The economic impact of EU membership on the UK

Standard Note: SN/EP/6730

Last updated: 17 September 2013

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Section Economic Policy and Statistics

This note examines the various channels through which membership of the EU affects the UK economy. A general sense of the EU's economic impact can be gained by reading Section 1 alone. Subsequent sections deal with particular issues, such as the EU's effect on UK trade relations, in more detail, and compare the UK's situation with alternative arrangements.

Contents

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1 Introduction and summary

1.1 Understanding the economic impact of EU membership

EU membership influences the UK economy in a number of ways. The most important effects arise through the Single Market, the programme of economic integration through which the EU's 'four freedoms'[1] are guaranteed. But the economic impact of the EU is felt in other areas of its policy, too. The EU has exclusive competence to negotiate trade and investment agreements with countries outside the Union; and it is a customs union with a common external tariff on imported goods. Membership thus profoundly affects the UK's trade relations with non-EU members. There are also fiscal consequences to membership as a result of the UK's contributions to the EU budget; and consumer prices are affected through the Common Agricultural Policy and common external tariffs levied on imports. The fact of EU membership may also influence decisions made by foreigners about whether to invest in the UK.

Understanding these economic impacts provides us with a framework to evaluate the costs and benefits of EU membership, but it does not tell us whether the UK would be better off outside the EU. In order to do this, a counterfactual scenario is required: for cost-benefit purposes, it is no use knowing that the Common Agricultural Policy costs the UK £10bn per year without specifying whether and how the UK agricultural sector would be supported in its absence.

The purpose of this note is not to reach a conclusion on the economic merits of the UK's EU membership (a brief overview of such cost-benefit analyses is provided in Section 2), but to describe some of its economic impacts, and the possible implications of alternative arrangements. Were the UK to withdraw from the EU, its subsequent relations would be the product of negotiation, and would be unlikely to mimic precisely the situation of another country. However, looking at other countries' relationships with the EU – from the non-EU members of the European Economic Area (EEA)[2] who adopt the majority of EU law in return for access to the Single Market, to those that are entirely free from EU influence and trade without any preferences – will help to clarify the effects of membership, and offers an insight into the trade-offs that might arise in the event of UK withdrawal.

1.2 Summary of the impact of the Single Market and economic integration

The free movement of goods, services, people and capital has been a fundamental principle of the EU since the 1957 Treaty of Rome. However, as discussed in Section 3.1, achieving the

1 The term 'four freedoms' refers to the freedom of movement of goods, services, capital and people.
2 The EEA comprises the Member States of the European Union (except Croatia), together with Norway, Iceland and Liechtenstein

extensive harmonisation of law and levels of economic integration necessary to achieve such openness in practice is a complex and continuous exercise.

Effect of free movement of goods and services

The stripping away of barriers to the free movement of goods and services should stimulate trade. Theoretically, this is beneficial for all Member States because it allows them to specialise in those goods and services that they are relatively more efficient at producing. Reducing barriers to trade also increases the competition faced by domestic firms. By increasing the size of the market into which firms can sell, it also enables them to reap economies of scale. All these effects serve to lower prices for consumers and raise overall economic welfare, though this may come at the cost of the disruption or demise of certain sectors exposed to foreign competition.

These benefits arising from trade creation may be counteracted by trade diversion from countries outside the EU. This occurs because of the barriers to trade in goods and services entering the UK from outside the Single Market; for instance, the EU applies a tariff of 9.8% on motor vehicles imported from outside the Union.[3] [4] Some commentators believe the EU is so 'protectionist' that it diverts more trade than it creates,[5] although such conclusions are generally based on data from a period when average EU tariffs were much higher, and rest on the assumption that, were the UK to withdraw from the EU, it would unilaterally remove all its tariffs on non-EU imports.

The impact of EU membership on the UK's trade relations is discussed in Section 3.

Effect of free movement of capital and labour

The free movement of goods and services allows the production of goods and services to take place where it is relatively most efficient. Similarly, the free movement of capital and people theoretically increases the efficiency with which *inputs* to production process are allocated, by allowing investment and labour to flow to where returns are highest. Theoretically, this serves to reduce prices and raise overall economic welfare.

In practice, achieving free movement of capital and labour means the elimination of capital and exchange controls, freedom for businesses to invest and locate wherever they wish in the EU without discrimination, and, more controversially, the elimination of immigration restrictions within the EU.[6] Despite the theoretical benefits, there remain concerns that the free movement of labour in particular comes with economic costs, in the form of depressed wages and unemployment for the domestic population, and pressure on public services.

The impact on the UK of free movement of labour within the EU is discussed in Section 4.

Sovereignty implications of the Single Market

The Single Market today is the product of a vast array of legislation designed to minimise or eliminate differences in the way markets function between Member States. This ranges from product standards for goods, and EU-wide rules on consumer protection, to health and safety legislation, and competition policy. The benefits associated with creating a 'level playing field' across the EU in these areas may be counteracted by the loss of individual governments' ability

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[3] WTO Tariff Download Facility

[4] This note was corrected on 28 June 2016 to remove an erroneous figure of 32% for the tariff on wine.

[5] See, for instance, Patrick Minford (2005) *Should Britain leave the EU?*, Chapter 7

[6] Even with the removal of these impediments, there remain cultural and linguistic barriers to businesses establishing and people moving abroad.

to set standards and devise regulation that is sensitive to domestic priorities and changing circumstances; in effect, costs may arise to the extent that the optimal policy that the UK would set individually differs from what is collectively decided by EU Member States.

A separate but related sovereignty 'cost' arises from governments losing the 'right' to regulate and structure their economies in precisely the way they want; for instance, the EU's competition policy on the one hand prevents state-subsidised firms gaining an unfair advantage over unaided competitors, but on the other limits the extent to which governments can support domestic industry or shield sectors from the disruptive effects of foreign competition.

While a degree of pooled sovereignty and collective action in certain areas may be necessary to achieve seamless markets and free trade, other EU regulation enacted 'in the name of' the Single Market has a more tenuous relation to its core objectives, at least as they are commonly understood in the UK (namely, the maximisation of trade and competition). Just as the boundaries of EU competence more broadly are often the subject of dispute, so the purpose and principles of the Single Market are open to debate. Some have seen the Single Market as a vehicle for political and social, as well as economic integration; for instance, Jacques Delors, former president of the European Commission and architect of the first Single Market programme described its social aspect as a 'vital dimension' in a 1988 speech to the Trades Union Congress.[7] The conception was challenged by Margaret Thatcher in her 'Bruges speech' that same year, when she stated that 'we have not successfully rolled back the frontiers of the state in Britain, only to see them reimposed at a European level'.[8] The position of the UK Government with respect to the Single Market remains similar today:[9]

> the right way of strengthening the social dimension of the Single Market is to allow Member States to regulate their labour market and their social systems according to their needs and political priorities.

Such differences within the EU about the purpose and objectives of the Single Market heighten the sovereignty trade-off, and increase the potential for divergence between EU regulation, and the measures that would otherwise have been pursued at a national level.

The impact of EU regulation on the UK is discussed in Section 5.

1.3 Summary of other impacts of membership

Outside the Single Market, the EU has competence to act in a host of policy areas that have direct economic impacts. The Common Agricultural Policy, when combined with tariffs and quotas on agricultural products, serves to protect EU farmers from foreign competition, but at the cost of higher consumer prices and a fiscal contribution from Member States. EU regional policy aims to reduce economic and social disparities across the EU, and ultimately may lead to larger markets for UK exports, but it entails a net contribution from richer Member States, including the UK.

The fiscal implications of the UK's membership of the EU are discussed in Section 6.

As discussed above, the effect of producer support under the CAP, and the EU's tariffs on goods from outside the EU is to create 'trade diversion', whereby certain imports to the UK come not from the lowest-cost country, but from a less efficient one within the Single Market.

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7 Jacques Delors, Speech to Trades Union Congress, Bournemouth, 8 September 1988
8 Margaret Thatcher, Speech to the College of Europe, Bruges, 20 September 1988
9 BIS (2011) UK Government Response to European Commission Consultation on the Single Market Act, p.31

The effect of this, relative to a position where domestic markets are completely open to foreign goods and services, can be to raise prices for consumers.

The impact of EU membership on consumer prices is discussed in Section 7.

Finally, membership of the EU may encourage foreign direct investment from non-EU countries seeking to gain access to the Single Market.

The impact of EU membership on foreign direct investment to the UK is discussed in Section 8.

2 Cost-benefit analyses of EU membership

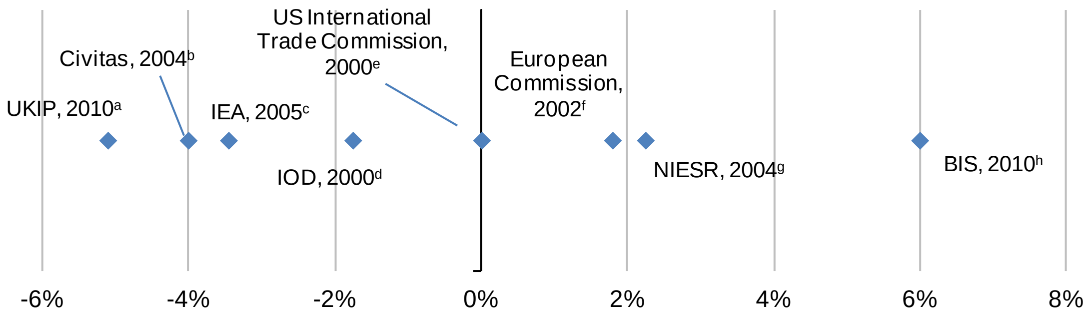
There is no definitive study of the economic impact of the UK's EU membership, or equivalently, the costs and benefits of withdrawal. Framing the aggregate impact in terms of a single number, or even irrefutably demonstrating that the net effects are positive or negative, is a formidably difficult exercise. This is partly because many of the costs and benefits are, in certain respects, subjective, diffuse or intangible; and partly because a host of assumptions must be made about the terms on which the UK would depart the EU, and how Government would fill the policy vacuum left in areas where the EU currently has competence.

Any estimate of the effects of withdrawal will be highly sensitive to such assumptions, and can thus be embedded with varying degrees of optimism. This perhaps helps to explain why the wide range of estimates from the EU cost-benefit 'literature' can appear influenced by the prior convictions of those conducting the analysis.

Selected estimates of the net benefits to the UK of EU membership

annual recurring cost/benefit as a proportion of GDP

N.B. the conclusions from the studies are not precisely comparable; see notes below for further details



a UK Independence Party *How much does the European Union cost Britain?* Based on conclusion that 'for 2010, the combined direct and indicrect costs of EU membership will amount to... £77 billion net'

b Civitas *A cost too far?* 'Most likely' estimate of annual cost is put at 4% GDP per year

c Institute for Economic Affairs (Minford et al) *Should Britain leave the EU?* Midpoint of estimated range of '3.2-3.7 per cent of GDP in ongoing costs'

d Institute of Directors *EU membership – what's the bottom line?* Estimated net cost of 1.75% GDP per annum

e US International Trade Commission *The impact on the US economy of including the UK in a free trade agreement with the US, Canada and Mexico* Estimate refers to the impact on UK GDP (-0.02%) of the UK withdrawing from the EU and 'joining' NAFTA

f European Commission *The internal market – ten years without frontiers*. Estimate refers to the impact on *EU* GDP of the existence of the internal market

g National Institute of Economic and Social Research *The macroeconomic impact of UK withdrawal from the EU*. Estimate refers to the permanent impact on the level of GDP of the UK withdrawing from the EU h Department for Business Innovation and Skills, written evidence to Lords EU Select Committee inquiry into Re-launching the Single Market. Estimate refers to the trade benefits of EU membership since the early 1980s and refers to impact of membership of *income per capita*. Based on argument that "EU countries trade twice as much with each other as they would do in the absence of the Single Market programme" and OECD estimates of the impact of trade exposure on income per capita.

