

The economic consequences of leaving the EU

The final report of the CER commission on the UK and the EU single market



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About the CER

The Centre for European Reform is a think-tank devoted to making the European Union work better and strengthening its role in the world. The CER is pro-European but not uncritical.

We regard European integration as largely beneficial but recognise that in many respects the Union does not work well. We also think that the EU should take on more responsibilities globally, on issues ranging from climate change to security. The CER aims to promote an open, outward-looking and effective European Union.

About the CER commission on the UK and the EU Single Market

The economic case for British membership of the EU has always rested on the country's participation in the single market. After British prime minister David Cameron pledged a referendum on the UK's continued membership of the EU, the CER invited leading economists, commentators, business people and EU experts to form a commission to consider the economic consequences of leaving the EU. Commissioners shared ideas and advice in a series of commission meetings, and commented on drafts of the final report.

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Summary

The Conservative party has promised a referendum in 2017 on the UK's membership of the EU. Opinion polls show that Britons are split on the issue – although recently, more have said they would vote to stay in than leave the Union.¹ The possibility that Britain might quit the EU prompted the Centre for European Reform to invite leading economists, journalists, business people and EU experts to form a commission, to discuss the economic consequences of such a move. This is the commission's final report.

The standard critique of the UK's membership of the EU is this:

- ★ The EU does little to open markets on the continent, and so creates few opportunities for British exporters. It follows that leaving the EU would have little impact on Britain's European trade.
- ★ EU rules tie up the British economy in red tape, and constrain the UK's ability to tap faster-growing markets outside Europe. A British exit would boost output by reducing the burden of regulation on business, and by freeing Britain to sign more free trade agreements with countries outside Europe.
- ★ If Britain left the EU, it would win back its net contribution to the EU's budget, which the Treasury estimates will be 0.5 per cent of GDP per year between 2014 and 2020.
- ★ Immigration from the EU diminishes Britons' employment prospects, and requires the British taxpayer to subsidise public services and provide welfare benefits for newcomers.

There are four reasons why these claims are ill-founded, and are a poor rationale for leaving the Union. First, the level of economic integration between the UK and the rest of the EU is very high, so healthy doses of competition and investment from elsewhere in the EU help to raise British productivity. Second, EU rules do not place large burdens on the

¹: YouGov, EU referendum voting intention tracker poll. <http://yougov.co.uk/news/2014/03/11/how-people-would-vote-eu-referendum/>

British economy as a whole, or large constraints upon British exports to countries outside Europe: 'Brexit' would not be an economic liberation. Third, EU markets are of such importance to national prosperity that after a vote to leave, British negotiators would try to secure access to them. The experience of countries like Norway shows that this would involve accepting many of the rules of the single market, and a contribution to the EU's budget, but with little influence on EU decision-making. Fourth, there is little evidence that migrants from elsewhere in the EU reduce Britons' job prospects or their wages. A smaller proportion of EU immigrants receive benefits than do Britons, and EU migrants are net contributors to the public finances, helping to pay for the pensions and healthcare of an ageing society.

The scale of UK-EU integration

The economic aim of the EU is to deepen integration between member-states' economies. Since trade between EU member-states is tariff-free, the EU has focussed on the non-tariff barriers to trade that arise from 28 different sets of national regulations. (It has done so by creating common minimum standards and getting member-states to recognise each other's rules. For example, a British lawn-mower can now be sold across Europe, without having to comply with 28 different standards.)

Has this approach worked? Britain's trade with fast-growing emerging economies, such as China, has been increasing more rapidly than with the EU. But this does not tell us whether the single market programme has been effective. British exports to China have been growing faster than its exports to France simply because the Chinese economy has been growing more rapidly.

The only good way to evaluate the worth of the single market is to measure UK trade with countries inside the EU and outside, and then control for economic size and other factors that affect trade, such as geographic distance. It is then possible to assess whether British trade with other EU member-states is higher than one would expect, given the size of their economies and their proximity.

★ The CER constructed such an economic model. It shows that Britain's EU membership has boosted its trade in goods with other member-states by 55 per cent. In 2013, Britain's goods trade with the EU was £364 billion, so this 'EU effect' amounted to around £130 billion.² By

2: HM Revenue and Customs, UKtradeinfo data.

comparison, the value of Britain's bilateral trade with China was £43 billion that year.

Britain is highly integrated with the rest of the EU's economy in other ways.

★ In 1997, other EU member-states accounted for 30 per cent of the accumulated stock of foreign direct investment (FDI) in Britain; this proportion had risen to 50 per cent in 2012.

★ In 2012 – at the height of the eurozone crisis – the value of UK banks' assets held in the eurozone was 70 per cent higher than their US assets, despite the eurozone's economy being only three-quarters the size of the US economy. The City of London has been a major beneficiary of the single market in financial services and the euro: the eurozone is a much larger market for lending originating in Britain than its economic size would suggest.

Would Brexit liberate Britain?

There can be little doubt that some of the EU's regulations impose more costs than benefits. But many of its regulations are justified: there would be no single market without them. Moreover, European rules are not a major constraint upon Britain's economy.

★ According to OECD data, Britain has the second least regulated product markets in the developed world, after the Netherlands. Both are EU members.

★ The OECD's labour market protection index shows that Britain has similar levels of labour market regulation to the US, Canada or Australia – and far lower than continental European countries. EU employment rules therefore do little to inhibit Britain's flexible labour market.

★ It follows that leaving the EU and 'de-Europeanising' British regulation would do little to boost its economy.

In any case, Britain would find it difficult to avoid EU regulation even if it left the club. Outside the Union, the UK would lose access to the single market unless it signed up to EU rules. Membership of the European Economic Area (EEA) would resolve little. This group, which includes

Norway, Iceland and Liechtenstein, has full access to the single market, but must sign up to all of its rules despite having little say in their drafting. The Swiss relationship is not much better: while it has a set of bilateral accords to give it access to some parts of the single market, it must regularly update its standards to match those of the EU, or risk a suspension of access. Were Britain to sign a free trade agreement with the EU, the latter would insist that British exports to the continent met EU product standards. And Britain would only be given full access to EU financial services markets if it matched EU rules. As access to the single market is of critical importance, Britain might perversely be left in a position where it would have 'EU regulation without representation'.

Indeed, outside the EU, the UK could end up with little control over financial rules. The EU insists that non-members' regulations are equivalent to their own, in return for limited access to the single market. The City of London – the eurozone's largest wholesale financial centre – would be unlikely to enjoy unfettered access to eurozone financial markets if it were outside the Union. Eurozone authorities prefer wholesale activities – trading and lending between banks, rather than between banks and customers – to be conducted under their watch. The British government has taken the European Central Bank to the European Court of Justice over its attempt to make clearing houses specialising in euro-denominated trading relocate to the eurozone. If it left the EU, and did not join the EEA, the UK would have little recourse to institutions that police the single market. Banks, exchanges and private-equity and hedge funds would relocate some of their activities to Frankfurt or Paris.

But does the EU not hold back Britain's trade with non-European countries, by imposing tariffs on their goods, for example? The CER's trade model offers no evidence that Britain imports less from outside the EU because of EU protectionism. Nor does the EU constrain exporters: Germany's exports to China have grown so rapidly that China is now its third largest trading partner after the rest of the EU and the US. And as multilateral trade negotiations have broken down, bilateral 'free trade' agreements have grown in importance. In such agreements, economic size matters: it is difficult to imagine the US contemplating such a far-reaching agreement as the Transatlantic Trade and Investment Partnership, a major EU-US trade deal that is currently under negotiation, with Britain alone.

Fiscal gains?

Ending Britain's contribution to the EU budget is the most easily quantified benefit from leaving the Union. However, the same trade-off applies: the EU insists that the price of unfettered market access is a fiscal contribution to the EU. EEA members and Switzerland help to fund the economic development of the poorer eastern half of the Union, by paying for infrastructure, R&D and training projects. If the UK were to pay into the EU budget upon the same basis as the Norwegians or the Swiss, its net contribution would fall by 9 per cent or 55 per cent respectively.

By quitting the EU, the UK could also leave the Common Agricultural Policy, which through its tariffs and subsidies drives up the cost of food for British consumers. But it would find it difficult to slash agricultural subsidies to zero. Wales and Northern Ireland are net beneficiaries of the EU budget. Their economies, particularly in rural areas, would suffer from the loss of agricultural subsidies and regional development funds, and the British government would have to make up at least some of the shortfall.

Free migration is a benefit for Britain

Alongside frustration at regulation from 'Brussels', high levels of immigration from Central and Eastern Europe are the other main cause of British dissatisfaction with EU membership. Many fear that Central and East Europeans are damaging the employment prospects of low-skilled Britons and driving down wages. There is very little evidence that this is the case. And many Britons forget that there are many high-skilled European immigrants in the UK, who raise British workers' productivity and hence their wages. But academic research shows that the combined impact of high- and low-skilled immigrants on British wages is small, and so immigration from the EU does not constitute a major reason to stay or to leave.

However, EU immigration is good for the public finances, as immigrants pay more in taxes than they receive in public spending. There are some costs that arise from higher demand for housing and public services. But current levels of immigration help Britain to deal with the costs of an ageing population, by replacing retiring workers, and by raising more taxes to pay for health and pension costs. Since hostility

to immigration is pushing Britain towards the exit door, it is likely that the UK would restrict immigration from the EU upon exit. This would require Britain to increase taxes or cut spending.

Moreover, British people can live freely elsewhere in the EU, and this is a major benefit for the 1.8 million people who do so. The EU's very large labour market gives Britons a bigger range of jobs to choose from. If their skills are in shorter supply in another member-state than they are in the UK, their income may be higher than if they stay put. And the rest of the EU – particularly France and Spain – is a major destination for British retirees: over 400,000 are living in other EU member-states.

In short, the high degree of economic integration between the UK and the EU will always require some system of shared governance. The EU will not allow the UK, upon leaving, to have the same level of access that it now has without paying a price. Britain will not be able to leave the EU and remain in the single market, unless it is willing to sign up to EU rules that it did not help to write.

Introduction

Over the last few years, the probability that Britain may leave the EU has grown. In December 2011, British prime minister David Cameron refused to sign the EU's 'fiscal stability treaty', after other member-states rejected his demands for safeguards for the City of London. In October 2012, his government announced that Britain intended to opt out of many areas of European justice and home affairs co-operation. And in January 2013, Cameron offered the British public a referendum on EU membership in 2017, if the Conservatives win the 2015 general election. The UK Independence Party won the 2014 European Parliament election.

Membership of the EU cannot be weighed solely in pounds and pence. But any decision about membership will inevitably be shaped by the economic costs and benefits. Unfortunately, the British debate has lacked objective analysis of these, with both 'outs' and 'ins' using evidence selectively to make their case.

Reports of varying quality have attempted to calculate the costs or benefits of exit. Liberal Democrat politicians have repeatedly said that three million jobs are at risk if Britain leaves. This claim was made a decade ago in a paper that tried to establish how many Britons were employed by firms that exported to the rest of the EU, or were involved in those firms' supply chains.³ Critics are right to point out that Britain would continue to export to the EU if it left, and so not all of these jobs would be lost. Indeed, in the long run employment levels would be largely unaffected: the number of jobs in an economy is mostly determined by the number of working-age people and how effectively the labour market matches workers and employers. However, if the consequence of a British exit were lower levels of British trade and foreign direct investment, this would reduce national income: British workers would be less productive.

Researchers who argue that Britain should leave the EU have, by and large, pursued a different method: add up the alleged regulatory costs

3: Brian Ardy et al, 'UK jobs dependent on the EU', South Bank University European Institute and NIESR, 2000.

of EU membership, the Common Agricultural Policy (CAP) and the UK's net contribution to the EU budget. Some add in the impact of the EU's tariff regime on British import prices. But they tend to ignore or dismiss any of the benefits, including the EU's main economic aim, which is to increase trade and investment flows between its member-states.⁴

More sophisticated researchers have used a macroeconomic model to try to calculate the impact of exit. Researchers at the National Institute of Economic and Social Research estimated that leaving the EU would permanently reduce UK GDP by 2¼ per cent, largely because of reduced foreign direct investment.⁵ But as the authors said, "quantifying the impact of withdrawal from the EU on the UK economy is a very difficult task given the range of factors that need to be considered." And to come up with their figure, they assumed that the UK would leave the EU entirely and not sign a deal to secure some access to the single market, even if that were partial. Such a quantification will always be highly uncertain, as the UK would try to negotiate a deal after a vote to leave the EU, and it is not possible to know how comprehensive that deal would be.

Rather than trying to quantify the net cost or benefit of exit in a single number, the CER's commission on the UK and the EU single market has taken a different approach. It has focussed on the choices that Britain would face in negotiations after having voted to leave the Union.

The CER invited a group of politicians, economists, business people and economic commentators to consider what the implications of leaving the EU might be for:

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

4: Tim Congdon, 'How much does the European Union cost Britain?', UK Independence Party, 2012; Ian Milne, 'A cost too far? An analysis of the net economic costs and benefits for the UK of EU membership', Civitas, 2004; Patrick Minford et al, 'Should Britain leave the EU?', Institute of Economic Affairs, 2005; Iain Mansfield, 'A blueprint for Britain: Openness not isolation', Institute of Economic Affairs, 2014.

5: Garry Pain and Nigel Young, 'The macroeconomic impact of UK withdrawal from the EU', Economic Modelling, 2004.

The UK is part of the EU's single market – a programme to open national goods, services, financial and labour markets to competition. Britain's 'external' trade policy – commerce with countries outside the EU – is managed by the European Commission. Therefore Britain's trade, migration, international finance and regulatory policies are – at least in part – made in negotiation with other member-states.

Each chapter in this report provides evidence of the effects – positive and negative – of EU policies. But leaving the EU would not necessarily turn benefits into costs and vice versa. After a vote in favour of leaving, the UK and the EU would enter into negotiations. The British would be faced with a trade-off: regulatory sovereignty or unimpeded market access. The EU insists that 'third countries' outside the Union accept its regulations and help to pay for the development of the EU's poorer regions in return for unfettered access to the single market. The countries of the EEA – Norway, Iceland and Liechtenstein – accept all of the rules of the single market, while the Swiss have agreed to all of the rules of the single market for trade in goods (but not services).

The purpose of this report is to try to clarify the choices British negotiators would face upon exit: between escaping EU regulations and budgetary contributions, and maintaining access to the single market; between scrapping financial regulations and maintaining the City of London's status as Europe's largest financial centre; and between maintaining the rights of British migrants in the EU and curbing immigration from Europe.

Chapter 1

Trade and investment

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 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.

David Cameron's referendum promise has reignited the 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. 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 EU single market is any longer a matter of overriding national interest.

This chapter provides a brief overview of the changing nature of global trade, and Britain's place within it. It then considers whether the single market has boosted Britain's trade and investment with the EU. Finally, it discusses the ramifications of leaving the Union for Britain's trade and its attractiveness as a location for investment.

1.1 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 fell steadily, reducing the cost of trade. Governments have also reduced 'non-tariff barriers' to trade – the different national regulations, quotas and protections that make it difficult for exporters to penetrate foreign markets.

Trade has grown between rich countries, and between the developed and developing world. 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. And recently, some emerging economies have been moving into higher value markets.

Does the rise of emerging economies make Britain's EU membership less important? 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, and a British exit could free the country to pursue more – and more comprehensive – trade agreements with emerging economies.

This argument ignores the fact that trade has also grown swiftly between rich countries (it is of far higher value than developed-developing world trade, and will be for years to come). This suggests that comparative advantage is not the only cause of expanding global trade. 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. Both countries faced a far more benign international environment than now confronts China.

Europe has become 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 1.1).

