January 2014

The Great British trade-off
The impact of leaving the EU on the UK's trade and investment

By John Springford and Simon Tilford

CENTRE FOR EUROPEAN REFORM

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- ★ As the eurozone economy continues to stagnate, the proportion of British trade accounted for by the rest of the EU is falling, and non-European markets are becoming more important for British exporters. But this is not a reason for the UK to leave the EU.
- ★ Membership of the EU significantly increases Britain's trade with other member-states, while there is little evidence that it reduces trade with countries outside the Union. Britain is home to a larger stock of EU and US foreign direct investment (FDI) than any other EU economy and is the preferred location for investment from other leading markets. Some of this investment would be threatened by a UK exit from the EU.
- ★ If Britain were to leave the EU, it would face a difficult dilemma: having to negotiate access to the EU's single market in exchange for continued adherence to its rules – or losing access in return for regulatory sovereignty that would be largely illusory.

In January 2013, British prime minister David Cameron offered the public a referendum on EU membership in 2017, if his Conservative party wins the next general election. Most surveys of public opinion show that a majority of Britons would like to leave the EU. Support for the UK Independence Party, which advocates withdrawal, has risen sharply in recent years: it may top the polls in May's European elections.

Cameron's promise has sparked an intense debate about the economics of Britain's membership of the EU. Much of this debate has revolved around the implications of an exit for British trade and investment. Pro-Europeans say that the single market has boosted trade and investment between Britain and the rest of the EU, and conclude that leaving would weaken Britain's economy. Eurosceptics counter that membership of the single market imposes too many regulations on Britain, in exchange for too little opening of European markets, and that Britain's trade with countries outside Europe would be higher if it left.[1] Even some pro-Europeans, such as Wolfgang Münchau of the *Financial Times*, argue that the single market has delivered little discernible macroeconomic benefit, that the eurozone will supplant the single market as the organising force within the EU, and that Britain therefore has little reason to remain in the EU.[2]

British politicians and commentators – and to a certain extent, the public – accept the value of freer trade. But they differ on whether Britain should prioritise trade with Europe or with the rest of the world – and on whether the country's EU membership constrains British firms' ability to expand into non-European markets. In 2012, British trade with the rest of the world overtook its trade with the EU, as the Union's economy remained depressed. As a result, it is legitimate to ask whether the UK's membership of the single market is any longer a matter of over-riding national interest.

This policy brief provides a brief overview of the changing nature of global trade, and Britain's place within it, followed by evidence on the extent to which the single market has boosted Britain's trade and investment with the EU. It then discusses the ramifications of leaving the Union for Britain's trade and for its attractiveness as a location for investment.

1: Nigel Lawson, 'I'll be voting to quit the EU', *The Times*, May 7th 2013.

2: Wolfgang Münchau, 'It does not really matter if the UK leaves', *Financial Times*, January 13th 2013.

The changing nature of global trade

Since the end of World War II, global trade has grown much faster than global output – apart from a brief pause in the 1970s after the oil shocks and the breakdown of the Bretton Woods system. Between 1980 and 2007, world trade tripled, while world economic output only doubled.

Globalisation has several causes. The emergence of East Asia as a major manufacturing hub since the 1950s – first Japan, then South Korea and South-East Asia, and then China – brought hundreds of millions of consumers and workers into global markets. Transport costs and tariffs have fallen steadily, reducing the cost of trade. Governments have also reduced 'non-tariff barriers' (NTBs) – the different national regulations, quotas and protections that make it difficult for exporters to penetrate foreign markets.

There are two trends that underlie this growth in global trade. The first is the increasing division of labour between developed and emerging economies, driven by the principle of comparative advantage. If two countries specialise in producing the types of goods they are best at, their combined output is higher if they trade freely with one another. The reason: specialisation leads to higher productivity, and higher productivity means more output. Comparative advantage has driven the growth in trade between the developed world and the emerging economies, as the former have specialised in high value-added production and the latter in labour-intensive manufacturing.

British eurosceptics contend that the rise of emerging economies reduces the importance of Britain's European trade. China's economy grew by ten per cent a year between 2002 and 2012, and its trade integration with the rest of the world expanded even faster. India managed growth of around seven per cent over this period. Emerging economies' growth has slowed since the crisis – and in all likelihood will be permanently lower – but they will continue to expand more rapidly than developed countries. Hence, the reasoning goes, the EU's single market is of declining value to the UK. It may even hold the country back from developing its trade with emerging economies: eurosceptics argue that a British exit could free the country to pursue more – and more comprehensive – trade agreements with emerging economies.

> *"British eurosceptics overstate their case that the rise of emerging economies diminishes the EU's importance."*

This argument ignores the second trend: that trade has grown swiftly between countries with similar economic characteristics for decades, suggesting that comparative advantage is not the only cause of expanding global trade. The value of trade between rich countries is far larger than that between rich and emerging economies, and will be for years to come. Consumers in developed markets want choice – for instance, in the case of cars they want different designs and differing levels of quality. Only rich countries have the infrastructure, knowledge and capital to provide this variety. Emerging economies will only break into high value-added markets by creating more innovative, well-designed and carefully-branded products. This process took Japan 30 years after World War II and South Korea a similar period from around 1980, and both countries faced a far more benign international environment than that which China must currently contend with.

This second trend has turned Europe into a regional trading hub. Over three-fifths of EU member-states' trade in goods is conducted among themselves. Intra-EU trade expanded less rapidly than extra-EU trade over the last decade, but it still managed growth of 5.4 per cent a year, suggesting that European regional trade integration is far from exhausted (see Chart 1).

These patterns of international trade prompt the question: has membership of the EU's single market increased Britain's trade, or merely diverted trade away from faster-growing non-European countries and towards Europe? Does the EU constrain Britain's ability to boost its trade with rich countries outside Europe and those developing countries that are reshaping the global economy?