Most studies that find a significant net cost to membership take a static approach, calculating the various impacts – fiscal, regulatory, trade-related etc. – in a given year and summing them to produce an overall cost. Those that look forwards generally judge that the process of harmonisation and integration taking place in the EU will exacerbate the costs identified in the static analysis. Those studies that find a net benefit tend to look at the longer-run effects of the UK being a member of the EU versus some more restrictive trading arrangement, with gains accruing each year in the form of higher trade flows and foreign direct investment serving to offset the clear fiscal cost. No recent study has seriously tested the sensitivity of its findings to alternative assumptions or counterfactuals, or attempted to model the impact of alternative policy scenarios or trade relationships following the UK's withdrawal.

Whether or not the UK would benefit economically from being outside the EU, withdrawal would have significant impacts on certain sectors (e.g. farming, which currently receives subsidies under the Common Agricultural Policy) and in certain areas (e.g. west Wales, which is currently eligible for the highest level of regional funding from the EU budget). How the UK Government of the day filled the gaps in economic policy left by withdrawal from the EU would have an important bearing on its consequences.

3 The effect of the EU on UK trade relations

3.1 How it works now

EU Member States are part of a customs union, with no tariffs on goods moving between Member States, and a common tariff applied to goods entering from outside the EU. Member States cannot operate independent trade policies, for instance by pursuing bilateral free trade agreements with non-EU countries; instead, external trade relationships are co-ordinated at EU level through the Common Commercial Policy (CCP). The EU Trade Commissioner acts as the negotiator in multilateral and bilateral trade talks, with the Council and Parliament making certain formal decisions regarding the commencement and mandate for the negotiations, and approving their final result.

The principle of free trade in services between EU member states (i.e. that businesses should be free to provide services within the EU, either on a cross-border basis or through establishing in the countries of their choosing) is also enshrined in the EU Treaties. In practice, however, there remain legal, regulatory, administrative and cultural barriers that mean trade in services within the EU is more restricted than trade in goods. These include:

- Differences in the way services are regulated between Member States, particularly in 'network industries' like water, power and telecoms
- Favourable tax treatment for services purchased from local providers
- Residence requirements for shareholders, staff and regulated professions
- Failure to recognise foreign diplomas and professional qualifications

The main instrument through which regulatory harmonisation and other services trade liberalisation takes place at EU level is the Services Directive, adopted in late 2006.

Implementation by Member States has in some cases been slow and patchy, however. The structure of the UK economy, and its comparative advantage in certain services sectors, mean the Government has put particular emphasis on the full implementation of the Services Directive, describing it as 'the first priority for boosting competitiveness in services'.[10]

More generally, tackling outstanding and emerging barriers to trade within the EU, including those affecting services, is an ongoing exercise. The European Commission and successive meetings of the European Council have recognised the importance of 'completing the Single Market' while the UK Government has described further reducing intra-EU barriers to trade as 'an opportunity not to be missed', estimating the UK GDP could be 7% higher as a result.[11] Currently, the principal instruments through which further EU trade liberalisation is undertaken are the Single Market Acts, two packages of legislative and regulatory measures proposed by the European Commission in April 2011 and October 2012.[12]

3.2 Alternatives to EU membership

No preferential access

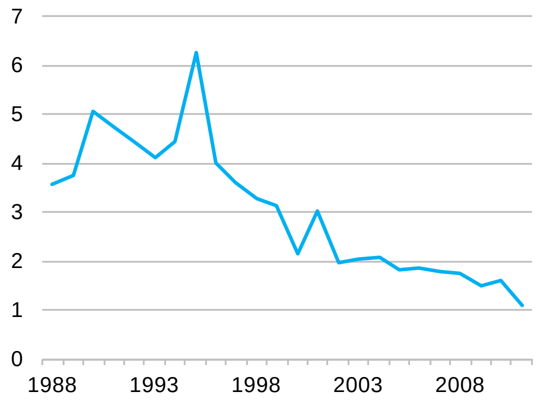
A vast number of different arrangements could result from the UK's leaving the EU. However, considering a situation in which the UK has no preferential access to EU markets offers a convenient point of reference. In this instance, the terms of World Trade Organisation (WTO) membership limit the range of outcomes. The details of such an arrangement are discussed below.

Tariff barriers

The principle of non-discrimination requires WTO members not to treat any member less advantageously than any other: grant one country preferential treatment, and the same must be done for all others. There are exceptions for regional free trade areas and customs unions like the EU, but the principle implies that, outside of these, the tariff that applies to the 'most-favoured nation' (MFN) must similarly apply to all.

In practice, this would prevent discriminatory or punitive tariffs being levied by either the EU on the UK, or vice versa. The maximum tariff would be that applied to the MFN. As the chart shows, the EU's MFN tariff has fallen over time, meaning that in this particular context the 'advantage' of membership has declined.

EU average (trade-weighted) MFN tariff
percent, 1988-2011



Source: data.worldbank.org

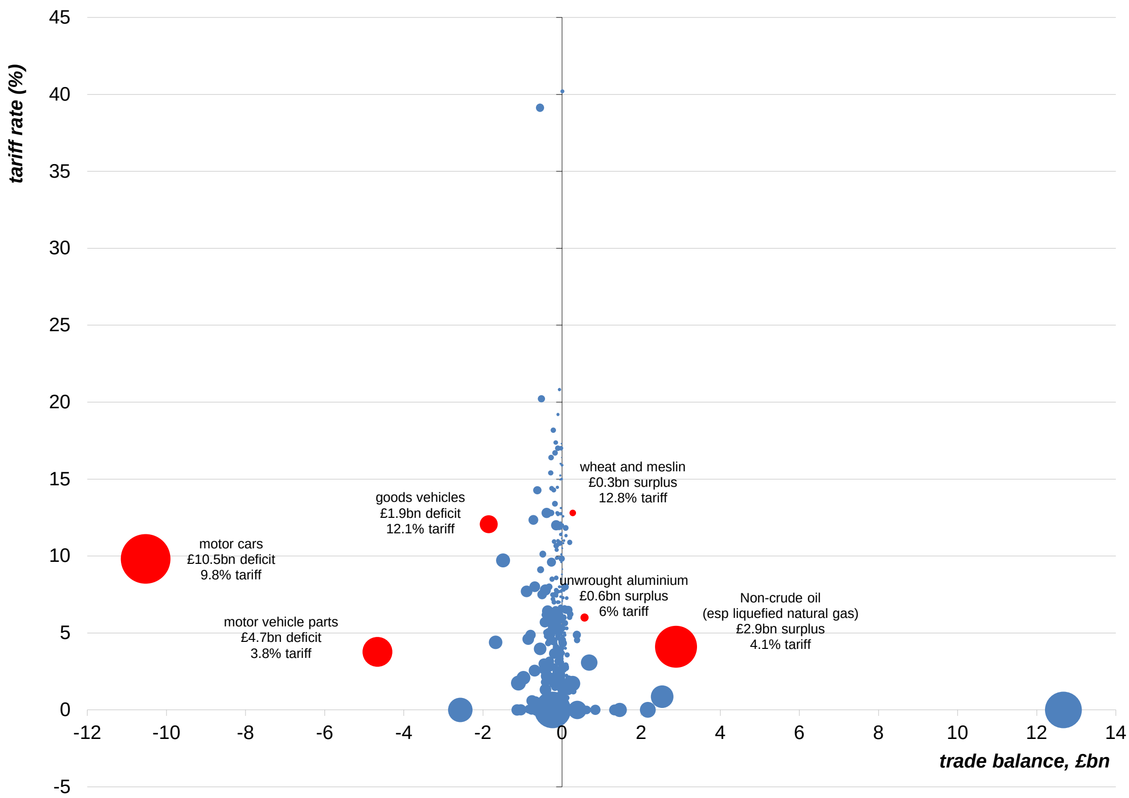
However, given that MFN tariffs would be imposed on around 90% of the UK's goods exports to the EU by value,[13] it would necessarily

[10] UK Government response to European Commission consultation on the Single Market Act (2011)
[11] BIS (2011) *Economic consequences for the UK and the EU of completing the Single Market*
[12] Further details are available on this page of the European Commission website.
[13] Uktradeinfo database and WTO tariff download facility

mean many exporters becoming less price competitive, to varying degrees, than their counterparts operating within the remaining EU, and those within countries with which the EU has preferential trading relationships. Similarly, because the UK has negotiated as part of the EU at the WTO, it is likely that it would inherit the EU's tariff regime at the time of leaving, meaning, at least initially, higher prices would be faced by consumers buying imports from the EU and those countries with which the EU has trade agreements. Without any change, a 9.8% tariff would be levied on imports of motor vehicles.[14]

The implications of a move to an MFN trading arrangement for exporters and domestic consumers would vary considerably by sector, as illustrated in the chart below, which compares the EU's average MFN tariff across over 1,200 product groups with the UK's trade balance in each. The size of the bubbles represents total trade in the commodity (imports plus exports). For instance, without a trade agreement, a tariff of 4.1% would be applied to liquefied natural gas exports from the UK to the EU; a tariff of 12.8% to wheat and meslin; and a tariff of 6% to unwrought aluminium, all items which the UK currently runs a trade surplus with the EU.[15]

EU MFN tariff (vertical axis) vs UK-EU trade bance (horizontal axis), 2011
HS4 product categories; bubble size represents total value of trade (imports plus exports)



Sources: HMRC trade data and WTO tariff download facility.

[14] This note was corrected on 28 June 2016 to remove an erroneous figure of 32% for the tariff on wine.
[15] This chart was corrected on 28 June 2016 to remove an erroneous figure of 32% for the tariff on wine. The interactive version of the chart has also been removed.

Non-tariff barriers

Non-tariff barriers to trade cover a range of measures that have the effect of reducing imports, either intentionally or unintentionally. They include anti-dumping measures that prevent goods being exported at a price below production cost (usually by the application of an additional duty), and product standards, such as labelling, packaging and sanitary requirements. Support to domestic producers and export subsidies, such as those provided under the Common Agricultural Policy, can also be interpreted as non-tariff barriers since they inhibit market access by foreign producers on equal terms. In the context of falling tariff barriers, such non-tariff measures have become more widely used as a means to protect domestic producers from foreign competition.

The terms of WTO agreements limit the circumstances in which such measures can be applied, and in particular uphold the principle of non-discrimination that would prohibit punitive measures against the UK were it to leave. Nonetheless, at the time of writing, the EU had definitive anti-dumping tariffs in place against 84 products in 24 countries, including the US, Canada and Korea.[16]

Just as important in a trade context are the standards the required of products imported from outside the EU. All UK businesses must comply with these standards already, although as in other areas of regulation (see Section 5), withdrawal from the EU raises the prospect of costly divergences between the UK and EU product standards. On the other hand, some proponents of withdrawal point out that, were the UK to leave the both EU and the Single Market, only exporters would have to be bound by the EU's product standards, leaving other businesses free to operate under a UK regime.

Restrictions on services trade

Without further negotiation, the UK's trade in services with the EU would be governed by the WTO General Agreement on Trade in Services (GATS). Under this agreement, EU Member States (and other parties to the agreement) have chosen which sectors they are prepared to liberalise, and the time scale over which they wish to do so. As with trade in goods, GATS also operates on the principle of non-discrimination, meaning broadly that outside of preferential agreements, restrictions on market access must be applied uniformly across all countries.