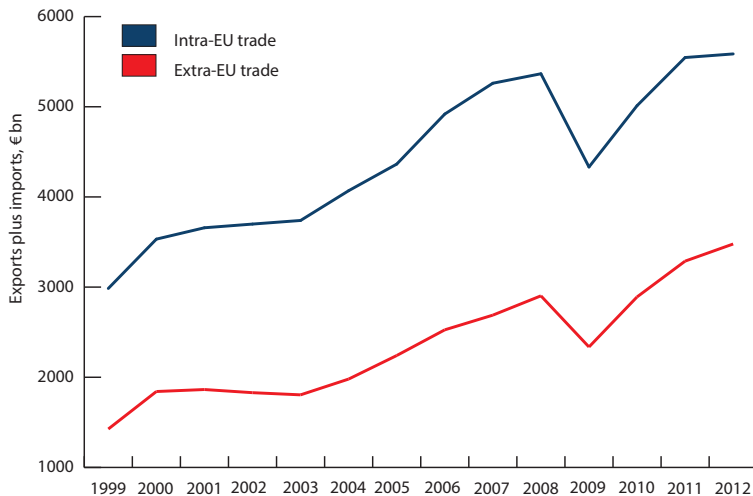


Chart 1.1:
Trade
between
member-
states of
the EU and
between the
EU and the
rest of the
world

Source:
Eurostat.

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?

1.2 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 across the single market. It also harmonises product regulations. This means that exporters no longer have to make 28 distinct products 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 would gain by leaving the single market.

Britain's trade with countries outside the EU is growing. Chart 1.2 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.

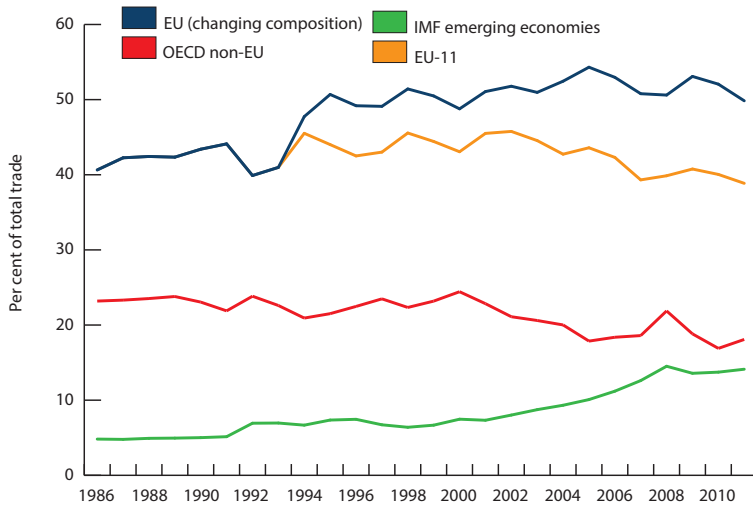


Chart 1.2:
Trends in UK
trade with
the EU and
the rest of
the world

Source:
*International
Monetary Fund,
Direction of Trade
Statistics.*

Similarly, the fact that the EU remains the UK's largest trading partner might have nothing to do with Britain's EU membership. It is unsurprising 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 probably be its largest trading partners in the absence of the single market. These aggregate trade 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 their proximity and developed economies. 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.

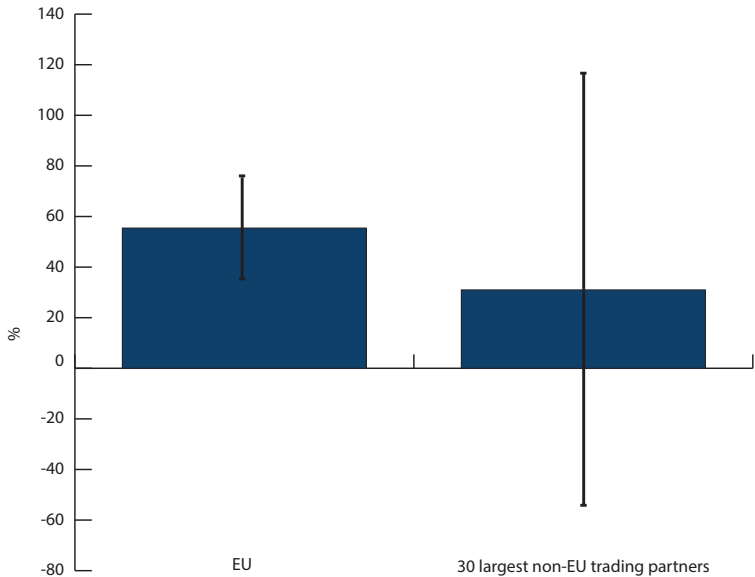
To capture the effect that membership of the EU has on UK trade, factors that determine the amount of trade between countries must be controlled for: economic size, distance from Britain, whether the trading partner's citizens speak English and so on. If these factors are held constant and Britain still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

The CER has 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 by 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 (see Chart 1.3).⁶ In 2013, Britain's bilateral goods trade with the EU was £364 billion, so this 'EU effect' amounted to around £130 billion.⁷ By comparison, the value of Britain's bilateral trade with China was £43 billion that year.

Chart 1.3:
Goods trade
created and
diverted
by Britain's
membership
of the EU

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



But is this trade merely diverted from outside the EU? The EU's tariffs might reduce UK imports from outside Europe, by making them more expensive than imports from the EU. The second bar of Chart 1.3 shows that the model found no evidence that British trading patterns have been diverted from outside to inside the EU. If the UK traded less with its 30 largest non-EU trading partners than the size of their economies, their distance from the UK, and other factors would suggest, the result would have been negative. The model estimated that UK membership of the EU might increase its trade with its 30 largest non-EU trading partners, although this result was statistically insignificant.⁸

6: 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 1.3. 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.

7: HM Revenue and Customs, UKtradeinfo data.

8: This means that the model could not be sure that the result was greater than zero.

However, the model lumps together many different types of goods. 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.⁹ 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.¹⁰

Nonetheless, the evidence accords with the 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?

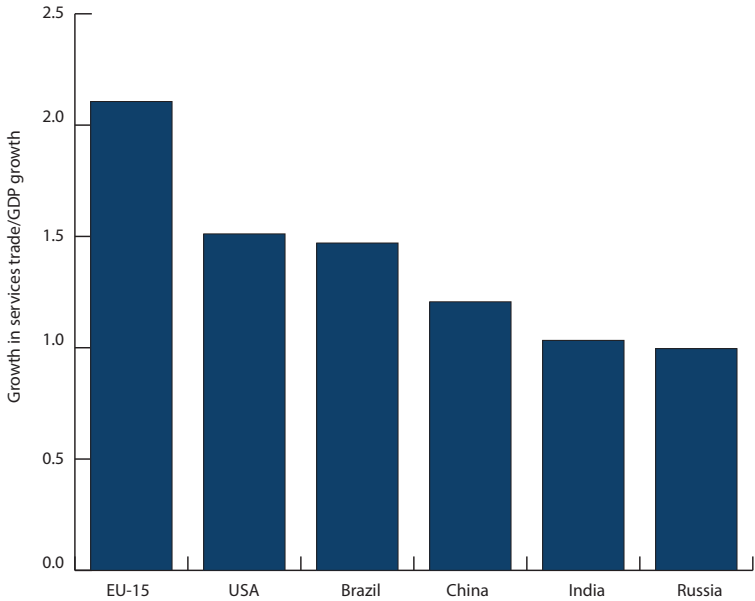
Britain's services trade with the EU has grown at slightly more than twice the rate of EU economic growth since 1998 (see Chart 1.4) – a faster rate than with most other countries and regions. (Since fast-growing economies trade more with each other, the only way to tell whether efforts to free up trade are working is to compare the rates of growth in services trade and GDP.) Services trade with the US grew by a similar amount over this period (around 6 per cent per year), but this translated into only one-and-a-half times the rate of US growth. 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.

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

10: World Bank weighted average tariff data.

Chart 1.4:
UK services
trade growth
with major
partners,
1998 to 2013

Source:
CER analysis of
ONS Pink Book
and IMF World
Economic Output
data.



However, while Britain's services trade has grown faster with the EU than with any other region, it 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.¹¹

The data for foreign direct investment (FDI) 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 1.5). 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. 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.

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

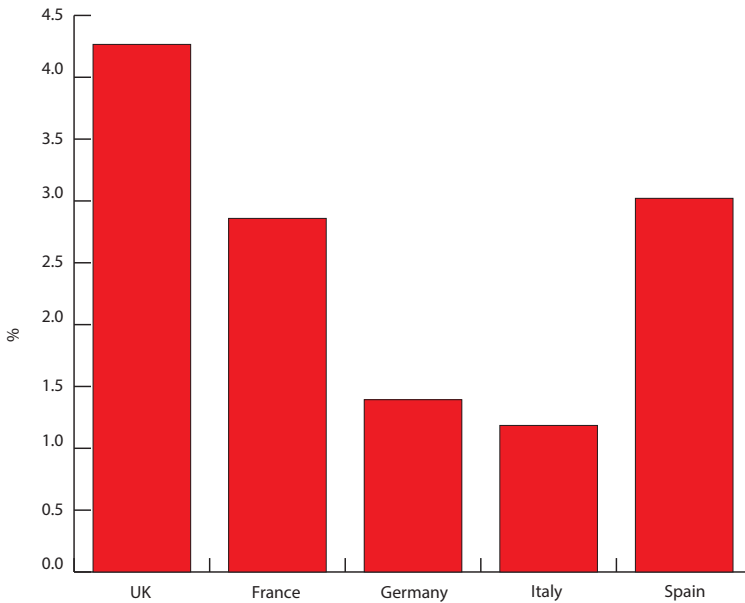


Chart 1.5:
Average
annual
inward
foreign direct
investment
from non-
European
OECD
countries,
2001-11

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.¹² (See Chapter 3 for more details on this sector.) 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 the US and other EU member-states (see Chart 1.7 on page 35).

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 while services integration has been slow, the UK has been the largest beneficiary of foreign direct investment from outside the EU seeking a country within the single market as a base. But would a British exit from the EU mean that these gains would be lost?

¹²: OECD, inward foreign direct investment statistics.

1.3 The consequences of exit for British trade

Advocates of 'Brexit' claim that Britain would have little trouble negotiating a free trade agreement with the EU once it left, 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. These arguments are simplistic and misleading.

“The UK will not be able to dictate exit terms to the EU because it is running a trade deficit.”

The EU is certainly a less important market for the UK than it was, and likely to remain so for as long as the eurozone fails to engineer a sustained economic recovery. 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.

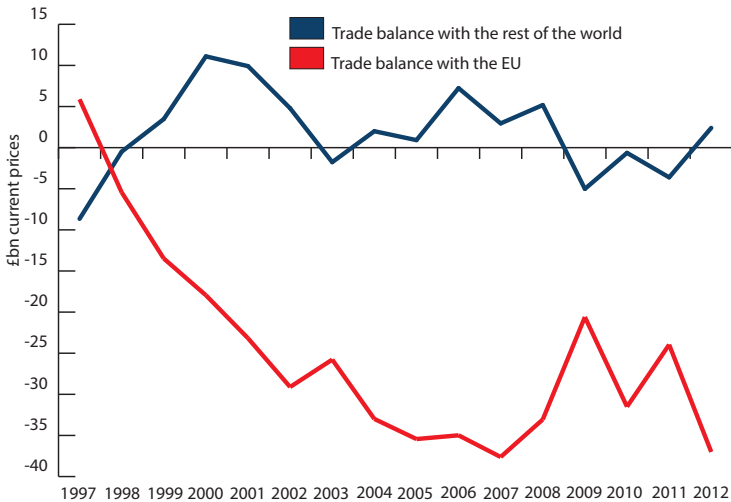


Chart 1.6:
UK trade
balance with
the EU and
the rest of
the world,
1997-2012

Source:
Office of National
Statistics.

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 post-EU Britain, and that it would have potentially far-reaching implications for the country's trade and investment.

1.4 Alternative arrangements

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 EEA (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.

EEA membership: If Britain joined the 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 origin¹³ 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. 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. A customs union eliminates internal tariffs, but requires member-states to agree common tariffs with countries outside. But the EU-Turkey 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 customs union entered into force in 1995. It is hard to see how this would be the best relationship for the UK upon quitting the EU.

Swiss-style: As irritation at 'Brussels interference' is at the heart of the 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

¹³: Rules of origin are used to determine the country of origin of a product, and therefore how much import duty is payable.

union. A Swiss-style relationship based on bilateral negotiations and agreements would be 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 with the EU, 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.¹⁴

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 'Trade negotiations' below). Moreover, the Commission (and member-state governments) are increasingly frustrated with the Swiss arrangement, which 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 (FTA): The UK could leave the EU and sign a free trade agreement with it. Trade with the EU would be tariff-free, but Britain could set its own trade policies with non-European countries, unlike a customs union. 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.

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

The UK might succeed in ensuring that any FTA with the EU included access to EU services markets – but this would be difficult, given the UK's large surplus in services with the rest of the EU. At the very best, such an FTA would 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. (In 2013, exports of goods and services totalled £506 billion, of which £202 billion were services.¹⁵) 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, law and accounting. 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 (see Chapter 3 for more details).

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.

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 quit 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.

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 non-tariff barriers to trade. For example, food imports are subject to an average

¹⁵: ONS UK trade data.

EU tariff of 15 per cent, while car imports face a 10 per cent tariff, and car components, five per cent.

Under WTO rules, 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. Such goods would be less competitive within Europe if they faced tariffs. And UK goods exports to the EU would also be vulnerable to anti-dumping duties.¹⁶

The implications of relying on only WTO rules for Britain's tradable services industries could only be serious. The WTO has made little progress in freeing up trade in services, so British firms' access to the EU's services market would be limited. This scenario is much less likely than an 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 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.

¹⁶: 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.

1.5 Trade negotiations with non-European countries

The EU has a plethora of FTAs with third countries and a complex system of unilateral trade preferences. If Britain leaves, it will not inherit the EU's bilateral trade agreements; it will 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 uncertainty over market access, which would reduce investment. For many countries, negotiating a free trade deal with the UK would not be as important as an FTA with the EU, given the difference in market size. Furthermore, the UK's administrative resources could be overstretched if it had to pursue several negotiations simultaneously.

Second, leverage is crucial to forcing open markets, and leverage is about concessions: what non-tariff barriers and tariffs a country is prepared to cut. An 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. If the EU was completely open it would have little leverage in trade negotiations.

Consider the Switzerland-China FTA, signed in 2013. It is not truly a free trade agreement. Switzerland has agreed to eliminate tariffs on the vast majority of Chinese imports immediately. China has promised to reduce tariffs on some goods over a five to 15 year period. For example, tariffs on Swiss wrist watches will be gradually reduced from the current rate of 11 per cent to a preferential rate of 4.4 per cent over ten years. The Chinese insisted that there be a review of the agreement every two years, which would allow them to change the terms of the deal.¹⁷

Is the EU's ability to use its heft undermined by its agricultural protectionism and the reluctance of its member-states to liberalise their services markets? Some 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 commitment to free 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

¹⁷: Wenfei Attorneys-at-law, 'A practical guide to the new free trade agreement between Switzerland and China', December 2013.

in prising open India’s services market on its own than as part of the EU. With the UK unable to offer much in exchange, would countries bother to negotiate with it?

1.6 The impact on investment

The UK is 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. In absolute terms, investment from all sources has risen strongly, but it has increased much faster from the EU than from anywhere else. 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 (see Chart 1.7) 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. (The stock of EU FDI is now equivalent to 30 per cent of UK GDP.)

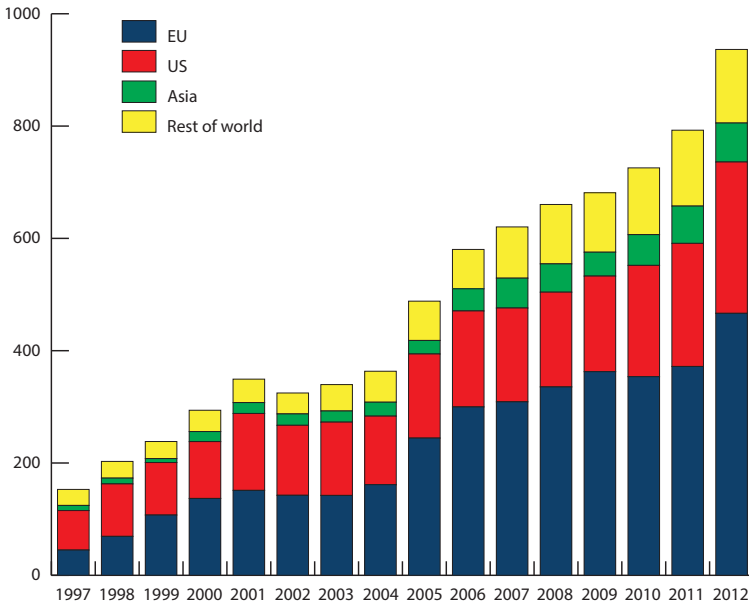


Chart 1.7:
The origin of
foreign direct
investment
to the UK

Source:
Office of National
Statistics.