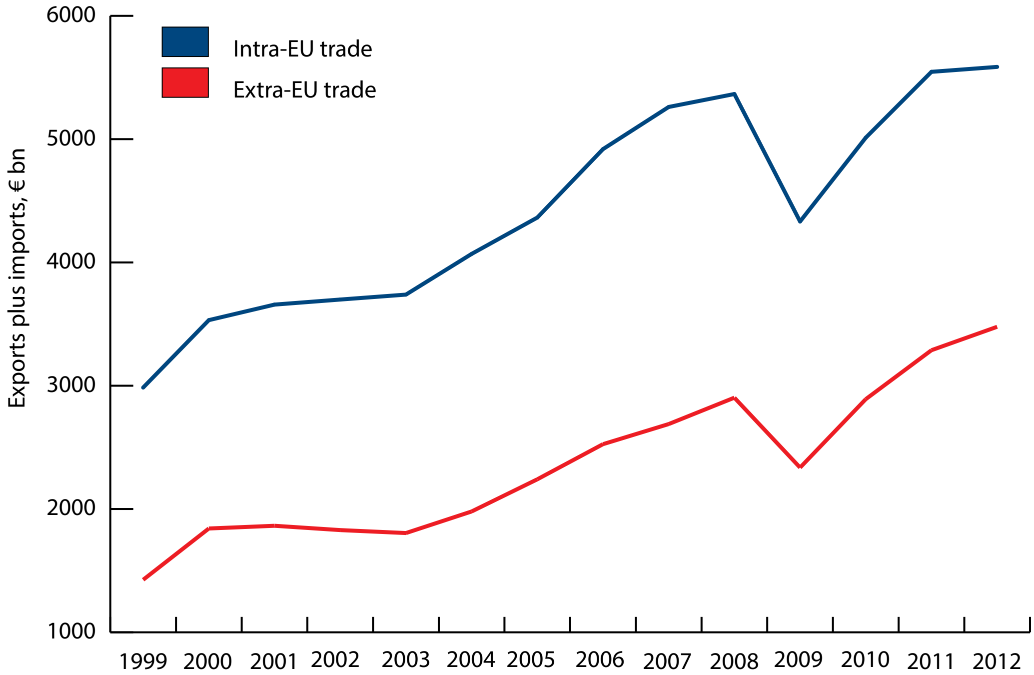

Chart 1: Trade within the EU-27, and between the EU-27 and the rest of the world

Source: Eurostat.

The impact of EU membership on British trade

The EU's single market employs three tools to boost trade. First, it eliminates tariffs on goods. Second, it establishes the right of companies and people to sell their goods, services or labour, or to invest, in other member-states – the so-called 'four freedoms'. Third, it reduces the cost of potential exporters having to comply with 28 different rule books. The EU creates minimum regulatory standards, and then requires all member-states to allow goods that comply with those standards to be sold unhindered. This means that exporters no longer have to produce 28 distinct products to comply with differing national rules.

However, there are two ways in which the UK's membership of the single market may constrain its trade with non-European countries. The first is membership of the EU's customs union. Trade is tariff-free between member-states, but the EU sets tariffs on imports from outside the bloc. The second is the way in which the EU removes non-tariff barriers: in doing so, it may regulate at a European level in a way that makes trade with non-European countries more difficult. Together, these may divert British trade from lower cost producers outside the EU, to higher cost ones inside. If more trade is diverted than created, Britain may gain by leaving the single market.

Britain's trade with countries outside the EU is growing. Chart 2 shows the trends in UK trade with the 11 other member-states that made up the EU in 1986; the existing EU with 28 member-states; non-European OECD members; and emerging economies. After an initial expansion in the proportion of British trade conducted with the EU in the 1980s and 1990s, it levelled off. The proportion conducted with the EU-11 (and the OECD) fell over the last decade, as trade with emerging economies rose. However, faster emerging economy growth may be the cause, and Britain's ties to the EU may do nothing to constrain trade with the rest of the world.

> *"It is unsurprising that much of Britain's trade is conducted with the rich and nearby member-states of the EU."*

Similarly, the fact that the EU remains the UK's largest trading partner might have nothing to do with Britain's EU membership. It makes sense that a large proportion of Britain's trade is conducted with the rest of the EU. The other members are rich countries on Britain's doorstep, so they would be its largest trading partners even if the EU did not exist. Yet these figures do not show the extent to which the single market has increased trade between Britain and other EU member-states by more than would be expected, given the trading partners' economic characteristics and location. Nor do they show if EU membership has reduced Britain's trade with the rest of the world to a level lower than would be expected.

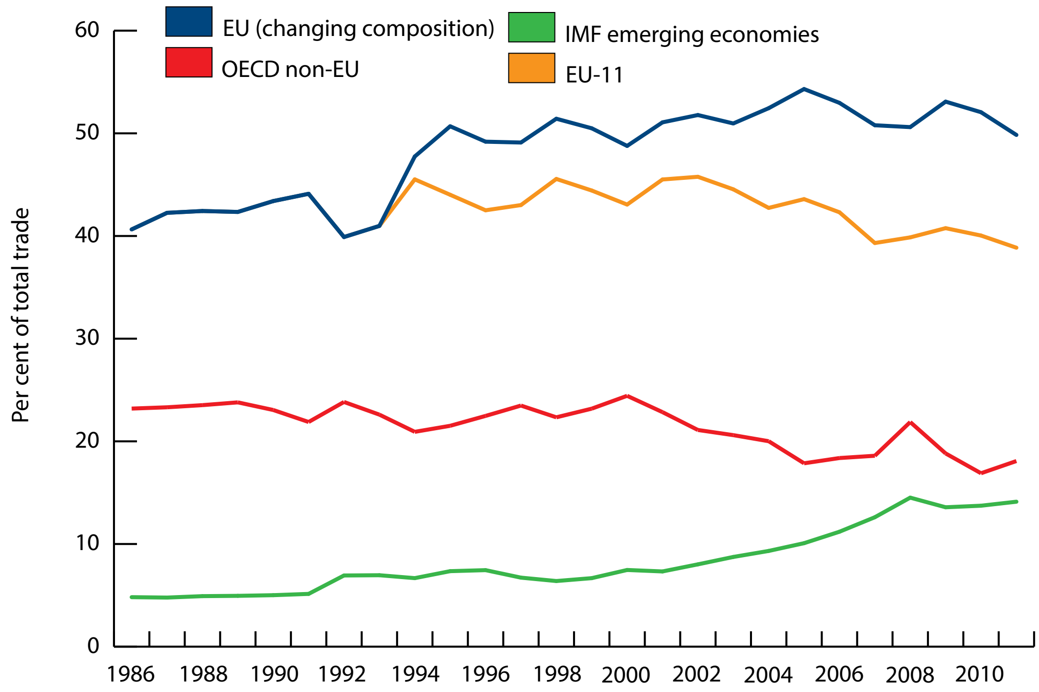

Chart 2: Trends in UK total trade with the EU and the rest of the world

Source: International Monetary Fund, Direction of Trade Statistics.

To capture the effect that membership of the EU has on UK trade, factors that determine the amount of trade between countries must be controlled for: economic size, distance from Britain, whether the trading partner's citizens speak English and so on. If these factors are held constant and Britain still trades more with the EU than with countries outside the bloc, then that additional trade is attributable to membership of the EU.

The Centre for European Reform has therefore constructed a 'gravity' model to measure the EU's role in creating and diverting trade between Britain, the EU and its 30 largest trading partners that are not EU members. Together, these countries account for almost 90 per cent of Britain's trade. We took data on the total value of goods traded – exports and imports – between Britain and 181 countries between 1992 and 2010. We then took data on the countries' GDP, and their real exchange rates and using a statistical technique called fixed effects, took into account other factors that affect trade, such as countries' populations, their distance from Britain and so on. Allowing for these factors, the UK's trade with the other EU members is 55 per cent higher than one would expect, given the size of these countries' economies and other controls.[3] (See Chart 3).

