COMMENTARY: THE ECONOMIC IMPLICATIONS FOR THE UK OF LEAVING THE EUROPEAN UNION

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Over the next few years, the issue of the UK's membership of the European Union is likely to be at the centre of our political debate. The main parties recognise that a referendum on membership may be desirable and possibly even necessary – whether because of significant changes in the governing Treaties or simply to give British citizens a chance to express whether they still believe, as in 1975, that membership is in the national interest. It is difficult to overstate the significance of a vote that would determine whether the UK remains part of a union of 500 million citizens, by most measures the wealthiest economic entity in the world.

Economics will be at the heart of this debate. Without downplaying the inherently political nature of the EU and the 'European project', it seems reasonable to assume that many, perhaps most, voters whose minds are not already made up will decide on the basis of economic factors. So far, while there has been plenty of partisan rhetoric, there has been little serious and comprehensive analysis of the implications for the British economy of an exit from the EU. The purpose of this article is to set out a research agenda for economists who would like to play their part in producing such an analysis, as NIESR and others are doing for Scotland's possible constitutional change, supported by the ESRC.[1]

As the House of Commons Library (Harari and Thompson, 2013) put it, "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."

Given these difficulties, it is perhaps not surprising that there have been no credible recent attempts by independent economists to estimate the overall impact of EU membership on the UK economy. Recent papers by Batten (2010) and the Department for Business (2010) have a fairly narrow focus. The most recent attempt to model the broader economic impact of UK withdrawal in a comprehensive global macroeconomic framework was conducted at NIESR by Pain and Young (2004), who concluded:

> "Withdrawal could cause disruption to the economy, but it is most unlikely that export sales to EU markets would cease completely, and monetary policy can be relaxed. In the longer term, flexible wages and prices would help employment to recover. However, this does not mean that withdrawal from the EU would be without long-term costs. The process of European integration means that the evolution of European institutions and policies now plays an increasingly important role in determining the international trade and investment patterns of individual member states... The resulting linkages have important implications for long-term growth prospects, because the degree of international openness is a significant determinant of the level of technical progress, and hence, total factor productivity in the UK economy. Our analysis suggests that withdrawal from the EU would mean that the level of output in the UK economy would be 2¼ per cent lower permanently than it otherwise would have been. "

Many of these points remain valid, but the numerical estimates are clearly outdated, and the analysis ignores a number of important issues. The world economy has

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changed considerably in the past decade, particularly as a result of the global financial crisis, and the resulting increase in government debt. Meanwhile our understanding of crucial economic issues, for example the interaction between trade and competition policy and the role of the financial sector in the macroeconomy, has also changed. All of these matter when deciding how, and at what level – international, national, local – economic sovereignty should be vested, and economic policy decisions should be made.

So, how should economists attempting to produce a timely assessment approach the task? The first point is that, more than in the early 2000s – and incomparably so by comparison to 1975 – the impact of EU membership on the UK economy is about far more than just trade. In fact, there are at least six key areas where leaving the EU might – or might not, depending on the future relationship – profoundly affect the UK economy. As well as trade, these include investment, regulation, migration, the financial sector, and the EU budget.

Both conceptual and quantitative analysis will be required for each of these, although the quantitative techniques will depend on the question being posed. Panel regressions may be appropriate for estimating the impact of EU entry on some variables (such as FDI); they have several limitations – and it is far from clear that costs and benefits are symmetric, so may not be appropriate for estimating the impact of EU exit. Given the profound nature of the impacts we are trying to model, and the need to be able to assess counterfactuals, Dynamic Stochastic General Equilibrium (DSGE) models may be useful, while NIESR's own global macroeconometric model, NiGEM, is particularly well adapted to simulating economic shocks in a general equilibrium framework.