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 stock of inward FDI in manufacturing and services depends on the country's membership of the EU. Many factors shape investment decisions: the quality of the legal system; the country's skills base; how quality of regulation; tax rates; and access to markets. 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. 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.

“Brexit would make the UK less attractive to foreign firms that intend to sell to other EU markets.”

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 also highly integrated into the rest of the EU economy and would be 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. Firms in the tradable services sector would be less likely to leave the UK than those in manufacturing, 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 some activity, particularly in the financial sector, would gradually relocate from the UK to elsewhere in the EU (see Chapter 3).

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.

In conclusion, 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, 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.

Chapter 2

Regulation

Some EU rules impose more costs than benefits on British businesses. But overall, European regulation does not prevent Britain from having one of the most lightly regulated economies in the OECD.

'De-Europeanising' British regulation would not therefore lead to large gains in economic output. And outside the EU, the government would find it difficult to repeal much EU environmental and social legislation, even if it wanted to.

EU regulation is intended to create a single market, so that exporters do not have to comply with 28 different standards. If Britain wanted to continue to export to the rest of the EU, its exports would have to match EU standards. And if the UK joined the European Economic Area, or persuaded the EU to give it an *à la carte* relationship with the single market, the government would have to continue to sign up to social and environmental rules.

Arguments over regulation are a central feature of the antagonistic British relationship with the EU. To many Britons, continental Europeans are more inclined to regulate markets than the UK, and 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.¹⁸

It is true that the EU is to a large extent in the business of regulation. It is also the case that some rules emanating from Brussels impose more costs than they confer benefits. The Commission, which proposes EU legislation, has made some progress on its 'better regulation' agenda, as the British government has acknowledged.¹⁹ 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.²⁰

18: David Myddelton et al, 'Saying No to the Single Market', Bruges Group, January 2013.

19: UK government response, 'Stakeholder consultation on smart regulation in the EU', 2012.

20: Charles Grant et al, 'How to build a modern EU', CER report, October 2013.

Still, Britain has the power to shape 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. The British government, alongside Ireland and the Netherlands, the Nordics and some member-states in Central and Eastern Europe, is comparatively economically liberal, and is a sceptical participant in the EU's regulatory process. But many EU member-states have a greater appetite for

regulating markets than the UK.

The upshot is that the British government must sometimes implement EU rules that are more burdensome than those it would have chosen itself.

“It is very difficult to calculate the ‘net cost of Europe’ by adding up the effects of EU rules.”

Some examples of recent directives and regulations that impose more costs than benefits include:

★ the ‘agency workers directive’, which gives temporary workers the same rights to equal pay and working conditions as permanent staff. According to the British government’s impact assessment, this directive has a net cost of £490 million a year (in 2010 prices).²¹

★ the ‘waste electrical and electronic equipment directive’, which requires member-states to promote the recycling of electrical goods. The British government calculated this would have a net cost of between £161 and £227 million a year (in 2007 prices).²² According to its impact assessment, the savings from recycled materials and the reduced use of landfill would not exceed the cost of collection.

However, it is an extremely difficult task to add together the economic effects of 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, calculated that EU rules lead to marginally more benefits for the British economy than costs.²³ However, all impact assessments are highly uncertain estimations, and many do not calculate benefits, as these can be difficult to quantify.

21: UK Department of Business, Innovation and Skills, ‘Impact assessment: European Parliament and Council directive on working conditions for temporary workers’, January 2010.

22: UK Department of Trade and Industry, ‘Partial regulatory impact assessment for the WEEE regulations’, 2006.

23: Open Europe, ‘Still out of control? Measuring eleven years of EU regulation’, June 2010.

Meanwhile, the method favoured by some 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.²⁴ 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.

2.1 Why the EU regulates

Regulations can and do impose costs on companies, and ultimately on consumers, because companies usually pass on these costs. When they are badly designed, such costs can be unnecessary and damaging. But there are legitimate reasons why governments regulate markets. One of these is that markets are not perfect: they sometimes fail, producing sub-optimal outcomes. An unregulated free 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 largely absent from 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.²⁵ But a deepening of 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

24: 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.

25: UK Department of Business, Innovation and Skills, 'Cut EU red tape: Report from the Business Taskforce', February 2014.

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 regulation, to provide services to their citizens without some common standards.

Similarly, 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. This would be unworkable: many UK firms who opt against exporting are still part of the single market because they compete with firms from elsewhere in the EU for British customers. 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.²⁶

“The regulatory costs of EU legislation would not simply disappear if the UK left the EU.”

Another reason why the EU has a legitimate interest in regulation is that there are times when collective action 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’). 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 (see Chapter 3).²⁷

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.

26: Business for Britain, ‘Setting out the British option: Liberating 95 per cent of UK businesses from EU red tape’, January 2014.

27: Philip Whyte, ‘Britain, Europe, the City of London: Can the triangle be managed?’, CER essay, July 2012.

2.2 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.

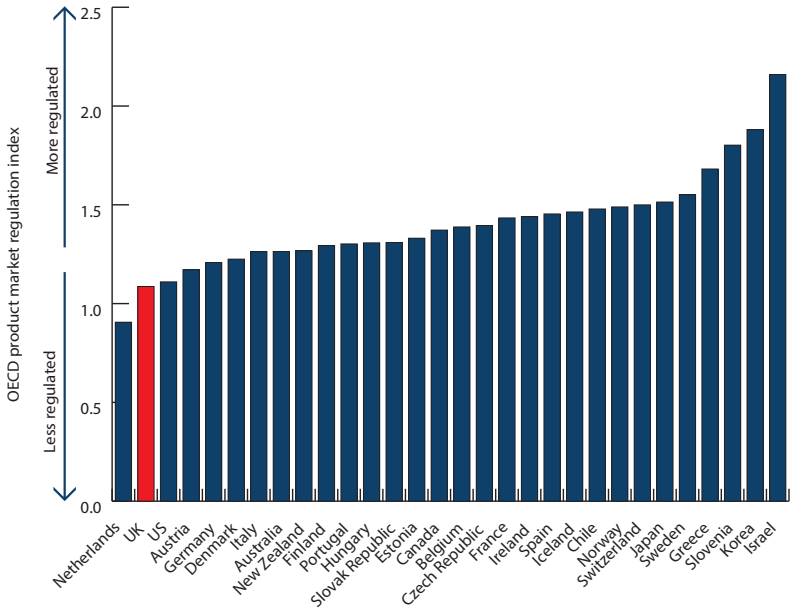
If Britain leaves the EU, it could in theory be freed to regulate its own product and labour markets as it sees fit (although if it wanted to continue to export to the continent, its firms would have to match many European standards). There may be some benefits from less costly rules in some sectors. 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 among the least regulated in the developed world.

The first thing the OECD's indicators show is that EU membership does not entail rigid harmonisation across the bloc as a whole. The adoption of common minimum standards at the EU level still allows scope for huge variations in levels of product and labour market regulation at the national level. To state the obvious, Britain's business environment is not identical to France's. The second thing the OECD's indices show is that being a member of the EU has not turned Britain into a country with 'continental' levels of regulation. Indeed, despite EU membership, the UK's product and labour markets still look more Anglo-Saxon than continental.

Consider first the overall level of product market regulation (PMR) in the UK. According to the OECD's index, the UK's markets for goods and services are not just freer of red tape than elsewhere in the EU (see Chart 2.1). They are also freer and less regulated than in any of the developed liberal economies in the English-speaking world (Australia, Canada, Ireland, New Zealand, and the US). In other words, despite the constraints and burdens that supposedly flow from EU membership, Britain's product markets are still among the least regulated in the OECD.

Chart 2.1:
Levels of
product
market
regulation

Source:
OECD product
market regulation
indicators.



The same story broadly holds true for the labour market (see Chart 2.2). The OECD's indices of employment protection legislation show a greater level of dispersion 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 being a member 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. At a macroeconomic level, then, the gains from leaving the EU are likely to be limited: a bonfire of European rules would not transform Britain's economic prospects.

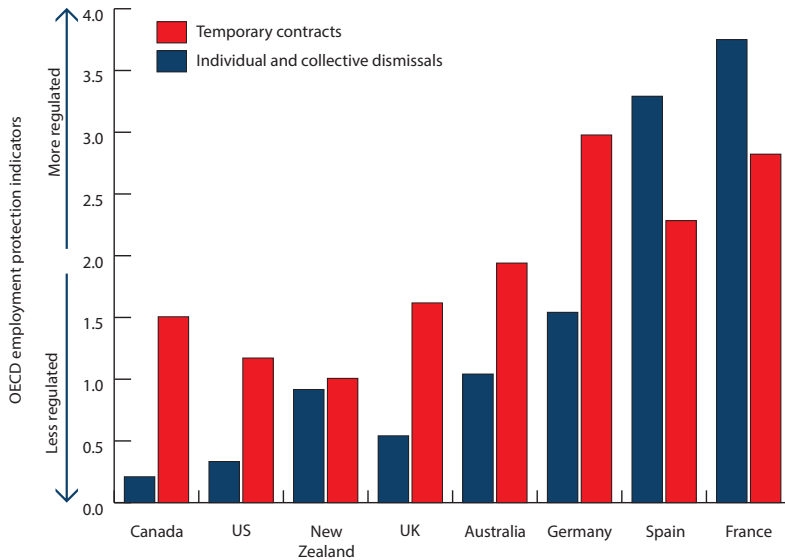


Chart 2.2:
Levels of
employment
protection

Source:
OECD
employment
protection
indicators.

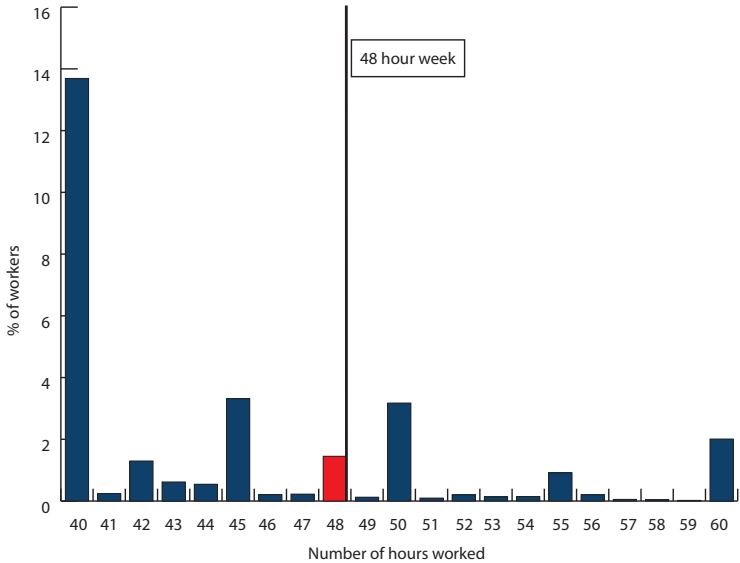
Some totemic EU rules, such as the ‘working time directive’, have a surprisingly limited impact. This directive violates the principle of subsidiarity: there is very little evidence that working hours or conditions have been made worse as a result of competition between EU member-states. (Working hours across the EU were in decline even before the introduction of the directive.)²⁸ There is therefore little reason for action at an EU level. Nonetheless, the working time directive’s negative effects are marginal at best, not least because of the opt-outs the UK has negotiated.²⁹ Chart 2.3 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 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: less than 1.5 per cent of British workers may work a few more hours a week (NHS workers might refuse to renegotiate contracts, for instance).

28: European Trade Union Confederation, ‘Trends in working time’, 2010.

29: Katinka Barysch, ‘The working time directive: What’s all the fuss about?’, CER policy brief, April 2013.

Chart 2.3:
The British
working
week, 2013

Source:
CER analysis of the
UK Labour Force
Survey.



European rules, then, 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.³⁰ 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.³¹

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

30: OECD, 'Going for growth country notes: United Kingdom', 2013.

31: Simon Tilford, 'Why British prosperity is hobbled by a rigged land market', CER Insight, 2013.

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.³²

There may, therefore, be some gains from more proportionate rules for 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. Furthermore, any UK government would face fierce domestic opposition to any 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.³³ And, as explained in more detail elsewhere in this report, in order to maintain access to EU markets, a 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; that the impact on output from repealing European legislation would be minimal; and that the economy's supply side might be hurt if divergent regulations between the EU and the UK made trade more difficult.

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

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

Chapter 3

The City of London

The UK is home to the largest financial centre in Europe. As the City of London was intimately involved in the financial crisis, the US and the rest of the EU have an interest in ensuring the City's financial stability, and vice versa. International regulation is being more closely co-ordinated to reflect the globalised nature of the financial system. A British exit would not give the UK wide latitude to regulate its financial factor as it saw fit.

The eurozone's banking union does not pose a threat to the City's European pre-eminence. British and continental regulation has moved in the same direction since the crisis – indeed, the UK has tightened regulation to a greater degree than other EU member-states. And if it remains a member of the EU, the UK can use the European Court of Justice to defend its single market rights.

If Britain leaves the EU, banks would shift some of their activities into the EU. The remaining member-states would insist that Britain sign up to many rules in exchange for more limited access to European markets than it currently enjoys. A British exit would damage the City, rather than setting it free.

The City of London's³⁴ pre-eminent position as a European financial centre pre-dated Britain's accession to the EU, and has only increased since the country joined. Until recently, EU membership was mostly perceived as a boon to the UK's financial services industry. Not only did it allow London to market itself as a bridgehead to non-EU financial institutions wanting to serve the wider European market; it also allowed continental European banks to concentrate most of their wholesale activities in London. (Wholesale finance consists of lending, borrowing and trading between financial institutions, rather than between banks and their customers.) Fears that the City of London's position as a financial centre would be gradually eroded if Britain did not join the eurozone have not materialised: to date, the City has thrived outside the currency union.

³⁴: In this chapter, we use 'the City of London' as shorthand for UK financial services. A good deal of activity takes place outside the capital – although the great majority of wholesale finance, the main subject of this paper, is located in London.

Relations between Britain, the City of London and the EU have, however, become more complicated since the financial crisis. Before 2008, British governments could assume that what was good for the City was good for Britain and the rest of the EU. The EU's efforts to remove barriers to trade in financial services were supported by British governments and the City. And while some member-states resented the fact that Europe's largest financial centre was outside the eurozone, British governments could plausibly claim that the City was a European asset whose success was vital to continental European prosperity.³⁵

“The British government, the City and the EU have had more tense relations since the financial crisis.”

Since 2008, however, any sense of harmony has broken down. In the UK, public attitudes to the City have hardened. Traditional claims made on the City's behalf about its

contribution to British jobs, tax revenues and export earnings now have to be set against the costs imposed by the financial crisis, as well as the impact on the City's reputation for probity of repeated scandals (Libor rate-fixing and the mis-selling of financial products being the most infamous). Few people still believe that the interests of the British state and the City of London naturally coincide. Indeed, Britain has led the way in tightening the regulatory screws on finance.

In continental Europe, several factors have conspired to upset the previous balance. First, the financial crisis has generated pressure to regulate finance – particularly firms, products and practices considered to be typical of financial capitalism in its most unrestrained, 'Anglo-Saxon' form. Second, the design flaws exposed by the eurozone crisis are forcing deeper levels of integration in the currency union (potentially reducing British influence in shaping financial regulatory policy at the EU level). Third, the European Central Bank (ECB) has sought to force some euro-denominated business to be cleared in the eurozone, rather than London.