But is this trade merely diverted from outside the EU? The second bar of Chart 3 shows how much of the UK's trade is diverted from its 30 largest non-European trading partners to countries within the Union. The model provides no evidence that trade has been diverted from outside to inside the EU by Britain's membership of the Union. Indeed, it estimated that UK membership of the EU might increase its trade with its 30 largest non-EU trading partners, although this result was insignificant, as shown by the very long error bar.[4] As 54 per cent of Britain's goods trade is currently conducted with the EU, UK membership of the Union boosts its goods trade overall by around 30 per cent.

> *"The UK's trade with the other EU members is 55 per cent higher than one would expect, given the size of these countries' economies."*

However, averages cover a multitude of sins. Trade in some goods – notably agricultural products – has certainly been diverted from outside the EU to within it. The Common Agricultural Policy (CAP) is clearly costly: several studies have found that trade in agricultural goods diverted by the CAP outweighs any trade created within the Union.[5] While the EU has reduced average tariffs from 5 per cent in 1990 to 1 per cent in 2011, those on footwear and clothes remain high, which makes it difficult for more efficient producers outside Europe to export to the EU.[6]

3: This result was statistically significant to the 0.0001 level, meaning that there was a 99.999 per cent chance that it was not zero. However, there are large confidence intervals which are shown by the error bars on Chart 3. Confidence intervals show how far the model could be sure that its estimations were accurate (the longer the error bar line, the less certain the estimation). See appendix.

4: The model could not be sure that the result was greater than zero – it was only significant at the 0.4 level, meaning that there was only a 60 per cent chance it was greater than zero.

5: See, for example, André Sapir, 'Regional integration in Europe', *Economic Journal*, 1992.

6: World Bank weighted average tariff data.

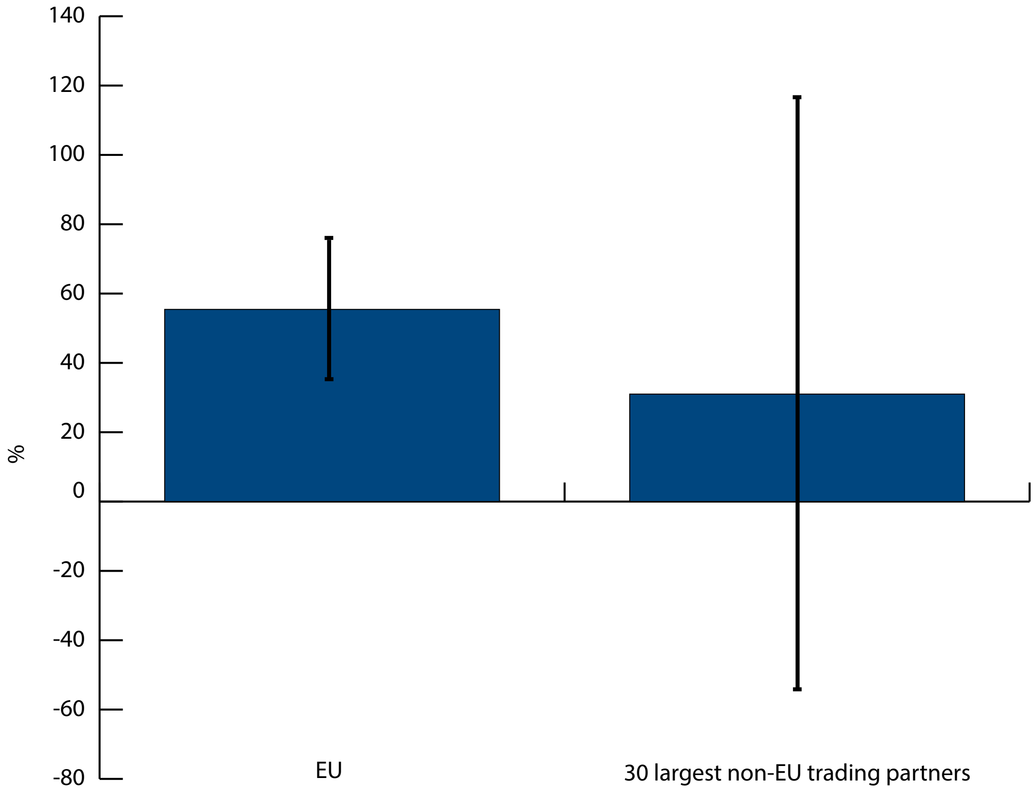

Chart 3: Goods trade created and diverted by Britain's membership of the EU

Source: Centre for European Reform calculations (see appendix).

Nonetheless, the evidence accords with theory. Rich, large and neighbouring economies trade more than poor, small and distant ones. The EU's tariff and non-tariff barriers to trade reduce Britain's imports of some products from countries outside the Union – although there is no evidence that the EU diverts trade overall. But the benefits of reduced barriers to Britain's natural trading partners – the many medium-sized, rich economies on its doorstep – outweigh those costs. Britain's economic interest lies in reducing the costs of trade with its largest trading partners, which the CER's model shows that the EU has been effective in doing.

However, two-fifths of British trade is in services, which the CER's model does not account for. Is there any evidence that the EU has boosted Britain's services exports? The UK has a strong comparative advantage in the trade of services, with its leading exports being financial and related business services, such as accountancy, law and consulting. Free movement of capital and unrestricted trade in services constitute two of the four freedoms of the EU's single market, and the EU has made successive attempts to reduce barriers to trade in these areas. Have these attempts worked?

Britain's services trade with the EU has grown at slightly more than twice the rate of EU economic growth since 1998 (see Chart 4). Services trade with the US grew by a similar amount over this period (around 6 per cent per year), but this translated into only 1.5 times the rate of US growth due to the US economy expanding more quickly than the EU's over this period. Britain's services trade with emerging economies rose rapidly between 1998 and 2012, but only in the case of Brazil did Britain's services exports grow significantly faster than the economy concerned.

However, the growth of Britain's services trade with the EU is not especially impressive. Given the EU's attempts to liberalise services, trade might be expected to be growing at a faster pace. While the EU has made some progress in lowering barriers to trade – the 2004 services directive reduced them by about one-third – there is more that could be done.[7]

The data for foreign direct investment is more conclusive. Britain is by far the largest recipient of FDI in the EU. A large proportion of Europe's inward FDI is from US firms, and the UK is its principal host (see Chart 5). Britain has some advantages that have little to do with the EU. It is a very open economy, and it is easy for foreign investors to own or start up British businesses; it has deep capital markets and a large number of publicly-listed businesses; and its citizens speak English – all of which make it an attractive place to invest. But it is difficult to believe that it would receive so much inward investment were it not in the single market – although the size of this effect is hard to determine. After all, many firms from outside the EU are seeking a European base from which to distribute products without the barriers they face when conducting trade from their home markets. Market size is a major determinant of the size of FDI flows, and membership of the EU expands the UK market.

7: John Springford, 'How to build EU services markets', CER policy brief, October 2012.