Barriers to services trade are usually in the form of non-tariff barriers, such as domestic laws and regulations, also known as 'behind the border' measures. In general, services markets are more highly regulated than the market for goods. Often, regulation is intended to meet social objectives, or to correct failures in supply, rather than directly to restrict foreign suppliers, but the effect on market access for foreign companies can in some cases be highly restrictive.

EU Member States retain considerable national discretion over services regulation and supervision. Just as a fully level playing field in services trade does not exist within the EU, so exporters from outside the EU face different levels of market access in individual Member States. However, the level of market access would generally be far more limited for UK exporters under a GATS arrangement than it is currently for a number of reasons.[17]

[16] European Commission, *Anti-dumping and anti-safeguard statistics covering the first eight months of 2013*

[17] See, for instance, Centre for European Policy Studies (2013) *Access barriers to services markets*

- many restrictions that are forbidden within the EU remain applicable to firms outside the EU because Member States have made no commitments under the GATS schedules in those areas

- the EU (unlike the GATS) has pursued the harmonisation of regulation and supervision in several large services sectors, thereby taking away the justification of Member States to insist on national regulation in this respect

- the right of commercial establishment is guaranteed under EU treaties, significantly facilitating trade in services provided via the commercial presence of a foreign firm

- similarly, the free movement of labour facilitates trade in those services provided through the presence of people in the territory of another economy

- EU competition policy prevents, to an extent, barriers to services trade arising from incumbent firms benefitting from excessive market power

- the Treaty rights with respect to free movement of services, freedom of establishment, and free movement of labour are enforced supranationally by the Court of Justice of the European Union, underpinned by extensive case law on services exchange. Under GATS, an independent panel can be appointed to settle and enforce disputes, but there is no presumed right of market access; the job of the panel is merely to assess whether the barrier in question non-discriminatory.

As well as affecting cross-border trade in services, these restrictions could also have implications for UK companies providing services through a commercial presence (effectively outward direct investment) in other Member States.[18] The EU treaties require that a service provider from one Member State be legally free to establish in another, while continuing to regulated by the authorities of its home country. A UK company that provides services through establishments in other Member States may find, if Britain is no longer a member of the EU, that it has to comply with the requirements of a foreign regulatory authority.

A negotiated arrangement

Beyond the ‘default’ most-favoured nation position, there are a host of more preferential trade arrangements between the EU and UK that may be negotiated were it to leave, although there is likely to be a trade-off between the level of access to the Single Market (i.e. freedom from tariff and non-tariff barriers to trade), and freedom from EU product regulations, social and employment legislation, and budgetary contributions. The particular obligations that arise from entering into such arrangements are discussed further in Section 5.

Under a ‘Swiss’ or an EEA model, assuming such an arrangement could be negotiated, the restrictions on trade outlined above would be significantly reduced. In particular, the EEA has full, tariff-free access to the internal market, and the EU’s ‘four freedoms’ concerning

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[18] This is recognised as a form of services ‘trade’ under GATS, but is not measured in trade statistics, which are intended to record *cross-border* trade. The effects of withdrawal on *inward* foreign direct investment to the UK are discussed in the following chapter.

movement of goods, services, capital and labour, apply equally to Norway, Iceland and Liechtenstein as they do to full Member States. However, relative to a position of full EU membership, a number of restrictions on trade would still apply under an EEA or 'Swiss' approach. These are discussed below.

Rules of origin

Because the EU operates with a common external tariff, goods entering from outside can travel freely within the Union once that tariff has been paid (e.g. a mobile phone imported into the UK from China can be re-exported to the rest of the EU tariff free). The same is not true of goods that enter the EU via the EEA (e.g. a mobile phone from China re-exported to the EU from Norway) or via other countries with which the EU has a free or preferential trading relationship, because they do not share the EU's common external tariff.

Determining where a good originated, and hence whether it should attract tariffs, is done through the EU's Rules of Origin. Given the complexity of some global supply chains and the range of preferential trading relationships the EU operates, this can be a difficult, time-consuming and often subjective process.[19] Some of this burden, according to the Trade Policy Research Centre, would fall on UK firms in the form of administrative and compliance costs; they note that "the process of adapting to rules of origin-based duty-free trade under a new UK-EU free trade agreement would be tedious, costly and disruptive to trade".

In its briefing on Rules of Origin, the US Congressional Research Service also noted that satisfying their requirements could be costly for businesses:[20]

> The benefit conferred by the preferential schemes in certain cases becomes marginal in comparison with the administrative workload and cost to plan the product mix to comply with the preferential ROO. This often leads to instances where firms, although meeting the necessary conditions for origin, decide that it is simpler and cheaper to pay the MFN tariff rates.

The briefing cites a 1992 study in connection with the EC-EFTA agreement that found that the cost of border formalities to determine the origin of products amounted to at least 3% of the value of the goods concerned.[21]

Anti-dumping and other non-tariff barriers

Were the UK in the EEA or adopted the Swiss model, goods would still be susceptible to anti-dumping action by the EU; for instance, in 2005, the EU imposed a 16% duty on Norwegian salmon. As discussed in Section 5, membership of the EEA or the negotiation of bilateral agreements analogous to those in Switzerland would also require the UK to adopt EU product standards (and other regulations) across the whole economy.

[19] In very simple terms, origin is determined on the principle of goods being wholly obtained in the exporting country, or substantially transformed there.

[20] Congressional Research Service (2012) *International trade: rules of origin*

[21] The study in question is Waer, P. (1992), "European Community Rules of Origin", in: Edwin Vermulst, Paul Waer and Jacques Bourgeois(eds.), Rules of Origin in International Trade: A Comparative Study,

Restrictions on services trade

As part of the Single Market, EEA countries like Norway are able to conduct services trade on the same basis as other Member States. However, as in other areas, they lack direct influence over how services are regulated at EU level. The loss of influence over the regulatory agenda and the ability to push directly for further services trade liberalisation may be particularly important for the UK, given that it has a comparative advantage in a number of sectors, and runs a services trade surplus with the EU.

Many voices in the financial services industry believe that the UK's ongoing influence over the regulatory agenda is important, particularly as the eurozone crisis brings about a wave of euro area-specific regulation and reform that could be potentially discriminatory to the City. In evidence to the Foreign Affairs Committee, TheCityUK, the lobbying body for the financial services industry, wrote:[22]

> the provision of financial services in the UK by non-UK firms has become to a large degree dependent on the maintenance of [a] common EU legal framework and the UK's part in devising it and operating within it. The evolutionary character of this common legal framework means that the UK must be engaged at all levels of policy development

An example of such regulation is the effort by the European Central Bank, backed by France and Germany, to bring clearing houses that deal in significant volumes of euro-denominated transactions to be located within the euro area;[23] the UK Government is currently challenging these proposals at the European Court of Justice on the grounds that they contravene the Single Market principles of free movement of services and capital across the union. On the other hand, sceptics might point out that the very fact that the UK failed to secure concessions for its financial services industry, despite demanding them at the December 2011 Council summit at which it eventually wielded its 'veto', illustrates its powerlessness to influence the agenda even within the EU.[24]

Were it to leave both the EU and the EEA, in negotiating its trade relationship with the EU, the UK may face particular difficulties firstly in securing ongoing access to services markets, and secondly in ensuring it benefits from further liberalisation of trade in services within the EU. For instance, despite extensive negotiations on the matter, there is no general and encompassing agreement on the free movement of services between the EU and Switzerland.

Financial services trade is an area that could be particularly affected by a 'Swiss' approach. Currently, non-EEA financial services providers must generally establish a subsidiary or branch in the EU in order to provide cross-border services. The precise requirements are currently a matter for national regulators in individual Member States, but developments in EU-level financial regulation, and in particular the MiFID II proposals, are likely to make provision of financial services to the EU from outside the EEA increasingly difficult. After 2019, off-shore (i.e. non-EEA) providers will be able to offer a more limited range of services, and only on

[22] Foreign Affairs Select Committee, *The future of the European Union: UK Government policy*, (written evidence), 11 Jun 2013, HC 87-II

[23] See, for instance, Reuters *ECB's Noyer ups pressure on London as Europe's finance hub*, 22 Apr 2013. Full details of the ECB's 'location policy' proposals were outlined in *Standards for the use of central counterparties in Eurosystem foreign reserve management operations* (Nov 2011).

[24] One of the Government's demands, which it did not get, was that the ECB's location policy proposals be scrapped. The leaked negotiating position is available here.

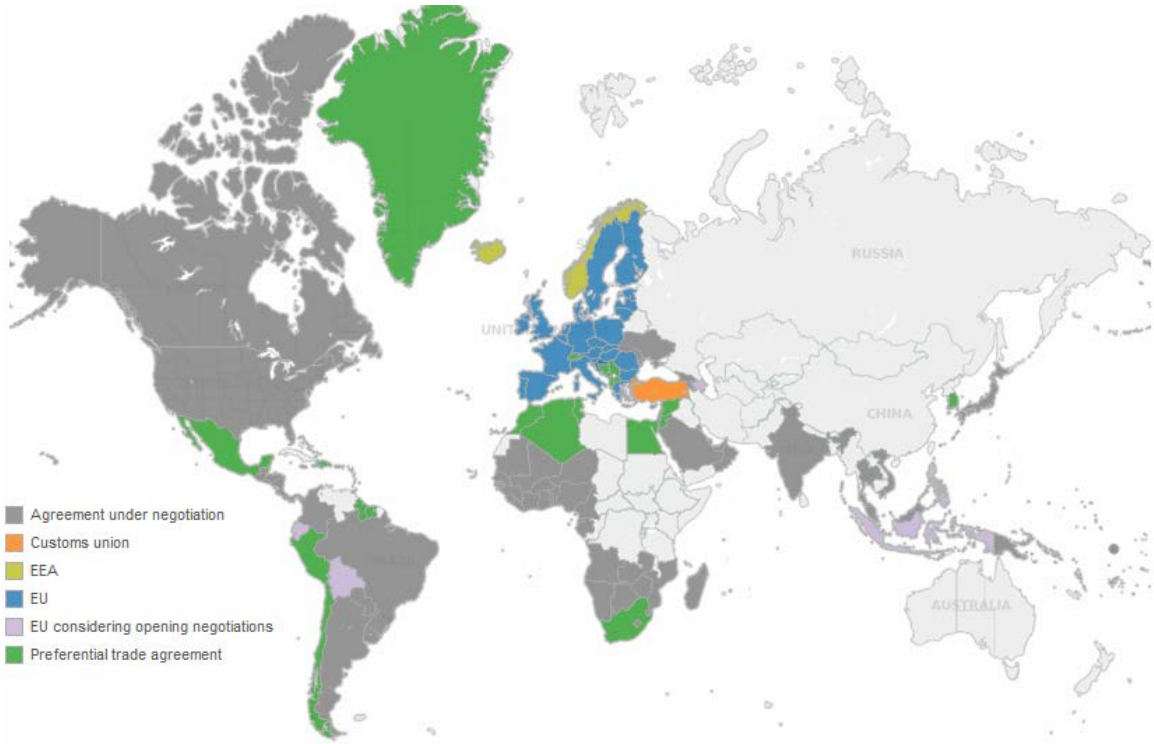
condition that they register with the European Securities Markets Authority (ESMA); the requirements for registration, according to a briefing note by KPMG, will be "strict and difficult to fulfil".[25] In written evidence to the Parliamentary Commission on Banking Standards, Goldman Sachs and JPMorgan both noted the importance of EU membership to the UK financial services industry:

> We believe that a key risk to London's retaining its status as a financial hub is an exit by the UK from the European Union. In common with financial institutions across the City our ability to provide services to clients and engage in investment activities throughout Europe is dependent on the passport that London-based firms enjoy to operate on a cross-border basis within the Union. If the UK leaves, it is likely that the passport will no longer be available, thereby forcing firms that wish to access EU markets to move their operations to within those markets.[26]

> We value the flexibility London offers as a platform for access to the Single Market in a variety of formats. Our trading activity in London benefits from an EU passport across the EU.[27]

3.3 The impact of membership on trade relationships outside the EU

EU preferential trading agreements completed and under negotiation



With the UK as part of it, the EU has negotiated an array of preferential trade agreements with other countries (see map). As with its trade relationship with the EU, the UK would have to negotiate ongoing market access with these countries were it to leave the Union, or else face the MFN tariffs levied by these countries. If an arrangement that was analogous in terms of

[25] KPMG *Provision of services by financial intermediaries from third countries in EU financial markets regulation*
[26] Goldman Sachs International, written evidence to the Parliamentary Commission on Banking Standards
[27] JPMorgan Chase & Co., written evidence to the Parliamentary Commission on Banking Standards

market access could not be reached, there is a possibility that the EU would have to pay compensation to the affected countries with which it has a trade agreement, as a result of the 'shrinking' of the market from what was originally agreed. This concern was raised by the European Commission in the run-up to Greenland's departure from the EU:[28]

> The free trade agreements concluded by the Community with the EFTA countries, which at present enjoy exemption from customs duties and free access without quantitative restrictions to the Greenland market, would automatically cease to apply to Greenland. The question whether the Community would have to negotiate with its partners compensation for the rights and benefits which those countries would lose as a result of the 'shrinking' of the Community would not arise if the same rights and benefits were granted by Greenland.

Any negotiated solution may therefore require the UK to maintain consistency in its trade treatment with countries outside the EU, thereby limiting the extent of trade policy independence it would gain on withdrawal.

Finally, there is no guarantee that the UK would be able to participate in EU trade agreements currently under negotiation. Most important among these is the US-EU Transatlantic Trade and Investment Partnership. According to some reports, US Administration officials have indicated to the UK Government that getting the TTIP through Congress would be made significantly more difficult were the UK to exit, and that even if an agreement could be reached, Britain's inclusion would not be guaranteed.[29]

[28] European Commission (1983) *Status of Greenland: Commission opinion*, COM (83) 66 final, Annex A, p.22
[29] See, for instance, The Guardian, *EU exit would put US trade deal at risk, Britain warned*, 27 May 2013

Would independence over trade policy lead to better results?

It is often suggested that independence over trade policy would allow the UK to join other free trade areas, such as NAFTA,[a] and forge its own bilateral free trade agreements that are tailored to its particular economic circumstances; as part of the EU, this is legally impossible. This freedom, it is argued, would allow the UK to refocus its trade on economies with brighter prospects and rectify its persistent trade deficit.

It is open to debate whether the UK's capacity to export to the rest of the world, and particularly to high growth emerging economies, is significantly held back by EU membership. Trade between the UK on the one hand, and China and India on the other, has more than doubled in the space of five years, while the share of exports going to the EU has declined from 54% in 2006 to 46% in 2012. Germany, meanwhile, exported four times more to China than the UK does by value and came close to a current account balance with it in 2012. Even outside the EU, the structure and orientation of the UK economy are likely to place important constraints on its capacity to reorientate its trade in the medium-term.

From a British perspective, the EU's trade policy does not appear to be wholly misguided in geographical terms; most of the countries the EU is currently in trade negotiations with are among the UK's top trading partners.[b] Some have noted that the EU has less interest in pursuing free trade agreements with Commonwealth countries than the UK: at 9.5%, the UK's export share to the Commonwealth is greater than, for instance, France's (5.7%) or Germany's (5.0%).[c] The EU already has preferential trading arrangements with 16 of the 53 other Commonwealth members, covering around a third of the UK's total Commonwealth exports, and is in negotiations with a further 26, covering an additional 45%; notable exceptions include Australia and Pakistan.[d]

The EU has thus far failed to secure any preferential trade agreements with Brazil, India or China. But whether the UK's trade negotiating strength and efficiency would be greater outside the EU is uncertain. On the one hand, concluding deals might be easier for the UK alone, given the greater diversity of interests involved when the EU negotiates as a group; on the other, the smaller size of its market may mean deals with the EU, like the Transatlantic Trade and Investment Partnership (the proposed FTA with the United States) are afforded greater priority by non-EU countries than deals with the UK alone. Typically, the EFTA countries follow in the EU's path when it comes to FTA negotiation (i.e. agreements are reached with the EEA and EFTA are reached shortly after those with the EU), although in the case of the recent South Korea FTA, EFTA led the way.[e]

A particular area where UK interests may be poorly represented in EU trade negotiations is services market access. Language, time zone and structural features of the UK economy give it a comparative advantage in cross-border services trade, but, according to OpenEurope, "the EU's lack of domestic liberalisation in services trade limits the enthusiasm of member states to push and prioritise these issues with third countries".[f] The recent exclusion of audiovisual services from the US free-trade negotiations, following pressure from France, is an example of the sensitivities attached to this area of trade liberalisation, and the compromises that must be struck when 28 countries negotiate as a group.

References:

[a] See, for instance, Wall Street Journal *Britain's future lies with America, not Europe*, 29 Dec 2011
[b] These include Canada, India and the US.
[c] UNCTADstat database
[d] European Commission (2013) *EU trade relations world wide – a map*
[e] EFTA also have a free trade agreement with Canada, something that the EU is currently negotiating.
[f] Open Europe (2012) *Trading places: is EU membership still the best option for UK trade?*

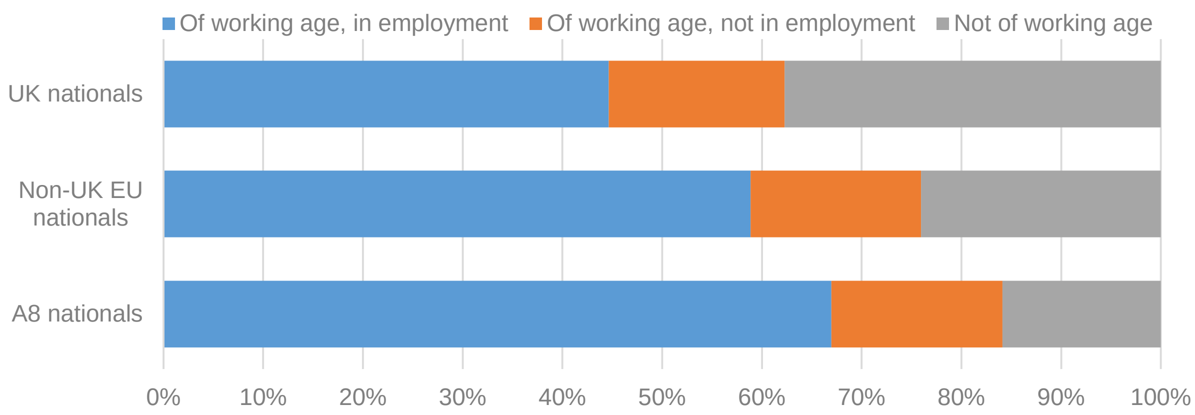
4 Impact of immigration from the EU

4.1 Overview and statistics

Under EU Directive 2004/38/EC, EU nationals do not require a visa to enter another Member State, and no time limit may be placed on their stay. Non-EU EEA and Swiss nationals enjoy broadly similar free movement rights to EU citizens and are treated in line with EU citizens for UK immigration control purposes. The inability of the UK to impose limits on immigration from the EEA and Switzerland is a controversial aspect of EU membership, particularly since the expansion of the EU to eastern Europe from 2004, which has driven a rise in net migration. The economic consequences of immigration are often a key part of this debate.

In total, 1.5 million non-UK EU nationals work in the UK, 5% of total employment (29.7 million). As the chart illustrates, a greater proportion of non-UK EU nationals are in work than are UK nationals, and among A8 nationals specifically, the proportion is still higher.

Age and employment status of UK population by country of birth



Note: the chart combines data on employment rates from the **UK** Labour Force Survey and data relating to the proportion of people of working age from Census 2011 results for **England and Wales**. It thus provides a broad indication, rather than precise detail, of the age and employment status of UK and EU nationals.

Sources: ONS Labour Market Statistics, September 2011 and UK Census 2011 results accessed via nomisweb.co.uk

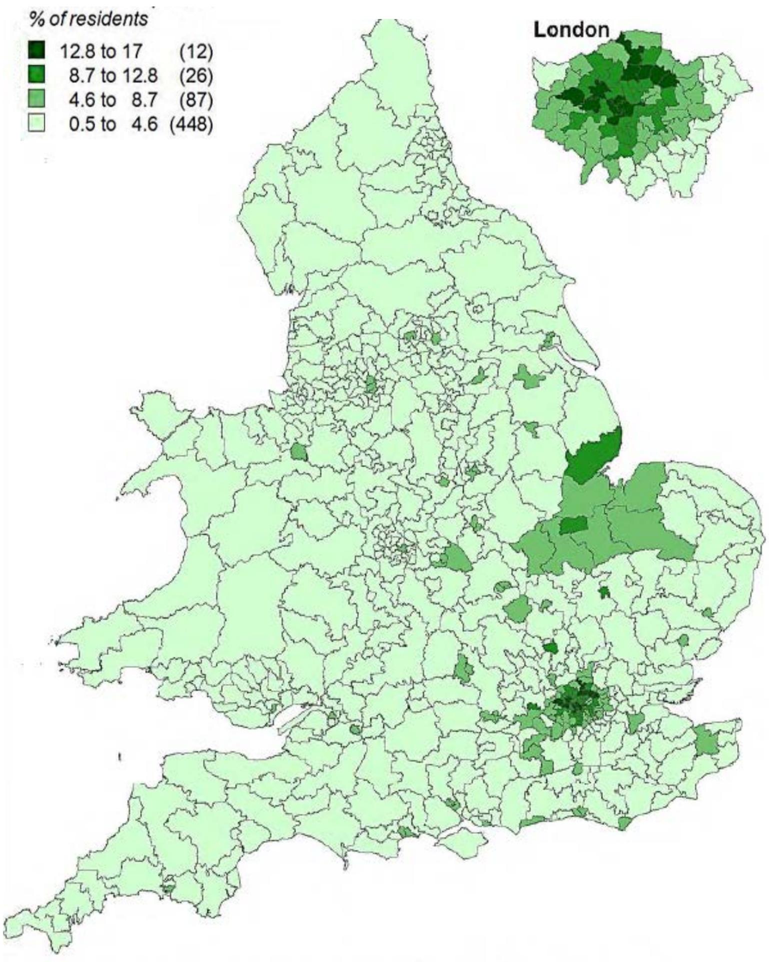
Among those of working age (16-64), employment rates are higher for those born in an EU country outside the UK (76.9%) than for the native population (72.0%). Again, those born in A8 countries have a still higher employment rate of 79.5%.[30]

[30] Figures refer to Q2-2013. Source: ONS Labour Market Statistics, September 2011

4.2 Economic impact of immigration

There is no widely accepted estimate of the effects of EU immigration, or immigration generally, on economic welfare. Most studies on the impact of migration on the UK economy as a whole have found weak or ambiguous effects on living standards, employment and wages. A few studies, however, show some depression of wages or displacement of resident employment in low-skilled jobs. Where they do exist, effects are likely to vary significantly by locality; as the map shows, the proportion of UK residents born in other EU Member States[31] varies by parliamentary constituency varies from 17% in Tottenham to 0.6% in Rhondda. They will also depend crucially on the characteristics of the migrants, as compared with those of the local population.

