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Challenge Panel

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An embrace of ‘openness’ – to trade and people, to investment and ideas from abroad – has been the foundation of Britain’s success. Coupled with investment in the UK’s economic infrastructure and in our education and skills system to prepare the UK for the competition that comes with openness, this global outlook has served Britain well and increased our prosperity as a nation.

However, this is the year when the world’s emerging markets – from the Eastern tigers to the growing powerhouses of Latin America – are set to take over from the developed world as the majority shareholder in the global economy. Opportunities for Britain to strengthen its role as a trading nation lie in all corners of the globe. At the same time, the UK’s closest trading partner, the European Union, is going through a period of extensive structural change – with an unknown end point – driven by the need to restore stability to the single currency. Britain must now adapt its open, global approach to reflect the realities of the 21st century.

For business, the nature and characteristics of the complex global economy are the starting point for taking such long-term strategic decisions. Being successful in today’s global world is rarely achieved through independent and unilateral action: economies and businesses from across the globe are increasingly inter-connected, as goods, services, finance and people – not to mention knowledge and ideas – cross borders ever more rapidly.

For the last 40 years, the UK’s relationship with the European Union has been the cornerstone of our engagement with this increasingly integrated world. When the UK joined, Europe was resurgent. Recovered from the Second World War, it seemed clear that the main opportunities for UK trade and growth were with our nearest neighbours. The current circumstances have thrown that conclusion into doubt to the point that some in the UK are questioning the value of our membership of the EU, and some are even advocating withdrawal.

For British business, large and small, the response to this is unequivocal: we should remain in a reformed EU. Membership of the EU’s single market remains fundamental to our economic future. In this report, the CBI has comprehensively and objectively analysed the advantages and disadvantages of EU membership and concludes that the EU brings considerable benefits to the UK in terms of supporting jobs and growth. The EU Single Market is the biggest in the world, opening up a 500 million-strong consumer market to UK businesses, allowing capital and investment – as well as people and ideas – to flow into the UK and be deployed productively across the continent. This has directly boosted the living standards of UK citizens.
The European Union also supports UK business in realising its global ambitions by providing significant influence over the rules, policies and priorities that allow British based firms to seize opportunities across the globe. It anchors UK trade around the world through the signing of high-quality, ambitious Free Trade Agreements and the creation of globally recognised standards that open markets. And in a world of competing ideas and ideals – where international action is increasingly the avenue for addressing problems across the globe – UK membership of the EU amplifies Britain’s voice internationally.

However, the EU is far from perfect. Business has frequently criticised many aspects of the regulations that the UK negotiates in Brussels. While being part of club of 28 countries inevitably means compromise, there is particular annoyance at the sense of a creeping extension of EU authority – regulating on trivial issues, sometimes counter to the wishes of the UK and its citizens, rather than focusing on the big picture issues like growth, trade and the Single Market.

The wider changes in the global economy means the EU must seize the opportunity to reform and renew its priorities and purpose in order to keep pace in an increasingly competitive international context. Business wants a permanent shift in the focus of the EU towards those issues that will underpin our prosperity in the future. The EU must be more outward-looking to facilitate new trade opportunities for business. It must be open and competitive, updating the Single Market for the 21st century and changing its regulatory approach to drive European competitiveness on the global stage.

The current crisis means that the Eurozone must integrate further but, sitting outside these moves towards integration, the UK will not be part of this. Safeguarding the Single Market and protecting the voting rights of those outside the Eurozone is critical. There is also a historic opportunity to both allow those states that wish to go further to do so but at the same time set the limits of what is best done in Brussels and what should be left to the member states themselves.

This reform agenda is achievable. British business is convinced that, by staying in a reformed EU, the UK can get the best of both worlds – access to markets in Europe and beyond that build on our innate strengths – our language, time zone, respected legal system and flexible labour market. And by working with its European partners, the UK can help put the EU on a path to sustainable growth and global competitiveness – maintaining EU membership as the cornerstone of the UK’s open posture.

Indeed, at the root of the decision about whether to retain EU membership or not lies a fundamental choice about this ‘openness’. We should not judge our membership of the EU on how it measures up against our past, nor by looking at the immediate economic prospects for the Eurozone, but on what we want our future to look like: open or closed; influential or uncertain. Deciding our future path is a choice we face imminently, and must make decisively. Nothing will be given to us for free in the 21st Century. We must set our sights on realising our global future.
Britain has looked outwards to the wider world for many centuries, but its patterns of trade and investment have constantly evolved. An open economy, combined with robust domestic industries, has long been a crucial part of the British success story.

However, the nature of economic openness is changing. The complex modern economy requires a new form of openness – one that is promoted by securing market access to trade at every stage of the value chain; having a regulatory climate that is both competitive and enabling to trade; increasing access to labour and investment through migration and capital flows; and improving the business climate for foreign direct investment. This is underpinned by a competitive economy, with investment in infrastructure and successful industries, as well as a long-term skills strategy.

Whereas in the 19th century Britain pursued openness through industrial dominance and naval power, in the second half of the 20th century membership of the European Union became the centrepiece of Britain’s global trade policy, as it looked to secure openness through multilateralism, regionalism and the setting of international rules. Britain now needs to adapt its global trading role for the 21st century and respond to the rise of new economic superpowers in Asia and South America.

British business is clear that the best way to be outward facing and globally competitive in the modern era is to continue to use and influence the EU as a base from which to build trading links and maximise interdependence with economies all over the world, whilst reforming the EU to ensure that it allows the UK to realise this global future. Attempting to reverse the process of increasing interdependence and return to a system of bilateral ad hoc arrangements will not create and keep the jobs the UK needs in order to maintain and improve living standards for all its citizens or enhance its standing as a global leader.

In assessing whether membership of the EU is in the UK’s national interest in terms of supporting its global trading ambitions, the CBI has considered the following aspects:

1. The changing dynamics of the global economy and how these affect where the UK needs to focus to maximise its opportunities for growth
2. How best to address the UK’s productivity challenge to boost exports around the world
3. The advantages and disadvantages of the UK’s membership of the EU and the future opportunities and challenges it may bring
4. UK influence in the EU and how the approach the UK takes directly affects its level of influence
5. Whether the further integration of the Eurozone might threaten the overall benefits of UK membership of the EU and whether the UK can respond to avoid this
6. Whether any alternative types of relationship with the EU offer a better balance of benefits than full membership
7. How to reform the EU to better support the UK’s – and Europe’s – global future
Overall, the CBI believes that the UK can help shape the EU for the 21st century if it engages in the right way. This is one reason why 8 out of 10 CBI members – including 77% of SMEs – said that they would vote for the UK to remain a member of the EU in a referendum if held tomorrow.

Growth in the developed world will be constrained for the foreseeable future. Ageing populations, highly developed economies with fewer ‘quick wins’ available from technological catch-up, and the overhang from the financial crisis will mean that many developed economies will see sluggish growth of around 2% at best for the next ten years. These global trends suggest that many companies looking for long-term growth rather than just maintaining existing sales will have to look outside the developed world.

The UK must do more to create trade and investment links to the high-growth markets, but this will take time. Exports to the emerging world are growing rapidly, but they are doing so from a very low base – only 2.8% of UK exports go to China, and just 6.6% go to the four BRIC countries (Brazil, Russia, India and China) in total. Despite some progress in recent years, Britain’s trade links are strongly tilted towards the slower-growing western European Union countries (rather than the faster-growing eastern European members), the United States and other developed economies.

Britain’s large established markets are likely to be important for some time to come. While the growing spending power of developing economies’ middle classes is likely to play to Britain’s trading strengths, progress is likely to be slow, and British firms face considerable practical barriers when breaking into emerging markets. Moreover, there are compelling economic fundamentals that make trade between advanced economies, especially those clustered in a region, particularly important.

Britain does not face an ‘either/or’ choice – it needs to maximise trade with existing large markets at the same time as building links to new markets.

The focus must be on building and strengthening links to markets all over the world by breaking down barriers between economies, participating in the exchange of people and ideas, and finding the common ground on regulation and global cooperation that can help harness the global trends reshaping the world economy to bring prosperity to the UK and its citizens.
2. The UK must maximise openness to the global economy to help tackle the productivity challenge

The UK is less productive than most comparable large developed economies – and this acts as a drag on its trade performance across the board. Openness to global exports, imports, investment and migration combined with the right industrial strategy and policies to boost skills levels can drive a virtuous circle of increased productivity and competitiveness that will support growth and exports, creating jobs and boosting prosperity.

The key to increasing exports is meeting the productivity challenge. Long-term sustainable GDP growth is driven by improvements in productivity, especially in developed economies where workforce growth, catch-up capital accumulation and natural resources are limited. But Britain faces a productivity challenge: in 2007, before the financial crisis, UK overall productivity was still 9% below that of Germany and 20% below that of the US, while only just pulling equal with that of France. Success for the UK in the modern global economy will not rest on competing for the lowest labour costs or subsidies for industry; it will instead be driven by boosting productivity through skills, technology and innovation.

Greater openness helps drive productivity improvements, by giving domestic firms greater access to markets that allow economies of scale to be exploited; improving the quality of supply chains available; increasing the ability of firms to plug skills shortages and build cross-border workforces; and by boosting access to capital that can be used for investment in jobs and innovation. All of this is helped by having a regulatory climate that is competitive and enabling to trade. Openness – including to overseas competition and immigration –can be challenging and have social impacts but, combined with a coherent industrial strategy, effective skills policy and sensibly managed migration, it can drive a virtuous circle of increased productivity and competitiveness.

For this reason, the world economy is generally becoming more open. The rest of the world is globalising and integrating more deeply, with tariff barriers lower than ever before and non-tariff barriers being lowered to help facilitate a boom in supply-chain trade. The process of increasing openness is now being driven by bilateral deals between regional trade blocs rather than through multilateral WTO negotiations, prompted by a shift in global trading patterns through the second half of the 20th century that saw rapid increases in global supply-chain trade.

Different countries have pursued varying degrees of integration, but for the last 40 years the UK has used membership of the European Union as the vehicle for pursuing openness. The EU is the most internally open and integrated of any international market, with lower barriers to trade – and therefore greater trade and supply-chain integration – than any other trading bloc in the world.

If the UK is to be successful in adapting its global trading role to the changing world, it must overcome the productivity challenge that acts as a drag on its trade performance across the board. To do this, the UK must pursue even greater levels of openness to the global economy. The European Union, which still accounts for around half of the UK’s trade, is the world’s most ambitious trade bloc, where the dismantling of internal non-tariff barriers to trade has gone the furthest.
3. The benefits of EU membership to British business have significantly outweighed the costs

Like any international arrangement involving co-operation, UK membership of the EU has always had advantages and disadvantages. But for the UK the benefits have been extensive. They significantly outweigh the costs of membership and have increased the ability of British business to pursue their global ambitions. 71% of CBI member businesses reported that the UK’s membership of the EU has had a positive overall impact on their business.

It is not unreasonable to infer from a literature review that the net benefit arising from EU membership is somewhere in the region of 4–5% of UK GDP or between £62bn and £78bn per year — roughly the economies of the North East and Northern Ireland taken together. This suggests that households benefit from EU membership to the tune of nearly £3,000 a year – with every individual in the UK around £1,225 better off.

The benefits of EU membership can be seen more clearly in the way the EU has supported the UK’s complex economy across six aspects of openness that underpin the UK’s global trading ambitions.

Access to European markets for goods and services has been the biggest positive for the UK economy, giving UK businesses access to the biggest single market in the world of over 500 million people. Three-quarters of CBI members of all sizes and sectors pointed to the creation of the Common Market as having a positive impact on their business. The Single Market has enabled UK businesses to exploit the economies of scale that can drive wider competitiveness, as well as bring them into complex pan-European supply chains that allow them to obtain inputs from the most efficient sources possible and boost their own exports by selling into larger European supply chains.

EU membership has given UK businesses access to the finance they need to grow. It has unlocked global and European direct investment into the UK — to help start up factories, build office space, stimulate R&D or support innovation in creative industries — and also provided new investment avenues for UK companies. Since 1992 and the creation of the Single Market, inward FDI flows to the EU from around the world have doubled, helping to make the UK an attractive global destination for investment with the second largest stock of FDI in the world.

Membership of the EU has also cemented the UK’s position as the world’s leading financial centre, which in turn helps provide the ‘invisible infrastructure’ to UK firms and European companies that can finance domestic and overseas expansion.

Labour mobility in the EU brings benefits for British business, but being open may mean having to be tougher. As one of the basic freedoms of the EU Single Market, the free movement of people allows UK firms to recruit employees with specialised skill sets easily from across the EU — a factor that is increasingly important given the UK’s high-value-added industries — and build pan-European supply chains. It also facilitates service exports where personnel need to be physically present to provide a service, and it has allowed many UK citizens to take up opportunities to work and live abroad. Ultimately, business and government must work to boost the UK’s domestic skills base. Nevertheless, 63% of CBI members stated that the free movement of labour within the EU had been beneficial to their businesses.

However, while the UK economy has benefitted from the creation of an EU-wide market for talent, and indeed from immigration more widely, pressures on local services and wider public perceptions threaten to reduce the legitimacy of a vital element of EU membership for business. The principle of free movement of labour is still wholeheartedly supported by the business community, but consideration should be given to ways in which the principle can continue to operate at a practical level for member states in the now enlarged and more economically diverse EU.

Common rules are needed but the UK’s lack of unilateral control over regulations is seen as the biggest downside to EU membership. Business is clear that any Single Market needs commonly agreed rules, to allow full access to the market on equal terms. Removing non-tariff and regulatory barriers between member states is one of the most important features of the European Single Market, and the UK’s ability to influence and improve these rules increases the ability of British firms to compete. Competitive and respected EU rules can also open up new markets to UK firms without having to duplicate standards as other regions often design their own rules around EU benchmarks.

Despite frustrations, over half of CBI member companies (52%) say that they have directly benefitted from the introduction of common standards, with only 15% suggesting this had had a negative impact.

However, the impact of poorly thought-out and costly EU legislation is a major issue for businesses: 52% of businesses believe that, were the UK to leave the EU, the overall burden of regulation on their business would fall. Areas where UK firms are frustrated with EU regulation include labour market regulation, highlighted by nearly half of businesses as having had a negative impact — with particular frustrations around the Temporary Agency Workers Directive and Working Time Directive.

The EU needs to make sure that all regulations (new and revised) will support Europe and the UK’s growth — working in a global context and for businesses of all sizes — and be adequately assessed and well evaluated to ensure they deliver against their objectives.
There are direct budgetary costs to EU membership, but the net costs are less extensive than often reported and the price of membership is well worth the overall benefits secured. There are net direct budgetary costs to EU membership for the UK, as well as complex and bureaucratic funding streams that reduce the transparency and accountability of how EU funds are spent. Once the UK ‘rebate’ and funding received through the EU’s major funding programme has been accounted for, there is a net direct budgetary cost to the UK of €7.3 billion, or 0.4% of 2012 GDP. However, there are benefits of pan-European approaches to funding for the UK, helping UK companies and universities produce innovative technologies by facilitating R&D collaboration across borders, as well as creating stronger markets for UK products in other EU countries through regional and structural funding that supports economic growth. Leaving aside the benefits of funding, the direct net budgetary cost of EU membership is the equivalent of around £116 per person each year. Even allowing for both the costs of membership of the EU club and the regulatory burden, the GDP boost as a result of the benefits of market access, capital and labour mobility dwarfs the UK’s membership fee.

The EU has helped open global markets to UK firms on terms that support its trading ambitions, through its leading role in global trade negotiations as well as by signing bilateral Free Trade Agreements (FTAs), helping UK businesses to import and export more profitably to non-EU markets. The EU is currently a signatory to 30 FTAs with over 50 partners including high-growth markets such as South Korea, Mexico, Chile and South Africa. Including the EU itself, British firms have therefore gained full access to a $24tn market through EU membership. If FTA negotiations with Canada, Japan and the US are successfully completed and fully implemented, the total market open to UK exports would nearly double to $47tn — and an EU–US deal would help set the benchmark terms for future global trade deals. If the EU were to complete all its current free trade talks tomorrow, the European Commission (Commission) has estimated it could add 2.2%, or €275 billion, to the EU’s GDP. However, there is significant complexity and a lack of nimbleness in EU trade negotiations, both in the internal process and in reaching a final agreement. As one of 28 EU states, the UK cannot guarantee that its priorities will always be represented in trade talks and cannot fully dictate which markets are prioritised for FTA negotiation.

Despite these drawbacks, the opportunities provided through collective EU trade negotiations are unmatchable elsewhere. It is difficult to envisage how a country the size of the UK could succeed in breaking down regulatory barriers to trade with a major country to the same extent in unilateral trade negotiations, especially given the recent predominance of non-tariff barriers over tariffs as practical barriers to trade for business. It is also likely that the UK would find itself in line behind the EU as third countries look to pursue FTA negotiations. Indeed, the clear message coming from a number of the UK’s major non-EU trading partners, such as Canada, the US and Japan, is that while they value the UK as a trading partner, they would strongly prefer an EU-level trade deal complete with compatible standards, regulations and processes.

The conclusion that the overall impact of EU membership on the UK economy has been positive is reinforced when analysing the most internationally exposed sectors of the UK economy, such as the UK’s world-leading aerospace, automotive, pharmaceuticals, chemicals, financial services, and technology, media and telecommunications (TMT) industries.

Whether focused on those aspects of EU membership that drive productivity through enhanced openness or on the wider macroeconomic benefits membership has brought, the EU has been a significant positive for British business in pursuing its global ambitions.

Worth around £1,225 a year to every individual in the UK, membership of the EU has also brought benefits to businesses of all sizes in varying sectors right across the country.

There will always be costs to membership — both overall and to individual sectors, firms, or individuals — but the positive balance of benefits is clear for an open, complex economy like that of the UK.
4. The UK is influential in the EU when it fully engages

From big picture developments to the nuts and bolts of everyday business decisions, UK influence in the EU is an integral element of supporting British business ambitions. The UK has historically exerted influence right across the legislative process to achieve the outcomes it desires, from the genesis of the Single Market in 1986 to recent British-led progress in the EU on climate change.

The nature of the EU means that the UK will not always get its way; being part of a club will inevitably mean that compromise occurs. Business wants to see the UK consistently and proactively engaged – throughout EU institutions and Europe’s member state capitals – if it is to continue to shape the EU to support its global future.

UK influence has helped maximise the openness of the EU. 72% of British businesses believe that the UK currently has a significant or influence on EU policies that affect their business. Furthermore, the challenges business faces today – and will continue to face in the future – in a global economy are increasingly insurmountable through purely national solutions.

British influence rests on the successful use of a variety of tools of influence to secure strategic interests. While the UK’s formal structural power has always been important, and underpins effective UK engagement in Europe, the ability to achieve policy outcomes that best realise Britain’s aims has often rested on strategic use of informal influence to augment the formal rights that EU membership gives the UK.

Voting power is the basis of UK influence, but is not enough on its own. The UK is a large member state and has correspondingly large structural power in the Council of the European Union (Council) and European Parliament (Parliament), as well as having a straight veto in a number of areas. But structural changes that have increased the power of the European Parliament and reduced the veto power of individual members in the Council mean that informal influence is increasingly important in the EU’s consensus-based policy process.

The UK is effective at building alliances and rarely finds itself isolated. Far from the ‘awkward partner’ often portrayed, Britain has historically built alliances in the Council but needs now to replicate this in other institutions, especially in the increasingly powerful European Parliament.

The UK needs to do more to ensure that it has personnel in key positions to help frame EU policy debates. Having national citizens in prominent positions, both political and official, in EU institutions facilitates information flows, gives the UK a platform to set the policy agenda, and allows greater influence over legislation as it is drafted and debated. The UK has had a strong presence in the Commission for many years, but faces a ‘generation gap’ with declining numbers of British staff and significantly reduced influence as a result.

The UK’s technical expertise gives it significant credibility on a range of issues that allow it to set the agenda. The EU looks to those with expertise when deciding policy direction, and the UK has used its expertise and credibility, both as a policymaker within institutions and as an external contributor to the policy process, to influence this. This can be seen in the UK’s record on shaping financial services legislation – although the financial crisis has reduced the standing of the UK on this issue – and also in areas such as energy and climate change.

The UK’s role in a number of global institutions magnifies the international pressure it can bring to bear in the EU. With the policy agenda increasingly set at an international level to deliver international responses to global challenges, UK influence in global institutions – as a large economy in its own right but also as a nation perceived as a leader in the EU – can help set the parameters of legislation at a European level in line with UK objectives. The UK’s ability to persuade international actors to bring pressure to bear on the EU could be diminished if the international community perceives the UK to be abrogating its leadership role in Europe.

The UK has been, and still is, influential in the EU – with a powerful voting strength and a good track record of building alliances. British personnel occupy senior positions in the staff of the Commission, and British technical expertise informs EU policy development.

The UK must, however, remain proactively engaged, redoubling efforts to win support for its agenda and reversing the decline in numbers of UK staff employed in the Commission.
5. The UK can remain influential in a changing European Union

The EU is a constantly evolving entity, and it is currently going through a particularly rapid period of change which has raised fears that the UK may be marginalised by a more integrated Eurozone. This is a legitimate concern, and the UK must be alive to it. However, securing safeguards for the Single Market for non-Eurozone members and restating a Europe-wide political commitment to the continuation of a European Union that works for all its members is achievable in a changing EU.

The Eurozone crisis is pushing further integration in the EU, spurring fears that the UK could be sidelined. Eurozone integration in an attempt to fix the underlying weaknesses in the currency union’s design could potentially divide the Eurozone members from those outside the currency and fragment the Single Market. The process of integration could even creep towards a fully federal union at EU level of which the UK wants no part.

The integration measures adopted to date have not fundamentally affected the balance of advantages and disadvantages of membership or the level of UK influence. Limited financial integration has seen the setting up of a Single Supervisory Mechanism, of which the UK is not a part. Fears that this might lead to Eurozone ‘caucusing’ against the UK have been reduced through the ‘double majority’ safeguards put in place. There has been some economic and budgetary integration, but the UK is outside these moves and has been largely unaffected. That said, additional developments need to be closely assessed to ensure that any potential dangers from further integration can be mitigated.

The degree of further integration ultimately depends on how far the key actors are willing to go – the political will exists to support the Euro but not to pursue full federalism. European integration is to a large degree controlled by its member states, each with different views on what the EU should look like. Most market observers believe that the Eurozone is unlikely to collapse because the political support exists to do ‘what it takes’ to support the single currency. It is also not likely that the EU will move towards a federal superstate. A federal Europe would mean a substantial pooling of powers to EU level in all areas, and political support for this in key member states is weak, even in parts of the ‘core’ EU such as Germany and the Netherlands.

The EU is likely to develop pragmatically in a way that will not fundamentally change the balance of advantages and disadvantages for the UK, especially as the UK is not compelled to sign up for further integration. Europe will take further steps towards a Banking Union, most likely based on co-ordination rather than full financial integration involving joint liabilities. Safeguards for those not taking part in Banking Union have been agreed, offering protection for the foreseeable future for the UK. European member states are likely to commit to limited structural support – conditional on reform – to enhance economic co-ordination but stop short of permanent fiscal transfers. Moves towards federal institutions and political union will be met with resistance by member states, especially given the need for Treaty change – and consequent referendums – to see them enacted.

This ‘multi-sphere’ Europe that emerges is not likely to leave the UK sidelined. Taken as a whole, none of the likely measures of further integration in themselves undermine the benefits of UK membership of the EU. Although there is a danger that the Eurozone will be able to outvote the UK and other countries outside the currency – especially given the Eurozone’s ‘inbuilt majority’ in the Council of Ministers after November 2014 – the diverse interests of EU member states mean that the UK will still have allies.

74%

Percentage of British businesses which believe that the UK will continue to influence EU policies in the future.
The Eurozone itself is not a club of uniformly like-minded countries. Despite a common currency, their interests in other areas still diverge, and they themselves recognise the need for safeguards for non-Eurozone members, having already shown willingness to provide these. More broadly, the agenda-setting body of the EU, the European Council, is driven by consensus and rarely enacts legislation in the face of strong national reservations, especially from large member states. Forcing change through the Eurozone’s ‘inbuilt majority’ is therefore unlikely in reality. However, were Eurozone members to attempt to further their own interests at the expense of the whole EU, there are already significant legal safeguards in place from previous Treaties to protect access to the Single Market for all EU members.

Finally, the nature of EU member-state interactions over the past 40 years suggests that the EU that emerges from the crisis will still be able to encompass the interests of all its member states. Members of the EU have long been integrating in a number of separate areas with different dividing lines, creating a Europe of flexible cooperation – a ‘multi-sphere’ Europe – rather than the ‘two-tier’ structure of Eurozone members versus the rest that is often assumed.

The changing EU is not likely to fundamentally alter the balance of pros and cons of EU membership or the UK’s ability to influence. This does not mean that it does not have the potential to do so – the UK and other non-Eurozone states must be alive to the dangers that present themselves as the EU’s institutions and member-state relationships evolve.

However, the varying spheres of integration in the EU allow the member states some flexibility over where to co-operate with other member states in pursuit of common interests.

If the UK continues to build alliances across Europe to protect the Single Market, as it has done in the past, further integration is compatible with, and indeed can support, the UK’s global future.
While the UK could certainly survive outside the EU, none of the alternatives suggested offers a clear path to an improved balance of advantages and disadvantages or greater influence.

6. Alternatives to EU membership do not offer greater advantages or influence for the UK

No alternative option to full EU membership can combine all the benefits of EU membership with none of the costs; such solutions are simply unrealistic. While the UK could certainly survive outside the EU, none of the alternatives suggested offers a clear path to an improved balance of advantages and disadvantages or greater influence over the terms of UK interaction with its nearest neighbours.

‘Going-it-alone’ through the WTO would reduce market access through increased tariffs on UK goods and services. Refraining from entering any formal relationship with the EU and simply relying on WTO terms is not a model that would assist Britain in achieving the global trading role to which it aspires. Access to European markets on WTO terms would hit British exporters and importers — as well as those in their supply chains — with tariffs and logistical delays, and this restricted market access would see investment into the UK fall over time. The ‘WTO option’ would give the UK power to pursue trade negotiations with any country of choice, but this freedom is offset by the risk of a period of dislocation while new deals are being drawn up and, more crucially, the likelihood that the UK would sign significantly fewer comprehensive bilateral deals than the EU can achieve.

‘One step removed’ — the ‘Norway option’ of leaving the EU but remaining in the European Economic Area (EEA) — would reduce the UK to a ‘standards taker’ on the fringes of influence. Leaving the EU and opting for the Norway model of membership of the EEA would not solve many of the challenges some see with the UK’s current relationship with the EU. Businesses would still have to follow EU rules — thereby leaving the regulatory burden in place — but the UK’s ability to influence those rules would be removed by relinquishing the UK’s seat at the table in Brussels. Freedom of movement would be unaffected. The UK would likely still pay a membership fee to be part of the club (albeit reduced) and UK firms could face customs controls and practical obstacles to trade that would impede UK goods exports.

‘Pick and choose’ — the ‘Swiss option’ of bilateral agreements — would provide greater flexibility but reduce market access and influence. The time it would take for the UK to renegotiate an agreement similar to the Swiss would mean a significant period of dislocation and uncertainty as negotiation takes place. More importantly, however, there is no guarantee that the UK would achieve agreements on all its prioritised areas — such as financial services — and, where it did, it would be likely to have to accept a package of EU-designed rules related to the Single Market in order to get market access. The agreement would require the UK to update its domestic rules to reflect any subsequent changes in EU law — changes designed without the UK at the table — if it wished to retain market access. Freedom of movement would essentially remain unaffected, although the Swiss have a limited ability to regulate migration flows. Moreover, the Swiss option would mean the UK negotiating global trade deals without the clout of the EU behind it.

‘A customs union’ — the ‘Turkey option’ — would be the worst of the ‘half-way’ alternatives, leaving the UK with very limited EU market access and zero influence over trade deals. Retaining membership only of the customs union would be an inappropriate economic stance for the UK in the modern global economy. With non-tariff barriers often replacing tariffs as the major obstacle to trade, a customs union would not be sufficient to support Britain’s trading ambitions in the modern global economy with its complex supply chains and it could limit UK access to EU markets in areas such as services. Moreover, opting for the customs union option would not free the UK from having to comply with EU regulation. Most importantly, it would not be in the UK’s interest to be a silent partner in the EU’s trade policy — as is the case with Turkey — allowing other member states to set the tone for Europe’s openness to the world and negotiate the technical details of its trade deals.
An advanced UK–EU Free Trade Agreement, while addressing some of the costs of EU membership, would fail to secure vital benefits for business. Although it is likely that, on exit, the UK could secure some form of bespoke trade deal with the EU, given the relative interdependence of the two economies, there is a large degree of uncertainty around the willingness of the EU to offer favourable terms to the UK that would fully support British business in its global ambitions. The EU’s clout – offering a market of 445 million people to the UK’s 63 million with an economy around six times the size – gives it a stronger negotiating hand than the UK. Moreover, the UK is more dependent on the EU for its trade than the EU is on the UK – around half of the UK’s total trade is with the EU while just 8% of EU trade is with the UK. The fact that Britain happens to run a deficit in exports with the rest of the EU is of little relevance compared to its overall dependence, in absolute and relative terms, on access to the European market. There are a number of further political considerations that could limit the potential deal available to the UK, including political fallout from UK exit and an unwillingness on the part of EU leaders to be seen to ‘reward’ exit.

The UK would not, therefore, be able to sign a UK–EU FTA that brings all the benefits with none of the costs. Even in a ‘best-case’ scenario – taking the best feasible elements of each of the previous alternative options together – the likely deal would still offer less support for British business in pursuing its global ambitions than full membership of the EU and access to the Single Market.

Securing tariff-free access to the EU markets for UK goods would not be straightforward and an agreement securing the same market access in services and public procurement that the UK enjoys today is unlikely. Removing non-tariff barriers would require compliance with EU regulation imposed from Brussels without Britain playing a role in its formulation. A particular worry for business would be the impact this would have on the UK’s financial services sector, potentially threatening the City’s position as the world’s leading financial centre. Investment in a number of industries is likely to be hit over time, as other locations within the Single Market become relatively more attractive for marginal investment decisions. Finally, despite greater notional flexibility, the UK’s ability to pursue an effective trade policy that supports business’ global ambitions would be reduced if negotiating unilaterally.

EU membership has its costs, but the assessment of five potential alternatives to full UK membership has shown that none of them is able to improve the overall balance of advantages and disadvantages to EU membership.

All alternatives mean a significant period of dislocation while the UK renegotiates with not only the EU but every existing trade partner in an Free Trade Agreement. All options other than joining the EEA offer unsatisfactory access to European markets. All would involve one or more barriers to trade – such as higher tariffs, burdensome rules of origin, border controls or other regulatory barriers – which would hit UK goods trade with the EU for both exporters and importers, and undermine the UK’s services sector’s ability to continue its increasingly important contribution to UK export performance.

This reduction in market access would not necessarily offer a substantial reduction in the rules that the UK would have to apply. Most crucially, the UK would also lose its influence over the creation of these rules and over the global standards that the EU helps shape, standards that affect UK business’ ability to take advantage of its strengths on the world stage.

Full membership of the EU is the best vehicle for harnessing the global trends reshaping the world economy.

6:1

The EU economy is almost seven times the size of the UK’s
Conclusion - a reform agenda that supports the UK’s global trading future

Business wants the UK to remain in the European Union – it is better than any realistic alternative as a means to achieve British growth ambitions through increased openness. But the EU has to change. Business wants an EU that is outward-looking, open and competitive; one that is rooted in the priorities of its member and respects the boundaries of power granted to it. The CBI believes that the right approach is to champion reform for the whole of the EU, not on the basis of negotiating a special deal for the UK. This reform agenda has support from a number of member states in the EU and, if approached correctly, the UK and other EU member states can together secure a global future for the Europe emerging from the crisis.

The EU must be outward-looking, opening up new trade opportunities for business. To capitalise on new global growth opportunities, the EU must increasingly look outward to open up global markets through continuing to make the case for trade liberalisation commitments at WTO level, aggressively pursuing bilateral trade deals with important established markets and further breaking down barriers to trade with emerging markets.

The EU must be open and competitive, and must update the Single Market for the 21st century. The EU must continue to exploit its main strength, its consumer market of 500 million people. Making further progress on unlocking the Single Market for Services is a high priority – either at EU level or through use of enhanced co-operation – by ensuring full implementation of the Services Directive and deregulating professional qualifications that can block pan-EU service delivery. Business also wants to see a sensible progression of the Digital Single Market, by identifying barriers to the Single Market where these legitimately exist while keeping competences at national level where possible.

