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POINT OF VIEW **Open Access**

The organizational implications of Brexit

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Abstract

This point-of-view article examines the organizational implications of the UK's exit from the European Union (Brexit). We identify the effects of Brexit on firms' transaction costs in cross-border trade within Europe and highlight the importance of EU residency to secure licenses to operate. We also address how access to skilled labor may be affected by rising restrictions to immigration. Finally, we discuss the possible implications of Brexit for the organizational design of British firms and foreign firms operating in the UK.

Keywords: Brexit, Multinational firms, Institutional changes, Organizational design

Introduction

The United Kingdom (UK) joined the European Community in 1973, confirming its membership with a referendum in 1975. In 2016, 52% of the participating UK electorate voted to leave the European Union (EU), a decision ratified in 2017 by the UK government, who invoked Article 50 of the Treaty on the European Union to withdraw from the EU, a decision commonly referred to as "Brexit." Brexit is presently scheduled to take place in early 2019 and will mean the UK's withdrawal from the EU's supranational political institutions and its myriad of constituent agreements.

Brexit will have a deeply significant effect on British firms operating in Europe, and particularly multinational firms whose activities span the UK and continental Europe. It is well established in extant research that firms' organizational structures and strategies reflect their broader institutional environment. For example, prior work has attributed to institutional conditions the emergence of business groups (e.g., Guillen 2000), internalization of transactions (Feinberg and Gupta 2009), and the decision to enter countries through joint ventures (Delios and Henisz 2000).

Since the Second World War, the world has witnessed growing economic integration facilitated by the creation of international institutional arrangements such as the World Trade Organization, ASEAN, and Mercosur. The EU stands out among these arrangements for its breadth and depth of institutional integration. Thus, while multinational enterprises (MNEs) typically confront a multitude of different institutional pressures and need to balance global integration (Moschieri et al. 2014) with local adaptation (Rosenzweig and Singh 1991; Westney 1993), the European project, with progressively greater levels of market integration and regulatory harmonization, has encouraged firms to integrate their organizations and strategies across European borders (Moschieri and Campa 2009).

Firms have responded to this integration in many forms, adapting their organizational design and strategy to the new context. Some firms have taken advantage of the removal of barriers to intra-European trade to develop value chains across European countries. Others have developed export platforms in specific countries to service the rest of Europe. Others still have sought cross-border consolidation, as hurdles for firms making acquisitions in other European countries have been lowered (Moschieri and Campa 2009). Moreover, regulatory harmonization has permitted firms that are registered and authorized in one European country to operate freely and offer services throughout the continent.

Brexit represents a potentially powerful disruption to the institutional foundations of economic integration between the UK and the rest of Europe, which should have a marked impact on firm strategy and organizational design. Below, we identify three areas where we think the main impacts are likely to manifest themselves and are likely to affect organizational design. Because the final terms of Brexit have yet to be determined, we base our discussion on the reasonable assumption that a post-Brexit arrangement will incur greater barriers to the flow of goods, capital, and labor between the UK and Europe and greater regulatory distance.

Disruptive effects of Brexit and organizational responses

Scholarly research (Ott and Ghauri 2019; Tetlow and Stojanovic 2018) and the broader press (Anonymous 2018; BBC 2016; Cadman 2016) have identified different possible scenarios for Brexit. While a "softer agreement" that parallels the agreements that govern the EU's relationship with Norway and Switzerland would still be impactful for businesses, "harder" Brexit options are expected to have stronger consequences for British firms and European firms operating in the UK. For example, under the so-called Turkey model, the UK would not be part of the EEA or the European Free Trade Association but would participate in a customs union with the EU, where there would be no tariffs or quotas on industrial goods exported to EU countries—but British firms would have to comply with the EU's common external tariffs on goods imported from non-EU countries. A further option—the Canada model—refers to a CETA-type free-trade deal with the EU, with almost no tariffs on goods (except for some food items and services). However, this model comes with hundreds of regulatory restrictions and strict rules of origin. For example, exporters would have to comply with EU product standards and technical requirements. Also, it would be difficult for London-based banks to get "passporting" rights for their services in the EU. A third option is the Singapore approach, which means Britain unilaterally removing tariffs on trade with the EU and relying on the World Trade Organization's (WTO) framework to secure access to the European market. This model potentially puts UK-based exporters at a disadvantage with respect to competitors in countries that have concluded trade deals with the EU. Under the Canada, Turkey, and Singapore models, freedom of movement would be restricted. A final possibility is that no deal is ratified by Britain and the EU, and Britain defaults directly to WTO rules on trade with the EU. This outcome would have the strongest consequences for British firms and European firms operating in the UK, because a no-deal Brexit is likely to lack the interim and transitional arrangements that any deal would include to help firms adjust to the new post-Brexit reality.

