Senior European Experts

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Introduction

In the debate about the costs and benefits of the UK leaving the European Union the biggest issue is what would happen to the UK economy. Would the UK economy gain or lose from Brexit? Much of the argument in the UK on this topic has been based on a number of detailed studies by economists, almost all of which conclude that a vote to leave would have adverse consequences for the economy in the short, medium and long-term.

This paper looks at the question of the economic case for remaining in the EU as against the economic benefits, if any, there could be from the UK leaving the EU. It is complementary to other recent Senior European Experts papers on trade and economic issues.

The economic impact of EU membership

Positive

The positive economic impact of EU membership can be summarised as:

- the four freedoms (of goods, services, capital and labour) to UK businesses and citizens, meaning easy access to the Single Market of 500 million people, the world's largest economic bloc;
- only having to comply (in many sectors) with one set of rules in all 28 EU Member States, making it easier to export goods and services to them; and in having a say in the formulation of those rules;
- lower prices to consumers and restrictions on unfair competition as a result of the Single Market and EU competition policy;
- encouraging foreign investors to invest in the UK because it is in the Single Market and is thus a gateway to other countries in it;
- giving the UK preferential access to the markets of 75 countries with which the EU has trade agreements;
- raising UK productivity through the competition and investment which comes from the EU.

The Single Market effect

The four freedoms implemented through the Single Market make it easier for the UK to trade with its nearest neighbours. The removal of tariffs, and of non-tariff barriers to trade, such as national product standards, and the existence of EU-wide rules for many business

sectors make it easier for UK businesses to export goods and services to the EU than it was when only tariffs were removed in the early years of the EU. The free movement of people means that UK businesses can recruit the people they need.

Studies show the positive effect of being a member of the EU. One such recent study found that UK trade is 55 per cent higher with the rest of the EU than it would be if we were not an EU member.[1] The overwhelming majority of studies of the economic implications of Brexit find that the UK would be worse off if it left. The 2016 HM Treasury analysis gave a range of outcomes depending on what alternative trading arrangement the UK was able to negotiate with the EU: from an annual loss of GDP per capita by 2030 of around £1,000 if the UK joined the European Economic Area (like Norway and Iceland[2]) to an annual loss of up to £2,700 per capita if we traded only under the rules of the World Trade Organisation.[3]

The consumer benefits of EU membership include lower prices, notably in areas such as civil aviation and travel, telecommunications and food. Lower prices are partly the result of greater competition for supply within a Single Market of 500 million and are also the consequence of EU de-regulation and state aid policies, which have opened up previously restricted markets in Europe.

UK Productivity

Studies of economic performance show that the openness of a country's economy to its large developed neighbours boosts its productivity. Put simply, more open economies are more productive.[4] The UK's economy is more open because of the UK being in the EU. While the UK's productivity is still inadequate, the Single Market has enabled higher productivity than the UK would otherwise have had, which translates into a bigger economy, with greater employment and higher levels of wealth.[5]

Foreign Direct Investment

The UK is the largest recipient of foreign direct investment (FDI) in the EU. Over the past decade FDI in the UK has totalled £540 billion – more than £148 million a day.[6] FDI is of benefit because it brings with it employment – for example, through foreign manufacturers opening plants in the UK (e.g. Hitachi trains and Toyota cars) – but also because it encourages competition and innovation in the UK economy.[7]

External Trade

Through the EU the UK has preferential trade access to markets which make up around a third of the global economy.[8] The EU's free trade agreements (FTAs) that facilitate trade with 75 countries have become more important as no agreement has been possible yet on

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1 John Springford & Simon Tilford, *The Great British Trade-Off: The impact of the UK leaving the EU on trade and investment*, Centre for European Reform, 20 January 2014, p. 4

2 An option that has been ruled out by Vote Leave

3 HM Government, *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives*, Cm 9250, 18 April 2016, Table, p. 7

4 *Ibid.*, p. 54, citing a range of studies

5 *Ibid.*, p. 122 *et seq.*, where the paper compares various alternatives to EU membership

6 Cited in HM Government, *Why the Government believes that voting to remain in the European Union is the best decision for the UK*, 7 April 2016, p. 4

7 HM Government, *supra* n. 3, p. 48

8 *Ibid.*, p. 45

the most recent attempt at a global free trade agreement, the Doha Round. The UK remains a member of the World Trade Organisation and continues to support large, multilateral trade agreements (such as the recent Trade Facilitation Agreement) but the EU is able to negotiate bilateral trade treaties more effectively on behalf of 500 million people than the UK would on behalf of 65 million.