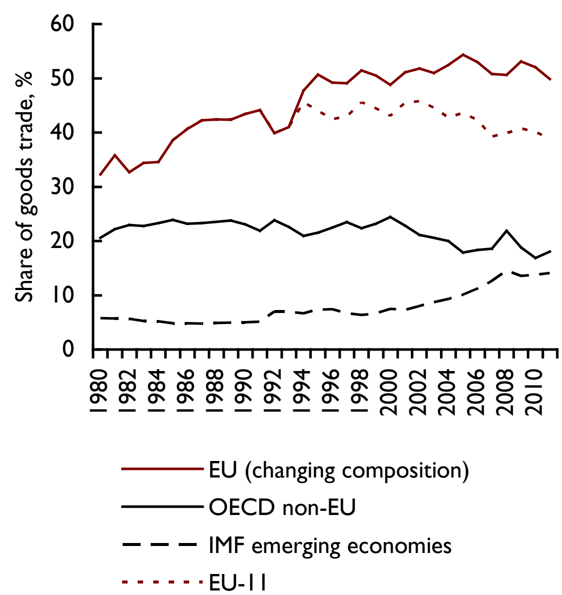
A further important methodological point is that there is no single 'right' answer, because there is no single counterfactual. We simply do not know what the broad parameters of the relationship between the UK and the EU would be after British exit, nor do we know how the British economy would change and adapt to its new status outside the EU. This suggests that, rather than producing point estimates of the economic impact of exit, it is more sensible and informative to try to identify plausible alternative scenarios, which can then be used to model potential impacts on different assumptions about the post-exit economic environment. This applies to each of the key issues below. Let me examine each of them in turn.

Trade

Britain is a 'small open economy' which is very reliant on trade, both in goods and, often overlooked, services. Currently, exports to the EU represent about 10 per cent of UK GDP. The rest of the EU is by far our largest trading partner. Although trade with the fast-growing emerging economies is growing rapidly, this figure has grown rather than shrunk over the past decade, reflecting both the increased importance of trade to the UK economy, and successive expansions of the EU. And, despite the sharp rise in the proportion of trade accounted for by emerging economies, the EU still accounts for approximately half of UK trade.

But, under most feasible scenarios, all this would still be the case after exit; our membership of the World Trade Organisation means that tariffs on goods would remain fairly low, even were we not to agree a special trading relationship with the EU along the lines of the European Economic Area or the bilateral agreements between the EU and Switzerland. So the immediate direct impact on trade might not be that great. For example, an internal UK government analysis, released under the Freedom of Information Act, found (using a standard gravity model) that EU entry had boosted UK trade with EU members by 7 per cent, but reduced it with non-members by 4 per

Figure 1. Trends in UK total trade with the EU and the rest of the world



Source: Centre for European Reform, based on IMF Direction of Trade Statistics.

cent – so a positive impact, but by no means huge. Of course, as noted above, the impacts might not necessarily be symmetric (that is, the impact of exit might not simply be to reverse that of entry). Moreover, increases in trade are not in themselves necessarily welfare-enhancing.

But analyses that look simply at the immediate impact on trade may understate the benefits. Perhaps more important, over the long run, would be the indirect economic impact. Economists now think that the size and degree of integration of markets – especially between developed countries – can improve welfare, not just because of the productivity enhancing benefits of intensified competition, the scope for greater economies of scale, and so on (for example, Melitz and Ottoviano, 2008). These benefits might well be eroded if we were outside the full Single Market (see below) – which of course is not just about the absence of tariffs and quotas, but about the harmonisation of regulation and standards that allow businesses to trade across national borders.

Services trade is likely to be particularly important here. The UK has long pressed for greater urgency in the creation of a proper 'Single Market for Services', an area where the UK is strong and where much future growth is likely to come from. Outside the EU, we would not necessarily be able to press the case for services liberalisation, nor to take advantage of it if it came. So the main impact might not be so much to reduce existing trade, but to reduce the potential for future expansion in service exports.

Regulation

Closely related to the issue of trade is that of regulation. Much has been written about the regulatory burden resulting from EU membership, and it is clearly the case that some EU regulations impose significant economic costs, although there are also benefits.

In particular, paradoxically, the creation of a full Single Market – the progressive dismantling of regulatory barriers to trade within the EU – necessitates a considerable amount of EU-level regulation, to prevent individual Member States from preserving non-tariff barriers and other trade reducing practices. Indeed, it is very notable that the first, and arguably most important, recommendation in the recent report 'Cut EU red tape' (Department for Business, 2013a) to the Prime Minister from his Business Taskforce was that "The European Commission should ensure the full implementation of the Services Directive across the EU". This amounts to a call for more 'EU regulation' rather than less, albeit regulation that should make it easier for business to operate rather than harder.

