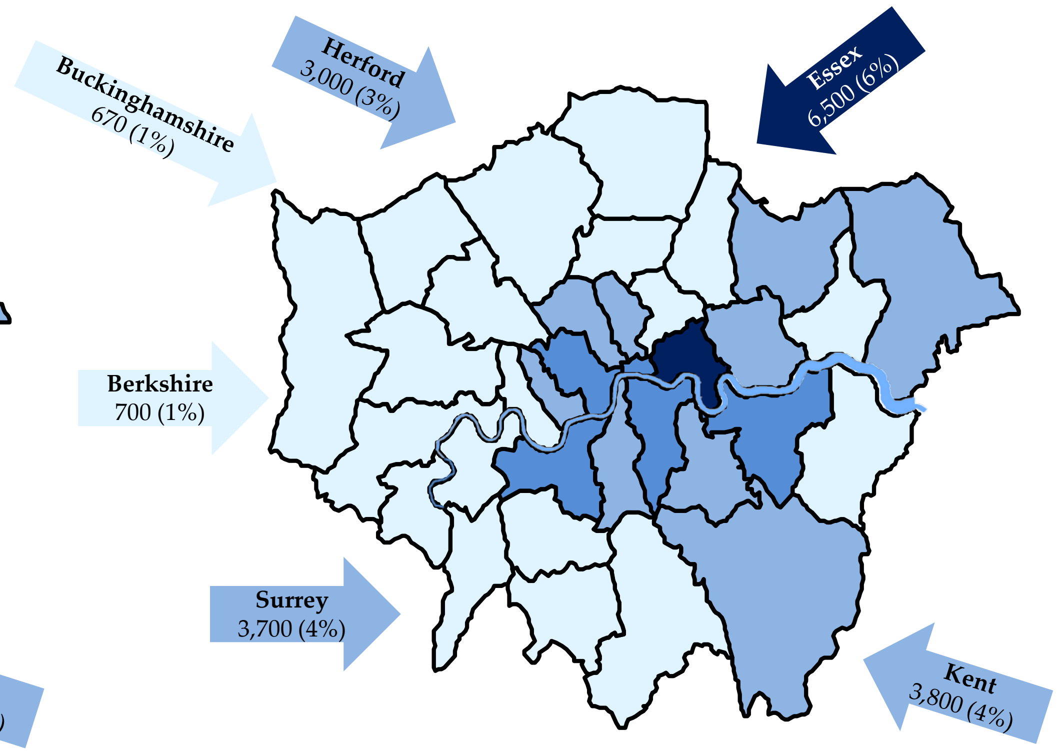
	2%	4%
	4%	6%
	6%	12%

Share of Canary Wharf workers by location of residence



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Colour	Low (>=)	(<) High
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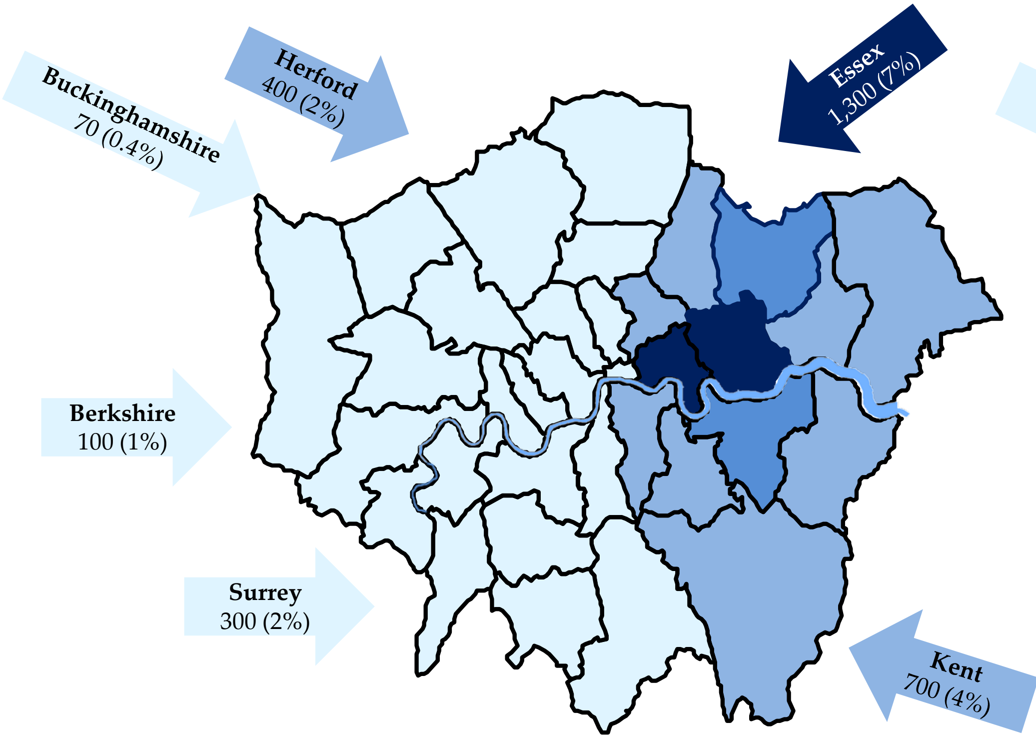
	2%	4%
	4%	6%
	6%	10%

Sources: Capital Economics and Office for National Statistics

Share of Isle of Dogs workers by location of residence



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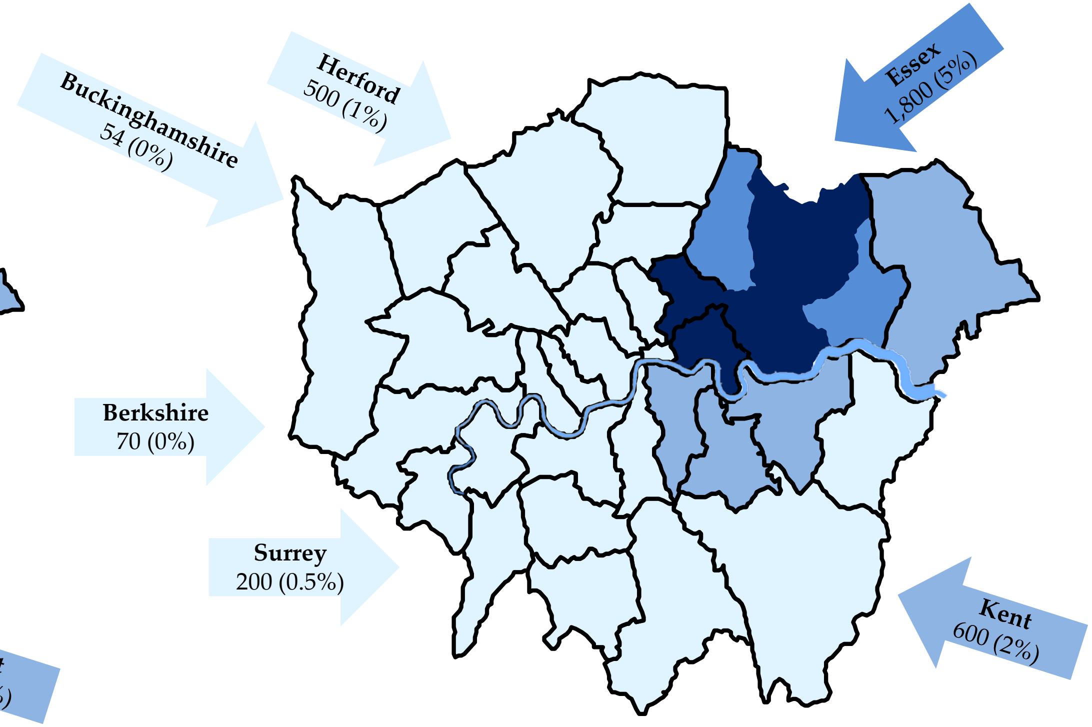
	2%	4%
	4%	6%
	6%	18%

Share of Central Borough workers by location of residence



Legend

Colour	Low (>=)	(<) High
	1%	2%
	2%	4%
	4%	6%
	6%	28%

Sources: Capital Economics and Office for National Statistics

Tower Hamlets is a dynamic jobs market

Tower Hamlets has high employment density

Tower hamlets is a significant employment hub, with large clusters of economic activity in Canary Wharf and the City Fringe. There are 1.35 jobs in the borough for every resident aged between 16 and 64, which makes it the seventh highest jobs density out of the 380 local authorities in the United Kingdom.

Large number of commuters fill jobs in the borough

According to data from the 2011 census, which is the latest available data on commuting patterns, 186,000 people travel to work in Tower Hamlets from outside the borough. This accounts for 86 per cent of the jobs in Tower Hamlets, leaving local residents to fill just fourteen per cent of the jobs.

	Number of jobs per resident aged 16-64
1. City of London	118.14
2. Westminster	4.41
3. Camden	2.26
4. Isles of Scilly	2.04
5. Islington	1.47
6. Kensington and Chelsea	1.39
7. Tower Hamlets	**1.35**
8. Southwark	1.29
9. Aberdeen City	1.19
10. Hammersmith and Fulham	1.18
London	*0.99*
United Kingdom	*0.84*

Job density of ten most dense local authorities in the United Kingdom, 2016

Source: Office for National Statistics

Tower Hamlets exposure to high value added services is relatively high

Tower Hamlets is service based economy

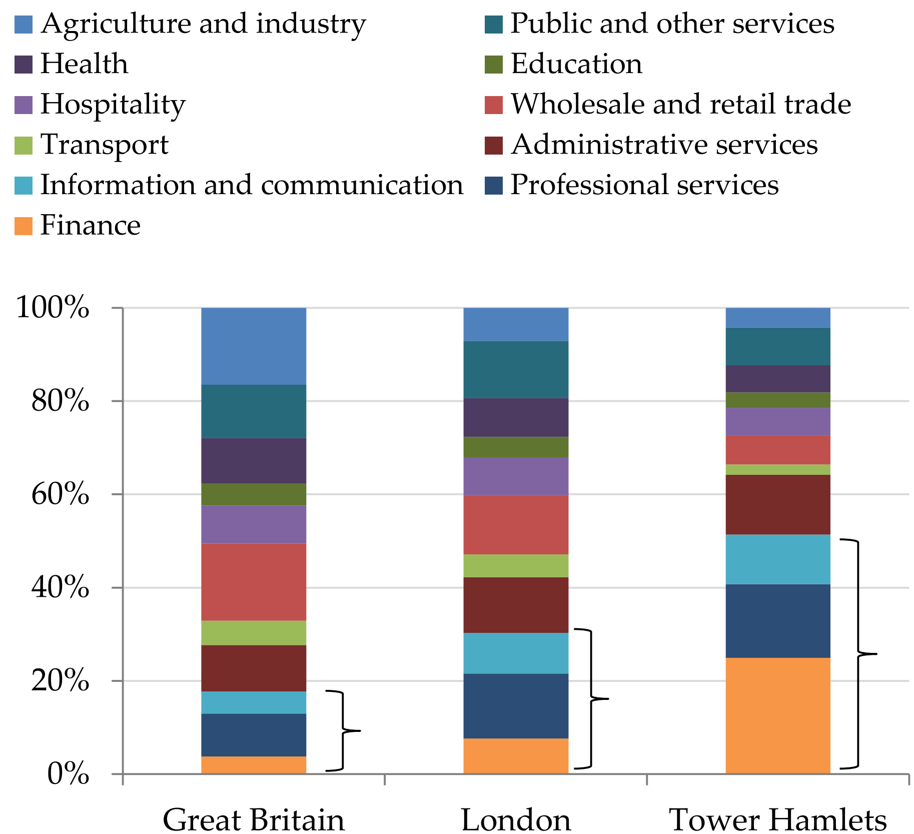
Tower Hamlets is a service driven economy, with only four per cent of employment in agriculture and industry compared to fifteen per cent nationally and around seven per cent for London as a whole.

Large share of high value services

At the borough level, high value services dominate, accounting for 48 per cent of employment. Nationally, this figure is just sixteen per cent. To support these industries the borough also has a relatively large administrative services industry.

Whole borough figures hide very different local economies

Canary wharf and its international hub of financial services is vital to the strength of the Tower Hamlets economy. However, looking only at borough wide statistics doesn't reflect the nature of the local economies within the borough.



Share of employees by sector, 2017

Sources: Capital Economics and Office for National Statistics

Public services account for over half of jobs in Central Borough

Around one fifth of Tower Hamlets jobs in Central Borough

In 2017, there were a total of 65,000 jobs in the Central Borough area, representing 22 per cent of the total jobs in the borough.

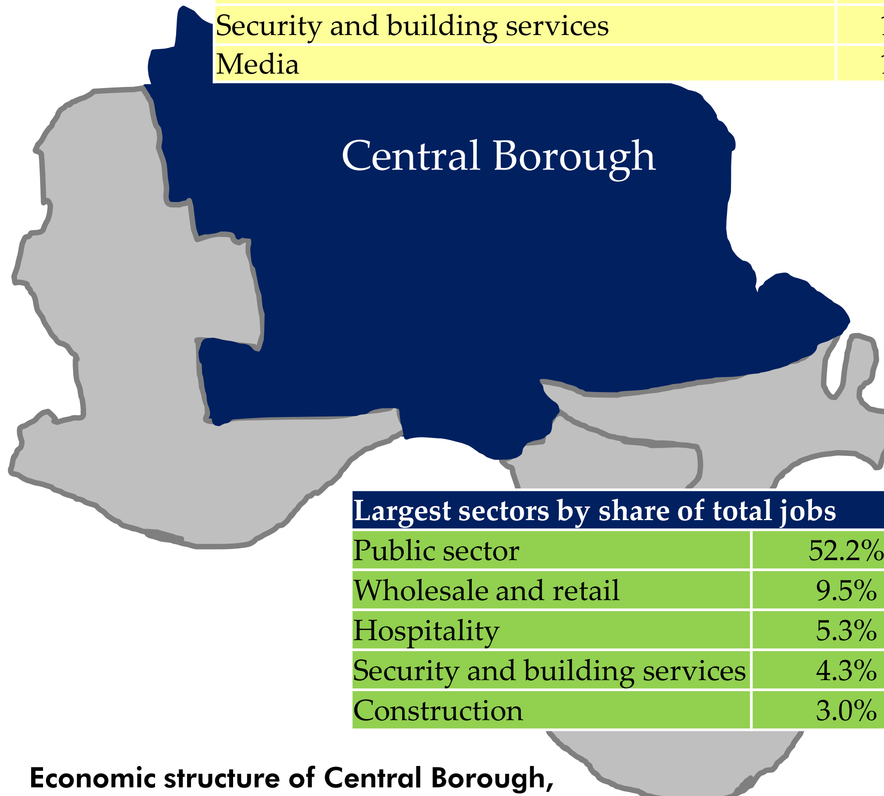
Public sector employment dominates the Central Borough

Over half of employment in the Central Borough area is in the public sector, including health, education and local government, employing a total of 34,000 people. Wholesale/retail and hospitality services are the next largest sectors, employing a combined total of 9,500 people or 14.8 per cent of the area's workers. Security and building services and construction complete the top five sectors in terms of total employment.

Disproportionate specialism in 'other professional services'

Although 'other professional services' accounts for just 0.9 per cent of the area's jobs, it is disproportionately represented relative to the national average. To measure this we have used the location quotient, which represents the share of jobs accounted for by a given sector in the local area divided by the share of jobs accounted for by that sector nationally. Central Borough has double the number of jobs in this sector than you would expect given the share of jobs it accounts for nationally. The type of activities included within this fairly diverse sector include specialised design, photography and translation services.

Most over represented sectors relative to UK average	
Other professional services	2.0
Public sector	2.0
Real estate activities	1.6
Security and building services	1.5
Media	1.2



Largest sectors by share of total jobs	
Public sector	52.2%
Wholesale and retail	9.5%
Hospitality	5.3%
Security and building services	4.3%
Construction	3.0%

Economic structure of Central Borough, 2017

Sources: Capital Economics and Office for National Statistics

City Fringe a mixed economy with important clusters

City Fringe provides 67,000 jobs

Although a much smaller area geographically, the City Fringe, stretching from Shoreditch to Aldgate and St Katherine's Dock, is home to roughly the same number of jobs as Central Borough. There are 67,000 jobs in the area, representing 23 per cent of all jobs in Tower Hamlets.

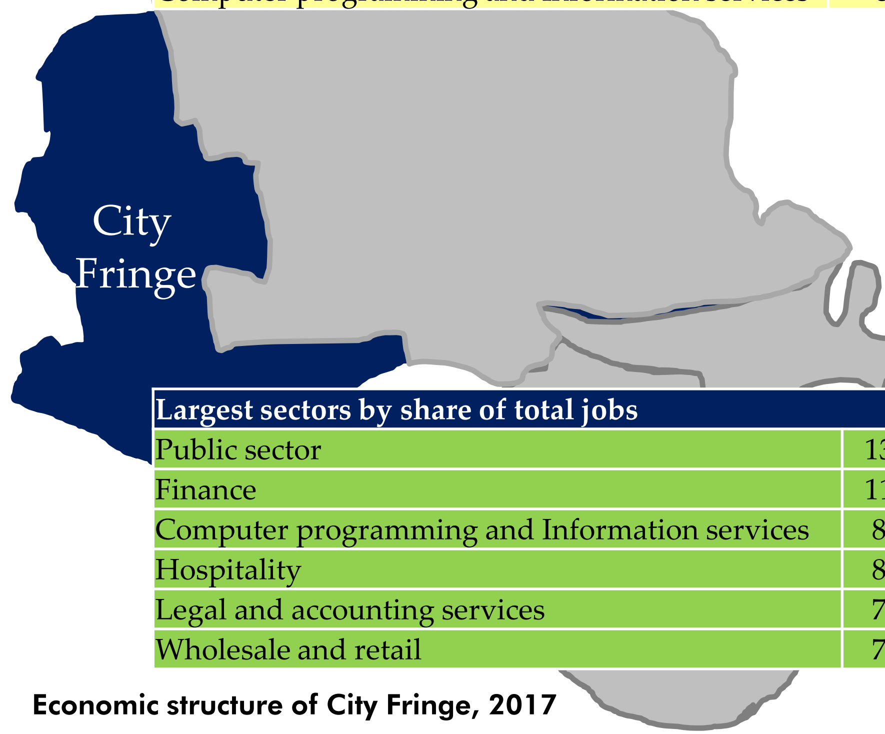
The economy's sectoral mix is varied

While public services jobs accounted for over half of the total in Central Borough, the largest sector in the City Fringe (also public services), accounts for 13.5 per cent of the total. Public sector employment here is boosted by the presence of the Royal London Hospital in Whitechapel and London Metropolitan University in Aldgate. Meanwhile, financial services is the second largest jobs provider at 11.8 per cent of the total. Other notable sectors in terms of total employment are computer programming, hospitality, legal and accounting and wholesale/retail which all account for between seven and ten per cent of jobs in the area.

Clusters of advertising, finance and media activity

The City Fringe has a number of important business clusters that represent much higher shares of activity in the area than they do nationally. In particular, the share of advertising activity locally is seven times bigger than it is nationally. Financial services, media activities, professional services and digital services are also disproportionately represented.

Most over represented sectors relative to UK average	
Advertising	7.2
Finance	6.0
Media	4.2
Legal and accounting services	3.3
Computer programming and Information services	3.3



Largest sectors by share of total jobs	
Public sector	13.5%
Finance	11.8%
Computer programming and Information services	8.9%
Hospitality	8.6%
Legal and accounting services	7.4%
Wholesale and retail	7.4%

Economic structure of City Fringe, 2017

Sources: Capital Economics and Office for National Statistics

Canary Wharf is an internationally renowned financial services cluster

Canary Wharf largest employment hub in the borough

Over 120,000 jobs are located in Canary Wharf, accounting for more than two fifths of all jobs in Tower Hamlets.

Area dominated by financial services

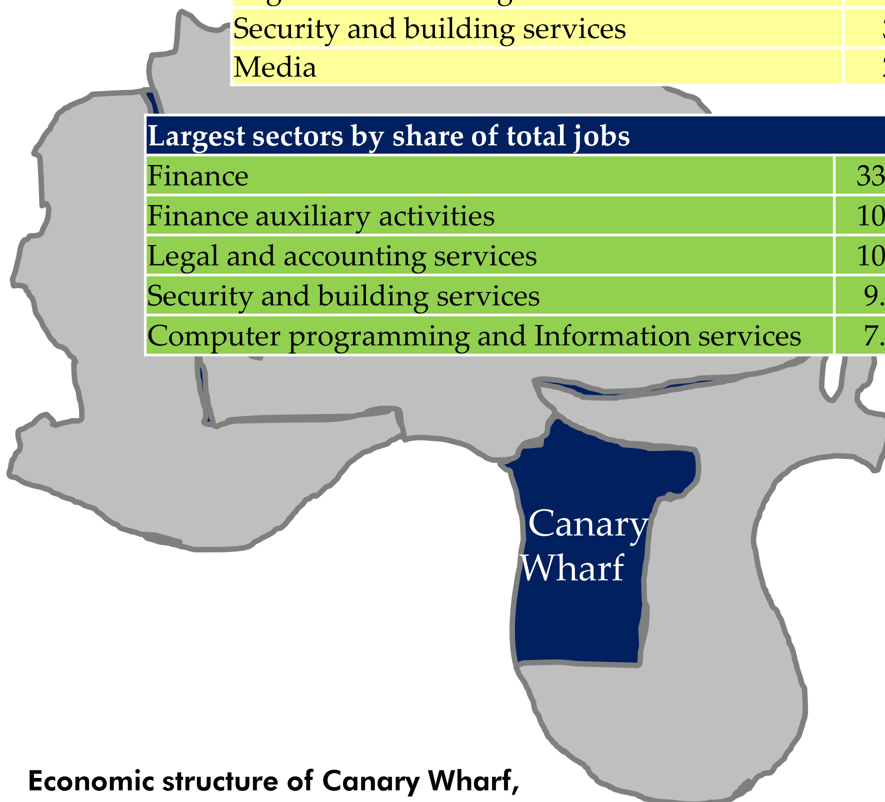
Unsurprisingly, financial and professional services dominate the Canary Wharf economy, with several large banks, legal and accounting firms based there. Together with auxiliary finance activities, such as exchanges, brokerages and investment advisory firms, these sectors account for 55 per cent of jobs in the Wharf. Security and building services, providing support services to the large tower blocks, represent a further 9.4 per cent of jobs, while there is also a significant presence of digital services firms.

Area dominated by financial services

Looking at shares of employment relative to national averages provides the same picture, with finance, professional services and its support activities over represented.

Most over represented sectors relative to UK average	
Finance	17.2
Finance auxiliary activities	7.0
Legal and accounting services	4.7
Security and building services	3.2
Media	2.8

Largest sectors by share of total jobs	
Finance	33.8%
Finance auxiliary activities	10.6%
Legal and accounting services	10.6%
Security and building services	9.4%
Computer programming and Information services	7.3%



Economic structure of Canary Wharf, 2017

Sources: Capital Economics and Office for National Statistics

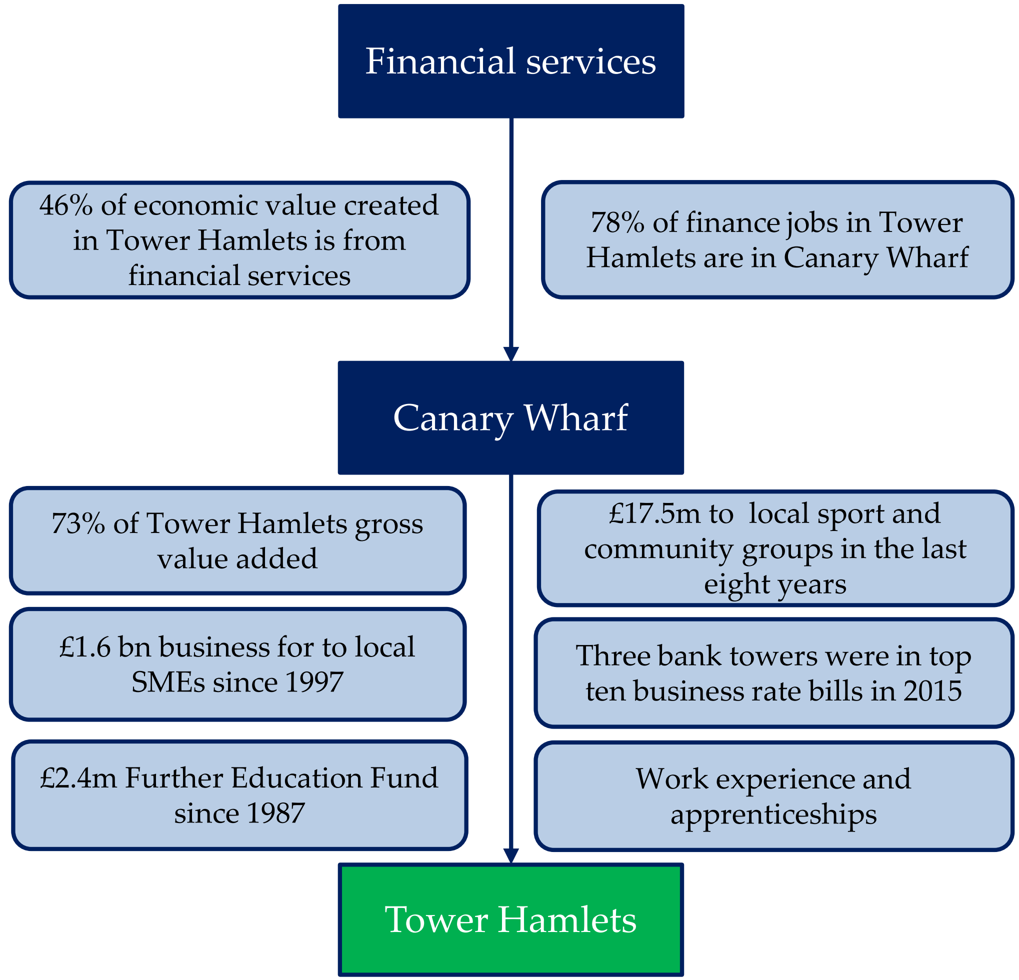
Canary Wharf crucial to Tower Hamlets economy

Canary Wharf a financial services hub

Around 46 per cent of economic value generated in Tower Hamlets is from financial services alone and the majority of that activity is based in Canary Wharf. Just under four fifths of financial services activity in Tower Hamlets is in Canary Wharf.