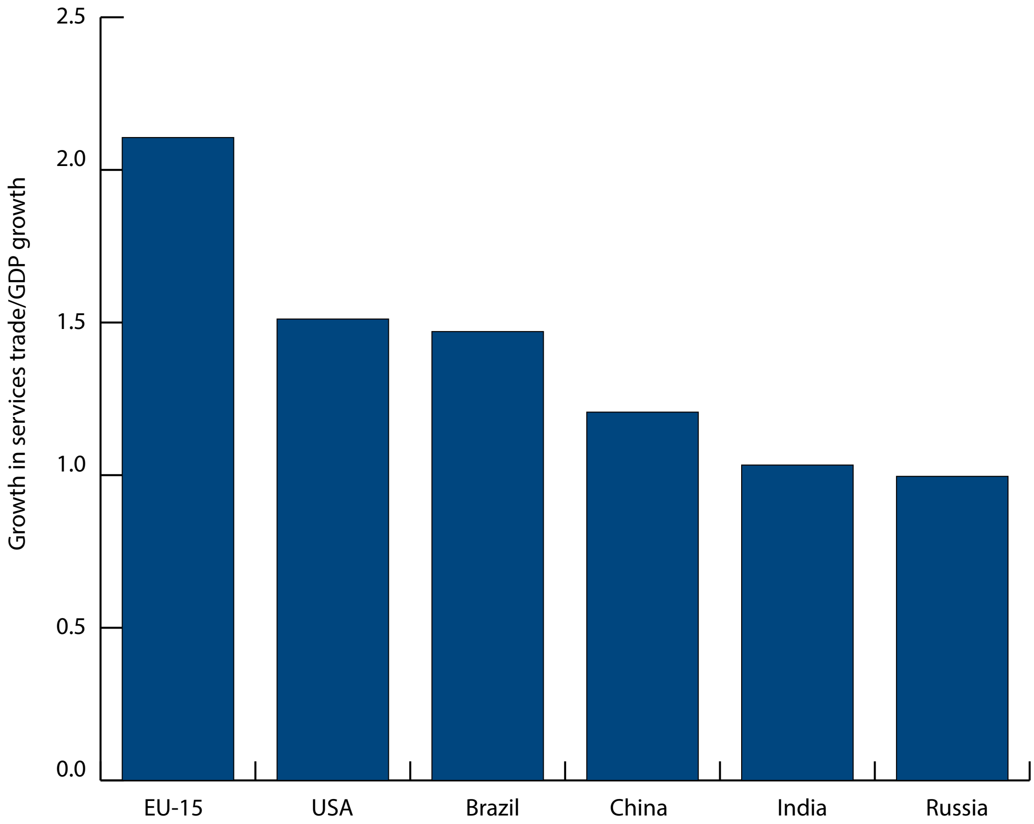

Chart 4: Britain's services trade as a proportion of GDP growth, 1998-2012

Source: Office of National Statistics, Pink Book, 2013.

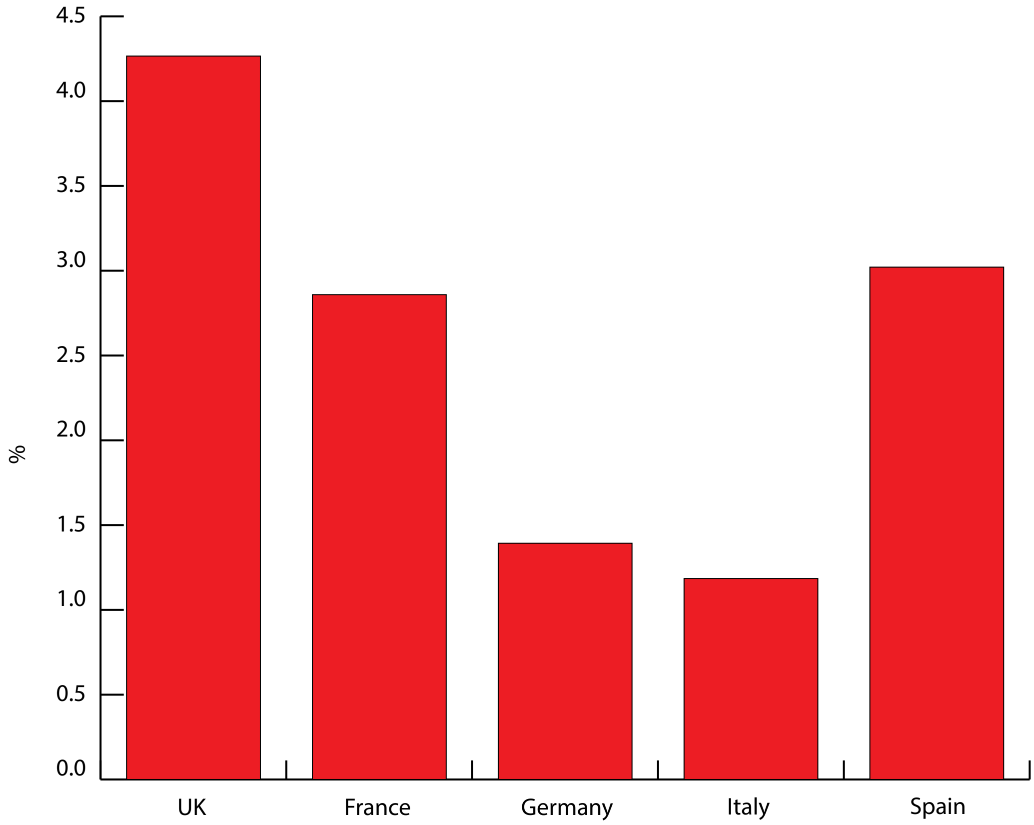

Chart 5: Average annual inward foreign direct investment from non-European OECD countries, 2001-11, as a proportion of GDP

Source: OECD, inward foreign direct investment statistics.

The bulk of this inward investment in the UK is in services, which received 60 per cent of all FDI over the last decade. And nearly half of all FDI in Britain's services sector is in banking – the services sector that the EU has most comprehensively liberalised.[8] (The CER will discuss the implications of a British exit for its financial services sector in a forthcoming paper.) While the single market for services remains a work in progress, Britain has nonetheless been the largest EU beneficiary of the free movement of services and capital, as it has been the location of choice for foreign investors from other EU member-states and the US (see Chart 7 on page 11).

In summary, membership of the EU has boosted Britain's trade and investment. Far more trade in goods appears to have been created than diverted; and the UK has been the largest beneficiary of capital from outside the EU which sought a country within the single market as a base. But would a British exit from the EU mean that these gains would be lost?

What might be the consequences for Britain if it left the EU?

British eurosceptics claim that the case for British membership has been weakened by the fall in the proportion of the UK's trade accounted for by the EU. They argue that, in the event of an exit, Britain would have little trouble negotiating a free trade agreement with the EU because the UK has a large trade deficit with the rest of the Union: if trade barriers between Britain and the remaining member-states were erected upon exit, the EU would lose more exports earnings from Britain than vice versa. At the same time, the UK would be freed from the burdens of EU regulation and hence able to boost trade with faster growing parts of the world, by eliminating tariffs and signing trade agreements without the constraints of EU membership. Underpinning this assertion is the belief that the UK is a big enough economy to be an effective trade negotiator in its own right. On the face of it, these arguments are persuasive. But they are simplistic and misleading.