Geographical distribution of UK residents born in EU outside British Isles* by Parliamentary constituency, England and Wales, 2011



Source: UK 2011 Census results, accessed via www.nomisweb.co.uk
* 'British Isles' includes UK, Ireland, the Channel Islands and the Isle of Man

The impact of migration on ***overall living standards***, measured by GDP per capita is found in a number of studies to be small but positive. In evidence to a 2008 enquiry into the economic impact of immigration by the Lords Economic Affairs Committee, the previous Labour Government estimated a positive effect of 0.15% per year on the GDP per capita of the native population in the decade to 2006.[32] Looking specifically at migration from the 'A8' accession states,[33] the National Institute for Economic and Social Research estimated the effect to be 0.25% per year over the 'long-run'.[34]

The effect of immigration on ***employment and wages*** depends on whether the particular skills and qualities possessed by migrants substitute for (i.e. compete with) those possessed the 'native' workforce,[35] or complement them.

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[31] The map does not 'count' those born in Ireland.

[32] House of Lords Select Committee on Economic Affairs *The Economic Impact of Immigration* (written evidence), 1 April 2008, HL 82-II p.358

[33] NIESR (2011) *Labour mobility within the EU: the impact of enlargement and transitional arrangements – August 2011 update*, Table 3.17

[34] In one scenario, described as "an extreme position" by the authors, where migrant productivity is only one-fifth that of the resident workforce, the impact on long-run GDP per capita was negative at -0.13% in the UK.

[35] The term 'native workforce' is often used in the literature to describe non-migrant workers.

The more migrant workers can be considered a direct substitute for existing workers, the more downward pressure there is likely to be on wages for those jobs. Research generally finds that that immigration does not displace native workers, nor does it lead to lower average wages for native workers.[36]

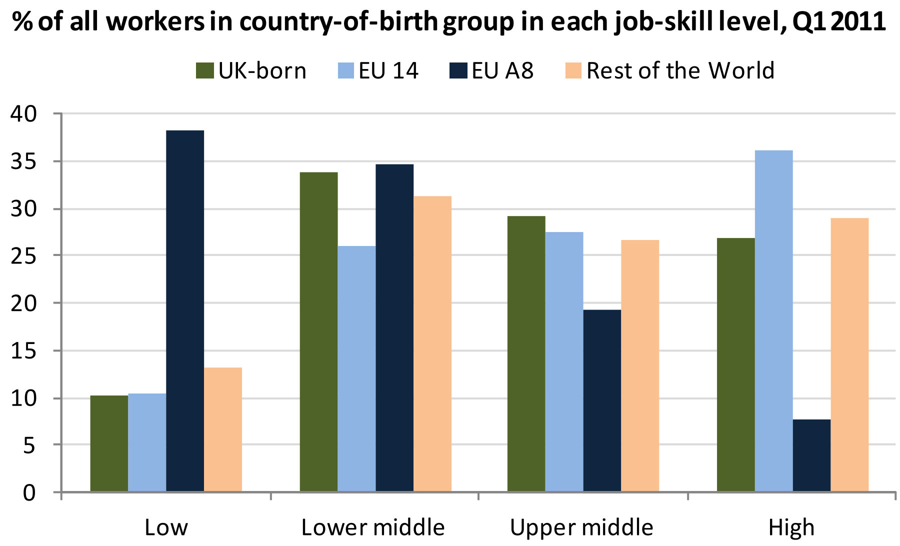
There is, however, some evidence that migration can affect pay at different points across the wage distribution. Focussing on immigration during the period 1997-2005, Dustmann et al found that each 1% increase in the share of migrants in the UK-born working-age population led to a 0.6% decline in the wages of the 5% lowest paid workers, a 0.4% decline for the 10% lowest paid, and to an increase in the wages of higher paid workers.[37] Similarly, another study focusing on wage effects at the occupational level during 1992 and 2006, found that in the unskilled and semi-skilled service sector, a 1 percentage point rise in the share of migrants reduced average wages in that occupation by 0.5%.[38]

In terms of their effect on ***public finances***, existing research generally finds migrants' net fiscal contribution to be small but positive. Such research is very sensitive to how a migrant is defined: for instance, whether spending on services for children born to one migrant parent and a UK-born parent is included in the resident population or immigrant population.[39]

The impacts of migrants on the UK ***housing market*** depend on their characteristics and how these compare with those of the resident population. For instance the effects will differ depending on how likely migrants are to rent, buy homes or use social housing. Crucially, the impact would also depend on how responsive the supply of housing is to changes in demand. A fixed housing stock inevitably results in immigration placing upward pressure on rents and/or prices.

4.3 Alternative arrangements

Should the UK wish to remain in the EU Single Market but outside the EEA, like Switzerland, then it would probably have to accept certain EU regulations. Whether or not this would include the free movement of people would depend on the outcome of UK-EU negotiations.



If the UK were to leave the Single Market, it would be free to impose its own controls on EU/EEA immigration; for instance, it could choose to apply the immigration controls that currently apply to non-EU/EEA nationals. This would

36 A good summary of existing research is available from: Migration Advisory Committee, "Analysis of the Impact of Migration", January 2012, Chapter 4.2, page 57 and table 4.2-4.5, page 66

37 Dustmann, C., Frattini, T. and Preston, I, *The Effect of Immigration along the Distribution of Wages*, 2008

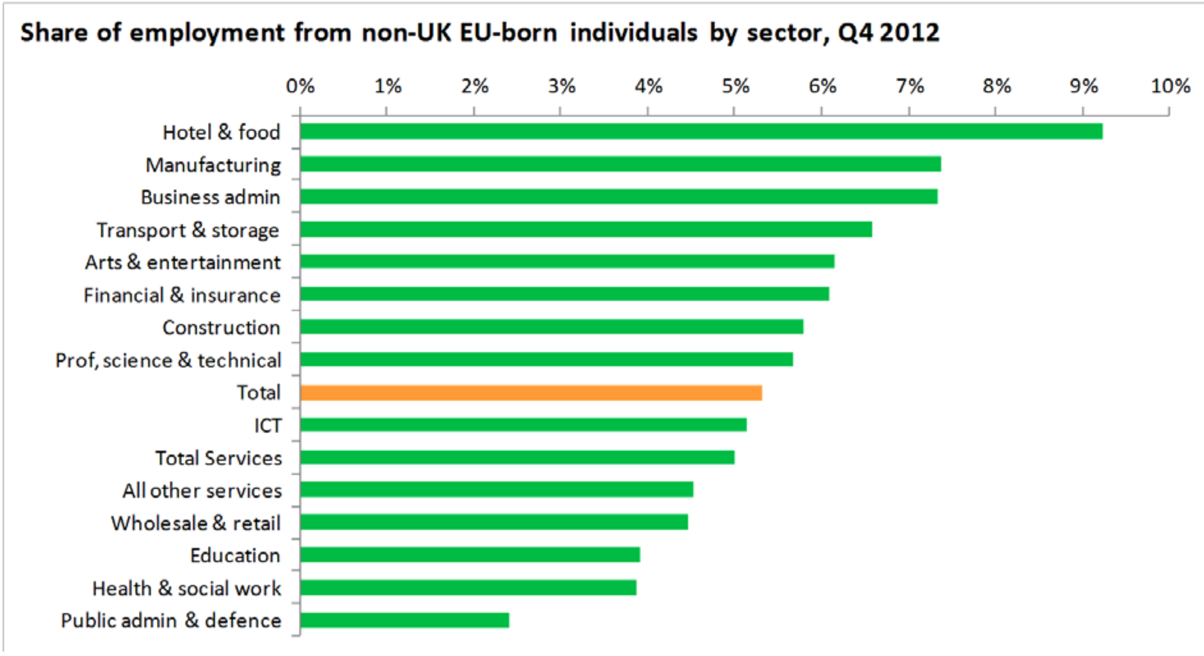
38 Nickell, S. and Salaheen, J., *The Impact of Immigration on Occupational Wages: Evidence from Britain*, 2008

39 The Migration Observatory, University of Oxford, *The fiscal impact of immigration in the UK*, February 2013.

restrict economic migration to predominantly high-skilled migrants (via a points-based system) and reduce the flow of migrant workers doing low-skilled jobs. As the chart shows, this would particularly affect A8 nationals entering the UK, who tend to be lower skilled than those coming from western Europe.

Just as the UK would be able to impose its own controls on EU/EEA immigration outside the Single Market, so the rights of UK citizens to visit or move to an EU/EEA Member State would depend on what visa requirements those states chose to apply. All parties would also have to consider how to ensure continuity of immigration status for persons exercising their free movement rights at the time of the UK's exit from the EU. Sudden mass expulsions/returns of their nationals could create significant costs and upheaval; it would, for instance, result in a reduction in the UK labour force of up to 5% that would only partially be offset by any return of UK nationals working in the EU.[40]

Even assuming all existing workers would be allowed to stay in the UK, a more restrictive immigration policy with respect to the rest of the EU would still have an impact on sectors which currently employ a higher share of EU migrants in their workforce, as they are more likely to hire such workers in the future. As shown in the chart, the sectors with the highest proportion of non-UK EU-born workers are accommodation and food services (9%), manufacturing (7%) and business administration (7%). Geographic impacts would also differ, with areas such as London with relatively high concentrations EU workers more likely to be affected than areas with low proportions of EU workers.



[40] There at least double the number of non-UK EU nationals working in the UK compared with the number of UK nationals working in other EU countries (based on information provided by Eurostat in 2010 about the number of UK nationals living in the rest of the EU, combined with data from the UK Labour Force Survey on the number of non-UK EU nationals living in the UK).

5 The impact of EU regulation

5.1 Understanding and measuring the impact of EU regulation

Through successive Treaties, the policy areas in which the EU has competence to legislate have been gradually expanded, although the volume of new 'hard' law (regulations and directives) emanating from the EU has declined from a peak in the early 1980s.[41] In particular, new EU aims and areas of activity in sustainable development, social protection and human rights have raised concerns about the impact of EU membership on business and the wider economy. Regulation in these areas, some argue, has little to do with the EU's founding purpose of establishing a common market between Member States, and imposes burdens that offset the trade benefits of membership.

The EU has the power to legislate in a number of areas that directly affect businesses. These include:

- Product specifications, e.g. Directive 2000/36/EC on cocoa and chocolate products intended for human consumption
- Competition, e.g. Council Regulation 139/2004 on the control of concentrations between undertakings, aka the EC Merger Regulation
- Employment terms, e.g. Directive 2008/104/EC on Temporary and Agency Workers
- Health and safety, e.g. Directive 2009/148/EC on exposure to asbestos at work
- Consumer protection (e.g. Directive 93/13/EC on Unfair Terms in Consumer Contracts)

Several studies have attempted to estimate the 'cost' of EU law to the UK using the Impact Assessments (IAs) prepared by the Government that assess the various potential costs and (sometimes)[42] the benefits associated with a particular measure. IAs are usually produced in response to Directives (where the Government will have some discretion over how EU requirements will be transposed into national law), but not Regulations or Decisions, which do not trigger a new piece of domestic legislation. The potential costs in question arise from administrative burdens on companies and the public sector (e.g. notifying the authorities about the possible presence of asbestos dust before commencing work), and from the additional practical obligations of putting the policy of the regulation into practice (e.g. providing employees who may come into contact with asbestos with relevant training). There may also be wider consequences arising from regulation (e.g. the demise of industries allied to asbestos manufacture) though these are rarely quantified in IAs.