It is important to the borough

Canary Wharf is a large source of business rate funds for local government. Although detailed figures aren't available, the Financial Times reported that in 2015 three bank towers in Canary Wharf were in the top ten single business rate bills in all of London. As well as employing around ten per cent of the borough's residents, it generates 73 per cent of the borough's gross value added. On top of this, it generates business for local small and medium sized enterprises and supports community schemes.



Sources: Office for National Statistics, Financial Times, Canary Wharf Group

Isle of Dogs provides support services for Canary Wharf

37,000 jobs in Isle of Dogs and South Poplar

The Isle of Dogs and South Poplar area is the smallest of the four in terms of number of jobs. It houses 37,000 jobs, accounting for thirteen per cent of the borough's employment.

Economy geared towards supporting Canary Wharf

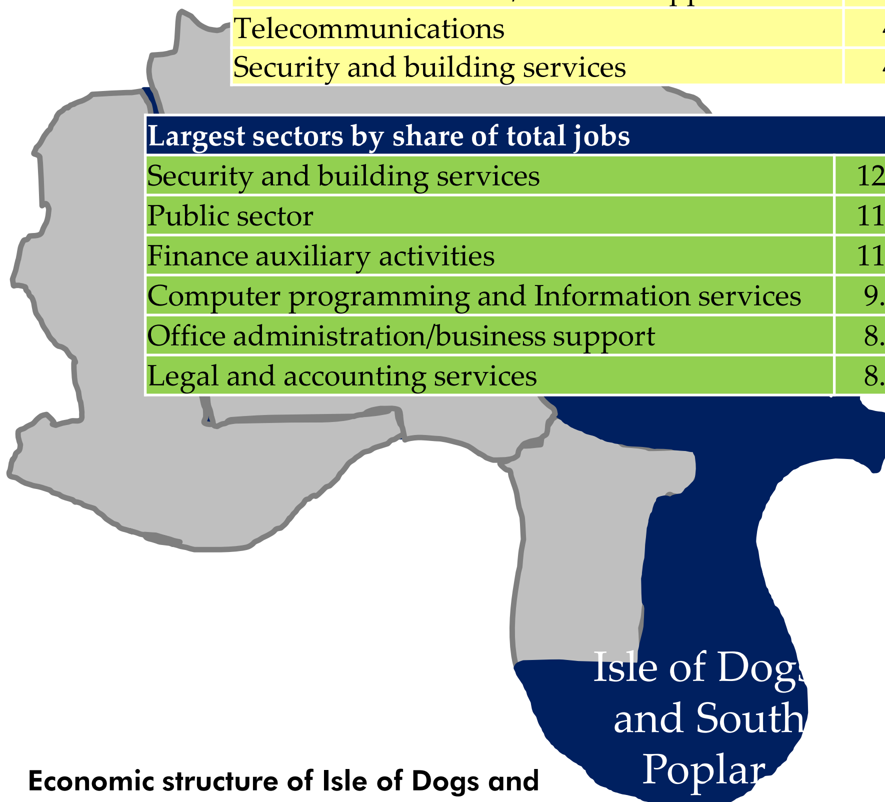
The local economy supports jobs in a mix of supporting activities for Canary Wharf including security and building services, auxiliary finance activities and office administration and business support activities. On top of this there are clusters of digital and professional services.

High density of business support activities relative to national average

The most over-represented sectors are generally the same as the largest sectors in the area. In addition to these there are disproportionately high travel agency and telecommunications activities.

Most over represented sectors relative to UK average	
Finance auxiliary activities	7.2
Travel agency	6.6
Office administration/business support	4.8
Telecommunications	4.1
Security and building services	4.1

Largest sectors by share of total jobs	
Security and building services	12.1%
Public sector	11.5%
Finance auxiliary activities	11.0%
Computer programming and Information services	9.3%
Office administration/business support	8.5%
Legal and accounting services	8.4%



Economic structure of Isle of Dogs and South Poplar, 2017

Sources: Capital Economics and Office for National Statistics

Employment mix differs for residents and commuters

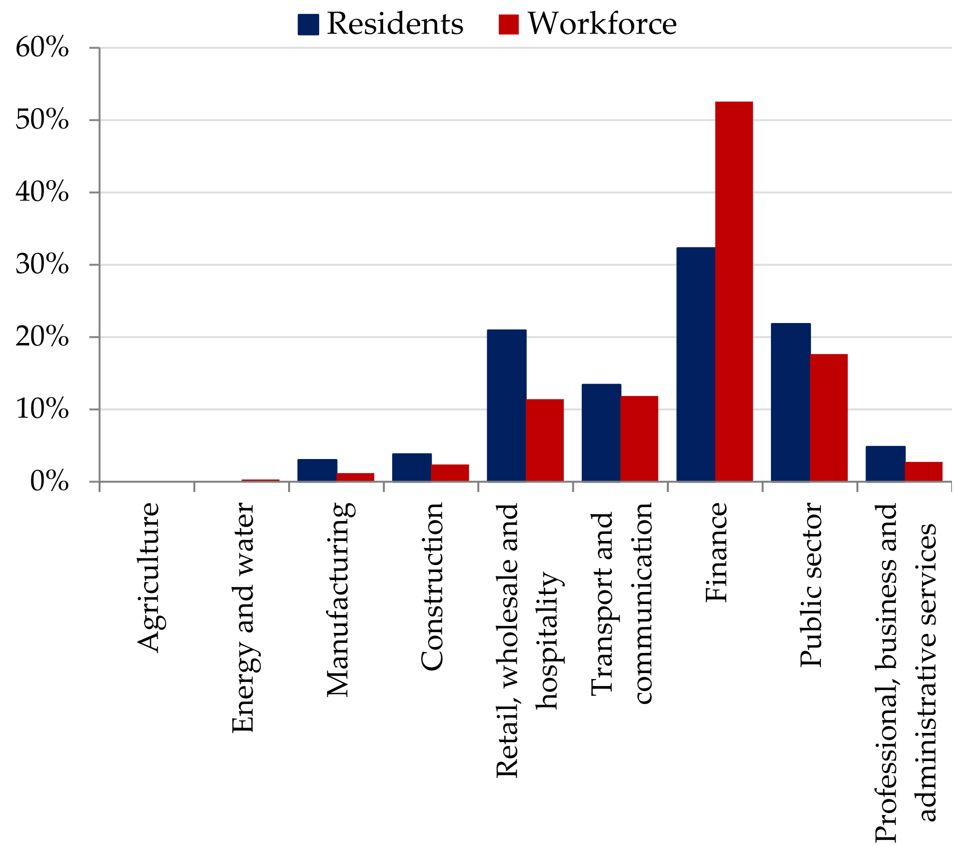
Commuters account for higher share of high value finance jobs

Over 50 per cent of the jobs located in the borough are in financial services. However, these jobs are disproportionately taken up by workers living elsewhere. Just over 30 per cent of Tower Hamlets residents work in the finance industry.

Residents tend to take up jobs in lower value industries

While commuters take a larger share of jobs in financial services, residents of Tower Hamlets work in typically less well paid and lower value added sectors.

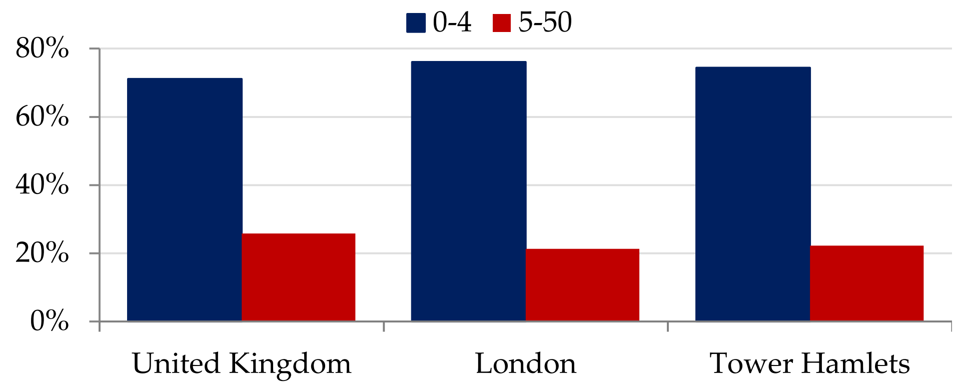
Over 20 per cent of Tower Hamlets residents work in retail, wholesale and hospitality jobs, whether in the borough or elsewhere, compared to just over ten per cent of workers from outside the borough. Similarly, the proportion of residents working in manufacturing, construction, transportation and the public sector outweighs the share of in-commuters in these sectors.



Share of Tower Hamlets residents and workers by industry of employment, 2017

Source: Office for National Statistics

Tower Hamlets has more micro businesses and more large companies



Share of businesses (local units) by number of employees, 2018

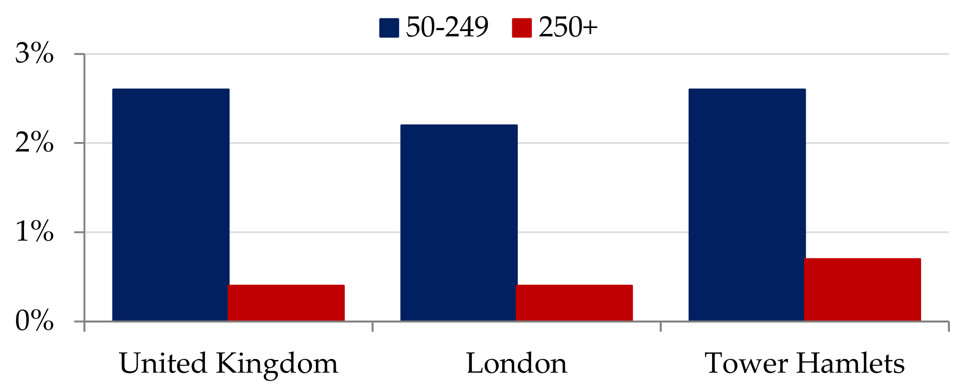
Tower Hamlets has a high share of large businesses

Although small and medium sized enterprises make up the vast majority of businesses across the borough, Tower Hamlets has a high share of large businesses compared to regional and national averages.

The share of business units with more than 250 employees in Tower Hamlets was 0.7 per cent compared to 0.4 nationally. This is unsurprising given the business clusters in Canary Wharf and parts of the City Fringe.

Tower Hamlets also has a high share of micro businesses

There is a disproportionately high share of micro businesses with less than five employees in Tower Hamlets. Across the country, 71.2 per cent of businesses have less than five employees while in Tower Hamlets that figure is 74.4 per cent. This reflects a dynamic economy with a high propensity for entrepreneurial start ups.



Share of businesses (local units) by number of employees, 2018

Source: Capital Economics and Office for National Statistics

Tower Hamlets has a significant voluntary and community sector

Tower Hamlets host a diverse voluntary and community sector

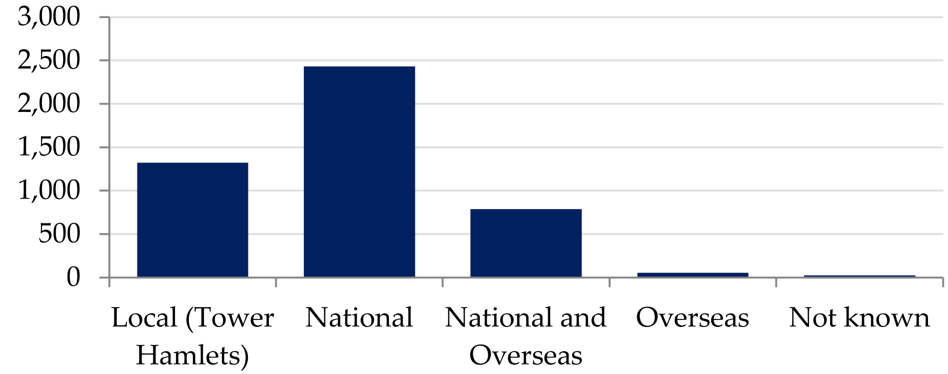
The voluntary and community sector is made up of a pool of organisations that are not-for-profit, add value to their communities and reinvest any financial profits into social, economic, environmental or cultural objectives. In Tower Hamlets, small neighbourhood community organisations that work at a very local level form a significant part of the sector.

Tower Hamlets' sector compares well to other authorities

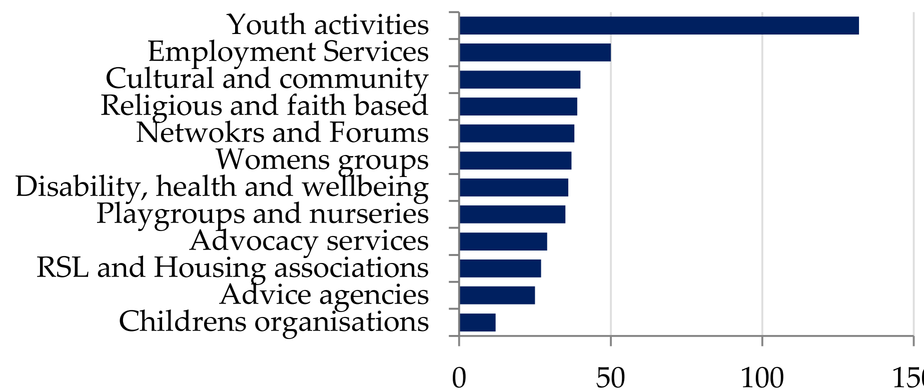
In 2015, the London Voluntary Service Council suggested that the voluntary and community sector in the borough was strong and above average in terms of the number of organisations, income and expenditure. That year there were expected to be 1,461 charitable organisations in the borough that generated a combined income of 352.4 million pounds and employed 5,219 workers.

Largest share of organisations involved in youth activities

Data for 2015 from the council's Third Sector Team on a sample of 500 organisations suggested that many of the voluntary and community sector organisations located in Tower Hamlets provided services to young people or offered employment support. This may reflect that the unemployment rate and share of young population are both higher than the national average.



Employment in the Voluntary and Community Sector of Tower Hamlets by scope of organisation, 2015



Number of voluntary and community sector organisations in Tower Hamlets by type for a sample of 500 organisations, 2015

Source: Capital Economics, London Borough of Tower Hamlets and London Voluntary Service Council

Trade in goods less important to Tower Hamlets economy

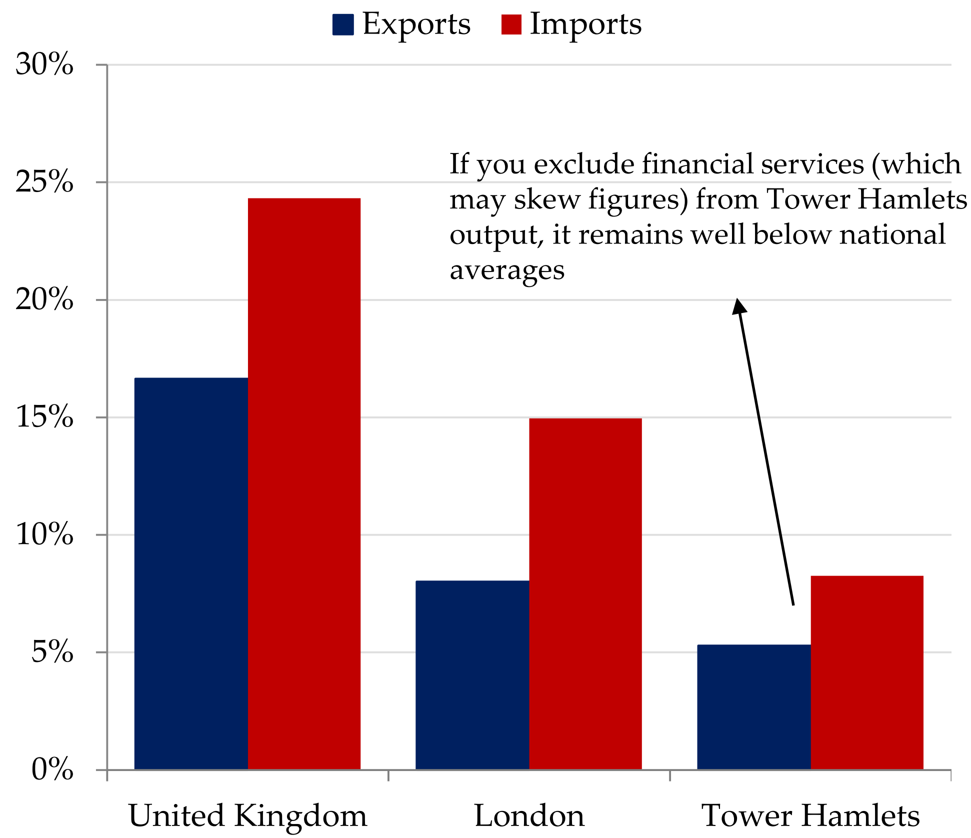
Tower Hamlets economy less exposed to trade barriers

Given that Tower Hamlets is a service driven economy, it is less exposed to the imposition of barriers to trade in goods, be they in the form of tariffs or otherwise. Only around five per cent of businesses located in the borough sell physical goods internationally compared to eight per cent in London as a whole and almost seventeen per cent nationally. The picture is the same for the import of physical goods.

Indeed, this may be an overestimate given the nature of regional trade statistics and the disproportionate number of head offices in the borough. Although attempts are made in the statistics to adjust for trade transactions that are attributed to head offices rather than where the value is actually generated, HMRC acknowledges that the statistics are still likely to be skewed in this way.

Small number of residents working in manufacturing outside Tower Hamlets

For residents working outside the borough, only three per cent work in manufacturing jobs compared to ten per cent nationally.



Exports/imports of goods as a share of total output, 2016

Source: Capital Economics and HMRC

Less exposed to European Union trade

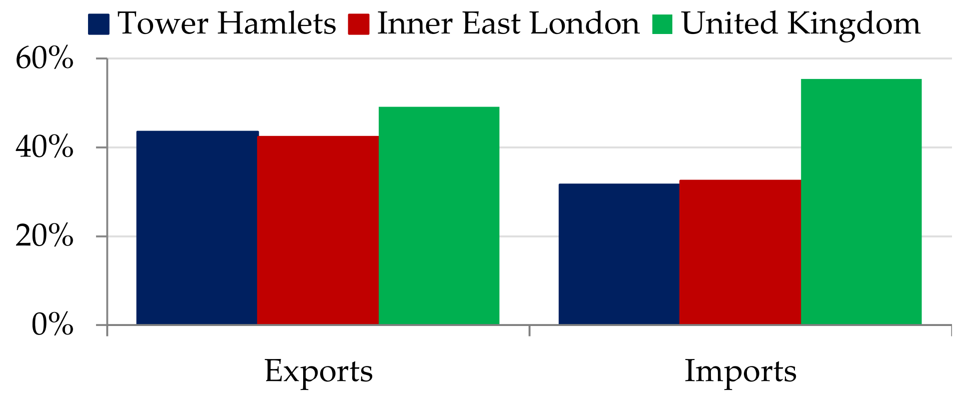
Majority of goods trade is not with the European Union

Of the goods trade that is conducted within Tower Hamlets, the majority is not with countries in the European Union. Nationally, 49 per cent of goods exports go to the European Union and 55 per cent of imports come from it. For businesses in Tower Hamlets, those shares drop to 43 and 32 per cent respectively. This is similar across all of the boroughs in Inner East London.

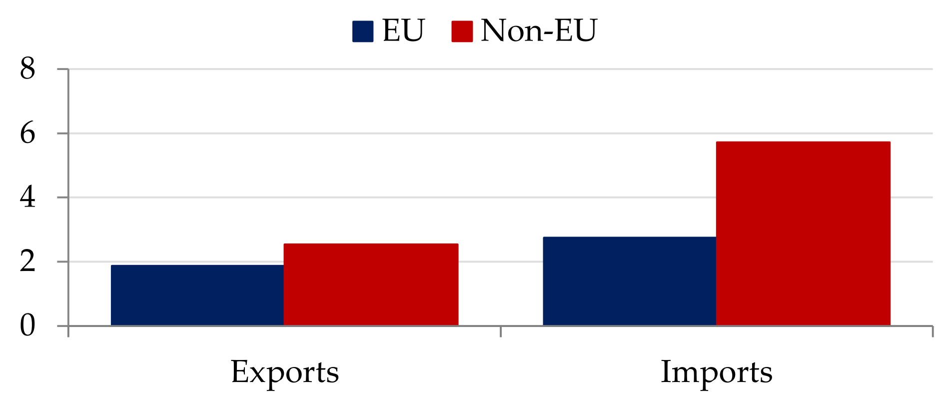
Inner East London non European Union exports and imports are higher

The value of imports of goods to Inner East London from non European Union countries was £5.7 million pounds in 2016. This value was £3 million above the total value of imports of goods from the European Union (£2.7 million).

The same holds for exports, with a higher share of exported goods from Inner East London sent to non European Union countries compared to European Union countries.



Share of total value of trade in goods to/from the European Union, 2016



Value of trade in goods from Inner East London by partner region, £ million, 2016

Source: Capital Economics and HMRC

Statistics suggest USA is the largest goods trading partner of Tower Hamlets

	Number of businesses (number)	Value of exports (£ million)
USA	1963	895
Switzerland	1008	304
Hong Kong	908	298
UAE	828	54
Australia	763	29
Japan	696	33
Irish Republic	635	285
Germany	619	385
Canada	615	135
France	600	152
Norway	583	18
Netherlands	568	352
Singapore	561	22
Spain	554	124
China	535	107
Top 15 as share of total		**72%**

Top 15 export markets by the number of businesses exporting

Source: HMRC trade statistics

	Number of businesses (number)	Value of imports (£ million)
USA	2618	565
China	2431	697
Hong Kong	1365	201
India	952	147
Turkey	791	137
Germany	558	466
Canada	522	83
Italy	502	338
Switzerland	499	235
Japan	473	70
Netherlands	466	499
France	453	240
Taiwan	445	32
Spain	414	145
Australia	395	48
Top 15 as share of total		**47%**

Top 15 import markets by the number of businesses importing

Source: HMRC trade statistics

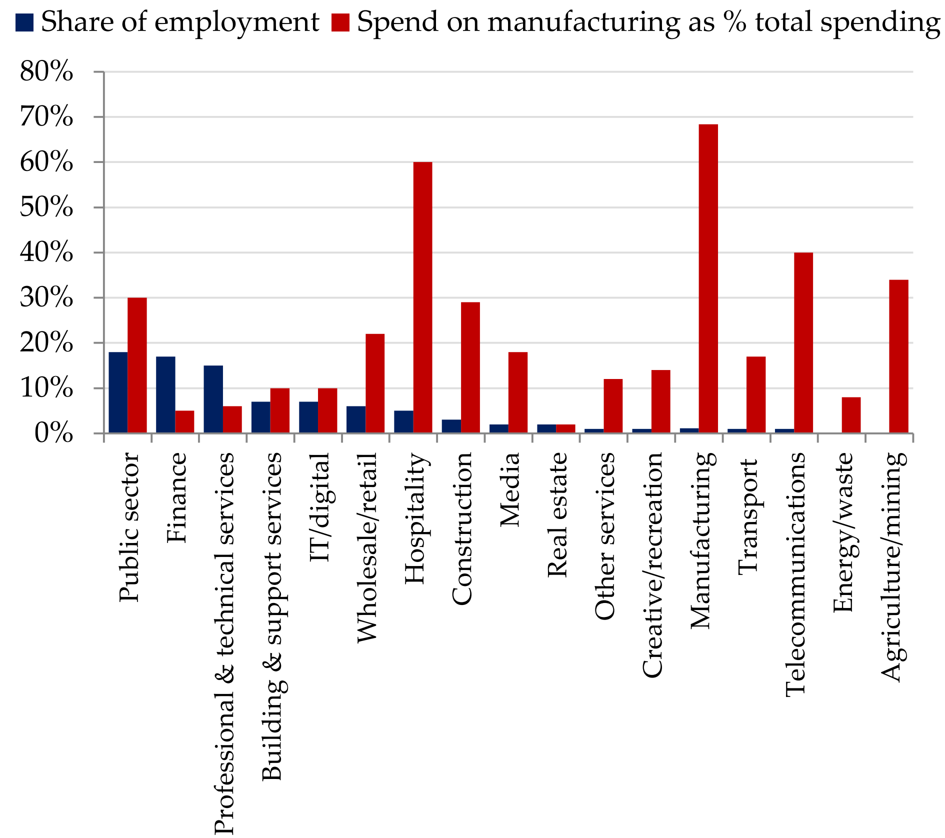
Despite low direct exposure, costs will feed through to Tower Hamlets economy

Local businesses have limited direct exposure to trade

Tower Hamlets is overwhelmingly a service based economy, with services accounting for 96 per cent of output in the borough. As such, Tower Hamlets is less exposed to any tariff or non-tariff barriers that increase the cost of goods trade with the European Union after Brexit.

But there will be impacts through their supply chain

Although few businesses import and export goods directly, their supply chains will involve goods originating from the European bloc. Some key sectors in the borough, such as hospitality, retail and the public sector, are more exposed to these costs than others, such as financial and professional services.