The EU is certainly a less important market for the UK than it was, and likely to become less important so long as the eurozone fails to engineer a sustained economic recovery. Eurosceptics are also right that the UK's trading relationship with the EU is imbalanced. But the UK would be wrong to assume that it could dictate terms in any negotiation with the EU by virtue of the fact that it is running a trade deficit. First, the EU buys half of Britain's exports whereas the UK accounts for little over 10 per cent of exports from the rest of the EU, so the UK would be in a weak position to negotiate access on its terms. Second, half of the EU's trade surplus with the UK is accounted for by just two member-states: Germany and the Netherlands. Most EU member-states do not run substantial trade surpluses with the UK, and some run deficits with it. Any agreement would require the assent of the remaining 27 members, some of whom buy more from Britain than they sell to it.

> *"The UK cannot assume that it could dictate terms because it runs a trade deficit with the EU."*

The regulatory costs of doing business in the UK could fall if the country quit the EU, but this is far from certain – while there is little doubt that British firms' access to EU markets would suffer. Moreover, the UK's access to non-EU markets is to a great degree determined by its membership of the EU, something that will only become more pronounced if, as looks likely, multilateral trade continues to recede in favour of bilateral and preferential trade agreements. The UK accounts for around 4 per cent of global exports of goods and services, a proportion that is falling steadily as emerging markets become increasingly integrated into the global economy. On its own, the UK would have much less bargaining power than the EU.

To consider what sort of EU trade agreement might realistically be on offer to Britain, an overview of current arrangements for non-EU countries is needed. It is clear that only one of these would be politically realistic for a Britain that quit, and that it would have potentially far-reaching implications for the country's trade and investment.

The alternatives

If Britain withdrew from full membership of the EU, there would be a number of potential options for managing its trading relationships: membership of the European Economic Area (the Norway option); a customs union, similar to the one the EU has with Turkey; a basket of bilateral agreements such as that which exists between Switzerland and the EU; a so-called 'vanilla' free trade agreement such as the ones the EU has with countries ranging from South Korea to South Africa; and finally trade with the EU under World Trade Organisation (WTO) rules. None of these options would be straightforward.

8: OECD, inward foreign direct investment statistics.

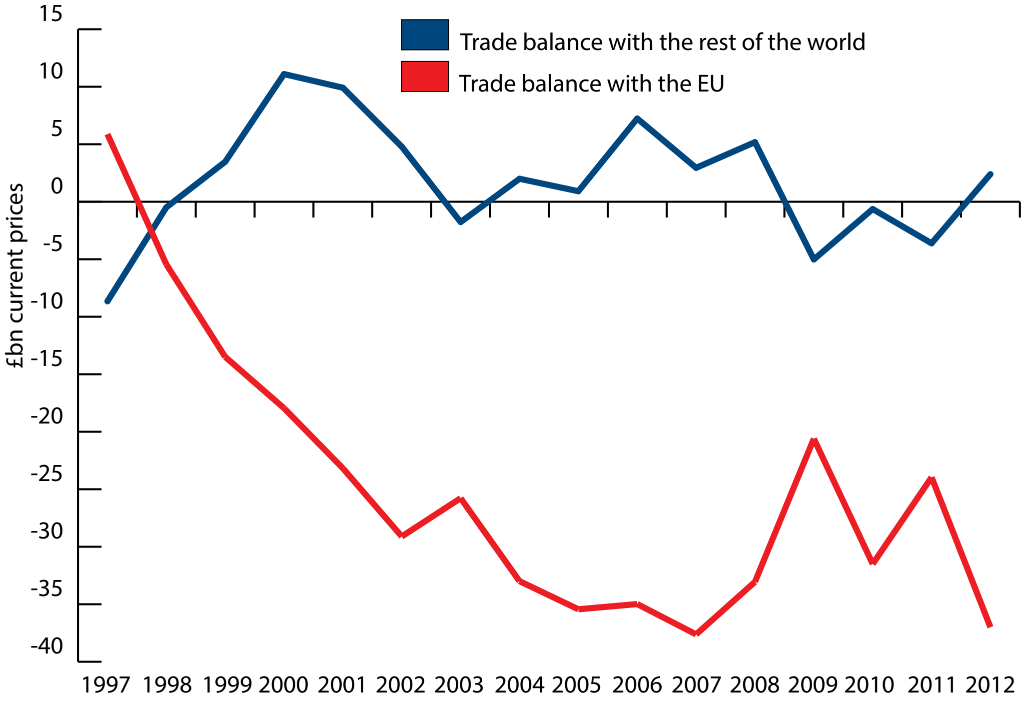

Chart 6:
The UK's trade balance with the EU and the rest of the world

Source: UK Office of National Statistics.

EEA membership: If Britain joined the European Economic Area (EEA), British firms would have unimpeded access to the single market and would continue to benefit from the EU's trade deals with other countries. But Britain would have no say over EU trade policy, and in order to qualify for EEA membership, the UK would still have to abide by EU regulations while enjoying very little input into the drafting of those regulations. EEA member-states largely experience 'regulation without representation'. And if an EEA member fails to implement a regulation, the EU can suspend its membership. Indeed, the UK could face increasing regulatory costs as a member of the EEA, because it would no longer be in a position to ensure that EU regulations were proportionate, and would have to abide by whatever the remaining EU members agreed between themselves. Furthermore, rules of origin would apply to British exports to the EU, and the administrative costs of working out the tariff costs of extra-EU imports can be large.[9] EEA states are not part of the CAP or the Common Fisheries Policy (CFP), but their agricultural exports to the EU face tariffs and can be subject to anti-dumping rules.

Customs union: An alternative to EEA membership would be a customs union of the kind that Turkey has with the EU. This arrangement is not really a 'union', as tariffs are decided in Brussels, with no Turkish input. Turkey must also follow the EU's preferential agreements with non-European countries. The UK would have no input into EU trade policy but would have to comply with it. Not only would British-based manufacturers have to comply with EU product standards, but the UK would have to abide by large sections of the EU's *acquis communautaire*. Failure to do so could lead to the suspension of market access or the imposition of anti-dumping duties. Customs unions are intended as precursors to full EU membership, even if in Turkey's case progress has been very slow since the union entered into force in 1995. It is hard to see how this would be the best relationship for the UK upon quitting the union.