A competitive EU is also one which ensures that its regulatory environment is globally competitive and not unduly burdensome. Although a Single Market needs commonly agreed rules, the EU must continue its work to reduce the overall burden of regulation – particularly strengthening the Commission’s work to make rules appropriate for SMEs and microbusinesses – and improve the processes for impact assessment and regulatory evaluation. The EU should also introduce a ‘Think Global First’ test to make sure that proposals support the EU’s global competitiveness and do not diverge detrimentally from global trends. Finally, and perhaps most importantly, a change of culture is needed in all institutions to make sure that rules adhere to the principles of proportionality and subsidiarity, so that decisions should always be taken at the lowest level of governance possible, with the EU legislating only where absolutely necessary.

Signs of progress could include:
1. The EU should successfully conclude a high-quality Free Trade Agreement with Japan, and sign the Transatlantic Trade and Investment Partnership (TTIP) agreement with the US.
2. The EU should push forward a more dynamic trade agenda with key emerging markets to support member-state trading ambitions.
The EU needs to continue to work for all its members. With an increasingly integrated Eurozone ‘core’, procedural and legal safeguards around Single Market access for non-Eurozone members should be a priority. These safeguards are not only about ‘protecting the UK’, but about ensuring that the benefits of the EU remain available to all its members. Safeguards achieved in Banking Union negotiations and financial services legislation should be replicated in other areas and the principles should be enshrined in any future Treaty change.

The EU needs to better respect the boundaries set by member states. The EU has moved too far from ‘adding value’ to ‘adding functions’, resulting in ‘mission creep’ in several areas. The recent Dutch declaration that “the time of an ‘ever closer union’ in every possible policy area is behind us” offers a positive indication that other member states are also looking at how to refocus the EU. Member state leaders and governments must work to restore the principle of subsidiarity in EU policymaking by signalling to the Commission that it must refocus its activities based on a more limited interpretation of its remit to ensure that “Europe where necessary, national where possible” is the default position. The EU should step back from pushing further legislation in the areas of social and employment law and ‘lifestyle’ regulation, leaving more to the discretion of member states as to how they achieve the ends agreed at European level, especially in the areas of health & safety and welfare legislation.

The functioning of the EU must be improved, prioritising measures to support growth and competitiveness. The Commission’s 27 different portfolios – each with a separate Commissioner with a legislative agenda – are hindering prioritisation and horizontal coordination. Tightening the organisation of the Commission by pairing ‘junior’ and ‘senior’ Commissioners on single portfolios should be considered, with a refocusing of Commissioners towards key portfolios, such as external trade and the Single Market. Similarly, Commission staff should be refocused on key priorities; the current situation where 1,174 staff work on development but only 533 work on trade is the wrong balance. The EU must also allocate its resources in a way that reflects the economic realities of its member states, and establishing a single seat for the European Parliament is an important contribution to this process. Furthermore, funding priorities in the EU need to continue to move towards supporting a dynamic and competitive economy through an increased focus on research and development and the digital economy, and further use of the European Investment Bank to help incentivise private investment.

Signs of progress could include:

6. EU leaders should adopt a declaration that explicitly calls for steps to be taken to ensure that further Eurozone integration does not undermine the Single Market and protects non-members from discrimination. This should then be formalised in any new Treaty.

7. Procedural safeguards should be introduced to maintain the integrity of the Single Market for all members, and legal safeguards should be enshrined in any new Treaty.

8. Member state leaders must work to restore the principle of subsidiarity. Until this is fully restored, there should be a moratorium on any new regulation where adequate legislation already exists or there is a strong argument for national decision-making, including in the area of social and employment law. The opt-out from provisions of the Working Time Directive should be made permanent.

9. The Commission should reduce the number of portfolios in order to increase the number of Commissioners and staff in key priority areas for the EU.

10. The EU must keep its budget in check, rationalise its bureaucracy, and focus funding on supporting a dynamic and competitive economy.
The UK needs to be fully engaged to help create a better EU. Securing a reformed EU will require the UK to build alliances both in Brussels and with other member states.

The UK must reform how it engages with EU institutions. The UK should step up its ministerial engagement in Europe, building links with other member state capitals and increasing the number of ministerial visits to Brussels at key points in the policy process. The UK government should draw up comprehensive plans for engaging with the European Parliament, and UK political parties should endeavour to raise the level of accountability of UK MEPs at home for the output from the legislative process, as well as better supporting UK MEPs to build alliances with MEPs from other member states. The UK must also substantially increase the levels of British nationals on the staff of the major EU institutions, including by ensuring that the undertaking of secondments into EU institutions by UK civil servants is encouraged and formally recognised in terms of career development and progression.

The UK must improve engagement with EU issues at home to underpin influence abroad. The UK should increase interaction with EU issues, policy and politics at home to allow for better engagement in Europe and a better relationship with the EU overall. This should be spearheaded by an increased role for the UK’s national parliament. The UK should look to best practice from other European parliaments to increase debate around EU issues in the UK parliament, either before ministers attend Council meetings or on the specifics of EU legislation, for example. The UK should also attempt to build links with other parliaments to improve co-operation and ensure that the ‘Yellow Card’ Procedure is an effective tool to uphold the principle of subsidiarity. Finally, with nearly half of UK businesses perceiving UK ‘gold plating’ to be the main challenge with EU regulation, the government must use the flexibility given at EU level when transposing legislation and ensure that it does not put the British economy and businesses at a disadvantage.

Signs of progress could include:

11. The UK government must set out a detailed EU engagement strategy. This should include an ambitious target for UK presence in EU institutions in the medium term – slowing the negative trend of a six-year long decline of UK nationals in the staff of the European Commission by the end of 2015, and beginning to reverse this decline by 2017 – as well as comprehensive plans for how government intends to engage with the increasingly powerful European Parliament to best support UK interests.

12. The UK Parliament should strengthen informal ties with like-minded national parliaments and seek to use the Yellow Card Procedure more frequently. It should take the initiative by creating an informal network of like-minded national parliaments to improve coordination on the Yellow Card Procedure.

This is an achievable reform agenda. If the UK engages in the right way, it can help shape the EU for the 21st century. Proactive, positive and permanent UK engagement will secure the outcomes that can support Britain’s global future.
INTRODUCTION

BRITAIN’S PLACE IN THE GLOBAL ECONOMY AT THE START OF THE 21ST CENTURY
An open economy, combined with robust domestic industries, has long been a crucial part of the British success story. In the 19th century, the rapidly industrialising UK was one of the world’s most open economies, with trade climbing to half of its overall national income – compared to 35–40% in France and Germany and around 10% in the United States. In this context, ‘openness’ for the UK was straightforward, with inter-industry trade predominating. Britain exported mainly manufactured goods – specialising in textiles, shipping and iron – while importing raw materials from the Empire and other resource-rich countries, today’s emerging economies. It also was the source of almost half of the world’s foreign direct investment (FDI) at the outbreak of the First World War, while receiving less than 2% itself, and had one of the world’s highest rates of net emigration. In leading the drive towards free trade and international investment that culminated in the world’s first wave of globalisation prior to the First World War, the UK’s global stance helped usher in an era of unprecedented levels of global trade, migration and investment flows fuelled by new technologies such as iron-hulled ships and the telegraph.

Whereas in the 19th century Britain forced openness through industrial dominance and naval power, through the 20th century openness became increasingly secured and influenced through multilateralism, regionalism and the setting of international rules. Once trade with the Empire and Commonwealth began to fade in importance after the Second World War, membership of the European Union and its predecessors became the centrepiece of Britain’s global trade policy to achieve this. After plummeting during the Great Depression, Britain’s ratio of trade as a percentage of GDP did not recover its level at the eve of the First World War until the 1970s, helped by entry into the EEC and the new wave of globalisation then emerging. ‘Openness’ for the UK by the end of the 20th century supported a web of complex supply chains and two-way flows of export, imports, investment and population movement. Britain’s trade make-up had shifted again, predominantly exporting and importing manufactured goods with its near-neighbours and other developed countries, part of a rising trend of ‘intra-industry’ trade, cross-border supply chains and economies of scale seen throughout the developed world. Britain’s approach to labour and capital flows had also shifted dramatically: later in the 20th century and into the next, Britain became a major recipient of FDI, while still remaining an important source, and experienced net immigration rather than the emigration seen during the 19th century.

The changing world has allowed the UK to play even more to a number of its strengths: for example, while the UK has been one of the world’s foremost exporters of financial services for centuries, new communications technologies have enabled these and other services to play an increasingly important role in British exports.

An open economy and a global trading role continue to underpin British prosperity today. However, the nature of economic...
openness – as well as the means of securing it and the technologies enabling it – has changed significantly. Today, openness is best promoted by securing market access to trade in both exports and imports at every stage of the value chain, having a regulatory climate that is both competitive and enabling to trade, increasing access to labour and investment through migration and capital flows, and improving the business climate for foreign direct investment. It is underpinned by a competitive economy, with investment in infrastructure, education and successful industries.

Today, the UK economy is diverse and its strengths spread right across the UK

Britain has one of the largest and most prosperous economies on the planet – 6th largest in the world in 2012, with a GDP per capita that puts it 3rd among the world’s ten largest economies. The British economy also has a rich and diverse sectoral mix. The bulk of the economy is service-based: from the large and world-beating financial & insurance industry (8% of Gross Value Added (GVA)), through professional, technical and support services (a further 12%) to the smaller but internationally renowned cultural sector (taking a 2% share). And, contrary to popular belief, the UK still makes, shapes and builds things too: its manufacturing sector is the 9th largest in the world; construction is the other large non-services sector, with a 6% share; while the oil & gas sector remains crucial in strategic terms, although its share of GVA has declined to 2%.

The UK’s industrial strengths also touch all corners of the country. For example, the food & drink industry provides nearly a third (29%) of Scotland’s manufacturing output; chemicals contribute a quarter (24%) and a third (33%) respectively to the North East and North West’s manufacturing output; the West Midlands and Wales both source around a fifth of this from the metals industries (21% and 20%); while engineering and transport equipment strength is found in the West Midlands (40%) and South West (44%).

The UK still has a prominent global trading role

Britain remains a trading nation. Over 65% of its GDP is linked to trade – higher than that in many other large advanced economies including France (57%), Italy (59%) and Japan (31%) – with £527bn of imports and £493bn of goods and services being exported around the world in 2012.

The UK has particular export strengths: for example, it is the second-largest exporter of services in the world after the United States, while OECD data on goods exports indicates that the UK’s comparative advantage lies in chemicals, transport equipment and food & drink. However, its export profile is marked by its diversity: Britain exports goods in 98% of the 4,913 World Trade Organization (WTO) product codes.

Britain’s imports are also diverse and are important across the economy, which means that many non-exporters are as reliant on trade as exporters themselves. In 2008, UK businesses used 57% of imports as intermediate inputs, with most of the remainder used by final household consumption or investment demand. A broader range of sectors is involved in the imported intermediates side of trade than in exports: 48% of Britain’s imported intermediates by value go into services industries, with some sectors such as health & social care and retailing & wholesaling that are mostly domestically focused on the output side being among the more prolific importers. Manufacturers account for a further 36% of imported intermediates and construction for another 6%.

Britain is also a key player in world investment markets. In the ten years to 2011, the UK was the 3rd largest recipient of FDI inflows in the world after the United States and China, and the largest in the EU. Over the same period, the UK was also a prolific source of FDI abroad, having the 3rd largest net outward flows in the OECD. International FDI flows are important even to sectors that participate relatively little in direct trade of goods and services. As well as being open to global capital flows, the UK has also been open to international labour: 14% of workers in 2012 were born outside the UK, and this proportion has been growing.
Britain now needs to adapt its global trading role for the coming century

For an island nation covering 0.16% of the world’s land area and with 0.9% of its population, British influence around the world remains extensive. It has a permanent seat on the United Nations Security Council helping to shape global affairs; it is a major force in the world’s most powerful military alliance, NATO; its economy is the 6th largest in the world, underpinning its leadership roles in both the G8 and G20; it is a leading member of the European Union, the wealthiest trading bloc in the world; the economy is diverse with export successes in manufacturing and services; and it is both a major recipient and significant source of global investment.

But the world is changing and so too is Britain’s place in it. The UK must again reinvent its global role for the 21st Century as the global economy changes at a staggering rate.

Growth in China and India is shifting the economic centre of gravity to the East – a process accelerated by the worst financial crisis in the developed world since the Great Depression. Over the coming decades, although Britain will undoubtedly remain a prosperous nation, it will see its weight in the world economy fall back as today’s emerging powers – the BRICs and other countries such as Mexico and Indonesia – take their places among the world’s largest economies.

The rise of emerging nations is also changing the nature of global trade, with the emerging world exploiting a comparative advantage in lower labour costs to drive specialisation in labour-intensive sectors. Britain’s share of trade with Europe and developed nations has been in decline in the early years of the 21st century. It remains to be seen what global economy will emerge from this blend of the intra-industry, regional model of 20th-century globalisation with the renewed inter-industry model of 19th century globalisation.

Closing off from this world is not how the UK will create and keep the jobs it needs to pay for public investment and provide a decent standard of living for all its citizens, or maintain its status as a global leader. We must decide if the best way to be outward-facing and globally competitive lies in continuing to use and influence the EU as a base to maximise integration and interdependence with economies all over the world or, instead, in attempting to reverse this process and return to a system of bilateral ad hoc arrangements.

This report will explore that key decision regarding the UK’s global future in the context of the changing global economy and the ongoing debate about the future of the European Union and Britain’s membership of it. The choices the UK makes will fundamentally affect its future. One thing is clear: the process of globalisation will continue, and even accelerate, whatever we decide.

The CBI believes that UK economic prospects would be damaged if it abandoned the open, trading approach that has served it well for centuries, with all the consequences that entails for prosperity and jobs. There is no reason to suppose that the UK cannot continue to thrive and prosper if it embraces and harnesses the forces reshaping the global economy, using its influence and skills to further develop the interdependent relationships that help to guide global practices and bring down barriers to trade in the modern economy.

Closing off from this world is not how the UK will create and keep the jobs it needs to provide a decent standard of living for all its citizens, or maintain its status as a global leader.
CHAPTER 1

THE UK MUST STRENGTHEN LINKS TO EMERGING AND DEVELOPED MARKETS TO REFLECT THE CHANGING WORLD
Despite some progress in recent years, Britain’s trade links are strongly tilted towards the slow-growing western European Union countries (rather than the faster-growing eastern European members), the United States and other developed economies. As global economic weight shifts towards emerging and developing economies, the UK must adapt to take advantage of new trading and investment opportunities.

However, it is unlikely that the UK will totally shift away from the trading and investment partners of today, since there are compelling economic fundamentals that make trade between advanced economies, especially those clustered in a region, particularly important. In addition, there is already substantial integration of the British and European economies.

This means that the UK’s trading relationship with the EU will remain of great importance regardless of the nature of formal relations. When planning its global future, the UK does not face an either-or choice between the emerging world and its current principal trading partners in the European Union and United States. With its diverse economy, a confident country like the UK needs to maximise trade with existing large markets at the same time as building links to new markets to take advantage of opportunities wherever it finds them.

1.1 The rise of emerging markets is reshaping the world’s economic geography

In the period from the end of the Asian financial crisis in 1999 through to 2012, emerging and developing economies expanded by 118% while developed economies grew by just 26%. This means that this year will be the first in which the developed world takes a minority share of global GDP (49.1%). It is forecast that non-OECD countries will account for around 55% of global growth from 2012 to 2025, and IMF projections show developing and emerging economies’ share of global GDP increasing further to 55.1% by 2018.

According to the latest PwC forecasts, by 2050 China, India, Brazil, Russia, Mexico and Indonesia will all have larger economies than any European Union country. The UK will not suddenly be eclipsed on the world stage – indeed it will remain one of the world’s largest economies and double in size by 2050 – but while it may remain in the Premier League of world economies, as was the case throughout the 20th century, it will rank mid-table at around 11th place by 2050.
Exhibit 1: As the world economy grows, emerging markets will take an increasing share

GDP in PPP terms (international $bn)

Source: IMF WEO April 2013

Exhibit 2: Today’s emerging economies will dominate the top 10 in 2050

1.2 Growth in the developed world will be constrained for the foreseeable future

The shift in global economic power towards emerging markets is also partly explained by sluggish growth in developed countries. It is forecast that the UK will be the fastest-growing of the EU’s five largest economies over 2012 to 2023 with annual growth of 1.7%, while Germany is expected to grow by 1.4%, France by 0.9%, Italy by 0.4%, and Spain by 0.3%. US growth is not projected to be much faster, at 2.0%, though some developed economies with a larger resource endowment and less overhang from the financial crisis may grow a little faster, such as Canada and Australia (2.3% and 3.0% respectively).

There is a vast amount of room for emerging and developing markets to grow further. Although they currently account for around half of global GDP, their share of the population comes to around 82%. Furthermore, most of the gains in share of global GDP over the last 15 years have accrued to emerging markets in Asia. In future decades, a broader range of emerging markets in South America, Africa and elsewhere are likely to gain clout on the world stage.

Three key trends are driving this growth in the emerging economies:

**Catch-up and convergence.** Developing economies are converging towards the technological and income levels enjoyed by the developed world. Globalisation and increased trade openness are pushing forward this process, as interaction, trade and learning allow emerging countries to catch up with developed markets and leapfrog intermediary technologies. Trend per capita growth in emerging and advanced markets diverged around the turn of the century and today is around twice as fast in the former (see Exhibit 3).

There is a vast amount of room for emerging and developing markets to grow further. Although they currently account for around half of global GDP, their share of the population comes to around 82%. Furthermore, most of the gains in share of global GDP over the last 15 years have accrued to emerging markets in Asia. In future decades, a broader range of emerging markets in South America, Africa and elsewhere are likely to gain clout on the world stage.

**Increasing prosperity and growing middle-class consumption.** The world’s middle class is forecast to expand by over two billion households by 2030 with around 90% of that expansion located in the Asia-Pacific Region. The emerging middle classes will have greater disposable income, which will lead to increased consumption and savings and investments that will in turn further drive economic growth.

**Urbanisation.** The economies of scale unleashed by the development of cities is one of the most powerful drivers of productivity in global markets. There remains huge scope for further gains, however, even in high-growth emerging markets. The urban population in developing countries stood at 45% of their total population in 2010 compared with 75% in developed countries. The urban population is expected to rise four times as quickly to 2020.

Most of the shift in the world economy from advanced to developing countries will be concentrated in a clutch of newly arriving global cities. Around 44% of the world’s economic growth to 2025 is forecast to come from 420 emerging market cities with two-thirds of that from cities in China. As much as 8% of global growth will come from emerging-market megacities with over 10 million inhabitants.
1.3 The UK must do more to create trade and investment links with high-growth markets, but this will take time

Today, the bulk of Britain’s exports go to economies in the EU15 and the US which are also suffering from the after-effects of the financial crisis and whose share of global economic activity is falling. In 2012, the US accounted for the single largest share of UK exports (17.1%) and also the largest trade surplus, at £33.5bn. The US was followed as the UK’s major export partner by Germany (8.8%), the Netherlands (7.0%), France (6.1%) and Ireland (5.5%). The EU27 overall accounted for 45.1% of exports – much more than any other standalone, single market. By contrast, only 2.8% of exports went to China and 6.6% to the four BRIC countries in total – less than the Netherlands alone. Exports to other major emerging economies, like Indonesia and Mexico, are even smaller (see Exhibit 4).

Three key trends are limiting growth in the developed world:

**Over-hang from the financial crisis.** The aftermath of the financial crisis is likely to depress growth in the developed world for some years to come. It is well established, empirically, that recessions following financial crises tend to be longer and deeper than average. A recent IMF study, for example, found that recessions following financial crises last an average of 5.7 years in industrial economies, whereas the average recession lasts 3.6 years. The special circumstances of the Eurozone crisis and the ensuing employment crisis are set to depress growth in Europe even further as periphery countries struggle to rebalance and regain competitiveness without recourse to currency devaluation. Past episodes of deleveraging suggest that developed economies generally face at least 3–5 more years before any ‘catch-up’ growth towards the pre-crisis trend is likely to emerge.

**Ageing populations.** Even beyond the present downturn, the ageing of developed countries’ populations will restrict overall growth and, even more so, growth per capita as the working age share of the population declines. The global median age is increasing by an average of around 2.6 years every decade, with developed countries predominantly affected (the notable exception being China, whose median age is already above that of the US and will overtake Europe’s in the next 20 years). A UN analysis forecasts that demographic change will subtract 0.3% per annum from EU15 and US growth over 2010–20 and 0.5% and 0.4% respectively over 2020–30 – and age-related public spending is expected to increase by around 4–5% by 2030, squeezing spending in other areas.

**Fewer ‘quick wins’ available from technological catch-up.** Developed economies have less potential for growth through capital accumulation and technological catch-up. Despite the remarkable growth of emerging and developing markets in recent years, the developed world’s income per head was still almost six times greater in 2012 in purchasing parity terms. That gap in incomes per head and, possibly, the associated catch-up growth will last well beyond the point at which the world’s major emerging economies surpass today’s G7 in terms of total GDP.

Exhibit 4: The bulk of Britain’s exports go to slow-growing developed economies

<table>
<thead>
<tr>
<th>Country</th>
<th>% of UK exports (2012)</th>
<th>IMF GDP growth forecast 2012–18 (% pa)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>4.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.4</td>
<td>3.9</td>
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<tr>
<td>Turkey</td>
<td>1.4</td>
<td>2.8</td>
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<tr>
<td>India</td>
<td>3.6</td>
<td>3.2</td>
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<tr>
<td>China</td>
<td>2.2</td>
<td>2.0</td>
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<tr>
<td>Ireland</td>
<td>2.4</td>
<td>3.2</td>
</tr>
<tr>
<td>France</td>
<td>2.7</td>
<td>2.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Germany</td>
<td>1.7</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Source: ONS Pink Book 2013; IMF WEO April 2013
Similarly, Britain sources the majority of its imports from developed economies. In 2012, 50.6% of its imports came from the EU27, within which the largest partners were Germany (11.6%), Netherlands (6.8%), France (6.3%) and Spain (4.1%). Outside the EU, the United States is the largest exporter into Britain (9.6%), followed by China (6.3%). Britain sources both final goods and services and intermediate inputs from Europe: in 2009, 47.5% of intermediate inputs were imported from the EU27.39

Britain also conducts the majority of both its outward and inward foreign direct investment (FDI) with the EU and United States. Nearly nine-tenths of all net inward FDI into the UK over the period from 2002 to 2011 came from other OECD countries, with the EU25 accounting for 41.5% and the United States 24.6%. Net outward FDI from Britain was also predominantly invested in developed economies – 33.6% of the total in the EU and 20.5% in the United States. There were small shares invested in emerging economies, however, with 2.2% of total new outward FDI going to India and a further 3.8% to the other BRIC countries.40

Building links with growing economies is undoubtedly a necessary part of broadening the base of sustainable growth in the UK. While the BRICs – Brazil, Russia, India and China – represent the largest emerging economies, British business also needs to tap into rapid demand growth from the likes of the ‘MINTs’ – Mexico, Indonesia, Nigeria and Turkey – and other members of the ‘Next 11’.

However, creating new trade and investment links with growing markets to match those with existing partners is an extremely challenging proposition. A number of the UK’s comparative advantages and world-leading industries lie in areas that are not currently of top priority to emerging economies, such as financial and business services and high-tech, knowledge-intensive manufacturing (Exhibit 5). Much of the disappointment in UK exports since 2007 has been due to services exports, which edged up only 0.7% between then and 2012.

In the current phase of rapid industrialisation being experienced by the BRICs and other key emerging markets, demand for capital goods, industrial chemicals and raw materials has advantaged countries with matching export profiles. German exports of chemicals to China increased by 6.2% pa in volume terms over the decade to 2012, and those of machinery & transport equipment grew 3.5% pa.41 Australia has supplied coal to fuel its power stations, and the Middle East and Africa have supplied the oil and minerals for production processes.

UK exports to the BRICs and other emerging economies are expanding rapidly: in value terms they have risen by 20.1% per annum over 2002–12 to China; 17.2% to Russia; 11.3% to India; 13.4% to Brazil; 5.9% to Mexico, and 8.1% to Indonesia – but from a very low base.

There are, however, potentially large-scale opportunities for British business in the coming years in emerging markets. Growing prosperity will not only lead to increased overall demand from the emerging world but may also alter the composition of demand in ways that play to the UK’s export strengths in high-end consumer services and goods.

Exhibit 5: Britain has trade surpluses in services and high-tech manufacturing

UK trade balances, selective sector breakdown, 2012 (£m)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Balance 2012 (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial services</td>
<td>35745</td>
</tr>
<tr>
<td>Business services</td>
<td>24828</td>
</tr>
<tr>
<td>Insurance services</td>
<td>11552</td>
</tr>
<tr>
<td>Aircraft &amp; spacecraft</td>
<td>10971</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>10726</td>
</tr>
<tr>
<td>Computer &amp; information services</td>
<td>9966</td>
</tr>
<tr>
<td>Royalties &amp; licence fees</td>
<td>9444</td>
</tr>
<tr>
<td>Machinery &amp; equipment</td>
<td>7144</td>
</tr>
<tr>
<td>Transport services</td>
<td>6935</td>
</tr>
<tr>
<td>Chemicals</td>
<td>4540</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>2391</td>
</tr>
<tr>
<td>Travel</td>
<td>1378</td>
</tr>
<tr>
<td>Food &amp; beverages</td>
<td>828</td>
</tr>
<tr>
<td>Computer, electrical &amp; optical equipment</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: ONS Pink Book 2013, ONS UK Trade in Goods
As middle classes grow around the world, there will be an increased demand for banking, and life and health insurance – with great potential for the financial services industry in the City of London. Middle classes also spend more on healthcare and education – both sectors where the UK has strong brand identity through the NHS and globally renowned academic institutes such as Manchester University (where researchers were recently awarded a Nobel Prize for graphene research) and Southampton University (a world leader in photonics). Top-end UK brands such as Jaguar and Burberry are increasingly favoured by new Asian consumers, and urbanisation may play to British strengths in town planning, design, architecture and infrastructure (See Exhibit 6).

Exhibit 6: UK opportunities in emerging markets

Burberry: Sales growth in emerging markets helped push Burberry, the UK-based global luxury brand to record sales in 2012. Sales in China grew by about 20% last year, accounting for 14% of the group’s sales. Latin America has also seen strong growth for the company with new shops opening in Brazil and Mexico, and new franchise agreements signed in Colombia and Chile.

Experian: As demand for credit grows among the middle classes around the world, Nottingham-based Experian is well placed to capitalise with a presence in Brazil, Columbia and India.

Benoy: The award-winning firm of architects, masterplanners, interior and graphic designers is responding to the new demand from governments in the Middle East and India, who are putting more money into housing projects to meet the needs of their populations as they grow, incomes rise and the economies develop.

The UK’s broad range of cross-discipline expertise can also allow for the packaging of product/service combinations that can be exported as holistic solutions to satisfy the demands of emerging economies and their governments. The next pages lay out some of the opportunities and challenges faced by British business in China and India. There are undoubtedly opportunities, but business faces a significant challenge in developing a new product mix, improving competitiveness and overcoming the practical and non-tariff obstacles to trading with and operating in the emerging world. Building links with these high-growth economies will take time.
1.35 billion
Population

$8.2 trillion
GDP (nominal) – just under three and a half times the UK’s GDP of $2.4 trillion

$12.4 trillion
GDP (PPP) – more than 5 times larger than UK GDP of $2.3 trillion

$9,200
GDP per capita (PPP) – ¼ of UK’s $36,900

8.4% p.a.
GDP growth over 2012-18

£13.7 billion
UK exports to China 2012 – 2.8% of UK total exports

China has witnessed spectacular economic growth in recent years. By 2018, China’s share of global GDP in purchasing power parity terms is expected to reach 28% – which is larger than the US economy and up from 5% in 1990.

★ Urbanisation is driving a huge increase in demand: 50% of China’s population live in urban areas and the rate of urbanisation is increasing at nearly 3% per year.

★ 125 Chinese cities are already ranked among the 600 largest urban economies in the world. By 2028, another 100 are expected to join this list, replacing cities in Europe and North America, and these 225 cities alone will contribute 29% of global growth over the next 15 years.

★ China is expected to provide half of the global growth in middle-class consumption with a potential market worth over $7,457 billion by 2022.
The UK is starting from a low base, but it is well positioned to improve trading links as China changes

The UK’s share of the Chinese market has fallen to around 1% over the past decade and has continued to lag behind France, Italy and Germany. UK exports to China in 2011 were less than a third of France’s and only around 15% of the comparable figure for Germany.

This, in part, is because the UK’s export mix is not particularly well aligned with China’s fastest-growing sectors today. In 2011, 32% of China’s imports were fuels, metals and other raw materials; with a further 28% related to machinery and electrical goods; only 12% were services. But the UK was supplying mainly the latter; over a quarter of UK exports to China were services in 2011, with machinery and electrical goods accounting for only 19% of UK exports and raw materials only 16%.

Despite this, the UK’s economy is well positioned to increase its participation in the Chinese market in future years. As China becomes wealthier, its economy will become more like that of other developed countries, replacing imports of industrial goods with imports of higher-value goods and services of which the UK is a leading exporter.

UK-China trade links are already strengthening. As of the end of 2012, the U.K. was estimated to be the second-largest EU investor in China, after Germany, with a cumulative direct investment value of US$18.76 billion. Furthermore, the UK is making encouraging progress in attracting Chinese investment to Britain: in 2012, the UK was the 4th most popular destination for Chinese outward investment - behind Hong Kong, the US, and Kazakhstan - up from 8th place in 2011 and 21st place in 2010. The overall stock of Chinese investment in the U.K. is estimated to be around US$8.9 billion.

For many British firms, China is already a major market

Pinewood Shepperton has entered into a 50/50 joint venture agreement with Seven Stars Media, one of the largest and fastest-growing media conglomerates in China.

BP has been investing in China since the early 1970s, investing around US$5 billion to date. BP currently operates 17 joint ventures and wholly-owned businesses in China with activities including exploration, petrochemicals manufacturing and marketing, aviation fuel supply, and oil product and lubricant retailing.

The University of Nottingham was the first Sino-UK University to operate independently in China, with over 5,000 international students now studying British degrees at its campus in Ningbo.

BT is emerging as a key player in IT consultancy services in the Chinese health sector, showing strong revenue growth in the past year and positioning itself well for future new business.

Airbus has seen demand from China rise from 6% of their planes in 1995 to 48% of the market today.

WPP: the London-based group is the world’s largest advertising and marketing services company, employing 170,000 people (including associates) in 110 countries. The group has a strong strategic focus on the BRICs and other fast-growing economies. Its companies have been active in China for many years, and WPP first held a board meeting in the country in 1989. China is now WPP’s third largest market after the US and the UK, with revenues of $1.4 billion and 14,000 people.

But significant barriers to entry remain

For companies looking to operate in China, there remain significant barriers:

• The increasing competitiveness of Chinese companies – in attracting global talent and investment, as well as fostering innovation – is making it harder for UK firms to break into the Chinese market. The global aspirations of Chinese companies and their ability to compete in international markets is increasingly apparent.

• Issues around the security of intellectual property remain a major concern for foreign companies operating in China. The threat of cybercrime and cyber espionage has been regularly highlighted by companies as a significant challenge.

• Preferential treatment afforded to domestic firms – through a variety of means including state-owned enterprises, market access barriers, FDI restrictions and licensing procedures – serve to restrict UK business opportunities for trade and investment in key sectors and in public procurement.

Progress in tackling some of these issues is slowly being made, but international pressure will be a vital driver of further improvements to highlight the business and societal benefits of a more transparent business climate.
India is becoming an increasingly powerful player in the global economy. Driven by urbanisation, Indian GDP per head has risen from less than $900 per person in 1990 to $4,000 today and growth is expected to average around 7% per year over the next decade.\textsuperscript{53} As the country gets wealthier, India’s weight in the global economy will rise: accounting for around 3% of global GDP in 1990, India is expected to account for over 6% in 2018.\textsuperscript{54}

★ India’s urban population is expected to double from 300 million to 600 million by 2030, driving a huge increase in consumer spending in urban areas as the new middle classes look to improve their quality of life. The level of consumer spending in Delhi and Mumbai is already twice the national average, and “tier II” cities are also growing in wealth.\textsuperscript{55}

★ To support this transformation, India has ambitious plans to promote growth, with over US $1 trillion of infrastructure development planned over the next 5 years and similar investments in public services and privatised state industries.
A growing Indian middle class presents huge opportunities for UK firms

Although progress is both patchy and slow, India is opening up to the global economy and paving the way for greater foreign ownership and trade. The UK has a number of advantages to boosting trade with India, including Indian respect for the quality of both the UK’s brands and legal system, and there is a long history of bilateral trade between the two.

Despite these potential advantages, India currently accounts for only 1.4% of UK exports. While this share grew by 59% between 2001 and 2012, it remains a low figure. This does not sufficiently reflect the value of the UK’s historic ties with India, and UK firms have often been left behind by more agile foreign and domestic competitors who have worked harder at their relationships with Indian partners.