Exposure to increased trade costs by sector in Tower Hamlets, 2016

Sources: Capital Economics and Office for National Statistics

London is hub for financial and professional services

There is a wide disparity in the financial sector's contribution to the economy across different regions of the United Kingdom

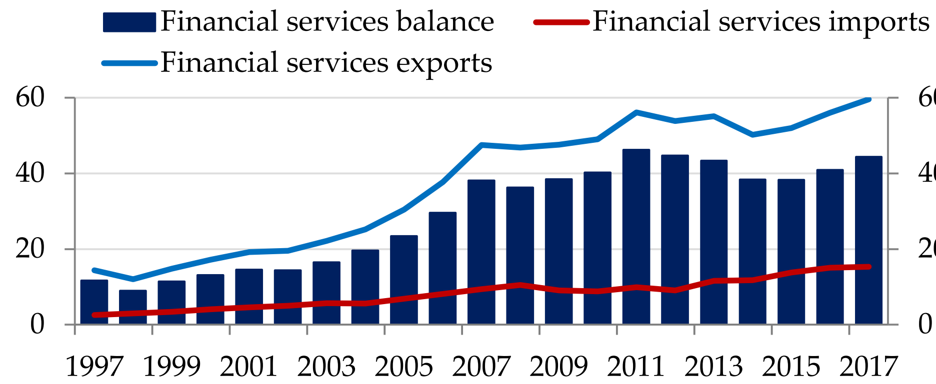
In London, the financial sector contributed £58.2 billion to the city's economy in 2016, fourteen per cent of its total economic output. London accounted for half of the total United Kingdom financial and insurance sector's gross value added in 2016.

In 2017, financial services were the largest contributor to the increase in the trade in the United Kingdom services surplus

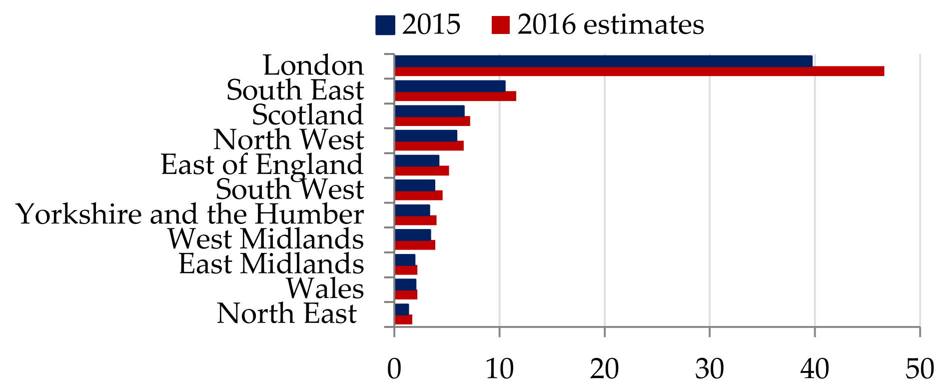
Financial services accounted for 21.5 per cent and nine per cent of total United Kingdom services exports and imports respectively in 2017. Exports of financial services increased £3.6 billion in 2017, whereas there was a relatively small increase of £0.1 billion pounds for imports resulting in a £3.5 billion increase to the United Kingdom's surplus in financial services.

London dominates the British financial and related professional services exports market

In 2016, according to The CityUK estimates, London exported 46.6 billion pounds of financial and related professional services, up seventeen per cent from £39.7 billion in 2015. The South East was the largest exporter outside the capital in 2016, followed by Scotland then the North West.



Financial services exports, imports and trade balance in £ billion, 1997-2017



London financial and professional services exports in £ million

Source: Capital Economics, theCityUK calculations and Office for National Statistics

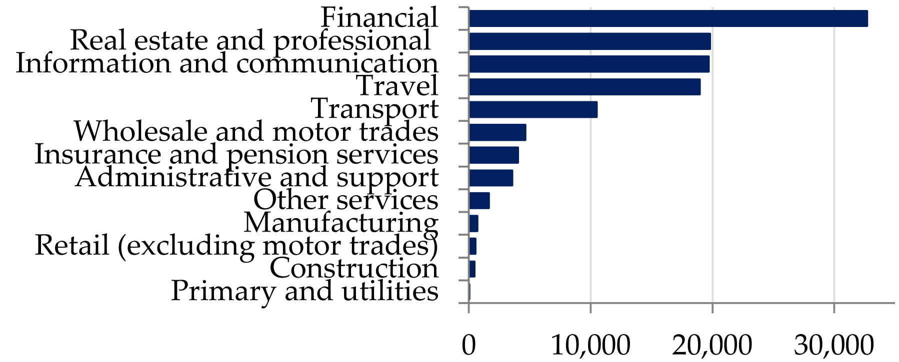
Financial and professional services are significant exports

Financial and professional services represent 45 per cent of London's service exports

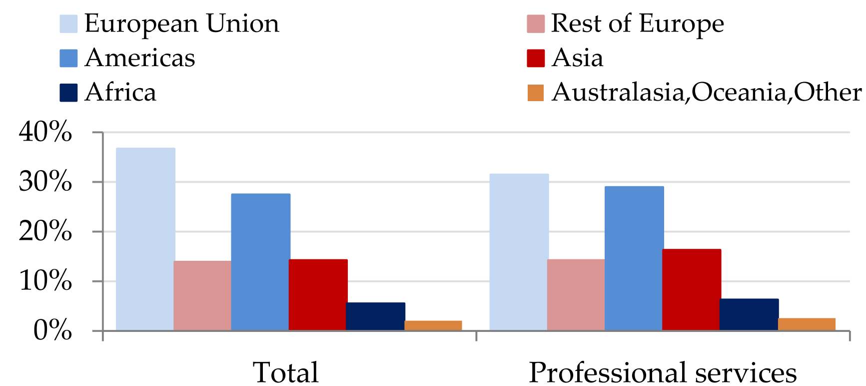
In 2016, Financial services was the largest category with service exports valued at £32.7 billion pounds, 28 per cent of London's service exports. London's second largest category was Real estate, professional, scientific and technical services at 19.8 billion pounds, seventeen per cent of London's service exports, followed by Information and communication at £19.7 billion.

London sells financial and related professional services overseas

According to Office for National Statistics data, almost 40 per cent of services are exported from London to the European Union with an additional fourteen per cent exported to the rest of the European continent. Americas is a destination for almost 30 per cent of total services exported from London, while Asia only accounts for fourteen per cent.



London services exports by functional category in 2016, £ million



Destinations of service exports, total and professional services, from London in 2015, £ million

Source: Capital Economics and Office for National Statistics

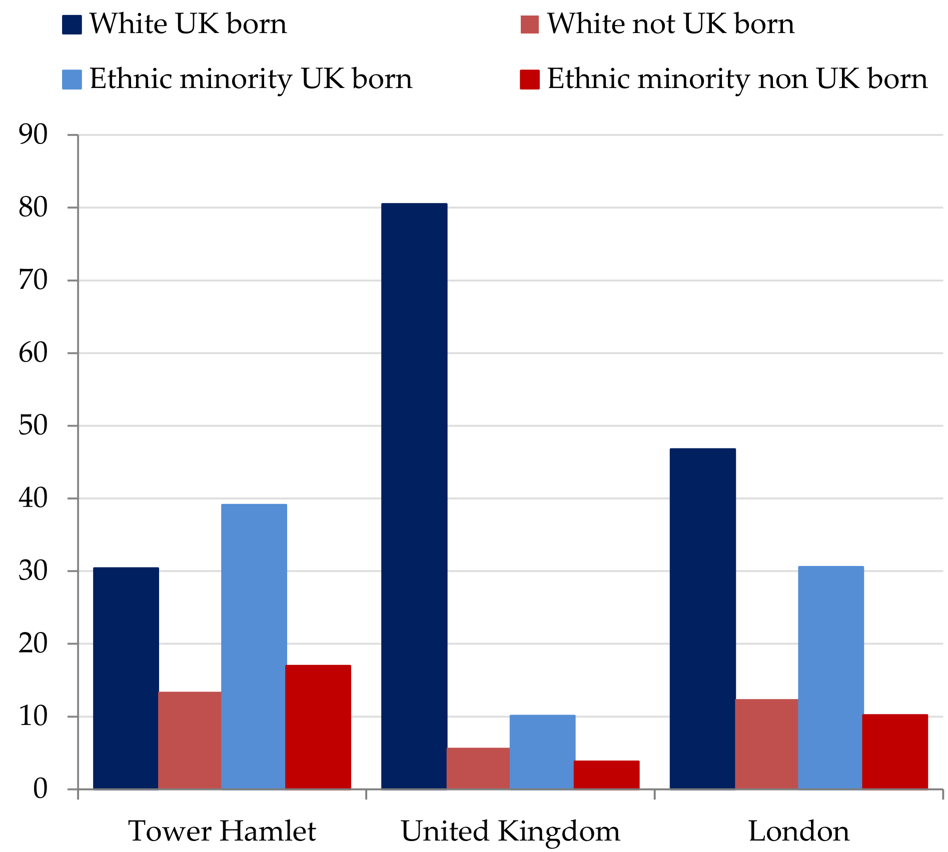
Tower Hamlets is a diverse borough

The borough has a high rate of foreign born residents

Tower Hamlets has a significantly higher rate of foreign born population than both national and London averages. Over 30 per cent of Tower Hamlets residents in 2018 were born outside the United Kingdom compared to 23 per cent in London and under ten per cent nationally.

Tower Hamlets has a large ethnic minority population

As well as having a high share of residents born outside the United Kingdom, Tower Hamlets also has a high share of ethnic minority communities. Around 56 per cent of the borough's population were identified as ethnic minorities in 2018 compared to 40 per cent across London and just fourteen per cent in the country as a whole.



Share of population by country of birth in per cent, 2018

Source: Capital Economics and Office for National Statistics

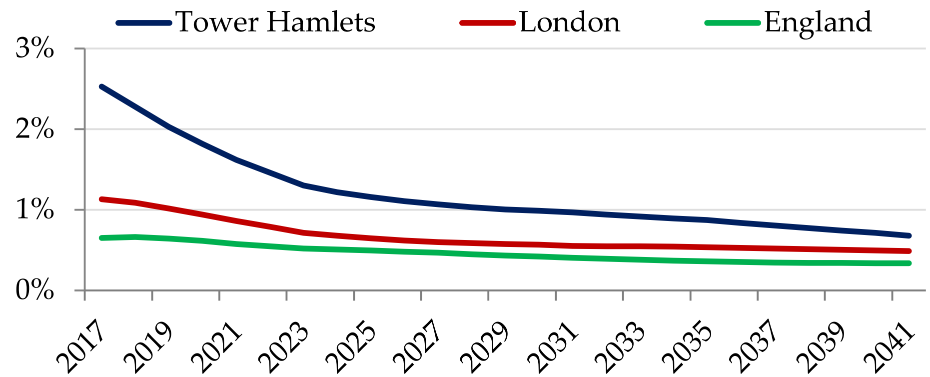
Tower Hamlets set for fast population growth and ageing population

Population set to grow above national averages

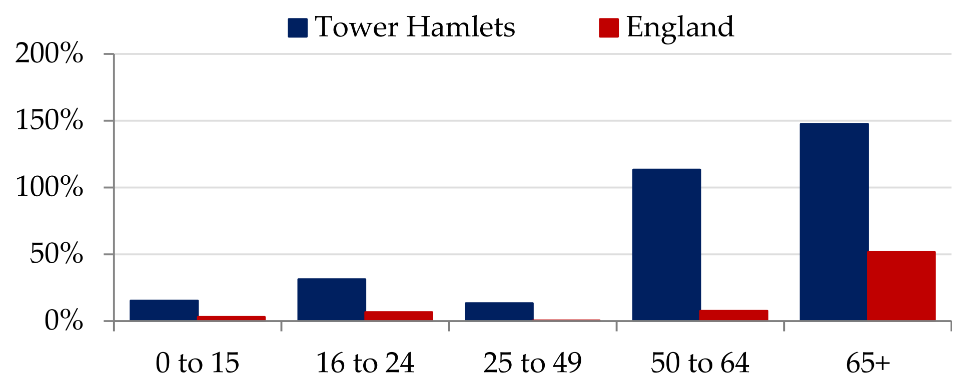
Projections from the Office for National Statistics suggest that Tower Hamlets is set for population growth averaging around two per cent over the next five years and one per in the subsequent two decades. These are considerably faster growth rates than expected for London and England as a whole.

Large increase in older age groups

The age breakdown of population projections shows that the fastest growing age group is over 65s, both nationally and in Tower Hamlets. Over the next 25 years the over 65 population is projected to grow to almost 2½ times its current level. An ageing population will put further pressure on public services.



Projected annual percentage change in total population



Projected percentage change in population by age group between 2016 and 2041

Source: Capital Economics and Office for National Statistics

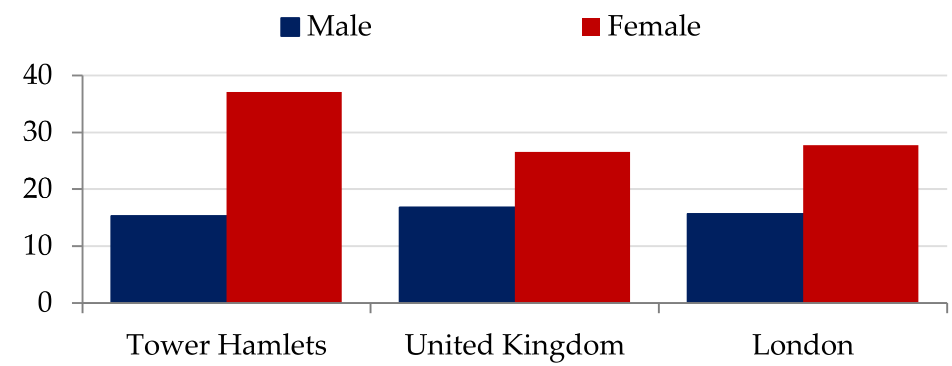
High share of economically inactive female residents

Females economic inactivity rate in Tower Hamlets is high

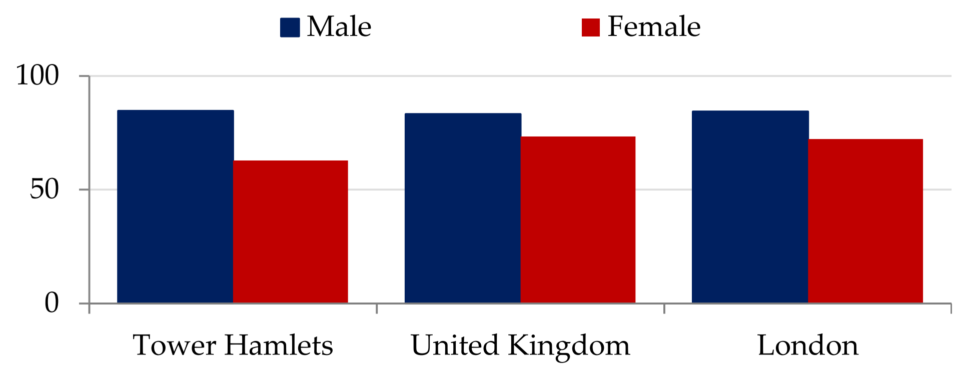
There is a large disparity between male and female economic inactivity rates in Tower Hamlets. At 37 per cent, the rate of inactivity in the local female population is considerably higher than the average rate in London (28 per cent) and the United Kingdom (27 per cent).

The overall rate of economic inactivity is slightly below national averages.

In terms of the economic activity rate, 84 per cent of the male population in the borough is economically active, comparing favourably to national averages. Conversely, only 63 per cent of the female population is economically active compared to 73 per cent nationally.



Economic inactivity rate for individuals aged 16 to 64 by gender in per cent, 2018



Economic activity rate for individuals aged 16 to 64 by gender in per cent, 2018

Source: Capital Economics and Office for National Statistics

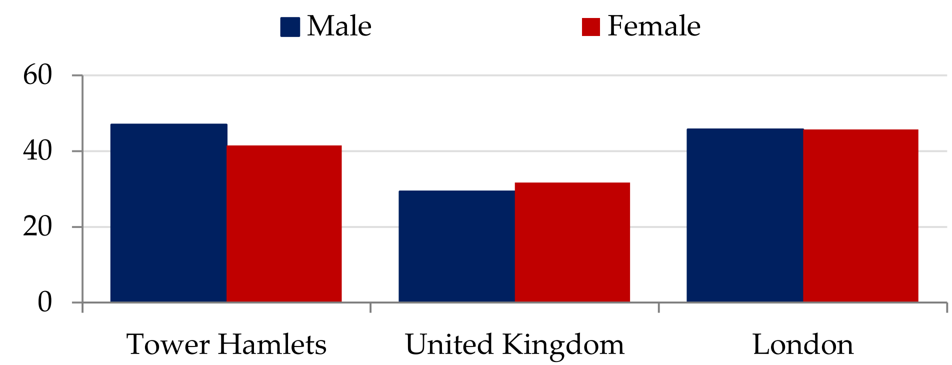
Large disparity with high share of both high and low skilled population

Number of local residents with no qualifications double London averages

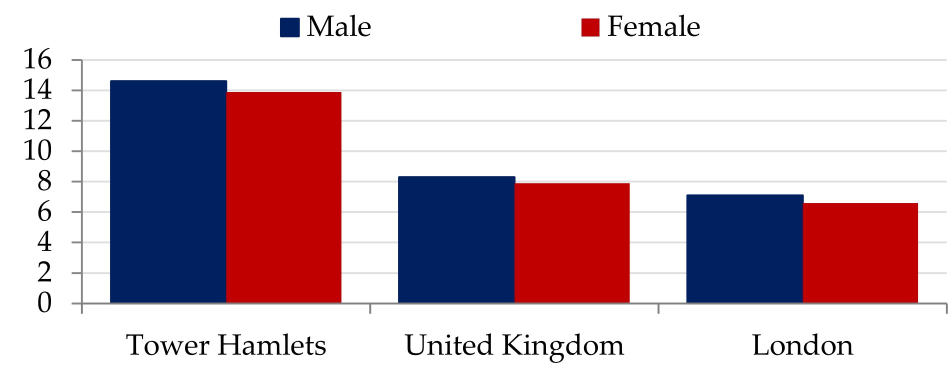
Tower Hamlets performs poorly on some metrics comparing the skill levels of its resident population with regional and national averages. In 2017, 13.9 per cent of females and 14.6 per cent of males between the ages of sixteen and 64 living in the borough had no qualifications. This is more than double the average for London as a whole and significantly higher than the United Kingdom average.

Higher than average degree level residents

In 2017, 47 per cent of males and 42 per cent of females in Tower Hamlets held a degree or equivalent. This rate is considerably higher than the national average. Compared to London as a whole, the share of Tower Hamlets males with a degree or above is higher but the share for females is lower.



Share of individuals aged 16 to 64 with a degree or equivalent and above by gender in per cent, 2017



Share of individuals aged 16 to 64 without qualification by gender in per cent, 2017

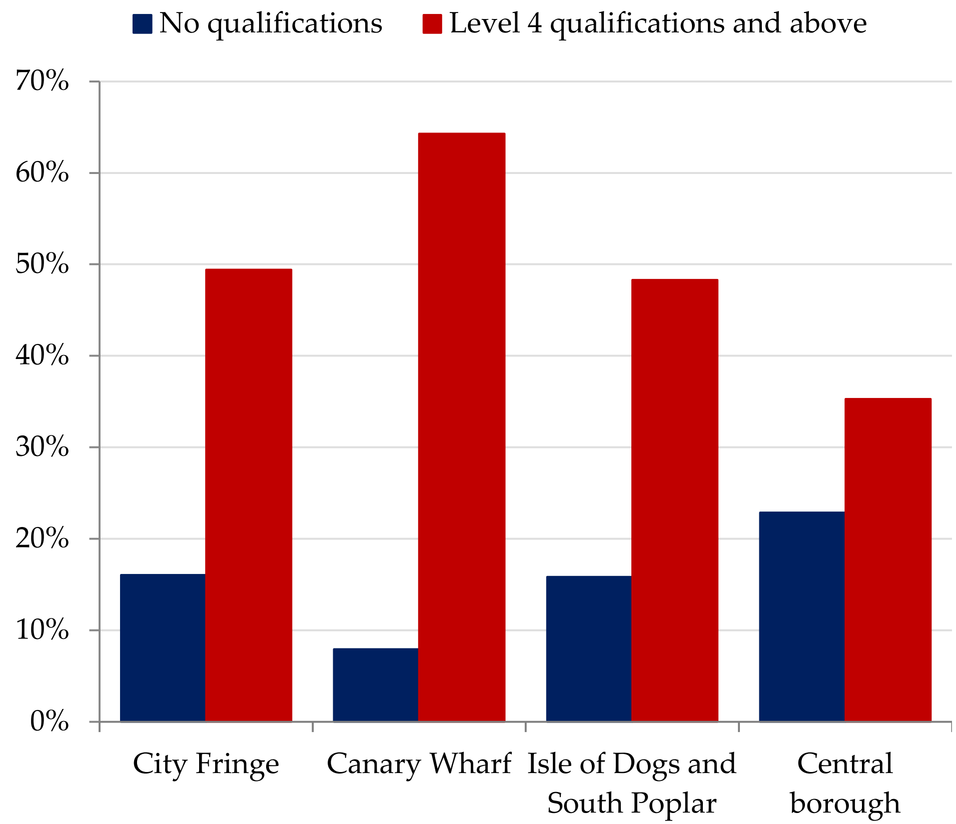
Source: Capital Economics and Office for National Statistics

Central Borough lags behind in skills

Mix of skills levels reflects local economies

Census data allows us to break down skills levels further than the borough level. They show that, in 2011, 23 per cent of Central Borough residents over the age of sixteen had no qualifications compared to just eight per cent in Canary Wharf. Conversely, 64 per cent of Canary Wharf residents over sixteen were educated to level 4 or above compared to 35 per cent in Central Borough. Again, City Fringe and Isle of Dogs and South Poplar were in the middle of this range.

Although these are dated figures, other evidence shown in this section suggests the pattern of disparity has persisted.



Share of all residents over 16 by highest level of qualification, 2011

Source: Capital Economics and Office for National Statistics

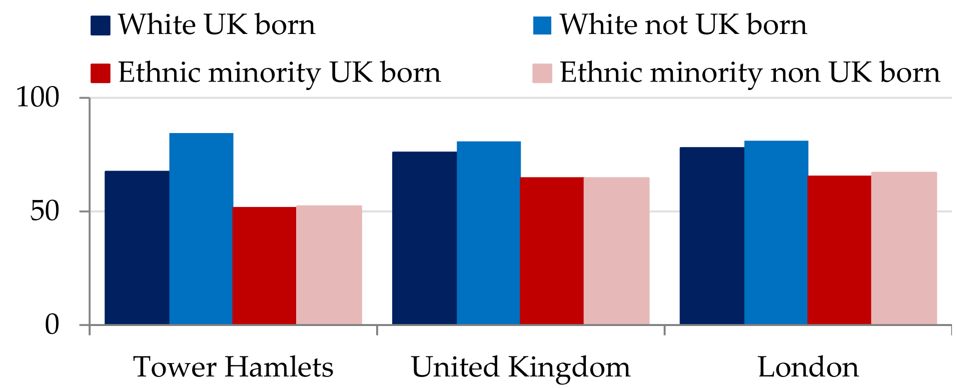
Differences between ethnicities as well

There is a difference in labour market between ethnicities

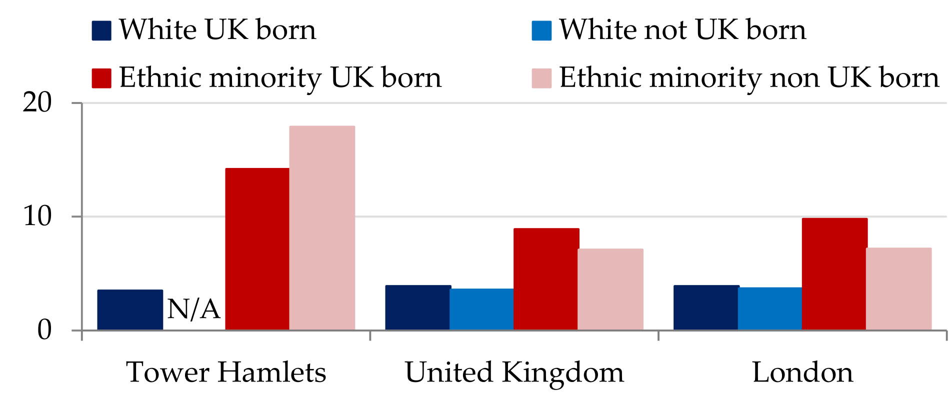
The employment rate for British and foreign ethnic minorities is close to 52 per cent, which is below both regional and national levels. Meanwhile, the borough has a much higher employment rate for foreign white population (85 per cent). This rate is well above the one observed for British workers.

Unemployment rates are higher for ethnic minorities

Around fourteen per cent of the total ethnic minority population born in the United Kingdom and living in Tower Hamlets is unemployed. The rate of unemployment is even higher for the foreign ethnic minority population (seventeen percent) and both are above national and regional levels of unemployment.



