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A bonfire of the vanities?

By John Springford

CENTRE FOR EUROPEAN REFORM

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★ Some EU rules impose more costs than benefits on British businesses. But European regulation does not prevent Britain from having one of the most lightly regulated economies in the OECD. Some totemic EU laws, such as the working time and agency workers directives, are not as costly as their opponents argue.

★ Attempting to 'de-Europeanise' British regulation would not therefore lead to large gains in economic output. Outside the EU, the government would find it difficult to repeal much European environmental and labour regulation, even if it wanted to. British workers would balk at losing their statutory right to paid holidays, for example.

★ And if the UK joined the European Economic Area, or persuaded the EU to give it an à la carte relationship after withdrawal, the EU would insist that Britain continue to sign up to relevant rules in exchange for access to the single market. The purpose of EU regulation is to reduce trade barriers, so that exporters do not have to comply with different standards, workers are not discriminated against, and capital is free to move. If Britain wanted to continue to participate, it would have to abide by EU law.

★ The claim that leaving the EU would be a supply-side liberation for the economy is wishful thinking: the constraints on Britain's long-term growth are overwhelmingly domestic, not European, and the economy's supply capacity would be impaired if divergent regulations between the EU and the UK curbed trade and investment.

Arguments over regulation are a central feature of the antagonistic British relationship with the EU. Many Britons think that continental Europeans are more inclined to regulate markets than the UK, and that as the EU itself has become so intrusive, the UK is subject to regulations that damage the economy by imposing large and mostly unnecessary burdens on British businesses. Some critics go further, arguing that the costs of regulation have become so great that they now outweigh the – as they see it – relatively modest benefits of single market membership.[1]

The EU is to a large extent in the business of regulation. Some of its rules are not well designed. The Commission, which proposes EU legislation, has made some progress on its 'better regulation' agenda, as the British government has acknowledged.[2] Nevertheless, its impact assessments are not always up to standard, and a respectable case can be made that some of its proposals conflict with the principle of subsidiarity.[3]

Still, Britain has the power to influence the regulatory process. The Commission proposes regulations and directives; and British MEPs and government ministers amend and vote on them at the European Parliament and Council, alongside representatives of the other member-states. Hence, it is important to build alliances.

1: David Myddelton and others, 'Saying No to the single market', Bruges Group, January 2013.
2: UK government response, 'Stakeholder consultation on smart regulation in the EU', 2012.
3: Charles Grant et al, 'How to build a modern EU', CER report, October 2013.

There can be no doubt that some EU rules impose more costs than benefits. For example, the cost of recycling waste electrical equipment, mandated by a 2012 directive, outweighs the savings from reduced landfill and recycled materials, according to an impact assessment by the British government.[4] And the Bank of England has found that capping bankers' bonuses at 100 per cent of their annual salary has increased risk in the financial system: banks find it more difficult to slash salaries than bonuses in a downturn, which makes them more fragile.[5]

However, it is an extremely difficult task to add together the economic effects of all EU rules to calculate a 'net cost (or benefit) of Europe'. Some analysts have added up the costs and benefits of major EU regulations that can be found in UK impact assessments. Open Europe, for example, found that EU rules lead to marginally more benefits for the British economy than costs.[6] However, all impact assessments are highly uncertain estimations, and many do not calculate benefits, as these can be difficult to quantify.

The method favoured by the EU's most trenchant critics can be crude: assign largely arbitrary, but invariably inflated costs to regulations; then imply that the UK would face none of these costs if it quit the EU.[7] It is a method designed to produce conclusions that have been determined before the exercise has been carried out.

To understand whether an EU exit would liberate the supply side of the British economy, one must establish why regulations exist in the first place; appraise the extent to which the EU has a legitimate interest in regulation; honestly assess the effects of EU regulation on British economic performance; and consider whether the UK would escape all the regulatory costs attributed to membership if the country chose to leave the EU.

Why the EU regulates

Regulations can and do impose costs on companies, and ultimately on consumers (because companies often pass on these costs). When they are badly designed, the costs of such regulations can be unnecessary and damaging. But there are legitimate reasons why governments regulate markets. Markets are not perfect: they sometimes fail, producing sub-optimal outcomes. An unregulated market may, for example, generate 'negative externalities' (such as pollution or congestion) because the social costs of activities are not borne fully by those who engage in them. In such cases, governments have a responsibility to intervene to correct the failure. If the end result is that a firm is made to 'internalise' social costs which it had previously managed to 'externalise', the fact that its costs have risen is no bad thing.