In the context of potential Scottish independence, the Department for Business (2013b) notes the large volume of regulation at both UK and EU level, suggesting that independence (and by analogy EU exit) would quickly lead to regulatory divergence, reducing trade:

> "However, given the number of legislative changes that affect businesses introduced in the UK every year, differences in regulations would be likely to appear relatively quickly. This is irrespective of whether the government of an independent Scottish state attempted to implement a similar regulatory and institutional framework. The experience of the EU Single Market shows that even small differences in implementation and interpretation of legislation have an impact on compliance costs for businesses."

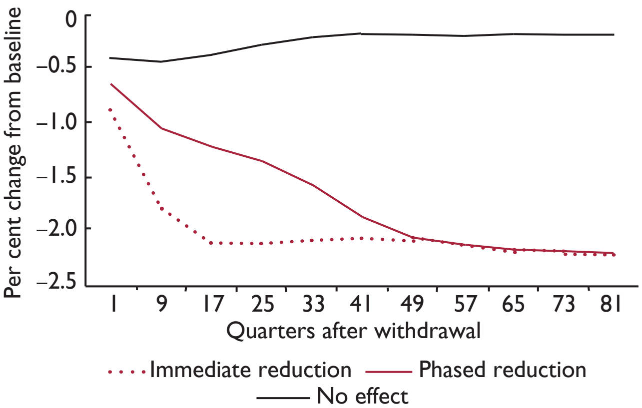
Nevertheless, outside the EU, the UK might have more flexibility about some aspects of the regulatory framework. If we wanted to maintain access to the Single Market, however, we would have to continue to observe EU regulations in a number of key areas. So the flipside of securing the continued benefits of access to the EU market for trading purposes would be an acceptance that the UK remains bound by much, if not all of the EU's regulatory '*acquis*'. Any flexibility would be limited, and likely subject to difficult negotiation. As Holmes and Rollo (2013) put it,

> "Outside the EU, as the experience of Norway, Turkey and Switzerland demonstrates, free access into the EU requires giving up almost the same regulatory sovereignty as full members, but without any say in the making of the rules."

While this trade-off may be acceptable for Norway or Switzerland, even if members might have relatively little influence, the UK might be giving up a more substantial role in EU decision-making.

Labour market regulation is frequently cited as an area where the EU imposes constraints, which could be looser if we were no longer members, subject to the constraints above. However, even within the EU, the OECD assesses that the UK has one of the most flexible labour markets among developed economies, so the potential for economic gains from greater flexibility is likely to be rather small. There might be greater scope for gains in other areas, such as environmental regulation. For example, it is not clear that the constraints imposed by EU regulation on the new London 'super sewer', currently expected to cost £4.2 billion, necessarily reflect a sound cost-benefit analysis.

Figure 2. The impact on real GDP of different FDI assumptions (per cent)



Source: Pain and Young (2004).

Investment

Another related issue is that of investment. Pain and Young (2004) found that the largest quantifiable impact on the UK economy would come via a reduction in foreign direct investment, which has been shown to have productivity-enhancing effects.