However, the growth of the Indian market includes a number of sectors where the UK is well positioned to capitalise:

- In financial services, the UK’s reputation for good practice is helping UK firms support the maturation of the Indian finance sector.
- Consumption of English language media is growing rapidly, creating market opportunities for UK creative industries (such as music, television and film), IT goods and services (such as software engineering) and educational establishments.
- The rising affluence of Indian citizens has also led to demand for education rapidly outstripping supply, and the UK’s reputation in India for high-quality education carries the potential to attract greater numbers of Indian students.
- As larger indigenous Indian retailers begin to emerge, there are opportunities for foreign retail companies to enter the Indian market at scale, bringing with them their expertise in managing supply chains, branding and marketing.

UK firms also stand to benefit from growing FDI from India: it was the fourth largest investor into the UK in 2013, ahead of China, and is the second largest investor in London after the US.14

For many British firms, India is already a major market

**Arup:** The company has won contracts to support the development of New Delhi Railway station, the Zirakpur Masterplan in the Punjab, and the Rajiv Gandhi International Airport, Hyderabad.

**Marks & Spencer:** India is a priority market for Marks & Spencer. The company has seen strong growth in India in recent years where the company currently operates 36 stores across the country.

**Tesco** has partnered with Tata Group, bringing their expertise in supply chain and distribution to Tata’s domestic network.

**Diageo** recently took a controlling stake in United Spirits, the world’s largest spirits producer by volume and largest player in the Indian market. India is currently the largest whisky market in the world but Scotch has only 1% of the market. EU pressure led to the Indian government protecting the status of Scotch in 2011.

**OCS Group,** an international facilities services provider, recently announced plans to double the size of its Indian operations, taking the staff in the country to 40,000. OCS currently employs a worldwide total of 85,000 people in 40 countries. OCS plans to grow its workforce over the next five years as it builds out the total facilities management (TFM) offer across India, making OCS the second-largest British employer in the country.

**Standard Chartered** has operated in India since 1858 and is India’s largest international bank, with 99 branches in 42 cities. As one of the largest banks in India, Asia and Africa, Standard Chartered is well placed to profit from an increase in trade between the three regions.

**BP** has investments of over US$ 8 billion and employs over 8500 people in India. It has a strategic partnership with India’s Reliance Industries Limited, working with them to explore for, produce and market natural gas in India. In addition, Castrol India is the leader in the Indian lubricants market.

But getting access to the Indian market is proving challenging

- Businesses often find themselves confronted by high tariffs to protect domestic industries: for example, the 100% tariff on cars is a major barrier to increasingly exports, and wine and spirits tariffs blunt the ability of Scotch whisky to fully reach the world’s largest whisky market.
- The lack of infrastructure for commerce in India remains a huge problem for fully exploiting those opportunities that are available. For example, Marks & Spencer has yet to expand into food retailing due to lack of cold storage in the domestic supply chain.
- Government-imposed foreign ownership limits in Joint Ventures have, especially in advanced industries such as aerospace, prevented expansion due to concerns over loss of IP in technology transfer arrangements.
- Retrospective changes to the corporate tax regime create an uncertain environment for investment, and withholding tax agreements between the UK and India make life difficult for small firms.

With EU–India FTA negotiations still to be concluded, UK business remains hampered by high tariffs, a complex regulatory system and extensive non-tariff barriers, which together represent a significant challenge to expanding operations in India in the short term.
The overall size of developed economies means that they are likely to remain key trading partners for the UK.

1.4 Britain’s large established markets are likely to be important for some time to come

With substantial challenges to expanding the presence of British firms in emerging markets, the UK cannot afford to ignore the 79% of exports currently going to the EU, US and other developed markets. As exports to these countries start from a much higher base, even a relatively modest improvement in demand and UK market penetration in the EU and US could match the impact from a proportionally more rapid expansion in exports to BRICs.

Furthermore, the overall size of developed economies – and the retention of their places at the world negotiating table that shapes the global trade agenda – means that they are likely to remain key economic and trade partners for the UK. Developed world economies are still large in absolute terms, as well as having a much higher income per capita than emerging market economies: the EU28 and US together accounted for 45% of global GDP in dollar terms in 2012. Despite currently depressed growth rates, the EU28 and US are still expected to be in the world’s top four economies in 2050 and the gap in incomes per head is set to persist for the foreseeable future.

Moreover, especially in Europe, growth rates are by no means uniform across developed markets. Within the European Union itself, there is considerable scope for further catch-up growth among the accession countries, where GDP per head is, for example, 79% of the EU average in the Czech Republic, 66% in Poland and 47% in Bulgaria. Over the ten years to 2012, these three economies grew by annual averages of 2.9%, 4.3% and 3.4% respectively, despite the impact of the financial and Eurozone crises. Currently, the UK takes little advantage of new trading opportunities with the 13 countries that joined the EU between 2004 and 2013 – together they accounted for only a 3.1% share of exports, highlighting the continuing opportunities in developed markets for UK firms.

Exhibit 7: Continued opportunities for UK firms in developed markets

Kingfisher: While EU demand as a whole has suffered from the economic crisis, new markets within the EU are showing great promise. Eastern enlargement of the EU has opened up new opportunities for UK companies through the expansion of the Single Market. For example, Romania’s DIY market has trebled in size since 2005 to around $1bn (2011), and Kingfisher PLC, who own B&Q and Screwfix, expanded into Romania in 2013, acquiring 15 large stores.

Omniverse Vision: This SME with six employees provides alternative content in more 4,000 cinemas in over 50 countries, with its biggest markets in Europe, the US and South America.
The fact that Europe and the United States are at a broadly similar level of income and development to the UK also means that they are likely to remain major trading partners for the foreseeable future, even as the BRICs, together with Indonesia and Mexico, surpass today’s G7 in terms of overall economic size. This is because, as well as specialising in areas of comparative advantage, economies of scale drive countries to specialise in exporting goods and services that are similar to those being demanded by their own consumers. This ‘home market effect’ has been invoked to explain the fact that the bulk of trade between developed countries (which continues to outweigh their trade with emerging economies) is in varieties of goods from the same industry (so-called ‘intra-industry trade’).61

UN merchandise trade complimentary data, shown in Exhibit 8, confirm that the UK’s current mix of exports is, indeed, closely matched to the import demands of other developed economies. The index measures the extent to which the sectoral mix of the UK’s goods exports match the import demands of other countries. All of the ten countries with import demands most closely matched to Britain’s exports are high-income economies – seven are in Europe, and the United States comes in ninth. These rankings are, of course, likely to change in the coming years as the UK’s export mix shifts to take advantage of new global opportunities, but the home market effect suggests that a bias towards high-income markets is likely to remain for a considerable period.

The UK needs to maximise its export offering to both new and existing export partners in order to drive the recovery.

**Exhibit 8: Britain’s export mix is suited to the demands of rich economies**

<table>
<thead>
<tr>
<th>Trade Partner</th>
<th>UK’s Export Complementarity</th>
<th>Ranking (1=partner most suited to UK export mix)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>71%</td>
<td>1</td>
</tr>
<tr>
<td>Australia</td>
<td>69%</td>
<td>2</td>
</tr>
<tr>
<td>Germany</td>
<td>68%</td>
<td>3</td>
</tr>
<tr>
<td>Canada</td>
<td>68%</td>
<td>4</td>
</tr>
<tr>
<td>France</td>
<td>67%</td>
<td>5</td>
</tr>
<tr>
<td>Sweden</td>
<td>66%</td>
<td>6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>66%</td>
<td>7</td>
</tr>
<tr>
<td>Finland</td>
<td>65%</td>
<td>8</td>
</tr>
<tr>
<td>United States</td>
<td>64%</td>
<td>9</td>
</tr>
<tr>
<td>Spain</td>
<td>64%</td>
<td>10</td>
</tr>
<tr>
<td>Brazil</td>
<td>64%</td>
<td>11</td>
</tr>
<tr>
<td>Russia</td>
<td>58%</td>
<td>30</td>
</tr>
<tr>
<td>China</td>
<td>48%</td>
<td>101</td>
</tr>
<tr>
<td>India</td>
<td>45%</td>
<td>135</td>
</tr>
</tbody>
</table>

Source: UN Comtrade
Economic fundamentals will continue to make regional trade with Europe particularly important

In addition to the predisposition of advanced economies to trade with each other, structural economic fundamentals make regional trade particularly important. It would be difficult, if not impossible, for Britain to achieve the same degree of collaboration and integration that it has today with European trade partners with more distant trading partners for a number of reasons:

Transport costs drive trade closer to home

By raising the cost of trade in proportion to geographic distance, transport costs drive trade closer to home, particularly in the cases of heavy goods and perishables such as food. Transport costs have remained a significant factor even following technological advances such as the development of shipping containers and, in recent years, the growth of express delivery service (EDS) companies. For example, in the UK’s food & drink sector, 9 of the top 10 export markets are in the EU, with exports to Ireland, France, the Netherland and Germany accounting for half of the UK’s exports. A study of 1,467 estimates of the impact of distance on trade found that it has been stable over the last fifty years, despite changes in globalisation and transportation technology and, if anything, has strengthened slightly.

There are lower barriers to entry for new exporters looking to trade with regional neighbours

Firms that are new to exporting generally find it easier to break into markets with greater cultural and legal similarities. Evidence suggests that most successful new UK exporters gain a foothold in the likes of the EU or the US before moving to more distant, less developed or institutionally unreliable countries.

For example, a respondent to the CBI’s membership survey on the European Union told us: “My organisation is small and constantly developing new products...It is the EU markets which form a solid well-regulated trade base which enables us to then move on to the risky markets outside of the EU.”

Integrated supply chains are concentrated in regions

Cross-border supply chains, which are an increasingly important aspect of globalisation and productivity growth (an issue explored in more detail in Chapter 2), appear to be particularly regionalised and sensitive to geographic distance. A recent OECD study, for example, found that a 10% difference in distance between two countries decreases intermediate goods imports by 8.2% as compared to 7% for consumption and 5.3% for imports of capital goods. A number of factors help explain the sensitivity of intermediates to distance and transport costs, although at present there is insufficient evidence to determine which ones are more important. First, intermediate inputs may be less differentiated than final goods, not being directly subject to consumer preferences, and therefore may be more price-sensitive. Secondly, geographic distance introduces greater risks to ‘just-in-time’ and other highly efficient production processes. Finally, face-to-face interactions and cultural similarities may be of greater importance when building and managing complex value chains.

For the UK, 40 years in a customs union with other European countries and a quarter of a century in a Single Market has meant that the UK and EU economies are greatly integrated. This goes beyond the headline statistics about shares of exports and imports. The UK is a major participant in European supply chains (See Exhibit 9), with around half of its imports from the EU consisting of intermediates that go on to be imbedded in British products that are variously consumed at home or re-exported.
This is part of a wider trend. As Exhibit 10 shows, already around 17% of the value of UK exports is comprised of imports from other countries – a trend that is growing in importance globally. For UK companies either at the top of or operating as part of supply chains, international co-operation is a vital part of their competitiveness, with final products today made up of parts from around the world.

Economic fundamentals suggest, therefore, that Europe is likely to play an important part in Britain’s economic future whether it is a member of the EU or not.

Exhibit 9: UK participation in – and reliance on – European supply chains

**Dewhurst:** An independent supplier of components for lifts and doors – selling to all the major lift manufacturers, including ThyssenKrupp, Kone and Schindler, in Europe. The company was founded in 1919 and the Dewhurst Group now has sales of approximately £40 million and employs over 300 people in locations around the world, supplying products from its manufacturing plant in West London.

**Ford:** Ford’s Dagenham plant supplies over 50% of global Ford diesel engine demand. Together with their Bridgend petrol engine production facility, Ford’s annual UK production capacity is over two million engines – more than 85% of which are exported, primarily to the EU. The plant produces engines for Ford and a number of other automotive manufacturers. Ford is investing £1.5 billion across its UK sites for low CO2 design, development and manufacturing.
The United States: The UK’s Biggest Trade Surplus

A ‘special’ commercial relationship

314 million
Population

$15.7 trillion
GDP (nominal) – more than six times larger than UK GDP of $2.4 trillion

$15.7 trillion
GDP (PPP) – more than six times larger than UK GDP of $2.3 trillion

$49,900
GDP per capita (PPP) – 35% larger than UK’s $36,900

3.0% p.a.
GDP growth over 2012-18

£84.1 billion
UK exports to US 2012 – 17.1% of UK total exports

The US is by far the UK’s most important non-EU market, accounting for 17.1% of the UK’s total exports. China, the next most important non-EU market, accounted for 2.8%.70

★ In 2012, UK exports to the US were £84bn while imports amounted to £51bn – a trade surplus of £33bn.71

★ Britain is the largest foreign investor in America. In 2011, the UK had $442 billion invested in the US, representing 17% of the $2.5 trillion of foreign direct investment (FDI) in America.

★ Every state in America has workers in jobs that are created and sustained by British companies. In total, they employ around 902,000 American workers – which is more than any other country.72

★ The US has a number of underlying qualities that UK companies appreciate: the size of the market, a culture that fosters innovation and risk-taking, the deep capital markets, and the pool of talented workers all rank highly.
UK business success in the US market

Philips AVENT: A leading manufacturer of mother and childcare products, with one of its global manufacturing sites located in Suffolk. Philips AVENT is a market leading brand across Europe, as well as in the world’s largest market, the United States. Part of the Dutch Royal Philips group, the majority of Philips AVENT’s innovations are produced at its Suffolk manufacturing site.

Virgin Atlantic: A major player in the transatlantic market, flying from London to 10 US airports. The strength of commercial ties between the US and the UK is reflected in the fact that 8 of the 10 most popular transatlantic routes link the two countries. There is potential for significant further growth between the two markets if runway capacity issues in the UK can be addressed. Virgin Atlantic recently launched UK domestic flights to offer additional connections around the UK, and will shortly launch a transatlantic partnership with US based Delta Airlines which will offer the passengers of both airlines connections to 63 destinations across the UK and North America. Delta have also completed the purchase of a 49% stake in Virgin Atlantic.

Atkins: One of the world’s leading design, engineering and project management consultancies, Atkins are a UK based firm employing 18,000 staff across 26 countries. In the USA, the 70 offices across 28 states and territories employ over 3,000 people delivering projects in a range of sectors including water, education, energy, building and transportation.

WPP: The US is the largest market for London-based WPP, the world’s leading advertising and marketing services company. In the US the company has revenues of more than $6 billion and employs 30,000 people.

WPP companies provide the full range of marketing services to clients in the US, from advertising and media investment management to public relations, branding and data investment management.

Despite historic successes, work towards removing remaining barriers can boost UK trade even further

The United States is one of the world’s more open markets, and the UK-US economic relationship is particularly strong, but barriers to increasing both exports and investment still persist. The bureaucracy of exporting to 50 individual, albeit related, markets adds another layer of complication, as import rules and regulations can vary in each state.

For UK firms to capitalise on the opportunities available, work needs to be done to:

Eliminate tariffs. Although UK companies exporting to the US already benefit from very low tariffs – the average is around 3%, and high-exporting UK sectors today face tariffs of between 0.5 and 1.5%[2] – eliminating tariffs as much as possible must be a priority.

Liberalise trade in services to boost market access in the transatlantic services economy, where longstanding trade barriers remain in sectors such as aviation, shipping, ICTs, re-insurance and professional services.

Improve access to US public procurement contracts, where opportunities are currently limited by imbalanced commitment under the Agreement on Government Procurement (GPA) and ‘Buy America’ provisions.

Reduce current non-tariff barriers to trade in key sectors. In automotive, chemicals, food & drink, financial services and pharmaceuticals among others, regulatory divergence limits export potential. Full regulatory harmonisation for most sectors may not be realistic, but sensible and economically meaningful mutual recognition agreements can help limit discriminatory regulatory requirements.

Prevent new non-tariff barriers to trade from arising in the future. The establishment of stronger mechanisms for cross-border co-operation and consistency when designing or updating regulations is an important stepping stone to future regulatory convergence. While eliminating tariffs would offer economic gains, a trade deal between the EU and the US which acted to address some of the major non-tariff barriers would bring even greater benefits for all sectors. The Transatlantic Trade and Investment Partnership (TTIP) could therefore be a game changer for the UK. It should help minimise non-tariff barriers and encourage regulatory cooperation between two economies that already share many common values and important trade and investment links.
Europe is Britain’s most important trading partner by some distance. Seven of the UK’s top ten export destinations are in the EU (in order: Germany, the Netherlands, France, Ireland, Belgium, Spain and Italy), and total exports to the EU and EFTA accounted for around 16% of GDP in 2012.\textsuperscript{76} Seven of Britain’s top ten import markets are also in the region.\textsuperscript{77}

Europe is a huge rich economy, near to Britain geographically. The ‘four freedoms’ of the Single Market go beyond a standard free-trade agreement to tackle non-tariff barriers, making the EU more open to British businesses than any other market in the world.

66\% of Britain’s exports to the EU and EFTA are goods, against 56\% of exports to other regions, which partly reflects the role of transport costs but also the impact of the Single Market. Financial and business services account for over two thirds of services exports to the EU and EFTA.

The EU and EFTA account for 53\% of the stock of FDI into Britain and 51\% of Britain’s outward FDI.\textsuperscript{78}
UK success in – and integration with – Europe

**Scotch Whisky Association:** The EU is the industry’s single largest export market and is vital to the Scotch Whisky industry. Global exports in 2012 were worth £4.3 billion, of which sales to the 26 other EU member states accounted for £1.45 billion. France is the world’s largest Scotch Whisky market after the US, while sales in new EU states like Poland, Romania, Bulgaria and the Baltic nations are growing strongly.

**Tesco:** One of the largest supermarket chains in Central Europe and has been active in the region since 1994. The market leaders in Hungary and Slovakia and the second-largest player in the Czech Republic and Poland, the company’s revenues in the region exceed £9 billion per year and it has nearly 1200 stores.

**Marks & Spencer:** In recent years Marks & Spencer has expanded across Europe where the company now has 155 stores and has launched local internet shopping sites in 8 key markets across Western Europe. In addition to stores in established western markets like Ireland, France and Netherlands, Marks & Spencer has operations in a number of East European markets including Czech Republic and Poland.

There are still new opportunities emerging in Europe

The EU and EFTA are growing slowly. Their share of UK exports has fallen from 58% in 1998 to 50% in 2012 – and, with the rise of emerging economies, it is set to fall further. The decline in Europe’s share of trade has recently been exacerbated by the recession and Eurozone crisis and, although it may stabilise in the years ahead, the long-term trend is nonetheless downwards.

Even so, the scale of Britain’s exports to the EU and EFTA is such that even a modest recovery in Europe would be positive for Britain.

Furthermore, expansion of the EU has made it an increasingly diverse trading bloc. Parts of the eastern EU are growing more rapidly and represent an under-exploited trading opportunity. The countries that have acceded to the EU since 2004 have a combined economy the size of Spain and are forecast to grow faster than the EU average. The UK’s exports to the 13 accession countries account for 6.8% of its total exports to the EU and EFTA, against their 8.8% share of the region’s GDP (excluding the UK).

There is still much work that can be done to further deepen the Single Market and, even with the ‘four freedoms’, barriers to trade and investment still exist. For example, in services, untapped potential exists in sectors including e-commerce, professional services and transport, given that services only accounts for around one-fifth of all EU trade yet is responsible for over 70% of the EU’s GDP.\(^7\)

---

457 Million people – the size of the European market excluding the UK

50% % of UK exports to EU & EFTA

$15tn Size of European economy
1.5. In response to shifts in global economic weight, the UK does not face an either–or choice between Europe & the US and emerging markets

As a confident nation with a broad range of entrepreneurial businesses, Britain stands to benefit from the great opportunities offered by this surge in world growth if it makes the right choices. Today, however, Britain’s trade and investment links are still heavily tilted towards other rich developed nations, principally the United States and members of the western European Union. Exports to the emerging world are growing rapidly, but they are doing so from a very low base. While the growing spending power of developing economies’ middle classes is likely to play to Britain’s trading strengths, progress is likely to be slow, and British firms face considerable practical barriers when breaking into emerging markets.

Moreover, it is unlikely that the UK will totally shift away from the trading and investment partners of today, since there are compelling economic fundamentals that make trade between advanced economies and especially between those clustered in a region particularly important.

This means that Britain does not face an ‘either/or’ choice. It needs to maximise trade with existing large markets at the same time as building links to new markets. This approach is not simply rooted in an economics textbook – it is one being adopted by UK businesses as they set out their strategies for growth over the coming years. Firms are choosing this ‘and’ strategy to maximise growth from as many sources as possible, and the UK as a whole should follow suit.

The focus must be on building links to markets all over the world by breaking down barriers between economies, participating in the exchange of people and ideas, and finding the common ground on regulation and global co-operation that can help harness the global trends reshaping the world economy to bring prosperity to the UK and its citizens.

"Britain does not face an ‘either/or’ choice. It needs to both maximise trade with existing large markets at the same time as building links to new markets."
CHAPTER 2

THE UK MUST MAXIMISE OPENNESS TO THE GLOBAL ECONOMY TO HELP TACKLE THE PRODUCTIVITY CHALLENGE
Globalisation and the rise of emerging markets present a great opportunity for Britain. Openness to global exports, imports, investment and migration combined with the right industrial strategy and policies to boost skills levels can drive a virtuous circle of increased productivity and competitiveness that will support growth and exports, creating jobs and boosting prosperity.

In the current wave of globalisation, the world economy is becoming more open and integrated, with tariff barriers lower than ever before and non-tariff barriers being lowered to help facilitate a boom in supply-chain trade. However, it is increasingly difficult to make progress through multilateral deals at the World Trade Organization, with the Doha Round struggling to deliver results since its inception in 2001. Instead, a variety of bilateral and regional trade deals are taking the lead in dismantling trade barriers – for example, for the last few decades the UK has used membership of the European Union as the vehicle for pursuing greater openness.

The UK faces a productivity challenge that acts as a drag on its trade performance across the board. Despite some progress in closing the gap, prior to the global financial crisis the UK was less productive than most comparable large developed economies. For the UK to pay its way in the world, and capitalise on those growth opportunities occurring across the globe, it must maximise openness to boost productivity and become more competitive.

Globalisation and the rise of emerging markets present a great opportunity for Britain. Openness to global exports, imports, investment and migration combined with the right industrial strategy and policies to boost skills levels can drive a virtuous circle of increased productivity and competitiveness that will support growth and exports, creating jobs and boosting prosperity.

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2.1 The key to increasing exports is meeting the productivity challenge through continued openness of the UK economy

Long-term sustainable GDP growth is driven by improvements in productivity, especially in developed economies where workforce growth, catch-up capital accumulation and natural resources are limited (see Exhibit 11). By enabling resources and labour to be used more intensively, productivity growth both increases the overall size of an economy and improves real income and the standard of living. And, by raising efficiency and lowering the cost of goods and services, improvements in productivity raise a country’s competitiveness, enabling it to increase exports and participate in attractive high-value-added parts of global supply chains. Success for the UK in the modern global economy will not rest on competing for the lowest labour costs or handing out subsidies; it will instead be driven by boosting productivity through skills, technology and innovation.
Exhibit 12: Much UK success comes from operating at high-value-added parts of the global economy

The UK’s motorsport sector is a jewel in the crown of UK engineering and a hidden powerhouse of the UK economy with global sales exceeding £6 billion, employing 40,000 people at 4,000 mostly SME companies. Motorsport Valley UK is home to 8 of 11 Formula 1 teams, more than at any time in history, all of which are located amongst an innovative community of leading producers supplying a wide variety of motorsport all over the world.

Europe is the sector’s leading market, closely followed by the US.

The UK faces a substantial productivity challenge. For several decades, UK productivity has lagged behind not only that of the high-productivity United States but also that of comparable western European countries including Germany and France (see Exhibit 13). From the 1980s up until the financial crisis, UK overall productivity grew more rapidly than in other major advanced economies, but in 2007 it was still 9% below that of Germany and 20% below that of the US (while it had just pulled equal with that of France). Since the global financial crisis in 2007, British labour productivity has declined sharply, as employment has performed surprisingly strongly considering the depth of the recession. While it remains unclear just how much of this shortfall in labour productivity is permanent and how total factor productivity has been affected – there may be a rebound in the coming years as GDP recovers – these figures underline the productivity and competitiveness challenge that the UK faced even prior to the downturn.

Exhibit 13: Britain’s productivity has historically lagged that of other advanced economies

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>France</th>
<th>West Germany</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP/hour worked</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973</td>
<td>95</td>
<td>132</td>
<td>160</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>112</td>
<td>157</td>
<td>166</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>123</td>
<td>161/143</td>
<td>156</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>117</td>
<td>133</td>
<td>146</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>109</td>
<td>119</td>
<td>147</td>
<td></td>
</tr>
<tr>
<td><strong>Total Factor Productivity (TFP)</strong></td>
<td>87</td>
<td>112</td>
<td>127</td>
<td></td>
</tr>
<tr>
<td>1973</td>
<td>103</td>
<td>135</td>
<td>135</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>110</td>
<td>133/123</td>
<td>128</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>104</td>
<td>115</td>
<td>123</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>101</td>
<td>110</td>
<td>125</td>
<td></td>
</tr>
</tbody>
</table>

Source: Nicholas Crafts, The economic legacy of Mrs Thatcher, 2013
Greater openness and trade can feed into greater productivity in a virtuous circle

The UK has always been an open economy. However, by further opening its economy to exports, imports, international skilled labour and capital, the UK can benefit from a virtuous cycle of increased competitiveness, productivity and growth. Openness is promoted by:

- Securing market access to trade in both exports and imports at every stage of the value chain
- Increasing access to labour and investment through migration and capital flows
- Improving the business climate for foreign direct investment
- Having a regulatory climate that is both competitive and enabling to trade.

Empirically, the link between international openness and productivity growth is backed by a study of 93 countries by the National Bureau of Economic Research (NBER), which found a clear link between openness and trend productivity growth, even after controlling for reverse causality (as well as openness driving productivity, increased productivity can drive greater openness).

To manage this openness effectively, however, domestic policy needs to be adapted to ensure that the UK economy is best placed to face the opportunities and challenges that being open to globalisation brings. The creation of an appropriate industrial strategy to maximise investment in productive sectors is essential, as is the need for suitable measures to handle the transition costs of structural changes to employment, managed migration, and skills policies to make sure the UK stays ahead of its competitors.
Exhibit 14 shows how openness to trade, investment and people can drive the economy to greater productivity and prosperity. Trade expands the market available to domestic firms, allowing them to expand and exploit economies of scale. Domestic industries that do not export themselves but who supply other exporters will also participate in the growing hub. Furthermore, imports of intermediates and participation in global supply chains, together with the utilisation of international skills, capital and knowledge, also enable increased specialisation and scale. Meanwhile competitive pressures from abroad will drive domestic innovation and adoption of new technologies.

This results in improved labour and capital productivity, product quality and international competitiveness. Together with domestic supply-side reforms, this openness allows domestic industries to participate in high-value stages of global value chains. Over the longer term, productivity gains drive structural changes to the patterns of production, with the creation of specialised clusters that pull in foreign direct investment. This, in turn, enables further success in trade, which sets off further rounds of productivity gains that boost the living standards of UK citizens.

**Exhibit 15: Specialisation and scale allowing UK business to compete globally**

Weir Group is one of the UK’s largest industrial companies specialising in the manufacture of high-tech pumps and valves for the energy and mining sectors. The development of European and Global standards has supported the growth of Weir Minerals Europe, the Group’s largest UK operation. The business exports more than 80% of its products to more than 50 countries. Aided by the Single Market, sales growth in Europe has been particularly strong, with new operations in Germany, Benelux, Scandinavia, Ukraine, Hungary, Spain, Turkey and Poland.

Over the long term, immigration could have a substantial positive impact on the UK’s fiscal position: the Office for Budget Responsibility has projected that the public sector net debt could be 52% of GDP in 2060 with net migration of 260,000 per annum but that this could rise to as high as 181% with zero net migration.82 Over the long term, immigration could have a substantial positive impact on the UK’s fiscal position: the Office for Budget Responsibility has projected that the public sector net debt could be 52% of GDP in 2060 with net migration of 260,000 per annum but that this could rise to as high as 181% with zero net migration.82

But the case for increasing openness to labour and mobility of workers and consumers rests not only on the balance of the direct benefits. There are significant indirect benefits to openness too, especially in a world of increasingly open and interconnected economies: making travel between countries as easy as possible is critical in building the personal relationships that often underpin trade and investment partnerships.

**Exhibit 16: Building outward links through openness to movement of people**

AVF Group: For AVF Group, a mid-size company who sell mounts and stands for audio visual equipment to corporate and domestic customers around the world, one major advantage of the free movement of labour has been the ability to recruit staff from the EU in the UK with the language skills that enable the company to operate in new markets. For a company with 37 employees in the UK, being able to recruit staff who speak French, Spanish and German has opened up new opportunities. Additionally, the recent signing of a free trade agreement between the EU and Colombia has helped break down many of the trade barriers that is slowing growth for the company in the BRICs.
Pure openness can be challenging

Pure openness can be challenging and have social impacts in the short to medium term, as shifts in the sectoral and employment composition of the economy cause dislocation effects such as changes in the nature of job opportunities and the skills required to fill them. Labour market impacts in particular necessitate active measures to promote re-skilling throughout the workforce and spread the aggregate benefits arising from migration.

For some parts of the British economy, greater competition – both from other member states and from outside the EU – has been damaging, with uncompetitive sectors migrating to other markets. Industries and sectors that have struggled to compete internationally have seen production moved outside the UK, both to EU states and further afield. For example, whereas the UK was once a major shipbuilder and coal miner, the creation of – and access to – global markets has dramatically reduced the UK’s industrial base in these sectors. UK shipbuilding has not migrated to other EU countries; instead, South Korea and China now build 74% of the world’s ships.84

For the UK to realise the benefits associated with openness, action at home is needed to ensure it is positioned to compete on the world stage for the long term. This means business and government working in partnership to put in place a coherent industrial strategy that gets behind key sectors where the UK has competitive strengths and sees strategic future opportunities, as well as developing a skills system that is demand-led. The CBI believes that a coherent 21st-century industrial strategy for the UK needs to be anchored around:

**Improving the competitiveness of the business environment:** Concerted action is needed to improve and strengthen the competitiveness of the UK business environment in the face of rising global competition. This means ensuring that the UK is competitive relative to other countries on indicators such as business taxes, infrastructure quality, access to finance, and education and skills.

**Championing key sectors:** A more targeted approach to supporting champion sectors such as automotive, life sciences and the information economy is essential. Strategic and open dialogue between business and government can help to unblock barriers to growth in key sectors

**Strengthening supply chains:** By strengthening supply-chain competitiveness and capabilities – especially among small and medium-sized suppliers – the UK has the potential to capture more value from investments at home and ensure that more UK content is included in the products and services exported overseas.

As the CBI’s recent Raising the Bar report argues, good progress is now being made on the industrial strategy agenda but it needs to be consolidated for the long term through effective implementation by government and business in partnership.85 To be successful, industrial strategy must also be election-proof, with commitment to continuity on key policy areas across the political divide.

Similarly, while the direct and indirect benefits of openness to movements of people are significant for business, there may be a period of dislocation and adjustment for some UK-born workers in certain sectors. An OECD study has encountered evidence of the temporary impacts of immigration on UK labour markets: a 1 percentage point rise in the non-UK-born share was found to increase UK-born unemployment by 0.4 percentage points two and three years later, but have no impact thereafter.85 The UK needs to provide appropriate support for job search and training to ensure that any temporary dislocation does not have permanent effects.

Managing openness through an industrial strategy, skills and appropriate migration policies can help mitigate the uncertainty of globalisation while harnessing the opportunities it brings, but it will not remove all of these concerns either from the public consciousness or from the priorities of policymakers.
2.2. The world economy is generally becoming more open

The UK needs to continue to drive forward openness to take advantage of the opportunities of globalisation because the rest of the world is doing so on an unprecedented scale. In recent decades, barriers between the world’s economies have consistently diminished and globalisation has transformed the way in which goods and services are produced and delivered. World tariff barriers have fallen consistently over the last 20 years, with the trend increasingly driven by developing countries (see Exhibit 17).