Against this backdrop, this chapter assesses the extent to which EU membership has been of benefit to the City, and how the eurozone's banking union or a British exit from the EU might imperil the City's position as a leading financial centre. First, it examines the drivers of the City of London's growth and its integration with the EU's financial system; it then provides an analysis of the implications of the eurozone's nascent banking union for London's status as Europe's dominant financial centre; and, finally, it specifies what forms of financial activity might be put at risk if Britain were to leave the EU.

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

3.1 How the City of London came together

Declining transport and communication costs have driven globalisation. But their impact across economic sectors has not been uniform. In the manufacturing sector, for example, supply chains have displayed a tendency towards increased geographical dispersal across the globe. In the financial sector, by contrast, the reverse has often been the case: lower communications costs have coincided with financial services – and wholesale financial services in particular – becoming increasingly concentrated in a small number of ‘global cities.’³⁶ The City of London has been one of the principal beneficiaries of this trend.

In the 1960s, the City of London was still predominantly an international clearing centre for sterling-based transactions. It has since evolved into a genuinely global financial centre, making markets in multiple currencies and providing the full gamut of financial services across borders – from securities and currency trading to bank lending, asset management, insurance, derivatives, trade and maritime finance, and so on. In so doing, the City has carved out for itself a special role in the European time-zone – not just as a hub between Europe, Asia and the US, but also as a provider of services not found elsewhere in Europe.

Although Britain’s share of global GDP has declined to about 4 per cent, the City of London itself has become the location for a disproportionate share of financial activity. Globally, the UK accounts for 46 per cent of the market in over-the-counter (OTC) interest rate derivatives and 37 per cent of turnover in foreign exchange. In Europe, the City’s size is even more marked: it boasts a higher share of euro-denominated foreign exchange trading than the eurozone, and accounts for 85 per cent of hedge fund assets under management, over 70 per cent of OTC derivatives traded, and 51 per cent of marine insurance premiums.³⁷ These markets are huge: in some cases annual turnover amounts to hundreds of trillions of US dollars.

Historically, a number of factors have attracted all this activity to the City of London. A non-exhaustive list would include, in no particular order, the following ‘pull’ factors:

- ★ The predictability of the legal system.
- ★ The international status of the English language.

36: Saskia Sassen, *The global city: New York, London, Tokyo*, 1991.

37: TheCityUK, ‘UK and the EU: A mutually beneficial relationship’, June 2013.

- ★ A generally accommodating regulatory environment.
- ★ A critical mass of expertise, both in finance and in ancillary services such as accountancy and law.
- ★ A tradition of openness to foreign firms and migrants.
- ★ The perceived integrity of London's markets and participants.
- ★ A market infrastructure able to support high levels of financial activity.

These 'pull' factors can combine to form a virtuous circle. For example, an international bank's principal reason for moving to London might be the legal system and the market infrastructure already in existence. But by setting up in the City, it brings more skilled workers, which provides more talent for the pool of labour. This renders the City more attractive to other banks.

The City also benefitted from the decision by governments to dismantle controls on the flows of cross-border capital in Europe, in which the development of the single market for financial services played a role. After the breakdown of the Bretton Woods system in the 1970s, the United States, Germany, Canada and the UK unilaterally removed controls on foreign capital. But capital controls were only removed at the EU level in 1988, after the introduction of the single market programme.

As part of that programme, the EU's introduction of the single banking licence allowed a bank based in one member-state to set up a branch in another, yet continue to be regulated by authorities at home. Member-states agreed to common prudential and regulatory minimum standards, to prevent a race to the bottom. Nevertheless, the impact was largely deregulatory: countries with higher levels of regulation feared that they would lose financial activity to less regulated financial centres, and so they reduced restrictions on the trading of shares and securities, foreign direct investment in the financial sector, and bank mergers and acquisitions. By 1998, all EU member-states had opened their financial sectors to the degree that the US, Germany, the UK and Japan had in the 1970s and 1980s.³⁸

In 1999, the introduction of the euro provided a further spur to financial integration. The City of London became the largest financial

³⁸: According to an index collated by Menzie Chinn and Hiro Ito, based upon IMF measures of financial openness. See their 'What matters for financial development? Capital controls, institutions, and interactions', *Journal of Development Economics*, 2006.

centre for euro-denominated trading, despite the UK choosing not to join the single currency. The British government won access to the eurozone's payments system, TARGET, for banks based in the UK, and in so doing established the principle that institutions based in the single market, but not in the eurozone, should have equal rights to conduct transactions in the common currency.

The principal effect of EU membership for the City has been to provide new European markets for banks and other financial firms based in the UK. But most of the increase in cross-border finance has been conducted in wholesale markets – between financial institutions themselves, rather than between banks and consumers. London is the EU's largest wholesale financial centre and the rest of the EU has an interest in its financial stability. Furthermore, the euro crisis has prompted the single currency's members to set up a banking union, to shore up a shaky eurozone financial system. As Britain is not a member of the euro, the tension over financial regulation between the single market and the eurozone has important implications for the UK's decision about EU membership.

3.2 The City's role in the European financial system

The rationale for the fourth freedom of the single market – the free movement of capital – is twofold. First, by allowing financial institutions to move into new markets, it is intended to raise the level of competition, and so drive down prices for consumers. Second, international capital flows allow savings to go to where they may be most profitably invested, giving savings-constrained but potentially fast-growing countries more capital to invest.³⁹ How much integration has occurred in retail and inter-bank markets, and with what economic consequences?

Retail markets

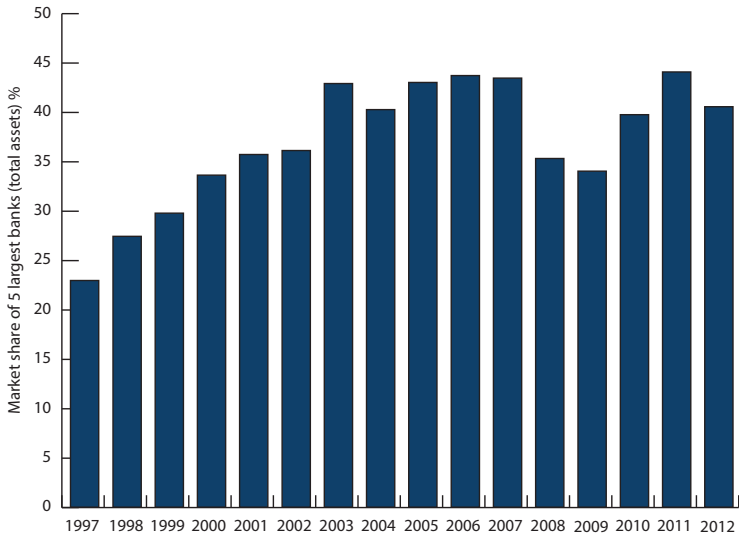
The single market programme has not transformed Britain's retail banking market, which has become more concentrated in recent years, not less. Four large banks became dominant mortgage and business lenders in the decade before the financial crisis: HSBC, Barclays, Lloyds group and Royal Bank of Scotland group. A series of mergers and acquisitions led to a less diverse banking sector, and the market share of the largest banks rose between 1997 and 2007. Since the crisis, the Spanish bank Santander has increased its share of the British retail

39: See, for example, Dirk Schoenmaker and Wolf Wagner, 'The impact of cross-border banking on financial stability', Tinbergen Institute Discussion Paper, 2011; Claudia Buch et al, 'Cross-border diversification in bank asset portfolios', International Finance, 2009; and Barba Navaretti et al, 'Multinational banking in Europe: Financial stability and regulatory implications', Economic Policy, 2010.

market by taking over three smaller banks, and Lloyds was broken into two by the government, after its bail-out in 2009. But retail finance now exhibits similar levels of concentration to those seen immediately before the crisis (see Chart 3.1).

Chart 3.1:
Five largest
banks'
market share,
1997-2012

Source:
European Central
Bank.



Wholesale markets

For Britain, the biggest impact of the single market has been on the City of London as an international financial centre. The development of the single market, as well as the reduction in barriers to capital flows across the developed world, led to larger cross-border flows of savings looking for investments, and the growth of European bond and equity markets. The British government and its officials were leading advocates for the single market programme, and its architects: the advantages of a liberalised European financial system for the City of London were obvious. UK-based banks now preside over a quarter of all EU banking assets.⁴⁰

As well as being the largest global financial centre in the EU, the City of London is also at the centre of the eurozone's financial system. Over the last economic cycle, the City integrated faster with the eurozone than with markets elsewhere. Chart 3.2 shows British banks' lending to the eurozone, the rest of the EU and European Economic Area, the US, Japan and developing countries, as a proportion of their respective

⁴⁰: International Monetary Fund, 'Technical note on financial integration and fragmentation in the European Union', March 2013.

GDPs.⁴¹ UK-based banks built up heavy exposures to both the eurozone and other EU member-states, with the scale of flows growing much faster than GDP between 1999 and 2008. The financial integration between the UK and the eurozone was five times greater than with the US, adjusted for economic size, in the depths of the euro crisis in 2012.

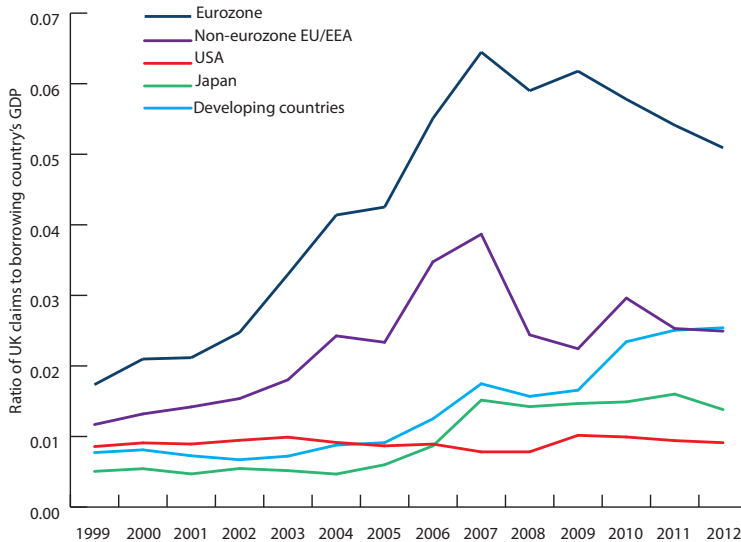


Chart 3.2:
UK banks' international assets as a proportion of GDP

Source:
CER analysis of Bank of International Settlements and World Bank Data.

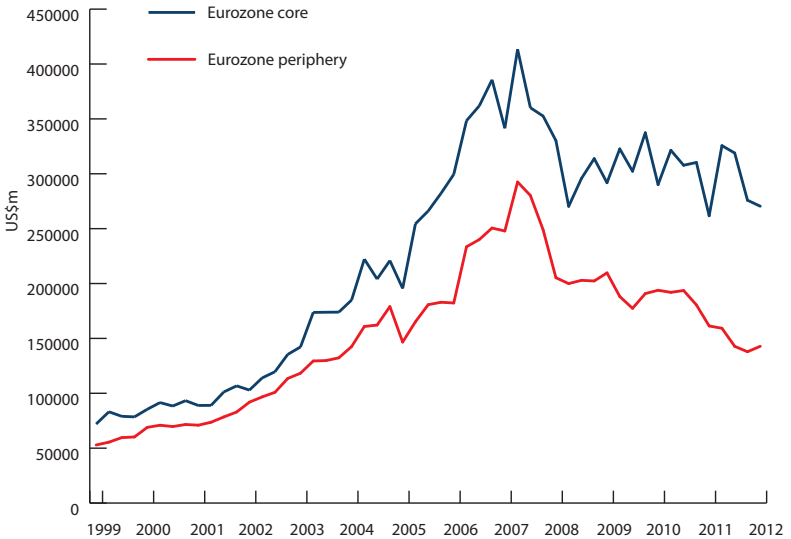
Since the eurozone got into difficulty, however, UK bank lending, particularly to countries in the eurozone's so-called periphery, has fallen sharply (see Chart 3.3).⁴² A significant part of the financial integration between the introduction of the euro and the crisis seems to have been cyclical, rather than structural. Before the crisis, EU banks under-priced macroeconomic risks in the eurozone's periphery, by failing to consider what might happen if their current-account deficits proved unsustainable, and paid the penalty. (Current-account deficits mean that countries are borrowing from abroad – they are investing more than they are saving – and when lending dries up, current accounts are forced back towards balance.)

41: By controlling for GDP, this provides a more accurate assessment of financial integration than gross figures.

42: The 'peripheral' eurozone countries in this paper are Greece, Italy, Ireland, Portugal, Spain, as well as Slovenia, Cyprus and Estonia after they joined the euro in 2007, 2008 and 2011 respectively.

Chart 3.3:
UK lending to the
eurozone
core and
periphery,
1999 to 2013

Source:
CER analysis
of Bank of
International
Settlements data.



Despite the decline in cross-border lending since the start of the euro crisis, the City remains at the heart of the eurozone's financial system. And it is still highly integrated with the US (see Chart 3.4): in the coming decades the City's largest markets will continue to be the US and the rest of the EU. The implication: the US and the rest of the EU have an interest in ensuring the City's financial stability, and vice versa. International regulation is being strengthened, and the UK, EU and the US are becoming less tolerant of financial centres outside their jurisdiction that may impose risks on the financial system as a whole.

As the City of London is at the core of Europe's financial system, but sits outside the eurozone, some compromise between the UK's single market interests and eurozone financial stability must be found. The free movement of capital within the EU's financial system requires member-states to share sovereignty over financial regulation. But negotiations between the UK and the eurozone will continue to be fraught – perhaps even more so, once the ECB takes over the supervision of the largest eurozone banks, which constitutes one 'pillar' of the eurozone's banking union. Will the banking union render the UK's position in the EU untenable?

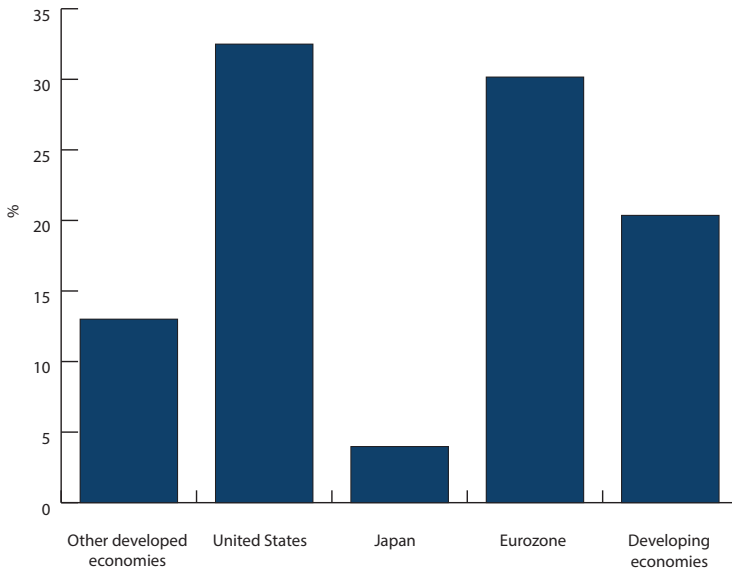


Chart 3.4:
Proportion
of UK
international
lending, Q3
2013.

Source:
CER analysis Bank
of International
Settlements Data.

3.3 Britain and the banking union

To tackle cross-border financial instability, nation-states face a choice. There is a trilemma in international financial economics – between financial stability, internationalised finance and national sovereignty.⁴³ It is possible to have two of these options, but not three. Financial stability and cross-border finance require rules that are agreed internationally. Equally, poorly co-ordinated national rules and the globalisation of financial markets can result in financial instability. After the crisis, the member-states of the EU, and those of the G20, recognised that international rules were too lax before the crisis, and that national regulatory competition to give financial centres a competitive advantage increased threats to the stability of the global financial system.

Britain faces the same trilemma as other countries, but more acutely, since it is home to one of the world's largest financial centres, and is outside the eurozone, but in the EU. It could seek to leave the EU, and then engage in regulatory competition to encourage more financial firms to set up in the City – but at the risk of reducing financial stability. And other countries would inevitably argue that the City threatened the world's financial system, and seek to reduce the threat by preventing British-based banks from having access to their markets.