Regardless of the type of agreement reached to govern Brexit and post-Brexit economic relations, the consequences of Brexit for foreign firms operating in the UK and for British firms operating in Europe are expected to be far-reaching. This has prompted scholars, managers, and officials to try and estimate the possible implications of Brexit for specific industries (e.g., Pollitt 2017), regions (e.g., Bell 2017), corporate decisions and deals (e.g., Scott et al. 2017), and entrepreneurial firms (Cumming and Zahra 2016). Similarly, the British Government has created several reports and guides to assist and support firms in their preparations for Brexit, whatever form it may take. These guides are often quite complex, laying bare the uncertainties and difficulties surrounding Brexit as well as the broad scope of its effects. For example, at the end of 2018, the UK government created an online guide on how to prepare if the UK leaves the EU with no deal. This guide covers 52 topics ranging from applying for EU-funded programs, transportation, and agriculture, to the handling of civil legal cases, cross-border trade, and product labeling (Gov.uk 2018). Interested managers and entrepreneurs can also take an online survey, which offers guidance to firms depending on their sector, operations, and the nature of their interactions with continental Europe, e.g., whether or not they sell goods in the UK or the EU, whether or not they employ EU citizens, whether they exchange personal data with organizations in Europe, and whether or not they receive EU or UK government funding (Gov.uk 2019). Such tools illustrate the potentially divergent effects of Brexit for firms across industries and activities.

Without wishing to underplay the differences in potential post-Brexit arrangements and the breadth and complexity of Brexit's effects, in this article, we assume that Brexit will raise barriers to the flow of goods, capital, and labor between the UK and Europe and increase regulatory distance, and focus our discussion on the effects of Brexit with respect to trade in finished and intermediate products, European residency and firms' license to operate, and labor mobility and firms' access to talent and their consequences for organizational design. Thus, we do not consider the full extent of Brexit's organizational impact and set aside issues such as its effects on entrepreneurship in the UK (Cumming and Zahra 2016) and how uncertainty about governmental funding and greater hurdles in IP protection may harm R&D ventures (Cumming and Zahra 2016).

Trade in finished and intermediate products

Since the incorporation of the UK into the EU, UK-EU trade has increased substantially, making the EU the UK's largest trade partner (Dhingra et al. 2016). Moreover, in using one or more countries as a "gateway to Europe," the UK has been a particularly attractive location, characterized by its strong institutions, the rule of law, relatively liberal economic policies, and a stable currency. Speaking about Japanese investment in the UK, Japan's Ambassador to Britain recently remarked that "The reason that many of those companies have come is that [the UK] is the best gateway to Europe" (Helm 2018).

In an environment of heightened barriers to trade post-Brexit, firms will find moving goods across borders to become more costly. The marginal effect is likely to be greatest for those firms that produce goods in the UK, primarily for export to the European market. As the top exporter from the UK to Europe, the automotive industry stands out as most likely to be adversely affected in this way (BBC, 2018). Indeed, Japanese automakers in Britain have been vocal in expressing their concern about how post-Brexit arrangements will affect their ability to manufacture in the UK and export to mainland Europe (Conn 2018). The chemicals industry best illustrates the problems of raising barriers to trade and integrated value chains between Britain and mainland Europe. During processing and development, chemicals and components pass back and forth between the UK and other European countries several times (BBC 2018). This process exacerbates the impact of higher post-Brexit barriers to trade. The logical organizational response for affected firms seeking to access the European market may be to transfer more of the stages of production from the UK to countries that are still within the EU after Brexit.

Firms within the UK that serve the domestic market but rely on imports from the EU are also likely to be affected by rising transactions costs associated with increased barriers to trade. These firms are likely to respond by finding UK-based suppliers to substitute for EU-based partners, or they may seek to vertically integrate more of the value chain domestically. For example, McLaren recently shifted its supply chain to the UK to mitigate the impact of Brexit on its activities (Ford 2017). In this regard, British-based manufacturers of substitutes for European imports may be able to offset some of the downsides associated with more costly access to European markets with a stronger position in the domestic market. Alternatively, to hold on to their markets in the UK, European suppliers may establish or expand their independent operations there. Overall, the general trend may be towards a localization of value chains and market relationships within the UK and the EU respectively.

It is important to note that the costs associated with greater barriers to trade are not limited to tariffs, and indeed tariffs may be a minor concern for many industries relative to non-tariff barriers. For instance, in many industries (e.g., chemicals), firms must comply with certification and verification procedures to sell their goods and services within the EU and the UK (BBC 2018). In the absence of regulatory harmonization post-Brexit, exporters will need to go through separate sets of procedures, which can be costly in terms of time and financial resources.