**Exhibit 17: Tariff barriers have fallen through the world in recent decades**

Furthermore, non-tariff barriers (NTBs), such as regulatory divergence, state aid and dumping, are also being dismantled, albeit from a much higher base and more inconsistently. While NTBs are very difficult to measure in the aggregate directly, their declining impact is evidenced in analysts’ estimates of ‘border effects’. Broadly, these estimates of the aggregate impact of differing national markets, state structures and national cultures on trade are obtained by estimating how much cross-border trade there ought to be based just on fundamentals like geography, population and wealth. A recent study that estimated global border effects from 1980 to 2006 found that they had declined consistently through the period and by around a quarter overall.87 However, non-tariff barriers undoubtedly persist, and are limiting the ability of UK businesses to seize potential opportunities around the globe: for example, US automotive export tariff rates of between 0.5% and 1.5% rise to an effective tariff rate of over 20% when one considers the NTBs that continue to exist due to regulatory divergence, severely limiting the ability of firms to get into the US market.88

In addition, barriers to the mobility of people and capital are also in retreat. The proportion of international migrants in the world population edged up from 2.9% to 3.1% between 1990 and 2010 but it rose more markedly in Europe, from 6.9% to 9.5%. Global cross-border capital flows, meanwhile, grew remarkably rapidly from the mid-1990s to the financial crisis and, although they fell sharply in 2008–09, they have partially rebounded and were estimated to be at 2005 levels in 2012 (see Exhibit 18).89

**Exhibit 18: Capital and people are increasingly internationally mobile**

More people than ever before work outside their country of origin – particularly in Europe.

<table>
<thead>
<tr>
<th>Year</th>
<th>World</th>
<th>Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>2.9</td>
<td>0.5</td>
</tr>
<tr>
<td>1990</td>
<td>3.1</td>
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<tr>
<td>2000</td>
<td>6.9</td>
<td>4.9</td>
</tr>
<tr>
<td>2007</td>
<td>9.5</td>
<td>9.5</td>
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</table>

Change 1990-2010 (pp)

<table>
<thead>
<tr>
<th>Year</th>
<th>World</th>
<th>Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1990</td>
<td>0.2</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>2.6</td>
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</tr>
<tr>
<td>2007</td>
<td>9.5</td>
<td>9.5</td>
</tr>
</tbody>
</table>

Trends in tariff rates (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Developing countries</th>
<th>World</th>
<th>High-income countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>40</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>1990</td>
<td>30</td>
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</tr>
<tr>
<td>2000</td>
<td>20</td>
<td>20</td>
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</tr>
<tr>
<td>2010</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: World Bank
Bilateral and regional trade deals are taking the lead in dismantling tariff and non-tariff barriers

Over the last decade, new commitments to maximise openness and access to the global economy have been best achieved largely outside the WTO-led model of multilateral integration. The lack of agreement to date in the Doha Round negotiations has contributed to a shift in emphasis away from the traditional multilateral trade talks designed to reduce global trade costs towards a mixture of bilateral and regional trade deals aimed at promoting deeper integration of national economies.

Although its dispute resolution mechanisms are still integral to the global trading landscape, the waning of the WTO model as a vehicle for securing new trade commitments has been driven in part by a shift in international trading patterns throughout the second half of the 20th century: at first trade between advanced economies was well served by the WTO model, but rapid increases in global supply-chain trade and trade between advanced and emerging economies, in combination with entrenched political blockages in WTO negotiations, have meant that a different approach has been required to break down modern trade barriers in recent years.

Among lower-middle economies, intra-industry trade began to take off from the 1980s onwards, creating new complementary regional hubs alongside the more established high-income country hub. In the 21st century, intra-industry trade is at the fore, and other links are developing between these hubs, taking the world into a new phase of globalisation (see Exhibit 19).

The effective operation of supply-chain trade requires that openness be taken well beyond tariff and quota elimination to encompass other issues such as customs procedures and intellectual property rights protection, regulatory harmonisation and capital and labour mobility (see Exhibits 20 and 21). Such measures, some of which have been pushed at WTO level by the EU, have so far been difficult to advance successfully at the multilateral level and so have been pursued actively at the regional and bilateral level.

Emerging economies eager to accelerate their industrialisation (especially smaller countries that do not enjoy the vast potential domestic markets of China and India), together with developed economies looking for low-priced factor inputs, have facilitated the rise of supply-chain trade with a series of reforms and trade deals made independently of the WTO. As Exhibit 22 shows, the pace of regional trade deal-making has been picking up since the mid-1990s and accelerated sharply once the Doha Round began to collapse. Almost all of the world’s major economies are now part of regional multilateral free trade areas that go beyond the WTO base, with China and Australia notable exceptions (see Exhibit 23).
Exhibit 21: Trade barriers in the modern global economy

1. Tariff barriers. Although these have been eroded by successive multilateral trade rounds, high tariffs in some countries still pose problems for EU exporters.

2. Burdensome customs procedures for import, export and transit as well as unfair or discriminatory tax rules and practices.

3. Technical regulations, standards and conformity assessment procedures that are not in line with WTO rules on technical barriers to trade (TBT Agreement).

4. Misuse of sanitary and phytosanitary measures i.e. those that are not justified on health and safety grounds within existing WTO rules.

5. Restrictions on access to raw materials, particularly restrictive export practices, including export taxes, which drive up prices for products such as hides and skins, and key mineral and metal goods, as well as dual pricing practices.

6. Poor protection of intellectual property rights including geographical indications and the lack of proper implementation and enforcement.

7. Barriers to trade in services and foreign direct investment such as unjustified foreign ownership caps, joint venture obligations and discriminatory treatment.

8. Restrictive government procurement rules and practices that prevent EU companies from bidding effectively for public contracts in third countries.

9. Abusive and/or WTO-incompatible use of trade defence instruments by third countries.

10. Unfair use of state aids and other subsidies by third countries in a way that constitutes market access barriers.

Exhibit 22: Regional trade agreements have expanded rapidly in recent years

Number of new regional trade agreements

Source: WTO
2.3 Different countries have pursued varying degrees of integration, offering the UK potential alternative models

The pace of integration is nevertheless uneven, and different countries around the world have adopted a variety of regional models of trade relations, often evolving from political initiatives to promote peace and security, to enhance openness in a way that suits their economic priorities and adapts to political constraints.

Some have prioritised a series of bilateral agreements that can be negotiated individually to provide increased market access in different parts of the globe, as South Korea has done. Others have also pursued their own FTAs, but at the same time have taken clear steps to be part of a regional trading bloc with the objective of explicitly reducing trade barriers (tariff and non-tariff) among participating members, such as ASEAN and NAFTA. A number of countries have gone one step further to introduce a customs union with a common commercial policy and a single external tariff, as Mercosur has tried to do, although with limited success.

Forms of economic union, such as the EU, have been even more ambitious, eliminating all tariffs internally and attempting to fully break down non-tariff barriers to trade in an effort to create a Single Market, for example through harmonised product regulation as well as pursuing external openness through FTAs. Finally, even deeper levels of integration towards monetary union, such as in the Eurozone, have attempted to facilitate trade by reducing the uncertainty that comes from exchange-rate fluctuations between trading partners.

Exhibit 23: Most countries are part of some form of regional multilateral trade area

40yrs

The UK has used membership of the EU as a vehicle for ‘openness’ for four decades.
Exhibit 24: Countries have adopted different models of interaction on regional and global trade

<table>
<thead>
<tr>
<th>Model of interaction</th>
<th>Removal of tariffs between members</th>
<th>Harmonised NTBs</th>
<th>Common external tariff</th>
<th>Free mobility of factors of labour/capital</th>
<th>Common economic and monetary policy</th>
<th>Examples</th>
</tr>
</thead>
</table>
| Series of bilateral FTAs | ✔️ | ✔️ | | | | Australia  
South Korea |
| Regional free trade Area (incl. bilateral FTAs) | ✔️ | 🟢 | ✔️ | ✔️ | | Singapore (ASEAN)  
Canada (NAFTA)  
Switzerland (EFTA) |
| Customs Union | ✔️ | ✔️ | ✔️ | ✔️ | | Brazil (Mercosur)  
Turkey |
| Common market | ✔️ | ✔️ | ✔️ | ✔️ | | Norway (EEA EFTA) |
| Economic union | ✔️ | ✔️ | ✔️ | ✔️ | | UK (EU)  
Sweden (EU) |
| Economic and monetary union | ✔️ | ✔️ | ✔️ | ✔️ | ✔️ | Germany (Eurozone)  
France (Eurozone) |

Key feature ✔️ Negotiated in some instances

For the last 40 years, the UK has used membership of the European Union as the vehicle for pursuing greater ‘openness’

The European Union is the most internally open and integrated of any international market, with measures to promote openness encompassing the total removal of tariffs and other physical barriers to trade between its 28 members, including via competition rules to prevent non-tariff protectionist measures such as dumping and state subsidy. Common EU standards and regulations are aimed at making it more practical for businesses to operate throughout the EU, while measures to promote labour and capital mobility have allowed considerable cross-border investment flows and migration of skills. Within its borders, the EU has lower barriers to trade – and therefore greater trade and supply-chain integration – than any other trading bloc in the world.92

The EU also promotes global openness with non-EU countries, primarily as a regional bloc in trade negotiations. EU membership is a crucial component of its members’ attractiveness as places to invest and do business for firms from across the globe.

In principle, the EU’s impact on Britain’s productivity, access to world markets and attractiveness as a place to do business can be leveraged to enhance the UK’s global role. However, membership of the EU does entail compromise, and limits the UK’s ability to pursue other forms of integration with the world economy.

“The EU is the most internally open and integrated of any international market.”
The cornerstone of the UK’s present strategy for driving forward trade and openness is its membership of the European Union.

2.4 The UK needs to maximise ‘openness’ to the global economy to boost productivity and increase exports

If the UK is to be successful in adapting its global trading role to the changing world, it must overcome the productivity challenge that acts as a drag on its trade performance across the board. To do this, the UK must pursue even greater levels of openness to the global economy. Openness to trade, investment and migration can be challenging, but done in the right way it can drive a virtuous circle of increased productivity and competitiveness that will support growth and exports.

The rest of the world is also becoming more globalised, open and deeply integrated, with tariff barriers lower than ever before and non-tariff barriers being lowered to help facilitate a boom in supply-chain trade. Increasingly, the leading edge of that process is being driven by regional trade blocs and bilateral deals between them rather than multilateral negotiations on the WTO model. Britain needs to remain engaged in this process.

The cornerstone of the UK’s present strategy for driving forward trade and openness is its membership of the European Union. The EU, which still accounts for around half of the UK’s trade, is the world’s most ambitious trade bloc, where the dismantling of internal non-tariff barriers to trade has gone the furthest.

However, the EU’s Single Market is far from perfect and membership entails compromises that in some cases limit Britain’s choices and might in practice do harm to its openness and prosperity. An assessment is needed as to whether the EU has been, and still is, the best way for Britain to underpin its global future, driving openness and raising productivity. Chapter 3 begins this assessment with an examination of the evidence on where membership has been of benefit and where it has been costly.
Chapter 3

The benefits of EU membership to British business have significantly outweighed the costs.
For many sections of the British economy, the EU’s Single Market is the defining factor in the debate. By establishing an overarching set of regulatory principles, the Single Market’s four ‘fundamental freedoms’ enable goods, services, people and capital to move between countries within the EU with the same rights as in the home state – in theory maximising all aspects of openness between economies worth a quarter of world GDP in total. The creation of standardised rules and reduced barriers to cross-border trade within the bloc allows UK firms to buy and sell goods and services in an expanded market, seek capital and employ staff from across the Continent, and tap into the economies of scale that can drive competitiveness and thus contribute to the productivity improvements needed to underpin Britain’s wider global trading ambitions. Three-quarters of CBI members of all sizes and sectors pointed to the creation of this common market as having a positive impact on their business.\(^9\) For some businesses, however, loss of UK control over many aspects of regulation can lead to negative outcomes; indeed, some believe that the costs of poorly drafted regulations outweigh the benefits of EU membership. Furthermore, the UK also pays a significant fee to be a member of the EU club. To come to a position on the overall benefit or cost of EU membership, all these considerations need to be assessed in the context of the modern, complex global economy in which the UK operates. Pure import and export figures are no longer as clear a guide to a nation’s trade performance as they once were, as the international supply chains that cross borders and industries now mean that components are often imported and exported around the world multiple times before the finished product is sold to its end user. The Single Market has supported – and helped to shape – this complex economy. And, by leading the drive towards a more outward-facing EU, the UK has also benefitted from the EU’s trade and regulatory clout in helping to open the UK’s economy to an even larger pool of specialised products, capital and labour from across the globe.

When assessing the degree to which the EU has, in practice, supported the global trading role to which the UK aspires, it is necessary to establish whether the overall balance of advantages and disadvantages is positive – especially in those areas that are of vital significance to business.
There are six areas of primary concern to business where the EU has an impact on the openness that underpins the UK’s global trading ambitions:

1. The role of the EU in giving UK firms access to European markets in goods and services
2. The role of the EU in driving investment and giving UK firms access to global capital
3. The role of the EU in allowing UK firms to draw employees from a global talent pool
4. The EU’s impact on the regulatory environment underpinning the Single Market
5. The direct budgetary costs of membership and the impact of funding on competitiveness
6. The role of the EU in giving UK firms access to global markets

Analysis in these areas – as well as a review of studies into the impact on overall UK GDP – shows that membership of the EU has been a material and lasting positive for British business in pursuing their global ambitions. It is not unreasonable to infer from a literature review that the net benefit arising from EU membership is somewhere in the region of 4–5% of UK GDP or £62bn to £78bn per year – roughly the economies of the North East and Northern Ireland taken together. This suggests that each UK citizen has benefitted from EU membership to the tune of around £1,225 every year for the last 40 years.94 This analysis is backed up by business opinion: 71% of CBI member businesses reported that the UK’s membership of the EU has had a positive overall impact on their business.95

3.1 Access to European markets for goods and services has been the biggest positive for the UK economy

Access to the EU’s Single Market in goods and services has been a major benefit for the UK economy, giving UK businesses access to the biggest Single Market in the world, allowing them to exploit the economies of scale that can drive wider competitiveness, and bringing them into complex pan-European supply chains that bring indirect benefit from sales and exports from European firms right across the EU and beyond. For CBI members, access to and participation in European markets has been the largest single benefit of EU membership for the UK, with 76% of firms of all sizes and sectors stating that the creation of the common market specifically had a positive impact on their business.96

The dismantling of tariffs and non-tariff barriers within the European Union has boosted European and UK trade

UK firms’ access to the European Union market is much more substantial than that covered by a standard free trade agreement and goes deeper than the UK’s access to any other international market. The EU has eliminated tariff barriers and customs procedures within its borders and, since the establishment of the Single Market, it has taken strides towards removing non-tariff barriers by enforcing EU-wide competition law and co-ordinating product regulations. This gives UK firms unparalleled access to a market with over 500 million people and a GDP of $16.6 trillion.97 Studies of the impact of the European Union and the Single Market on trade overwhelmingly agree that it has unleashed a large expansion of trade within its borders – beyond that which could have been achieved without co-ordinated action on non-tariff barriers. The EU still suffers from ‘border effects’ (the cumulative impacts of non-tariff barriers and differences in language and culture on trade) – trade between the states of the US is around 70% higher (as a percentage of GDP) than that between members of the EU15.98 But a recent study has shown that the EU has lower barriers – and therefore greater trade and supply-chain integration – than any other trading bloc in the world.99
The UK’s membership of the European Union and its predecessors has therefore helped create substantial trade flows between the UK and its European neighbours. The share of today’s EU27 in total UK goods trade was already rising before entry, from 23% in 1948 to 41% in 1972 but, after UK entry, this rocketed to 52% by the end of the 1970s, and peaked at 59% in the early 1990s. The rise of emerging markets has seen the EU’s share decline but, even so, the EU currently remains the UK’s most significant market by some distance: it was the destination for 45% of all exports in 2012 and half of goods exports specifically, and the establishment of the Single Market helped trade between the UK and the rest of the EU27 grow by 74% in real terms from 1997 until 2006, the year before the financial crisis began.

Undoubtedly, UK–EU trade would have grown even if the UK had not been a member. However, a number of studies have shown that Britain’s trade with other members of the Single Market was higher than it would have been if the UK had not been a member – up to 50% higher for some member states.

Exhibit 25: Access to European markets has significant benefits for UK firms

Adnams: has seen a rise in their sales across the EU in recent years as British beers have become more popular. For the Suffolk based brewery, Scandinavia is their largest market, accounting for 40% of sales.

Sage: for the UK’s largest software company, the free movement of employees across its European offices has been a big plus in their expansion of their existing software business around the EU and into new markets. Their SagePay operation provides online payment services to 50,000 predominantly small and medium sized businesses across Europe. Further work on completing the digital Single Market and establishing common e-payment regulations offers significant scope for further growth.

The trade boost to other EU states as a result of UK membership, particularly the accession countries of Eastern Europe, has an indirect benefit to the UK of increasing prosperity in key export markets for UK firms. This, in turn, can increase demand for UK goods and services.

A larger ‘domestic’ market helps drive competitiveness and economies of scale

One of the most significant benefits of openness to a larger market, and the trade that has come with that, is the economies of scale – and commensurate productivity improvements – that this has brought. Through the creation of an enlarged pan-European market for trade, the EU has been a key driver of UK competitiveness, both in Europe and when competing in the global marketplace.

As explained in Chapter 2, a key benefit of openness to a larger market is the potential for improvements in competitiveness and productivity. Greater competition from abroad drives innovation and forces costs down, and a large ‘domestic’ market allows competitive sectors to expand far beyond the limits of national economies to operate on a pan-European level.

The competition a large Single Market brings can be seen in the number of firms in a particular sector, and in the mark-ups being charged to consumers in that sector. A lower score on the Hirschman–Herfindahl Index (HHI) indicates that more firms participate in the market and thus it is more competitive: as the Single Market developed between 1997 and 2006, the median index was found to have declined 28% in the EU15 and 35% in the EU27 for motor vehicles and by 17% in the EU27 for pharmaceuticals. In a related vein, a study measuring firms’ average mark-up over costs found that the establishment of the Single Market had helped reduce mark-ups in manufacturing by 32% by the end of the 1990s – significantly benefitting both end-consumers and those businesses that use manufactured goods as inputs to their final products.

Although difficult to quantify, there is tentative evidence that the Single Market has had a positive impact on innovation too. Europe Economics found that research & development spending as a proportion of EU27 GDP rose from 1.8% to 2.0% from 1995 to 2009. While it is not clear that this increase can be attributed solely to the Single Market, and the level remains low compared to the United States and Japan, it should be noted that many of the countries that entered the EU in 2004 saw substantial increases in R&D spending, driving innovation and helping to boost EU competitiveness.
The Single Market underpins access to European supply chains

The UK’s membership of the Single Market has helped the UK take advantage of, and be part of, integrated pan-European supply chains, allowing domestic firms to source inputs from the most efficient sources possible as well as expand their own export numbers by selling into larger European supply chains. For UK companies either at the top or operating as part of supply chains, international co-operation is a vital part of their competitiveness, with final products today made up of intermediate parts from around the world. For many sectors – aerospace and automotive, for example – the opportunity that the EU Single Market has created to co-operate with partners in other countries through supply chains has been the foundation of global success (see Exhibit 26).

Exhibit 26: UK access to EU supply chains boosting trade around the world

Cheese Cellar: This SME sources cheeses, chocolate and charcuterie from around Europe, as well as using local produce, for exports to global markets such as the UAE, Hong Kong, Sri Lanka and the Caribbean.

Wright Group: Northern Ireland based Wright Group is the UK’s second largest bus manufacturer. The EU Single Market is an important source of key components including chassis and engines. Working with European partners is a key part of the company’s growth plan in high-growth markets such as Singapore, China and India who value the UK firm’s history of innovation in developing low-floor and hybrid busses.

The UK is already substantially integrated into European supply chains. According to world input–output data, in 2009 $207bn of the UK’s total of $293bn of exports to the rest of the EU27 was used as inputs to industries rather than being consumed directly. Britain’s world-class financial services industry was particularly important in this regard, accounting for $51bn of exported intermediates (58% of Britain’s total financial intermediate exports). Integration into European supply chains means that Britain imports from the EU not only to meet consumer demands but also to obtain intermediates for production in the UK. Imports are therefore every bit as important to UK competitiveness as exports, which means that even sectors that are not prolific exporters can be heavily exposed to EU trade. The UK imported $161bn of intermediates from the EU27 in 2009, the health & social sector being particularly prolific with imports of $19bn (principally of pharmaceuticals and other chemicals).

The importance of EU imports to UK export performance cannot be underestimated: a significant quantity of EU imports is embodied in UK exports, with OECD estimates suggesting that 8% of the value-added in UK exports in 2009 originated in other EU member states, compared to 3% from the United States (domestic value-added was 83% of the total). In the transport equipment sector, the proportion of EU value-added was as high as 16%.

The provisions of the Single Market help to underpin supply chains: if UK intermediates are to be combined with intermediates from elsewhere in the EU, it helps if EU goods comply with the same standards and regulations as the UK’s and can be moved easily across borders.
Historic successes present a solid platform for future opportunities

The historic benefits of access to the European market have been a significant net positive for UK business and have provided a strong platform for increased jobs and growth in the UK economy. The EU can continue to play the role of facilitator of access to the European market over the coming years and bring new opportunities for UK firms as it breaks down barriers that still exist to certain parts of the Single Market and updates how the Single Market is defined for the 21st century economy.

The two big areas for future opportunity are in developing a Single Market for services – a major economic strength of the UK – and in updating the Single Market for the digital age.

- Whereas intra-EU trade in goods amounts to a third of the size of the EU’s manufacturing sector, the corresponding figure for services is around 3%. For the UK, as a global leader in services exports, this undeveloped market has significant potential.

- Digitalisation is not just revolutionising the way firms do business, it is also a key lever which can be used to unlock broader economic benefits: a larger ‘online’ consumer base, job creation and retention, together with support for high-growth industries.

Progress towards a completed Single Market – including on digital and services – could add up to 14% to EU GDP after ten years with a 7.1% increase in UK GDP, according to a BIS study. Although the total elimination of all barriers is not feasible – cultural and language barriers will always remain, as an extreme example – these figures nonetheless point to the huge gains potentially available.

Overall, access to the EU market in goods and services has been a major benefit for the UK economy, expanding the potential market, allowing UK firms to become part of complex supply chains, and increasing trade. For CBI members, access to and participation in European markets has been the largest single benefit of EU membership for the UK.

3.2 Membership of the EU has given UK businesses access to the finance they need to grow

A thriving domestic economy trading globally and with Europe relies on the ability of companies to obtain affordable finance. Capital and financial services are needed to start a company, invest in necessary infrastructure and equipment, improve skills and research for further growth – or simply to keep the business going.

Membership of the EU has significantly helped in boosting access to capital for the UK’s economy. It has unlocked global and European direct investment into the UK, to help start up factories, build office space, stimulate R&D and support innovation in creative industries; provided new investment avenues for UK companies; and has given UK-based businesses – from small to FTSE 100 – access to a globally competitive financial market on their doorstep.

The UK’s access to the EU Single Market has attracted investment from around the world

Investment from around the world brings jobs to the UK and helps boost productivity to allow UK firms to compete on the global stage. The UK is the leading destination for EU FDI and an attractive global destination for investment – with the second-largest stock of FDI in the world – and it remained Europe’s top destination for FDI projects in 2012, securing a higher number of projects and larger market share than in 2011.

The UK has several strong domestic benefits that have enabled it to maintain its investment attractiveness. The CBI’s report Making the UK the best place to invest stressed the importance of the UK’s world-class universities, rule of law, flexible labour market and ease of doing business for inward investment. According to EY’s 2012 UK attractiveness survey, investors continue to highlight domestic factors, such as the level of demand in the UK for their products and the UK’s economic growth, as key factors underpinning investment decisions. Building on these domestic strengths, being part of the EU’s Single Market has helped increase the UK’s stock of FDI – both from European firms and non-EU global companies.
Exhibit 27: International businesses invest in the UK for access to the Single Market and its workforce

Fujitsu: For the Japanese firm, which employs almost 14,000 people in the UK & Ireland, the UK’s influence in Europe has been a vital tool in helping shape pan-European public and private-sector demand for the business services they provide. While there is still a great deal of progress to be made on the pan-European services market, the UK’s leadership in services is proving to be an increasingly powerful export tool globally into emerging markets.

EDF Energy: The Hinkley Point C project is a showcase of the value of the UK’s attractiveness to EU and third country investors. An important Anglo-French collaboration on nuclear energy, the project would be the first new nuclear power station in the UK for more than 20 years. Chinese investment in the project was announced in October 2013 and opens the door to further Chinese investment in the UK’s nuclear sector, offering the potential for the UK to play a leading role in the development of new nuclear capacity around the world. A stable investment framework for energy infrastructure projects will be an important factor in securing foreign investment, including for Hinkley Point.

Today, the UK receives a substantial share of intra-EU FDI: the EU accounted for 47% of the UK’s stock of inward FDI at the end of 2011, with investments worth over $1.2 trillion. The UK is the preferred destination for French investments, and European countries take up half of the top ten origins of UK investments. This investment from member states also provides a strong platform to attract further investment to the UK from non-EU international partners (see Exhibit 27).

This UK performance reflects a wider increase in intra-EU investment in most member states, driven by EU integration that created better conditions for investment between EU member states: intra-EU investment accounted for 30% of all FDI involving EU countries from 1985 to 1988, but it rose to 62% over the next five years, during the period of implementation of the Single Market. Regional integration increases FDI flows in two major ways. It can boost ‘vertical’ FDI as companies can benefit from locating different parts of the production process in different member states to maximise efficiency. Secondly, if integration succeeds, firms outside the region are likely to be attracted by more competitive production conditions, particularly if the market size is large. Economic literature suggests that market size is the strongest driver of FDI as third-country investors will have greater incentives to invest if investment provides access to a much larger market. This integration has not only ensured that the UK has benefitted from inward investment, it has also allowed UK firms to take advantage of the investment opportunities throughout the EU – raising supply-chain efficiency and increasing profits that return to the UK to be re-invested in jobs and research & development.

Exhibit 28: The EU has allowed UK firms to take advantage of investment opportunities throughout Europe

Vodafone: The company has expanded significantly beyond its UK origins. Its local UK operating business now generates less than 3% of the Group’s adjusted operating profits. As a pan-European business (which also has a significant emerging markets presence), Vodafone has benefited in the past from EU policies to establish Europe-wide mobile standards. Complementing its £1 billion acquisition of Cable and Wireless Worldwide in the UK in 2012, Vodafone recently announced the €7.7 billion purchase of the Kabel Deutschland cable business in Germany to boost its presence in that market. The majority of Vodafone’s shareholders are resident in the UK and include many of the pension and savings funds relied upon by millions of UK citizens. Vodafone employs more than 8,000 people in the UK and is a source of indirect employment to tens of thousands more.
Since 1992 and the creation of the Single Market, inward FDI flows to the EU from around the world have doubled and they currently represent 2% of the EU’s GDP. The UK’s membership of the EU – and the access to the Single Market that this brings – has also seen an increase in the UK’s openness and attractiveness to investment from around the world. Furthermore, an econometric study from the National Institute of Economic and Social Research (NIESR) found that the level of FDI from US manufacturing multinationals in the 1990s was significantly higher than it would have been if the countries analysed – including the UK – had not been members, even after controlling for GDP, growth, factor prices and unit labour costs.115

Today, the UK’s access to an integrated Single Market – providing a ‘gateway to Europe’ – remains a significant positive factor in attracting investment flows from across the globe. According to EY’s 2012 UK attractiveness survey, ‘gateway factors’ are among the top factors influencing decisions to invest in the UK, with the ability to use the UK as a base for export the second most cited factor (see Exhibit 29).

In some cases it is the combination of EU membership and strong domestic factors that brings companies to the UK. For instance, the UK’s place as a large English-speaking EU member makes it particularly attractive to overseas businesses looking to enter the European market but struggling with the barrier of working in multiple languages, as highlighted in the CBI’s report Making the UK the best place to invest. For a number of key sectors and companies, however, investment is particularly contingent on unconstrained access to the EU’s Single Market, as highlighted in the sections on the automotive industry and financial services sector later in this chapter. These are also amongst the sectors in the UK that receive the most inward investment (see Exhibit 31).

Exhibit 30: Japan, a major investor in the UK, values the UK’s EU membership

The UK is the preferred European destination for Japanese investments, and its government highlighted the UK’s membership of the EU as a major reason for why Japanese companies choose to invest in the UK in their response to the UK government Balance of Competences Review. The evidence from international investors submitted to the UK government’s Balance of Competences Review in 2013 also demonstrates the importance of access to the EU Single Market for foreign investors (see Exhibit 30).

Exhibit 29: Although not the only factor, being a ‘gateway’ to the EU is critical to the UK’s attractiveness as a place to invest

After domestic demand, the ability to use the UK as a base for export is the second-most cited factor influencing investment in the UK.

Top factors influencing investment in the UK (%)

- Level of UK demand for your products
- Ability to use the UK as a base to export to other markets
- UK economic growth prospects
- Existence of UK clusters of expertise relevant to your business
- Existance reciprocal trade between the UK and countries in which you operate
- History of your UK investment
- UK ability to support research and innovation
- UK track record as a destination for investment
- UK demographics profile

Source: EY’s 2012 UK attractiveness survey: Staying ahead of the game
The EU has cemented the UK’s position as the world’s leading financial centre, securing access to financial markets for UK businesses

Through a large market and common regulation, the EU has helped the UK develop a substantial domestic financial services sector. The strength of the UK’s financial services industry also supports a much wider nexus of business and professional services such as accountancy, auditing and legal services: while financial services contributed 8% of UK GVA in 2012, these business and professional services contributed a further 6%.117

In addition to providing value to the economy on its own, this has helped improve the availability of capital for UK companies as they benefit from access to a globally competitive financial market at its doorstep, secured by the UK’s EU membership. Providing ‘invisible infrastructure’ to the UK economy, the financial services sector helps UK firms finance domestic and overseas expansion not only through bank finance but also through bonds, equity-backed securities and other forms of corporate finance (see Exhibit 32). For example, many companies looking to export high-value manufactured goods benefit from having a financial centre in the UK that can help raise money for investment as well as hedge against currency risk all in one place.

Exhibit 31: Inward FDI is important to a broad range of UK industries, not just those directly involved in exporting

Exhibit 32: The UK’s financial centre helps SMEs and MSBs achieve their growth opportunities

As set out in the CBI’s report Future Champions, MSBs could be worth an additional £20bn to the UK economy by 2020, but only if they can access the finance they need to grow. Although there is still potential for improvement, the UK financial services sector has created initiatives to help boost affordable capital for small and medium-sized businesses beyond traditional bank lending:

Public equity markets for SMEs: The main public equity market in the UK and Europe for high-growth businesses is the Alternative Investment Market (AIM), operated by the London Stock Exchange. AIM offers smaller growing companies a public market with access to both retail and leading institutional investors within a regulatory environment designed specifically to meet their needs. Since its launch in 1995, more than 3,000 companies from across the globe have chosen to join AIM, collectively raising over £80.6bn (including £44.6bn in further issues).

Retail bond markets: In 2010, the London Stock Exchange launched a platform for retail bonds (Order book for Retail Bonds (ORB)) which are bought by individual investors rather than major institutional investors. Investors in retail bonds can buy or sell a bond at any time through the ORB and check its price on the London Stock Exchange like a share. Issues on ORB have ranged from £25m to £300m, with most bonds issued between £50m and £75m, and businesses have so far raised around £3.2bn.
The free movement of labour allows businesses to employ people with the skills they need from across the Continent.

3.3 Labour mobility in the EU brings benefits for British business, but being open may mean being tougher

As set out in Chapter 2, labour mobility is an important component of the openness that drives productivity improvements. As one of the basic freedoms of the EU Single Market, the free movement of labour allows businesses to employ people with the skills they need from across the Continent. It facilitates service exports where personnel need to physically be present to provide a service and has also allowed many UK citizens to take up opportunities to work and live abroad. In total, 13.6 million EU citizens (2.7% of the EU’s population) now live in other member states and there are 2.4 million citizens of other EU countries living in the UK, making up 3.7% of the total population.118 In 2012, 5.2% of employed people in Britain were born in other EU member states – a little over one-third of all those who were born overseas.119 At least 750,000 UK nationals live in other EU countries.120

However, free movement for labour is perhaps the most controversial of the EU’s four freedoms. While the UK economy has benefitted from the creation of an EU-wide market for talent, and indeed from immigration more widely, the level of migration to the UK was greater than expected from the more recent accession countries: the number of people born in the A8 countries working in the UK increased from 0.4 million in 2004 to 0.7 million in 2012.122 Taken together with immigration from countries outside the EU, this has created some local social pressures. British business wants to protect the advantages that derive from free movement of people and therefore understands the political need to address any costs, both perceived and real, to wider society.