43: Dirk Schoenmaker, 'The financial trilemma', *Economics Letters*, 2011.

As the City is distrusted by many eurozone politicians, and 'Anglo-Saxon' finance is considered by some to be one of the causes of the eurozone's problems, the eurozone is even more unwilling to allow British authorities wide latitude to regulate and supervise the eurozone's largest financial centre. Furthermore, eurozone member-states have agreed to pool sovereignty over banking supervision – and, to a lesser extent, the closure or rescue of failed banks. The UK's position on the banking union is that it is necessary to put the eurozone on a more

“In recent years, British regulators have shown little desire to give the City a competitive advantage.”

stable footing. But it also wants to maintain regulatory sovereignty, and protect its interests in the single market, despite the City's role as a eurozone financial centre.⁴⁴

Thus, if the City is to remain open to international capital flows – with its banks having access to international interbank markets, its investors buying financial assets in other countries, and its hedge funds providing investment services for international clients – then it must be willing to cede sovereignty over financial regulation.

As it happens, British regulators have shown little desire in recent years to design regulation to give the City a competitive advantage. Before the crisis, the Financial Services Authority was legally required to consider the City's competitiveness when drafting rules. This is no longer the case: Britain has, in many ways, been leading the charge towards stricter prudential regulation. The authorities have forced banks to raise capital and to hold more liquidity; banks are now required to draw up recovery and resolution plans (so-called 'living wills'); and the government has agreed to implement most of the recommendations of the Vickers Commission, which will force banks to ring-fence their retail operations from their trading and investment arms.⁴⁵

By contrast, many EU countries have been slower to force their banks to raise capital. The EU directive that aligns the way in which banks across the EU should be resolved was agreed at the end of 2013, well after British rules had been changed. (The British considered it a success for their resolution system, which already included many of the same provisions that the EU directive requires.⁴⁶) And the EU is only now implementing the 2012 Liikanen report's suggestions for ring-fencing operations – although the timeline for implementation is very similar to Britain's.

44: Philip Whyte, 'What a banking union means for Europe', CER essay, December 2012.

45: Independent Commission on Banking, 'Final report', September 2011.

46: Deloitte, 'European requirements on recovery and resolution', June 2012.

This is not to say that all recent EU proposals have been welcomed by the City – or the UK government. The draft Alternative Investment Fund Managers Directive (AIFMD), when it was originally proposed by the Commission in 2010, imposed limits on the ability of non-European funds to provide services in the EU. These funds had little to do with the financial crisis, many Britons argued, and the UK government successfully pushed for some (but not all) of the restrictions in the directive to be eased. In addition, the ECB has tried to force clearing houses that settle large volumes of euro-denominated trades to relocate to the eurozone. The British government has taken the ECB to the European Court of Justice (ECJ) over its location policy, arguing that the move violates the free movement provisions governing the single market in the EU treaties. It has also gone to the ECJ over eleven eurozone member-states' plans for a financial transactions tax – a small tax on financial trading – that would raise a disproportionate amount of money from business carried out in London; and also the EU's limits on bank staff's bonuses, which the British government voted against in the European Council.

In March 2014, the EU reached agreement on banking union. The UK, while it opted out, had hoped for a more centralised structure for the eurozone than was ultimately agreed. While the ECB has taken over the supervision of the 130 largest banks in the eurozone (although it has ultimate supervisory responsibility for all banks), the provision for closing a failed bank is complex, requiring assent from the ECB, the Commission and the member-states. The common fund to finance the closure of banks is small and will take eight years to reach full capacity.

This leaves the UK in a potentially uncomfortable position: the eurozone financial system may not be much more stable than it is now, which poses further risks to the European economy, the UK included. But supervisory authority will be concentrated in the hands of the ECB, which will thereby wield considerable influence on supervisory and regulatory policy throughout the EU. And the British government fears that financial regulation will be made to satisfy the interests of the eurozone, rather than the EU as a whole.

As a result, many in the City fear a new regulatory assertiveness on the part of the eurozone. There are certainly areas in which it is easy to envisage conflict. The resolution of a eurozone headquartered bank with large operations in the City of London is one. The eurozone and the UK government may have opposing interests when it comes to

resolution: eurozone authorities will seek control of the bank's assets, even if a part of its balance sheet is under the Bank of England's jurisdiction. There are unresolved questions about how banks that get into trouble in London will access ECB liquidity. The eurozone member-states may seek to impose caps on the exposure of a eurozone bank to its sovereign, in an attempt to break the link between governments and banks. They might demand that UK banks do the same.

However, these moves would hardly amount to an unbearable threat to the City's competitiveness – and hence a reason for Britain to leave the EU. The regulatory focus on both sides of the Channel has been on bank safety; and the difference in regulatory philosophy between the UK and the eurozone is not as wide as is often implied. There have been few attempts to roll back the freedoms of the single market, the ECB's location policy aside. The financial transactions tax may never come into being, since the participants are divided on how comprehensive it should be, and the Council's legal service has concluded that the tax infringes EU treaties. (On April 30th 2014, the ECJ ruled that the British government's case against the tax was premature, as the member-states involved had not yet decided on how the tax would work. Yet the judges said that this did not stop another challenge once the details had been finalised.)

The British government has won a 'double majority' voting system in the European Banking Authority, which sets the rules for the EU, so that any measure requires a majority of both eurozone members and those outside. If more EU member-states join the euro, this rule will have to be revisited, as it would end up granting the UK disproportionate power over financial regulation. Should the euro 'outs' eventually consist of just Denmark and the UK, which have opt-outs, the UK would have a veto on all financial rules. But most of the 10 non-eurozone member-states will not join the single currency for many years, and in the medium term, the double majority system will prevent eurozone interests from assuming precedence over those of the single market. Finally, while the UK is a member of the EU, it has recourse to the European Court of Justice, which may determine whether eurozone-inspired regulations violate the single market's principles.

The days when the UK set the agenda on EU financial regulation are over. Eurozone policy-makers will focus on the single currency's financial stability, and extending the single market will be less of a priority. This may make life uncomfortable for Britain in some ways,

but it is difficult to argue that eurozone financial integration poses an unbearable threat to the City. Insofar as it makes the European financial system safer, it is to be welcomed.

3.4 The City and Brexit

But what might be the consequences for the City if the UK chose to leave the EU? British eurosceptics argue that even outside the EU, the City's deep and liquid capital markets, legal regime, time zone, language and historic trading ties would give it a formidable competitive advantage. Pro-Europeans argue that it would be a disaster for the City's competitiveness.

Both positions take it as axiomatic that the fate of the City of London should be an important factor in any decision about EU membership. The UK has a strong comparative advantage in financial and related business services, and it has a large trade surplus in this sector. It is in ordinary times an important source of tax revenue for the British treasury, although the cost of recapitalising the banks in the aftermath of the financial crisis has revealed the size of taxpayers' exposure to banks that are too big to fail. It is perhaps unrealistic to expect Britain not to seek regulatory advantage for a major exporting industry based within its borders. But it is likely that, upon leaving the EU, the City of London would be less open to the rest of the world, not more, unless it signed up to EU rules.

Advocates of a British exit believe that an EU exit would not be a disaster for the City. This is probably true at least in the short term. Much of the City's business is global, rather than merely regional. It is the world's largest centre for foreign exchange trading. And, like New York and Tokyo, it is a hub for trade in securities for firms all over the world.

Upon exit, there might be some competitiveness gains for the City if the UK rescinded some rules that it considers damaging. The recent rule limiting bankers' bonuses to double their annual salary would be one. Britain might choose lower capital requirements for insurers than the EU has imposed under the Solvency II directive.

However, marginally lower regulatory costs would have to be set against reduced access for City-based firms to EU markets. In any exit negotiation with the EU, the UK would have to make a bargain, because the EU insists that, in exchange for access to EU markets,

so-called third countries – those outside the club – must have regulation and supervision of their financial sectors that is equivalent to that of the EU.

The EU is in the process of tightening rules on third country access. To comply with the new Markets in Financial Instruments Directive (MIFID II), third-country firms that want to sell services to ordinary consumers will have to open a branch within EU borders. This branch must be regulated and supervised by that country's authorities, in co-operation with the supervisors of the host country. Firms will only be allowed to set up branches if the European Securities and Markets Authority (ESMA) recognises the regulations of the country of origin as equivalent to the EU's. ESMA must also accept that the country of origin's supervisors have the ability to supervise the firm abroad (which is expensive and administratively difficult). The branch will also have to meet EU capital requirements, and if the bank's home country changes its regulations or fails to supervise the branch effectively, the bank will no longer be free to operate in the EU.⁴⁷

After strong pressure from the British government, the Commission's first proposal for testing the equivalence of regulation has been watered down. In its original form, the directive insisted upon 'line-by-line' equivalence tests for third country rules. In its final, agreed form, ESMA will test whether the regulatory outcomes of third countries are likely to be equivalent.

If Britain leaves the Union, banks from other EU countries will face a difficult choice. Currently, many use a branch in the City of London as a base. The UK is by far the largest centre for foreign branches in the EU (see Chart 3.5): as a centre of wholesale markets, many banks from elsewhere in the EU make London their centre of European operations. Many choose to establish branches, rather than fully capitalised subsidiaries supervised and regulated by the UK authorities, because it reduces funding costs. (Each subsidiary must comply with the capital and liquidity rules of the country it operates in, which makes intra-bank transfers of funds difficult. Branches need only comply with their home country rules, and are supervised jointly by their home authorities and those of their host.)

47: KPMG, 'Provision of services by financial intermediaries from third countries in EU financial markets regulation', 2011.

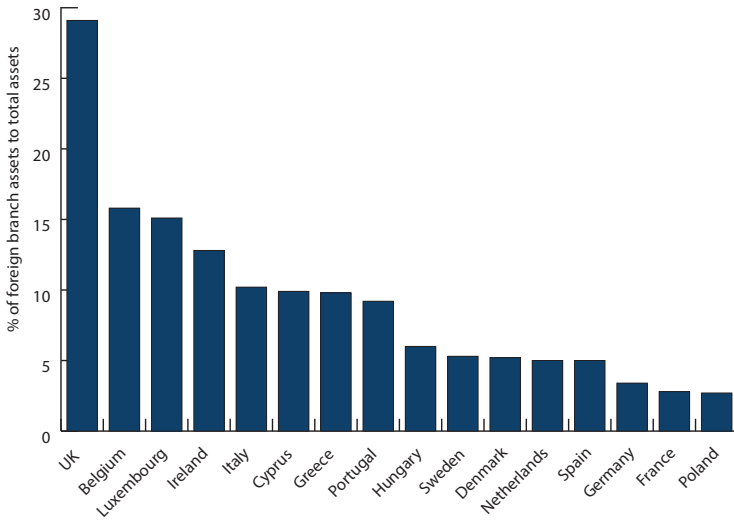


Chart 3.5:
Foreign
branch
assets as a
proportion of
total banking
assets

Source:
Bank of England, 'Supervising international banks: the Prudential Regulation Authority's approach to branch supervision', February 2014.

If Britain leaves, the EU will treat it as a third country' For British banks to continue to be able to sell investment services or retail products to clients in the EU, British rules and supervisory requirements would have to be deemed equivalent. And as a non-member, the UK would not have the power to stop the EU tightening the rules on third country access by insisting upon line-by-line equivalence tests. There would be a risk that it could lose access to the single market, or sign up to EU rules without any say in how they were drafted.

The UK could, of course, still allow EU banks to set up branches in London and recognise EU member-states' rules as equivalent to its own. But banks from outside the EU would no longer be free to set up a subsidiary in London, and then branch out to other EU member-states. (In order to use a banking 'passport' and branch out into other member-states, a non-EU bank must set up a subsidiary somewhere in the EU.) To continue to maintain a range of operations across the EU, they would have to set up another subsidiary, probably in Paris or Frankfurt. And they would have to satisfy three regimes under MIFID II: that of their home country; any further supervisory requirements that the British authorities required as a condition for setting up a subsidiary in London; as well as the supervisory requirements of the EU member-state in which they established their EU subsidiary.

It is impossible to know with any sort of precision how large the impact a British exit would have on the location decisions of non-EU banks,

as much depends upon future decisions on third country access. As the City of London would continue to be an international centre for wholesale financial markets, some non-British banks might continue to bear the increased supervisory costs of three different supervisory regimes. But this might not be the case. Many banks might instead choose to restructure their operations to reduce the regulatory burden, and this might entail moving some of their business from London to the EU.

There are two areas of financial activity where more precision is possible about the consequences of exit: euro-denominated trading, and hedge and private equity funds serving clients in the EU.

The ECB would be highly likely to force clearing houses that settle euro-denominated trades to relocate to the eurozone, should the British leave. As noted above, the British government is taking the ECB to the ECJ over its location policy, arguing that it violates the rules of the single market. Outside the EU, it would have no such recourse. And the text of the ECB's location policy gives it wide latitude to deal with 'offshore' centres, as the City would be in the event of British exit. It says that 'key technical facilities' and information systems of any clearing house with a large proportion of euro-denominated business must be located in the eurozone. The ECB argues that it must be able to ensure that clearing houses are managing risk effectively, in order to safeguard eurozone payments systems and derivatives markets. The policy says that the ECB may 'grant an exception', but as it has been unwilling to do so for Britain when it is in the EU, it is unlikely to offer one to the City as an offshore centre.

Nor would the UK gain much regulatory sovereignty over hedge and private equity funds by leaving the EU. The AIFMD requires hedge and private equity funds to comply with EU capital requirements, pay guidelines, and other rules if they are based outside the EU's borders. Those funds that wanted to continue to market their funds in the EU would have to comply with these rules should Britain leave (under the AIFMD, non-EU regulations must be equivalent for cross-border provision of services to be legal).⁴⁸

The UK would be likely to find itself in a similar situation to that of Switzerland. Swiss financial institutions only have limited access to the EU, and must set up branches and subsidiaries inside the union – usually in London – in order to be able to sell services to EU customers.

48: PwC, 'The AIFMD outside the European Union', May 2013.

To maintain their limited right to sell services across the Swiss border, they must constantly update their regulations to ensure that they are seen as equivalent by the EU. In order to maintain the City's market access, the UK would come under heavy pressure to do the same upon exit.⁴⁹

The regulatory sovereignty that would supposedly flow from leaving would, in short, be largely illusory: in order to maintain access to EU financial markets, the UK would have to align its regulations with the EU. It would have no influence on the design of those rules, so it might even lose regulatory sovereignty upon leaving, since the EU makes third countries sign up to EU rules in exchange for market access. As Britain would not be represented in the Council or the European Parliament, such restrictions would be more likely to happen. And as it would no longer be a member of the EU, the UK would not be able to use the ECJ to defend its single market rights.

Finally, it cannot be taken for granted that the UK would be more outward-facing and laissez-faire upon leaving. The British authorities' regulatory stance towards the financial sector has changed dramatically since the financial crisis: a British exit would probably not lead to a bonfire of red tape. And since hostility to immigration from the EU is one reason for Britain's equivocation about its EU membership, and the City's pre-eminence is partly founded upon its skilled foreign labour, banks may find it more difficult to bring in skilled workers if Britain decides to leave the Union.

In sum, the City of London is at the core of the EU's financial system, and indeed that of the eurozone. Its interests lie in a comprehensive banking union to strengthen the eurozone's financial system, and strong EU institutions – the Commission and the ECJ – to ensure that eurozone integration does not lead to regulatory protectionism. Leaving the EU would deprive Britain of guaranteed access to these institutions.

There are two priorities for the UK government in its negotiations over the City's European status. First, it must ensure that the domestic, European and global financial systems are stable. As finance is internationalised, financial stability requires co-ordination with the EU and the G20. Second, for good or bad reasons, British politicians will inevitably want to maintain the competitiveness of the City of London. Both require it to trade regulatory sovereignty for financial stability and market access.

49: University of Kent Centre for Swiss Politics, 'Switzerland's approach to EU engagement: A financial services perspective', April 2013.