The EU also has legitimate reasons to be interested in regulation. One is the single market. Since all 28 member-states regulate their markets, and conflicting regulations can act as barriers to trade, the EU sets the common minimum standards that are necessary for mutual recognition – the animating principle of the single market – to work. This basic premise is widely misunderstood in the British debate. For example, one recommendation of the British government's 'Business taskforce on EU red tape', which was asked to find regulations to scrap, was to push for the full implementation of the EU's services directive.[8] But deepening the EU market for services would be impossible without more EU regulation. Services markets tend to be more highly regulated than markets in goods. Consumers find it more difficult to assess the quality of a lawyer than an apple before they make a purchase, so the state intervenes to ensure legal standards are high. Member-states would not allow foreign companies, operating under foreign rules, to provide services to their citizens without common standards at the EU level.

"It is misleading to imply that all the regulatory costs associated with EU legislation would disappear upon Brexit."

Confusion also reigns over the reach of EU regulation. Business for Britain, a cross-party business campaign for a renegotiation of Britain's EU membership, has suggested that UK companies which do not export to the rest of the EU should be exempt from EU regulation.[9] That would be unworkable: many UK firms who opt against exporting are still part of the single market; they compete for British customers with firms from elsewhere in the EU. Meanwhile, some companies do not export directly, but supply parts, components and services to firms that do. By exempting non-exporters from EU rules, the UK would effectively be withdrawing from the single market.

Another reason why the EU has a legitimate interest in regulation is that there are times when collective action

4: Department for Business, Innovation and Skills, 'Waste electrical and electronic equipment system impact assessment', October 2013.
5: Marilena Angeli and Shahzad Gitay, 'Bonus regulation: Aligning reward with risk in the banking sector', Bank of England Quarterly Bulletin, Q4 2015.
6: Open Europe, 'Still out of control? Measuring eleven years of EU regulation', June 2010.
7: Tim Congdon, 'How much does the EU cost Britain?', UK Independence Party, 2012 and Taxpayers' Alliance, 'The great European rip-off: A background note explaining the new estimated total cost of the EU', March 2009.
8: UK Department for Business, Innovation and Skills, 'Cut EU red tape: Report from the Business Taskforce', February 2014.
9: Business for Britain, 'Setting out the British option: Liberating 95 per cent of UK businesses from EU red tape', January 2014.

at a European level may produce better outcomes than countries acting independently at a national level. In policy areas like climate change, for example, collective action at an EU level should, in principle at least, produce superior outcomes by reducing the opportunity for individual member-states to 'free ride'.

Nonetheless, the EU's member-states retain broad powers to regulate their economies. Some of the costs that firms complain about arise when national legislatures impose regulatory burdens over and above those required by EU legislation (a practice known as 'gold-plating'). And if the EU did not exist, member-states would have to make their own rules: it is misleading to imply that all the regulatory costs associated with EU legislation would simply disappear if the UK left the EU. British banks, for example, would not cease to be regulated. The regulatory burden on them might not even fall, because the era of 'light touch' financial regulation is over: UK standards are now often stricter than those required by the EU.[10]

In short, if a regulatory requirement in force in Britain is to count as a cost of EU membership, at least two conditions must be satisfied. First, it must be shown that its costs outweigh its benefits. And second, it must be proved that the UK would have no such requirements if it left the EU.

The gains from 'de-Europeanising Britain'

How large might the gains of 'de-Europeanising Britain' be? There are four reasons to believe that they would not be as large as critics of EU membership imply: the EU does not impose rigid harmonisation upon its member-states economies; some of its most iconic directives, such as the 'working time directive', are not as costly as its opponents argue; the largest supply-side constraints on the British economy are the result of domestic policy; and Britain, out of necessity, would be likely to retain many EU rules even if it left the Union.

If Britain quits the EU, it could in theory be freed to regulate its own product and labour markets as it sees fit (although if it wanted to continue to export to the continent, its firms would have to match many European standards). There may be some benefits from less costly rules in some sectors. But the comparative indices of the Organisation for Economic Co-operation and Development (OECD) for product and labour market regulation show that British markets are already among the least regulated in the developed world.