Negative

The negative aspects of EU membership can be summarised as:

- the UK's financial contribution to the EU budget;
- EU regulations that impose additional costs on business;
- the need for joint EU decision-making in the commercial and economic field;
- the inability to negotiate trade agreements with third countries on our own;
- the fact that EU Single Market in services is incomplete but services are the largest share of the UK economy;
- some of the consequences of the free movement of people.

UK Budget Contribution

The UK makes an annual net contribution to the EU budget. This contribution has been reduced by roughly 30 per cent since 1984 because of the UK rebate.[9] The net contribution the UK makes, allowing for our rebate, has averaged £7.1 billion a year in recent years; this means that just over 1p in the £ of tax paid by the UK taxpayer goes to the EU.[10] This is less than half the figure of £350 million a week suggested by some supporters of Brexit; that figure ignores the rebate the UK receives from the EU and EU expenditure in the UK.

Regulatory burden & joint decision-making

EU regulation creates a level playing field for business but some regulations are sub-optimal. The burden of such regulations can be substantial on individual businesses but it is important to note that outside the EU, national regulatory legislation would in most cases still be required. EU regulation also extends into the fields of social and employment rights, notably the Working Time Directive, which impose costs on employers. Decisions on EU legislation in the Single Market are determined by qualified majority voting which can result in the UK being outvoted. Official statistics show that since 1999, the UK has voted against EU proposals 56 times in the Council of Ministers, abstained 70 times and voted for 2,466 times; this means that the UK was on the winning side 95 per cent of the time.[11]

Trade rules

The EU conducts trade negotiations with third countries on the basis of a remit agreed by the Member States. This means that although there are benefits from the EU's increased leverage, it can take the EU longer to negotiate a trade agreement. Non-EU European

[9] HM Government, *supra* n. 3, p. 67
[10] *Ibid.*
[11] The UK in a Changing Europe, 'Facts behind the claims: UK influence', 5 May 2016

countries like Norway and Switzerland have successfully negotiated their own FTAs with third countries although these do not cover trade in services.

Services

The Single Market has achieved a high degree of integration in the trade in goods but far less in services. This is because many national barriers to trade in services remain, such as qualification requirements for professionals. The EU's 2006 Services Directive was an important step forward but it failed to include large areas of the services sector. The incomplete Single Market in services is a disadvantage to the UK because 80 per cent of its economy is in services.

Free movement of people

Free movement enables employers in the UK to fill skills shortages but this can have unwelcome effects in the economy and on society. Studies of the impact of free movement of people on the lowest paid show that while there may be some impact, it is very small. For example, the Bank of England found that the pay of unskilled and semi-skilled staff between 1992 and 2014 was 1.88 per cent lower for every 10 per cent increase in migrants working in that sector; the impact was even less on skilled workers, such as electricians and gardeners.[12] Although immigration into the UK from outside the EU has always been greater than that from inside, EU migration has contributed to strains on public services in some parts of the country.

The impact of Brexit: short-term and long-term

Leaving the EU would have both short and long term consequences. The short-term consequences are likely to include:

- the impact of the transition from EU membership to another trading relationship with the EU in terms of uncertainty for manufacturers, investors, shareholders and managers;
- the effect on interest rates – the UK's current account deficit of close to £100 billion is financed by borrowing from overseas lenders who would probably demand higher rates of interest;
- the effect on sterling – as the Bank of England has warned, overseas investors are likely to pull out of sterling because of the uncertainties, leading to a fall in the value of the pound; while this could give a short-term boost to exports, it would also make imports more expensive and thus hit the consumer;[13]
- the effect on EU citizens (and their employers) working in the UK and on UK citizens living in the rest of the EU – there would be uncertainty about their future and difficulties over new recruitment as overseas candidates would not know what their circumstances would be once Brexit was implemented;
- a chilling effect on foreign direct investment.