Britain's eurosceptics are right that the City would not collapse in the event of an EU exit. Its central role in foreign exchange and securities trading, in insurance and asset management, and in financial law and accountancy services would continue, as would its position as the location of choice for many leading private equity and hedge funds. But some activity would be lost if Britain left the EU; and the costs of an EU exit would outweigh the (largely illusory) benefits of sovereignty. The EU's new regimes for third countries are making the choice a stark one: third countries must either maintain standards at EU levels, or lose access to the EU market. It is difficult to believe that this principle would not apply should the EU and the UK negotiate a British exit.

Chapter 4

Migration

Britain's EU immigrants are a boon, not a burden. They are young and more likely to be in work than Britons, and thus pay more in taxes than they take out in benefits and public services. They do, however, push up housing costs – a problem Britain must confront.

Contrary to popular opinion, EU immigrants are far less likely to take up benefits than the British population. 'Benefit tourism' is a canard: the great majority of EU immigrants come to Britain to work. Being net contributors to Britain's public finances, they help the country to deal with the costs of an ageing society.

If Britain left the EU, future British governments would be more likely than not to curb immigration from the rest of Europe. But as baby-boomers retire and jobs are created at the high- and low-skilled ends of Britain's labour market, demand for immigrant labour is likely to grow, not shrink.

The free movement of people – one of the 'four freedoms' of goods, capital, services and labour – is a fundamental principle of the EU's single market. Member-states open their labour markets to immigrants, knowing that the others will reciprocate. However, since the EU's enlargement to the east in 2004, many Britons feel that the reciprocal arrangement has broken down: free movement is no longer perceived to be an arrangement that works for the mutual benefit of both Britons and other Europeans.

EU migration will be a central issue in a referendum campaign, and so this chapter considers the extent to which Britons' fears about EU migration are supported by economic evidence; what the potential demand for EU labour over the next decade might be; and how closed Britain might become to immigration if it leaves the EU.

In Britain's last referendum campaign on membership of the then European Economic Community (EEC) in 1975, its free migration

rules barely featured. Most of the other member-states were wealthier than Britain, and few people thought that European migrants would come to Britain in large numbers looking for work. Anti-immigrant sentiment may have been prevalent at the time, but it centred primarily on non-European migrants from Britain's former colonies.

Since 2004, however, the free movement of European labour has become highly controversial. The UK, expecting the resulting influx to be relatively modest, was one of just three EU countries not to impose transitional restrictions on migrants from the member-states that joined in that year (the so-called A8). In the event, migration from the

A8 was much larger than the UK had expected: there are around 1.1 million people from these countries in the UK, some 660,000 of whom are in work.⁵⁰

“Since 2004, the free movement of European labour has become highly controversial.”

On average, per capita income in the eight new member-states is around one-third that of Britain at market exchange rates. (Romania and Bulgaria, whose workers gained access to the British labour market in January 2014, are poorer still.) Such large income disparities make the UK an attractive destination for A8 immigrants. Many A8 workers are employed in British jobs that pay the minimum wage, or just above, but their earnings are much higher than they would receive at home. In addition, EU rules require member-states to offer European immigrants broadly similar access to state benefits and services. As a result, many Britons believe that immigrants from the EU take jobs from British workers, or reduce their pay, and that they unfairly receive financial benefits and public services, funded by British taxpayers. Does the evidence support these views?

4.1 EU migrants and Britons' employment prospects

The EU's free movement rules are based on liberal economic theory: if a worker can earn more money in another country, it is better for the worker and the foreign employer for migration to be unhindered. Migratory flows expand Europe's economy as a whole, as workers move to where they may be most productively employed. Yet migration poses a dilemma for the British government. While immigration might make the country's economy larger, it may have no impact on the incomes of the pre-existing British population – or it may, in theory, reduce it. The government is caught between competing

⁵⁰ Migration Observatory, 'Migrant flows from the A8 and other EU migrants to and from the UK', April 2013.

priorities: that of boosting economic output and helping businesses (which like to have a larger supply of labour from which to choose), and that of protecting workers, whose individual prospects may worsen as a result of immigration. In short, immigration may raise national income, but the economic case should rest on its impact on Britons' incomes.

Increased immigration inevitably raises output, unless every immigrant displaces a British worker. More people will be working in Britain, so output should be higher. The higher tax take from immigrant labour allows more government spending or lower tax rates. Yet the costs or benefits of immigration for the British population are not easily measured by its effects on economic output alone. If migrants depressed Britons' wages or pushed up the native unemployment rate, even if output were higher as a result of immigration, the average British worker could be worse off.

Therefore, a central question for any cost-benefit analysis will be whether EU migrants take jobs from Britons, or reduce their wages: in essence, are immigrants competing with Britons or are they complementary to them? If they are complementary, immigrants will make the host population more productive, by doing work that Britons do not want to do or do not have the skills for, or by introducing new ideas or technology. They may free British workers to specialise. This process would then raise the wages of immigrants and British workers, who would both become more productive.

In practice, of course, both competition and specialisation happen at once. Some workers will lose out, as immigrants will always compete against some native workers. But if immigrants are on average complementary, it makes economic sense to let them in, as it will raise the productivity, and thus the average income of the host population. With those principles in mind, are EU immigrants competing with British workers, or complementary to them?

The number of people in England and Wales who were born elsewhere in Europe stands at around 2.7 million. Of these, 1.6 million come from the old EU-15, and the European Economic Area countries – Norway, Liechtenstein and Iceland – whose citizens are all free to work in the UK. (Henceforth, this group will be referred to as 'western Europeans'.) The remaining 1.1 million come from the A8 countries.⁵¹

51: Migration Observatory, 'Migration flows of A8 and other EU migrants to and from the UK', April 2013.

These two groups of immigrants have different average ages and levels of education. Western Europeans are slightly younger than the average Briton – 51 per cent are under 40 years old, compared to 49 per cent of British people. A8 immigrants are much younger: 53 per cent are under 30, and 85 per cent are under 40 years old.⁵²

Both western European and A8 immigrants are more highly educated than the average Briton – more have finished secondary education, and more have university degrees.⁵³ But their involvement in the British labour market is very different.

A8 immigrants migrated to Britain in very large numbers from 2004, adding approximately 2 per cent to the labour force between 2004 and 2011. Compared to western Europeans, many did not speak English well, and being young, many lacked marketable skills in the British labour market, despite being comparatively highly educated.

So the majority found jobs in low-skilled, low-paid work. Chart 4.1 shows the proportion of Britons, western Europeans and A8 nationals in different occupations. In rough terms, the more highly-skilled and better-paid jobs are on the left, and the lower-skilled jobs on the right. Western European immigrants tend to be working in more highly skilled jobs than the average Briton. Sixteen per cent of western Europeans direct or own businesses, compared to 10 per cent of Britons. A higher proportion work in sectors such as science, technology and engineering, or work as public service professionals such as doctors, teachers and nurses, than Britons. By contrast, a higher proportion of A8 nationals work in skilled trades (especially construction) than do Britons, and an even higher proportion work in low-skilled manufacturing, construction and services jobs.

52: Office of National Statistics, Labour Force Survey, 2012 data.

53: Madeleine Sumption and Will Somerville, 'The UK's new Europeans: Progress and challenges five years after accession', Equality and Human Rights Commission report, 2009.

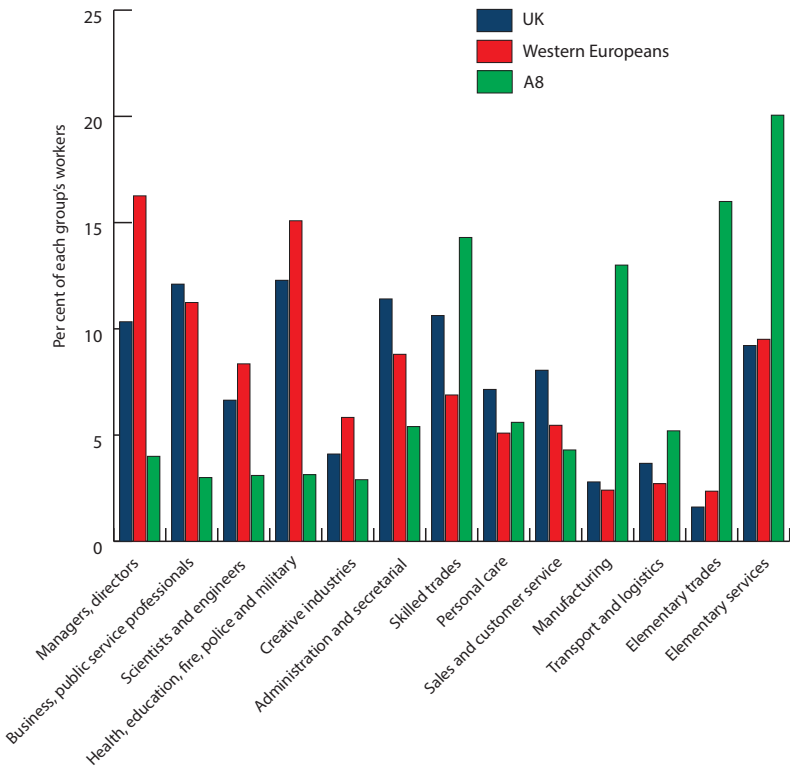


Chart 4.1:
Occupations
of EU
immigrants
in Britain

Source:
*Labour Force
Survey, 2004-2012.*

Has this influx of higher- and low-skilled workers put downward pressure on the wages and job prospects of British graduates and low-skilled workers?

Various econometric studies, which are listed in Table 4.1, have found little evidence that the large flows of A8 immigrants after 2004 increased unemployment among Britons. Similarly, little evidence has been found that A8 migration has reduced Britons' average wages, or the wages of the poorly paid. One study found that A8 immigration is associated with higher average wages. Another found a small negative impact on employment of British nationals. But both are outliers.

Table 4.1:
Impact of A8
immigrants
on Britons' employment
and average
wages,
and on the
UK wage
distribution

Source:
Migration
Advisory
Committee,
'Analysis of
the impacts of
migration', 2012.

Study	Employment/ wages	Estimated impact
Portes and French (2005)	Employment	A 1 percentage point increase in A8 Worker Registrations in local authorities is associated with a 0.09 per cent increase in native unemployment in that area.
Gilpin et al. (2006)	Employment	Not statistically significant.
Lemos and Portes (2008)	Employment	Not statistically significant.
Lemos (2010)	Employment	Not statistically significant.
Migration Advisory Committee (2012)	Employment	Not statistically significant.
Lemos and Portes (2008)	Average wages	Not statistically significant.
Lemos (2010)	Average wages	A 1 percentage point increase in the A8 migrant-working age population ratio is associated with an increase in natives' average wage of approximately 3.4 per cent.
Lemos and Portes (2008)	Wage distribution	Not statistically significant.
Lemos (2010)	Wage distribution	An increase of 1 percentage point in the A8 migrant-working age population ratio is associated with a 3.9 per cent increase in the wages of workers in the 60 th percentile of the distribution.

These findings are in line with studies that have examined the impact of both EU and non-EU immigrants, not just A8 workers, on Britons' employment prospects. The majority of these studies also found that immigration in total had only small effects on native employment and on average wages. They did find, however, that it increased wage inequality slightly.⁵⁴

⁵⁴: Christian Dustmann et al found that 10,000 immigrants reduced wages of the bottom 10 per cent of earners by about £1 per year, but increased average wages by £4 per year, and the top 10 per cent of earners' wages by £5 per year ('The effect of immigration along the distribution of wages', UCL Centre for Research and Analysis of Migration, 2008). Stephen Nickell and Jumana Salaheen found larger impacts in particular occupations: in semi- or unskilled occupations, 10,000 low-skilled immigrants reduced wages by about £8 per year ('The impact of immigration on occupational wages: Evidence from Britain', Federal Reserve Bank of Boston, 2008).

A8 immigration, then, has had little discernible effect on British workers' wages. What about western Europeans? Policy-makers and analysts have paid less attention to them. Unlike A8 immigrants, the inflow of western Europeans has been slow and steady, with an average annual net immigration rate of 23,000 between 1991 and 2013.⁵⁵ This has endowed the British economy with a slowly growing stock of highly skilled workers. One cause of long-run economic growth is the quality of the human capital stock: the more highly skilled the workforce, the higher its productivity, which raises output. Thus western European immigration has had a positive impact on British GDP.

But what impact has this had on the employment prospects for highly skilled natives? While direct evidence on the impact of western Europeans on the UK economy is hard to come by, the evidence for high-skilled immigrants in general suggests that they are complementary to, and not substitutes for, British workers, and are thus likely to raise their wages.

The strongest reason why highly skilled immigrants are complementary is that they bring with them knowledge and technical expertise that allows British workers to become more productive. In the United States, for example, skilled natives are more likely to work as managers and executives, while skilled immigrants are more likely to work as scientists, engineers and statisticians. These skills are in short supply in the domestic labour market.⁵⁶ As Chart 4.1 above shows, the same is true of Britain. Highly skilled immigrants also bring in knowledge and technology that makes firms more productive. For example, highly skilled immigrants work disproportionately in developing and deploying information technology, which tends to raise the productivity of other workers.⁵⁷ Multinational companies operating in Britain bring in workers from other countries in intra-company transfers to a greater degree than elsewhere in the EU. This allows firms to make use of the worker's knowledge about their home country's market.⁵⁸

As A8 migration does not appear to reduce the wages of the host population, and high-skilled immigration from western Europe is likely to slightly increase Britons' productivity (and therefore wages), migration from the EU has been beneficial to the UK economy, although the effects on Britons' incomes are likely to have been small. But will Britain continue to wring benefits from EU immigration? To make such a judgement, some assessment of the future path of the demand for skills in the UK is needed.

55: Office of National Statistics, Long-term international migration data.

56: Giovanni Peri and Chad Sparber, 'Task specialisation, immigration, and wages', 2008.

57: David Autor et al, 'Computing inequality: Have computers changed the labour market?', 1998; Timothy Bresnahan et al, 'Information technology, workplace organization and the demand for skilled labor: Firm-level evidence', 2003.

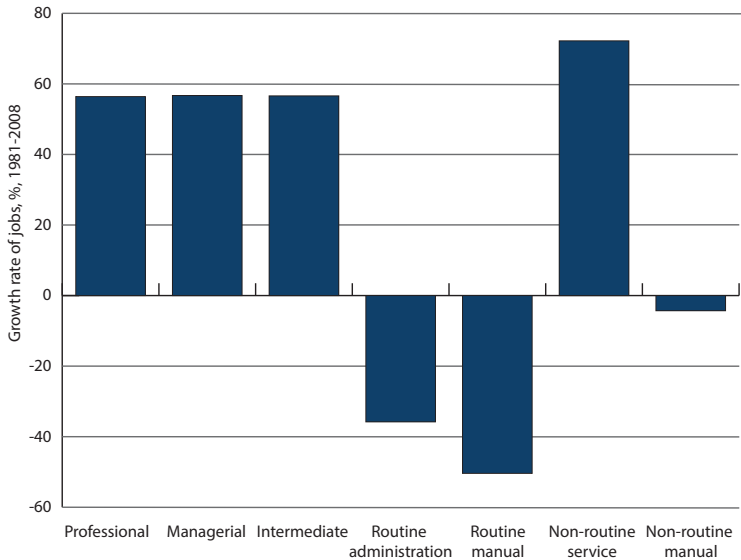
58: Marion Frenz and Grazia Ietto-Gillies, 'The impact on innovation performance of different sources of knowledge', 2009.

4.2 The changing shape of the UK labour market

Over the last three decades, the British labour market has ‘hollowed out’. Most new jobs have been created at the upper end of the skills scale, and in low-skilled services work. Technological change and trade are the main causes. The microchip has enormous disruptive power, replacing semi-skilled labour with information technology and machinery. For instance, employment in book-keeping and skilled manufacturing, which computers and computerised machinery can do more productively, has been in decline. Many manufacturing jobs have been lost to countries with lower wages. Meanwhile, the number of highly skilled jobs has been on the rise. So has work in services such as personal care, retail and hospitality. Such work is not easily replaced with technology (see Chart 4.2).