Chart 1 shows the overall level of product market regulation for the UK, the EU and the OECD. British markets for goods and services are the second least-regulated in the OECD, behind the Netherlands, another EU member-state. Rules at the EU level are designed to create common standards in order to make products more tradable: a lawnmower made in the UK can be sold in Germany without having to be manufactured according to German specifications, for example.

But the chart shows that EU rules do not appear to impose rigid harmonisation upon the Union as a whole: under EU directives, member-states are able to impose higher standards on their own firms if they wish, and over time, other member-states have moved towards Britain's liberal approach, rather than the other way round. It is hard to argue that Britain's product and services markets are highly regulated as a result of EU membership.

> *"It is hard to argue that Britain's product and services markets are highly regulated as a result of EU membership."*

The same story broadly holds true for the labour market (see Chart 2). The OECD's indices of employment protection legislation show a greater level of diversity among the countries surveyed, with continental European countries embracing markedly higher levels of employment protection than the English-speaking countries outside Europe. So where does this leave the UK? The answer is that membership of the EU does not prevent the UK from belonging firmly to the Anglophone camp. According to the OECD's indices, employment protection legislation is only slightly more restrictive in the UK than it is in the US or Canada, and less so than in Australia. It is, of course, much less restrictive than in continental European countries like France or Spain.

10: Philip Whyte, 'Britain, Europe and the City of London: Can the triangle be managed?', CER essay, July 2012.

Chart 1:
Levels of product market regulation

Source: OECD.

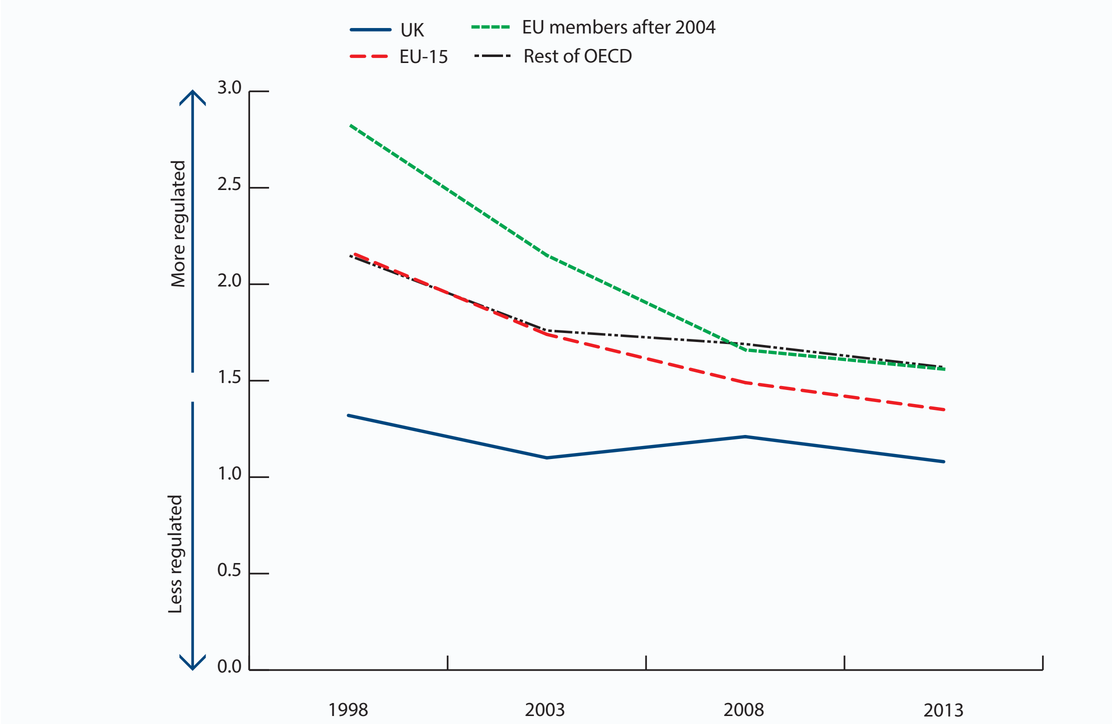
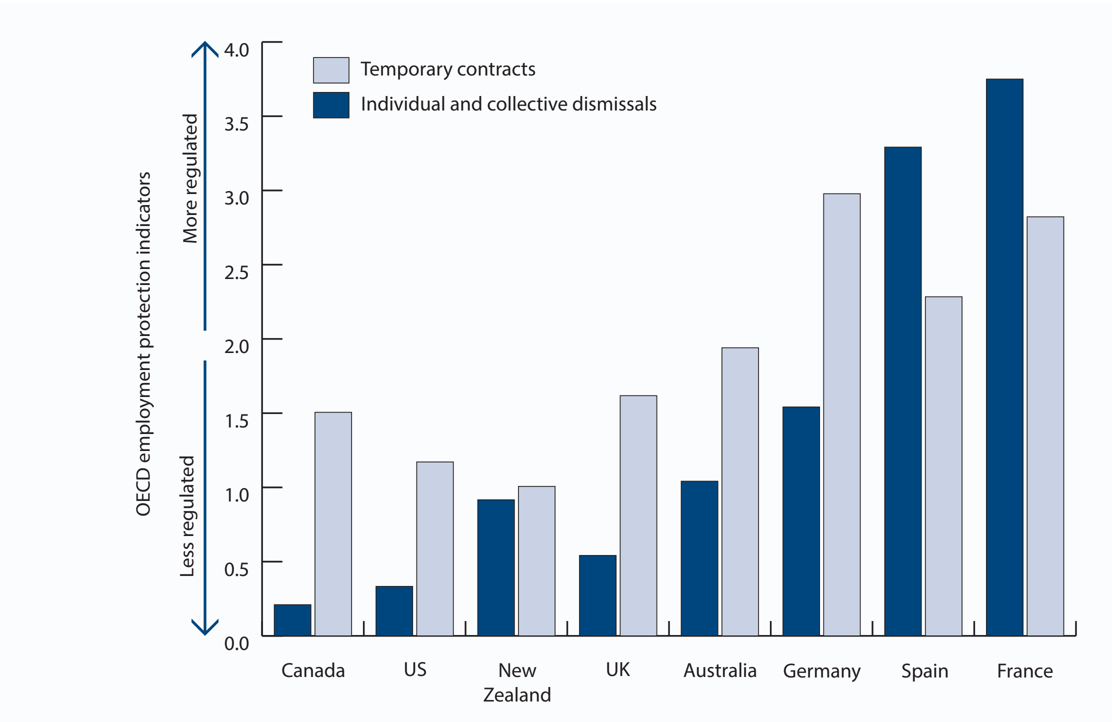