A study of 2,500 IAs produced since 1998 by Open Europe estimated that the annual cost of regulation stemming from EU legislation in 2009 was £19.3bn and that the cumulative cost since 1998 had been £124bn.[43] Using a similar approach, but looking at a smaller number of regulations with the largest associated costs, the British Chambers of Commerce estimated the annual cost to be £7.6bn and the cumulative cost since 1998 to be £60.8bn.[44] Among the regulations cited by both as imposing the highest costs are the Working Time Directive, the Pollution Directive, the Data Protection Directive and the Directive on the Sale of Consumer Goods.

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[41] The number of EU laws reached a peak of over 14,000 instruments in the early 1980s and there was a lower peak in the mid-1990s. See HC Library Research Paper 10/62 *How much legislation comes from Europe?*

[42] Benefits are only quantified in a minority of Impact Assessments produced since 1998

[43] Open Europe (2010) Still out of control? Measuring eleven years of EU regulation

[44] British Chambers of Commerce (2010) *The burdens barometer*

The costs to businesses of complying with EU regulations are not equivalent to their economic impact because they will be offset by benefits, most obviously to employees and consumers. Open Europe acknowledge this in their analysis, noting that "the whole point of regulation is for it to produce a total benefit... which outweighs the total cost", adding that "the benefits of regulations on the whole outweigh the costs". Their analysis, however, finds that the benefit-cost ratio of EU regulation, at 1.02, is considerably below that of regulation imposed directly by the UK Government (2.35). This may at least partly be due to the particular policy areas in which the EU regulates; it has also been argued that the wider benefits of EU regulation that improves access to the Single Market are particularly great, but are left unquantified in Impact Assessments.[45]

5.2 The impact of regulation under alternative arrangements

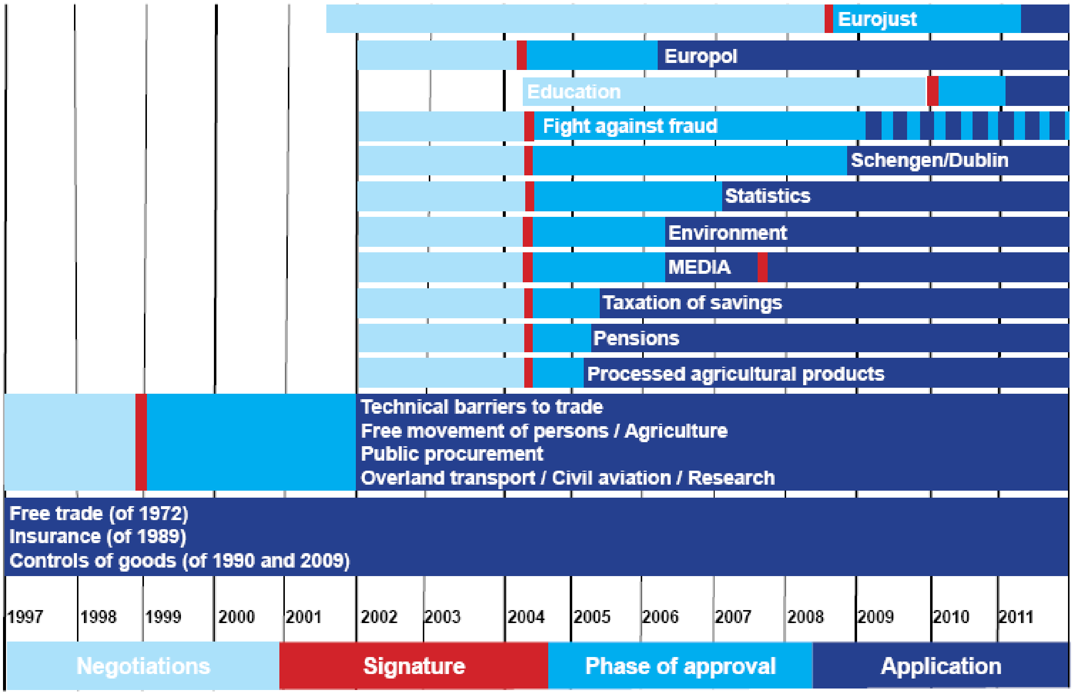
EEA and Switzerland

In return for access to the Single Market, Norway and other EEA EFTA countries must adopt nearly all EU legislation relevant to the free movement of goods, services capital and people, together with laws in areas such as employment, consumer protection, environmental policy and competition. In practice, this means that the vast majority of the EU regulations identified as most burdensome to businesses, including the Working Time Directive, would still exist if the UK left the EU but remained a member of the EEA. It would also be bound by future EU law in these areas, with arguably less influence over their content.

The sets of bilateral agreements that the EU maintains with Switzerland do not 'automatically' incorporate new EU law in the same way as the EEA Agreement. Instead, they provide largely for equivalent legislation to be adopted in the areas covered by the agreements (see chart overleaf), although in the case of Schengen and civil aviation, they are based on direct adoption of EU law. The sectoral approach means that, with the exception of civil aviation, Switzerland is not bound by horizontal policies, such as environment or competition. However, its Agreement on the Free Movement of Persons means that it must introduce equivalent employment legislation to that in operation throughout the EU, including the Working Time Directive.

Switzerland – bilateral agreements with the EU

[45] See, for instance, Public Service Europe *What is the true cost of Britain's EU membership?* 29 May 2013



Source: Centre for European Reform (2012) *Outsiders on the inside: Swiss and Norwegian lessons for the UK*

Complete withdrawal

The Single Market was itself established only through a vast legislative programme to remove technical and legal barriers to trade, and current models of access to the Single Market involve acceptance of associated EU law to some degree, often without a say in shaping it.

There is more generally a trade-off between national sovereignty and the sort of integration and harmonisation necessary to achieve completely free trade, particularly in services markets. Already, concerns are being raised in the US, particularly on the right, about the implications of a comprehensive free trade deal for independence and sovereignty. An article in The New American, argued that “the TTIP [Transatlantic Trade and Investment Partnership, the name for the EU-US free trade agreement] has been crafted specifically to bring about U.S.-EU political and economic ‘integration’ in the same manner that the nations of Europe were integrated into the EU.”[46]

If the UK withdrew completely from the EEA, and shunned bilateral negotiation on access to the Single Market, it would be free to regulate as it saw fit. Initially, this would leave a policy gap in a range of areas that the EU is currently responsible for regulating meaning that, in the short-term at least, the EU regime would be inherited. Over the longer term, the Government would have to decide which parts of this EU inheritance it wanted to reject or reform; such judgements would depend significantly on its political stance.

Because the Government would undoubtedly decide to retain the substance of at least some EU law, and because the costs of EU regulations are (at least partially) offset by benefits, the cost of regulation estimated by Open Europe and the BCC is emphatically not equivalent to the economic benefit of withdrawal. Proponents of withdrawal, however, argue that the UK would be better able to balance the costs and benefits of regulation according to its own

[46] The New American *Secretly trading away our independence*, 9 May 2013

domestic priorities; and that the regulatory regime would be more responsive to changing circumstances (amending EU law requires negotiations with all Member States and the European Parliament). On the other hand, businesses that export to the EU would still have to comply with product standards which, if the UK pursued an alternative regime may be different from those required to sell to the domestic market.

The argument over the effect of withdrawal in this context, then, boils down not to the size of the 'burden' on businesses, but to whether the benefits of having a more tailored and flexible national regulatory regime outweigh the loss of access to the Single Market that may come with pursuing an independent agenda.

6 Fiscal consequences of EU membership – the EU budget

The UK's budgetary contribution to the EU is one of the more quantifiable costs of its membership. Net of receipts under the Common Agricultural Policy, EU regional funding, and the budget rebate, the Government contributed an estimated £6.9bn to the EU in 2012, around 1% of total public expenditure and equivalent to 0.4% of GDP.[47]

6.1 How it works now

The EU's budget is used to pay for policies carried out at a European level, including agricultural subsidies via the Common Agricultural Policy, regional funding to assist poorer parts of the EU, research, and some aid to developing countries.

The basis for budgeting in the EU is a financial framework set for a period of years. The current framework runs from 2007 to 2013 and was agreed in 2006; the subsequent one will run from 2014-20. The framework sets out annual expenditure ceilings, and allocates spending to broad priorities. A separate, but concurrently negotiated decision sets out the limits and sources of revenue for the budget. Year-to-year expenditure and revenue are set through an annual budgeting process that takes place within the limits set by the financial framework.

Contributions by Member States to the Budget consist of four elements, called 'own resources'. These are described in more detail in Library Standard Note *The EU budget 2007-13*. By far the most important element, accounting for 87% of total revenue, are GNI-based contributions, which are calculated by taking the same proportion of each Member State's Gross National Income (0.7288% in 2013).

Around 6% of the EU's budget is spent on administration and a further 6% on the EU's foreign policies, international development, and pre-accession aid. The remainder is redistributed back to Member States in the form of agricultural and regional funding. Depending on its standards of living in relation to the EU average, and depending on the size of its agricultural sector, a Member State may get more or less back than they 'put in'. In 2011, 10 of the 27 EU Member States, including the UK, were net contributors to the budget. Per capita, contributions ranged from net receipts of €752 in Greece to net contributions of €208 in the Netherlands. The UK's per capita contribution was €150.[48]

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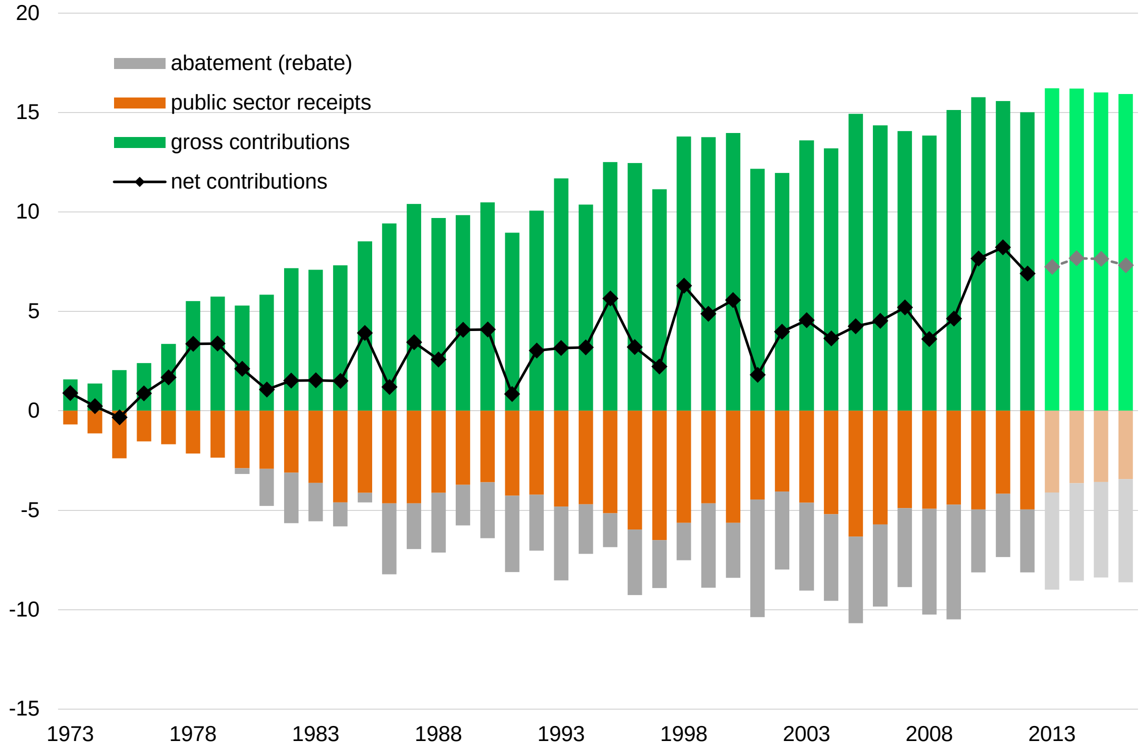
[47] HM Treasury *Annual Statement on EU Finances 2012* and *Public Expenditure Statistical Analyses 2013* Table 4.1; ONS National Accounts Series YBHA