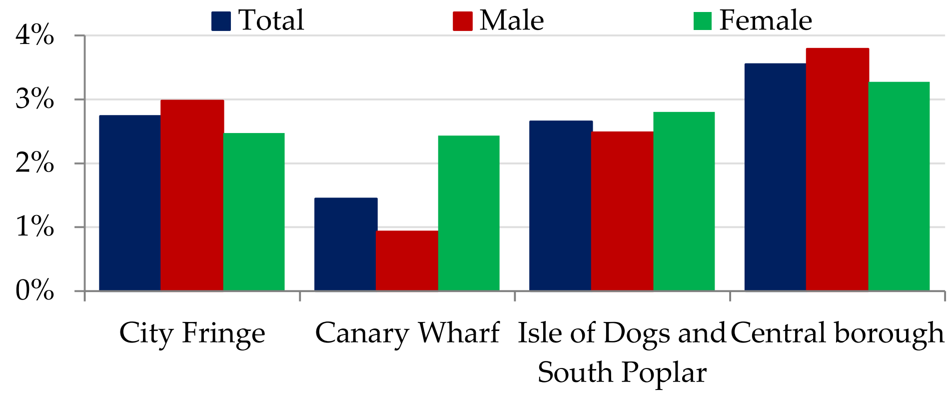
Employment rate by country of birth in per cent, 2017



Unemployment rate by country of birth in per cent, 2017

Source: Capital Economics and Office for National Statistics

There are four distinct local areas in Tower Hamlets

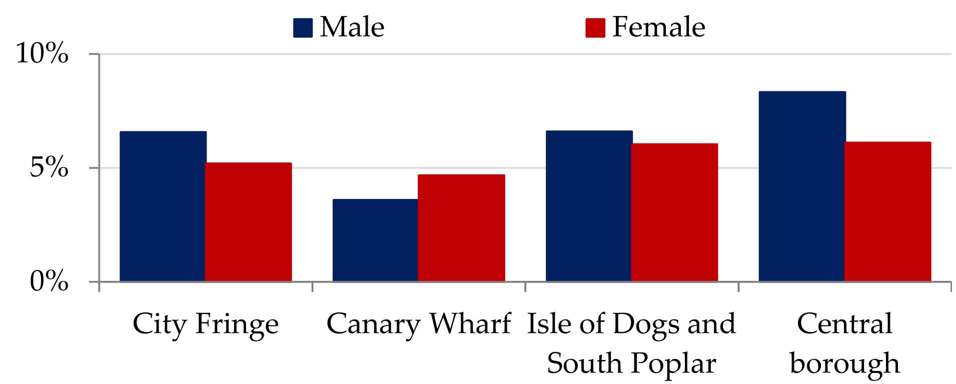


Claimant count as a share of 16-64 population, October 2018

Labour markets show differences within Tower Hamlets

Unemployment rates are highest in Central Borough and lowest in Canary Wharf. As of October 2018, 3.6 per cent of residents in Central borough claimed job seeker's allowance, compared to 1.4 per cent of Canary Wharf residents. The City Fringe and Isle of Dogs and South Poplar measure somewhere between the two on this measure.

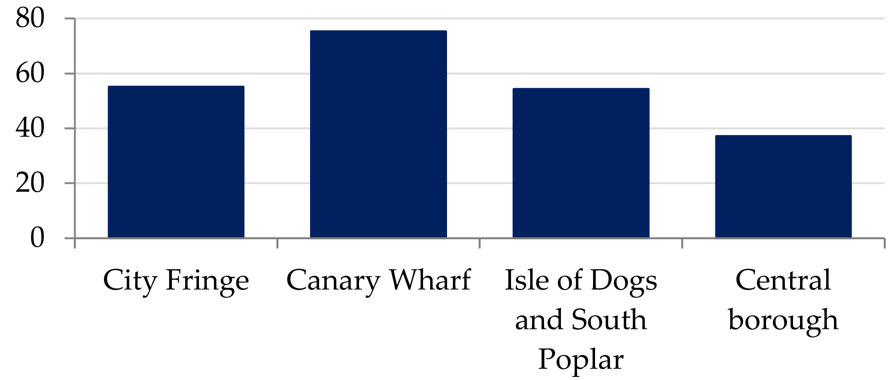
Although dated, much of the information from the last census shows the same pattern between the four local areas.



Share of residents aged 16 to 74 that are unemployed, 2011

Source: Capital Economics and Office for National Statistics

Disparity in wages between different parts of the borough



Estimated median annual wages of workers in each local area in 2017, £ thousands

Wages in Canary Wharf outstrip rest of borough

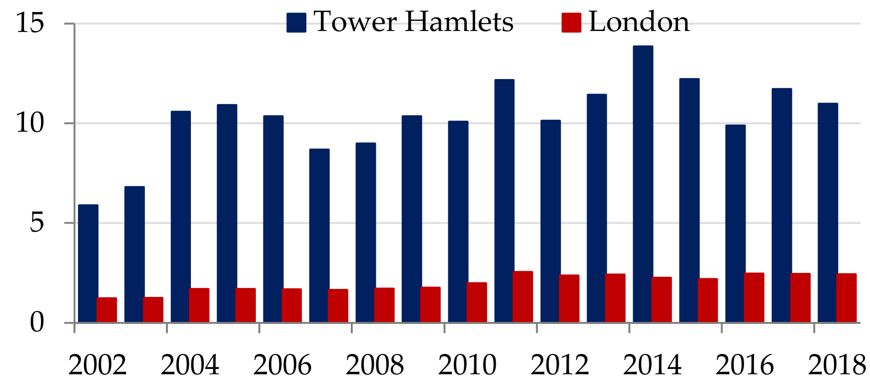
Average wages for jobs located in different parts of the borough vary considerably. Using data on the sectoral mix of jobs in the four local area, we have estimated average wages in each of the four areas. Unsurprisingly, given the high value service sector located in Canary Wharf, average wages are the highest there at around £75,000 per annum.

Lower wage jobs concentrated in the Central Borough area

At £37,000, average wages for jobs in the Central Borough are just under half that of those in Canary Wharf, highlighting the disparity of economic prosperity within the borough.

Gap between the wages of residents and workers has grown

Since 2002, the gap between the average wages of those who live in Tower Hamlets and those that work there has grown from just under £6,000 to around £11,000 in 2018.



Difference in the annual gross pay between workers and residents, £ thousands

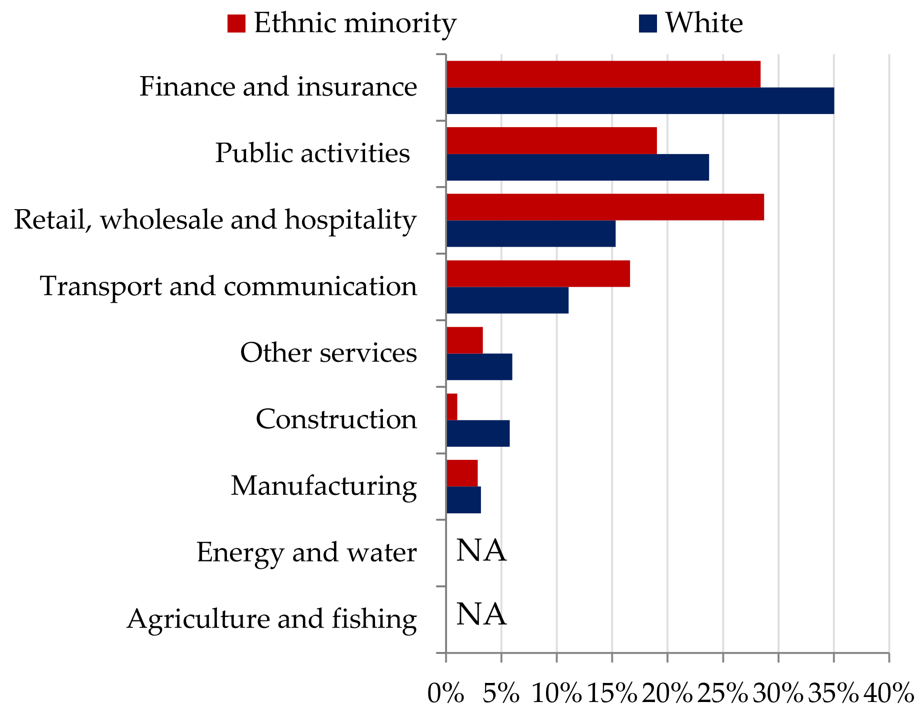
Source: Capital Economics' analysis of Office for National Statistics

Non-white residents more likely to hold jobs in retail, hospitality and transport

Sectors employment differs by ethnic group

Tower Hamlets ethnic minority residents are disproportionately employed in the retail, wholesale and hospitality activities. In 2018, 29 per cent of ethnic minority residents who are employed work in the retail, wholesale and hospitality sector compared to fifteen per cent of the resident white workforce.

Meanwhile, white residents are more likely to hold jobs in financial services and the public sector.



Share of employed population aged over 16 by sector and ethnic group in Tower Hamlets, 2018

Source: Capital Economics and Office for National Statistics

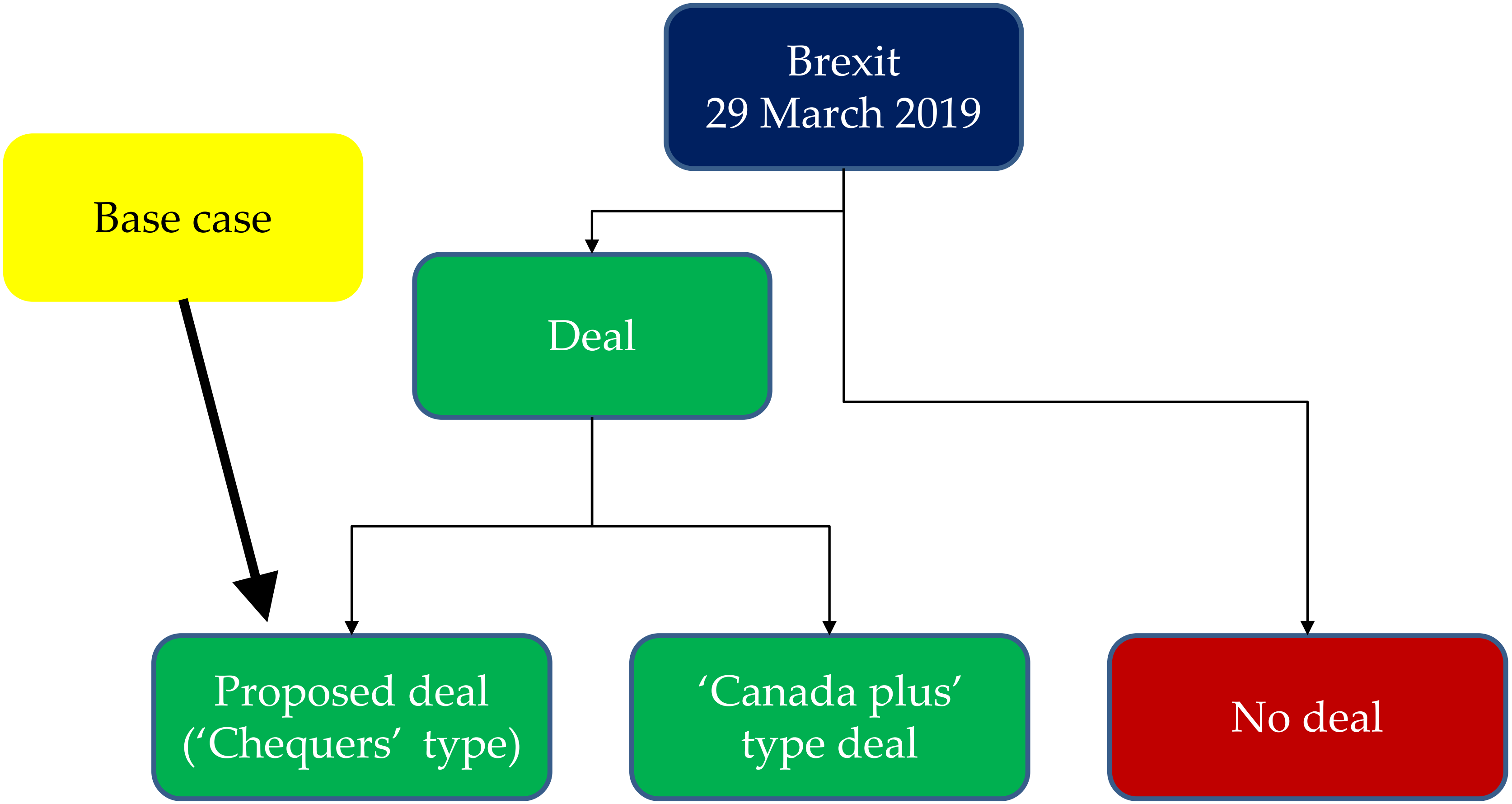
3: Brexit scenarios

Three possible post-Brexit economic scenarios

Economic prospects after the United Kingdom exits the European Union on 29 March 2019 are highly uncertain. The table below summarises three possible scenarios: a Canada plus deal, the proposed deal (a Chequers-type deal) and no deal. In the following slides in this section we assign probabilities to the three scenarios, set out the timeline for Brexit, present the key differences between the three scenarios and provide a glossary of key terms.

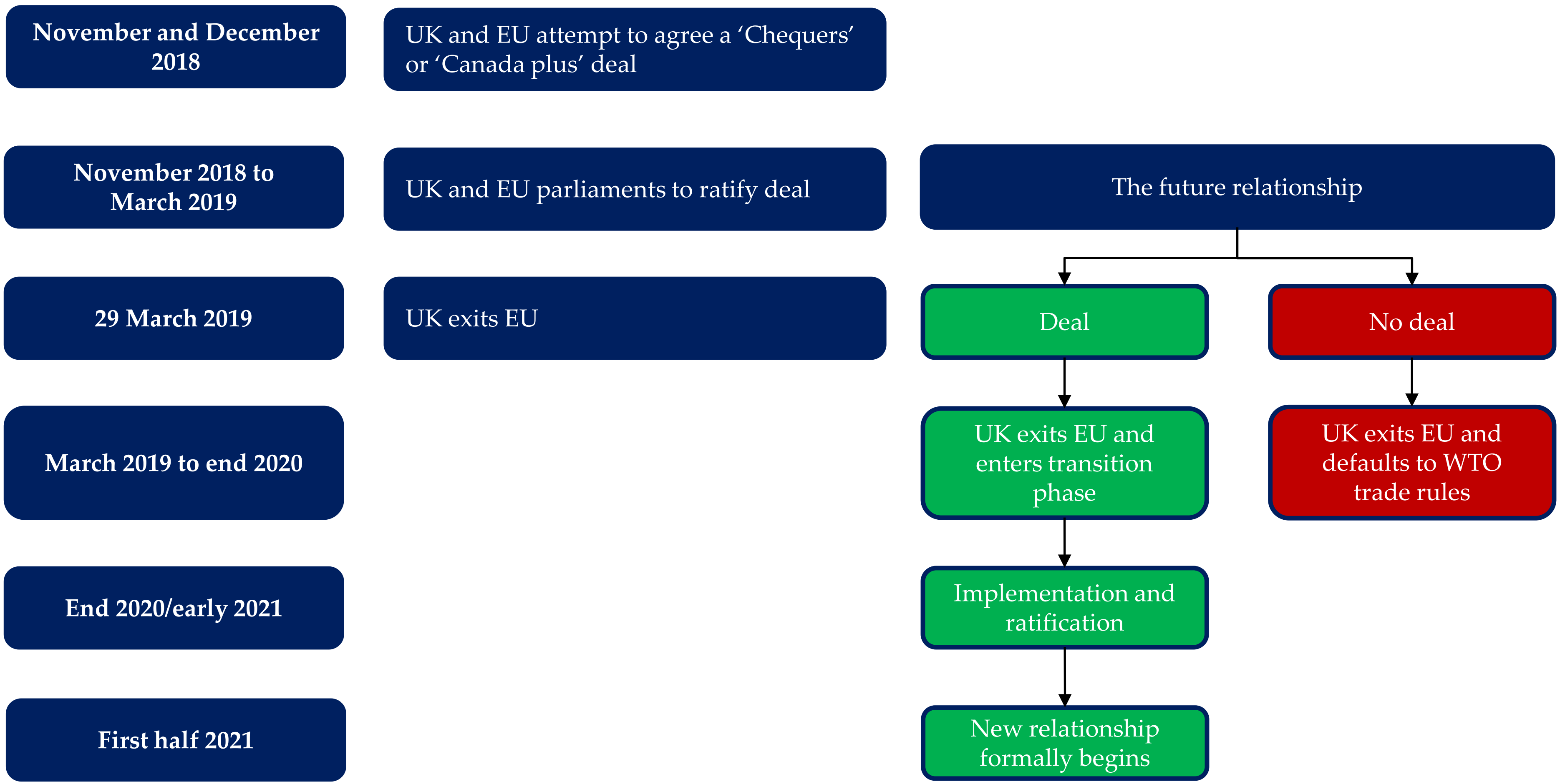
	Proposed deal	Canada plus deal	No deal
2019 – 2020	In both of these scenarios the currently proposed Withdrawal Agreement is approved. Brexit happens on 29 March 2019 and there is a transition period until the end of December 2020. During this time, freedom of movement continues, the United Kingdom effectively remains in the Customs Union and Single Market and continues paying into the European Union budget. The post-2020 relationship is negotiated and ratified, which means that the controversial "backstop" to prevent a hard border with Ireland does not come into play. Britain begins negotiating trade deals with non-European Union countries, but its focus is on negotiations with the European Union.		A Withdrawal Agreement cannot be reached. On 29 March 2019 the United Kingdom exits the European Union. Freedom of movement ends and the country immediately exits the Customs Union and the Single Market. Trade with the European Union defaults to World Trade Organisation rules. The divorce bill is unpaid or greatly reduced. Britain begins negotiating free trade deals with other countries. The regulatory burden begins to be gradually reduced.
2021 – 2023	The new relationship begins. The United Kingdom is outside of the Customs Union and Single Market, but copies European Union regulations on goods and agri-food to facilitate trade. It aligns with European Union rules necessary to prevent a hard border with Ireland. This close alignment with the European Union will limit the ability to negotiate new trade deals with other countries.	The new relationship begins. The deal is a comprehensive free trade agreement that leaves the United Kingdom outside of the Customs Union and Single Market. "Mutual recognition" of regulations facilitates cross border trade and gives the United Kingdom greater scope for setting its own rules. The hard border issue is resolved with technology or separate arrangements for Northern Ireland.	It takes years for talks with the European Union on free trade to be revived and an agreement is not reached during the next five years. Trade agreements with other countries are concluded only gradually.

Brexit base case and scenarios



Source: Capital Economics

Summary of Brexit timeline



Source: Capital Economics

Applicability of changes under different Brexit scenarios

	Canada plus deal	Chequers style deal	No deal
Removal of freedom of movement of people	Full	Full	Full
Removal of membership of the Single Market	Full	Full	Full
Imposition of tariffs on trade with EU	Partial/uncertain	None	Full
Imposition of Rules of Origin	Full	None	Full
Increased customs checks	Full	Full	Full
Flexibility to change business regulation	Full	Partial/uncertain	Full
Flexibility to adapt product standards regulation	Partial/uncertain	Partial/uncertain	Full
Ability to do trade deals with other markets	Full	Partial/uncertain	Full
Loss of trade deals through EU	Full	Full	Full
Loss of financial sector 'passporting' rights	Full	Full	Full
Transition period	Full	Full	None

Source: Capital Economics

Full   Partial/uncertain   None

Glossary of the Brexit process

Withdrawal agreement	The proposed Withdrawal Agreement covers the process for the United Kingdom exiting the European Union in a managed way. It includes areas such as the United Kingdom's financial settlement with the European Union (the "divorce bill"), the rights of citizens and arrangements to prevent a hard border between Northern Ireland and Ireland until a permanent solution is agreed. The Political Declaration that accompanies the Withdrawal Agreement provides a broad outline on the future relationship – and in particular, the future *trading* relationship – between the United Kingdom and the European Union.
Transition period	The Withdrawal Agreement includes a transition period from 29 March 2019 until the end of 2020. During this period the United Kingdom's relationship with the European Union will remain largely the same; free movement continues, the United Kingdom effectively remains in the Customs Union and Single Market and pays into the European Union budget. The transition period allows time for government, businesses and individuals to adjust and prepare for the new relationship, which will begin at the start of 2021 unless an extension to the transition period is agreed in advance.
Canada plus	'Canada plus' is an enhanced version of the free trade deal that Canada reached with the European Union in 2016. Most trade in goods would be tariff free and, rather then the United Kingdom following European Union rules, there would be mutual recognition of each other's regulations. Canada plus would also include access to the European Union market for the United Kingdom's financial services.
Chequers plan	The Chequers plan was agreed by Cabinet in July 2018. It includes leaving the Single Market and the Customs Union and ending the free movement of people. On behalf of the European Union, the United Kingdom would collect tariffs on any goods entering the country from outside the European Union but destined for it. Trade between the United Kingdom and the European Union would remain tariff free and there would be no border between Northern Ireland and the Republic. The United Kingdom would follow some European Union rules, such as on food standards.
No deal	If a Withdrawal Agreement, a "deal", is not reached there will be no transition period. Brexit will occur on 29 March and freedom of movement will cease at that point and the country immediately exits the Customs Union and the Single Market. The United Kingdom will default to trading under World Trade Organisation rules with the European Union (and countries the European Union has trade deals with).

Source: Capital Economics

Glossary of features of post-Brexit trading relationship

Free movement or people	Citizens of member countries of the European Union have the right to live and work anywhere within it. Free movement of people between the United Kingdom and the European Union will come to an end after the end of the transition period, if there is one, or on 29 March 2019 if no deal is reached. The United Kingdom will be able to determine how many, and what skill-level, of migrants admit from the European Union.
Single market	The Single Market covers all European Union members and participating in it entails accepting free movement of people, money, goods and services. The Single Market aims to reduce non-tariff barriers to trade in goods and services between members through such measures as harmonizing rules and regulations, thereby supporting economic specialisation, economies of scale and, ultimately, the size of the economy. 'Passporting rights' (see below) are part of the Single Market. The United Kingdom government plans to exit the Single Market.
Customs Union	In the European Union Customs Union there are no tariffs on trade in goods between members and a common set of tariffs is applied to all non-member countries. Some countries outside of the European Union are members, such as Turkey. The Chequers plan and the Canada plus deal both entail the United Kingdom leaving the Customs Union, although the Chequers plan proposes a mechanism to allow continued tariff free trade between the United Kingdom and the European Union while enabling the United Kingdom to set its own external tariff.
WTO rules	The World Trade Organization is a body that administers the rules of trade between its members. Most countries are members of the World Trade Organisation. Countries that do not have trade deals between them trade under World Trade Organization rules and levy tariffs on goods imports. If the United Kingdom exits without a deal it will trade with the European Union under World Trade Organization rules. United Kingdom goods exports to the European Union will be charged a tariff. The United Kingdom will likely impose tariffs on goods imports from the European Union.
'Passporting' rights	'Passporting' rights enable financial service firms that are authorised in any European Union or European Economic Area member state to trade in all other member states without regulatory barriers. Passporting rights are the foundation of the Single Market in financial services. The United Kingdom maintaining any of these rights after Brexit is subject to negotiation.

Source: Capital Economics

4: Macroeconomic impact

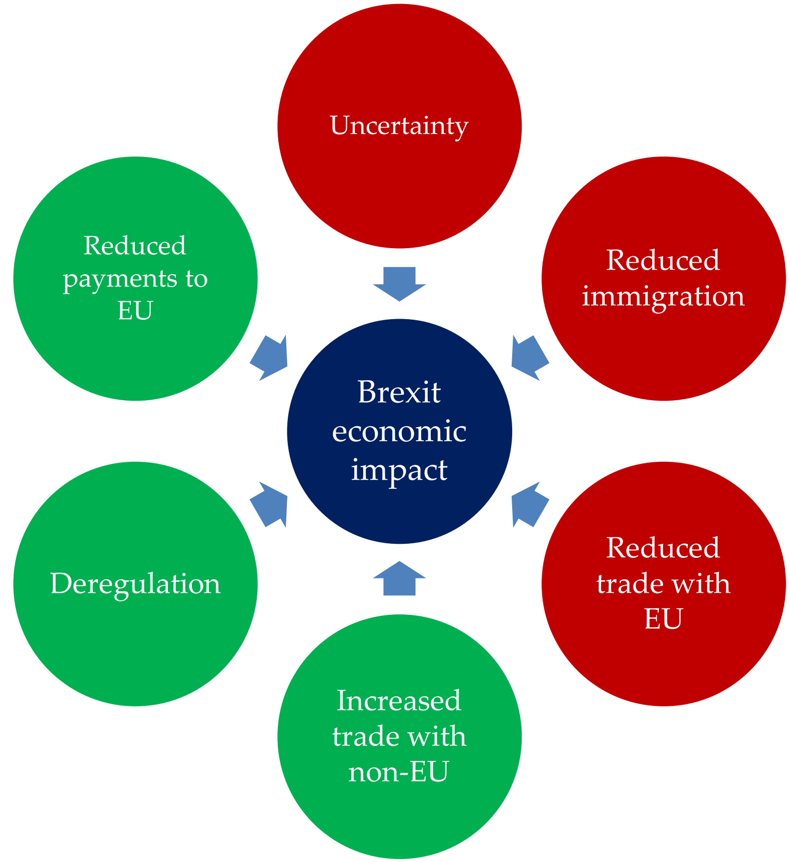
Brexit will bring significant changes to the UK economy over the next five years

Brexit brings changes that negatively impact the United Kingdom economy. First, since the referendum in June 2016, the prolonged period of uncertainty over what Brexit will mean has curtailed investment spending and this will likely reduce the sustainable growth rate of the economy on a longer-term basis. Second, a lower level of net immigration can be anticipated; the reduced availability of workers will hamper economic growth. Third, leaving the Customs Union and Single Market will make trading with the European Union more costly, lowering exports compared to if the United Kingdom had remained a member. If a deal is reached, some of this hit to exports will be mitigated.