Chart 2:
Employment protection

Source: OECD employment protection indicators.



Some totemic EU rules, such as the 'working time directive', have a surprisingly limited impact. This directive violates the principle of subsidiarity: there was no need to regulate working hours or conditions at EU rather than national level, because there was little evidence that EU member-states were trying to improve economic competitiveness by driving down labour standards. Working hours across the EU were in decline even before the introduction of the directive.[11] Nonetheless, the working time directive's negative effects are marginal at best, not least because of the opt-outs the UK has negotiated.[12] Chart 3 shows how many British people work more than 40 hours per week. There is a spike at 40 hours: 14 per cent of British workers work 8 hours a day. There are further spikes at 45, 50, 55 hours and so on (because people tend to work 9, 10 or

11: European Trade Union Confederation, 'Trends in working time', 2010.

12: Katinka Barysch, 'The working time directive: What's the fuss about?', CER policy brief, April 2013.

11 hour days, five days a week). But there is also a spike at 48 hours – the working time limit under the directive. This is evidence that it has an impact on the labour market: there is no other reason why a larger proportion of people work 48 hours rather than 46. But the spike is small, making up only 1.5 per cent of workers. It follows that the gains in economic output that would flow from the abolition of the working time directive would be small: at best, 1.5 per cent of British workers may work a few more hours a week.

Chart 3:
The impact of the working time directive

Source: CER analysis of the UK Labour Force Survey.