[48] European Commission *Financial Report on the EU Budget 2011*

The UK has been a net contributor to the EU budget in 39 out of its 40 years of membership (the exception being 1975), contributing a total of £401bn in real terms gross, and £134bn net of receipts and the budget rebate. The chart illustrates the trends in the UK's contribution since it joined. The UK has received an abatement, or rebate, on its budget contribution since 1984, worth £3.2bn in 2012 and £103bn (in real terms) since it was first agreed;[49] this was originally negotiated due to the high proportion of EU expenditure that went towards the CAP, and consequently benefitted the UK, with its smaller farming sector, less than other Member States. Details of the UK's contribution since accession are shown in the chart below.[50]

UK contributions to and receipts from the EU budget - outturn and forecasts
real terms, £bn,1973-2012 and forecasts to 2016
lighter shades show OBR March 2013 forecasts, which are for financial years



Source: HM Treasury *European Community Finances* (various editions); OBR *Economic and Fiscal Outlook, March 2012*, Supplementary Fiscal Table 2.20

6.2 The fiscal impact under alternative arrangements

EEA

Since the entry into force of the EEA agreement in 1994, the EEA EFTA states (Norway, Iceland and Liechtenstein) have made financial contributions to the EU in two ways. Firstly, they contribute to broad EU regional policy goals by providing grants to 'reduce social and

[49] Before this, refunds to the UK were negotiated annually.
[50] All statistics in this paragraph based on HM Treasury *European Community Finances* (various editions)

economic disparities in the EEA.'[51] Since the 2004 enlargement, funds have been provided under two schemes: 'EEA Grants', which Norway, Iceland and Liechtenstein all contribute to, and which is targeted at the twelve new Member States, plus Greece, Spain and Portugal; and 'Norway Grants', which Norway alone contributes to, and is targeted at the twelve new Member States only. €1.79bn has been allocated to both schemes for the period 2009-14, to which Norway provides 97% of the total.[52]

Secondly, EEA countries contribute to the costs of the EU programmes in which they participate under the EEA Agreement, in proportion to their percentage of EU GDP. The EEA states have also committed to second national experts to the Commission as an 'in kind' contribution to these programmes.[53]

Norway, which by virtue of its relative size provides the vast majority of EEA contributions, provided £524m in 2011, or £106 per capita.[54] This compares to the UK's net budget contribution that year of £8.1bn, or £128 per capita. If the UK left the EU and instead contributed to the EU budget on the same basis as Norway, its contributions would fall by around 17%. Further details are shown in the table below.

Norway and the UK - contributions to the EU and EEA/EFTA in 2011

Norway [a]	£m	*£ per capita*
Norway Grants	139	*28*
EEA Grants	162	*33*
EEA/EFTA commitment to EU operational costs	214	*43*
EFTA budget	10	*2*
Total	**524**	***106***

UK	£m	*£ per capita*
Gross EU budget contribution	15,356	*243*
Net EU budget contribution	8,102	*128*

[a] EEA/EFTA commitment and grants figures converted from EUR to GBP at 2011 annual average exchange rates; EFTA budget contribution converted from CHF to GBP at 2011 annual average exchange rate

Sources: HM Treasury *European Union Finances 2012* ; EFTA 51st Annual Report (2011); Agreement between the Kingdom of Norway and the European Union on a Norwegian Financial Mechanism for the period 2009-14; Protocol 38 B of the EEA Agreement

Switzerland

Like the EEA contries, Switzerland contributes to both enlargement costs 'to reduce economic and social disparities', and the EU programmes in which it participates under its array of bilateral agreements. Its enlargement contributions are provided under multi-year frameworks, the most recent of which covered the five year period to 2012; negotiations on a new one are ongoing. Switzerland's contribution in recent years has been around £420m per annum, or **£53**

[51] The scheme is also intended to strengthen relations between Norway and the beneficiary states, making it an instrument of Norwegian foreign policy

[52] The basis for these contributions is contained in Articles 115-117 of the EEA Agreement; the specifics of the 2009-14 arrangement can be found in the Agreement between the Kingdom of Norway and the European Union on a Norwegian Financial Mechanism for the period 2009-14, and Protocol 38 B of the EEA Agreement

[53] A list of the programmes that EEA states participate in under the agreement is available here.

[54] These figures include Norway's contribution to the EFTA budget.

per head. If the UK left the EU and contributed on the same basis as Switzerland, its contributions would fall by around 59%.[55]

[55] Based on information published by the Swiss Government in its 2009 brochure *Bilateral agreements Switzerland-EU*

The EU budget – winners and losers

Although the UK is a net contributor to the EU, certain regions where living standards fall short of the EU average receive significant levels of support from the budget through the European Regional Development Fund and the European Social Fund, boosted by matched funding from government or the private sector. Farmers, too, receive payments under the Common Agricultural Policy. Receipts from the EU budget for the financial year 2008/09 (the latest year for which data underpinning the calculations are available) are broken down by the four UK nations in the table below. Wales, a significant part of which is eligible for the highest level of regional funding and has a large agricultural sector receives £163 per head. England, by contrast receives just £52.

Indicative receipts from the EU budget in 2008/09

UK constituent nations

		Wales	England	Scotland	N Ireland
£m	Structural funding	207	659	103	63
	Agricultural/fisheries funding	290	1,990	512	289
	Other	0	53	0	12
	Total	***497***	***2,702***	***615***	***364***
£ per capita	Structural funding	68	13	20	35
	Agricultural/fisheries funding	95	38	99	162
	Other	0	1	0	7
	Total	***163***	***52***	***118***	***204***

Source: HM Treasury *Consolidated statement on the use of EU funds in the UK for year ended 31 Mar 2009* ; ONS mid-year population estimates

This divergence in public sector receipts means that some parts of the UK (Wales and Northern Ireland) are effectively net recipients from the EU budget while others (England and, more marginally, Scotland) are net contributors, as illustrated in the table below.

EU budget contributions and receipts, 2008/09 - indicative disaggregation by UK constituent nations

£m unless stated

	UK	Wales	England	Scotland	N Ireland
Gross	13,155	474	11,287	1,092	303
Less abatement	5,595	201	4,801	464	129
Less public sector receipts	4,558	497	2,702	615	364
Net	3,002	-225	3,784	12	-190
Net per capita (£)	*48*	*-74*	*72*	*2*	*-106*

Note: Gross contributions are disaggregated using GVA share. Public sector receipts are disaggregated using HMT Consolidated Statement on use of EU funds

Sources: ONS *Regional, sub-regional and local Gross Value Added 2009* ; ONS mid-year population estimates; HM Treasury *European Union Finances 2010* , Table 3.2A; HM Treasury *Consolidated statement on the use of EU funds in the UK for year ended 31 Mar 2009* , Table 2

The tables do not show the net 'cost' of withdrawal for each of the UK nations; rather, they indicate that, as with other policy areas where the EU has competence, withdrawal from the EU will leave a policy vacuum which the Government must fill if it wants to avoid certain regions and sectors losing out. How it chooses to do so has important implications for the fiscal and broader economic consequences of withdrawal.

7 The EU's effect on consumer prices

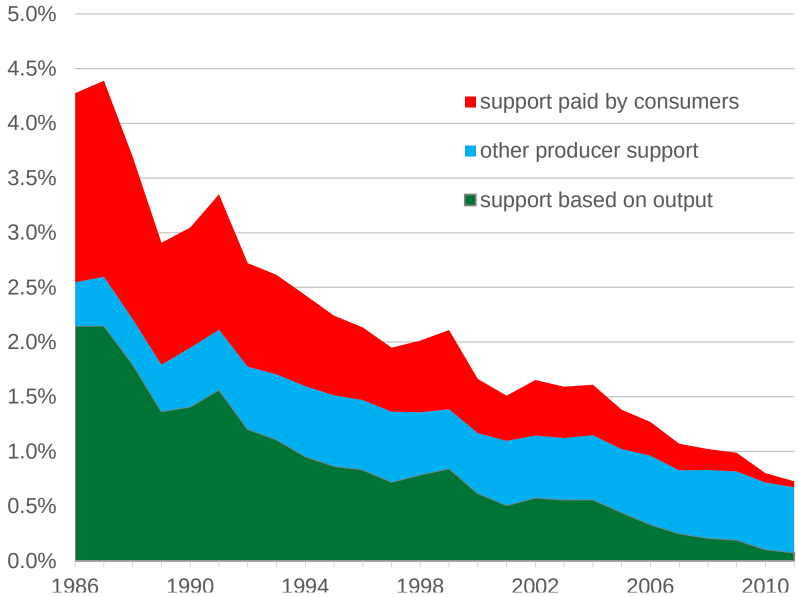
7.1 Food prices and the Common Agricultural Policy (CAP)

Farmers operating in the EU are supported in two ways: through subsidies via the CAP, and through a common external tariff on agricultural produce imported from outside the EU. Around 70% of the CAP budget is paid out in direct income support to farmers on the condition that they meet safety, environmental and animal welfare standards; the remainder goes towards rural development (farm modernisation, land management, and economic diversification and development in rural areas) and interventions to support the price of agricultural output. The CAP also mandates production quotas for certain products (e.g. sugar).

The wide-ranging criticisms of the CAP and the substantial reform it has undergone over the past two decades are beyond the scope of this analysis. But the principal criticism of the policy from an economic perspective is that it artificially inflates food prices for consumers and diverts productive resources from areas in which the EU might have a true trade advantage. The cost of the CAP to the UK is considered to be particularly high because it imports more and produces less agricultural produce than, for instance, France, Italy and Spain.

The OECD produces regular estimates of the extent of support arising from its members' agricultural policies, including the cost to consumers of paying higher prices.[56] The results are shown in the chart, which illustrates the following:

Support under the Common Agricultural Policy
% EU GDP, 1986-2011



Source: OECD *Agricultural policy monitoring and evaluation*

- the overall level of support provided under the CAP has declined from over 4% GDP in 1986 to less than 1% GDP today. This is partly due to a series of reforms over this period, but also because agriculture's share of total output has declined substantially

- reforms that have largely delinked financial support from farm production have caused a payments based on agricultural output, which have partially been replaced with other forms of producer support

- the delinking has been accompanied by reforms to reduce other price- and trade-distorting aspects of the CAP. This, combined with the convergence of world food prices to target prices under the CAP has reduced the total support to farmers arising from consumers paying higher prices

The UK's share of direct support to producers in 2011 from the EU budget was around €6.7bn. Total support paid by consumers in 2011 was estimated by the OECD to be €7bn, of which the share paid by UK consumers would be around €1bn.

[56] OECD (2012) *Agricultural policy monitoring and evaluation*

Leaving the EU would require the Government to consider whether and how to support UK farmers that are currently insulated by common external tariff and CAP payments.