Brexit also offers some economic positives. First, the United Kingdom will be able to negotiate trade deals with countries outside of the European Union, although experience shows that negotiating trade deals can be a slow process. Second, there is also an opportunity to amend and or reduce regulation, decreasing the cost of doing business. Third, payments to the European Union budget will be reduced, if not eliminated. Should the United Kingdom reach a trade deal with the European Union, the terms of the deal may have an influence on each of these factors.

Overall, we expect the economy to be negatively impacted by Brexit over the next five years.

The following slides in this section provide further information on each of the major factors that will affect the economy after Brexit and on our economic forecasts under three scenarios: a Canada plus deal, the proposed agreement (a Chequers-type deal) and no deal.



Summary of factors impacting the economy in the Brexit scenarios (red circles are negative factors, green circles positive factors)

Source: Capital Economics

Economic growth has slowed since the referendum and the pound weakened

Economic growth has slowed since the referendum…

In the nine quarters since the vote the economy grew by an average of 0.4 per cent quarter-on-quarter, or 1.7 per cent at an annual rate, compared to 0.5 per cent quarter-on-quarter, or 2.2 per at an annual rate, in the nine quarters prior to the referendum.

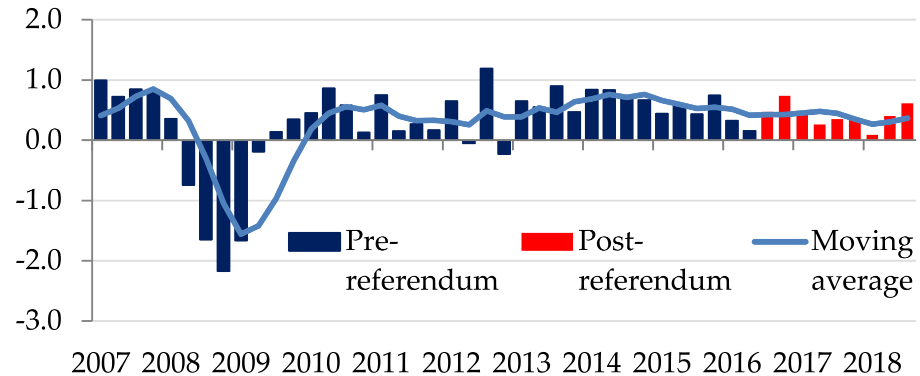
…but not collapsed as some forecasters had expected

Some forecasters had expected that a vote for Brexit would be an immediate adverse shock to the economy and cause a recession. But with more than half of voters in favour of Brexit and with Brexit not coming into effect until at least two years after the referendum, that analysis was misjudged.

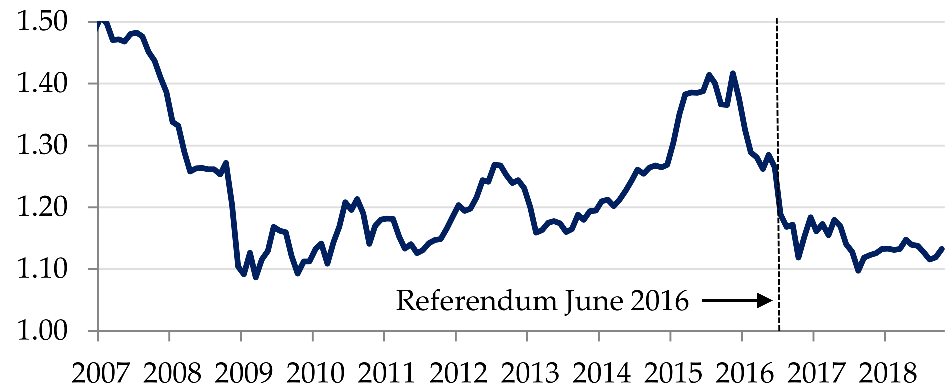
The Bank of England and sterling have provided support

The Bank of England helped support the economy after the referendum by loosening monetary policy. The Bank lowered interest rates from 0.50 per cent to 0.25 per cent per cent in August 2016 and increased asset purchases.

Lower interest rates and uncertainty about the future caused the pound to weaken by over ten per cent which acted as a shock absorber, helping to boost the stock market and the international competitiveness of United Kingdom businesses.



Real gross domestic product growth (quarter on quarter change and four quarter moving average, per cent)



Sterling/Euro exchange rate (monthly average)

Source: Capital Economics, Bank of England and Thomson Reuters

A weaker pound boosts international competitiveness but pushes up inflation

A weaker pound boosts competitiveness, at least in the short term

A weaker value for the pound against other currencies means that United Kingdom goods and services priced in pounds can become cheaper in foreign currency terms, enabling firms based in the United Kingdom to be more price competitive internationally. This is the case for exporters of both goods and services, including cars, financial services and tourism.

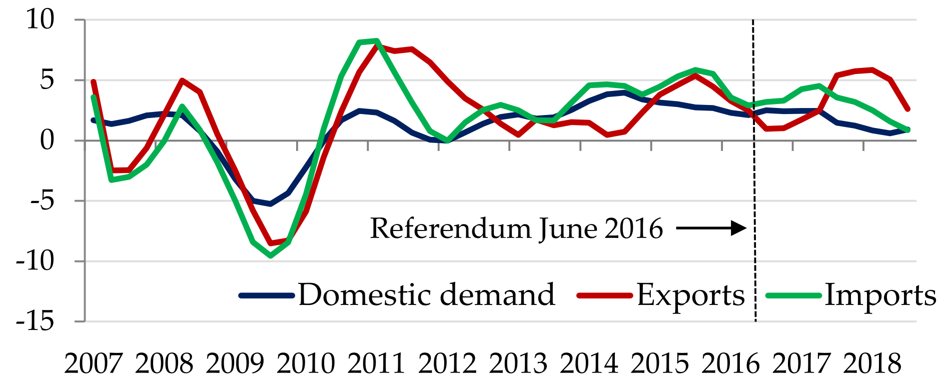
The fall in the value of the pound after the referendum contributed to a strong increase in export growth, at least initially, which was positive for economic growth.

A falling pound pushes up inflation

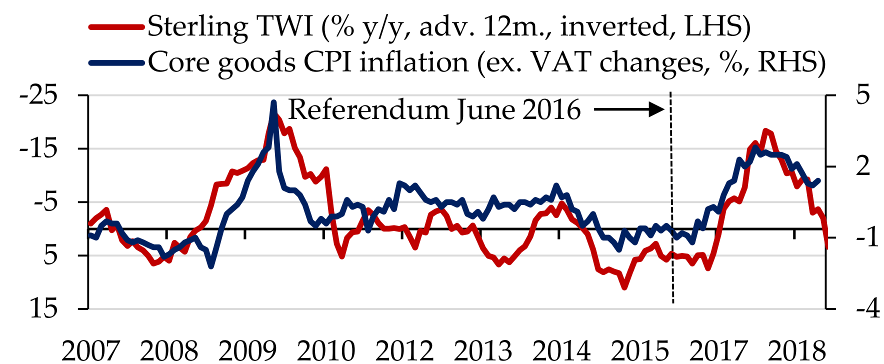
Similarly, a weaker pound can increase the price in pounds of good and services priced in foreign currencies. This enables firms based in the United Kingdom to be more price competitive with imports and to gain market share, boosting economic growth. Since the referendum import growth has slowed relatively sharply as imports have become less competitive.

Rising import prices push up the costs of supplies bought by businesses and consumers. As a result, inflation increased after the referendum.

If a Brexit deal is reached, the pound should recover and contribute to inflation subsiding. In a 'No deal' scenario the pound could fall by a further ten per cent or more, pushing up inflation once again.



Year-on-year change of selected components of gross domestic product (per cent)



Sterling trade-weighted-index and core goods consumer price index (year-on-year change, per cent)

Source: Capital Economics, Bank of England and Thomson Reuters

Higher inflation can squeeze consumer spending power

Higher inflation reduced confidence and retail sales growth

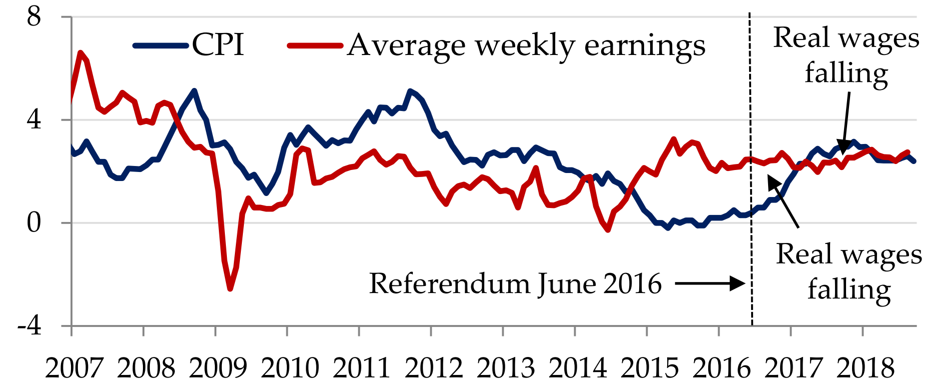
Prior to the referendum average weekly earnings were growing faster than inflation, meaning that consumer spending power was increasing. This was reflected in buoyant consumer confidence and retail sales growth.

The rise in inflation after the post-referendum depreciation of sterling squeezed consumers spending power, causing both confidence and retail sales growth to weaken. Although the squeeze has come to an end, spending power is barely increasing.

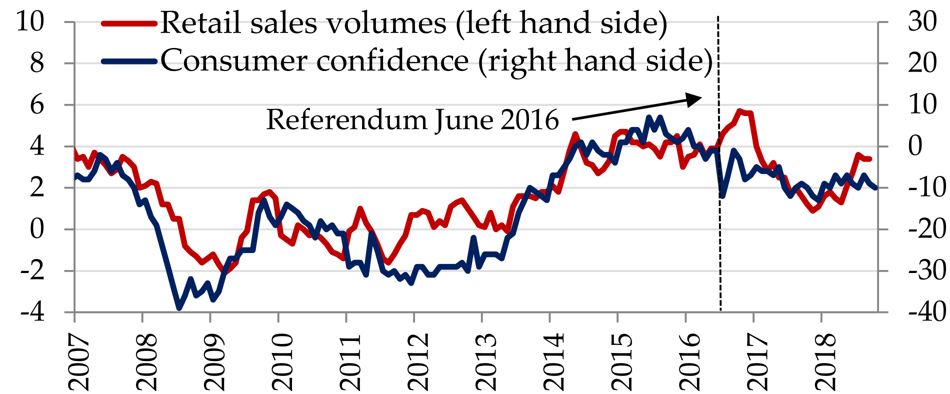
The 'no deal' scenario would see a repeat of this experience

If a deal is reached, spending power is likely to strengthen. The economy will pick up as uncertainty diminishes, increasing the demand for labour and wages, and a stronger pound will help reduce inflation.

Conversely, the 'No deal' scenario would see rising unemployment, slowing wage growth and rising inflation in 2019 and 2020. Consumer spending would contract next year and barely increase the following year.



Year-on-year change in United Kingdom average earnings and consumer price index (per cent)



Year-on-year change in retail sales volumes (per cent) and consumer confidence index

Source: Capital Economics, Bank of England and Thomson Reuters

Uncertainty deters investment and may have long-lasting economic effects

Investment has underperformed since 2016

Political and economic uncertainty may prompt households to delay making major purchases and firms to put off investment decisions.

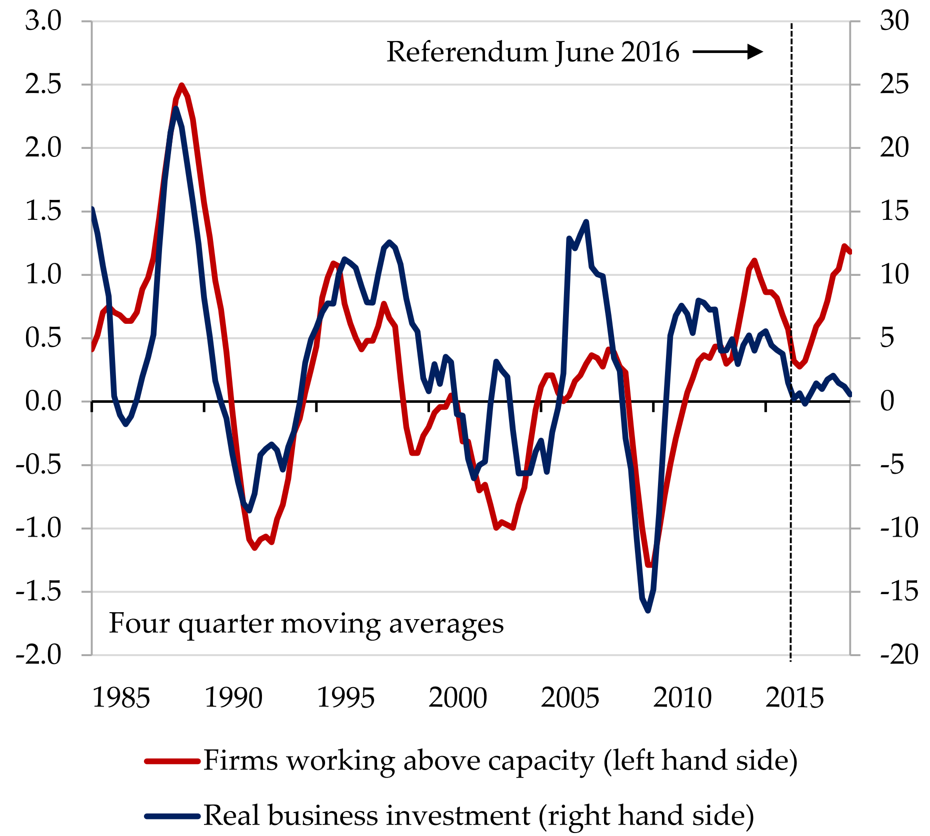
Uncertainty over the United Kingdom's future relationship with the European Union has caused investment to be postponed. Survey readings suggest that investment growth should have grown much more strongly over the past two years than it has.

This has two negative impacts on the economy. In the short term, the underperformance of investment has a direct negative impact on domestic demand and economic growth. Over the longer term investment is a key driver of productivity growth and thereby of the economy's sustainable rate of economic growth.

Not all 'lost' investment will be recouped

Some of this foregone investment will be recouped if a Withdrawal Agreement is concluded. However, full clarity over future relations with the European Union will not be reached until the future trading relationship has been agreed, hopefully by late 2020. Some of the investment will have been permanently 'lost' because, for example, firms have chosen to invest abroad instead of in the United Kingdom.

A no deal scenario would introduce a fresh bout of uncertainty in 2019, adding to the downward pressures that would weigh on investment. The period uncertainty would perhaps be shorter than in the deal scenario.



Business investment (real terms year-on-year change) and capacity utilisation (survey balance, standardised)

Source: Capital Economics and Thomson Reuters

The United Kingdom has become less attractive to immigrants

European Union expansion and the global financial crisis affected the 2000s

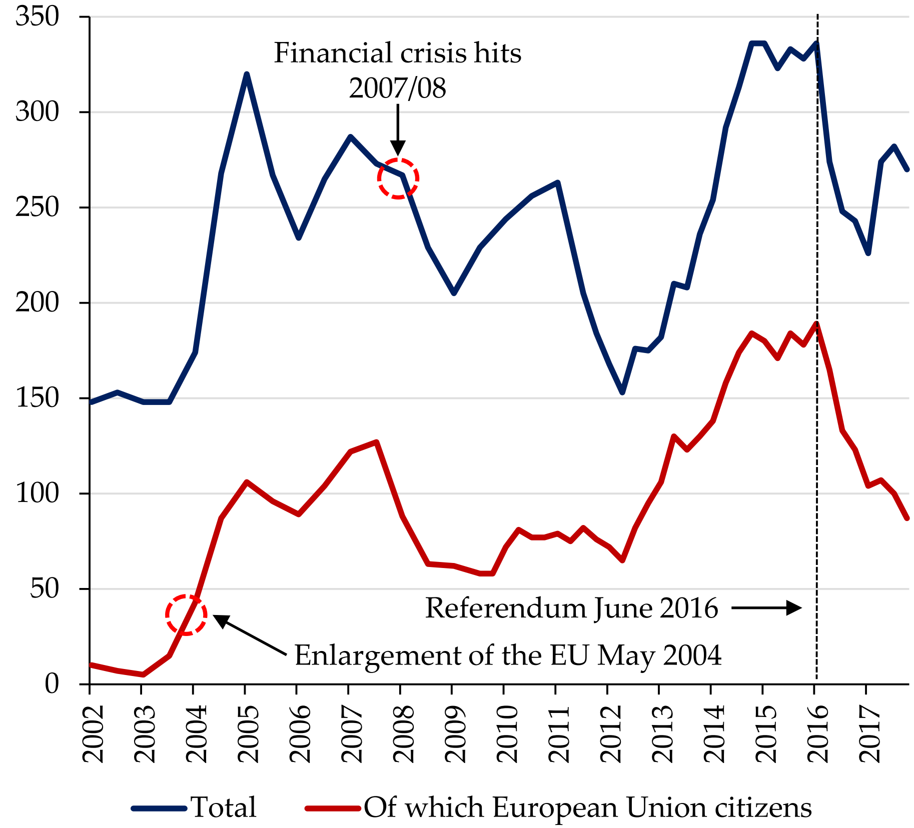
In the mid-2000s, eight eastern European countries joined the European Union, resulting in a surge in immigration. Immigration was subsequently significantly impacted by the 2008 global financial crisis.

United Kingdom net immigration surged during 2012-16

The out-performance of the United Kingdom economy versus the crisis-bound euro-zone economy between 2012 and 2016 prompted a rise in the number of European Union immigrants. And the lifting of restrictions on immigration from Romania and Bulgaria in 2014 provided a further boost.

Net immigration from the European Union has fallen sharply since early 2016

There has been a considerable drop in net European Union migration of over 100,000 since the referendum in June 2016 to its lowest level since 2012.



Net migration to the United Kingdom, thousand persons, rolling 12 month total

Sources: Capital Economics and Office for National Statistics

Reduced immigration will be negative for economic growth

Free movement of labour within the European Union will end after Brexit

With membership of the European Union Single Market comes free movement of labour. After Brexit, free movement will continue during the transition period if a deal is reached. Thereafter, free movement will come to an and the United Kingdom will establish a new immigration system, determining the number and origin of immigrants. In the no deal scenario, freedom of movement will come to an end on 29 March 2019.

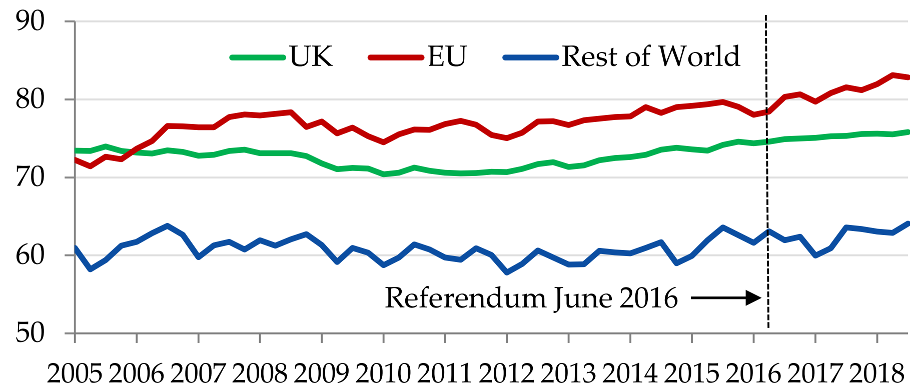
European Union migrants play a key role in the United Kingdom labour market

European Union migrants to the United Kingdom predominantly come to work and they play a significant role in the labour market. Over 80 per cent of European Union nationals in the aged 16 to 64 in the United Kingdom are employed, compared to around 75 per cent for United Kingdom born citizens in that age group and around 63 per cent of non-European Union nationals.

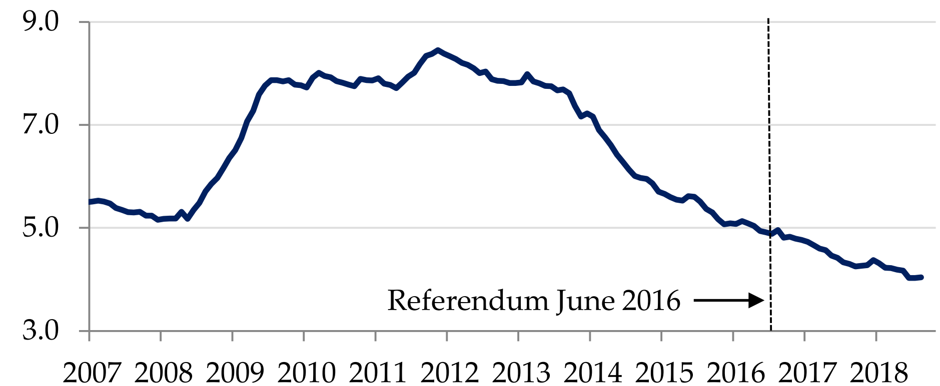
The number of European Union nationals in employment has risen from 1.1 million to 2.2 million over the ten years to September 2018, accounting for over 40 per cent of the increase in total employment during the period and contributing significantly to economic growth.

Job vacancies may become harder to fill

The unemployment rate is at its lowest since the mid-1970s. Reduced net immigration may make job vacancies harder to fill and raise wage costs for employers.



United Kingdom employment rates by country of birth (percentage of people aged 16 to 64, not seasonally adjusted)



Labour Force Survey unemployment rate (per cent, three monthly moving average)

Source: Capital Economics, Office for National Statistics and Thomson Reuters

The EU is the UK's largest trading partner

Strong trading links exist between the United Kingdom and the European Union

The European Union is the United Kingdom's largest trading partner, accounting for 42 per cent of total exports in 2017.

The United Kingdom accounts for 7 per cent of the bloc's exports. Italy, Spain and Ireland depend more on the United Kingdom market than the United Kingdom relies on them.

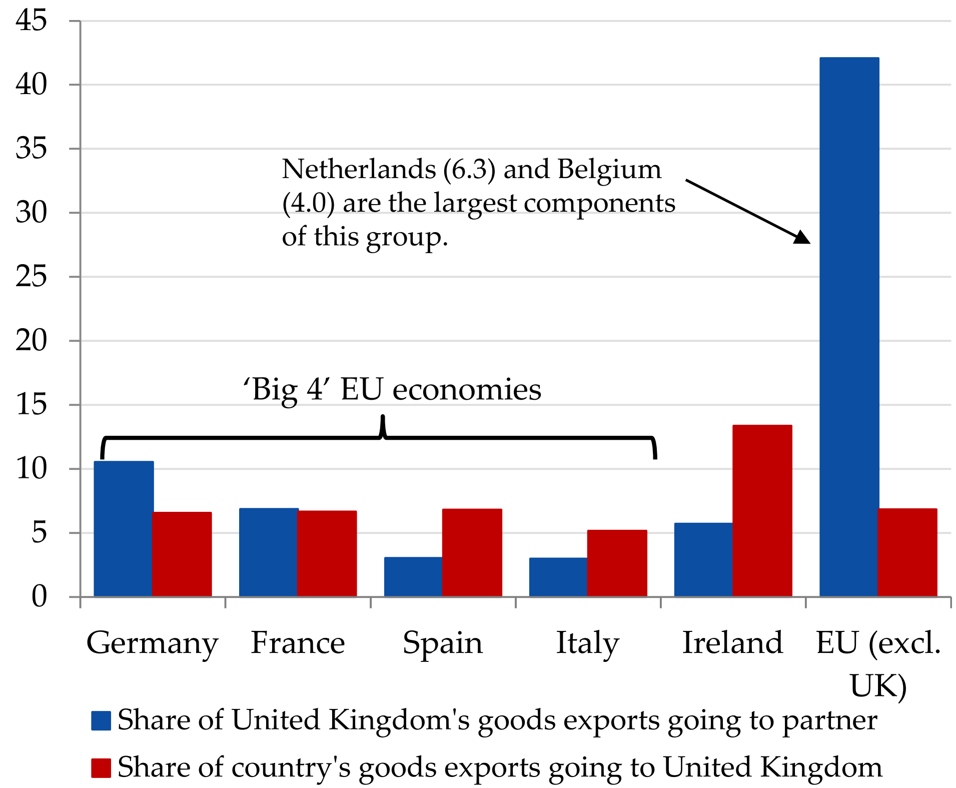
The United Kingdom is more exposed to trade with the European Union than the bloc on aggregate is to the United Kingdom.

Supply chains are vulnerable to changes in trading arrangements

The Customs Union and Single Market have facilitated the development of supply chains that span national borders; significant changes to the existing trading relationship would negatively impact both the companies involved in those supply chains and economies more broadly.

The population would also feel the impact directly. For example, 30 per cent of the United Kingdom's food supply comes from the European Union.

Under either of the deal scenarios the negative impact of Brexit on trade with the European Union in the period to 2023 is less than in the no deal scenario. This is particularly the case in 2019 and 2020 when a no deal will result in an abrupt change in the relationship. Further ahead the marked weakness of the pound in the no deal scenario will help to support exports to the European Union.



Exports of goods and services by destination as a percentage of total, 2017

Source: International Monetary Fund and Capital economics. The European Union is shown as one block and therefore excludes trade between member

Raising trade with non-EU countries is an opportunity for growth

United Kingdom's share of trade with European Union is falling

In 2009, the share of the United Kingdom's exports of goods and services going to countries outside of the European Union exceeded 50 per cent for the first time. The share has been on a rising trend since, although 2017 was an exception.

The changing pattern of trade is due to economic growth of emerging market economies outpacing that of the European Union, causing their share of the global economy to rise.