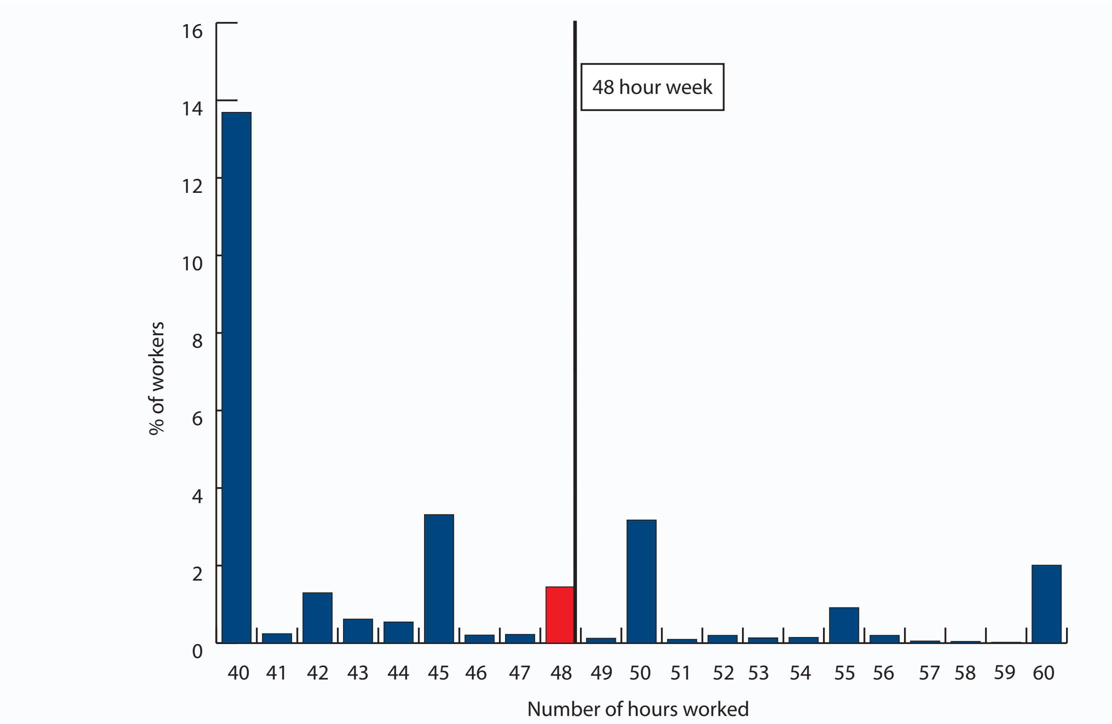
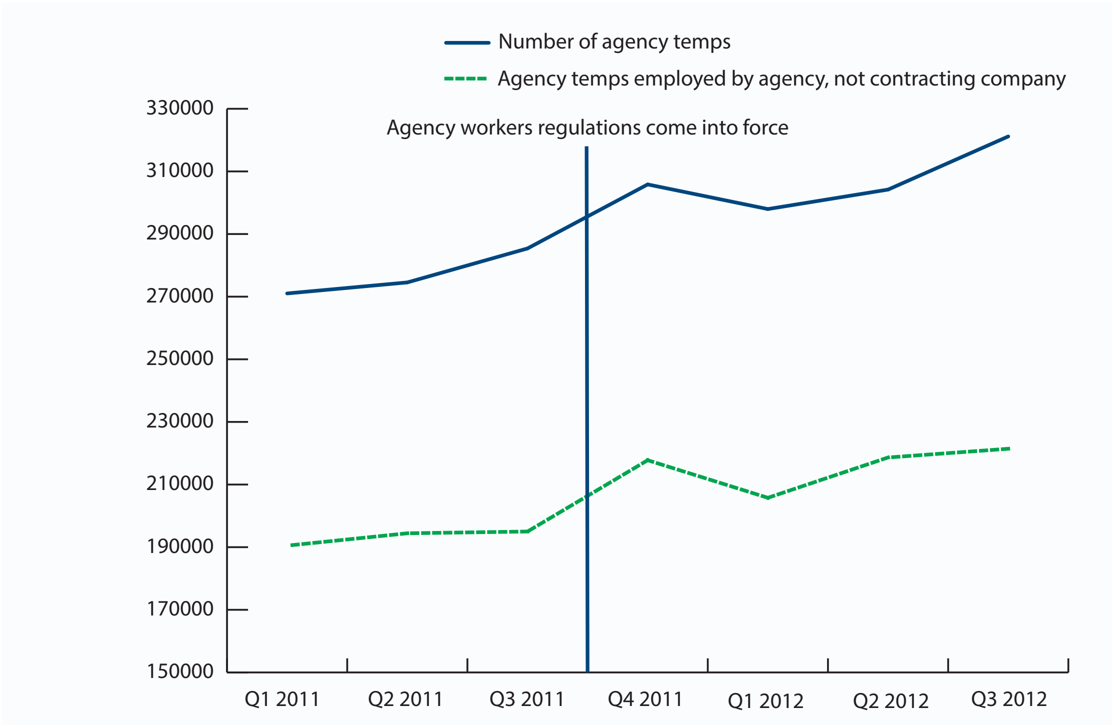