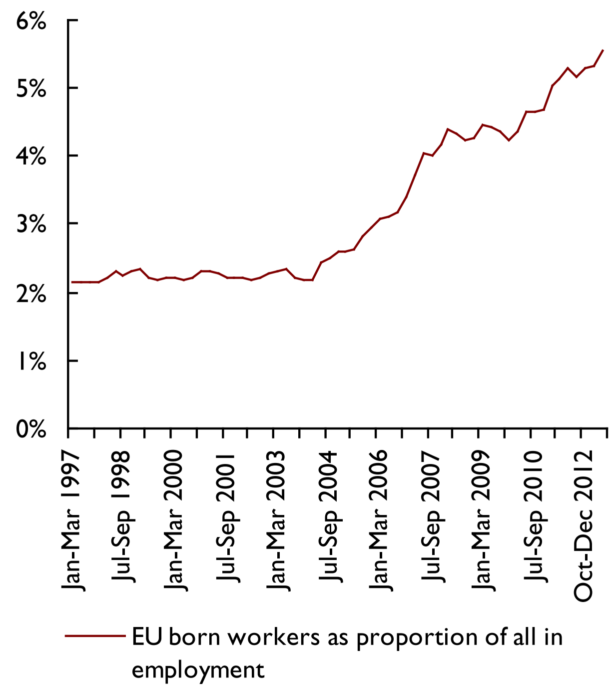
So if EU exit led to a reduction in foreign investment, because businesses were no longer certain of easy access to the Single Market, the damage might be significant. Indeed, at least some of these costs are likely to arise in the short term as a result of the debate about possible UK exit. US research (Baker, Bloom and Davis, 2012) has shown that uncertainty is a powerful deterrent to business investment. Although clearly 'policy uncertainty' is specific to time and place, it hardly seems plausible that a UK referendum on EU membership would not result in a significant increase in such uncertainty – although, arguably, given the tenor of the current political debate, that is inevitable under any plausible scenario. A number of major foreign investors have already made public statements to this effect, although evaluating the actual impact on investment will be very difficult.

Labour mobility

A fourth issue which has recently assumed increasing prominence is that of labour mobility. Workers of EU origin play an increasingly important role in the UK labour market, now representing well over 5 per cent of employment. This figure has tripled since 1997.

A number of studies have documented the – broadly positive – impact of EU workers on the UK labour market (Lemos and Portes, 2008). Moreover, the fiscal impacts are positive and significant, since EU nationals are considerably more likely be in work than the UK-born, and considerably less likely to be claiming benefits (Dustmann, Frattini and Halls, 2010).

Figure 3. EU-born workers as proportion of all in employment



Source: ONS Labour Market Statistics, table EMP6, August 2013. 'EU-born workers' refers to non-UK born, and includes 2004 Accession countries from May 2004, and Bulgaria and Romania from 2007.

Of course, there is no prospect of EU-origin workers who are not UK citizens being expelled from the UK en masse. However, given the proportion of people who cite immigration as a motivation for leaving the EU, it seems highly probable that EU exit would result in significant restrictions on immigration to the UK from EU member states, with presumably reciprocal restrictions on UK citizens moving to the EU. Everything would depend on the precise arrangements. But such restrictions would certainly cause considerable disruption for both current immigrants and emigrants and their employers, and would reduce the flexibility of the UK and EU labour markets going forward.

Financial services

The UK is the major centre for EU financial services. The

UK has a trade in services surplus with the rest of the EU of 16.6bn, around 40 per cent of all euro denominated foreign exchange transactions and an estimated around two-thirds of all EU financial services are conducted through the City. While there are significant cluster effects and path dependency around financial services, competition is emerging in other countries (for example, in Germany, following the development of Eurex exchange). In light of the structural changes to Europe's post-crisis regulatory structures, there are conflicting views on whether the UK financial services industry is better off within the EU.

The most important current regulatory initiative in the EU financial services industry is the move towards a banking union.[2] The UK has made it clear that it does not intend to participate in the banking union. While there are significant hurdles to be overcome, especially agreement over mutualisation of any residual losses from the resolution regime, it is unclear how this might affect the UK. For example, if the EU deposit insurance scheme or resolution scheme is more generous than offered in the UK there may be some migration of activity to the continent. Even without participating in the banking union, the UK has considerable influence over EU financial regulation through the European Banking Authority based in London. Currently, the UK is set to punch above its weight in determining the standards for banking supervision throughout the EU, due to the 'double majority' for non-eurozone countries in the European Banking Authority.[3]

While this 'double majority' currently gives the UK a strong voice in ensuring a level playing field in financial services for the City – this may change. The relationship between the ECB as the new single financial regulator and the EBA is likely to change. While all eurozone countries will join the EU banking union, if a majority of the ten non-eurozone member countries decide also to join the union then the UK's safeguards at the EBA through its voting arrangements would be greatly weakened. Given that the UK competes with non-EU countries for global financial services it is not clear whether it would be better to be within an EU denominated by banking union countries if they were to advance a regulatory agenda which would stifle activity, or whether the UK would be better placed outside of the EU altogether and so able to compete for non-EU business.