Chart 4.2:
Growth
in jobs by
occupation,
1981-2008

Source:
Craig Holmes
and Ken Mayhew,
*The changing
shape of the UK
job market and
its implications
for the bottom
half of earners*,
Resolution
Foundation,
March 2012.



As demand for high- and low-skilled work has been growing, so has the demand for immigrants from the rest of the EU who can do the work. Typically, western Europe provides a supply of workers in highly skilled managerial, financial and public services occupations, while the A8 supplies workers for lower-skilled jobs in construction, manufacturing, and services.

It is difficult to predict the future patterns of demand for skills. But there is little reason to believe that this pattern of demand for immigrant labour will change. If anything, it is likely to get stronger, if British demographic change is taken into account. The UK Commission on Employment and Skills estimates that 1.5 million jobs are going to be created by 2020 in management, business, science and technology, and in the public services – occupations in which western Europeans are highly represented (see Chart 4.3). The number of new low-skilled jobs, apart from those caring for the increasing ranks of the elderly, will decline: manufacturing and administration will see further job losses over the next decade.

However, the chart also shows how many workers will be needed to replace retirees in different sectors. Britain’s baby boom generation is on the verge of retirement, leaving behind a smaller working age population. Some jobs will have to be filled by immigrants. Demand for workers to replace retirees will be strong in low-skilled administration and services, in manufacturing, and in skilled trades, occupations in which A8 nationals are over-represented. In these sectors, baby-boomers will retire so fast that they will outstrip the rate at which employment in these sectors is falling. Meanwhile, western Europe is one source of workers to replace retirees, as well as filling new jobs created in skilled sectors of the economy.

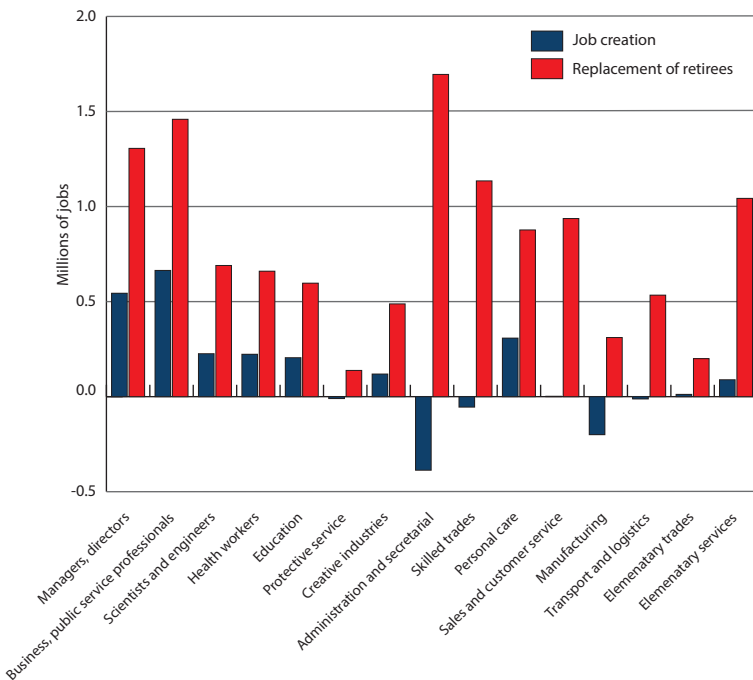


Chart 4.3: Job creation and the replacement of British retirees, 2010-2020

Sources: UK Commission on Employment and Skills, 'Working futures, 2010-2020'; 2012.

Despite public hostility, the evidence suggests that immigrants from the EU improve the wage prospects of the host population on average, and employers are likely to become more reliant on EU immigrants as the country ages.

4.3 The impact of European immigration on housing and public services

The benefits identified above must nonetheless be set against the impact on public services and housing. EU immigrants' fiscal impact is benign: they are net contributors to the British treasury. In its 2013 International Migration Outlook, the OECD lists three factors that determine whether an immigrant is a net contributor or net beneficiary. First, the age of immigrants: young immigrants of working age are likely to be net contributors until they are between 40 and 45 years of age, as they receive little health or pension expenditure (two of the three biggest expenditure items for most governments, including Britain's). Second, their employment rate: if the immigrant employment rate is higher than the native population's, then they are less likely to receive welfare benefits – and if immigrants have come to work, rather than to be reunited with their families, they are more likely to be net contributors. And third, their skill level: if immigrants are highly skilled, they are more likely to be employed, pay more in taxes, and receive fewer benefits.

“EU immigrants' fiscal impact is benign: they are net contributors to the British treasury.”

EU immigrants are on average younger than Britons; they are more likely to be in employment; and they are overwhelmingly in Britain to work rather than to join a family member. On average, therefore, they are net contributors to Britain's public finances. Christian Dustmann and Tommaso Frattini of University College London found that EU migrants contributed 34 per cent more in taxes than they received in benefits between 2001 and 2011.⁵⁹ According to the UK's fiscal watchdog, the Office for Budget Responsibility (OBR), this net contribution will be large in the future. It projects that debt would be 40 percentage points higher in 2062 if net migration is reduced to zero from 140,000 per year (the OBR's central estimate).⁶⁰

However, those immigrants from the A8 that settle in the UK, rather than returning home after a short period of work, are young and

59: Christian Dustmann and Tommaso Frattini, 'The fiscal effects of immigration to the UK', UCL Centre for Research and Analysis of Migration, November 2013.

60: Office for Budget Responsibility, 'Fiscal sustainability report', July 2013.

increasingly having children. Immigrants from other countries are also contributing to a baby boom. This boom will raise education spending for immigrants' children, and it will raise demand for housing.

Britain's population has grown by 20 million since 1960; a rise of nearly 50 per cent.⁶¹ Immigrants and their higher birth rate make up the majority of this population growth. While immigration is one reason for the large increase in the number of British households, so too is the rise in the number of British households headed by one adult: Britons are increasingly living on their own, or as single-parent families. Meanwhile, the country has failed to build enough housing to keep up with demand, especially in fast-growing areas like London and the south-east of England. As a result, house prices and rents have risen faster than incomes, putting downward pressure on Britons' living standards, as an increasing proportion of their disposable income is spent on housing.

Until the accession of the Central and East European member-states in 2004, immigration from the EU made up a small part of Britain's population growth. Since then, however, net immigration from the EU has made up 45 per cent of the total net inflow.⁶² A8 countries will be poorer than Britain for many years, and so incentives for people to move to Britain will remain strong. Immigration has also picked up from peripheral eurozone countries – Spain, Ireland and Portugal, in particular – where unemployment is high. Thus EU immigration will continue to raise demand for British housing in the future.

But by how much? Using the UK Department of Communities and Local Government's (DCLG) data on housing demand, which are based upon assumptions about fertility, life expectancy and immigration, it is possible to make a rough estimate.⁶³ According to their (very conservative) assumptions, long-term net immigration to England, where the vast majority of immigrants live, will be 157,000 per year to 2033. This translates into an extra 83,000 extra households formed each year by migrants, each of which needs somewhere to live. If we assume that EU net migration continues at the average rate seen between 2004 and 2012 – 87,000 per year – the DCLG's assumptions about the number of immigrants per household suggest 46,000 extra EU immigrant households a year. That is 20 per cent of all household formation in England.

However, recent studies of the impact of immigration on local house prices has found that it has caused them to fall.⁶⁴ There are two reasons.

61: World Bank, World Development Indicators.

62: Migration Observatory, 'The impact of migration on UK population growth', 2012.

63: DCLG, 'Household projections, 2008 to 2033', 2010. Data for England only.

64: Filipa Sá, 'Immigration and house prices in the UK', 2011 and Nils Braakman, 'Immigration and property prices in England and Wales', 2013.

First, migrants tend to live in more cramped conditions than do Britons. Second, the researchers found that when immigrants move into a local area, Britons move away, and so demand for housing falls in the short term. However, Britons will push up prices in the areas they move to, and in the long run, migrants are likely to move into less crowded accommodation. This will push up housing costs – unless Britain builds more houses – especially in the south-east of England. It is impossible to say whether this effect will be larger than the productivity gains that arise from EU immigration, but the rise in housing costs may erode immigration's benefits in the long term, if housing supply does not match rising demand.

The British government does not systematically record migrants' use of public services: neither the NHS nor the British school system record their users' country of birth. It is therefore not possible to know how much pressure immigration puts on these services in regions with high levels of immigration. Fast rates of population growth in some regions are likely to raise demand above supply, if investment in capacity lags behind. But immigration can help to improve the supply of public services as much as it raises demand for them. The NHS makes heavy use of skilled immigrant labour, for example.

So what policy should the government pursue? The most rational would be to take advantage of the labour market benefits of EU immigration by keeping the border open to them; liberalise planning laws to ensure housing supply matches demand; and use some of the extra revenues that immigration brings to invest in public services and infrastructure to ease congestion costs.

The government's dilemma – keeping borders open for economic reasons, or closing them to soothe public hostility – is likely to become more acute, not less. These policies will be politically challenging, requiring the government to confront a hostile public and media, and challenge the privileged position of homeowners, whose interests lie in higher house prices. But these policies would maximise the benefits that EU immigration brings.

4.4 Closing the drawbridge

If Britain leaves the EU it will recover the ability to restrict immigration from the rest of Europe. What would be the probable implications of a British exit for its labour market – and for Britons living elsewhere in the EU?

If, upon leaving the EU, the UK's immigration policies were set with the needs of its economy in mind, the British government would allow free immigration from the EU to continue. This would maintain the inflow of labour that employers demand, providing workers to fill newly created jobs and replace retirees. As low-skilled immigrants from the rest of the EU do not displace British workers, and higher-skilled workers probably make them richer and more productive, this would be rational. If Britain joined the EEA, it would have to sign up to free migration in order to have full access to the single market, as the group's other members currently do.

Upon exit, it would be sensible to allow all EU migrants in Britain to remain. This would help to secure the rights of Britons living abroad. However, the government would probably redirect EU immigrants through Britain's current immigration system for non-EEA migrants. After all, immigration has been one of the main reasons for rising British antipathy to EU membership. This system allows entry by awarding would-be immigrants 'points' for possessing certain qualifications, skills and capital.

There are five 'tiers' within the system, of which the first three are relevant to this analysis. Tier 1 allows very highly skilled people entry if certain conditions are met. Entrepreneurs must hold £200,000 in cash in a bank account. Investors must show they can invest £1 million or more in the UK. Other Tier 1 migrants must be scientists, engineers or artists who have very good qualifications and show that their careers have been highly successful. At the time of writing, the quota for this tier is 500 people a year. If the UK were to leave the EU and reroute highly skilled Europeans through Tier 1, it would have many fewer entrepreneurs, scientists, engineers and managers, unless it increased the quota.

Tier 2 deals with skilled migrants – such as teachers and lawyers – whose job usually requires a university degree. Would-be immigrants must have an offer for a job earning more than £20,000, and the employer must have advertised the job to UK residents and found no one suitable. Migrants earn extra points if their job is on the list of occupations in short supply, drawn up by the government's Migration Advisory Committee. At present, only 20,000 visas may be given through Tier 2 annually. There is no limit on the number of intra-company transfers conducted under Tier 2, but transferees must earn more than £40,000. The total number of visas issued each year is around 30,000.⁶⁵ Yet 34,500 graduate immigrants from the rest of the

65: Christine Whitehead et al, 'The impact of migration on access to housing and the housing market', London School of Economics, 2011.

EU come to Britain each year. (150,000 immigrants have come to the UK each year from the EU, on average, since 2004.⁶⁶ Twenty-three per cent of these immigrants hold university degrees.⁶⁷) If Britain made EU immigrants go through the Tier 2 route, and did not raise the quota, Britain would take in far fewer skilled immigrants than it currently receives.

The third tier governs low-skilled immigration. It is now closed, as the government says that Britain's demand for low-skilled workers is currently sated by immigration from the A8. It could re-open it upon leaving the EU, but as one rationale for leaving would be to reduce the inflow of A8 workers, this is unlikely.

The most plausible outcome of an EU exit must therefore be that Britain would be much more closed to immigrants of all skill levels than it is now. This would make the country worse off, and would require more tax rises and spending cuts to help deal with the costs of an ageing population.

It should also be remembered that over 1.8 million Britons live elsewhere in the EU. Spain and Ireland house around 400,000 each (Spain's figure is far higher if Britons who live there part-time are included), and there are 150,000 and 175,000 in Germany and France respectively.⁶⁸ Britain's EU membership is, of course, a major benefit to these migrants. The EU offers a much larger choice of jobs than the UK labour market alone, which leads to higher incomes and a better quality of life for many Britons who choose to live in other member-states. It is also a major destination for British retirees: there are over 400,000 living in other EU member-states.⁶⁹

But in the event that the UK decided to leave, some settlement would have to be negotiated with other EU member-states, to ensure that British emigrants could continue to live there. The outcome of such a negotiation may not be as straightforward as one might assume. Retired immigrants are on average a net drain on the public finances because of their heavy use of healthcare. In any bilateral negotiations between Britain and these four countries, the fact that free migration is more costly for France, Germany, Spain and Ireland than it is for Britain would not go unnoticed, and Britons abroad may find that access to healthcare becomes more expensive: currently, the Spanish government pays for British migrants' visits to GPs.

66: Office of National Statistics, Long-term International Migration Survey data.

67: Office of National Statistics, Labour Force Survey data.

68: World Bank, Global Bilateral Migration Database, and Office of National Statistics, NOMIS data.

69: CER analysis of Department of Work and Pensions state pensions data.

Britain could negotiate free movement with western European countries bilaterally, to allow existing migrants to stay and future migrants to move unhindered. This would probably be the simplest solution, if the UK were to insist on closing the door to the A8. But Britain cannot control the outcome of such negotiations, which may lead to migration opportunities for Britons being curtailed.

In summary, leaving the EU would make it easier for future governments to restrict immigration. This may have some political benefits, but it would have harmful economic effects. Many Britons presume that EU migration is zero-sum: a job taken by an immigrant is one less for a British national. The idea that immigration might have benefits – that, for example, an immigrant might raise native workers' income – is rarely considered.

Yet economists have found little evidence that immigration from the A8 endangers Britons' employment prospects. The impact of highly skilled workers from western Europe is positive: they are likely to raise the productivity of the British workforce. Demand for immigrant labour is likely to be robust in the future. And both immigrant groups are net contributors to the public finances.

However, EU immigration will be a significant cause of rising housing costs in the future, unless the government manages to ensure more houses are built. While EU immigrants are net contributors to the public finances, they also raise the demand for school places.

If Britain left the EU, it would almost certainly reduce immigration in a period when demographic and economic change makes access to European labour a significant benefit. And it might endanger the residency rights of over one million Britons living on the continent and in Ireland. Ultimately, Britain must decide whether the economic benefits of free EU migration are a reason to stay in Europe. The evidence shows that they are.

Chapter 5

The EU budget

Each year, Britain's net contribution to the EU budget will be 0.5 per cent of its GDP between 2014 and 2020. The economic effects of the EU spending in the UK are mixed. The budget's farm subsidies push up food prices and lead to environmental damage. But EU economic development funds boost growth in poorer regions of the UK, and British scientists and researchers win more EU funding than any other member-state.

If Britain left the EU's orbit entirely, it would save 0.5 per cent of its GDP. But if it seeks continued access to the single market along Norwegian or Swiss lines, it will have to make a contribution to development funds. If the UK were to withdraw to the EEA and pay into the EU budget on the same basis as Norway, it would reduce its contribution by 9 per cent. If it were successful in negotiating an agreement like Switzerland's, its contribution would fall by 55 per cent.

Outside the EU, the British government would find it difficult to cut farm subsidies and development funds. All OECD countries subsidise their agricultural sectors. And Wales and Northern Ireland are large net beneficiaries of the EU budget: if EU spending were not replaced by funds from Westminster upon exit, their economies would shrink.