Chart 4:
The impact of the agency workers directive

Source: Chris Forde, 'The effects of Agency Workers Regulations on agency and employer practice', ACAS, 2014.



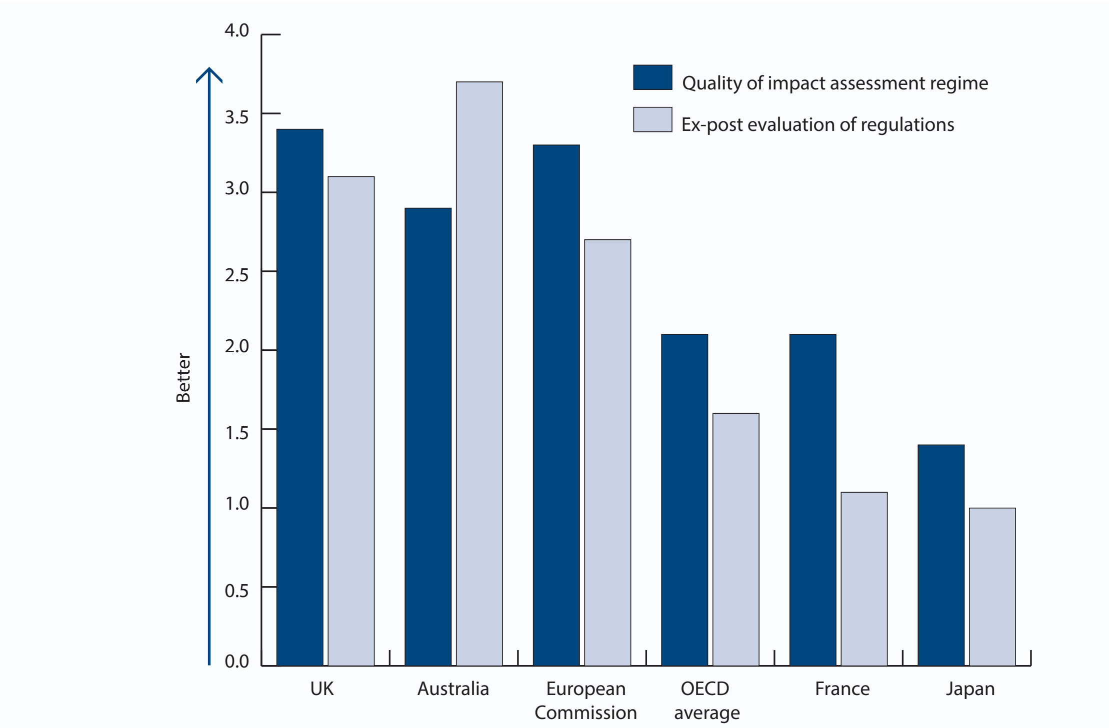
The other bugbear, the Agency Workers Directive, has also had a surprisingly modest impact. The rules, which came into force in 2011, give employment agency workers the right to the same pay, holidays and working conditions as equivalent permanent workers once they have worked for the same company for 12 weeks. Before it came into force, businesses and the Conservative leadership warned that it would make companies less willing to take on agency workers. But between 2011 and 2015, the proportion of temporary workers who found work through an agency grew from 19 to 20 per cent: the regulations did not lead employers to switch from agency temps to other temporary workers.[13] Chart 4 shows that agency employment continued to climb after the rules came into force. The chart also shows that businesses continued to make use of a loophole that allows an exemption from the right to equal pay if workers are formally employed by the agency, not the company they are working for. Two-thirds of agency workers were employed by agencies, not employers. The largest potential cost of the regulations – equal pay – therefore only applies to a minority of agency temps.