[12] Stephen Nickell & Jumana Saleheen, *The impact of immigration on occupational wages: evidence from Britain*, Bank of England Staff Working Paper No. 574, 18 December 2015, p. 22

[13] Mark Carney, *The turn of the year*, Peston Lecture at Queen Mary University of London, 19 January 2016

The longer term effects could include:

- the re-shaping of the UK economy around different sectors (for example, a decline in financial services as foreign investors relocate to continental Europe) and new investment goes there if the UK is no longer a gateway to the Single Market;
- the effects of UK leaving on the rest of the EU economy (anything from a gain for the other 27 to the EU's collapse and break-up);
- the effects on the UK exchequer of, for example lower tax yields because of a smaller, less prosperous UK economy (or vice versa) - the Treasury analysis suggests, for example, that if the UK were to negotiate a bilateral trading arrangement with the EU, that would reduce the size of the UK economy such that taxation receipts would be £36 billion a year lower; the negative effect would be greater if we traded with the EU only under the World Trade Organisation rules. These losses would dwarf the saving from the net contribution to the EU budget of roughly £7 billion a year;[14]
- societal impacts, including a reduction in immigration, a weaker/stronger economy leading to lower/higher public spending, loss of EU funding, changes in agricultural support etcetera.

The trading relationship with EU after Brexit

The impact on the UK economy of Brexit would depend in a large part on what kind of trading relationship (if any) the UK negotiated with the EU, currently the largest destination for its exports (at 44 per cent). Alternative trading arrangements to EU membership have already been considered in previous SEE papers.[15] The options can be summarised as:

- a bespoke trading agreement with the EU (like Canada);
- membership of the European Economic Area (like Norway);
- a series of bilateral trading agreements (like Switzerland);
- no agreement with the EU – trading under World Trade Organisation rules.

Each of these alternatives has good and bad aspects, which the 2016 Treasury analysis exhaustively considered; in common with other studies, it found that all of the alternatives were worse for the UK than EU membership. This was so even allowing for the potential advantages of the UK being able to adopt its own trade policy with third countries.[16] This is because the UK is already a very open economy and there is little we could do to make it more open to foreign trade and investment. In addition, the UK's freedom to set its own trade policy would still need to take account of the fact that it sells 44 per cent of its exports to the rest of the EU. There are no EU constraints that prevent the UK expanding its exports to countries outside the EU.

[14] HM Government, *supra* n. 3, p. 12

[15] See, for example, Senior European Experts, *The UK & the EU: Are there alternatives to membership?*, 6 January 2015

[16] HM Government, op. cit. pp. 12-13; this takes a 15 year view of the impact of the alternatives

An economic gain from Brexit?

A study by supporters of Leave has estimated that output would be two per cent higher by 2020 if the UK left the EU, and that the UK would be more competitive and wages would be higher.[17] Other estimates of the potential economic gain from Brexit have been made. For example, a report on the "insider advantages" of EU membership by Michael Burrage in 2014 argued that the UK had not gained from Single Market membership, indeed that the share of UK exports to the rest of the EU had slightly declined since 1973.[18]

These studies are very much a minority view and clearly produce a completely different outcome from Brexit compared to the reports of the Treasury and others, including those of the International Monetary Fund and the Organisation for Economic Co-operation & Development (OECD). The explanation for these differences lies partly in the tendency of critics of EU membership to use analyses based on one year and supporters of Remain to use longer-term dynamic analyses.[19] There is also the tendency of Leavers to be optimistic about the likelihood of the UK obtaining favourable trading terms from the EU in contrast to Remain supporters who tend to be sceptical about the chances of retaining full access to the Single Market. It is not convincing to claim that the UK would get favourable trading terms from the EU given the necessity (as many of their leaders would see it) of deterring other Member States from leaving the EU, and the fact that the UK only buys eight per cent of EU exports, in contrast to the 44 per cent we sell them. Finally, it is noticeable that many business supporters of Brexit are in non-exporting sectors, such as small retail or local services.