The EU budget is one of the few areas in which the benefits of a British exit are easily quantifiable. By far its largest components are the Common Agricultural Policy (CAP) and structural funds, which each constitute around 40 per cent of the total. First introduced in 1963, the CAP was the fruit of a bargain between West Germany and France after the Treaty of Rome. West German manufacturers would have access to French markets, while in exchange, West Germany would help to subsidise French farmers' incomes. While it was sold as a way to align the six founders' various national subsidy schemes, and thus promote fair competition, France was a large net beneficiary: inefficient farms were supported by a system of quotas and subsidies that raised European food prices. Since the 1990s, the system has been reformed to reduce its costs to consumers and the environment, but it still raises food prices, damages the environment and hampers economic development in poor countries outside Europe.

Structural funds are spent on the economic development of the EU's poorest regions. From the start, the architects of the EU recognised that the four freedoms might have a centripetal effect: the most efficient producers would win larger market shares as national markets were opened to foreign competition. These producers would have higher profits, invest more, and pay their workers higher wages, concentrating wealth in the regions that were already most advanced. To counteract these forces, the EU provides money from the budget to invest in infrastructure, and to a lesser degree, education and training in poorer regions.

5.1 Ending British participation in the EU budget

Britain has been a net contributor to the EU budget in every year since it joined (bar one – 1973). It has a small and relatively efficient agricultural sector. While it has quite severe regional disparities of economic development, it is a richer member-state than the EU average, which means that its net contribution to the EU budget has risen to 0.5 per cent of GDP. Over the next budget period, between 2014 and 2020, the UK's net contribution will amount to £7 to 8 billion each year.

“Britain has been a net contributor to the EU budget in every year since it joined (bar one – 1973).”

Therefore, if the UK left the EU entirely, Britain would save 0.5 per cent of GDP per year. And upon exit, the government could decide to raise consumers' incomes further

by reducing tariffs and quotas on agricultural produce imported from outside the UK to zero. In 2012, the EU's tariffs and quotas raised agricultural prices by 18.6 per cent, according to the OECD.⁷⁰

Britain could also abolish farm subsidies. Since the late 1990s, quotas and subsidies linked to farm output have been cut, as they resulted in surplus 'mountains' of butter and 'lakes' of wine, and distorted prices. They have been replaced with direct payments to farmers, largely based upon farm size (see Chart 5.1). Subsidies that are not linked to production are less distorting of prices. But they reduce efficiency: farmers do not have to constantly improve productivity to remain competitive. Many do not use the highest-yielding crops on their land, and invest less than they should in new technology.⁷¹ Subsidies and tariffs also encourage over-production in Europe – the latter by rendering agricultural imports to the EU more expensive – when

70: OECD Producer and consumer support estimates database.

71: OECD, 'Agricultural policy monitoring and evaluation: OECD countries and emerging economies, European Union', 2013.

the environment would be better served by allowing land to return to the wild.⁷² And they hamper economic development in those poor countries outside the EU that have a comparative advantage in agricultural exports.⁷³ However, all countries in the OECD subsidise their farmers to a certain degree, and it is unlikely that Britain would cut subsidies to zero if it left the EU.

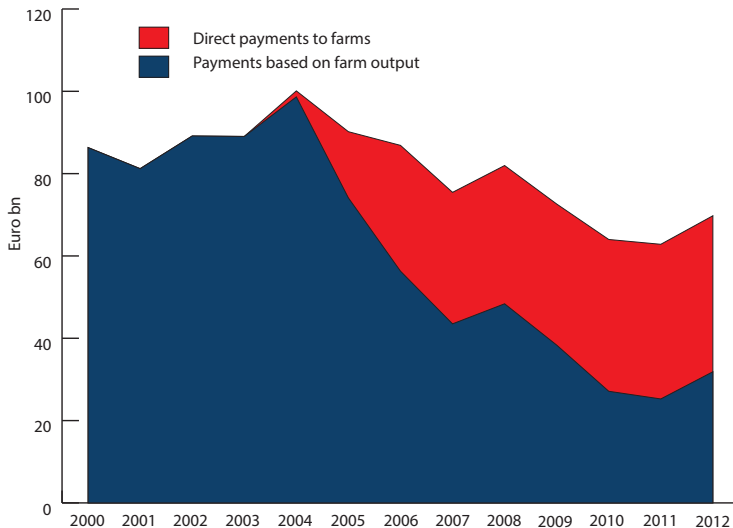


Chart 5.1:
EU farm
subsidies by
type

Source:
OECD agricultural
policies and
support data.

Upon exit, the UK would face a choice over whether to replace the EU's structural funds with national regional development spending. Some academics have criticised the EU's structural funds in the past for failing to generate additional growth.⁷⁴ But their studies' method was based upon a comparison of EU regional spending with countries and regions that did not make similar investments. As growth rates in poorer European regions were no better than poorer regions in countries outside the EU, they concluded that regional spending is a failure. But they were hardly comparing like with like: countries and regions outside Europe have very different characteristics to those in the Union. More recent studies have focussed on regions that were poorer, but ineligible for 'convergence' funds as they were just over the GDP per capita limit that the EU sets (75 per cent of the EU average). Researchers then compared them with regions that fell below the limit.

72: Ian Bateman et al, 'Bringing ecosystem services into economic decision-making: land use in the United Kingdom', *Science*, July 2013.

73: Dirk Willem te Velde et al, 'The EU's common agricultural policy and development', Overseas Development Institute, November 2012.

74: Xavier Sala-i-Martin, 'Regional cohesion: Evidence and theories of regional growth and convergence', *European Economic Review*, 1996; and Michele Boldrin and Fabio Canova, 'Europe's regions: Income disparities and regional policies', *Economic Policy*, 2001.

Their conclusion: EU structural funding does raise regional growth.⁷⁵ Sascha Becker and colleagues at the University of Warwick found that, on average, one euro of EU investment translated into €1.20 of regional GDP growth. However, there was wide variation in how much growth EU investment generated. The best performers were regions in countries that were well governed, and had high educational standards – namely, poor regions in richer, western member-states, like the UK.⁷⁶

“Northern Ireland and Wales will be large net beneficiaries in the next EU budget.”

It would be sensible for Britain to cut agricultural subsidies if it left the EU. The case for regional investment is less clear cut. Given that regional investment raises

regional output, it might be economically rational to replace EU funds with British ones. Critics of regional policy, however, would point out that educating and training people in poorer regions of the UK and encouraging them to move to areas where there are more job opportunities would be a more productive use of public money than investment in infrastructure.⁷⁷ A reorientation of any repatriated funds away from infrastructure towards education might bring the highest return on public investment.

5.2 The regional impact of ending EU spending in Britain

However, policy decision-making rarely rests upon pure economic analysis. Farm subsidies and infrastructure investment by their nature are regional expenditures, and so the pain of reducing this spending will be concentrated in certain areas. This means that people in those areas will urge Westminster to replace EU funds with national spending if the UK leaves the Union.

Which areas would suffer the largest losses if EU subsidies and spending were not replaced? Northern Ireland, Scotland and Wales will receive much more subsidy per head than England under the current round of CAP funding. Northern Ireland receives four times as much CAP spending per capita as England, and Scotland and Wales receive three times as much. (See Table 5.1.) In the budget negotiations, the Council agreed to reorientate funding towards the least developed regions of

75: Maaïke Beugelsdijk and Sylvester Eijffinger, 'The effectiveness of structural policy in the European Union', *Journal of Common Market Studies*, 2005; and Sjef Ederveen et al, 'Funds and Games: The Economics of European Cohesion Policy', CEPS, 2002.

76: Sascha Becker, 'EU structural funds: Do they generate more growth?', Chatham House, December 2012.

77: Henry Overman and Stephen Gibbons, 'In unequal Britain who you are is much more important than where you live in determining earnings', *British Politics and Policy* at LSE blog, November 2011. <http://eprints.lse.ac.uk/39565/>

the EU – defined as those with a GDP per capita below 75 per cent of the EU average – which are mostly in the eastern member-states. As West Wales and the Welsh Valleys are the only two British regions that qualify, the devolved Welsh government will receive more EU funds per head than Scotland, Northern Ireland or England.

	England	Northern Ireland	Scotland	Wales
CAP total spending	£2,184 m	£317 m	£614 m	£353 m
CAP spending per capita	£31	£145	£96	£96
Structural funds total spending	£735 m	£54 m	£95 m	£255 m
Structural funds spending per capita	£13	£30	£18	£83

Table 5.1:
CAP and structural funds spending per year, 2014-20⁷⁸

Sources:
Alan Matthews, 'The CAP budget in the MFF', *capreform.eu*; House of Commons Library, 'CAP Reform 2014-20: EU Agreement and Implementation in the UK and in Ireland', November 2013; UK Department of Business, Innovation and Skills, 'Making European funding work better for the UK economy', January 2013.

It is possible to work out which of the constituent countries of the UK will be a net contributor or net beneficiary from the EU budget.⁷⁹ Each country's net contribution can be estimated by first, working out what proportion of tax they pay to the Treasury, and thus how much of the UK's contribution to the EU they pay – and second, how much European spending they receive.⁸⁰

The results are in Table 5.2. Overall, the UK's net contribution will be 0.5 per cent of its GDP over the period. England's net contribution will be larger than the UK's. Scotland's account with the EU will be roughly in balance. But Northern Ireland and Wales will be large net beneficiaries, receiving annual payments from the EU budget of £151 million and £838 million. Were the UK to leave the EU, Northern Ireland and Wales would be likely to ask Westminster for continued agricultural support and development funding.

78: Tables 5.1 and 5.2 update tables on EU budget winners and losers in the House of Commons Library's research paper, 'Leaving the EU', July 2013, p. 38.

79: This method is the same as that of the House of Commons Library team, but projects it forward to the 2014-20 period. It takes the average GVA growth of each country between 1997 and 2012, and projects that forward into the 2014-20 period.

80: Each country's payment to the EU is calculated by dividing the UK's contribution to the EU by how much private sector economic output that country generates (which offers an estimate of how much each country contributes to the UK tax take).

Table 5.2:
Annual net
contributions
to the EU
budget, by
UK country,
2014-20

	UK	England	Northern Ireland	Scotland	Wales
Gross payments, m	£16,907	£14,582	£567	£1,417	£340
Less UK rebate, m	-£3,844	-£2,436	-£310	-£592	-£507
Less public sector receipts, m	-£5,078	-£3,217	-£409	-£781	-£670
Net contribution, m	£7,985	£8,930	-£151	£44	-£838
Net contribution per capita	£117	£154	-£84	£8	-£273

Sources:
HM Treasury,
'European
Union finances',
2013; Office of
National Statistics,
Workplace-based
GVA data.

Furthermore, if the UK were to retain some links with the EU in order to benefit from access to the single market, it would find it difficult to avoid payments to the EU budget. The Swiss and Norwegian models of association with the EU come with fiscal costs. If the UK were to join the EEA, it would leave the CAP, but EEA member-states participate in other EU programmes, such as research and policing. EEA member-states also contribute to the development of the member-states that joined the EU after 2004, as does Switzerland. In recent years, Norway has paid £524 million annually (£106 per capita) and Switzerland £420 million (£53 per capita).⁸¹ Since the UK net contribution amounts £117 per capita, if it withdrew to the EEA and paid into the EU budget on the same basis as Norway, it would reduce its contribution by 9 per cent. If it were successful in negotiating an agreement like Switzerland's, its contribution would fall by 55 per cent. (Of course, the Swiss have much less access to the single market than the EEA states.)

The UK wins a bigger share of research funding than any other member-state. Researchers based in the UK received 16 per cent of EU R&D funding, and 20 per cent of its grants for scientific research in the last budget period – the country contributed 11 per cent of the EU's total budget.⁸² Should Britain leave, more research funding will have to be made available to make up the shortfall, to avoid damage to the country's scientific base.

In sum, as with all other areas, the EU insists that the prize – access to the single market – comes at a cost. To trade freely with the EU, Switzerland and Norway must make contributions to the EU's spending priorities. Some of these priorities, such as the CAP, make little economic sense. However, if Britain seeks a looser relationship with the EU, but one which includes full access to the single market, it will have to pay for it.

81: House of Commons Library, 'Leaving the EU', July 2013.

82: Russell Group, 'Response to the Government Review of the Balance of Competences between the UK and EU: Research and development', 2013.

Conclusion

Britain is deeply divided over its membership of the EU. Most business people and economists see access to EU markets as beneficial. The government does too, hence its attempts to defend Britain's interests against the eurozone, which it fears may gang up on EU countries that are not members of the currency union. But many Conservative parliamentarians, some business leaders and many voters would prefer Britain to withdraw, arguing that Britain's economy would be liberated by doing so, and that the UK could in any case negotiate access to European markets if it were outside the Union.

This report has shown these assumptions to be doubtful. The trade-off that the UK must make is quite simple: it is between regulatory sovereignty – which would not transform Britain's growth prospects – and unimpeded access to the EU's single market.

Eurosceptics are wrong to say that the EU offers little market access for a good deal of red tape, or that it constrains Britain's trade with fast-growing economies outside Europe. The EU has no tariffs and quotas on internal trade, while common rules have further reduced trade costs. These policies work: Britain's membership of the EU has led to increased trade with the other member-states. At the same time, there is no evidence that membership of the EU constrains Britain's trade with the rest of the world.

The EU's efforts to promote trade in services have been half-hearted – a shame for Britain, given that it has a comparative advantage in this sector. Nonetheless, the UK is the largest recipient of foreign direct investment in the EU – and much of this investment in the services sector. Half of Britain's FDI stock is owned by companies with headquarters in other EU countries. A sizeable chunk of the rest is from non-European companies who seek a base for their European operations in a lightly-regulated economy. The EU's single market has brought sizeable benefits to Britain that it could not have won without sharing some sovereignty in the European institutions.

If it leaves the EU, the UK will have to negotiate terms. Britain will face an invidious choice: access to the single market, but less influence on the rules that govern it; or freedom from the rules, but loss of access to the single market. If Britain joins the EEA, it will have to sign up to all new single market rules with little hand in their drafting. Even Switzerland, which has a set of bilateral agreements with the EU, has limited access to those areas of the single market whose rules it cannot stomach, such as financial services. Britain could trade with the EU under WTO rules in order to regain regulatory sovereignty. But its exporters would face EU tariffs, and would have to comply with EU product standards if they wanted to sell their wares on the continent. And as Britain has one of the least regulated economies in the world, according to the OECD, any economic gains from repealing the EU's rather limited social legislation would be small.

The UK would be free to negotiate trade agreements with countries outside the EU. But it would not inherit the EU's existing bilateral trade agreements that are already in existence: it would have to negotiate new ones. So, upon exit, it would have less access to markets outside the EU, not more. And it is hard to believe that Britain would find it easy to forge new deals. To persuade a trading partner to start negotiating, it would need to be able to offer something attractive. Britain's economy is far smaller than the EU's – and would be less of a priority for the US or China. The UK is already very open to imports and inward investment, so it would have little to offer in return for its demands that other countries reduce tariffs and other trade barriers. Britain benefits from the EU's size in trade negotiations, which gives it something to bargain with.

The alternatives to EU membership are unsatisfactory: they either give Britain less control over regulation than it currently enjoys, or they offer more control but less market access. In a referendum, Britain will have to choose between national sovereignty and unimpeded access to EU markets. While membership of the EU is as much about broader, political questions as economics, the economic case for staying in the Union is strong.

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:

$$\ln(X_{ijt}) = \beta_1 \ln(Y_{jt}) + \beta_2 \ln(R_{jt}) + \beta_3 EU_j + \beta_4 TT_j + u_{jt} + \varepsilon_{ij}$$

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.

Other publications

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The economic consequences of leaving the EU

The final report of the CER commission on the UK and the EU single market

The CER invited leading economists, commentators, business people and EU experts to form a commission to consider the economic consequences of leaving the EU. This is the commission's final report.

The EU's critics claim that its rules do little to enhance British trade with the continent, that they hold back Britain's economy and that they limit its trade with fast-growing economies outside Europe. Yet this report shows that trade, investment and financial flows between Britain and the continent are much larger than would be the case if the single market did not exist. It finds that EU rules do little damage to Britain's economy and that they do not account for its lacklustre trade with emerging economies. If Britain voted to leave the EU, it would face an invidious choice in the subsequent negotiations: full access to the European single market, with little influence on the rules that govern it; or freedom from those rules, with less access to the market.



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