All this suggests that the most valid criticism one can make of the Working Time and Agency Workers directives is that, thanks to opt outs and loopholes, they fail to meet their stated objectives.

Alongside its labour and product market indices, the OECD has compiled an index of the quality of countries' regulatory regimes (Chart 5). Open Europe has argued that after conducting impact assessments, the EU fails to drop many of its proposed laws, and that the quality of the assessments are poor. But the OECD tested the European Commission's rule-making process alongside those of other countries, and found that it is of better quality than the OECD average – and similar to that of UK and Australia, which the OECD ranks highest. There can be little doubt that some proposals are forced through the EU's legislative machinery without proper assessment of the potential costs, but it is far from clear, on the basis of the OECD's index at least, that the EU does this more than the UK itself.

Chart 5:
The quality of regulatory regimes

Source: OECD.



At a macroeconomic level, then, any gains from leaving the EU are likely to be limited: a bonfire of European rules would not transform Britain's economic prospects. European rules are not major supply-side constraints upon the British economy: according to the OECD, the largest of these constraints are the result of poor domestic policy.[14] The OECD is especially critical of Britain's rigid planning rules and its restrictions on making land available for development. These rules help to explain why, despite rapid growth in the population, housing construction is running at half the level of the 1960s; why the average size of new homes built is smaller than anywhere else in the EU; why office rents are the highest in the EU; and why Britain's transport infrastructure is so congested and expensive to build.[15]

The OECD also criticises Britain's education system, which is a vital public good, given the importance of

13: Office of National Statistics, 'Temporary employees' data, November 2015.
14: OECD, 'Going for growth country notes: United Kingdom', 2013.
15: Simon Tilford, 'Why British prosperity is hobbled by a rigged land market', CER Insight, 2013.

human capital to economic prosperity. The UK's record in this area is patchy. It has assets, such as the best of its universities, which are world class. But its rates of literacy and numeracy at age 15 are only around the EU average, as are its rates of graduation from secondary education. Add to this the longstanding weaknesses in vocational training, and the result is that Britain has a comparatively large number of people with low skills – a failing that constrains Britain's labour supply to a far greater degree than EU employment rules.

Is it not possible that the UK could become more attractive as an investment location if it quit the EU? Outside the Union, would the British authorities not be free to reduce the cost of doing business in the UK, by lowering social and environmental standards, for example? Britain would certainly be freer to introduce less onerous regulatory requirements for new technologies, such as nano-technologies, the life sciences, genetically modified agriculture, space vehicles and interactive robots. This could increase the attractiveness of the UK as an investment location for these sorts of activities.[16]

There may, therefore, be some gains from more relaxed standards in particular sectors, especially in technologies that may drive up productivity. But any small benefits that arose from better regulation must be set against the costs incurred by British exporters and the loss of foreign investment that would result from leaving.

Besides, it is far from certain that Britain would reduce most environmental and social standards after an exit. After all, some environmental standards in the UK are more stringent than those required by the EU. Britain has, for example, introduced a far more ambitious system of carbon pricing than that countenanced by the EU as a whole. And any UK government would face fierce domestic opposition to further erosion of labour and social standards. It could, of course, choose to live without any equivalent to the EU's working time directive, but it would be a brave government that explained to Britons why they should lose their statutory right to four weeks' paid holiday a year.[17]

Finally, in order to maintain access to EU markets, Britain on the outside would have to sign up to many of the EU's rules. As a non-participant in the EU's institutions, it would have little say over the rules' drafting – and without the UK's liberal principles informing the regulation-setting process, EU rules may be more restrictive than they are now.

In short, the claim that leaving the EU would be a supply-side liberation for the economy is wishful thinking. The truth is that the factors that weaken Britain's long-term economic growth are overwhelmingly domestic, not European; the impact on output from repealing European legislation would be minimal; and the economy's supply capacity would be impaired if divergent regulations between the EU and the UK curbed trade and investment.

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This policy brief is the first in a series updating the work of the CER's commission on the economic consequences of leaving the EU, which reported in June 2014.

16: David Willetts, 'Eight great technologies', Policy Exchange, 2013.

17: Katinka Barysch, 'The working time directive: What's the fuss about?', April 2013.