While the issue of EU regulation is important for Leave supporters, evidence of large-scale negative impact from EU regulations is hard to find. An Open Europe study identified high compliance costs for some EU regulations but still found that the benefits of regulation outweighed the disadvantages.[20] The overall burden of regulation is one indicator of the impact of EU regulation and the OECD assesses the UK within the EU as having the second lowest level of product regulation of the 34 major industrialised economies.[21]

Supporters of the UK leaving have made much of the success of Iceland and Switzerland in negotiating FTAs with third countries such as China and the USA. The Swiss experience, however, is that, while it is possible to negotiate FTAs on a bilateral basis, the terms of such an agreement are not as good as those a larger bloc of countries like the EU can get. This was the case with the Swiss-China FTA, where the Swiss made many more concessions in opening their markets to the Chinese than they obtained from China.

Calculating gains or losses from restricting immigration is difficult because of the multiple factors involved. The UK would still need labour in the hospitality, agriculture and food sectors, (the largest employment sectors for European migrants) and in public services such as nursing and care, and, given the reluctance of UK born people to take those jobs, what alternative would there be to immigration from neighbouring countries? The volume of

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[17] 'Leave campaign hits back with its own economists', Larry Elliott, *The Guardian*, 28 April 2016

[18] Michael Burrage, *Where's the Insider Advantage?: A review of the evidence that withdrawal from the EU would not harm the UK's exports or foreign investment in the UK*, Civitas, 18 July 2014, p. 11

[19] Gavin Thompson,*The economic impact of EU membership on the UK*, House of Commons Library Standard Note 15/6730, 18 September 2013, p. 5

[20] Quoted in *ibid.*, p. 20

[21] Isabell Koske *et al.*, *The 2013 update of the OECD's database on product market regulation*, OECD, Economics Department Working Papers No. 1200, 31 March 2015, p. 29

immigration since the 1990s has caused public disquiet in the UK but part of the reason for the relatively high number of EU migrants after 2004 was that the UK Government did not exercise its right to restrict access to the UK labour market, unlike the overwhelming majority of other EU Member States who retained controls for seven years afterwards. It is highly unlikely a British Government will make a similar decision in future.

Balance of the evidence

The balance of the evidence thus points to significantly greater losses than gains from Brexit. In summary this is because:

- the UK can't stop being dependent on the EU market quickly (if at all);
- it would be difficult to establish favourable trading arrangements with EU as they hold many of the cards;
- we could only negotiate the most favourable trading arrangement if we agreed to free movement of persons – i.e. no restrictions on EU migration into the UK;
- a Europe-wide tariff free trading area, such as that suggested by Leave campaigners, does not exist and is not on offer;
- the likely action by EU Member States in certain sectors where the UK currently has an advantage (for example, financial services), where they could see an opportunity to take market share from the UK;
- the loss of foreign direct investment as the UK ceased to be a gateway into the Single Market and became a less favoured destination;
- the lack of access for UK service exporters to the EU;
- the likely loss of manufacturing currently located in the UK as a result of foreign investors relocating to countries within the Single Market;
- the loss of opportunity, as the EU continues to open up new areas to competition within the Single Market (e.g. in digital services and in energy);
- the loss of EU negotiated FTAs and the consequent time delay while the UK negotiated its own; and the difficulties of negotiating FTAs of comparable quality to EU ones;
- the uncertain performance of emerging market economies as alternatives to the EU Member States.

For all these reasons the Treasury analysis (and other similar studies) convincingly shows that any alternative to EU membership is worse for the UK economy.

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Senior European Experts

The Senior European Experts Group is an independent body consisting of former high-ranking British diplomats and civil servants, including several former UK ambassadors to the EU, and former officials of the institutions of the EU.

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senioreuropeanexperts.org

info@senioreuropeanexperts.org

@SEE_Group