United Kingdom's export growth driven by services

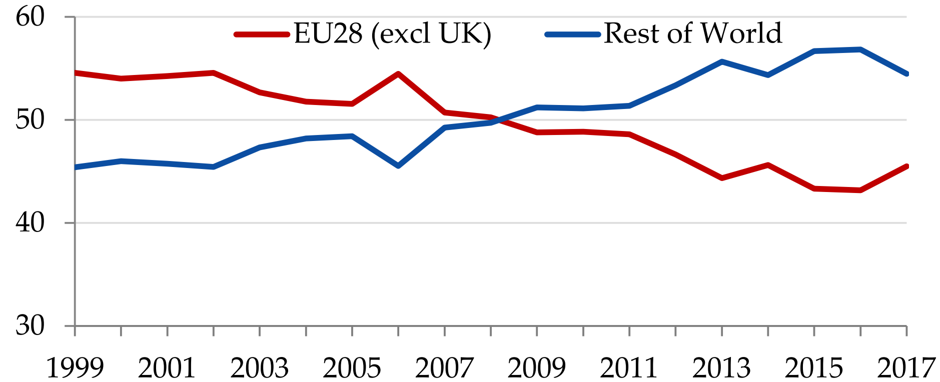
United Kingdom export growth, both to the European Union and to the rest of the world, is driven by services which accounted for 45 per cent of United Kingdom exports in 2017 compared to 31 per cent in 1999.

The increase is due to the global growth in trade of services outpacing that of goods and the expertise and global competitiveness of United Kingdom-based services companies.

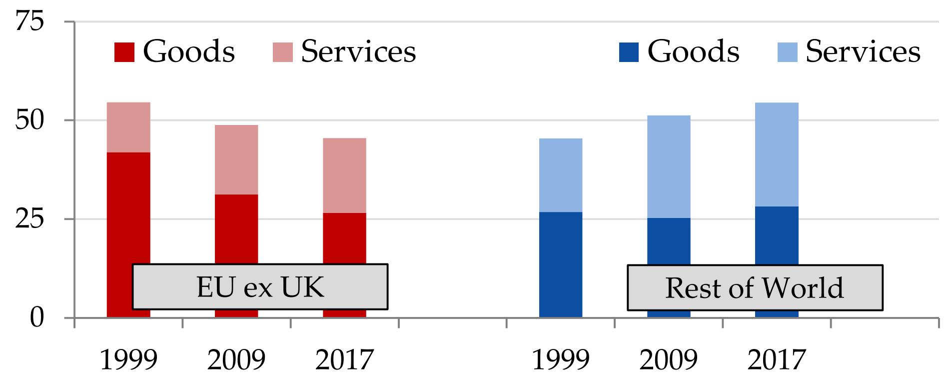
Goods exports are driving the relative decline in European Union trade

United Kingdom goods exports to the European Union have fallen from 42 per cent of total exports in 1999 to 27 per cent in 2017.

Many industrial sectors recorded a declining share, but the bulk of the decrease resulted from the production of electronics relocating to emerging market economies.



United Kingdom exports of goods and services to the European Union and to the rest of the world, percentage of total



United Kingdom exports of goods and services to the European Union and to the rest of the world, percentage of total

Sources: Capital Economics, Eurostat and International Monetary Fund

In general tariffs have been falling over time

No deal will lead to World Trade Organisation rules

If the United Kingdom leaves the Customs Union and Single Market without a new trade agreement, trade will automatically be conducted under World Trade Organisation rules.

Under World Trade Organisation rules members may not grant special favours to any other member; a tariff applied to one member must similarly apply to all. United Kingdom exporters would face the European Union's Most Favoured Nation tariff rates when selling into the Customs Union.

Tariffs may not be as burdensome as some fear

Tariffs on goods have fallen substantially over the last few decades as part of a global trend towards reducing trade barriers. However, integrated supply chains can mean that goods may be subject to tariffs multiple times as they criss-cross borders during their assembly into final products.

European Union tariffs would apply only to goods, not services. Manufacturing is the most directly exposed part of the economy to tariffs, but it has fallen substantially as a share of the United Kingdom economy from nearly a fifth of gross domestic product in 1995 to just under ten per cent now. Although, as noted, consumers are also directly exposed to tariffs via their purchases of goods in the United Kingdom.

European Union Most Favoured Nation average tariff on manufactured goods (per cent)

Sources: World Trade Organisation and Capital Economics

Leaving the Single Market will increase non-tariff barriers to EU trade

The Single Market aims to reduce non-tariff barriers to trade

Non-tariff barriers are an important factor in trade in goods and services. Non-tariff barriers are rules and regulations that put importers at a disadvantage to domestic producers of goods and services (see table for examples).

The aim of the Single Market is to reduce non-tariff barriers to trade in goods and services between members through such measures as harmonizing rules and regulations. Academic studies estimate that the impact of the Single Market has been to raise gross domestic product by between 1.0 and 1.5 per cent.

A deal would avoid some non-tariff barriers

The United Kingdom intends to leave the Single Market. This will have a negative impact on the economy. Canada plus and the proposed agreement would avoid some non-tariff barriers, although the details differ between the plans. For example, under a Chequers-type deal Rules Of Origin are not required, while under a Canada plus deal they are required. The Chequers-type deal envisages harmonisation with a "common rule book" in some areas, such as food standards, obviating the need for border checks. The Canada plus deal could include mutual recognition of regulations, which would also remove the need for some border checks.

Reaching a deal would mitigate some of the negative economic impact of leaving the Single Market. Without a deal the United Kingdom will see a greater increase in non-tariff barriers to trade with the European Union and a larger negative economic impact.

Non-tariff barrier	What it means
Sanitary and phytosanitary measures	Plant and animal health regulations
Technical barriers to trade	Regulations on the contents of products, the manufacturing process, their labelling etc.
Pre-shipment inspection and other formalities	Requirements that goods be checked or licenses secured before being imported
Contingent trade-protective measures	Policies that protect the economy from the impact of certain imports, such as anti-dumping measures
Measures affecting competition	Such as compulsory requirements to use national services
Distribution restrictions	Measures which make it harder to sell imported goods in all parts of a market
Government procurement restrictions	Ensuring that governments buy goods from domestic producers
Rules of origin	Rules requiring products to be able to demonstrate in which countries they were produced

Examples of non-tariff barriers to trade

Source: Capital Economics

After Brexit the UK will be free to negotiate trade deals with non-EU countries

The Single Market aims to reduce non-tariff barriers to trade

After Brexit the United Kingdom can negotiate trade deals with non-European Union countries. In the deal scenarios the United Kingdom can negotiate free trade deals with other countries, but they cannot come into force until the transition period ends.

Progress on negotiating trade deals with non-European Union countries is likely to be a lower priority during the transition period than securing a future deal with the European Union. In the no deal scenario the United Kingdom focuses on negotiating trade deals with non-European Union countries from 29 March 2019.

The Single Market aims to reduce non-tariff barriers to trade

The no deal scenario leaves the United Kingdom with the greatest scope to negotiate trade deals with other countries as it has no commitments to follow European Union rules and regulations. The Canada plus deal will provide somewhat less scope. The Proposed deal provides the least scope as the United Kingdom will have the least autonomy over rules and regulations in this scenario.

Trade deals are complex and can take years to negotiate. Deals with the European Free Trade Area (Iceland, Liechtenstein and Norway), Canada and Japan may be reached sooner as they already have trade deals with the European Union which could form the basis for agreements with the United Kingdom. Negotiations with larger economies, such as the United States and China, may be challenging for the United Kingdom as their economic heft provides them with significant bargaining power. The benefits of future trade deals are likely to mostly accumulate beyond 2023.

The UK could choose to deregulate, reducing the costs of doing business

There are three potential economic costs of regulations

1. **Administrative costs:** the costs to businesses of, for example, providing authorities with required information, record-keeping, public reporting and other such tasks that they would not have had to undertake otherwise
2. **Policy costs:** both the initial and ongoing costs of restructuring business processes and activities to meet regulatory requirements
3. **Wider knock-on costs:** the impact through supply chains of higher prices and/or restricted supplier activities (e.g. wholesalers and retailers are impacted by the regulation of the transport and logistics sector)

Total costs of European regulation could be substantial

The costs of European regulations across the economy are difficult to measure and the range of estimates on this topic vary widely.

However, various estimates suggest that they could be substantial. Studies have found that the administrative and policy costs alone could be somewhere between 0.5 and 3.0 per cent of gross domestic product.

After Brexit there will be scope for the United Kingdom to reduce the cost of regulation to the economy. The scope for doing so may be greater in a Canada plus deal than in the proposed deal.

Type of cost	Size of cost as per cent of GDP (unless noted)	Source of estimate
Estimated costs of European Union regulations		
Administrative and policy	0.5 to 3	Milne[1]
Administrative and policy	1.4	Gaskell and Persson[2]
Administrative	30 per cent of total cost of regulation	Better Regulation Task Force[3]
Estimated costs of all regulations (European Union and national)		
Direct compliance costs	5	Ambler and Boyfield[4]
All costs	Around 10	Ambler and Boyfield
All costs	10 to 12	Open Europe[5]

Estimates of the costs of regulation

Sources: 1) Ian Milne, A Cost Too Far? (Hartington Fine Arts, Lancing), 2004; 2) Sarah Gaskell and Mats Persson, Still out of control? (Open Europe, London), 2010; 3) Better Regulation Task Force, Regulation – Less is more (Cabinet Office Publications & Publicity Team, London), 2005; 4) Tim Ambler and Keith Boyfield, Route Map to Reform: Deregulation (ASI (Research) Ltd., London), 2005; 5) Open Europe, Less Regulation: 4 ways to cut the Burden of European Union Red Tape (Open Europe, London), 2005

Financial services exposed to loss of ‘passporting’ rights

Financial services account for seven per cent of the United Kingdom economy

The main sub-sectors of financial services are banking, asset management and market infrastructure activities. So-called ‘passporting’ rights allow financial services firms based in the United Kingdom to trade across the European Economic Area (the European Union, Iceland, Liechtenstein and Norway). Exposure to passporting rights varies the across financial service subsectors. Banking is the most exposed sector with an estimated twenty per cent of output at risk from the loss of passporting rights.

Sharp output fall expected in no deal scenario

Passporting rights are not compatible with leaving the Single Market; they will remain in place during the transition period if a Withdrawal Agreement is reached, but be lost on 29 March if there is no deal and result in an initial sharp fall in financial sector output.

In the Proposed deal scenario, we assume that there is ‘regulatory equivalence’, i.e. the European Union accepts United Kingdom financial regulations as equivalent to its own. This allows market access for some parts of the financial services sector that currently have passporting rights, limiting the loss of output. However, since subsequent changes to regulations could result in regulatory equivalence being lost, the United Kingdom flexibility to negotiate trade deals that involve financial services is restricted. In the Canada plus scenario there is no regulatory equivalence but financial services are included in the free trade deal and the United Kingdom has greater leeway when negotiating with other countries.

Industry	Annual gross value added (£ billion, 2016)*	Share of output at direct risk from loss of passporting**	Annual gross value added at risk from loss of passporting (£ billion, 2016
Banking	58.0	20%	11.6
Asset management	16.0	7%	1.1
Insurance and reinsurance	31.5	1%	0.4
Market infrastructure and other	18.0	-	-
Total	123.5	10.6%	13.1

United Kingdom financial services industry gross value added at risk from loss of passporting

Sources: Open Europe, *How the UK’s financial services sector can continue thriving after Brexit* (Open Europe, London), 2016 and Oliver Wyman, The impact of the UK’s exit from the *EU on the UK-based financial services sector* (Oliver Wyman, London), 2016. * Mid-point of Oliver Wyman’s estimate. ** These are the estimated shares of revenue that would be lost if passporting is removed. As such, we have assumed a constant ratio of gross value added to revenue.

There will be savings on the UK's contributions to the EU

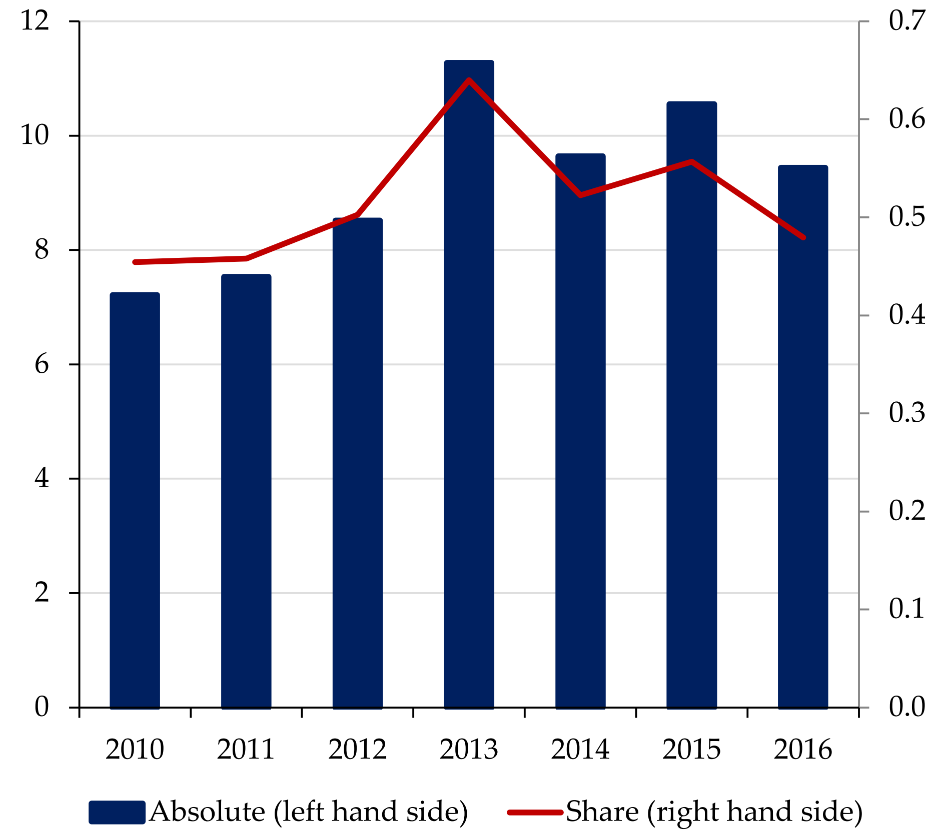
The United Kingdom is a net contributor to the European Union budget

As a member state, the United Kingdom makes financial contributions to the European Union budget. The United Kingdom also receives funding from European Union programmes, but on balance is a net contributor to the union. Since 2010 net payments have averaged £9.2 billion per year, equivalent to 0.5 per cent of annual gross domestic product.

The "divorce bill" could be £39 billion in the deal scenario

Net payments will not end immediately after Brexit. If a Withdrawal Agreement is approved by parliament, Britain will continue to pay into the European Union budget during the transition period and to honour other financial commitments, such as pension payments to European Union employees. The size of this so-called "divorce bill" has not been finalised, but in October 2018 the Office for Budget Responsibility estimated that it could be £39 billion.

In the event of no deal the United Kingdom would not make annual payments into the European Union budget in 2019 and 2020. Other potential financial payments could be the subject of legal dispute.



The United Kingdom's net contributions to the European Union (billions of pounds and percentage of gross domestic product)

Source: Capital Economics and Office for National Statistics

Overall impact: *Proposed deal scenario (Chequers-type deal)*

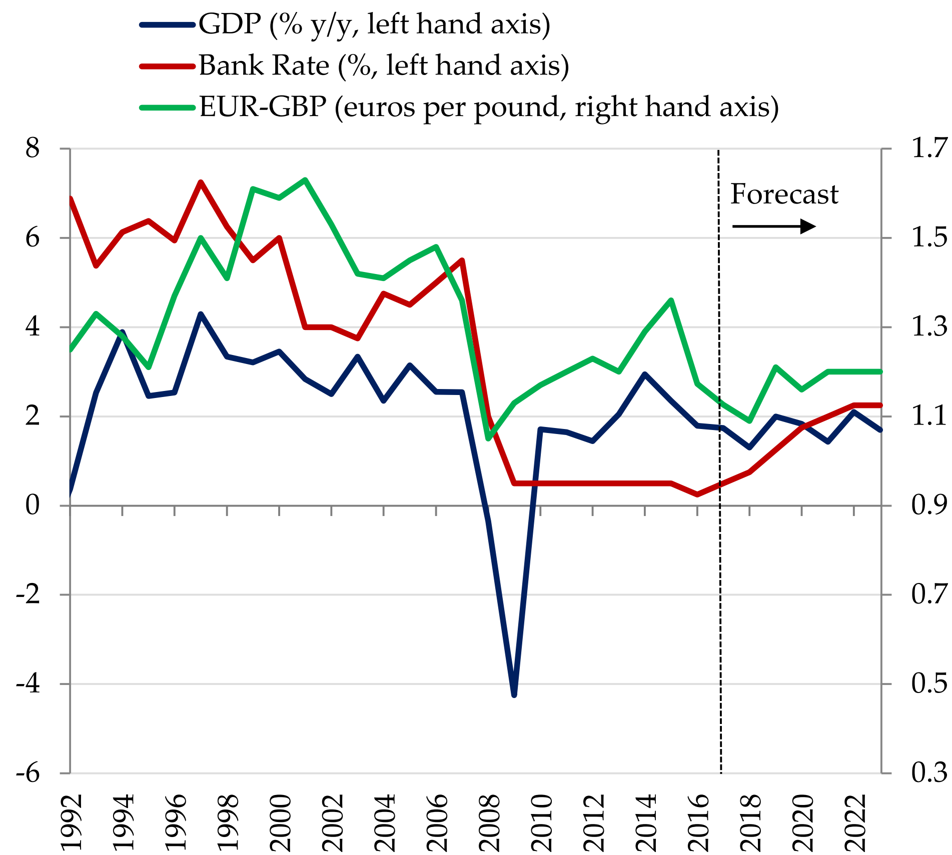
United Kingdom negotiates mutually beneficial future relationship

The United Kingdom and the European Union conclude a Withdrawal Agreement. This allows for a transition period until the end of December 2020, during which time freedom of movement continues and, in effect, the country remains in the Customs Union and Single Market. The Proposed deal is negotiated and comes into effect at the start of 2021, avoiding the need for a "backstop" arrangement for the Northern Ireland border. The United Kingdom can also begin negotiating free trade deals with non-European Union countries.

The United Kingdom makes full membership contributions in 2019 and 2020 and meets any longer term obligations included in the Withdrawal Agreement. Britain may pay into the European Union budget in order to participate in specific programmes, as Switzerland does.

United Kingdom economy holds up well over next five years

Economic conditions are relatively benign and growth picks up in 2019 as Brexit-related uncertainty diminishes. Growth slows once again in 2021 due to disruption associated with moving to the new relationship, but rebounds in 2022. With growth at reasonable rate, the Bank of England gradually raises interest rates from their abnormally low level. Commensurate with this, the value of the pound rises slowly against the euro. In summary, average growth over the period to 2019 to 2023 is 1.8 per cent per annum, a little below the average from 2010 to 2018 of 1.9 per cent.



Forecast year-on-year change in United Kingdom real gross domestic product (per cent), Chequers plan deal scenario

Sources: Capital Economics, Office for National Statistics and Thomson Reuters

Overall impact: *Canada plus deal scenario*

Greater scope to amend regulations and negotiate trade deals

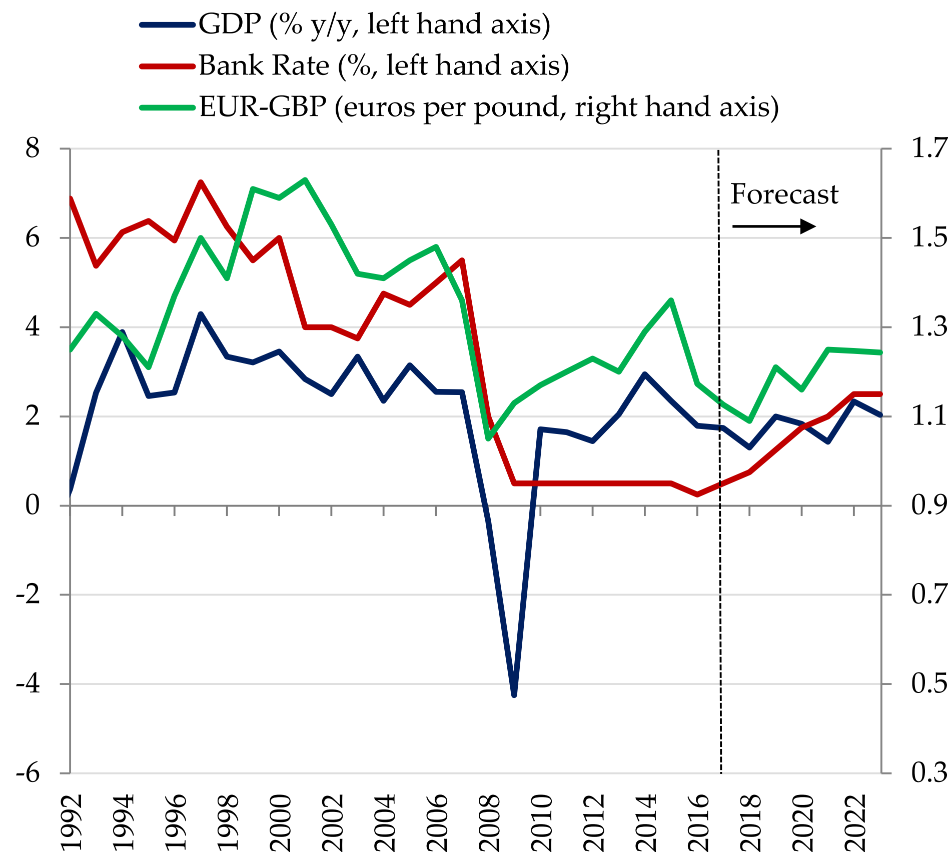
As with the Proposed deal scenario, in the Canada plus scenario a Withdrawal Agreement is concluded. The United Kingdom enters a transition period with the same terms as in the Proposed deal scenario, then transitions to the new deal at the start of 2021.

Compared to the Proposed deal scenario, the future trading arrangement enables the United Kingdom to be less closely aligned with European Union rules and regulations, increasing the scope to reduce regulatory and compliance costs. This greater flexibility around rules and regulations also increases the scope for trade deals to be negotiated with other countries, although the benefit of these largely accrue over the longer term.

Canada plus is our least likely scenario

The Canada plus deal has some economic costs versus the Canada plus deal, such as Rules of Origin, but the increased scope for amending regulations and negotiating trade deals with other countries more than offset this. As a result, gross domestic is around 0.5 per cent higher than the Proposed deal scenario by 2023. Inflation and the level of interest rates will also be a little higher. The differences arise in the final two years of the scenario as we expect economic conditions during the transition period and during the start of the respective new regimes to be the same.

The United Kingdom is outside of the Customs Union in this scenario, which increases the challenge of finding a solution that avoids a hard border in Northern Ireland.



Forecast year-on-year change in United Kingdom real gross domestic product (per cent), Canada plus deal scenario

Sources: Capital Economics, Office for National Statistics and Thomson Reuters

Overall impact: *no deal scenario*

Recession in 2019

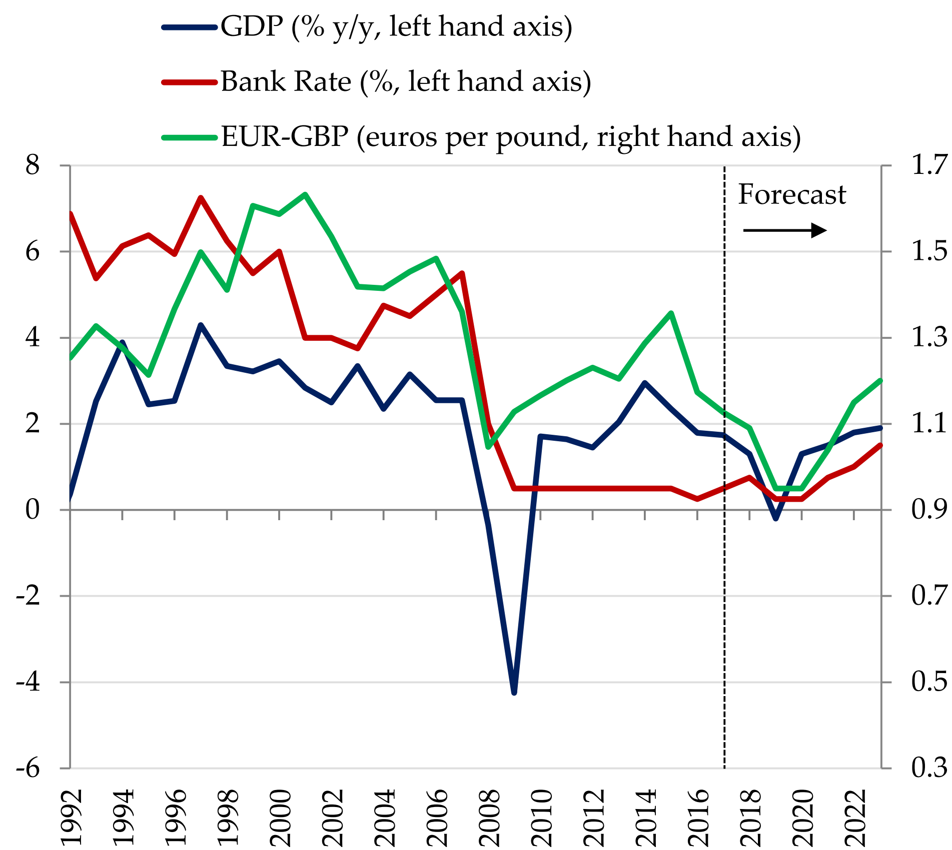
In the no deal scenario the United Kingdom leaves the European Union at the end of March 2019 without a Withdrawal Agreement. Freedom of movement ceases at that point, the country immediately exits the Customs Union and the Single Market. The economy experiences a recession in 2019, the pound slumps and the Bank of England lowers interest rates.