Swiss-style: As irritation at 'Brussels interference' is at the heart of the eurosceptic case against EU membership, the UK would find it politically intolerable after leaving the EU to accept hand-me-down legislation as the Norwegians do in the EEA or the Turks do as part of their customs union. A Swiss-style relationship based on bilateral negotiations and agreements would be inherently more palatable. Switzerland's relationship with the EU rests on a series of bilateral sectoral agreements – 20 of them important, another 100 less so – and not all important sectors are covered. Switzerland has free trade in goods, but unlike the EEA it has no agreement with the EU on services. Swiss access is limited to those parts of the EU services market for which they have brokered sectoral agreements with the EU. The UK's financial services industry would face the same challenges as its Swiss counterpart; Switzerland has no accord with the EU on financial services, except for a 1989 agreement on non-life insurance.[10]

9: Rules of origin are used to determine the country of origin of a product, and therefore how much import duty is payable. British goods would be subject to tariffs if the non-EU share of the value of these goods exceeded certain levels (which vary for different products).

10: David Buchan, 'Outsiders on the inside: Swiss and Norwegian lessons for the UK', CER policy brief, September 2012.

The Swiss develop their legislation with the EU in mind, because they want to gain reciprocal access to the single market on the basis that their legislation is equivalent to that of the EU. But Switzerland has no common institutions with the EU to guarantee such equivalence. The UK would be free to negotiate bilateral trade agreements with non-EU countries, but these could prove less of a benefit than they appear (see below). Moreover, the Commission (and member-state governments) are increasingly frustrated with the Swiss arrangement as it involves constant renegotiation of bilateral agreements when EU legislation moves on. As a result, it might not even be possible for Britain to negotiate a comparable deal to the Swiss one.

A free trade agreement: The UK could leave the EU and sign a free trade agreement with it. Given the importance of the UK market to the eurozone, the UK would probably have little difficulty in negotiating an FTA. There is a good chance that the tariffs levied by the EU on British manufactured goods would be zero. However, an FTA with the EU would not leave Britain free to set its own regulations. As part of any deal with the EU to create an FTA, the EU would make demands on labour market rules and health and safety, and in all likelihood competition policy would be subject to mutual regulatory oversight. The deeper the trade agreement, the more EU regulation the UK would have to abide by. British manufacturers would certainly have to continue to comply with EU product standards and other technical specifications in order to sell their goods to other EU countries. In all likelihood, UK firms would continue to manufacture to only one set of product specifications determined by the EU, in order to avoid the costs associated with duplication. As with a customs union, the UK would still be subject to anti-dumping rules.

The UK might succeed in ensuring that any FTA with the EU included access to EU services markets. But at best that would only give Britain the same level of access that it currently enjoys; Britain would not be in a position to push for the further liberalisation of services trade. And without Britain pushing such liberalisation, progress within the EU would almost certainly be very slow. Services account for an unusually high proportion of total UK exports, so the country has much to gain from EU-wide liberalisation of services (in 2012 exports of goods and services totalled £475 billion, of which £193 billion were services). The UK's trade in services with non-EU markets might also be impaired if leaving the EU undermined the attractiveness of the UK as a financial hub and as a centre for business consultancy and other services: Britain's membership of the EU is important for many foreign investors in these sectors, but they also export to non-European markets from their UK operations.

What would be the potential benefits of Britain controlling its own trade policy? It is not always easy to find a consensus among 28 countries; some influential member-states are less enthusiastic free-traders than, say, the UK or the Netherlands. The European Parliament can exert some influence on the EU's FTAs, since a vote from MEPs is required to approve them, so EU trade agreements may on occasion be less liberal than the UK would like. Withdrawing from the EU altogether could potentially reduce the prices of imported goods from outside the EU, on the assumption that the UK reduced tariffs to below EU levels. Indeed, Britain might opt to have a unilateral free trade policy.

"It might not be possible for Britain to negotiate a comparable trade deal to the Swiss one."

However, the EU has signed numerous FTAs that have been liberal and beneficial to the UK and there are reasons to believe that the UK would be less successful in brokering comparable agreements on its own (see 'trade negotiations' below). Moreover, there is no guarantee that the UK would opt to reduce tariffs to zero if it were to quit the EU. For example, it is far from clear that the UK would choose to reduce agricultural tariffs more quickly than the EU. The British government may well decide to protect its agricultural sector in an effort to maintain domestic production and provide for food security. Britain's agricultural lobby is powerful and would press hard to keep hold of the privileges it enjoys through EU membership: generous financial support under the CAP and protection from more efficient producers.

Trade under WTO rules: Finally, if the UK balked at the requirements of a free trade area, it could opt to trade with the EU under WTO rules. The UK would not have to comply with EU regulations, but it would face the EU's Common External Tariff (CET) and substantial NTBs to trade. For example, food imports are subject to an average EU tariff of 15 per cent, while car imports face a 10 per cent tariff, and car components, 5 per cent.

Under this scenario, UK manufactured exports could be hit hard. For example, the EU is easily the biggest market for British car-makers, and the country's car components industry is fully integrated into pan-EU supply chains. Indeed, a much higher proportion of UK exports to the rest of the EU take the form of intermediate goods than is the case for Britain's exports to the rest of the world. These would be much less cost-competitive within Europe if they faced tariffs. UK goods exports to the EU would also be vulnerable to anti-dumping duties.[11]

11: Anti-dumping duty is charged in addition to normal customs duty and is applied across the EU. It is designed to allow the European Commission to take action against imported goods that are sold at less than their normal value – that being defined as the price for 'like goods' sold in the exporter's home market.

The implications of relying on only WTO rules for Britain's tradable services industries could be serious. The WTO has made little progress in freeing up trade in services (see 'trade negotiations' below), so British firms' access to the EU's services market would be limited. This scenario is much less likely than a FTA: very few trading relationships of the scale and complexity of the one between the UK and the EU are undertaken under mere WTO rules.

In summary, a Swiss-type arrangement, a customs union or EEA membership would not address the reason for the UK quitting the EU in the first place. The UK would still have to comply with the *acquis communautaire* in exchange for market access, but it would be powerless to influence the *acquis*.

In practice, the only option that would make any sense would be to go with as deep an FTA as possible with the EU, with all the constraints outlined above, and then try to sign as many bilateral trade agreements with non-EU countries as possible. This would be much harder than envisaged by Britain's eurosceptics. Much of the debate in the UK about the implications of a British exit from the EU for the country's trade and investment presupposes the existence of a flourishing multilateral trade system. The reality is rather different. Multilateral trade liberalisation has essentially stalled since the Uruguay Round came into effect in 1995. Emerging economies have assumed greater importance in the trading system and they are less committed to multilateralism than the mid-sized OECD countries they have supplanted. Preferential trade areas have become more important than multilateral trade policy, and as a result reciprocity has assumed greater importance. Finally, tariffs are no longer as important as non-tariff barriers to trade. These trends have a strong bearing on how the UK would fare outside of the EU.

"A Swiss-type arrangement or EEA membership would not address the reasons why the UK is dissatisfied."

Trade negotiations

The EU has a plethora of FTAs with third countries and a complex system of unilateral trade preferences. If Britain quit the EU, it would not inherit the EU's bilateral trade agreements; it would have to renegotiate trade agreements with non-European countries from scratch. Renegotiating these would be far from straightforward. The process would be time-consuming, leaving Britain's exporters facing higher barriers to trade, and for many countries negotiating a free trade deal with a relatively small economy like the UK would not be a big priority. Furthermore, the UK's administrative resources could be overstretched if it had to pursue a plethora of negotiations simultaneously.