European residency and firms' license to operate

In certain key industries, the EU has established restrictions that require firms to be "European" in order to qualify for access to the European market. In such industries, Brexit poses a direct challenge to British firms as well as non-European firms whose European headquarters are in the UK. This is particularly evident in the aviation sector, where only European carriers can secure licenses from EU member states to fly between European airports (Spero and Toplensky 2018). To qualify as a European carrier, a firm must be more than 50% EU owned and controlled, which creates problems for firms with a large British shareholding that will no longer qualify as European after Brexit, i.e., Ryanair, EasyJet, and the International Airlines Group (parent company of Aer Lingus, British Airways, and Iberia).

London-based financial institutions face a similar challenge because once the UK ceases to be part of the EU, they may lose the right of automatic access to European financial markets. The process, commonly referred to as "passporting," allows banks and other financial services firms to operate throughout Europe once they are authorized and given a license to operate by one EU member (BBA 2016). Following Brexit, authorization by the UK government will cease to be a valid passport to operate in the rest of the EU. Furthermore, the European Central Bank places restrictions on the assets and operations that European banks can establish in "third party" countries, fearing that firms will use non-EU countries to benefit from lax oversight of their operations (Morris et al. 2018).

The aviation and banking sectors illustrate that to gain the benefits from regulatory harmonization and a Europe-wide license to operate often requires firms to establish registration, authorization, and/or ownership by European authorities and citizens. Firms whose license to operate in the EU has been based on their UK presence now need to adjust to continue being able to offer goods and services within Europe. The most logical option may be to move operations from the UK to other countries within Europe. In fact, many banks have already begun to increase their operational presence in EU financial hubs such as Paris, Frankfurt, and Dublin (Paduano 2018; White 2018). Similarly, European firms, whose freedom to operate in the UK has been predicated on their EU membership, may also be forced to shift operations to Europe. For example, European Central Bank's pressure has already prompted entities such as Deutsche Bank to shift assets and operations away from the UK (Morris et al. 2018).

Labor mobility and firms' access to talent

The UK has been a popular destination for firms seeking skilled workers and a location for their R&D activities (Helm 2018). Such activities are often more locationally bound—and thus less susceptible to an increase in transactions costs associated with cross-border economic activity post-Brexit. However, these activities are not immune from the effects of Brexit and Brexit threatens to weaken the supply of skilled workers to the UK. Immigrant labor from within the EU has helped to strengthen Britain's workforce and keep wages competitive for employers. With English being a commonly spoken second language in the EU, the UK has been able to attract some of Europe's best talent, making it an attractive center for research and development, as well as technological and scientific innovation.

While issues relating to market access and licenses to operate may be partly overcome with UK-EU agreements that seek to replicate aspects of existing arrangements, barriers to immigration are likely to be more significant post-Brexit given the fact that that immigration was a dominant issue in the debate surrounding the Brexit vote. A post-Brexit brain drain from Britain may be exacerbated by the limited access that British universities will have to European funding for research. The organizational implication for firms investing in research activities in the UK is that they may progressively shift their R&D activities elsewhere. For R&D activities where proximity to European markets is less important, firms can choose to locate outside of Europe altogether, possibly in emerging markets.

Consequences for organizational design and strategy

Organizational structure

Regardless of its form, Brexit is likely to impact British and European firms organizationally, affecting their structures, investments in the UK, and location and relocation decisions. First, the disruptive effects of Brexit may have multiple consequences for how firms design, define, or adapt their organizational structure, including its vertical structure, business areas and business units, individual roles, and reporting lines (Puranam 2012; Roberts 2007). With the growth of barriers to trade, firms manufacturing in the EU may struggle to arbitrage on local expertise, raw materials, or cheaper labor. Moreover, following Brexit red tape and administrative duties may become more complex as regulatory harmonization diminishes. As a result both British and European firms are likely to find coordination costs increasing after Brexit between their headquarters and local branches, and between units in the UK and the EU.

Thus, following Brexit multinational firms working across Britain and the continent would find themselves operating in increasingly distinct jurisdictions. In reaction to this, firms may need to alter their structure and governance. For example, multinational firms operating in the UK and other European countries may not be able to design an organizational setup so that their British subsidiary is incorporated and aligned to the rest of the continent. Rather, these firms may need to create a regional structure, similar to EMEA, to account for the proximity and yet the differences between the EU and the UK. This would likely involve moving further towards a multidomestic or transnational strategic orientation with greater autonomy granted to local units (Bartlett and Ghoshal 2002) operating in the EU and Britain respectively to enable them to adapt to different local regulatory and institutional demands.