It is clearly not necessary to be part of an economic and political union to serve as a financial and trading centre for an area, as several current and historical examples show. However, it seems highly implausible that the rest of the EU would allow the City of London simply to play the same role as it does now with respect to the EU if EU financial regulation no longer applies. In particular, the City plays an important role as a conduit for non-EU financial firms to provide services into the EU. This may be at risk if the UK were to leave the union. On the other hand, Bank of England officials have expressed a clear preference to move towards greater 'subsidiarisation' of banking services (the presence of foreign banks in the UK would be through a subsidiary rather than a branch) which is currently incompatible with a requirement to allow branches of EU banks to operate in the UK.

While there are many uncertainties, the sheer size of the surplus in financial services suggests the financial services angle of the UK's membership to the EU is of first order significance.

The EU budget and the Common Agricultural Policy

The UK makes an annual net contribution to the EU budget of about 0.5 per cent of GDP, so this would be a potential saving, although it should be noted that some non-EU members (e.g. Norway) do make a financial contribution to the EU budget, in part return for the market access resulting from EEA membership. The budget issue is also closely bound up with the future of UK agriculture post-exit, since agriculture remains by far the most important area of direct EU budgetary spending. The distortions resulting from the Common Agricultural Policy are well documented, including by the European Commission itself (European Commission, 2004). If we moved to a much more liberal regime for agriculture, with much lower subsidies and fewer price controls, then the potential economic gains – both to the exchequer and to UK consumers – could be significantly higher. Of course, domestic political economy considerations would still remain, so this may be optimistic.

And two non-issues

It is also worth disposing of two red herrings that frequently emerge in the public debate, one on each side of the argument. The first is that leaving the EU would **"jeopardise up to three million jobs in this country"**, as the Deputy Prime Minister has claimed (Clegg, 2013) – a figure based originally on Pain and Young (2004). Even if the potential negative impact on trade and investment discussed above were actually to materialise, such claims are totally implausible, and certainly not based on evidence. As Pain and Young emphasise, over the medium to long run, the main determinant of employment and unemployment is the supply side of the economy – the flexibility of the labour market and the skills and qualifications of potential workers – so there is unlikely to be any significant long-run impact. Trade makes us richer and more productive – so a reduction in trade may well feed through to a reduction in real wages – but most conventional economic models do not suggest that it creates (or destroys) substantial numbers of jobs over the medium term.

The second is that we would benefit from exit because we have a large trade deficit with the EU. This shows a complete misunderstanding of the basic principle of comparative advantage, and why trade is good for prosperity. Buying things that foreigners can produce more cheaply and efficiently than we can raises our welfare rather than lowering it, by allowing us to concentrate on doing things we can do (relatively) well. rather than those we can't. We benefit from buying Italian olive oil just as Italians benefit from buying Scotch whisky. If the impact of exit were to reduce imports, that would make us poorer, not richer.

To conclude, it is vital that the UK political debate on EU membership over the next few years is informed by high-quality, objective economic analysis. There will be few decisions that will be so important for our long-term economic future. But the impact on the UK economy from EU exit cannot be assessed without knowing broadly what the UK-EU relationship would look like.

This means that economists wishing to present an objective assessment need to state explicitly what they are assuming about life after exit, and where possible present alternative scenarios. What is clear now is that the impact of EU exit would range across the entire economy. By comparison, the impact on investment, the financial sector and labour mobility might well be more important and more problematic than the more commonly discussed topics of trade and regulation. Nor should we discount the risks posed by a prolonged period of uncertainty.

NOTES

1 See http://www.esrc.ac.uk/research/major-investments/future-of-uk-and-scotland/

2 This is to consist of a single regulator (the ECB), special resolution regime and single deposit insurance.

3 The double majority refers to a new voting rule for the EBA, whereby both a majority of eurozone and a majority of non-eurozone votes is required to pass a measure. As the group of non-eurozone countries is smaller, this confers greater weight to each non-eurozone vote.

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