The EU’s free movement of people has had a number of benefits to the UK economy

There is significant evidence that, rather than taking a slice of the economic pie away from the existing population, immigrants add to the productive potential and level of demand in an economy, thus raising long-term GDP. For example, a NIESR study found that immigration from the EU accession states over 2004 to 2009 added 0.84% to the UK’s long-term GDP.123 At a business level, the EU facilitates the free movement of labour across 28 European countries, which helps companies match labour supply to demand for the skills they need: indeed, 63% of CBI members stated that the free movement of labour within the EU had been beneficial to their businesses, with only 1% saying that it had had a negative impact.124 And this is not only for bigger businesses. For SMEs, free movement of labour is undoubtedly an important benefit of EU membership: 69% of CBI members with 250–499 employees and 55% of those with 50–249 employees said that it had had a positive impact. Large-scale labour and skills shortages can now be addressed across the EU through migration in a way that was previously confined to population movements within individual states. For example, access to skilled labour from within the EU is a key factor in the ability of Alderley Systems – a Gloucestershire-based company employing 150 people locally that makes metering and water treatment systems for the international oil and gas industry – to achieve the tight deliveries required by its international clients. Without the facility to enhance skilled staff teams at short notice it could not function as a business, with Eastern EU countries so far proving the best source of tradesmen with the necessary skills. A secondary major benefit of free movement of labour is the ability of UK firms to easily recruit employees with specialised skill sets from across the EU, which is increasingly important given the UK’s high-value-added industries. In highly productive sectors, such as financial services, this has created a pool of talented staff from around the EU that firms can employ in the UK. It also allows UK specialists to be deployed internationally more easily. In over 45% of cases where the UK was chosen as an FDI location by financial services firms, access to skilled staff, including EU nationals, was cited as one of the core reasons for choosing the UK.125
As a related point, free movement for labour has facilitated cross border staff mobility for pan-European companies, enabling companies to flex their EU staffing resources accordingly. For example Kingfisher PLC, Europe’s largest home improvement retailer, has a pan-European senior management team which operated as one team across its six EU markets. In practical terms, this means staff move around the business, bringing their skills to different EU operating companies and benefitting from the experience of working in different operating companies.

Similarly, for UK providers of highly specialised services, free movement of labour has helped create pan-European markets. Firms rely on the ability to send staff to other countries to provide their services. Barriers such as onerous visa and work-permit requirements would limit the ability of these firms to function across the EU. For example, cyber-security has created a growing demand for specialised staff to deal with a problem that costs UK companies an estimated £27 billion annually; the free movement of labour provided by the EU enables companies such as Thales to deploy staff across the EU at short notice and have access to a wider pool of expertise to provide a niche service, the demand for which is hard to predict and often requires rapid deployment. Equally, UK academic institutions and industries reliant on tourism benefit from free movement across the EU and the absence of visa requirements for students and visitors.

These benefits to business and the economy should be considered in light of the impact they have on jobs and wages. As is the case with all immigration flows into Britain in recent years (see Chapter 2), there is in fact little quantifiable evidence that migrants from the A8 countries have had any large impact on the employment or wages of UK-born citizens. A8 migrants are thought to have boosted GDP, as the increase in numbers adds to the level of production in the economy, but the immediate impact on GDP per capita seems to be broadly zero. Over the long term, however, the fact that migrants to the UK are generally of working age could have beneficial consequences for Britain’s dependency ratio, and consequently for growth per head.

While immigration generally has benefitted the UK, it has led to perceived social pressures which business cannot ignore. The significant increase in net immigration following EU enlargement has led to perceptions of a strain being put on some services in localised areas of the UK. Some believe that rapid immigration has put pressure on social infrastructure. Although there is strong evidence that immigration has an overall net positive fiscal impact, localised pressures and delays in redeploying resources can occur. A Home Office report has documented some of these pressures, although non-economic migrants such as asylum seekers were found to place a greater burden on infrastructure than economic migrants who account for the vast majority of movement within the EU. This has been especially concentrated in some local areas and has given rise to legitimate concerns about the ability of some areas to absorb and integrate a population influx.

Also, and despite the evidence above, a rapid rise in immigration has created the impression of an unacceptable call being made on UK welfare systems by people who have not contributed to those systems. While these are primarily social (rather than business) issues, much of the debate around the UK’s relationship with the European Union is dominated by the issue of migration.
Being open may mean being tougher, but making the case for both is vital

The principle of free movement of labour that underpins much of the immigration seen from EU member states was established at a time when the European Community consisted of countries of predominantly similar economic development. This, coupled with the small number of countries involved, allowed immigration to occur without large fluctuations in numbers and speed of immigration, enabling social security systems to adapt more easily to any pressures when they occurred.

Although the principle of free movement of labour is still wholeheartedly supported by the business community for the reasons outlined above, consideration should be given to reforms that address, for example, unbalanced entitlements to welfare. This must be done in a way that allows the principle of free movement to remain, but operate in a way that works practically for member states in the now enlarged and more economically diverse EU.

Similarly, part of the answer to making the case for free movement of labour involves employers working with government to improve skill levels in the UK workforce, to ensure that UK workers have the skills to compete with European workers who take advantage of the right to free movement.

If the UK is to have a global trading role, it must maximise labour mobility as a component of boosting productivity, regardless of the status of the UK’s membership of the EU. Business therefore needs to recognise the strength of public feeling on immigration since this could undermine public support for having an open economy and, as a consequence, the UK’s global trade ambitions more generally.

It is only by taking account of the concerns of the wider public that labour mobility across the EU, and the significant economic advantages that go with it, will be maintained.

3.4 Common rules are needed, but the UK’s lack of unilateral control over regulations is seen as the biggest downside to EU membership

A Single Market needs commonly agreed rules. This allows firms full access to the market on equal terms, and ensures they are able to fully exploit the economies of scale that a large market can bring. In this respect, the drive by the EU to harmonise regulations, standards and processes across the Single Market has had significant benefits for businesses. As outlined above, cross-border trade in goods and services, investment flows and labour movements in the EU have grown significantly and, for many companies, the move into exporting or international operation is made easier by the EU’s harmonised policies on many key areas of business regulation.

As a result, product standards, labour regulations and common business practices are subject to regulation at an EU level in many areas. Removing these non-tariff barriers between member states is one of the most important differences between a Single Market and a customs union. For UK firms operating in the EU market, the UK’s ability to influence these rules has had a significant impact on their ability to compete.

Despite frustrations with a number of specific pieces of legislation, the majority of CBI members continue to believe that the benefits of EU membership through enhanced market access and competitiveness outweigh the costs of regulation. 71% of CBI member companies reported that, on balance, the UK’s membership of the EU has had a positive impact on their business – with over half (52%) saying that they had directly benefitted from the introduction of common standards. Only 15% suggested this had had a negative impact.128

However, while the EU has less extensive influence over UK law than is often stated (see Exhibit 33) and the UK is influential in shaping EU law itself (as will be explored in Chapter 4), the impact of poorly thought-out EU legislation is a major issue for businesses. In a survey of CBI members, 52% of businesses said that they believed the overall burden of regulation on their business would fall if the UK were to leave the EU.129 There is clearly a significant problem that needs to be addressed to ensure that the benefits of the Single Market are not diluted or even outweighed by the negatives of unnecessarily costly or bureaucratic regulation.
The regulation that transposes EU rules into UK law makes up a significant, but often overstated, percentage of UK legislation. While figures as high as 70% are regularly mentioned by politicians and media commentators, the evidence suggests that the figure is much lower. According to the House of Commons Library, between 1997 and 2009 6.8% of UK primary legislation (Statutes) and 14.1% of secondary legislation (Statutory Instruments) had a role in implementing EU obligations, ranging from passing reference to explicit implementation.

A single set of rules can help business if it is well designed

As discussed earlier, having a single set of rules deepens market access and supports integration and economies of scale. Common frameworks of regulations and standards for automobiles, pharmaceuticals and electronic equipment have created economies of scale for manufacturers by reducing compliance costs and expanding the size of the market (see Exhibit 34). Such common standards can also lower administrative costs by reducing the burden of compliance with multiple sets of rules and requirements when trading across borders or when servicing the needs of EU customers. Moreover, common regulations create a level playing field for all businesses to boost fair competition in the market by outlawing compromises on levels of safety and environmental regulations.

Baxter Healthcare: For the US based manufacturer of medical devices and pharmaceuticals, the attractiveness of the UK as a place to invest was significantly increased by the development of the Single Market. Their plant at Thetford in Norfolk manufactures a range of healthcare products, employing over 400 people, and has recently completed a £20 million investment programme. The creation of the Single Market enables Baxter to supply products from this site across the whole EU based on harmonised regulatory procedures.

Portakabin: The UK’s early adoption of new technology and approaches has enabled York-based Portakabin to expand into Europe, aided by the development of standardised regulations and product safety standards that allow the firm to exploit economies of scale to sell to 28 markets with one product. However, further alignment of pan-European regulations is needed to ensure a more level playing field. Strong growth in demand for its products across the EU and a recent major acquisition in Germany have helped establish Portakabin as Europe’s second-largest manufacturer of portable and modular buildings.

Common EU regulations and the co-ordination they bring between domestic regulators in EU member states also help tackle cross-border challenges more effectively. For example, UK advocacy at an EU level on climate change has led to action to introduce emissions targets, a challenge that simply cannot be addressed on a unilateral basis at national level.
Emissions trading is the most effective way to reduce emissions and stimulate low-carbon investment in Europe, and it should remain the cornerstone of an EU energy and climate change policy that can help overcome challenges through joint endeavour. However, while technically operating effectively, the current EU Emissions Trading System (ETS) is not delivering on its potential, meaning that European economies are missing out on vital investment. If not reformed effectively, Europe risks fragmentation towards 28 different national systems for reducing emissions and stimulating investment, undermining the level playing field the EU ETS provides across the EU and creating huge complexities for businesses operating across the different member states. The EU must act swiftly to reform the EU ETS to ensure that the system works for all businesses, with competitiveness concerns placed at the heart of reforms, so that all EU member states can feel the benefits of cross-border co-operation through a policy that supports a dynamic, low-carbon Europe.

Furthermore, the development of EU-level rules that support the world’s largest Single Market can also bring global opportunities. First, the adoption of regulations at EU level has led to their international adoption and thus created benefits for EU firms who are then able to compete on the global stage without additional compliance costs and with the assurance of fair competition with international competitors. A prominent example of this has been the adoption or adaptation of the EURO emission standards for goods vehicles in countries as diverse as Australia, Russia, Thailand, China and India.138

Secondly, the adoption of voluntary standards has a major effect in opening markets and preventing non-tariff barriers to trade. Basing national technical regulations on international standards, in line with the WTO TBT Agreement, means that products can be placed on the market across the globe without additional requirements needing to be met. In many sectors, such as medical devices and the electrotechnical sector, standards are global, with international standards being adopted in Europe.

Finally, and importantly given the development and predominance of regional blocs in global trade matters discussed in Chapter 2, the EU has been able to use its clout to keep regulatory divergence between blocs to a minimum. In the absence of true global requirements in a number of industries, this has allowed UK firms to continue to be able to trade around the world without significant alternation in conditions between jurisdictions. The most striking example of this has been in financial services, where the development of EU financial services legislation over the past 20 years has broadly kept the EU and US regimes in line (in large part due to UK influence, as is discussed in Chapter 4), allowing the UK’s financial services sector to act as a crossroads between regimes and attract business from both sides of the Atlantic.

ARCO Limited: The Hull-based distributor of personal protective equipment has benefitted from the increasing adoption of EU standards around the world, allowing them to develop a significant export business. With sales in over 100 countries worldwide, the company opened its first Chinese office in 2005 and also distributes in a range of Middle Eastern and African markets.

BSI: The UK’s National Standards Body coordinates the European position on the role of standards in the US-EU trade negotiations, and is leading the work at European level on the use of standards to stimulate transformation in the services sector. In addition, BSI is negotiating with its counterpart in China to establish a new system which will enable British Standards to be more widely accepted in China.

Fane Valley: This farmers’ co-operative based in Armagh City, Northern Ireland, now exports 85% of its output of meat and dairy products. While the majority of its products go to the EU, export opportunities in Africa, China and South America are growing, with the strength of EU standards playing a major role in establishing the credibility of the brand with consumers in those markets.
While there are certainly costs to EU regulation, the net costs are often over-estimated.

The frameworks of regulations and standards that help create a pan-European market has also had significant consumer benefits. Some of these have come from direct pan-EU regulation intended to bring consumer benefits – such as recent moves to bring down mobile phone roaming charges and the use of standards defining voluntary agreements on common mobile phone chargers – or as a result of the extensive consumer benefits that come from increased competition – for example, the pan-European open skies agreement has led to a sharp decline in the cost of air fares across the EU and a significant increase in the number of options for customers.

Assessment of the gross cost of EU regulation alone does not show the whole picture – looking at the impact on business in the round is important.

Figures on the cost to the British economy of EU regulation differ significantly. One analysis of the issue suggests that, since 1998, the total gross cost to UK business of implementing the 2,000 pieces of business regulation has been as much as £176 billion, with £124 billion of this related directly or indirectly to the implementation of EU policies.132

However, while there are certainly costs to EU regulation, the net costs of regulation are often over-estimated, with many analyses, including the one above, failing to factor in the potential benefits of harmonised regulation and the market access it facilitates. Simply adding up costs taken from impact assessments – without netting out those costs between sectors, employers and consumers and without factoring in any benefits – is a misleading way of assessing the overall regulatory impact.

Moreover, when assessing the impact of EU regulation on UK business, it is important to take account of the counterfactual; that is to say, whether it is likely that domestic regulation would be required if EU regulation ceased to apply, either to maintain desired standards in the home market or to fulfil the UK’s international obligations.

In many cases, the UK would be likely to regulate domestically in the absence of EU rules to maintain standards to which UK consumers and workers had been accustomed. For example, a large proportion of the £2.6 billion per year gross cost to UK business of the Working Time Directive is the result of employees being entitled to paid annual leave.133 The Directive requires that workers are given at least 20 days paid annual leave, but the UK’s regulations that transpose the Directive go further, requiring at least 28 days. With little domestic debate over reducing paid leave entitlements, a large proportion of this cost would remain if working time rules were set domestically rather than in Brussels. As another example, even if the UK could choose to repeal the REACH Directive, it would still require businesses to comply with some rules for the safe use and disposal of chemicals. Moreover, as discussed in more detail in Chapter 6, were the UK outside the EU, British businesses seeking access to EU markets would still have to comply with most regulations – including controversial examples like REACH – over and above any alternative domestic regulation in order to meet the criteria for selling into the EU market.

This counterfactual analysis applies equally to the UK’s obligations as part of the various international institutions of which it is a member. Some of these institutions are outside the EU but often confused for EU institutions. A notable example is the European Court of Human Rights in Strasbourg, a body which has previously caused controversy in the UK with its rulings on the UK’s blanket ban on allowing British prisoners to vote.

However, the real focus of this international element of the counterfactual concerns those regulations in areas where the UK has global ambitions and so benefits from global standard setting. Whether through signing up to the WTO’s GPA rules on public procurement (currently implemented via EU Public Procurement Directives) or fulfilling its G20 obligations to follow the Basel III regulatory standards on capital adequacy in the UK banking sector (currently implemented via the EU’s Capital Requirements Directive IV), the UK would be likely to introduce UK regulation even if it ceased to be bound by EU regulation so that it could continue to push the global regulatory standards that benefit its businesses by allowing them to compete fairly with international competitors.

Any assessment of the burden of regulation and the extent to which the original legislation needs to be altered to reduce this burden needs to take account of the implementation element of regulation: much EU regulation, although it originates in Brussels, is implemented and calibrated in the UK. Indeed, for CBI members, the number one priority for ‘reform of the EU’ was addressing the poor implementation of EU rules in the UK. While different legal frameworks across member states do pose challenges for legislating at EU level – for
example, directives written for a civil law system may require a greater level of detail when translated into UK common law, where the letter of the law seeks to ensure compliance – but this must not be used as an excuse for poor or expansionist UK implementation. While the UK government’s ‘Red-Tape Challenge’ has had a positive impact, ‘gold-plating’ of EU directives is still perceived as a problem in the UK at both a central and local government level. One example of the scale of the problem can be seen in the UK’s record on government procurement. A report in 2010 found that public procurement using the EU procurement directives in the UK took 50% longer and cost 50% more than the EU average. Only Greece and Malta had slower systems and the UK was home to the most expensive procurement processes in the EU.\(^\text{134}\) The UK’s TUPE regulations, which implement the EU Acquired Rights Directive, are another example of ‘gold-plating’. Welcome changes are planned for 2014 to make it easier to manage workforce transitions and the government has committed to making the case for greater flexibility in the EU Directive. While these are welcome steps, it will still be too difficult legally for firms to fairly harmonise terms and conditions by comparison with elsewhere, highlighting the fact that the UK government must do more to stand up for the UK’s interests when implementing EU rules. Finally, it is worth considering the overall impact EU regulation has had on the UK economy and assessing the extent to which this has really been a drag on the UK’s global competitiveness. Despite some unwelcome regulation that British business would prefer to be repealed, the fact remains that the UK appears to be lightly regulated in comparison with other EU states and international developed competitors, including in those areas where the EU has competence to legislate. The World Economic Forum recently ranked the UK as the 10th most competitive economy in the world.\(^\text{135}\) As Exhibit 37 shows, the UK’s capital, labour and product markets are among the most liberal in the developed world, which calls into question whether the EU is actually placing an insurmountable barrier to global competitiveness through the regulation agreed at European level.

While CBI members of all sizes and across all sectors of the economy are clear that the benefits of EU membership outweigh the costs of regulation, there are undoubtedly problems caused by poor EU regulation and its domestic implementation. In an ideal world, business would seek national control over employment legislation and some other social policies – and, even if control remains at EU level, business is keen to see reform to the approach taken to regulation. However, given that EU markets remain competitive despite this regulation, they conclude that it is not worth losing the wider benefits of the EU simply to regain control of those competences.
But poor and unnecessary regulation is a significant frustration for business

Nevertheless, there remains a significant problem with poorly thought-out regulation that stifles business while failing to deliver the hoped-for results. There is also a sense that the Commission constantly seeks to accrete power in a form of ‘mission creep’. EU attempts to bring in regulations detailing the allowed size and shape of bananas or bans on olive oil containers are often highlighted as examples – some real, some exaggerated – of meddling EU regulation that is nothing but detrimental to business and the UK way of life. They undoubtedly raise issues of proportionality and subsidiarity, but business is more concerned with those EU regulations that affect the ability of UK firms to create jobs and growth.

For CBI members, the biggest complaints centre on the rising cost of compliance and the increasing cumulative burden of regulation. Regulatory approaches that take a uniform approach to a diverse set of national systems have created problems. CBI members are particularly frustrated by EU attempts to apply a one-size-fits-all approach across the diverse range of labour markets and industrial relations systems in EU member states – 49% stated that the introduction of common labour market rules had had a negative impact, with particularly strong views expressed by mid-sized businesses.136 This is a trend that has been exacerbated by the increasingly expansive judgements of the EU courts, which have taken an approach of maximising the effect of directives. This is something that businesses want to see tackled as part of any reform.

With each national labour market facing its own unique challenges, EU-wide solutions to problems in some but not all member states can have unintended consequences for the other member states. The Temporary Agency Work Directive is a prime example of this situation. It was introduced to remove the unreasonable restrictions on the use of temporary workers that existed in some countries and to ensure equal treatment for temporary workers in others. But the impact in the UK – where workers were already paid 92% of the level for all comparable employees137 and where there were no unreasonable restrictions to remove – has been an additional cost to employers of £1.9 billion per year.138 These costs arise primarily from having to apply new onerous compliance processes, without the large benefits for businesses or workers experienced from liberalisation in other countries. The CBI did not oppose the idea of a Directive in principle, if it was well-targeted, but this did not turn out to be the case.

The Working Time Directive is also frequently cited as a particular frustration for businesses. The priority of firms when regulating working hours is that they retain a degree of flexibility to be able to manage their workforce effectively. The freedom for individuals to opt out of the cap on weekly working hours is a vital source of this flexibility. In addition, it is also very popular with employees who want to determine how many hours they work to suit their lifestyle choices, for example often wanting to work overtime to increase their earnings or to work longer hours while overseas in order to complete a job quicker and return home to their families earlier. Despite its importance to businesses, the Directive being valued by many workers and the fact that the majority of member states use it, the consistent drive from Brussels to challenge it is creating disruptive uncertainty for UK and other EU businesses.

Beyond labour market regulation, there are further concerns for the UK’s more globally focussed sectors that centre on cases where EU standards are out of step with global regulatory trends. The implications for UK companies operating internationally can be minor and entail only small costs to duplicate compliance standards. However, in sectors where EU regulations are significantly stricter than those in other markets, this can be a major source of cost for businesses, reducing their global competitiveness. For example, proposed EU data protection regulation threatens to diverge from other international approaches and hinder the ability of UK and EU companies to compete in the global digital marketplace. This is a major concern for British business, and threatens to hinder their attempts to break new markets and sell around the world.

The EU needs to make sure that all regulation reviewed or put forward will support Europe and the UK’s growth. Rules must therefore be made to work in a global context and for businesses of all sizes, and they must be adequately assessed and evaluated to ensure that they are delivering against their objectives.

"EU regulation that is out of step with global regulatory trends hinders the ability of UK and EU companies to compete in the global market place."
3.5 There are direct budgetary costs to EU membership, but the net costs are less extensive than often reported

As one of the largest economies in the EU, the UK has historically been one of the largest contributors to the EU budget in absolute terms with a gross contribution of €17.4 billion in 2011. The UK receives most of that money back through the ‘rebate’ and the EU’s major funding programmes – research funding, agriculture and regional aid – leaving a net cost of €7.3 billion or 0.4% of GDP. As a comparison, this is around a quarter of what the government spends on the department of Business, Innovation and Skills, and less than an eighth of the UK’s defence spend. It is the equivalent of around £116 per person, the sixth-highest per capita level behind Sweden, Denmark, Finland, Germany and the Netherlands.139

In many of the UK’s most competitive sectors, EU funding has been a major driver of innovation right across the UK. By being part of the EU, the UK is able to shape research priorities in aerospace, automotive, pharmaceuticals and chemicals that directly benefit UK firms and also create more innovative supply chains around Europe with which UK firms can partner. 49% of CBI members stated that access to EU funding streams had had a positive impact their business.140 As an example, EU funding for work on 14 public-sector projects in the UK allowed The Agency, a provider of advertising, marketing and technology services based in Bath, to develop first-in-class case studies which helped them win work in the US and the Middle East. The EU has also helped the Southwest National Composites Centre become a world leader in advanced materials with a significant funding contribution of £9m.

In addition to funding innovation, EU programmes have been a major driver of regional development. This development funding has helped finance a number of regeneration programmes across the UK, particularly in deprived parts of England and the devolved nations. In England alone, European Regional Development Fund investments have helped over 12,000 businesses to start or expand, creating over 40,000 jobs.143

Nevertheless, the UK remains a net contributor, and the priorities the EU sets and the processes for delivering these desired outcomes limit the overall benefit the UK obtains from EU funds.

A recurring theme with EU funding is that the priorities set do not correspond with spending that the UK would choose to make if it decided independently where funds should be allocated, especially frustrating given the bureaucracy involved in handing over money to the EU only for it to be returned to member states minus an administration fee via EU funds.

These issues have led some to argue that the UK could do better if it funded its own research, regional and agriculture programmes. Given that the UK is a net contributor, there is a clear logic that the UK could more than pay for such programmes from its own resources if funds were not being directed to the EU budget.
For example, while it should be noted that the size of the UK’s net contribution to the Common Agricultural Policy (CAP) was a significant factor in securing the UK’s annual rebate of £3.6 billion, the UK is a significant overall contributor to the scheme. In the current budget period, the UK contributed €33.7 billion while payments to UK farmers totalled £26.6 billion, making the UK the fourth-largest net contributor to the CAP at £7.1 billion. Although some argue that participating in the subsidising of agriculture on a pan-European basis rather than through a national subsidy scheme is effectively a prerequisite to exporting to the European food market, the UK could, in theory, fund a more generous scheme of support to its farmers outside the EU.

There are also distinct drawbacks to the UK’s participation in other EU funding schemes. Securing EU funding is often a complex, bureaucratic process, and the monitoring systems of the EU greatly restrict the purposes for which EU funding can be used, reducing the flexibility of national authorities. Furthermore, although the complex nature of the funding systems themselves makes it difficult to account fully for expenditure, there is clearly a lack of transparency in the EU’s accounts, with the most pressing concern being the failure of the Court of Auditors to fully approve the EU’s accounts for the past 18 years.

There are wider benefits of pan-European approaches to funding for the UK and European economies

Despite the complex nature of some EU funding streams and the overall net cost to the UK, there are nevertheless a number of wider benefits to the UK from participating in pan-European funding structures, especially given that the net cost is low.

First, the pan-European nature of research funding has benefits that could not be replicated nationally. An EU structure has helped UK companies and universities produce innovative technologies by facilitating collaboration across borders with a range of academic and commercial partners. The whole is greater than the sum of the parts. Secondly, the benefits to the UK of EU regional funding go beyond a simple measurement of direct costs and benefits in monetary terms to the UK itself. Just as specific EU programmes like broadband funding have benefitted specific sectors of the UK economy, EU programmes have contributed to significant economic development in the accession countries through infrastructure investment and regional funding. In turn, this is creating stronger markets for UK products in those other EU countries. For example, the EU’s recent funding drive to boost broadband capacity and uptake in Central and Eastern Europe has played a role in creating a new market for internet shopping in the region. Tesco has recently launched online shopping services in Hungary, Slovakia, Poland and the Czech Republic, highlighting one of the indirect benefits that EU funding can bring for UK businesses.

Some have argued that regional funding for wealthier EU countries could be removed from the EU budget and restored to member states. Although this would potentially reduce the domestic bureaucracy associated with those schemes and restore national flexibility in countries like the UK, it would still mean a net contribution by wealthier countries to fund regional development in poorer member states. It is in the UK’s national interest to help fund the development of less wealthy member states, not least because this helps provide increased demand from those member states for UK goods and services.

There is a net budgetary cost to the UK in terms of the EU membership fee but – at only £116 per person each year – this is more than justified by the wider net benefits.
Our Global Future: the business vision for a reformed EU

Exhibit 38: UK business benefiting from EU FTAs

Herbert Smith Freehills: The signing of the EU–South Korea FTA in 2011 has made it easier for UK companies to operate in the country’s highly regulated services sector, allowing law firm Herbert Smith Freehills to open a new office in Seoul in early 2013.

Bombardier Transportation: The firm’s Derby factory delivered 15 trains to run on the Gautrain commuter network between Pretoria and Johannesburg following a contract facilitated by the EU–South Africa FTA.

3.6 The EU has helped open global markets to UK firms on terms that support their ambitions

The net benefits to British business of EU membership are further strengthened when one considers how the EU has also helped British businesses access a range of international markets beyond Europe. Adopting an outward-looking approach that builds links to these markets is a central part of fulfilling the UK’s global ambitions.

The EU’s status as one of the world’s largest trading blocs has allowed it to play a leading role in global trade discussions as well as sign numerous bilateral Free Trade Agreements (FTAs), helping UK businesses to import and export more profitably to non-EU markets. Although the value of the EU’s clout in trade negotiations is partially offset by the cumbersome nature of negotiating as part of a bloc of 28 countries rather than as a single nation, it is unlikely that the UK could have secured more far-reaching deals outside the EU, and even more unlikely that the UK would be able to do this while maintaining its current level of market access to the EU.

The negotiating clout of the EU has helped set the terms for global trade

The sheer weight of the EU – its economy accounted for 23% of the global total in dollar terms in 2012 – has driven forward negotiations at the GATT and, later, the WTO that have reduced worldwide barriers to trade in goods and services. This has helped create a rulebook for global trade backed up by robust enforcement mechanisms.

Over the last decade, the UK has benefitted from the EU’s influence in pushing a pro-free trade agenda at the WTO, including through pursuing options to reopen the Doha Round of WTO trade negotiations. It also plays a vital role in defending industry on those occasions when UK and other European business interests are negatively affected by non-WTO-compliant trading practices by third countries.

However, in the wake of slow progress at the WTO in recent years, the EU has directed its negotiating power to advance the negotiation of bilateral FTAs, a move that has been strongly welcomed by the CBI. As a result, the EU is currently a signatory to 30 FTAs with over 50 partners including key high-growth markets like South Korea, Mexico, Chile and South Africa. Including the EU itself, British firms have thereby gained full access to a $24tn market. If FTA negotiations with Canada, Japan and the US are successfully completed and fully implemented, the total market open to UK exports would nearly double to $47tn – and an EU-US deal would help set the benchmark terms for future global trade deals.

However, it is not simply the quantity of FTAs and the sheer market size captured within these that is the major advantage that British business gains from EU membership; the quality and scope are increasingly important to the UK’s modern economy. The incentive for other countries of access to the large EU market has allowed the EU to successfully pinpoint trade barriers that typically fall outside the scope of many free trade agreements negotiated by other economies. For many CBI members, the EU’s ability to negotiate on non-tariff barriers such as divergent product standards, approval processes and environmental regulations has opened up new trading opportunities for businesses (see Exhibit 38). Furthermore, in addition to NTBs, key EU FTA negotiations have resulted in extensive market access commitments on services and public procurement, as well as rules provision on issues such as competition and intellectual property rights that are not realistically achievable at the WTO level due to their high level of ambition.

The EU’s weight in international trade talks and leadership in regulatory setting has helped the EU to set the global standard for many key regulations which have brought a dividend for European and UK businesses looking to operate right across the world. Notably, any FTA signed between the EU and the US, the world’s two biggest economies, could lead to compatible approaches to regulatory setting and compliance over such a large percentage of the global economy that it would help set the standards for the rest of the world.
Despite partially restricting the UK’s trade flexibility, the opportunities provided through collective EU trade negotiations are unmatchable elsewhere

There is significant complexity and a lack of nimbleness in EU trade negotiations – both in the internal process and in reaching a final agreement – but the opportunities this provides for the UK and its most internationally tradable sectors means that efforts at co-operation from an EU base are the best option for the UK to pursue its global trade agenda.

Allowing the EU to conduct trade negotiations on behalf of the UK brings some downsides. First, there is the simple fact that, as one of 28 EU states, the UK cannot guarantee that its priorities will always be represented in trade talks and cannot fully dictate which markets are prioritised for FTA negotiation. Some argue that the UK could have been more nimble in negotiating its own trade deals—with the US or Commonwealth countries, for example. Moreover, the number of places to influence the negotiation process has resulted in competing national interests and defensive positions being pushed by sectoral lobby groups in some EU states, slowing down some FTA negotiations and reducing the scope for reaching agreement on contentious issues such as agriculture. For example, this has been a feature of recent negotiations involving both Canada and Mercosur. This is not helped by the institutional procedures involved in negotiating FTAs that can lengthen the process and present stumbling blocks to completion, including the need to square off interests in both the Council and the Parliament.

However, not all of the perceived sluggishness to EU FTA negotiations can be laid fully at the door of the EU itself; the UK going it alone would come up against similar barriers to quick deals being signed. FTA negotiations have become increasingly complex in the last decade: non-tariff barriers have increased in their relative importance to tariffs as practical barriers to trade for business, and their ‘grey’ nature often makes them more difficult to address adequately. At the same time, disguised forms of local industry support in target FTA countries – as well as lobbying campaigns by interest groups trying to use political issues to derail negotiations, such as labour rights in the EU–Columbia FTA or data protection in the ongoing EU–US negotiations – can slow the pace of signing of FTAs. It is likely that the UK would face similar hurdles were it to attempt to pursue its trade agenda outside the EU.

Despite these limitations to EU trade policy, UK business is clear that continuing to pursue a trade agenda within the context of the EU is the best way forward to fulfil the UK’s global ambitions. The nature of the modern FTA, the quality of the FTA that UK industry requires to properly realise global business opportunities, and the size of market the UK offers to potential trading partners all indicate that the UK would struggle to match the deals it can achieve and the market access it can attain if it attempted to strike out alone with trade negotiations.

Although the UK is one of the world’s largest economies, it is several times smaller than the world’s largest (the EU, United States and China). It is difficult to envisage how a country the size of the UK could succeed in breaking down the required regulatory barriers to trade with a major country in its own separate trade negotiation. For example, the UK would struggle to negotiate mutual recognition of a UK product standard with the US or the EU on its own, whereas any deal between the EU and US would probably set the subsequent terms for any UK–EU or UK–US deal.

At the very least, the UK would find itself in a long queue to sign deals with major economies on similar terms to those being signed by larger blocs such as the EU. It is likely that FTAs with the UK would take second place to agreements with the EU in the priorities of third countries, since access to the EU’s Single Market is a huge attraction for companies looking to boost their exports. The clear message coming from a number of the UK’s major non-EU trading partners, such as Canada, China, the US and Japan, is that, while they value the UK as a trading partner, they would strongly prefer an EU-level trade deal complete with harmonised standards, regulations and processes (see Exhibit 39 overleaf).
The UK has been one of the leading voices in Europe shaping EU trade policy priorities and protecting the openness of the EU’s market to international trade.

Exhibit 39: Membership of the EU makes the UK more attractive to potential trading partners and increases their desire to sign an FTA that involves the UK

The EU is well-positioned to negotiate timely FTAs. It is questionable whether, if the UK was outside the EU, the UK would be as well-placed to negotiate access to these markets on behalf of companies based in the UK, and possible that these companies would be at a competitive disadvantage relative to their European peers.