We assume that it takes years for talks with the European Union on free trade to be revived and an agreement is not reached during the next five years. In the intervening years, the trading relationship is governed by World Trade Organization Most Favoured Nation rules and the associated tariff rates and non-tariff barriers. Trade agreements with other countries are concluded only gradually.

Economy around three per cent smaller than in the deal scenario

The negatives more than offset the savings to the United Kingdom from not paying into the European Union budget, the boost to competitiveness from the fall in the value of the pound, a reduction in interest rates, looser fiscal policy and the scope to amend regulations.

The economy does begin to adjust to the new circumstances and to recover, but by 2023 gross domestic product could be around three per cent lower than in the Canada plus and Proposed agreement scenarios.



Forecast year-on-year change in United Kingdom real gross domestic product (per cent), no deal scenario

Sources: Capital Economics, Office for National Statistics and Thomson Reuters

Summary of key macroeconomic forecasts in the base case and scenarios

	2017	2018	2019	2020	2021	2022	2023
Proposed agreement ('Chequers plan' type deal)							
Gross Domestic Product	1.7	1.3	2.0	1.8	1.4	2.1	1.7
Consumer spending	1.9	1.6	1.8	1.9	1.6	2.0	1.8
Inflation	2.7	2.6	2.2	2.0	1.8	2.0	2.0
'Canada plus' type deal							
Gross Domestic Product	1.7	1.3	2.0	1.8	1.4	2.3	2.0
Consumer spending	1.9	1.6	1.8	1.9	1.6	2.1	1.9
Inflation	2.7	2.6	2.2	2.0	1.8	2.2	2.0
No deal							
Gross Domestic Product	1.7	1.3	-0.2	1.3	1.5	1.8	1.9
Consumer spending	1.9	1.6	-1.0	0.2	0.9	1.7	1.8
Inflation	2.7	2.6	2.9	3.0	2.5	2.3	2.0

Source: Capital Economics

5: Distribution of impacts

No deal will lead to tariffs, which will hit small number of goods sectors hardest

No trade deal will lead to World Trade Organisation rules

If the United Kingdom leaves the European Union and single market without a new trade agreement, trade will automatically be conducted under World Trade Organisation rules. Under World Trade Organisation rules, United Kingdom exporters would face the European Union's Most Favoured Nation tariff rates when selling into the Customs Union, which stipulate that members may not grant special favours to any other member; a tariff applied to one member must similarly apply to all.

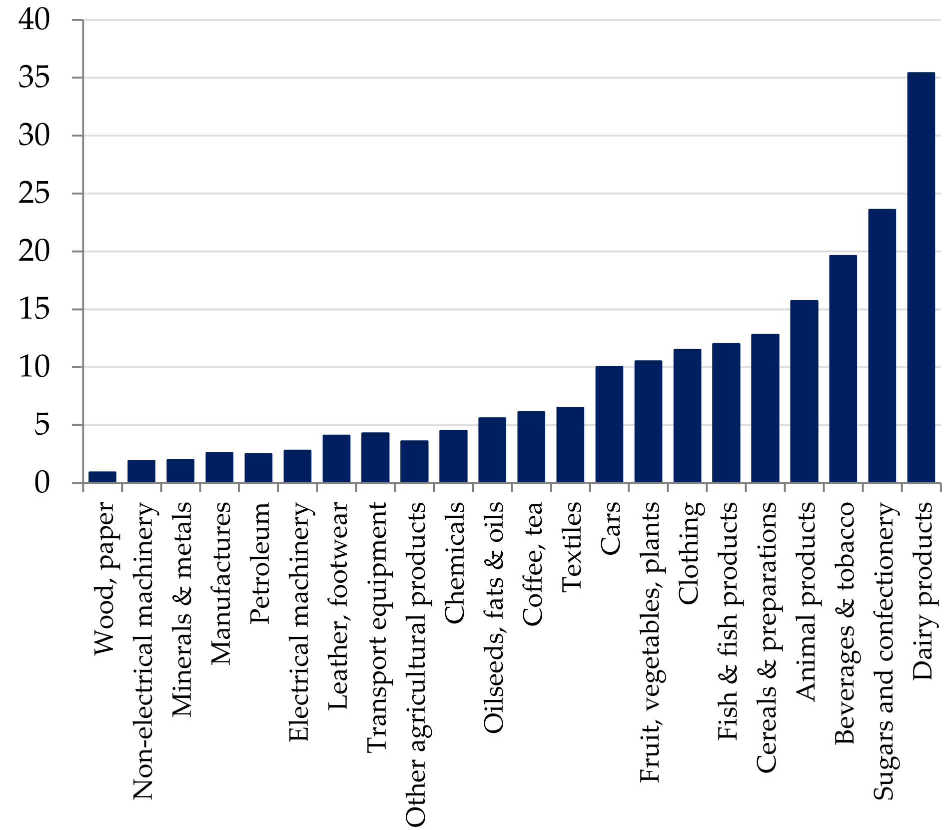
Average tariffs under World Trade Organisation relatively low

Tariffs on goods have fallen substantially over the last few decades as part of a global trend towards reducing trade barriers. The overall average European Union tariff on non-agricultural goods was 4.2 per cent in 2017.

Some sectors will suffer more than others

The sectors that would be most affected are largely agriculture and food manufacturers; the average tariff for agricultural products is eleven per cent, while there are some tariffs of up to 35 per cent for dairy products.

Outside of agriculture, the most negatively impacted sectors would be beverages and tobacco, clothing/textiles and cars.



European Union tariffs by selected sectors in 2017 (Most Favoured Nation applied duties, per cent)

Sources: World Trade Organisation and Capital Economics

Non-tariff barriers could add costs

Rules of origin will add costs

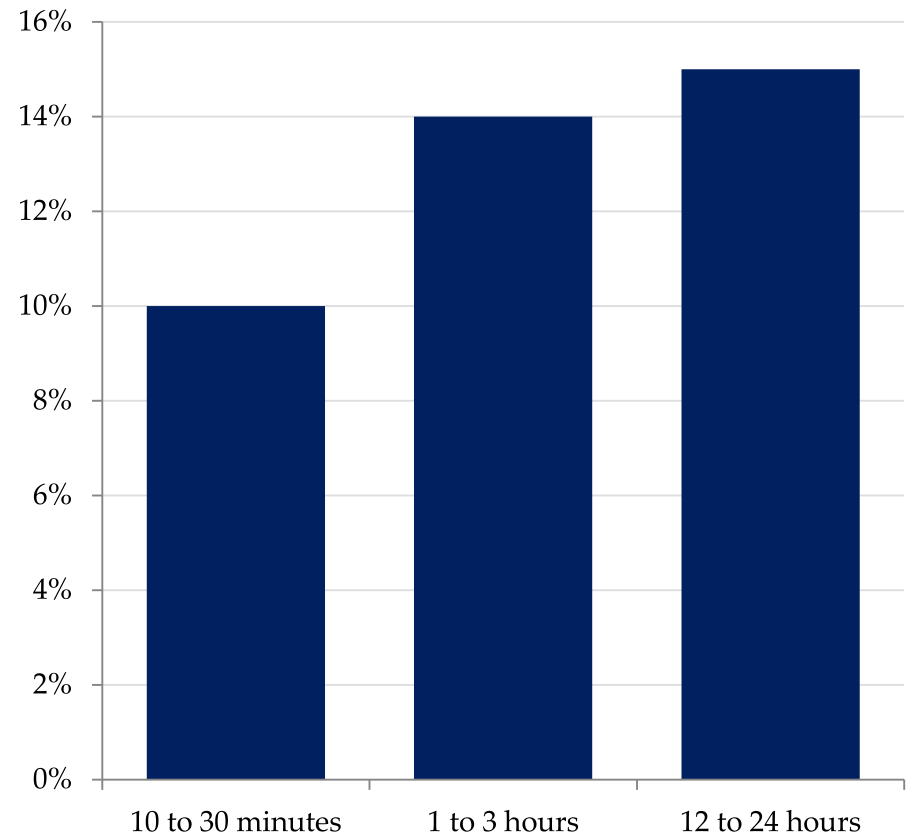
Rules of origin are used agreements to define which goods can be exported to the partner country tariff-free and which cannot based on where the value was produced. Currently, rules of origin are not required for trade between Britain and the bloc because once inside the good has paid the appropriate tariff on entry to the customs union. Outside a customs union, rules of origin are needed to ensure partner countries can't use one side as tariff free entry into the other.

Border checks and declarations to contend with if outside customs union

A survey of supply chain managers suggested that one in ten United Kingdom businesses believe they would likely go bankrupt if goods were delayed by ten to 30 minutes, rising to fourteen per cent for delays up to three hours. Procedures such as payments ahead of time and new digitalised systems could mitigate some of the impact.

Proposed agreement would require tracking of imported goods

A 'shared customs territory' as proposed in the Chequers proposal would require imports into the United Kingdom from non-European sources to be tracked to ensure that importers pay the right tariff. The government White Paper published in July on the Chequers proposals implies that sixteen per cent of non-European Union imports will need tracking.



Share of European and British business that believe they would go bankrupt with customs delays, from a survey of 1,300 supply chain managers (of which 1100 in the United Kingdom)

Source: Chartered Institute of Procurement and Supply (CIPS)

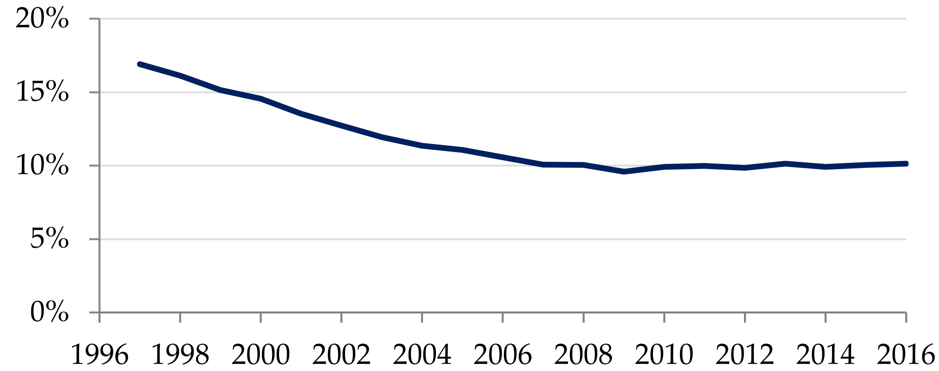
Any impacts will depend on size of manufacturing base

Manufacturing has been falling as a share of Britain's economy

European Union tariffs would apply only to goods, not services. Manufacturing has fallen substantially as a share of the United Kingdom economy, down from nearly a fifth of gross domestic product in 1995 to just under ten per cent in 2016.

Impacts will vary depending on reliance on manufacturing

The impact of increased trade costs will disproportionately hit areas with large manufacturing sectors. At two per cent, London has by far the smallest share of its output accounted for by manufacturing of any region. Wales, the East Midlands and the North west are most reliant on manufacturing, which comprises seventeen, sixteen and sixteen per cent of their economies respectively.



Manufacturing output as a share of total output, United Kingdom

Manufacturing output as a share of gross value added by region, 2016

Source: Capital Economics and Office for National Statistics

Small to mid-sized businesses are at the lowest risk from potential trade barriers after exit

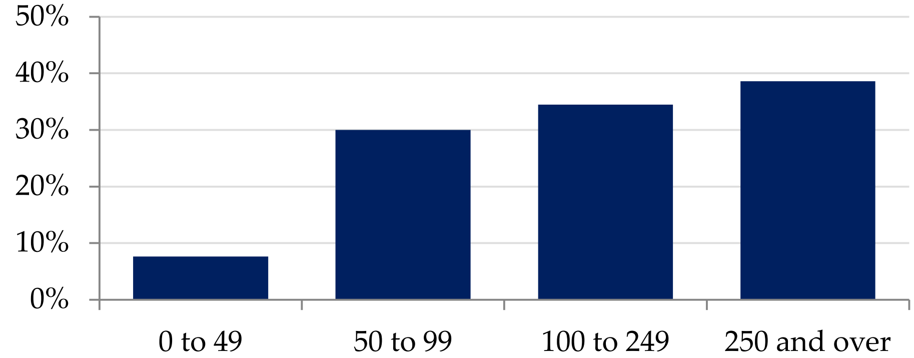
Larger businesses are more likely to trade internationally

With higher values of both exports and imports compared to small and medium companies, large business are likely to suffer more from the implementation of trade barriers.

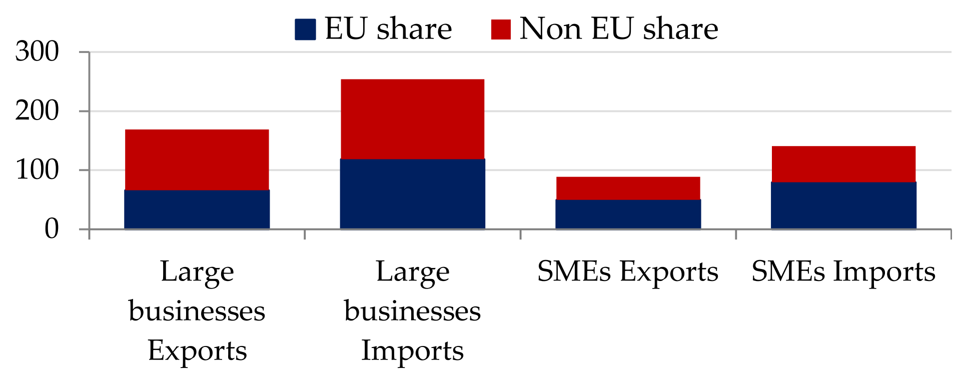
The propensity to trade internationally increases with business size; under eight per cent of companies with less than 50 employees trade goods internationally while almost 40 per cent of those with over 250 employees do.

Significant trade by small and medium businesses are still exposed to trade barriers

Although far fewer small businesses engage in international trade, companies with less than 250 employees account for 34 per cent of the total value of United Kingdom exports. Small and medium sized companies that do trade are also more likely to do so with European Union companies. Over half of Small and medium sized companies' exports went to the bloc in 2016 compared to 40 per cent for larger companies.



Share of United Kingdom businesses that export and/or import goods to any country by number of employees, 2016



Value of trade by business size, £ billion, 2016

Sources: Office for National Statistics' Annual Business Survey

Manufacturing, hospitality and telecommunications most exposed to increased supply chain costs

Production sectors directly affected by tariffs and trade costs

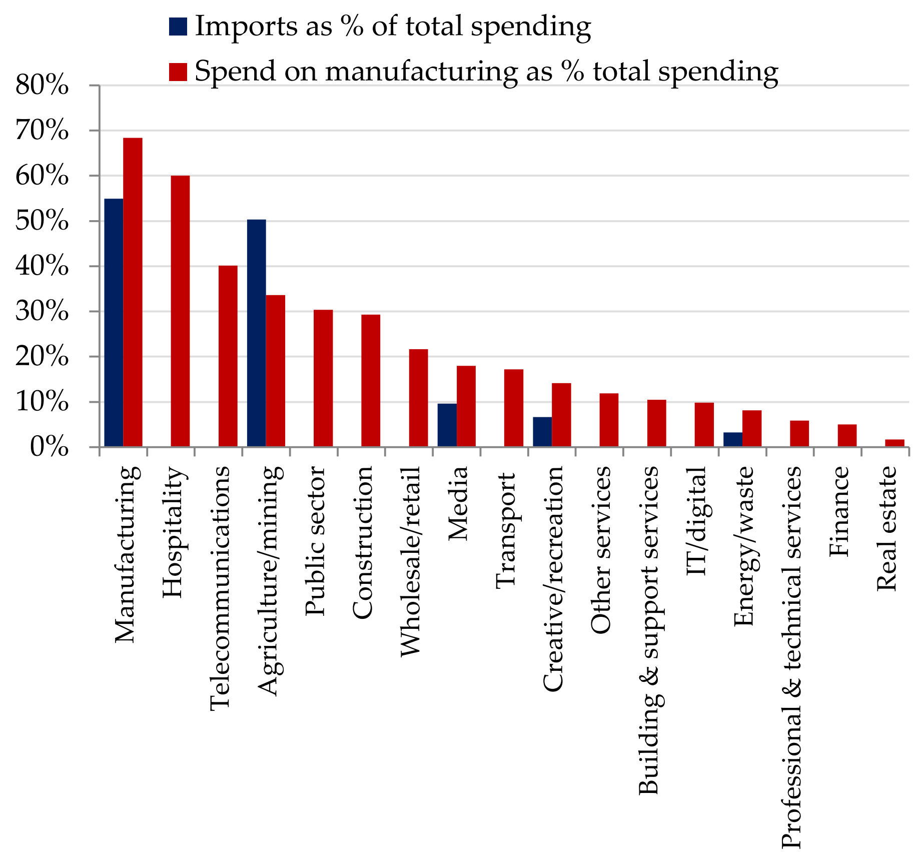
The direct impact of increase in trade costs will be felt by the production sectors in the United Kingdom, which imports over half of its inputs.

Impact of increased trade costs will pass through the supply chain

Most sectors have little direct exposure to tariffs, but they will feel the impact as it is passed through the supply chain. Although far from a perfect measure, assessing the proportion of spending on inputs by sector suggests that the manufacturing, hospitality and telecommunications sectors will be most exposed to rising costs. Meanwhile, financial and professional services are some of the least exposed sectors.

Margins will be squeezed and consumer prices pushed up

Businesses best placed to deal with the impact of tariffs will be those with the highest margins and a strong position in the value chain in being able to pass costs onto consumer or exert price leadership over competition. Consumers are likely to feel the impact of increased trade costs.



Exposure to increased trade costs by sector, 2016

Sources: Capital Economics and Office for National Statistics

Companies prone to international trade could benefit from future trade deals

As member of the European Union the United Kingdom has access to 34 bilateral and regional trade agreements

The European Union has ratified and currently has in force 26 trade deals with 26 countries. These agreements allow the United Kingdom to trade with these countries freely as a member of the European bloc. Trade with these countries accounts for twelve per cent of British exports and eleven per cent of British imports.

Contingency free trade deals may be lost after Brexit

After Brexit, the continuation of existing trade agreements will depend on political negotiations between the United Kingdom and the third country, as well as the spill-over implications of the United Kingdom – European Union negotiations. The renegotiation of existing free trade agreements would not be as onerous as it may appear as 74 per cent of Britain's exports and 70 per cent of its imports related to these contingent agreement countries are associated with just three trading blocs: the European Free Trade Association, South Korea and South Africa.

New trade agreements may be better suited to the British economy

As the United Kingdom remains one of the largest economies in the world, there is likely to be interest from other countries in obtaining favourable trading terms with Britain after Brexit. Moreover, being one country, the United Kingdom may be able to strike deals faster and make them better suited to its economy.

Trade in goods summary

Key points on impact of changes to trade in goods arrangements:

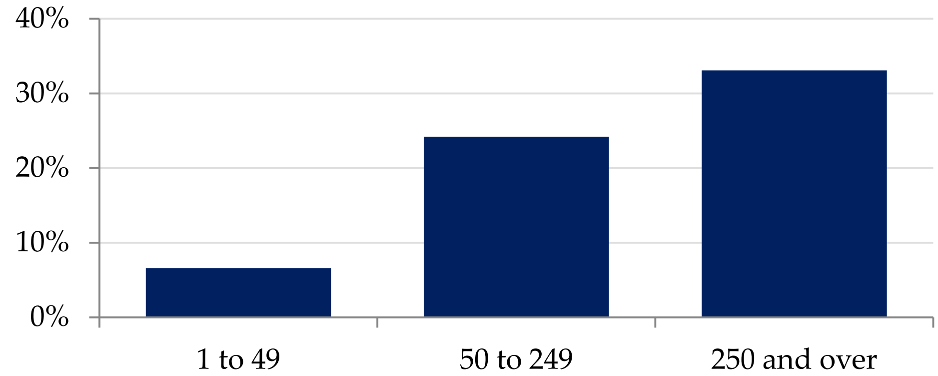
- Imposition of tariffs will disproportionately impact goods sectors subject to high European Union WTO tariffs under their current schedule including certain foods, textiles and cars
- Areas with high reliance on manufacturing activity more at risk from increased trade costs
- Areas with more larger companies, which generally have a higher propensity to trade internationally, more at risk from increased trade costs
- Areas with a higher propensity to trade with the European Union more at risk from increased trade costs
- Administrative costs will be disproportionately burdensome for those smaller companies that do trade, as well as companies in sectors with smaller profit margins
- Delays at the borders would hit businesses deploying 'just in time' models
- Faster negotiation of free trade deals will be advantageous for companies able to take advantage of international trading opportunities
- Increased trade costs will push up prices for consumers

Deal (short term)	Short term	Long term
Proposed agreement *(2 year transition and possible backstop extension)*	• Little change	• Tracking of goods • Independent trade policy
Canada plus *(2 year transition with possible extension)*	• Little change	• Rules of origin • Customs checks • Independent trade policy
No deal *(no transition)*	• WTO tariffs • Customs checks • Possible loss of contingent trade agreements • Independent trade policy	• WTO tariffs • Customs checks • Possible loss of contingent trade agreements • Independent trade policy
Single Market	• Rules of origin • Independent trade policy	
Customs union	• No change	

Changes to current arrangements under different Brexit deals

Source: Capital Economics

Less risks to trade in services



Share of businesses that are service exporters and/or importers by business size, 2016

Services will not be affected by tariffs

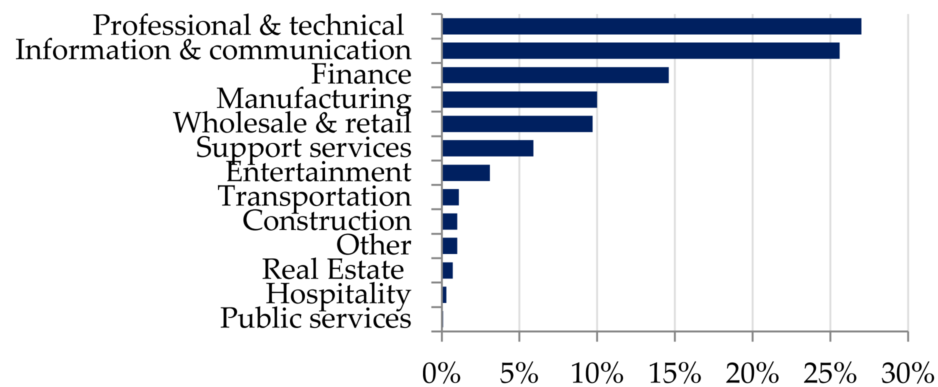
Service sectors, which make up 79 per cent of British output, are not bound by tariffs. In general the Single Market is far less developed for services and therefore the risks from leaving it are lower. There may be some non-tariff barriers imposed such as being ineligible to bid for public contracts and the loss of passporting rights for some financial services activity selling to European Union countries.

Small number of sectors most exposed

Professional and technical services, information technology and finance make up over two thirds of the services exports from the United Kingdom.

As with trade in goods, large firms more likely to trade

The propensity to trade services internationally (as observed for goods) increases with business size; around six per cent of companies with less than 50 employees trade services internationally while 33 per cent of those with over 250 employees do.



Share of British service exports by sector, per cent, 2016

Source: Capital Economics and Office for National Statistics

Financial services is sector most at risk

Loss of 'passporting' rights is a concern

Just over one-third of the financial services industry's exports are generated through European Union business, but just over ten per cent of total revenue is related to the 'passport'. Most 'passport' related exports are banking, with limited exposure for asset management and insurance companies. The hardest hit sub-sector would be euro clearing activities (worth approximately £1.1 billion annually to the United Kingdom), which could be moved to the continent.

There are certainly a wide range of outcomes for financial services, presenting large risks but also some opportunities.

There are potential mitigating factors to the loss of 'passporting' rights

It is possible that United kingdom-based firms may be granted equivalence status, allowing them to continue as before. Alternatively, firms may set up a subsidiary in a member state whilst still carrying out the bulk of their activities in the United Kingdom.

Brexit could bring opportunities for financial services

The potential for future legislation from Brussels that could damage London as a destination of choice (such as the potential Financial Transactions Tax), may be avoided. In pursuing its own free trade agreements, the United Kingdom may be able to prioritise coverage of financial services in a way which the European Union, as a collective entity, would not.

What are 'passporting' rights?

'Passporting' rights currently allow financial services firms based in the United Kingdom to sell into other European Economic Area countries without having a base there. Similarly, banks in the United States can locate in the United Kingdom and sell throughout the European Economic Area.