7.2 Other prices

Consumer prices across a range of other goods imported from outside the EU are raised as a result of the common external tariff and non-tariff barriers to trade imposed by the EU. These include footwear (a 17% tariff), bicycles (15% tariff) and a range of clothing (12% tariff), although tariffs are not applied uniformly, and least developed countries benefit from tariff-free access to EU markets. Although they raise prices for consumers, they also help producers by shielding them from more price competitive imports; so while the Government would be free to set its own tariffs outside the EU, removing the protection they afford to certain industries could prove politically difficult, given that the costs will be specific and localised, but the benefits diffuse.

Trade barriers and economic efficiency

Conventional economic theory shows that tariffs reduce aggregate economic welfare, not only because they raise prices for consumers, but because, by shielding certain sectors from the vagaries of domestic competition, they divert productive resources away from sectors in which there might exist a trade advantage. In other words, some of the labour and capital tied up in the car industry might, absent a tariff, be more productively employed in, say, business services. In evidence to the Foreign Affairs Committee, Patrick Minford summed up this view thus:[a]

> If you leave a protectionist organisation, the prices of protected things fall. Consumers gain and certain producers lose... jobs are not lost; jobs are created overall, because you become a more competitive economy, producing the things that you are better at

On this basis, he went on to advocate a withdrawal from the EU and a move towards an abolition of all import tariffs in the UK.

While the UK, on leaving the EU, might wish to alter its tariff regime for the benefit of consumers and to encourage a reorientation of activity to more competitive sectors, it is unlikely that it would unilaterally remove all tariff barriers, despite the theoretical benefits of doing so. Such a move could, at least in the short-term, create unemployment and worsen the trade deficit as domestic producers are forced to compete with cheaper imports. The political imperative to protect domestic industry, and the leverage that existing tariff barriers command in negotiating trade agreements, have meant that all major economies have taken a more measured approach to trade liberalisation.

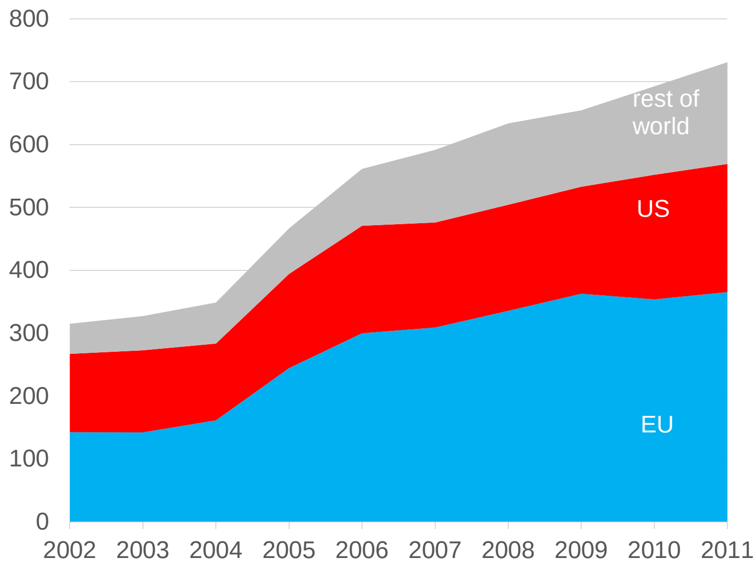
References

[a] Foreign Affairs Committee *The future of the European Union: UK Government Policy*, oral evidence

8 Foreign direct investment (FDI)

8.1 FDI in the UK – extent and effect

UK - stock of inward foreign direct investment by source
£bn, 2002-11



At $1.2tn, the UK had the second largest stock of inward foreign direct investment (FDI) in the world in 2011, behind the United States,[57] and it was recognised the most attractive location for investment in the EU in the 2013 Ernst and Young European Attractiveness Survey.[58] 48% of the FDI stock is a result of inward investment by other EU countries, a figure that has declined from a peak of 53% in 2009, but remains above levels seen before 2005.

In 2011, foreign companies invested £31.9 billion in the UK, a slight fall on 2010 and the lowest investment since 2004. The largest decreases in inward investment flows in 2011 were from the EFTA countries and the Americas.

If it involves the construction of new operational facilities ('greenfield' investment), such investment can have benefits for the economy directly through the creation of jobs; and even where it does not (e.g. the Qatari Government's acquisition of Harrods), FDI can theoretically benefit the economy indirectly by improving productivity through the introduction of new working practices and transfers of technology that can spread to indigenous firms. However, establishing the existence of these theoretical benefits empirically, particularly the 'spillover effects' of FDI on the domestic economy, has proved challenging, and the econometric analysis has produced, at best, mixed results.[59]

8.2 Impact of EU membership

It is often argued that being part of the EU makes the UK a more attractive place to invest, as firms with a presence in the UK benefit from unrestricted access to the markets of other EU Member States via the Single Market. However, establishing the existence and estimating the magnitude of the 'EU effect' on UK inward FDI, and hence the consequences of withdrawal, is very difficult. The decision to invest is motivated by any number of factors, including the integrity of the UK legal system, the availability of particular skills and services, and the status

[57] FDI, also known as (international) direct investment, forms part of the capital account of the balance of payments. 'Direct Investment' is defined as an investment that adds to, deducts from, or acquires a lasting interest in an enterprise operating in an economy other than that of the investor where the purpose is to have an 'effective voice' in the management of the enterprise.

[58] Ernst and Young *2013 European Attractiveness Survey*

[59] See, for instance, Rodrik, D. (2008) *One economics, many recipes: globalisation, institutions and economic growth*

of the English language. Disentangling these motivations from those arising from the Single Market, and accounting for other factors that have caused a surge in FDI over the period of EU integration, including the removal of capital restrictions and the development of capital-intensive technologies, is, in the words of a 2005 Treasury paper 'fraught with problems'.[60] Going on to judge the contribution of such investment to UK output and productivity is still more problematic.

On the one hand, the removal of barriers to trade eliminates an important incentive to physically locate abroad, meaning the Single Market could be argued to discourage *intra* EU investment. On the other, membership of the Single Market should stimulate inward investment in the UK from outside the EU, since by doing so, they can access 27 other EU markets tariff-free.[61] The choice of foreign car manufacturers, including Honda, Nissan, BMW, Toyota and General Motors, to locate in the UK, is often cited as an example of companies locating in the UK as a bridgehead to other EU markets.

In a survey of 2,272 multinationals, the UN Conference on Trade and Development found that size of the local market was the most important criterion determining the location of FDI for both the manufacturing and services sectors, and the third most important for the primary sector.[62] This would suggest that EU membership plays an important role in determining investment decisions. However, the results of the Ernst and Young UK Attractiveness Survey on this issue are more equivocal: 72% of companies interviewed in North America thought reduced integration with the EU would make the UK *more* attractive as a destination, against 38% of those interviewed in Western Europe.[63]

On the whole, it is reasonable to conclude that membership of the Single Market is one of a number of important determinants of FDI; but outside the EU, the UK may be able to establish a regulatory regime more favourable to overseas investors that could offset the effect of its departure. In particular, the UK would regain competence to negotiate international agreements on foreign direct investment with third countries, something which it has not been able to do since the Lisbon treaty entered force in 2009.

Appendix Table: a comparison of the freedoms and obligations of countries in the EU with those in other trading arrangements

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[60] HM Treasury (2005) *EU membership and FDI*

[61] Including Croatia, which will accede to the EU on 1 July 2013

[62] UNCTAD (2009) *World investment prospects survey 2009-2011*, p.18

[63] Ernst and Young *2013 UK attractiveness survey*, p.35

the colours are intended to give a broad indication of the relative extent of freedom each group or country enjoys across each dimension, running from green (free) through yellow, orange, to red (restricted). For example, countries in the EU enjoy tariff-free access to EU markets (green), but are not free to pursue trade relationships with non-EU countries (red).

		EU	EEA	Switzerland	Countries with no preferential access to EU markets
barriers to goods trade with EU	*tariff barriers*	none	none	none	exports face EU's 'most-favoured nation' tariff, which currently averages 1% on a trade-weighted basis
	non-tariff barriers	none	must comply with rules of origin procedure; eligible for EU anti-dumping measures	as for EEA	exports can be subject to full range of non-tariff barriers, provided these are applied in a non-discriminatory way and comply with WTO agreements
barriers to services trade with EU		Services Directive has not been fully implemented and tackling outstanding and emerging barriers is an ongoing exercise	EEA countries conduct services trade on same basis as EU members, though they lack direct influence over services market regulation	no general agreement on free movement of services	Services trade goverened by GATS. No presumed right of access as under EU treaties; market access at discretion of Member States (but must not be discriminatory)
barriers to trade with non-EU countries		preferential agreements with 45 countries (not including EEA). The EU's trade restrictiveness index score* is 5.6% (2009)	EFTA has preferential agreements with 36 countries, including Canada, which has no EU agreement yet. Norway's trade restrictiveness index score* is 8.9% (2009)	In addition to the EFTA agreements, Switzerland has agreements with Japan and China. Switzerlands's trade restrictiveness index score* is 3.6% (2009)	depends on trade policy pursued and agreements negotiated by particular country
freedom to pursue trade relationships with non-EU countries		the EU has a common external tariff and it has exclusive competence to conduct trade and investment agreements with non-EU countries	trade agreements are conducted through EFTA or bilaterally; EEA members can determine their own trade policy, including tariff levels, subject to these agreements	trade agreements are conducted through EFTA or bilaterally; Switzerland can determine its own trade policy, including tariff levels, subject to these agreements	trade agreements purused and trade policy determined independently
free movement of persons		EU nationals are free to move between Member States without a visa and no time limit may be placed on their stay	EU provisions on free movement apply equally to other EEA members	arrangements analogous to EU/EEA members, under Agreement on Free Movement of Persons	no right of free movement in EU; immigration controls vary by Member State (but free to apply own immigration restrictions to EU nationals)
EU law/regulation	*influence*	representation on EU decision-making bodies, with seats in European Parliament and votes in Council reflecting population size	no formal access to EU decision-making bodies (Parliament and Council); some access to Commission expert groups and comitology committees	no access to EU decision-making bodies or to Commission working groups and comitology committees	no formal means of inflluencing EU law, including product market regulations
	compliance	adoption of all EU legislation unless specific opt-outs negotiated	EEA members must adopt nearly all EU legislation relevant to the free movement of goods, services capital and people, together with laws in areas such as employment, consumer protection, environmental policy and competition	Bilateral agreements largely provide for equivalent domestic legislation to be adopted in relevant areas. Switzerland is not bound by horizontal policies, such as environment or competition; and unlike EEA countries it is not obkliged to take on new EU legislation	no requirement to adopt or transpose EU law, but goods exported to the EU must comply with EU product standards; service providers with a commercial presence in the EU may be required to submit to the regulatory regime of the host country
fiscal contributions		obliged to contribute to all areas of the EU budget, with size of contribution determined substanitally by relative economic size. Some provisions for reductions (e.g. UK abatement)	financial contributions to meet objectives of EU regional policy and for participation in particular EU programmes	as for EEA countries, although the size of the contribution in practice has been lower, per capita	no obligation to contribute

*This measures the extent of tariff and non-tariff barriers to trade imposed on imports; lower values imply a less restrictive trade policy (with respect to imports)

Sources: Open Europe (2012) *Trading Places: is EU membership still the best option for UK trade?*; Centre for European Reform (2012) *Outsiders on the inside: Swiss and Norwegian lessons for the UK;* Kee et al (2009, updated July 2012) for World Bank *Estimating trade restrictiveness indices;* Centre for European Policy Studies (2013) *Access barriers to services markets*