Also, trade partners would likely put a lower priority on negotiating with the UK alone, compared to negotiating with the EU, which allows access to the markets of its 27 Member States. The overall opportunity for UK firms to gain access to emerging market economies, and benefit from the liberalisation of fast-growing emerging economies, is significant.

British American Business and American Chamber of Commerce in the EU Response to the UK government Consultation on the EU Internal Market, July 2013

For Canada, and for Great Britain as a member of the EU, this will be a historic step – a monumental one, in fact: a joint Canada–EU study has shown that a commercial agreement of this type would increase two-way trade by 20 percent.

Stephen Harper, Prime Minister of Canada, Address to the Houses of Parliament of the United Kingdom, June 2013, discussing the EU–Canada trade negotiations. A political agreement was announced on 18 October 2013.

The UK has been one of the leading voices in Europe shaping EU trade policy priorities and protecting the openness of the EU’s market to international trade. Despite the arguments about the UK being held back by slow negotiations, the quality and deep coverage of FTAs matter more than the speed at which they are negotiated. For businesses, the evidence is clear that EU-level FTAs offer far more advantages than bilateral UK FTAs. The prospect of access to the EU market gives the EU a significant leverage with which to address non-tariff barriers and protectionist policies which the UK would struggle to replicate.

The recent landmark trade deal between the EU and Canada shows that the EU is now focussed increasingly on signing the deals that can drive forward the global ambitions of its member states, with this deal estimated to boost UK exports to Canada by nearly a third. In order to ensure that the UK has access to the emerging markets that are driving global growth and the developed markets that continue to offer opportunities for British business, the EU has represented the best tool to date – and it is likely to continue to do so for the foreseeable future.

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3.7 The GDP boost from the UK’s membership of the EU far outstrips the costs

Chapter 3 has focused on those aspects of EU membership that are vital to the UK in evolving its global trading role to take advantage of the opportunities that structural shifts in the global economy are offering. It has shown that, on balance, the EU has been a positive for British business in pursuing its global ambitions. While there have been clear costs to membership – most notably the direct net budgetary cost of the membership fee and cases of unnecessary and damaging regulation – overall, the majority of British business is in favour of membership.

It is also worth noting that most macroeconomic analyses have come to a similar conclusion – although they vary in their areas of focus and in the rigour of their assessment. Taking the EU membership as a whole – including the benefits of harmonised rules underpinning market access, free-flowing capital and mobility of labour set against any downsides of poor regulation, trade diversion and net budget contributions – the clear majority of credible analyses that have tried to calculate the overall macroeconomic impact of EU membership on the UK find a significant positive impact (shown in detail in Exhibit 40).

On the costs side of the ledger, the static negative impact of unwarranted regulation on prices and employment is easier to identify than the positive dynamic impacts that it may have on integration, innovation and ultimately growth, affecting any numeric cost–benefit analysis. On top of that, any attempt to aggregate the various pros and cons of membership into a measure of the overall impact adds another layer of complexity. And none of the analyses measure the impact of trade deals with countries outside the EU that the UK might not have been able to secure otherwise.

The upshot is that analyses of the overall impact of EU membership tend to be non-overlapping: they focus on different aspects of membership, use different methodologies and counterfactual assumptions, and often cover different periods in Europe’s history. Since these studies are not mutually exclusive (as detailed in Exhibit 40 overleaf), it is not unreasonable to infer that the net benefit arising from EU membership is somewhat higher than 2–3%, perhaps in the region of 4–5% as a conservative estimate.

The GDP benefit to the UK economy of EU membership could therefore be estimated – from a simple aggregation of the literature available – at between £62bn and £78bn per year. That is roughly the combined economies of the North East and Northern Ireland taken together.

This suggests that households benefit from EU membership to the tune of nearly £3,000 a year – with every individual in the UK around £1,225 better off.
**Exhibit 40: The majority of credible analyses that have tried to calculate the overall macroeconomic impact of EU membership on the UK find a significant positive impact**

<table>
<thead>
<tr>
<th>Paper</th>
<th>Benefits/costs covered</th>
<th>Notable benefits/costs not covered</th>
<th>Net benefit of membership</th>
<th>Period/ event covered</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eichengreen &amp; Boltho, The economic impact of European Integration, 2008</td>
<td>Most areas covered in a broad literature review – including trade creation &amp; diversion; CAP; impacts on competitiveness; economies of scale/ hubs; political impact of Common Market ‘discipline’ on protectionism and reform.</td>
<td>Net budget contribution; FDI flows</td>
<td>~5% of EU-15 GDP</td>
<td>Entire history of European integration from 1950s onwards</td>
<td>Unlike other studies in this table, this paper takes a broad historical overview of the political economy of Europe in order to construct a detailed counterfactual. The quantitative estimates come from a literature review of various estimates of the benefits of trade, integration and competition. The benefits accrue mainly from the Common Market and Single Market. The 5% figure is a ‘rough order of magnitude’ based on a literature review of the various benefits of membership. Unlike most other studies in this table, it therefore is not a single, internally consistent estimate of the net benefit. However, as a result it has significantly greater coverage of the various costs and benefits than those other studies.</td>
</tr>
<tr>
<td>Pain &amp; Young, The macroeconomic impact of UK withdrawal from the EU, 2004</td>
<td>Inward FDI flows; trade in goods; impact of CAP on food prices; net contribution to EU budget</td>
<td>Non-tariff barriers to trade; impacts on competitiveness; economies of scale/ hubs; mobility of labour; supply-chain trade.</td>
<td>2.25% of GDP</td>
<td>Hypothetical withdrawal from the EU</td>
<td>UK economy is 2½% smaller in the long run mainly due to 10% fall in inward FDI stock. Overall trade impact limited (to around ½% of GDP) since non-tariff barriers are not modelled. Overall, these benefits are more than enough to outweigh losses from the Common Agricultural Policy and Britain’s net contribution to the EU budget. Uses a macro-econometric model.</td>
</tr>
<tr>
<td>Ilzkovitz, Steps towards a deeper economic integration: the internal market in the 21st century, 2007</td>
<td>Overall impact of Single Market on competition and productivity in manufacturing; impacts of expansion on trade</td>
<td>Benefits prior to 1992; mobility of labour; FDI flows; net budget contribution. Impacts on competitiveness; economies of scale/ hubs included implicitly not but directly</td>
<td>EU-15 GDP 2.1% higher</td>
<td>Benefits from Single Market Programme and 2004 enlargement up to 2006</td>
<td>Results are not given for individual member states. Only covers to the years 1992–2006. Benefits of SMP inferred from falls in pricing mark-ups and rises in total factor productivity. This is likely to capture much, but probably not all, of the overall impact of the SMP on productivity. Uses a computable general equilibrium (CGE) model.</td>
</tr>
<tr>
<td>Gasiorek, The accession of the UK to the EC: A Welfare Analysis, 2002</td>
<td>Trade impacts; impacts on competitiveness in manufacturing</td>
<td>Single Market (post-1985); services and agricultural sector; mobility of labour; FDI flows; economies of scale/hubs; supply-chain trade; net contribution to EU budget; impact of regulation</td>
<td>Net welfare benefit to UK consumers equivalent to 2% of GDP</td>
<td>Initial UK entry into the EEC but not the common market or subsequent enlargement (i.e. 1973–85)</td>
<td>Only models benefits of EEC entry up to 1985, against a counterfactual in which the UK did not join. Simulates the impact of increased competition in UK manufacturing and finds a significant positive impact in addition to a positive effect from trade. The bulk of the benefit from EEC membership arises from the increase in competitive pressures rather than direct trade impacts. Uses a computable general equilibrium (CGE) model.</td>
</tr>
<tr>
<td>Minford, Measuring the economic costs and benefits of the EU, 2006</td>
<td>EU non-tariff protectionist regulations and impact on UK prices and sectoral mix</td>
<td>UK export markets; non-tariff barriers to trade; economies of scale/hubs; mobility of labour; FDI flows; supply-chain trade; net contribution to EU budget</td>
<td>Net welfare cost to UK consumers equivalent to 2.5% of GDP</td>
<td>Hypothetical withdrawal from the EU</td>
<td>The harmful impact of EU membership arises from protection of agricultural and manufacturing sectors, inferred from the difference between UK and world prices. It is assumed that all protection is due to EU regulation and is entirely removed upon withdrawal. This results in lower consumer prices, smaller agricultural and manufacturing sectors, and a larger services sector. The study highlights the potential harmful impact of over-regulation at the EU level, but it does exclude other areas of benefits &amp; costs. For example, income effects arising from possible loss/gain of exports to the EU/rest of the world after EU withdrawal are not included. The analysis compares the UK economy before EU withdrawal and after withdrawal once all adjustment is complete. It therefore does not cover transition costs, but they would probably be substantial – it is acknowledged that withdrawal entails the ‘effective elimination’ of the UK’s high-tech manufacturing industry, for example. It is also assumed that the UK pivots totally away from the EU upon exit, possibly ignoring the geographic factors discussed in Chapter 1 of this report. Uses a computable general equilibrium (CGE) model.</td>
</tr>
</tbody>
</table>
3.8 Analysing the most tradable sectors of the UK economy highlights the positive balance of pros and cons of EU membership

The conclusion that the overall impact of EU membership on the UK economy has been positive is reinforced when analysing the most internationally-exposed sectors of the UK economy. Twelve sectors account for around 80% of UK exports, imports and foreign direct investment, and 40% of employment. However, three of these sectors are ‘fragmented’ in the sense that their output is so varied that economic dynamics do not apply consistently to the sector as a whole.

Of the remaining nine sectors, six are most exposed to the international economy based on their tradeability – the amount of importing and exporting in the sector – and their share of FDI (see Exhibit 41).

- Advanced industries – aerospace
- Advanced industries – automotive
- Pharmaceutical & chemicals
- Technology, media and telecoms
- Financial services
- Natural resources

The following pages demonstrate the overall positive balance of advantages and disadvantages of UK membership of the EU for five of these sectors.

Exhibit 41: The most internationally-exposed sectors of the UK economy

This does not mean that the remaining parts of the British economy do not receive the benefits of EU membership. On the contrary, even those sectors that do not participate directly in international trade at all almost invariably are involved in international and European supply chains, whether by providing inputs and services to Britain’s exporting business or by importing inputs for further manufacture or sale. The retail industry, for example, is largely domestically focused when it comes to output but is extensively involved in importing goods for sale. Furthermore, all sectors of the economy and firms of all sizes can and do benefit from the international movement of labour and of investment and capital.
The UK is home to the world’s second-largest aerospace sector. With world-class capabilities in the development, design and manufacture of some of the most sophisticated and high-value parts of modern aircraft, the UK’s aerospace sector is an international success story.

The sector is also notable for the large number of small and medium-sized businesses active in the UK, with more SMEs active in the UK than in France, Germany, Italy, Spain and Norway combined. 75% of the UK’s civil aerospace gross output is exported. The UK’s focus on the supply of parts, systems and services – rather than assembly – means that demand for products is focused around the major manufacturers. In 2011, sales to the EU showed the strongest growth (16.9%) followed by the US (13.3% growth).

Global Trends

By 2030 growing demand will require more than 27,000 new planes and 40,000 helicopters worldwide. With orders alone worth over $4 trillion and a growing market for services and maintenance, the UK is well positioned to take advantage of these opportunities.

Global demand is split between emerging markets where air travel is expected to grow significantly, and mature markets where airlines are replacing existing capacity with more fuel-efficient models.

Cost pressures and tightening environmental standards are the key drivers of change in the sector. With fuel costs representing a third of airline operating expenses, the reward for developing new technologies that help reduce costs is significant.

Increasing R&D intensity means that international co-operation will be vital to the future competitiveness of the UK. £7 billion of civilian aerospace research and development was funded by companies, the EU and national governments in Europe in 2011. EU expenditure is proportionally twice as high as US spending.

The UK government’s support for the sector has been an important additional element supporting the UK’s competitiveness. The recently announced Aerospace Technology Institute will see £2 billion of government and industry funding over the next seven years to help the UK maintain its competitive advantage.

The growing importance of service provision to support products makes the UK well placed to compete if barriers to entry can be addressed. After-sales services like maintenance and technical support are growing at over 4% annually. However, for UK companies, gaining access to foreign markets often requires companies to overcome significant non-tariff barriers.
**Case Studies: the UK aerospace industry rests on complex supply chains**

**Bombardier Aerospace:** The largest manufacturer in Northern Ireland produces advanced composite wings for the new Bombardier CSeries aircraft, fuselages and advanced composite structures for Bombardier commercial and executive aircraft, as well as supplying aircraft engine nacelles to Airbus, Rolls-Royce and General Electric.

**AgustaWestland:** Britain’s only helicopter manufacturer, AgustaWestland is deeply embedded in the UK’s advanced manufacturing base and directly employs 3,280 people while supporting a further 10,000 jobs in the supply chain, including 650 small and medium sized enterprises.

**Park Air Systems:** The world’s leading manufacturer of ground-to-air communication systems for civil and defence aviation environments, Park Air Systems have been highly successful at opening up new markets in their field. In 2012, Park Air Systems exported products to over 80 different countries. The highly-successful medium-sized business has won contracts around the world supplying radio systems for airports in developing and developed markets. They are well placed to capitalise on the increasing demand for air travel in Africa, Asia and South America.

**GKN:** A leading tier one aerospace business, GKN has 7 UK plants in addition to major operations in elsewhere in Europe and in the USA. GKN works with all the major aircraft manufacturers producing a range of parts including complex, high-value metallic and composite aero-structures and engine components, and transparencies.

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**Advantages of EU membership: the EU has helped drive technological development**

The creation of a pan-European market for research and development has been a powerful driver of innovation and productivity. Programmes like Horizon 2020 and FP7 have harnessed the EU’s ability to facilitate cross-border collaboration reducing cost and risk in technology development and driving critical mass, as well as integrating private-sector and university innovation funding in the aerospace sector.

The creation of a common labour market has helped European aerospace companies whose operations are often highly specialised work effectively across national borders. Employees from across the Airbus Group are able to transfer across the groups major sites in France, Germany, Spain and the UK.

The EU’s open capital markets have been a major boost to helping companies fund the development and commercialisation of cutting-edge technology and finance sales of products to customers in the UK and abroad.

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**Challenges of EU membership: the Emissions Trading Scheme has created a backlash**

The EU’s introduction of an emissions trading scheme for air travel in the EU without agreement from the sector’s major international trading partners has caused tensions and has led to significant delays and cancellations of orders with key customers including China.

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**Forward Agenda: UK aerospace needs continued access to the EU Single Market**

The UK aerospace industry is part of complex pan-European supply chains. The maintenance of pan-European innovation strategies, giving companies and research institutions access to EU and national funding to promote and fund R&D, is essential to ensure that the EU industry as a whole is well placed to capture new opportunities.

The industry needs access to skilled labour – particularly across the EU given where the UK’s value chains are located.

Ensuring that access to finance for customers and supply chains is not adversely impacted by changes in financial regulation particularly, in areas such as the use of financial instruments for raising debt and managing risk, will be important.

Long-term clarity on EU energy, energy security and climate change policy, to provide greater certainty for firms to make decisions about market conduct and structure, and investment in new technologies, is vital.
The UK possesses one of the most diverse and productive automotive sectors in the world, which is well positioned to drive growth and investment across the UK economy.

The automotive industry in the UK is fully integrated into the EU industry, with significant EU supply chains and substantial exports of finished vehicles and engines to EU markets. The Automotive council believes that the UK’s active membership of the EU is an essential factor in the automotive industry’s current and future success.

With seven global volume car manufacturers, eight commercial vehicle manufacturers, ten bus and coach manufacturers, eight Formula 1 teams and over 2,000 component manufacturers in the supply chain, the UK’s automotive sector is highly diverse in both output and ownership.

Over 80% of the volume of vehicles manufactured in the UK today are exported and more than 50% of exports go to the EU. With total export value of £31 billion in 2012, the sector accounts for 11% of the UK’s total exports and has attracted over £7 billion of FDI over the past two years.

Global Trends

Technology is driven by the global push to reduce emissions. The EU – and other markets which are adopting the EURO standards – have some of the most challenging CO2 standards. Emissions regulations are driving a significant increase in the manufacturing costs of vehicles, with estimates that meeting the EU’s 2020 emissions targets of a 40% reduction will increase costs by almost €2,000 per vehicle.

Increasing R&D intensity.

Responding to the global push for cleaner vehicles is requiring a significant increase in the amount of R&D spending, with estimates that €150 billion could be invested in low-carbon vehicle technology over the next 20 years. Last year, the automotive sector invested more than €1.5 billion in R&D in the UK.

Global competition for labour.

Firms around the world are finding recruiting skilled employees challenging. The UK sector faces significant skill shortages but, in a global market dominated by the US, China, Japan and Germany, the UK will have to dramatically increase the supply of both domestic and foreign labour to remain competitive with many current employees due to retire over the next decade.

Huge demand in emerging markets.

Sales of British-built Jaguars and Land Rovers in China increased by 71% in 2012 and overall sales of UK cars in China are projected to increase from £2 billion in 2011 to £9.3 billion by 2020. UK car export volume to China grew by 64% from 2011 to 2012 to account for 8% of total export volume.

Global vehicle production is also shifting strongly to China and other emerging markets: it is estimated that, by 2020, Asian markets will account for half of global passenger car production.
Case Studies: UK exports are growing in Asia but Europe is the main market

**Nissan:** Nissan are the largest UK manufacturer of motor vehicles, producing over 510,000 cars in 2012 – accounting for more than one third of the UK’s total production. Over 80% of production is exported and the plant recently started production of the Nissan Leaf – the UK’s first mass produced electric car.

**Jaguar Land Rover:** There were record sales from Jaguar Land Rover (JLR) in 2012, with more than 350,000 vehicles delivered to customers around the world from the company’s factories in the West Midlands and Merseyside. A 71% increase in sales saw China become the company’s largest single market with over 70,000 vehicles sold. In addition, sales in emerging markets in South East Asia and Latin America are growing strongly, complementing the strong rise in sales in more traditional markets in North America and Europe. Exports account for 85% of JLR’s revenues.

**Vauxhall:** Ellesmere Port has been chosen as the lead European plant for the production of the new Vauxhall Astra beginning in 2015. The plant’s high-level of productivity, flexible labour market and integration into UK and EU supply chains helped secure the £125 million investment from the US-based parent company General Motors. After the investment, the plant will have an annual capacity of over 220,000 cars.

**Toyota:** More than 3.25 million cars have been produced by Toyota in the UK over the last 20 years. Toyota’s UK plant was the first in Europe to produce a full hybrid vehicle and its engine factory in Wales was the first outside Japan to produce hybrid engines. Toyota employs 3,800 people and, in 2013, makes around 180,000 cars a year – of which 160,000 are exported, including 140,000 to the EU.

**BMW UK:** BMW Group’s continuing investment in its UK manufacturing and business operations amounts to over £1.75 billion since 2000. The company and its dealership network employ 18,000 people directly while supporting more than 46,000 UK jobs in total. Eighty per cent of MINIs and over 90 per cent of Rolls-Royce Motor Cars are exported. Together with engines built in the UK for BMW and MINI brand products, the BMW Group exports over £2.4 billion worth of products each year while sourcing £1.2 billion worth of goods and services from UK-based suppliers. The production of the next-generation MINI at its Oxford plant, beginning in November 2013, is an indication of the BMW Group’s future commitment to the UK, further establishing its position as a major investor, employer, manufacturer and exporter.

Advantages of EU membership: access to the EU market has driven foreign investment

**Access to EU markets has been a key driver of foreign investment** into the UK automotive sector. EU action to remove controls on capital flows has promoted significant FDI in both the supply chains and the final manufacture of motor vehicles in the UK, with a number of announcements in recent years. For example, Nissan and Toyota chose the UK as their base for wider European operations and have continued to make significant investments in the UK.

**The creation of common regulatory standards** across the EU has created significant economies of scale across Europe. Since 2009, European Directives have cemented approval processes for new vehicles sold in Europe. Emissions standards for passenger and commercial vehicles have also been standardised, creating a clearer roadmap for R&D activities. EU regulation has also influenced other markets to recognise or adopt the EU’s standards in many areas such as crash safety and environmental performance, creating further benefits based on common standards.

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**Challenges of EU membership:** a lack of progress in some trade deals limits growth

- **While the UK already exports cars to markets outside the EU in large volumes, the slow progress on negotiating better market access with major economies like India, China and Brazil has limited potential growth. In the case of India, UK exports currently face tariffs of over 100% in some cases, while Indian exports to the EU face only a 10% tariff.**

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**Forward Agenda: the automotive sector needs the EU to strike equitable trade deals**

**The maintenance of an EU wide-market** will be essential to promote the economies of scale needed for research into low-carbon vehicles (with a focus on energy storage and management, electric motors and power electronics, internal combustion engines, lightweight vehicle and powertrain structures, and intelligent mobility).

**Effective FTAs, enabling fair competition with growing markets**, is a priority for the sector. With car ownership in China alone expected to overtake the US by 2030, and with China and India together being expected to account for a third of all global car ownership by 2050, the need for UK and EU manufacturers to break into these markets is obvious.

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**Percentage of vehicles manufactured in the UK that are exported:** 82%
The chemicals and pharmaceuticals sector represents 15% of total UK manufacturing output.187 With exports of £53 billion, the sector is one of the UK’s largest exporters, accounting for 18% of the UK’s goods exports.188

In life sciences, the UK is a global leader, ranking second in the world after the US with a 10% share of global exports.189 In chemicals, the UK is home to a wide range of companies from around the world. The UK has a particular focus on speciality chemicals and is the fourth largest chemicals producer in the EU.190 Both sectors have become extremely globalised, helping a number of UK companies to emerge as international players and attracting significant investment into the UK.

However, while some parts of the sector have flourished, the UK has lagged behind many of its main competitors in recent years. A number of major chemical plants in the UK have closed and several research laboratories have moved to other countries.

Global Trends

The chemical and pharmaceuticals sector is highly regulated. More than 500 pieces of national, EU and transnational pieces of environmental legislation affect the industry in the UK.

In pharmaceuticals, the number of new drug approvals has declined significantly over the past five years. Despite attempts to streamline processes, new medicines take an average of 12–15 years and cost on average £1.2bn to develop. As a result only one in five new medicines recoups its costs.191

The drive to develop new chemical compounds and new techniques of making them is putting increasing pressure on the sector to invest in research and development. In the UK, the sector invests over £5 billion in R&D every year. This represents more than 28% of total industrial R&D spend in the UK.192

The cost of energy is rising in importance to the global chemicals industry based on the availability of cheap shale gas and chemical feedstocks in the US. Energy costs can be up to 60% of the production costs for many of the industry’s common products.193 Cheap shale could give the US a “profound and sustained competitive advantage” in chemicals, plastics and related industries. As a result, US chemical output is expected to double by 2020.194

Emerging markets are becoming increasingly large sources of demand and competition. In the chemicals sector, it is estimated that emerging economies in Asia will represent a third of speciality chemicals and half of plastics demand by 2030. Similarly, in pharmaceuticals, while developed markets account for 90% of healthcare spend today, it is estimated that Asian markets will represent almost a third of all healthcare spending by 2030.
Case Studies: the UK exports chemicals and pharmaceuticals export all over the globe

**Croda:** A global leader in specialty chemicals, Humber-based Croda exports most of its UK production and overseas sales are now 95% of global turnover. In 2012, 62% of sales were outside Europe and sales in the US rose by 5% with a 4% growth in overseas markets.

**AstraZeneca:** The UK’s second-largest pharmaceutical company, employing around 50,000 people worldwide. The company are present in over 100 countries across the world, manufacture in 16 and spend over $4 billion on research across 3 continents. It has been particularly successful at entering emerging markets and is currently the second largest pharmaceutical company in China by sales, with revenues in China rising by 17% in 2012.

**PZ Cussons:** Africa now accounts for 40% of profits for PZ Cussons and Nigeria is now the largest single market for the manufacturer of soaps and toiletries. Similarly, the company’s expertise in entering new markets has given it a 40% of the market in the emerging babycare toiletries market in Indonesia.

Advantages of EU membership: harmonised EU regulations have helped drive economies of scale

**Harmonised legislation for the approval of medicines** through the creation of the European Medicines Agency (EMA) has greatly simplified the procedures for approving new medicines across the EU, by introducing a single approval process for the whole of the EEA. The decision to locate the EMA in London has boosted the attractiveness of the UK to FDI in the pharmaceutical sector.

**The EU has played a key role in harmonising intellectual property processes** that create incentives for innovation in the pharmaceutical and chemical sector. Additionally, the EU has been a powerful actor in pushing for the protection of intellectual property for innovative compounds in developing countries.

**The creation of the Single Market** has enabled the UK to operate as part of a pan-European supply chain of chemical products. The removal of tariffs has enabled the UK to specialise in the production of high-value chemicals for which the UK alone would not represent a sufficient market.

**Pan-European research funding** through programmes such as the Innovative Medicines Initiative (IMI) has contributed to the UK’s competitiveness in the pharmaceutical sector. All of the 40 projects funded through the €2 billion programme has involved companies and universities in the UK working as part of pan-European initiatives to develop new medicines and healthcare solutions.

Challenges of EU membership: regulations such as REACH can be costly

**The EU is the most regulated chemical market in the world.** Since chemical manufacturers operate at a global level, EU legislation has in some cases put EU-based companies at commercial disadvantage when it comes to supplying non-EU. For the UK, where over 90% of companies in the sector are exporters, the impact of regulation goes significantly further in this sector than in many other areas of the economy.

**The REACH directive on chemical safety** is the most high-profile example. It is the largest environmental regulation ever produced by the European Commission and many companies, especially smaller producers, are struggling to deal with the requirements. Overall, the UK Chemical Industries Association, further supported by the Association of the British Pharmaceutical Industry, stated that they see REACH as a positive development and support its principles but that “interpreting the legislation is proving extremely complex, more than it needs to be, and there would be some benefits in considering how the guidance that has been produced to help companies comply could be simplified.”

Forward Agenda: UK chemical and pharmaceutical producers need the EU to address the energy challenge and sign a trade agreement with the US

**The needs of ‘Energy Intensive Industries’ must be integrated within the EU’s post-2020 energy and climate change framework.** The EU needs to ensure that its transition to a low-carbon economy works for all businesses, including for those industries that rely heavily on energy to support jobs and growth in the sector.

**The average price of natural gas in the US is a quarter of the price in the EU due to the exploitation of shale gas.** However, the very different circumstances in the UK and EU to the US mean that this situation is unlikely to be fully replicated here. The EU has a far more stringent and comprehensive regulatory framework than the US through which unconventional exploration can take place safely. Within this existing framework, member states are also looking at how to remove barriers to shale gas exploration to ensure that industry can extract shale gas commercially. The EU should not, therefore, seek to legislate further in this area.

**The Transatlantic Trade and Investment Partnership (TTIP) offers the potential for increased regulatory convergence and harmonisation between the UK and US for pharmaceuticals, with huge potential benefits for the industry.** This – alongside the improved alignment on protection of Intellectual Property Rights and their enforcement - would be particularly relevant given the success of UK companies in the global market.

18%
The sector accounts for nearly a fifth of UK goods exports

Our Global Future: the business vision for a reformed EU

87
£126 billion
Gross Value Added\(^{199}\)

2,336,000
Jobs\(^{200}\)

£65 billion
Exports

44%
Exports to EU

The technology, media and telecoms sector combines both the manufacturing of goods (especially in the technology subsector) as well as the provision of services (in media and telecoms). The UK today has the EU’s largest creative and computing sectors and the second-largest telecoms sector after Germany.\(^{201}\)

Over the past decade, the sector has seen strong FDI flows into the UK. In telecoms, three of the UK’s four major mobile operators and the second-largest fixed-line operator are now foreign owned. In 2010, FDI in the UK telecoms sector accounted for 5% of total UK inward FDI.\(^{202}\)

The UK historic strength in manufacturing and recent strength in services have attracted a variety of global technological players creating a high-tech subsector that employs almost 1.3 million people in the UK and generates £65 billion of value added.\(^ {203}\)

Global Trends

New business models are transforming the sector at a staggering pace. Technologies like cloud computing are enabling providers and customers to adopt new approaches. These changes in turn are driving a new wave of innovation and investment.

A value creation shift towards services is underway. Global revenues in hi-tech services and applications are expected to grow by 18% and 22% annually respectively, whereas manufacturing revenues are expected to decline by 3% per annum throughout the next decade.\(^{204}\) For the UK, with its historic strength in services, this transformation offers potentially huge opportunities.

Internet usage and new services will increase 13-fold over the next five years: data is forecast to reach 50% of mobile revenues by 2020 as customer usage increases to 1 gigabyte per day in 2020.\(^{205}\)

The growth in developed markets is expected to be more than matched by growth in emerging markets. Mobile data traffic in India rose by over 90% in 2012 alone\(^{206}\) and demand in Africa is growing rapidly.

Cluster formation continues around industry anchors. The Silicon Fen cluster near Cambridge has to date given birth to 12 companies with market capitalisations of more than $1bn. Today it contains more than 1,500 technology companies, employing more than 53,000 people.\(^{207}\)

Regulatory policies such as fibre-access, service and content export, roaming pricing and spectrum policy are forecasted to impact the telecom industry in the near future. The current regulatory focus is considered by many operators to have prioritised short-term retail consumer concerns (e.g. roaming pricing, contractual requirements, network neutrality) over the need to create an environment conducive to multi-billion Euro fast internet networks deployment.
Our Global Future: the business vision for a reformed EU

Case Studies: the UK has a diverse range of media and technology companies exporting globally

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
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<tr>
<td>BT</td>
<td>One of the world’s leading communications service companies, serving the needs of customers in more than 170 countries in both the EU and the rest of the world. The company serves around 7,000 large corporate and public sector customers worldwide, including 94% of the FTSE 100 companies, 74% of the Fortune 500 companies and national and local government organisations and other public sector bodies in 26 countries.</td>
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<tr>
<td>Premier League</td>
<td>The Barclays Premier League is the biggest continuous annual global sporting event in the world. Last season more than 13.6m fans attended matches with average stadium occupancy in excess of 95%. Across nine months of the year 380 matches are viewed in 212 territories worldwide. Coverage of the matches is available in 804m households around the world.</td>
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<tr>
<td>PRS for Music</td>
<td>PRS represents over 100,000 writers, composers and publishers whose musical work is licensed for use all over the world. While the US and Europe remain the most important overseas markets (accounting for 76% of international income), growth in income from Brazil, for instance, doubled between 2008 and 2012.</td>
</tr>
<tr>
<td>Amino Technologies plc</td>
<td>A world-leading IPTV/OTT innovator, bringing new entertainment products and solutions to a global market. With more than five million devices sold to 850 customers in 85 countries, the company’s key markets include North America, Latin America and Western Europe. Recently, Amino has announced a significant contract with a major operator in South Eastern Europe, where EU funding to improve broadband networks has created a new market for digital media.</td>
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<tr>
<td>Red Kite Animation</td>
<td>A multi-award winning children’s animated production company, Red Kite produces content for channels in countries including France, the US, Germany, Canada and Australia.</td>
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<tr>
<td>Sophos</td>
<td>A leading developer of computer security, anti-virus, mobile security and network security headquartered in the UK with subsidiaries in countries including Canada, France, Germany, Italy, Japan, Singapore and the US. The company currently has more than 1,700 employees working in dozens of countries around the world.</td>
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<tr>
<td>Redwood Technologies</td>
<td>Suppliers of cloud communications solutions for a range of sectors based in over 50 countries, including financial services and media.</td>
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<tr>
<td>Vodafone</td>
<td>The creation of a single European market and a single set of standards was fundamental to Vodafone’s success. The opening up of national telecoms markets to new competitors enabled Vodafone to expand across the EU. Vodafone now has operations in nearly 30 countries including 13 EU markets and is transforming itself into a unified communications company offering fixed line services as well as mobile, broadband and cable TV in selected markets. Vodafone recently announced a £6 billion investment programme to establish further network and service leadership across all of its markets, including accelerating its 4G network build to cover 90% of its five main European markets (Germany, UK, Italy, Spain, Netherlands) by 2017.</td>
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Advantages of EU membership: the EU has helped liberalise markets while protecting rights

The creation of a single market in many areas of the sector has been a vital enabler of the UK’s export success. The EU’s 500 million consumers purchase 44% of the UK’s exports.

The EU has played a valuable role in supporting global efforts to improve copyright enforcement as part of trade negotiations around the world as well as harmonising regulations across the EU. For the UK’s highly successful music industry, where annual exports exceed £17 billion and account for 12% of the global market, action against IP theft is vital to the industries ongoing success.

Industry has benefitted from EU investment in R&D and infrastructure. In sectors with high R&D intensity such as TMT, the creation of pan-European standards and co-ordinated R&D has been a significant driver of the UK’s competitiveness in many parts of the sector.