Second, leverage is crucial to forcing open markets and leverage is about reciprocity: the concessions a country can make, that is to say what non-tariff barriers and tariffs it is prepared to cut. A relatively small and open economy such as the UK would enjoy little in the way of leverage. The EU's imports from China are seven times larger than the UK's. By virtue of its size (over a quarter of global output and a population of 500 million) the EU is in a strong position when it comes to trade negotiations: the bigger the domestic market, the greater an economy's negotiating power. British eurosceptics ignore the importance of reciprocity. If the EU was completely open it would have little leverage in trade negotiations.

Eurosceptics assert that the EU's ability to use its heft is undermined by its agricultural protectionism and the reluctance of its member-states to liberalise their services markets. They argue that the UK would find it easier than the EU to negotiate deeper free trade agreements, including substantive service sector access, because of the openness of its own service sector, its openness to trade and its lack of agricultural protectionism. But the CAP is less of an obstacle to multilateral trade liberalisation than it once was because price supports have been phased out. And it is hard to believe that the UK would, for example, have had more success in prising open India's services market on its own than as part of the EU. Overall, the EU has been adept at using its economic clout in negotiations with China, India and the US, for example. A UK outside of the EU might well be less effective. With the UK unable to offer much in exchange, would countries bother to negotiate with it?

The impact on investment

The UK is very successful at attracting foreign investment. It is home to a larger stock of EU and US FDI than any other EU member-state and is the preferred location for investment from the other markets. The rest of the EU has grown steadily in importance as a source of FDI for the UK: in 1997 EU countries accounted for 30 per cent of the accumulated stock of investment, but this proportion rose to 50 per cent in 2012. Over this period, the share accounted for by the US fell from 45 per cent to 28 per cent, and that of the rest of the world from 19 per cent to 14 per cent. In absolute terms, investment from all sources has risen strongly, but it has increased much faster from the EU than from anywhere else (the stock of EU FDI is now equivalent to 30 per cent of UK GDP.)

The UK undoubtedly derives considerable benefits from its openness to foreign investment, but foreign capital is more mobile than domestic capital. Foreign-owned businesses are more likely to relocate activity if they disagree with the direction of government policy than locally-owned ones. It is difficult to quantify what proportion of the UK's considerable inward stock of FDI in manufacturing and services depends on the country's membership of the EU. But it is also hard to dispute that leaving the EU would make the UK a less attractive investment location for firms intending to sell to other EU markets from their UK facilities, even if the UK succeeded in agreeing a wide-ranging FTA with the EU. EU membership is only one of a number of factors that firms consider when deciding between various locations, but faced with two potential locations with similar strengths, Britain's position outside the EU would be likely to count against it. After all, for some of these inward investors unrestricted access to the EU market is of pivotal importance.

Which forms of FDI would be most vulnerable? Manufacturing capacity is relatively easier to relocate because it is more capital intensive than service sectors where capital predominantly comes in human form: people are harder to move than machines. Manufactured goods also tend to be tradable and hence market access is highly important. Perhaps the most vulnerable sector would be car manufacturing – the part of the UK's manufacturing industry that is growing most strongly, and one which is almost entirely in foreign ownership. Factories would not close overnight, but it would be harder for firms to justify new investment in their British plants, and component suppliers could opt against building up industrial capacity in the UK. Both Nissan and Jaguar Land Rover – the sector's two biggest investors – have already indicated that a UK exit would reduce the attractiveness of the UK as a manufacturing base. The food industry is similarly highly integrated into the rest of the EU economy and likely to suffer in a similar way. Another major centre for foreign investment in the UK is the computer software industry. The factors which attracted foreign investors in this field to Britain, such as the availability of skilled labour and the English language, will remain if the UK leaves the EU. But would these firms continue to use the UK as a springboard to serve the wider pan-European market if they no longer enjoyed unrestricted access to that market?

The impact on the services sector would in all likelihood be less dramatic, not least because services as a whole are less tradable than manufactured goods. Foreign investment in service industries that serve the domestic market would be least affected. The tradable services sector would be less likely to leave the UK than the manufacturing industry, because it relies on large concentrations of highly skilled people, who are expensive to recruit and difficult to move. Nevertheless, the UK would no doubt lose attractiveness as a location for these kinds of businesses, and activity would gradually relocate from the UK to elsewhere in the EU. The most vulnerable sectors are almost certainly the financial and business services sectors: Goldman Sachs, one of the biggest foreign investors in this sector, has already made it clear that it would relocate business from London to other EU financial centres were the UK to quit the union.

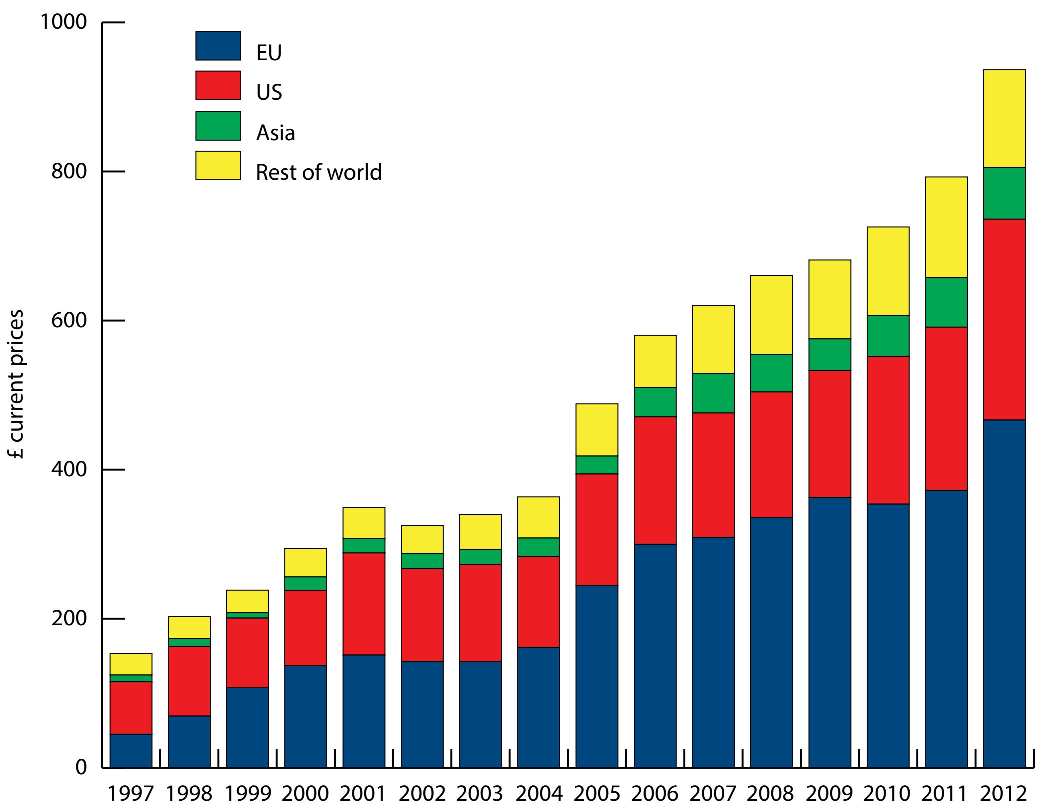

Chart 7:
The origin of foreign direct investment in the UK

Source: UK Office of National Statistics.