Trade in services summary

Key points on impact of changes to trade in services arrangements:

- Overall risk of negative impact on services trade lower as single market far less developed in terms of services but the United Kingdom is particularly exposed to trade in services and passporting
- Sector most at risk is financial services if 'passporting' rights are lost
- Larger companies, which are more likely to trade internationally, are more exposed to risks
- Professional and technical services, information technology and finance make up over two thirds of the services exports from the United Kingdom

Deal (transition)	Short term	Long term
Proposed agreement *(2 year transition and possible backstop extension)*	• Probable loss of passporting rights • Little change	• Probable loss of passporting rights • Independent trade policy
Canada plus *(2 year transition with possible extension)*	• Little change	• Probable loss of passporting rights • Independent trade policy
No deal *(no transition)*	• Loss of passporting rights • Inability to bid on public contracts • Independent trade policy	• Loss of passporting rights • Inability to bid on public contracts • Independent trade policy
Single Market	• No change	
Customs union	• Probable loss of passporting rights	

Changes to current arrangements under different Brexit deals

Source: Capital Economics

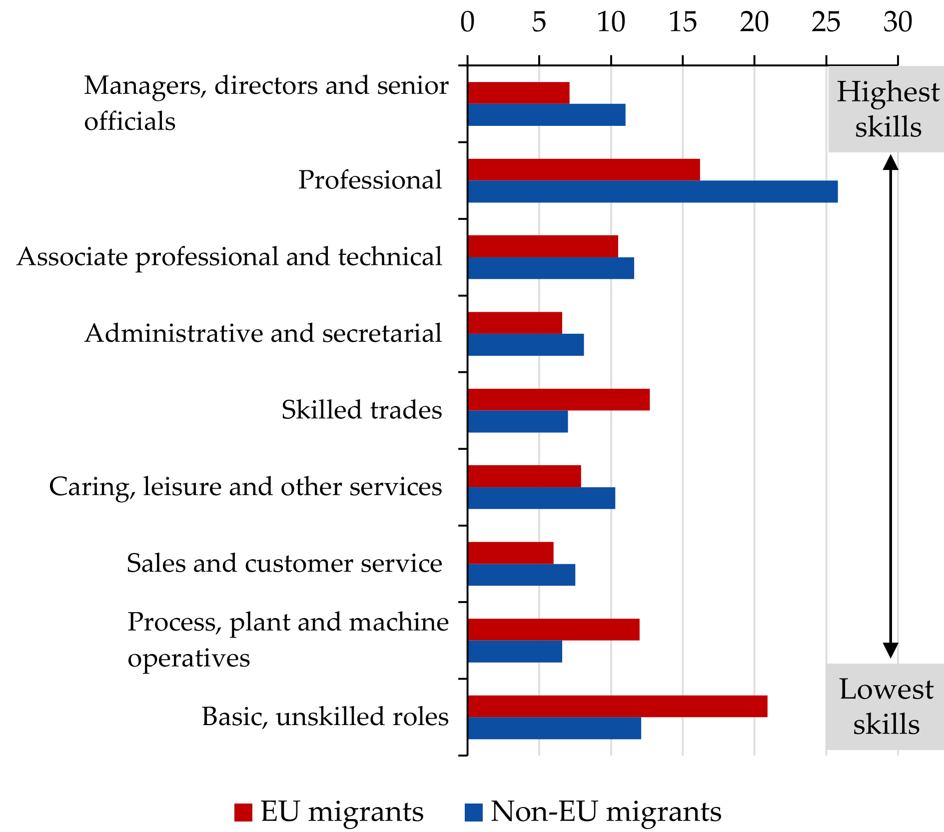
The skill composition of immigration likely to change, with a marked reduction in the inflows of lower-skilled migrants

Immigration from the bloc is skewed towards low-skilled workers

In 2017, 21 per cent of European Union workers in the United Kingdom were low-skilled, while for non-European Union workers the share was twelve per cent. Meanwhile, 23 per cent of European Union workers were in professional or managerial roles compared to 37 per cent for migrants from outside the bloc.

United Kingdom can design new immigration policy post-Brexit

In the medium term, the decision to leave both the European Union and the single market should mean that the United Kingdom will be free to design a new immigration policy. The government has set a target to gradually reduce total (including rest of world) net migration to under 100,000 persons per year. It is likely that the number of lower-skilled workers entering the country will be restricted, while the number of high-skilled workers may be increased.



Migrant employment in the United Kingdom by occupation, per cent of migrant employment, 2017

Sources: Capital Economics and Office for National Statistics

Companies reliant on lower-skilled European migrants could struggle to fill vacancies and face further upward pressure on labour costs

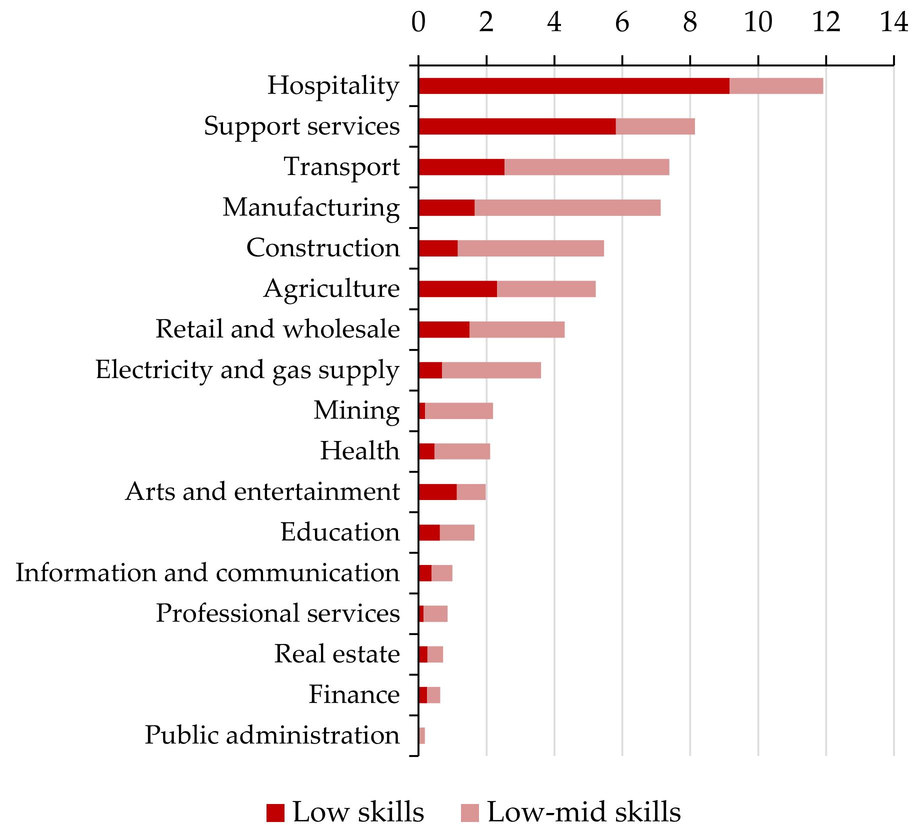
Tourism related companies are the most exposed

European Union migrants with the lowest skills account for nine per cent of employment in the hospitality sector. If reductions in lower skilled migration also affects those with low-mid skills – such as operators of machinery – then the transport and manufacturing sectors will become increasingly exposed.

Reduced access to lower skilled migrants may affect companies' ability to deliver outputs and/or push up labour costs in the affected sectors. Low margin businesses are most at risk if costs rise.

Finance and professional services are among the least exposed

European Union migrants with low and low-mid skills are account for just 0.4 per cent of employment in the finance sector and 0.7 per cent in the professional services sector. These sectors may benefit if access to higher skilled migrants is enhanced because around 90 per cent of employment in these sectors is in higher skilled roles



Share of total employment by industry in the United Kingdom accounted for by those born in the European Union in low and low-mid skills occupations, per cent in 2015

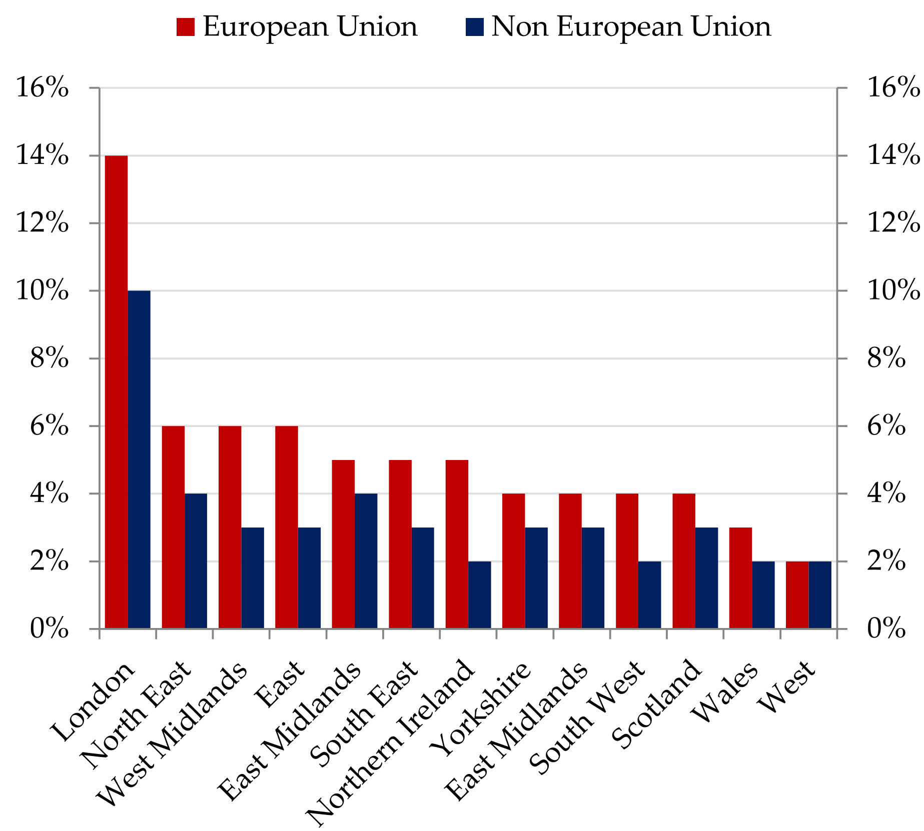
Sources: Capital Economics and Office for National Statistics

Regions with higher levels of immigration are most at risk

London is the most exposed region in terms of foreign population

With almost fifteen per cent of it population having a European Union citizenship London is by far the region of the United Kingdom with the highest exposure to potential changes in immigration regulation due to Brexit. This contrasts with regions such as the West Midlands and Wales where European Union citizens represent only two and three per cent of the population respectively.

Similarly, London has the highest share of non Europeans (ten percent) compared to other regions. Both London's population share of European and non European citizens are well above the national averages of 5.2 and 3.4 per cent respectively.



Share of population by nationality and by region, 2017

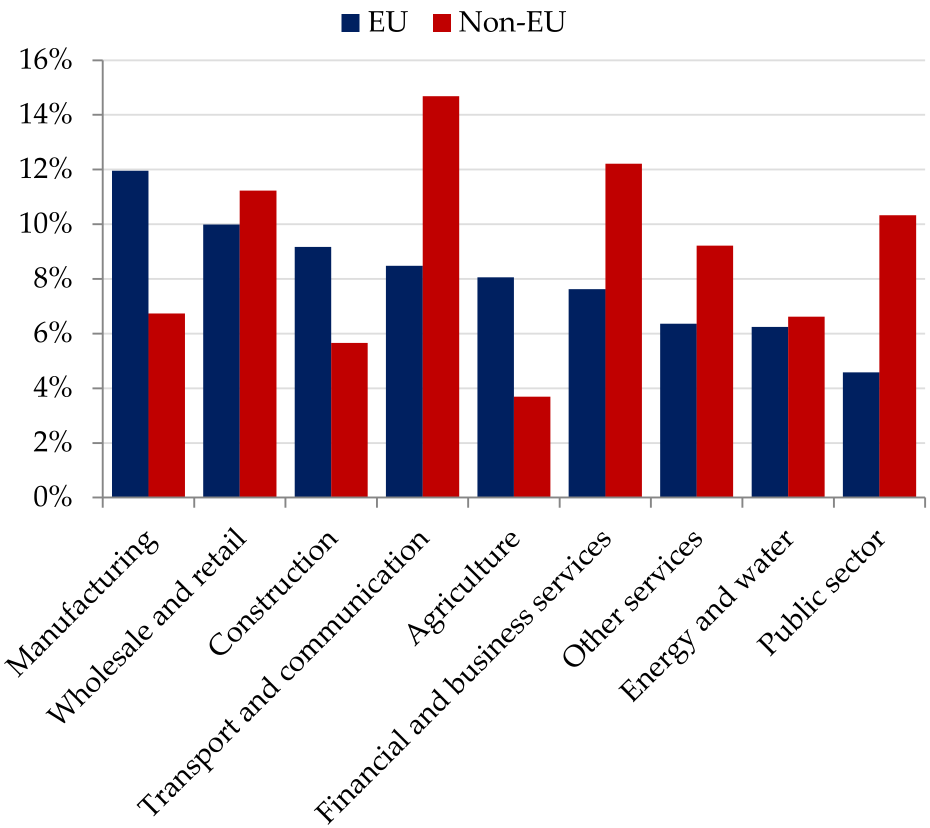
Source: Capital Economics and House of Commons Library

Reliance on European workers varies by sector

The manufacturing and the wholesale and retail sectors employ the highest share of European nationals

The manufacturing and wholesale and retail sectors are currently most reliant on European Union workers, representing twelve and ten per cent of the total sectors' workforce respectively. Construction and transportation both have over eight per cent of their workforce made up of European Union nationals. The public sector has the lowest share of workers from the European Union but this is still represents over four per cent of the workforce.

The transport and communications sector has the highest total share of foreign born workers with fifteen per cent non European Union citizens and eight per cent European union citizens.



Share of workers in each sector by nationality, 2017

Sources: Capital Economics, House of Commons Library and Office for National Statistics

Skills shortages are a big issue for some sectors

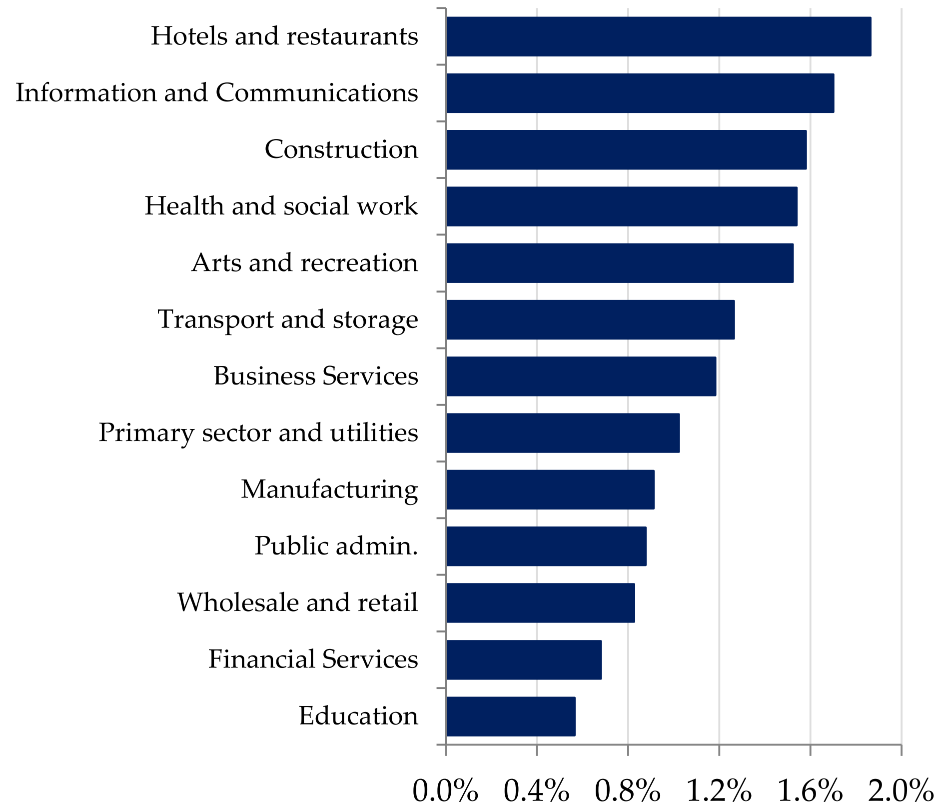
There are acute skills shortages across a range of sectors

In 2017, the Department for Education published a new Employers Skills Survey highlighting that over that year, hotels and restaurants in the United Kingdom had the highest level of hard-to-fill job vacancies as a share of the sector's total employment. These businesses were particularly exposed to the lack of skilled worker such as the Chefs, highly demanded in the United Kingdom. Information technology's share of hard-to-fill vacancies was 1.7 per cent, the second highest proportion in 2017.

The construction, health and arts and recreation sectors make up the rest of the top five sectors most impacted by skills shortages, with hard-to-fill vacancies representing around 1.5 per cent of their total employment.

Highly skilled workers also in demand

According to the United Kingdom's Visa Bureau, high-skill workers including engineers, scientists, healthcare workers and software professionals are all in short supply. Some companies are expecting it will become even more difficult to recruit after the United Kingdom leaves the European Union if a new immigration regime is implemented.



Hard-to-fill vacancies as a share of total employment by sector in per cent, 2017

Source: Capital Economics and Department for Education

Immigration and skills summary

Key points on impact of changes to immigration and skills arrangements:

- Under an independent trade policy it is most likely that restrictions will be based on lower skilled migrants
- Sectors most at risk from shortages from these restrictions specifically on low skilled migrants would be hospitality, support services, transportation and manufacturing
- Sectors currently most reliant on all workers from the European Union are manufacturing, retail and construction
- Hospitality, information and communication, construction and health are identified as sectors with the highest number of hard to fill vacancies
- In some cases, a restrictive immigration policy would provide opportunities for British workers at higher wages. However, evidence suggests many businesses are struggling to get the right skills regardless, while higher wages present a risk to lower margin businesses
- Our three main scenarios all allow for independent immigration policy in the long run; the details and implementation of this policy will determine the extent of the impacts

Deal (short term)	Short term	Long term
Proposed agreement *(2 year transition and possible backstop extension)*	• Little change	• Independent immigration policy
Canada plus *(2 year transition with possible extension)*	• Little change	• Independent immigration policy
No deal *(no transition)*	• Independent immigration policy	• Independent immigration policy
Single Market	• No change	
Customs union	• Independent immigration policy	

Changes to current arrangements under different Brexit deals

Source: Capital Economics

Smaller businesses are disproportionately burdened by regulations and therefore have most to gain from an improved UK regulatory regime

Freedom to repeal or amend European Union-originated regulations

Leaving the European Union and its single market will enable the United Kingdom to repeal or amend Brussels-originated regulations. The exact scope for doing this will depend on the negotiated future relationship.

European Union regulations are one size fits all, whereas nationally drawn up regulations can be tailored to a country's own circumstances. An Open Europe study found that, on average, nationally-derived legislation had a benefit to cost ratio of 2.35 – in other words, the benefits exceeded costs by an amount equivalent to 135 per cent of the costs. For European regulation enforced in the United Kingdom, the ratio was only 1.02 – meaning that their expected benefits were only two per cent greater than their costs.

Small and medium sized enterprises have the most to gain

The most costly regulations cited by small and medium sized enterprises include those concerning chemicals, value added tax, product safety and labour. Small and medium sized businesses have more to gain from improving the regulatory regime given that a lack of economies of scale mean that the costs of adherence are relatively higher for them.

*'It is also a well-recognised fact that SMEs bear a disproportionate regulatory and administrative burden in comparison to larger businesses. Experts estimate that where a large company disburses €1 per employee because of a regulatory duty, a small business might have to spend up to €10.'**

Description	Sectors most likely to benefit if repealed/improved
Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH)	Chemicals
Refund of value added tax to persons in other member sates	All
Common system of value added tax	All
General product safety	Manufacturing
Working time directive	Labour intensive sectors
Safety and health of workers at home	Services
Recognition of professional qualifications	High value services
Packaging and packaging waste	Manufacturing, retail, wholesale
Procedures for the award of public contracts	Public sector contractors
Modernised Customs Code	All

Top ten most commonly identified burdens by small and medium sized enterprises

Sources: Capital Economics and European Commission, *Results of the public consultation on the TOP10 most burdensome legislative acts for SMEs* (European Commission, Brussels), 2013

European Union labour market regulations are amongst the most costly to United Kingdom businesses

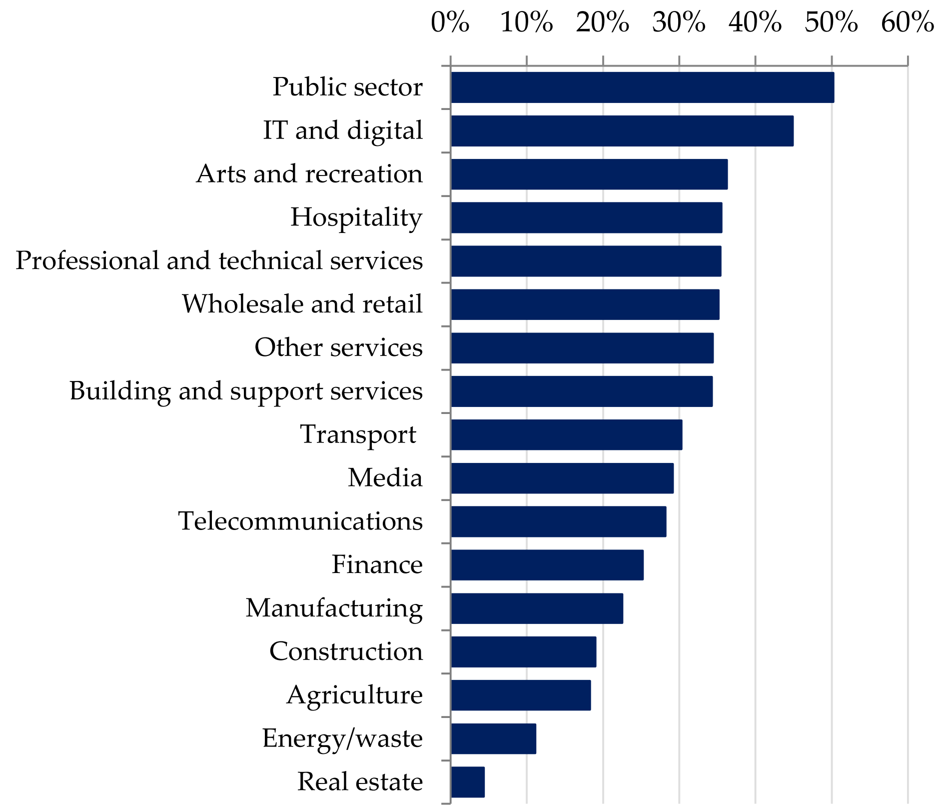
The cost of European Union labour regulations is significant

A study by Open Europe found that labour market regulations account for almost one-fifth of the cost to United Kingdom businesses (of all sizes) of European Union regulations. The Working Time Directive accounts for thirteen per cent of the cost an Agency Workers Regulations a further six percent.

Importance of labour costs vary widely across sectors

For the whole economy, labour costs account for 29 per cent of turnover. Financial services and manufacturing are relatively capital intensive sectors and, as a result, labour costs are a lower share of their turnover than for the whole economy. The public sector and information technology services have the highest labour cost shares. However, these sectors employ relatively small numbers of highly paid workers.

The hospitality and retail sectors have higher than average labour costs shares. These sectors employ relatively large numbers of lower paid workers and, as a result are, the burden of labour market regulation is likely to fall relatively on them.



Labour costs as a share of turnover, 2016

Sources: Capital Economics and Office for National Statistics

Opportunity for financial services to gain competitive advantage

Leaving the single market provides opportunities for targeted policies

Tariffs or restrictions imposed by the European Union as part of the future trading relationship that is negotiated will not have any direct impact on at least the 60 per cent of companies with between 50 and 250 employees who do not trade internationally. Outside the European Union completely it would be possible for government to implement a policy which imposes certain regulatory standards only on those companies that wish to trade with the European Union rather than blanket rules applied across the whole economy.

Financial services deregulation the biggest opportunity

In reality, it is unlikely that many regulations will be rolled back, especially in the short term. However, there is an opportunity, particularly for financial services, to open up a 'regulatory gap' between Britain and the European Union, which will act to make the domestic market more attractive to foreign business.

The European Union has already indicated that it intends to, or could, impose new regulations on financial services firms in the areas of (i) restrictions on over-the-counter derivatives, (ii) implementation of Basel 3 regulations, (iii) bankers' bonuses and (iv) the financial transactions tax. Many firms are therefore likely to conclude that their chances of operating under a less onerous regulatory regime are higher in the United Kingdom.

Business regulation summary

Key points on impact of changes to business regulation arrangements:

- Regulations bear a disproportionate regulatory and administrative burden to SMEs in comparison to larger businesses
- Outside of the single market there will be opportunities to deregulate to improve the business environment, although the extent to which this is likely to happen is unclear
- The biggest opportunity comes from removing the financial services sector from future European Union legislation

Deal (short term)	Short term	Long term
Proposed agreement *(2 year transition and possible backstop extension)*	• Little change	• Adherence to 'common product standards' • Likely to have to adhere to other regulations in return for access to tariff free trade
Canada plus *(2 year transition with possible extension)*	• Little change	• Freedom to amend and repeal some European Union regulations
No deal *(no transition)*	• Freedom to amend and repeal European Union regulations	• Freedom to amend and repeal European Union regulations
Single Market	• Adherence to future EU regulations	
Customs union	• Some form of common standards required	

Changes to current arrangements under different Brexit deals

Source: Capital Economics

Timeline and budget summary

Key points on impact of timeline and budget arrangements:

- It is likely the government will pay the divorce bill, estimated to be in the region of £39 billion, in all but the no deal scenario
- A no deal outcome will involve the United Kingdom leaving the European Union on 29 March 2019 and automatically reverting to World Trade Organisation trade arrangements
- The proposed agreement involves a two year transition period, which can be extended once. If no agreement on the future relationship is made by then there is a 'backstop' which involves the United Kingdom remaining in the customs union

Deal (short term)	Short term	Long term
Proposed agreement *(2 year transition and possible backstop extension)*	• Two year transition period to negotiate future relationship with potential to extend • Backstop involves UK staying in customs union with no time limit • Liable to pay divorce bill	• Likely to contribute to specific programmes
Canada plus *(2 year transition with possible extension)*	• As in proposed agreement but with no backstop	• Likely to contribute to specific programmes
No deal *(no transition)*	• No transition • Not liable for divorce bill	• Likely to contribute to specific programmes
Single Market	• No change	
Customs union	• As in proposed agreement	

Changes to current arrangements under different Brexit deals

Source: Capital Economics