Challenges of EU membership: funding priorities are not always right

Cuts to EU broadband expenditure damaged UK interests. While the agreement to reduce the EU’s overall budget that was struck earlier this year in many ways represented a positive development, the impact on the TMT sector was less positive. The budget for the Connecting Europe Facility was cut from €9.2 billion to €1 billion. This represents a setback for the UK as a leader in e-commerce and content development.

Forward Agenda: The TMT sector needs a sensible completion of the Single Market

While the sector contains divergent opinions on the shape of reform, there is broad agreement that increasing the level of cross-border e-commerce systems by increasing harmonisation in areas such as payments, merchandising requirements and legal systems would offer significant benefits for UK companies.

The TMT sector would benefit substantially from further high-quality FTAs providing access to third country markets around the world.

EU research funding offers the potential for UK companies to participate in pan-European clusters both in the UK and abroad and ensure that the UK’s policy priorities shape the research environment.

44% Percentage of exports from the TMT sector going to the EU
The UK is the world’s leading financial services centre and the most internationally focused marketplace in the world: it is a global leader in cross-border bank lending, foreign exchange operations, interest rates OTC derivatives, maritime insurance and the leading western centre for Islamic finance.

The UK’s global reach relies on a strong presence in Europe. For the sector as a whole, Europe is the largest single destination for exports. The UK’s insurance industry is the largest in Europe, and the UK accounts for 85% of European-based hedge funds’ assets.

The sector is a valuable asset for Britain. Financial services provide around 8% of the country’s total GVA. It has the highest tax burden as a percentage of GVA of all sectors (37%), contributing around 7% of government tax receipts.

The financial services industry plays a critical role in supporting British business operations by providing capital for investments. The UK’s financial services industry also supports a much wider nexus of business and professional services such as accountancy, auditing and legal services. While financial services contributed 8% of UK GVA in 2012, business and professional services contributed a further 6%.

Global Trends
The sector is still recovering from the impact of the financial crisis which, in addition to hitting the sector economically, made it a focal point of public and political mistrust.

A series of regulatory reforms is sweeping through the sector. Following the crisis, new rules aimed at strengthening supervision of the sector and improving stability are suppressing returns as actors must hold more capital, more liquid assets and more collateral.

A global regulatory consensus with two major regimes – the EU and the US – has emerged after the crisis, influencing the rules for financial services across jurisdictions and reducing the room for manoeuvre for smaller regimes. There are, however, recent signs of concerning divergence between these regimes.

International companies must navigate between reforms taking place at different levels of governance – globally, at regional level, and domestically.

Significant opportunities for growth lie in shifting global pools of savings and wealth. A large and growing middle class will fuel life and health insurance growth in Asia. Although mature markets remain predominant, emerging markets will contribute about 50% of growth through 2014.

The rise of new channels to reach customers is changing the market. The increases of direct sales, such as online and by phone, have been spectacular, with direct motor insurance accounting for 40% of the total market in the UK.
advantages of eu membership: the scale of the eu market gives strength to the fs sector

A key driver of growth for the UK’s financial sector has been the Single Market, which has brought FDI into the sector as European and global actors move their operations to London and regional hubs across the country. The UK’s financial services trade surplus with the EU has doubled in the past decade. This has substantially improved access to well-developed liquid capital markets for UK companies, assisting domestic investment and export ambitions.24

A substantial advantage for UK financial services firms is that EU rules have opened up European markets, particularly for securities and banking.25 For example, rules offering firms the ability to use a single ‘passport’ across all member states to deliver services has allowed companies authorised in the UK to conduct business across the EEA (the 28 EU plus the three EEA EFTA states).

Integration has helped consumers and businesses through a reduction in cost of cross-border payments (average charge for a payment of €100 fell from €24 to €2.50 between 1999 and 2004).220

The sector is also reliant on the access to EU labour markets. In over 45% of UK positive investment cases, decision-makers cited access to skilled staff – including EU nationals – as one of the core reasons for choosing the UK.221

challenges of eu membership: the regulatory wave

New EU regulations will increase costs for financial services companies. However, reform post-crisis has been pushed at all levels, with a substantial part of EU rules implemented due to G20 commitments to ensure financial stability. A number of reforms have been pushed by the UK itself, such as the Retail Distribution Review and Banking Reform Bill on structural reform. Regulation at EU level nevertheless remains a key risk for financial services companies. That said, there are a number of examples of positive EU regulation, such as the Recovery and Resolution Directive.

forward agenda: UK financial services need continued access to the single market and rules that underpin the role of finance for the economy

Maintaining access to the EU Single Market is essential for financial services firms to continue to prosper and for the UK to remain an attractive location for foreign companies to base their European operations.

Completing the Single Market, in particular improving the digital policies to allow further penetration of online services to continental Europe, could add 11% to Europe’s GDP for the financial services sector. The sector needs to maintain access to EU labour markets to allow UK-based companies to gain access to the best talent. This should be supported by an emphasis on UK’s skills level through studies on financial literacy and STEM subjects supported and encouraged by the sector.

Securing access to third country markets through the EU’s negotiating weight will drive improvements in local regulation in emerging markets on foreign ownership – particularly for insurance companies. The sector would also like to see improvements of current double tax arrangements.

The regulatory agenda at global, EU and national level must link the need for good regulation and supervision with enabling the financial services sector to play its role supporting businesses and consumers.
"UK membership of the EU has brought benefits to businesses of all sizes in varying sectors right across the country. There will always be costs to membership, but the positive balance of benefits is clear."

3.9 The benefits of EU membership to UK business have significantly outweighed the costs

Whether focused on those aspects of EU membership that drive productivity through enhanced openness or on the wider macroeconomic benefits membership has brought, the EU has undoubtedly been a positive for British business in pursuing its global ambitions.

£1,225

The approximate value per year of EU membership to every individual in the UK

Worth approximately £1,225 a year to every individual in the UK, membership of the EU has also brought benefits to businesses of all sizes in varying sectors right across the country. There will always be costs to membership – both overall and to individual sectors or firms – but the positive balance of benefits is clear for an open, complex economy like the UK’s.

There is, however, a question as to whether the UK can continue to harness these factors that underpin its new global role over the coming years. Whether the UK is able to do so or not will rest to a large extent on its ability to influence the direction of the European Union, which is explored in Chapters 4 and 5.
CHAPTER 4

THE UK IS INFLUENTIAL IN THE EU WHEN IT FULLY ENGAGES
The benefits to the UK from EU membership have not happened by accident: from big-picture developments to the nuts and bolts of everyday business decisions, UK influence in the EU is an integral element of supporting British business ambitions. The UK has historically influenced right across the legislative process to achieve the outcomes it desires, from the genesis of the Single Market in 1986 to recent British-led progress in Europe on climate change. However, there is a danger that UK influence could wane if the UK does not take steps to maintain it.

The EU policy process is complex and has many actors, with its output having a direct impact on business competitiveness and its ability to create jobs in sectors and regions right across the UK. The nature of the EU means that the UK will not always get its way – being part of a club will inevitably mean compromise occurs – but the UK has a variety of ‘tools of influence’ at its disposal. Not only is it formally one of the most powerful EU members in terms of its voting strength, it is also highly effective at building alliances with other member states. British personnel occupy senior positions in the Commission; British technical expertise informs the detail of policy development from financial services to broadcasting; and the UK uses its membership of international bodies such as the G20 to help shape the international context in which the EU operates.

However, UK business is concerned at recent indications that the UK is not maximising its potential influence on EU outcomes. Domestic action is needed if UK interests are to continue to be best realised through the European Union. The UK must be consistently and proactively engaged throughout EU institutions and Europe’s member state capitals - if it is to continue to shape the EU to support its global future.
4.1 UK influence has helped maximise the openness of the EU

As shown in Chapter 3, specific policies of the EU have helped increase the openness that drives productivity improvements and boosts UK trade globally. The UK has used its influence in Europe to shape the Union to this end to a greater extent than many realise. It drove the establishment of a Single Market to bring down internal protectionist barriers, pushed an external posture that is predicated on a free trade agenda, and spearheaded an enlargement process that widens rather than deepens the EU. The UK has also influenced specific EU policy outcomes that have helped it lead the world in a number of fields, such as financial services and climate change technology. British pragmatism and co-operation with European partners have produced workable solutions at EU level to the big challenges facing all of Europe’s economies.

The need to continue to influence these policy outcomes becomes even more acute when one considers the nature of the modern economy in which many British businesses operate. The challenges business face today – and will continue to face in the future – in a global economy are increasingly insurmountable through purely national solutions (see Exhibit 42). Being influential in the EU and the world would be less of a priority if the UK economy could act in isolation from others. However, as the previous chapters have identified, being successful in a global world is rarely achieved through independent and unilateral action: economies and businesses from across the globe are increasingly interconnected, as goods, services, finance and people – not to mention knowledge and ideas – cross borders ever more rapidly.

“...The UK has used its influence in Europe to shape the Union to a greater extent than many realise...”

Setting the rules of this game, so that everyone gets the chance to compete fairly, increasingly requires co-operation and solutions at European and international level. Given that co-operation often requires negotiation and trade-offs, whether the UK is inside or outside the EU, exerting influence becomes essential to getting a good deal for British business.

Exhibit 42: Creating a positive, modern business environment requires co-operation across borders

Increasing financial stability
The ability to regulate banks’ capital requirements at a national level is limited because the global nature of the banking industry allows actors and capital to relocate to less-regulated areas. This risk was in part addressed by the global G20 agreement setting out common global rules of bank recapitalisation after the financial crisis. As the Governor of the Bank of England, Mark Carney, has said, building “an open, integrated, resilient system...requires full, consistent implementation of new standards, better information-sharing and co-operation to solve cross-border problems”.

Supporting innovation and investment
A company basing its business model on patented innovations might find it difficult and costly to operate across borders, due to the prohibitive cost and the complexity of obtaining patent protection in new countries. The EU unitary patent, agreed in December 2012 under the enhanced co-operation procedure, will create a single patent system across the Single Market (with the exception of in the non-participating Spain and Italy) and will have a single specialised patent court ensuring the highest review standards. According to the Commission, this could “radically reduce, by up to 80%, translation and related costs for obtaining patent protection in the EU”.

Our Global Future: the business vision for a reformed EU
Engaging in EU policy is complex and time-consuming – and being part of a club means that you don’t always get your way.

The EU policy process spectrum encompasses everything from totemic shifts in the direction of the Union – including the creation of the Single Market or eastwards expansion of the EU – to the day-to-day execution of specific pieces of legislation that can significantly alter the relative competitiveness or even fundamental business models of UK firms.

The impact on business of a specific piece of legislation is the product of a process in which policies are, in stages, initiated, discussed, debated and then adopted. Different actors try to make their voice heard to ultimately ensure the final outcome best realises their interests and objectives.

The nature of the EU policymaking process itself – and the number of actors involved – highlights why influence rather than straight ‘hard power’ is important: the process requires reaching an agreement between 28 member states, over 750 elected Members of the European Parliament, and the European Commission. No single country can get its way without support. Such a consensus-based system means that the various actors work to find the space for a compromise that everyone can approve. Although it is often assumed that it is UK officials conducting these negotiations on behalf of the UK, the EU process allows for significant input from the whole spectrum of British society: UK politicians, private businesses, employer organisations, trade unions and civil society groups can all influence the process both directly and indirectly.

The number of actors shaping legislation in the policy process – and the fact that they increasingly interact with each other during the majority of policy processes – means that the UK has to seek to influence right across the board: in European capitals (to get agreement in the Council and at senior Commission level), in the directly elected European Parliament and in the EU civil service (whether the Commission or various agencies).

Engaging in this policy process is time-consuming, for both business and government, but influencing it is vital to ensuring that the UK continues to benefit from EU membership. High-level political forces clearly dictate many of the EU’s big-picture priorities and over-arching strategies. The UK must undoubtedly influence the EU at this level, and indeed EU Summits and Council meetings are often the focus of headline political messages and reporting. But business is also focused on those day-to-day decisions that create the conditions in which they have to operate, however unglamorous the nuts and bolts of policymaking may be. Exerting real influence on the policy process – to secure the outcomes that affect businesses on the ground – requires serious and significant effort at both levels.

Negotiations in Brussels go through many rounds in the attempt to refine solutions so that they are as satisfactory as possible to the largest number of actors. It is therefore vital to engage throughout the legislative process to ensure that the ultimate solution fits the UK’s priorities. To begin with, the pre-legislative phase is important for exercising influence, especially in the case of novel policy development where getting in early means that the UK can set the agenda and ensure that the EU focuses on its priorities. For example, the UK has been a key player in driving the recently launched EU trade and investment negotiations with the US and Japan. However, given the extensive alterations that can be made later on in the process – through political horse-trading within and between the institutions – relying solely on the initial stages of the process is not sufficient for a rounded influence strategy.

The policy process is a dynamic competition of ideas and interests that can be influenced to further one’s own interests; the winners of the game are the ones that consistently engage over time. The UK will not always get its way, but it has historically been influential enough to ensure that overall successes have outweighed occasional setbacks. Indeed, 72% of British businesses believe that the UK currently has a significant or very significant influence on EU policies that affect their business.

In finding ways to be influential, the UK has a number of ‘tools of influence’ available to it that can be used to bend the EU process to its will. Locating the right tools of influence – formal or informal – and deploying them at the right time towards the appropriate people is the key to a successful influencing strategy. The UK has effectively harnessed the tools of influence available to persuade both partners and opponents to support the UK’s position at key moments in the policymaking process, to the broad benefit of British business in pursuit of their global ambitions.
4.2 British influence rests on the effective use of a variety of ‘tools of influence’, and the UK must ensure that the use of these tools is maximised

The UK is one of the most structurally powerful individual member states in a number of EU institutions. But, while the power of this formal influence has always been important and undoubtedly underpins effective UK engagement in Europe, the ability to achieve policy outcomes that best realise Britain’s aims and objectives has often rested on strategic use of informal influence to augment the formal rights that EU membership gives the UK.

While there is no readily available objective measure of any member state’s informal influence in the EU – or indeed any overview of the influence exercised by other actors, such as business representatives or NGOs – analysis of the deployment of the tools of influence available in terms of outcomes gives a useful picture as to how much influence a member state has.

Building alliances is the key to maximising the formal influence available to the UK through voting. This is furthered by the extent to which the UK can place supportive personnel in key EU institutions, use its credibility in areas of national expertise and bring pressure from international actors to bear in order to shape legislation that best realises UK interests and objectives (see Exhibit 43).
Voting power is the basis of UK influence

The UK is a large member state and has correspondingly large structural power. The UK is today among the major powers within the Council with the same largest share of weighted votes (29 or 8%) as Germany, France and Italy. In the European Parliament the UK has 73 of 766 seats, around 10% of the total, which is the third-largest share after Germany and France. This formal influence leaves the UK well placed to use its voting power to further its aims.

In the Council of the European Union each member state’s vote is currently weighted according to population size, with the UK having the third-highest population among EU member states. Certain decisions still require unanimity to pass, namely in the areas of taxation, social security or social protection, the accession of new states to the European Union, foreign and common defence policy and operational police cooperation between the member states. Unanimity offers some protection to the UK, but can also limit the UK’s ability to achieve the change it wants if other member states oppose it, as they hold the same power of veto as the UK.

In the European Parliament, the formal voting power of MEPs takes a number of forms. At the most basic level, all UK MEPs have an individual vote on EU legislation. MEPs are also members of various political groupings in the Parliament, made up of collections of different parties from across Europe, and they can vote to decide their group’s position in advance of policy being decided. Influencing the larger groups from within can be crucial to influencing the wider Parliament.

In the Commission, formal voting is less important. That said, during the initial drafting of legislation to propose, all Commissioners have to agree on a proposal before it progresses to the full legislative process. It is important that the UK’s Commissioner exercises this right to vote, or works to shape a consensus so that a formal vote is not needed.

However, the formal influence garnered through voting rights is by no means the ultimate barometer of overall influence for an EU member state, for two main reasons. First, the potential of voting to influence outcomes has changed over time through formal changes to the Council voting process, including the shift from unanimity to an increasing number of decisions being taken under QMV and, from November 2014, a new voting system which aims to increase the ease of decision-making in Council. Furthermore, the rise in power of the European Parliament through its increasing role in the policymaking process has reduced the ability of member state governments to simply rely on their formal voting power in Council to realise their aims.

Secondly, because consensus is preferred to putting policies to a straight vote, the nature of the EU policy process means that using formal influence tools alone is rarely the best way to further UK interests. Informal influence is therefore increasingly important.
The UK is effective at building alliances and rarely finds itself isolated

The UK is effective at building alliances when it engages positively and consistently. The UK's large voting weight allows it to act as an attractive anchor for alliances, facilitating coalitions with a large member state at the base.

Britain has historically been closely aligned with other northern European countries – who often share similar economic stances – in particular Finland, Ireland, Germany, Sweden, Denmark, the Netherlands and the Baltic states. Far from the ‘awkward partner’ often portrayed and despite not taking part in a number of areas of further integration such as the single currency or Schengen Area, the UK has historically built alliances across the EU to corral support for its position in areas right across the policy spectrum.

It has been argued that, by choosing to remain outside the Eurozone, the UK may struggle to build alliances within the Council. However, in reality, the ‘opt-out’ countries appear to perform on a par with the ‘in’ countries when it comes to forming alliances. It is important to be seen as credible and co-operative – each participant has to be willing to find common ground and acceptable solutions to concrete problems, often in the face of overarching ideological disagreement – and the most powerful states, such as Germany and France, broadly see the UK as such a partner.

A survey of more than 600 member state representatives found that the UK, although outside the Eurozone, is a powerful member state with high ‘network capital’, indicating that other member states are keen to engage and co-operate with Britain. In the three years when the survey was conducted, the UK had the highest network capital of all countries in the EU in 2009 and 2003, and it came second in 2006.

Moreover, the UK is the preferred partner of the most powerful member states and often functions as a key intermediary between countries. The UK has best realised its interests when it has built strong coalitions in Council to robustly defend its interests during negotiations. For example, in response to suggested amendments to the 1992 Directive on pregnant workers, the UK was able to block damaging proposals during the negotiation phase by building an alliance with Germany and other member states who also believed the proposals overstepped the boundaries of subsidiarity and would increase costs for both companies and governments without solid evidence.

Again, on trade policy, the UK has recently been effective in building coalitions with Germany, the Nordics and the Netherlands in cases when the European Commission has sought to introduce proposals that restrict the EU’s market openness, including on public procurement and mandatory origin marking.

These alliances are most influential in the build-up to a vote that will form a position, whether internal or final, rather than at the technical specification phase when political disagreements are likely to have already been overcome. However, effective coalitions at even earlier stages, especially in more than one institution, can sometimes prevent an issue becoming a concern even before a full proposal emerges, as was the case in the Commission's review of rules for pension funds (IORP), where a broad alliance put a halt to a capital requirements regime unfit for the pension industry (see Exhibit 44).

Far from the ‘awkward partner’ often portrayed and despite not taking part in a number of areas of further integration such as the single currency or Schengen Area, the UK has historically built alliances across the EU to corral support for its position.
Building alliances helps the UK not only when it is looking to defend its interests but also if it wants to set the big-picture agenda items that the Commission and Council focus on in the longer term – whether to prioritise a free trade agenda or to cut red tape. Setting the agenda is most likely when the UK has built a coalition of like-minded states before the legislative phase even begins. For example, the ‘Green Growth’ group – driven in large part by UK Secretary of State for Energy and Climate Change Ed Davey – brings together 14 ministers from across the EU to discuss positions among like-minded countries and to build the public and political momentum necessary to influence EU energy and climate change policies and legislation to the advantage of those states and the EU as a whole. A CBI/Oxford Economics report showed that business investment would be 5.2% lower than otherwise in the mid-2020s, with a shortfall of 1.4% still being felt in 2040.229 Moreover, the UK argued that pensions should be treated differently from other financial products as they are deeply integrated into national social protection systems and regulated by national social and labour laws, and generally backed by outside sources of solvency, such as the sponsoring employer, contingent assets and the Pension Protection Fund (PPF). The UK was able to build over time a broad alliance with countries such as Germany, the Netherlands and Ireland. This led to changes to funding requirements being dropped from the scope of the Commission’s work on this issue.

Creating a common position among domestic actors is vital to presenting a united UK position in Europe that can be the foundation of strong pan-EU coalitions. Having the UK government, UK MEPs, UK staff in the Commission (including the UK Commissioner) and UK external actors such as business groups united behind a broadly common position greatly increases the chance of then mapping this position on to the European policy process. Using business federations or technical bodies can help member states strengthen arguments that persuades other member states to enter alliances. For example, the CBI’s report with Oxford Economics on the impact of strict prudential rules on pension funds helped give rigorous underpinning to arguments against an overly strict regime that resulted in a successful outcome on the legislation (see Exhibit 44).

Furthermore, powers granted in the Lisbon Treaty to national Parliaments also increase the importance of involving domestically elected representatives in this process, so they can then use their connections to build links with parliamentarians in other member states as well as their own UK party’s MEPs (see Exhibit 45).

Exhibit 44: IORP – Early alliance building supporting long-term investment for pension funds

The Commission began its work on a legislative proposal to review the existing 2003 IORP Directive for pension funds in 2010, and it became clear that the revision would include higher capital requirements for occupational pension funds.

The UK government believed that the plans would damage long-term growth and destabilise markets. Increased requirements would increase scheme liabilities, which in a British context could mean additional costs for businesses of up to £450bn. Funding would be locked away in the pension fund diverting it away from business investments and job creation. A CBI/Oxford Economics report showed that business investment would be 5.2% lower than otherwise in the mid-2020s, with a shortfall of 1.4% still being felt in 2040.229

Moreover, the UK argued that pensions should be treated differently from other financial products as they are deeply integrated into national social protection systems and regulated by national social and labour laws, and generally backed by outside sources of solvency, such as the sponsoring employer, contingent assets and the Pension Protection Fund (PPF).

The UK was able to build over time a broad alliance with countries such as Germany, the Netherlands and Ireland. This led to changes to funding requirements being dropped from the scope of the Commission’s work on this issue.
Exhibit 45: Building coalitions between national Parliaments can stop damaging legislation in its tracks

National parliaments have the right to object to EU rules if they believe member states, rather than the EU, would be better placed to solve the problem. If at least one-third of all national parliaments together object to a proposal within eight weeks of publication, the “Yellow Card” Procedure forces the Commission to review the proposal to decide whether to maintain, amend or withdraw it.

The procedure was introduced with the Lisbon Treaty to counter the democratic deficit of the EU and gives national parliaments the right to ensure that the EU does not regulate if an issue is better dealt with at national level – the so-called ‘subsidiarity principle’. If more than half of parliaments object, the proposal is sent to the Council and Parliament who can reject it by giving it a ‘Red Card’.

In September 2012, this procedure was used successfully to object to Monti II, a proposed EU Regulation on the right to strike, when a coalition of 12 member states, including the UK and the Netherlands, used the Yellow Card and forced the Commission to withdraw its proposal.

Once a common UK position has been adopted, it is important to build coalitions right across the EU institutions throughout all stages of the policy process. As described above, the UK has historically been successful at building alliances in the Council, but it needs to replicate this in the other institutions. The UK needs to work to build support for its reactive positions in the Commission – at staff level and at Commissioner level – but also for those issues where it wants the UK Commissioner to push issues proactively.

Building alliances in the European Parliament between MEPs of different member states must also be a focus, and engaging at a political level to build alliances at political party and grouping level is also an important influence channel. Unfortunately, the UK’s historical success in building alliances in the Council has struggled to spill over into the Parliament. The party political nature of the institution – as well as the current lack of UK representation in the biggest political grouping, the European People’s Party – has reduced UK influence here. The UK’s first ever defeat on a piece of substantive financial services legislation is an example of this need to increase influence across institutions and throughout the policy process: proposals regarding remuneration in the banking sector hijacked a wider vote on the Capital Requirements Directive IV, seeing the UK outvoted for the first time on financial services legislation after it had failed to build and maintain alliances on the issue throughout the legislative process in both the Council and the Parliament.230

Historically, proactive and positive engagement to craft consensus has led to successful outcomes. The lack of prior diplomatic engagement which led to the December 2011 ‘veto’ was not only ineffective in that the veto did not particularly influence the final outcome (the bulk of policy behind the proposed Treaty for Stability and Growth went ahead), but it also harmed British influence in day-to-day negotiations in Brussels, particularly on financial services. In contrast, the UK’s positive coalition building led to a considerable ‘win’ for the UK during EU budget negotiations 12 months later. The UK government is clearly most influential when it is most engaged, and business supports a continuation of this positive engagement.

Exhibit 46: UK coalition building to achieve an EU budget ‘win’

The EU budget negotiations for 2014-2020 highlight the UK’s ability to build alliances and achieve clear ‘wins’ when it engages in the right way. Instead of finding itself isolated, the UK managed to find agreement with other net contributors such as Germany, Sweden, and the Netherlands that there had to be a real cut in overall EU funds in order to reflect significant cost-saving measures that had been implemented at national level by member state governments. In spite of opposition from some net beneficiaries from EU funding, the UK was able to secure an outcome that resulted in a 3.5% reduction of the overall budget in real terms (£960 million),232 compared with the Commission’s original proposal which called for a 4.8% increase (£1.025 trillion) on the previous seven-year period.231
The UK needs to do more to ensure that it has personnel in key positions to help frame the EU debate

Having national citizens in prominent positions, both political and official, in EU institutions is an important tool of informal influence.

Such personnel give a number of advantages. First, information that helps member states stay up to date with policy developments that might impact on national interests often flows from personnel posted to EU institutions. As former UK diplomat Sir Colin Budd told the House of Commons Foreign Affairs Select Committee: “all EU member states rely significantly on the nationals they have in the EU institutions as part of their collective networking strength”. Secondly, it gives the UK a platform to set the agenda of the EU’s institutions. This is true in the Commission, where the Commissioner (and his Cabinet and Director-General) can help set the agenda, but it is also increasingly true in the Parliament, as senior Parliamentarians in political groupings and as Chairs of key Committees are more often taking a lead on policy promotion.

A third benefit of having personnel in the EU institutions is the influence it affords a member state over the details of legislation. This is useful both during negotiation stages – for example, by having Rapporteurs in the Parliament or desk officers and senior officials in the Council/Commission – and when technical details are being finalised in technical committees or agencies. Having influential people in the Commission who closely understand the UK’s point of view – either by their nationality or by having heard persuasive representations from UK actors – is crucial, especially during the drafting of legislation.

Politically, the potential for UK influence via the Parliament is considerable, especially when one considers the power that rapporteurs or shadow-rapporteurs have to influence the final text of legislation. For example, in the case of data protection, UK MEPs Timothy Kirkhope (Conservative) and Baroness Ludford (Liberal Democrat) used their positions as shadow rapporteurs in the Civil Liberties, Justice and Home Affairs (LIBE) Committee to champion amendments alleviating the burdens on firms against the more stringent approach taken by the main rapporteur on the data protection Directive.

There are also challenges in the European Parliament: the UK needs to look to improve the attendance and voting record of its MEP representation, as some MEPs are currently failing to exercise those formal rights they have been given to further British interests (see Exhibit 47). British business is dependent on MEPs who work for the UK in the increasingly powerful Parliament because their activity has a direct impact on the day-to-day operations of companies by deciding issues like product rules, capital requirements or labour market reform.

The UK has had a relatively strong presence in the staff of the European Commission for many years, with UK nationals holding strategically valuable positions at a senior level (see Exhibit 48). This strong representation over the past 20 years has allowed the UK to hold the joint highest number of the most senior EU civil service positions in the Commission, with five Directors-General currently in post (see Exhibit 48). However, in terms of the Commissioners themselves, the present division of Commission portfolios among member states does not favour the UK in terms of business priorities.
Historically, the UK has been relatively effective in using its representation in the staff of EU institutions, most notably in the Commission. But the UK is in danger of a significant reduction in its ability to use this channel of influence. In relation to its share of the EU’s population, the UK is now significantly under-represented in terms of staffing levels in the Commission and Parliament.234 The lack of UK staff in the Parliament is especially concerning given the increase in its formal powers and political influence in recent years.

Exhibit 48: UK representation – influence across the EU

Jonathan Faull: Commission Director-General for the internal market and services
Philip Lowe: Commission Director-General for Energy
Robert Madelin: Commission Director-General for Communications Networks, Content and Technology
Lowri Evans: Commission Director-General for DG Mare, responsible for Fisheries
Steven Quest: Commission Director-General for DG Informatics (DIGIT)
Professor Anne Glover: EU chief scientific adviser

The number of UK nationals in the Commission staff has fallen by a quarter in seven years, standing at a total of 4.6% of Commission staff, compared to the UK’s 12.5% share of the EU’s population. In comparison, French nationals make up 9.7%. UK presence has also fallen in the last three years in the secretariat of the Council and the European Parliament. The UK has higher shares of senior positions than junior ones (a worrying ‘generation gap’) but comes behind France in all categories. For instance, among junior positions in the Parliament staff the UK had just a 2.1% share at the start of 2013 compared to France’s 17.4%, and at entry-level administrator grade in the Commission there were 14 member states with more nationals than the UK.

Given the importance of staff to framing the parameters of legislation, fixing this ‘generation gap’ that has opened up at levels where early decisions are made about the direction of legislation, and reversing the overall downward trend in UK representation, is essential. The UK government’s EU Staffing Unit in the Foreign and Commonwealth Office (FCO), established in April 2013, should be a helpful tool, working to place additional seconded national experts in the short term and increase the number of permanent officials in the longer term by promoting recruitment opportunities to students, graduates and professionals. But Foreign Secretary William Hague could not have put it better when he said that present staff numbers indicated a failure to “give due weight to the development of British influence in the EU”, and the UK needs to address this deficiency.

“Fixing the ‘generation gap’ that has opened up among UK staff in EU institutions is essential to maintaining UK influence.”

-The number of UK nationals in the Commission staff has fallen by a quarter since 2006.
The UK has historically used its expertise and the credibility of its citizens, both as policymakers within institutions and as external contributors to the policy process, as an important tool to influence the direction of policy in the EU.

The UK’s technical expertise gives it significant credibility on a range of issues that allow it to set the agenda

Although the direction of the policy agenda is dictated primarily by political forces, the EU undoubtedly looks to those member states with expertise when deciding policy direction, as well as specifics, in particular areas. This allows member states with key interests, and often therefore the corresponding expertise, to better protect and further those interests. This is especially true during the policy formulation stage, when establishing a fact-base for a proposal necessitates engaging with experts and those with real-world experience of the issue, but also during ongoing negotiations, when technical dexterity can often find a way around political roadblocks.

The UK has historically used its expertise and the credibility of its citizens, both as policymakers within institutions and as external contributors to the policy process, as an important tool to influence the direction of policy in the EU. For example, the UK’s expertise in the area of financial services – based on London’s position as a global financial centre and the Bank of England’s historic reputation as a regulator as well as central bank – has given it significant influence on the direction and development of financial services legislation, from the liberalisation of financial services under the Irish Commissioner Charlie McCreevy at the end of the last decade to forming the EU’s response to the recent financial crisis (see Exhibit 49).

Exhibit 49: UK influence on financial services legislation maximised through credibility and expertise

The UK government put forward their position on the ongoing review of the Markets in Financial Instruments Directive in alliance with other member states, through fact sheets and Q&A briefings to other member states about the operations of financial markets and how to best regulate them. The UK’s policymaking credibility – both in the Treasury and the Bank of England – ensured that these arguments were given prominence during debates in the EU on the subject, and they allowed the UK to shape the Council position that would allow financial markets to function better for the whole of the EU as well reflecting the priorities of the City of London.

Once legislation reaches the technical specification phase, having expertise becomes crucial: details are technical and it is difficult for political actors to follow the process, so having expertise becomes the primary way to exert influence on the details that can impact directly on business models. This is particularly true in areas with increasing use of detailed legislation at EU level (see Exhibit 50). For example, the use of delegated and implementing acts in Commission drafts for both the Network and Information Security Directive (cyber security) and the General Data Protection Regulation have sparked fears among industry that inappropriate calibration of final rules could hinder innovation. Having UK expertise informing the development of these rules is therefore an important influence tool to get the right result for business.
Outside groups and individuals, including from the UK, can also influence the policy process through credible intervention and by showing examples of best practice. The EU’s policymaking and deliberative organisations are in constant demand for information as resources are relatively scarce. EU officials therefore regularly call on a number of external actors during the European public policy process, including national regulators and the business community, and the UK’s credibility on a number of issues has historically allowed it to increase its influence on the policy process (see Exhibit 51 overleaf).