Is it not possible that the UK could become more attractive as an investment location if it quit the EU? For example, outside the Union would the British authorities not be free to reduce the cost of doing business in the UK, for example by lowering social and environmental standards? Would the UK not also be free to negotiate the kind of deep FDI agreements with non-European countries which elude the EU because of the differing interests of the various EU member-states? And could this not offset the loss of market access, leaving the UK more attractive as an investment location?

The UK would certainly be freer to introduce less onerous regulatory requirements for new technologies, such as nano-technologies, the life sciences, space vehicles and interactive robots. This could increase the attractiveness of the UK as an investment location for these sorts of activities.

But it is far from clear that an unencumbered UK would reduce environmental and social standards. 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. Secondly, any UK government would face fierce domestic opposition to any further erosion of labour and social standards. After all, the UK already has one of the most flexible labour markets in the OECD. It could, of course, choose to live without any equivalent to the EU's working time directive, but there is no evidence this directive has a deleterious impact on the attractiveness of the UK as a place to do business. And it would be a brave government that explained to Britons why they should lose their statutory right to four weeks' paid holiday a year.[12]

Moreover, any potential benefits from a reduction in regulatory costs would in all likelihood be more than offset by the greater difficulties in recruiting skilled foreign workers. A UK on the outside of the EU would in theory be free to run an open door immigration policy, but this possibility can be discounted because a major reason for British hostility to the EU is unrestricted EU migration. The UK would inevitably have a less open labour market, which would impose costs and difficulties on businesses.[13]

"The idea that the UK would be freer outside the EU is based on a series of misconceptions."

Finally, the UK would struggle to negotiate comprehensive international investment agreements for the same reason that it would struggle to broker favourable bilateral trade deals: the UK is already very open to foreign capital, so it would enjoy little leverage when it came to such negotiations. It might be able to come to an agreement with small, like-minded economies, but would struggle to gain better access to major emerging economies such as China and India.

Conclusion

The UK has very little to gain by quitting the EU and much to lose. Britain's interest lies in reducing the cost of trade with its largest trade partners – which the EU evidently does. The CER's model suggests that the country's membership of the EU's single market has boosted its trade in goods with the rest of the Union, and there is little evidence that trade overall has been diverted away from other major trading partners. While the single market for services has not been a great success – Britain's trade in services with the US has grown as quickly as with the EU over the last decade – leaving the EU would not reduce barriers to services trade. It may increase them, unless the EU granted Britain the same level of access to its services markets that is currently available.

While it is impossible to know exactly what terms a departing Britain could negotiate, it seems unlikely that all those trade gains would disappear: Britain and the EU would probably negotiate an FTA, although it is impossible to know how comprehensive it would be. But life would be uncomfortable on the outside: the UK would be powerless to push for liberalisation of EU services markets; it would find that in some sectors, inward investors would switch their money to countries inside the EU; and it would find it very difficult to negotiate trade agreements with non-EU countries as comprehensive as those that the EU regularly agrees.

The idea that the UK would be freer outside the EU is based on a series of misconceptions: that a medium-sized, open economy could hold sway in an increasingly fractured trading system, dominated by the US, the EU and China; that the EU makes it harder for Britain to penetrate emerging markets; and that foreign capital would be more attracted to Britain's economy if it were no longer a part of the single market. The UK should base policy on evidence, which largely points to one conclusion: that it should stay in the EU.

12: Katinka Barysch, 'The working time directive: what is all the fuss about?' CER policy brief, May 2013.

13: John Springford, 'Is immigration a reason for Britain to leave the EU?' CER policy brief, October 2013.

Appendix: The CER's gravity model

In the 1960s, Dutch economist Jan Tinbergen discovered that there is a close analogy between Newtonian physics and trade flows. Newton discovered that the gravitational force between two objects is proportional to their mass and the distance between them. Tinbergen found that trade flows between two countries are proportional to their GDP and the distance between them.

Since Tinbergen's discovery, trade economists have refined the gravity model so that it is possible to estimate the impact of trade agreements on the size of trade flows. There are two ways to do so.

One is to try to add as many determinants of trade into the model as possible, including population growth; measures of distance; whether one country has been the colony of another; whether two countries speak the same language; whether a country is landlocked; and so on. Once all of these factors are isolated, it is possible to determine whether trade between two countries that have signed a trade agreement is larger than the model predicts. This would provide evidence that EU membership is creating trade between the UK and the other members of the Union.

The problem with this approach is that it is very difficult to add all of the determinants of trade into the model. Some are unobservable. Trade between two countries is strongly affected by policy – such as the extent to which an economy is protected from foreign imports. The extent of protection is difficult to quantify. Without taking these effects into account, the model can produce biased results.

Therefore, the CER has used a 'fixed effects' model. We took panel data from 181 countries between 1980 and 2010. Using data for the same countries over many years, it is possible to control for the variables that affect trade that are not observable.

The equation for the model is:

$$\ln(X_{ijt}) = \beta 1 \ln(Y_{jt}) + \beta\, 2 \ln(R_{jt}) + \beta 6 EU_j + \beta\, 7 TT_j + u_{jt} + \varepsilon_{ij}$$

Where **X** is bilateral total trade in deflated US$ between the UK and country j
Y is country j's GDP measured in constant 2005 US$
R is the nominal exchange rate of country j's deviation from purchasing power parity
EU is a dummy variable for EU members, with new members coded as 1 the year they joined
TT is a dummy variable for the UK's 30 largest non-EU trade partners
u signifies time-varying country-specific fixed effects
ε is an error term

The data sources were: IMF Direction of Trade Statistics for trade data; World Bank Development Indicators for GDP in 2005 dollars; the Penn World Tables for the nominal exchange rate's deviation from purchasing power parity; and the CEPII Geodist database for the measures of distance, and the dummy variables for colony and common language. The IMF trade data was deflated using the Fund's US dollar GDP deflator.

Standard errors were adjusted for heteroscedasticity.

Table of results

R2 = 0.86
F = 625.38 on 7 and 4948 degrees of freedom
p = < 0.0001

	Estimate	Std. error	t-value	p-value
Y	0.97	0.08	12.70	<0.0001***
R	-0.26	0.07	-3.67	0.0002***
EU	0.44	0.05	9.15	<0.0001***
TT	0.27	0.57	0.48	0.63

*** = significant at the 0.01 level*

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January 2014