New investments

A further consideration is that firms may face heightened uncertainty in the coming months and years. The Brexit vote unleashed months of wrangling between the EU and UK over post-Brexit conditions and market access, and a frequent refrain from business leaders has been a demand for greater certainty about what the future will hold. Deep and complex international arrangements, such as the EU, are difficult to undo, and thus, the prolonged uncertainty despite nearly 2 years of negotiations is not a surprise.

However, uncertainty does not just emerge from the ongoing absence of a final agreement between the EU and UK. Even in the presence of post-Brexit agreements, there will be uncertainty surrounding how those agreements will affect firms when implemented. In such an environment, it is therefore unsurprising that many firms have responded by withholding investments (Helm 2018) and hedging their bets by setting up operations in mainland Europe while not closing down activities in the UK yet. This reaction is consistent with extant research that finds that political institutional uncertainty and the expectation of adverse political shifts is typically associated with divestitures or withheld investments (Berry 2010; Blake and Moschieri 2017).

Organizational relocations

Many of the organizational responses that we have highlighted above involve relocating activities and operations from the UK to the remaining members of the EU. Policy makers in the UK are likely to seek to arrest this pattern and enhance the attractiveness of the business environment in the UK through independent policies (e.g., favorable taxation regimes and investment incentives). If this happens, firms will need to weigh the benefits of such policies against the increases in cross-border transaction costs associated with Brexit.

At this stage, we are unable to forecast with great certainty what a future post-Brexit UK policy regime may resemble across industries. Yet, industry reports note that in the corporate world, a general climate of distrust and preoccupation has emerged as a no-deal Brexit has become a genuine possibility. For example, the CBI think tank notes that "UK businesses are dealing with significant levels of political turmoil and feel that no deal is hurtling closer. The impacts of a no deal are vast and will impact every region and nation of the UK. […] A no deal would be a disaster for the UK economy, for businesses and for individual livelihoods" (CBI 2019). In our view, there is a genuine risk that Britain's struggles to form a political consensus around a workable model for Brexit will provide a stable platform for business in the future. This lack of consensus and the current uncertainties around the process will have a long-term negative impact on how firms perceive the business environment in Britain. In other words, beyond Brexit itself, the government and opposition's tortured handling of Brexit will lower confidence in the ability of Britain's political establishment to provide a reliable business environment, further encouraging firms to relocate away from Britain. This will hold even more in the event of a no-deal Brexit.

Conclusions

The foregoing analysis carries with it some notable caveats. As of our writing, there is no final Brexit agreement and most issues remain unresolved (CBI 2019). Therefore, assessing the full organizational effects of Brexit is something that we can only determine empirically once an agreement has been reached and implemented. In any case, we believe that our analysis stands on reasonably firm ground in the assumption that market barriers and transactions costs will increase for business activities between the EU and the UK. The further post-Brexit arrangements are from the status quo, the more the organizational changes highlighted above are likely to take place, and the greater the adjustment costs will be for firms operating between the UK and the EU. These costs manifest themselves through direct increases in transactions costs associated with cross-border activities and restrictions on market access, as well as through the adjustments costs associated with moving employees and operations from one location to another. Such costs will inevitably be passed on to shareholders and consumers.

Our analysis would seem to indicate that multinational firms and firms engaged in cross-border trade are particularly exposed to the disruptive effects of Brexit and will need to respond organizationally. One might therefore conclude that the impact of Brexit on firms that are concentrated primarily in domestic markets may be more muted. However, even firms focused on domestic markets—and in particular domestically focused British firms—may still be affected considerably. For example, the British construction industry currently benefits from easy access to labor and just-in-time supply of raw materials from the EU. A post-Brexit disruption in these two areas is likely to lead to pressure to change the way this industry currently operates. Furthermore, multinational firms may be able to rely on the international diversification of their activities to mitigate the negative impact of Brexit on their operations and performance. For instance, in an analysis of the FTSE100 firms, Oehler et al. (2017) found that after the Brexit referendum stocks of firms with higher proportions of domestic sales realized more negative abnormal returns than stocks of firms with more sales abroad, i.e., a higher degree of international diversification.

Brexit represents an interesting, yet not unique, case to study the consequences of the disruption to the institutional foundations of economic integration for firm strategies and organizational design. "The world of global business activity is sited in mutating environments; where borders are ambiguous, innovations spread globally, and where daily life in one corner of the world is tangibly affected by actions in other corners" (Delios 2017: 394). The experience of Brexit is likely to prove instructive because Brexit is but one example of other centripetal forces against globalization. Other recent examples include the case of Catalonia asking for independence from Spain and the Trump administration withdrawing from trade and commercial agreements such at the Trans-Pacific Partnership. Thus, the issues we raise here are likely to have broader implications beyond the specific case of the UK-EU relationship.

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