Although the UK is seeing its standing increasing in a number of areas, most notably on climate change issues and in the area of telecoms, one of the biggest threats to UK influence in the EU in this area comes from the reputational hit the UK took as a result of the financial crisis. Some in Europe have pointed to the failure of the ‘Anglo-Saxon’ model (as critics term it) as an indication that the UK can no longer be trusted on financial services regulation. Regaining credibility in this area should be a key aim of the UK government and financial services industry, as historic gains in this area have, in part, been built on the European model for deferring authority to those who have credibility and expertise in a particular area.

**Exhibit 50: Exerting UK influence on EU broadcasting regulations through domestic expertise**

British expertise on digital and broadcasting issues allows the UK to influence the policymaking process from the outset, during the setting of regulatory requirements, and during the ongoing process of supervising and regulating the industry.

- UK leadership in opening up government datasets and the appointment of a ‘digital champion’ in Martha Lane Fox has seen calls from President Barroso and the Commissioner for the Digital Agenda, Neelie Kroes, for other member states to do the same.
- UK regulatory expertise during lobbying on the Audiovisual Media Services (AVMS) Directive led to the incorporation of the ‘country of origin’ principle in the final legislation, which means that content being disseminated throughout the EU need only comply with the national rules where the broadcaster is based, rather than with rules in each of the 28 member states. This allows the UK to be the leading commercial broadcasting hub in Europe, with the regulation allowing firms broadcasting to any EU country to set up in the UK without having to duplicate regulation.
- The UK regulator, OFCOM, represents the UK in the Body of European Regulators of Electronic Communications (BEREC), allowing it to use its expertise to help shape the debates in the EU on all telecoms regulation and best practice. OFCOM also has a seat at the table during European negotiations on spectrum allocation – an issue of prime importance to the UK telecoms industry – working with the European Commission’s radio Spectrum Policy Group and, on pan-European allocation, with the 48 country-strong European Conference of Postal and Telecommunications Administrations.
The UK’s role in a number of global institutions magnifies the international pressure it can bring to bear in the EU

The final ‘tool of influence’ for the UK is the use of international forums that can shape the strategic direction of policy debates. Global institutions can help set the parameters of legislation at a European level in line with UK objectives, especially as the agenda is increasingly being set at an international level to deliver responses to global challenges (see Exhibit 52).

The EU operates in a global environment and the priorities of third countries and international institutions have an impact on the EU policy process. As an international actor itself, the EU is informally influenced by discussions that occur at international level on global issues, such as on global warming and tax transparency, as well as taking part in formal international institutions such as the WTO that dictate the parameters within which certain policies must operate.
Exhibit 52: UK presence in international bodies is an important tool of influence over EU policymaking

The Group of Eight (G8) is a forum for governments from eight of the world’s largest economies – including the UK, Italy, Germany and France – with leaders meeting once a year to discuss global issues. Not only is the EU represented as a ‘ninth member’ (although it cannot host or chair summits), but G8 discussions often set the broad agenda for policy at EU level.

The Group of Twenty (G20) gathers finance ministers, central bank governors and heads of government or heads of state from 20 major economies and the EU as well as several member states – UK, Germany, France and Italy – have a seat at the table. The body discusses global economic and financial issues, and its conclusions commit the G20 countries to undertake reform with the aim of reaching greater global coherence. The UK’s direct access gives it a unique opportunity to shape international rules which then set the agenda for European rules.

The Financial Stability Board (FSB) oversees implementation of many of the G20 commitments on financial regulation. It co-ordinates the work of national financial authorities at an international level and develops and promotes the implementation of effective regulatory, supervisory and other financial sector policies. The UK has a broad representation in this institution, and the current Governor of the Bank of England, Mark Carney, is its chair.

The United Nations (UN) is an intergovernmental organisation that aims to promote and facilitate international co-operation across a range of fields, from security issues through international law to progress on human rights and democracy. The UK is a voting member of the UN and holds a permanent seat on the Security Council (along with France, the only other EU member state represented).

The Organisation for Economic Co-operation and Development (OECD) is an influential organisation, particularly on issues such as tax and structural reform, and it gathers 34 countries including the EU and 21 of its member states. The UK is a direct member. The members meet in specialised committees and there are about 200 on specific policy areas, such as economics, trade, science, employment, education and financial markets.

The World Trade Organization (WTO) deals with the global rules of trade between nations and facilitates interaction between member governments on trade issues, including negotiating trade liberalisation agreements and settling trade disputes. The UK is a member of the WTO and has signed up independently. However, the EU negotiates on behalf of all its member states.

In a globalised world, there is also an increasing impact on the EU’s day-to-day policy process from international decisions, with a significant amount of EU regulation now stemming from international agreements to which the EU and its member states are signatories. The international response to the global financial crisis, and its subsequent impact on EU and UK legislation, highlights this trend. Following the financial crisis, the EU has driven forward comprehensive reform of the financial services regulatory framework. A substantial part of these reforms are the translation of the commitments the EU has made in the G20, as stated in the Commission’s description of the financial services reform: “The G20 has been instrumental in establishing the core elements of a new global financial regulatory framework that will make the financial system more resilient”. More than half of the 47 pieces of legislation put forward in total since 2009 directly refer to the EU’s G20 commitments.

This international policy agenda is mirrored to some extent in trade policy: many EU rules are ratifications of WTO agreements developed by WTO members, such as rules on public procurement, while the recently agreed international Nagoya Protocol on biodiversity will decide EU’s rules in this area. The UK can therefore use its influence in the various international bodies – both political and technical – to ensure that the rules which filter down to the EU from international institutions, and therefore which will eventually reach the UK via the EU, are set in line with UK interests.

The UK is influential in these international bodies partly by virtue of being a large economy in its own right but also because it is seen as influential in the wider EU. In a bi-causal relationship, the UK can influence international bodies – which in turn can influence the EU to UK advantage – precisely because the other actors in those bodies believe that the UK can influence the direction of the 500 million-strong EU bloc in the first instance. Therefore there is a danger that the UK’s ability to persuade international actors to bring pressure to bear on the EU could be diminished if the international community perceives the UK to be abrogating its leadership role in Europe.
The UK has large voting power, is effective at building alliances, has key personnel in EU institutions, and is an acknowledged thought leader in a number of areas. It now needs to work to maximise this influence.

4.3 The UK is influential in the EU, but the UK approach itself is the key to success

The UK has been influential in shaping the EU to maximise the aspects of openness that underpin the UK’s global trading role. It has considerable voting power, is effective at building alliances, has key personnel in EU institutions, and is an acknowledged thought leader in a number of areas. It also uses its membership of international bodies such as the G20 to further influence the EU in a top-down approach.

There are, however, signs that the UK is not maximising its potential to influence EU outcomes. The UK government must continue to proactively build alliances to achieve its aims across the EU institutions and in other member states. The fallout from the use of the veto in December 2011 has meant that the UK must redouble its efforts to proactively win support. Similarly, the UK must work to reverse the decline in numbers of UK staff employed in the Commission and Parliament, and attempt to rebuild its reputation as a source of expertise on financial services issues.

UK influence will matter more than ever in the coming period, as the further integration of the Eurozone potentially changes the nature of the EU. The UK must navigate a course that ensures it shapes the EU to preserve the advantages of membership felt by British business. The likely scenario for the development of the EU and the Eurozone are explored in Chapter 5.
CHAPTER 5

THE UK CAN REMAIN INFLUENTIAL IN A CHANGING EUROPEAN UNION
The EU is a constantly evolving entity and is currently going through a particularly rapid period of change driven by the global financial crisis and subsequent crisis in the Eurozone. The new wave of integration by Eurozone members could, in theory, undermine the Single Market – as well as leaving the UK sidelined with reduced influence. However, the changes underway are also providing an historic opportunity to reshape and reform the EU.

Eurozone member states are unlikely to move any further towards federalism than is necessary to stabilise the single currency and, even in this scenario, the UK can still influence the openness of the whole EU to its advantage if it approaches this changing Europe in the right way.

Those member states looking to further integrate understand that this process has the potential to significantly alter the landscape of the EU; they realise that they are asking to change the rules of the game for much of the EU. Securing safeguards for the Single Market for non-Eurozone members and restating a Europe-wide political commitment to the maintenance of a European Union that works for all its members – focused on flexible co-operation to take on common challenges and shape effective solutions – is achievable.

5.1 The global financial crisis exposed underlying weaknesses in the design of the Eurozone

The EU economy has suffered a triple-dip recession since 2008, leaving GDP today still 2.3% below the 2008 peak. A rise in net trade has eased the downturn, but domestic consumption and investment languished 5.3% below their peak level. Meanwhile, public-sector debt rose from 59.2% of GDP in 2008 to 85.9% five years later, unemployment was 11.0% at the latest count and youth unemployment was 23.4%. The situation was even worse in the Eurozone periphery, with GDP over 20% below peak in Greece, 9.8% below in Ireland, 8.9% below in Italy and 7.5% below in Portugal and Spain.236

The global financial crisis and resulting downturn exposed a number of economic and institutional weaknesses in the Eurozone, eventually triggering the wave of sovereign debt crises beginning with Greece’s in 2010. The causes of the Eurozone crisis are complex: over-leveraged sovereigns are only part of the story and different factors lie behind the crisis in each periphery country. The common theme, however, was a lack of central oversight and functions that greatly exacerbated pre-existing imbalances among Eurozone members and provided inadequate tools to fight the crisis.
The Eurozone was not an ‘optimal currency area’ when it was established in 1999: having limited labour mobility allowed wage imbalances to persist, a lack of price flexibility allowed divergences in inflation to build, and uncoordinated business cycles made a single monetary policy a poor fit. Countries entered at different levels (and with different trends) in productivity. Furthermore, the Eurozone failed to develop the central institutions that could have helped smooth over these imbalances – notably a central fiscal fund that could redistribute income from boom regions to depressed regions and an authority that could oversee competitiveness imbalances and initiate reform.

As a result, the act of imposing a one-size-fits-all monetary policy in many ways worsened Eurozone imbalances. Germany’s relatively sluggish economy faced the same central bank interest rate as Spain’s construction boom. Germany’s gain in competitiveness was underpinned by labour market reform but fuelled also by tight interest rates, which suppressed wages and consumption and drove up German savings, which flowed abroad to fund current account deficits in the Eurozone periphery. In the periphery, much of which already started at a productive disadvantage, relatively high inflation further eroded competitiveness. Cheap borrowing helped enable a construction boom in Spain and unsustainable fiscal deficits in the likes of Greece and Portugal. The Stability and Growth Pact (SGP) failed to keep public deficits and debts within its prescribed limits.

When the global financial crisis began to shake these weak foundations, the Eurozone lacked the central crisis-fighting tools needed to prevent meltdown. It became apparent that sovereigns with an independent fiscal policy but with no currency of their own were far more vulnerable to runs and default than others, for example the UK, which was able to bail out its huge financial sector itself despite having a much higher public deficit and debt stock than Spain. Ireland and Spain, on the other hand, were unable to guarantee their outsized banking sectors without international help, despite being in compliance with the SGP.

Furthermore, the lack of central institutions with mandates for the welfare of the Eurozone as a whole also made it difficult to stimulate the economy to ease the recession. The European Central Bank, although nominally mandated to do so, has moved more cautiously on monetary stimulus than its counterparts in the UK and the United States. Meanwhile, fiscal automatic stabilisers that might have leveraged fiscal strength in the core to offset weakness in the periphery were not in place.

The urgency and magnitude of the crisis led to strong demands for action. To stabilise the economy and the currency union, it was vital to address the banking crisis, improve public finances and increase Europe’s competitiveness. Although many changes would have to be made at national level, failures of national regulation, supervision and behaviour, the mutual Eurozone interest in avoiding a break-up and the fact that individual periphery members were losing access to the markets led a majority of EU leaders to see ‘more Europe’ as the answer, albeit in some cases reluctantly. Thus closer co-operation at both EU and Eurozone level quickly became an essential element of the solution to the crisis. The Eurozone as a whole is in a relatively strong fiscal position – its public deficit peaked at 6.4%, much lower than either the UK or United States – and it has needed to leverage this combined strength in order to find a solution to the crisis.

The global financial crisis exposed a number of economic and institutional weaknesses in the Eurozone.
5.2 The Eurozone crisis is pushing further integration in the EU, spurring fears that the UK could be sidelined

Discussion of further integration has once again spurred concerns in the UK regarding its role in the new Europe that will emerge after the crisis. As the Eurozone integrates to a closer core, it could start pushing through policies and take actions that are not in the UK’s interest, hitting the City or other areas of national importance. This concern is exacerbated by the prospect of the Eurozone getting larger – at worst encompassing all member states except the UK – and beginning to develop common interests across policy areas beyond those directly linked to the Eurozone. This could potentially segment the ‘ins’ from the ‘outs’ and fragment the Single Market. The process of integration could even move towards a fully federal union of which the UK wants no part.

The changing EU will undoubtedly have an impact on the UK. Any assessment of how the EU in practice supports the UK’s global role must therefore look ahead, insofar as it is possible, to determine the UK’s place in this changed EU.

Further integration in Europe is happening in four main areas – each individually bring concerns for the UK and, taken together, could potentially threaten the UK’s place at the top table in Europe

Further integration is seen as the foundation of recovery for the Eurozone. The debate has moved towards a broad consensus for reform, set out in reports put forward through 2012 spanning all the key actors at EU level: the ‘Barroso blueprint’ of the European Commission, the Parliament’s own initiative report and, most importantly, the ‘Roadmap’ developed by the four presidents of the European Council, the Eurogroup, the European Central Bank and the Commission.238

In the discussion about achieving a ‘genuine economic and monetary union’ (EMU) on the focus has been on four main areas where ‘deeper’ integration of the Eurozone (but also in part of the wider EU) could take place in the future: financial, economic, fiscal and political integration (see Section 5.4). A fifth area of further integration involves increasing the number of countries in the EU involved in the closer co-operation of the Eurozone, thereby bringing more members into the integrated core. The EU could, of course, also ‘widen’ through geographical integration as its external borders may change to include new member states. This would continue the historical journey of a Europe moving towards a union that is increasingly larger and which co-operates on an increasing number of areas.
Financial integration – from common regulation and supervision of the financial services sector to the potential pooling of risk, all to increase stability in the system – could pose an added cost to the City if new harmonised rules are wrongly designed. Moreover, the UK could potentially lose the power to supervise its financial services sector independently, as well as find itself facing a European authority that could wind down UK banks and make demands on the UK to pay into a deposit guarantee scheme that would fund lost deposits in struggling Eurozone countries. In the long run, the City could be hit if the Eurozone, supported by the monetary strength of the European Central Bank and rules discriminating against London, becomes a more attractive place for banking operations than the UK.

Economic integration – designed to increase co-ordination and reduce divergences among European economies – could see control over national budgets taken away from the UK’s elected institutions, with the EU imposing budget targets and outlining reforms that have to be undertaken by member states.

Steps towards fiscal integration – following the logic that joint economic and monetary policy requires moving towards a single fiscal policy to help correct for imbalances – could see UK budget contributions increase, to be spent on permanent transfers to struggling Eurozone countries. British people may also have to pay an EU tax going directly to fund EU initiatives.

Further political integration – could take political accountability further away from Westminster to Brussels. At the furthest extreme, the UK could find itself locked into a federal Europe where it would have to give up national power in areas such as defence and education.

Finally, the Eurozone makeup could change, continuing to grow in numbers until the UK is the only country outside the zone, leaving the risk of potentially being outvoted in all areas of EU policy by a Eurozone caucus.

The discussion over the response to the crisis has led to fears in the UK about the potentially harmful impact on the UK’s role in the EU. Although unlikely, it is argued that further integration could potentially increase the disadvantages of EU membership or diminish UK influence in the EU, limiting its ability to fashion future opportunities for UK business and society. Taken together, a package of measures along these lines – implying one of the highest levels of EU integration – could leave the UK marginalised, undermining its historic role as one of the EU’s leading member states.
5.3 Integration measures adopted to date have not fundamentally affected the UK’s place in the EU

A number of the potential measures for integration of the EU and the Eurozone set out in the roadmap have already been enacted. However, the fears over the UK being sidelined have so far not been realised.

Following the financial crisis, the EU took steps towards EU-wide supervision of the financial services sector by establishing common EU supervisory authorities for banking, securities markets and insurance and pensions (for details, see Section 5.4). The UK has never been a strong supporter of giving supervisory power over financial services to the EU, and the creation of these authorities was met with scepticism by the UK government. However, with other member states equally hesitant to give up control over their banks, the powers of the new EU authorities were kept to a minimum, focusing on co-ordination.

The move towards creating a single supervisory mechanism (SSM) for banks from participating member states as the first stage of Banking Union, with the ECB as the common supervisor for the Eurozone, was also seen as a risk to the UK. Quickly dismissing the idea of joining the SSM, which was technically possible, the UK feared the SSM could give the Eurozone countries an in-built majority in the European Banking Authority (EBA) that develops the detailed technical rules for all banks in the Single Market. In those circumstances, the Eurozone countries could potentially outvote – or ‘caucus’ against – the UK in an area of vital national interest.

However, during negotiations, the UK gained support from other member states for a ‘double majority’, which in practice means that decisions in the EBA need a majority from both the ‘insiders’ and the ‘outsiders’ of the SSM.239 The UK used its tools of influence to secure safeguards against a perceived threat arising from Eurozone integration.

The Eurozone has also integrated its economic policymaking. It has introduced two packages of legislation to scrutinise member states’ budgets at EU level before they are passed in national parliaments (via the European Semester), improve surveillance, and given the EU more power to sanction member states that have debt and budgets judged to be unsustainable.240 The Eurozone has also committed to write its budget rules – the Stability and Growth Pact (SGP) – into national constitutions. This has little impact on the UK since most of the measures apply only to the Eurozone. The UK must submit its national budget for scrutiny by the European Commission, but is not obliged to take up on the recommendations, and the Commission does not have the means to sanction the UK.

It has also been necessary to assist struggling member states through a number of temporary bailout funds and the establishment of a more permanent measure, the European Stability Mechanism (ESM). As a non-contributor, the UK has not felt a substantial impact from this measure, but it does have a small liability because part of the EU’s budget has been allocated to struggling Eurozone economies (see Exhibit 53).

Overall, this first phase of Eurozone integration in response to the crisis has, in fact, been positive for the UK. It is in the best interests of UK business that Europe and the Eurozone stabilise and take steps towards sustainable growth because Europe’s downturn hits UK trade with Europe. It has not fundamentally altered the balance of the advantages and disadvantages of UK membership in terms of fragmenting the Single Market or disturbing capital and labour flows. Nor has it diminished the UK’s ability to influence the future outcomes of the EU.

The CBI has therefore been strongly supportive of the Eurozone taking steps to restore credibility and stability to the euro-area banking system.

Nevertheless, the developments to date have shown that the Eurozone’s first priority is to save the currency. This was highlighted by the intergovernmental treaty on stricter budget rules signed in 2011 by all EU member states except the UK and the Czech Republic, after the UK’s failed attempt to block measures at the EU level which the Eurozone saw as essential for its stabilisation. The future integration of the EU will be driven by the Eurozone and, as Angela Merkel has put it: “We cannot stand still because some do not want to go with us”. The impact that this will have on ‘outsiders’ like the UK depends on how far it is necessary, and how far member states are willing, to go to save the currency.
Exhibit 53: UK’s limited liabilities in relation to the Eurozone crisis

Although the UK has chosen to stay out of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), it is indirectly liable for loans made under the European Financial Stabilisation Mechanism (EFSM) through its share in the EU Budget, which was used as guarantee for the borrowing. The agreement between member states to use the EFSM was made by qualified majority and so the UK could not have unilaterally opted-out of the mechanism. However, the UK’s liabilities are small and it will only be liable if the loans default. In that event the UK would have to make further budget contributions of 12.5%, which amounts to a maximum of €7.5bn (£6.6bn), a highly unlikely event according to a House of Commons report. Based on borrowing up to 19 May 2011, the UK’s liability would be only €1.2bn (£1.1bn).

5.4 The Eurozone is likely to integrate further, but the final degree of integration and its impact on the UK is unclear

The steps already taken towards EU integration in response to the currency crisis (primarily along the first four main axes) have not impacted materially on the UK’s interests. However, the Eurozone is likely to integrate further to resolve the crisis. The degree of integration that is both necessary economically and acceptable politically is not yet clear. More radical changes would require the reopening of the Lisbon Treaty and involve referendums across Europe to achieve the democratic mandate required for EU Treaty change. There is therefore a broad delta of possible outcomes for further integrationist moves (see Exhibit 54 overleaf), ranging from those having a very limited impact on the UK to those that could substantially alter the benefits of EU membership in terms of how it supports the UK’s global future.

Were all the above reforms to be implemented fully and to their ultimate conclusion, the Eurozone would have a single set of authorities for financial services supervision and resolution, issue common debt and have a Eurozone-wide tax base, and have pan-European political entities that would be likely to set the parameters for national budgets and enforce the rules to avoid deviation from agreed economic policies. In effect, the Eurozone would look increasingly like a single country, potentially fragmenting the Single Market and the advantages the UK obtains from it.

“The steps already taken towards EU integration in response to the currency crisis have not materially impacted on the UK’s interests.”
### Exhibit 54: Steps towards integration in response to the currency crisis are proceeding along four main axes

<table>
<thead>
<tr>
<th>Financial integration</th>
<th>The problem to be addressed</th>
<th>The solutions so far</th>
</tr>
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<tr>
<td>Integration of the rulemaking and supervision of the financial sector</td>
<td>Lack of common supervision while markets are liberalised across the EU. Fragmentation of the banking system in the euro area along national lines, in some cases drying up credit supply. A ‘vicious circle’ between banks and sovereigns, where the failure of one could cause the other to fail – exacerbated by Eurozone members lack of control over their currencies.</td>
<td>Common supervisory authorities: First, steps taken towards integrated supervision of the financial sector with common European authorities established in 2011 co-ordinating supervision of banks, securities markets, insurance and occupational pension funds, while keeping most of the supervisory power at national level. Common rulebook: The EU created new rules for financial markets, including rules on capital requirements, further harmonisation of recovery and resolution regimes and deposit guarantee schemes. Banking Union (Single Supervisor): These authorities proved insufficient as responses to the crisis were national causing fragmentation of financial markets. A Banking Union has been proposed to combat this while addressing other weaknesses in the bank system, and would be based on a single rulebook of bank regulation and involve a common supervisor, a common deposit guarantee scheme and common resolution rules backed up by a common resolution fund. To date, only the common supervisor has been adopted, with the ECB becoming the supervisor of the Eurozone in a new ‘Single Supervisory Mechanism’ (SSM) as of mid-2014.</td>
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| Economic integration | The euro-area governance system was based on surveillance of fiscal policy to make sure countries stuck to the Stability and Growth Pact (SGP), which sets the limits for budget deficits and public debt of 3% and 60% of GDP respectively. In the case of a country breaching this, it would be put under the Under the Excessive Deficit Procedure (EDF) where they have to follow EU recommendations to improve the situation. However, the governance was not effective as it lacked the right level of surveillance, co-ordination, and strong sanctioning means. In a currency union where the economic divergence was large at the start, this led some member states to thrive while others dodged structural reform and ran unsustainable levels of debt and deficit without penalty. | The EU has introduced several measures to get member states’ budgets and debt under control. • It has created a common budgetary timeline and common budget rules for euro area member state – the European Semester. • Two regulatory initiatives, the ‘six-pack’ and the ‘two-pack’, have strengthened expenditure rules, altered the conditions for Excessive Deficit Procedure (EDP) to include debt developments, and introduced a new Macroeconomic Imbalances Procedure (MIIP) – a surveillance mechanism aiming to prevent macroeconomic imbalances and identify and allow the timely correction of any emerging competitiveness divergences – and strengthened the ‘corrective arm’ of the Stability and Growth Pact, including by introducing the possibility of sanctions for countries that breaks with the pact with an interest-bearing deposit of 0.2% of GDP. Member states have also given further impetus to the governance reforms through intergovernmental agreements. • The Euro Plus Pact in March 2011 was signed by 23 member states, including six outside the euro-area (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). It commits signatories to strong economic co-ordination for competitiveness and convergence, including areas of national competence, with concrete goals agreed on and reviewed on a yearly basis by heads of state or government. It is now integrated into the European semester and the Commission monitors implementation of the commitments. • All EU member states except the Czech Republic and the UK have also committed themselves to a stricter version of the SGP in the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSG). The Treaty obliges Eurozone countries to incorporate EU rules on balanced budgets into their national legal frameworks. Only a few parts of the Treaty formally apply to non-Eurozone countries, although they can choose to adopt the full Treaty, as Denmark has done. |

| Fiscal integration | The no-bail-out clause is supposed to make sure that no country had to save another financially didn’t hold. Furthermore, the lack of a system for sharing the risks and the fiscal burdens, including fiscal transfer mechanism to redistribute wealth to weaker areas, contributed to countries needing – and getting – bail-outs. | Bail-outs: To enable bail-outs of Eurozone states in distress, the solvent nations in the Eurozone have supported struggling nations through guarantees and loans via two short-term facilities: • European Financial Stability Facility (EFSF): Created in May 2010 by the EU’s then 27 finance ministers. A limited fund authorised to borrow up to €780 billion backed by guarantees given by the 17 euro-area member states, providing financial assistance conditional on reforms. To date this fund has distributed to Greece, Ireland and Portugal. • The European Financial Stabilisation Mechanism (EFSM): Operational since May 2010 and is reliant upon funds raised by the European Commission on the financial markets and guaranteed by the EU budget, thereby involving all 27 member states. The European Central Bank (ECB) has also stepped up and secured market confidence through OMT, with President Mario Draghi ultimately promising to do “whatever it takes to preserve the euro” and announcing a programme to buy an unlimited number of bonds. A permanent emergency fund: the European Stability Mechanism: The Eurozone countries established the ESM in 2010. Unlike the EFSF, this fund is not based on member states’ guarantees, but comprises in part paid-in capital (€80 billion) and in part callable capital (€620 billion) split between the member states, which gives an effective lending capacity of €500 billion. The ESM Treaty was signed in February 2012 giving the fund the power to provide loans and intervene in the primary and secondary debt markets. The Eurogroup then enabled the ESM to directly recapitalise struggling banks in member states in June 2013 under stringent conditions. The fund can pump cash directly into teetering banks against strict requirements instead of providing support through governments which increases the country’s debt. |

| Political integration | Further financial, economic and particularly fiscal integration requires political integration. Accountability must take place at the level where decisions are taken and democratic legitimacy needs to be strengthened if further power is transferred to the European level. | This is the least developed part of the discussion about a changing EU, with few changes adopted to date. The changes that have happened are limited in scope. When the Single Supervisory Mechanism was created, accountability and transparency arrangements were strengthened in negotiations. For instance, the chair and vice-chair of the Supervisory Body will be approved – and potentially dismissed – by the European Parliament, while national parliaments will have a stronger role, through hearings with the supervisory board chair and requesting written replies from the ECB supervisor. The Commission adopted a recommendation in March 2013 urging European political parties to nominate a candidate for European Commission President in the next European elections. This has been done in previous elections, but not all political parties have put forward a candidate. |
Further potential development

- **Common rulebook:** Work to strengthen the Single Market rules on financial services could continue both across all existing areas covered by EU regulation and in new areas in the future. Moreover, to avoid divergence between member states; in particular between the euro-area and the rest of the EU - the single rulebook could be underpinned by uniform supervisory practices led by a single supervisory handbook developed by the European Banking Authority (eba).

- **Stronger common supervisors beyond banking:** The European Financial Authorities’ power could also be strengthened.

- **Resolution:** Work is ongoing both on common EU rules (Recovery and Resolution Directive) and a new Resolution Mechanism to create a common resolution authority and an appropriate backstop to support the SM. The Commission has suggested giving itself power to shut any failing lender in Europe’s banking union, based on the advice of a ‘Single Resolution Board’, even in the face of home state opposition.243

- **Deposit insurance:** Work is on-going to update common EU rules on deposit guarantees, but it has been argued that the Eurozone needs to go further than harmonisation of national rules on DGS towards creating a common deposit guarantee scheme. This scheme could be combined with a European Resolution Scheme, and be managed by an institution, potentially one independent of the common supervisor, the ECB.

- **Financial backstop:** A full Banking Union would need a credible and powerful financial backstop. This could be facilitated through a number of common euro-area assets (see Fiscal integration).

Ex-ante co-ordination: Because national reforms, especially large-scale ones, might have cross-country spill-overs, there could be a development towards greater ex-ante co-ordination of such reforms. The Commission has put forward a communication for how this could take place before final decisions are taken at national level.

Formal reform obligations: It is also being discussed whether the Eurozone should bind member countries more formally to structural reform. The Commission has put forward ideas for how contracts could be introduced between member states and EU institutions on the policies countries commit to undertake and on their implementation. Such contracts could be a quid pro quo for receiving fiscal assistance as part of the Convergence and Competitiveness Instrument (cci) (see Fiscal integration).

Common economic government/Treasury functions: The Eurozone could also move towards creating a common economic government – potentially a European Treasury within the Commission – which would meet every month to discuss ways of promoting growth. This could also involve giving the European Court of Justice the ability to monitor national budgets.

- **A limited fiscal capacity:** A limited fund could provide temporary, targeted and flexible financial support to structural adjustment in member states who commit to reforms. The Commission has put forward thoughts for the use of such an instrument – a Competitiveness and Convergence Instrument (CCI). If a fiscal capacity is set up, a key aspect would be whether it would be given the ability to borrow. Building on the limited fund, a more permanent capacity could be set up and be used to absorb country-specific shocks, for instance through an insurance system set up at central level.

European Redemption Fund: This concept was first presented in 2011 by the German Council of Economic Experts and provides a framework for bringing down the euro-area member states’ debt by pooling all ‘bad national debt’ above the limit set out in the Eurozone rules – 60% of GDP – into a joint fund, with member states being obliged to redeem the debt over a specified period of time, for instance 25 years. The fund would issue its own bonds, serviced by the participating member states, and – to get the sufficient credit rating – be backed by a joint guarantee of all euro-area member states. Treaty change would be required and, to limit moral hazard and ensure the redemption of payments, it would have to include strict conditions.

- **Eurobills:** A mechanism to overcome differentiated risk premium put on Eurozone member state debt – commonly issued short-term government debt with a maturity of up to one to two years. They could progressively replace existing short-term debts and create a large integrated short-term securities market in the euro area. Due to their character as financial instruments requiring joint and several guarantees by participating member state, this too would involve Treaty change.

- **Eurobonds:** All Eurozone member states would issue common debt. This would be a permanent fiscal transfer and would certainly also require Treaty changes. This option is less discussed given the opposition from the more fiscally stable countries of the Eurozone such as Germany.

Common tax: Not part of the current discussions, this proposal has support from those favouring a federal EU. It could be a common tax for the Eurozone or the EU as a whole and would generate “own resources” for the EU, creating a European budget separated from national contributions: in other words, creating full fiscal federalism.

Accountability through the European Parliament: One suggestion is to increase the involvement of the European Parliament in various discussions and in setting the multiannual priorities of the Union, as the EP is the only EU institution directly accountable to the people of Europe. Another suggestion has been that the Parliament adapts its internal organisation to a stronger EMU by setting up a special committee on euro matters to scrutinise the work of the Eurogroup – the special group set up for finance ministers of the Eurozone countries.

In addition other ideas have also been touted, such as having a directly elected president of the EU – whereas today the president is appointed.

The Commission has also tabled a proposal for a revised statute for European political parties which would give a legal status for European political parties and their affiliated foundations, as most of them are today registered as Belgian non profit-making associations.252

Move towards a political union: Some argue that there is a need to take further steps towards political union, by gradually giving the EU control over even more areas until the EU level becomes the primary level of power in a fully federal Europe with a European government. The European Parliament’s powers could be strengthened and the Council could form a second chamber. However, while some have always favoured making the EU a federal state, there is very limited support among member states.
5.5 The political will exists to support the Euro but not for full federalism

Fears about a changing Europe are understandable, and legitimate. In the same way that changes in the past have created threats and opportunities for British business, future changes may alter the advantages and disadvantages of being a member of the EU.

However, the extent to which these fears will materialise depends in part on the impact of current changes and likely future developments and in part on the UK’s ability to influence the direction the EU takes in the future, through use of the tools discussed in Chapter 4. The final outcome of European reform is difficult, if not impossible, to predict. What can be done is outline possible scenarios, assessing their likelihood and the potential impact they could have on the factors that underpin the UK’s global role.

The Eurozone to break up, speculating on the political impact on the UK’s place in the EU would take second place to the consideration that would need to be given to economic consequences on the UK economy following the enormous disruption faced by its closest trading partners in Europe. However, in these circumstances the UK is likely to retain influence in the EU. Only if the EU moved to a fully federal structure would the UK be likely to find its influence significantly set back. In most scenarios short of the creation of a federal state, the UK retains the tools of influence set out in Chapter 4.

The overall direction of the EU – including the level of integration pursued – is dictated by the details of the current EU Treaties and the priorities and policies of member states.

The degree of further integration ultimately depends on how far the EU’s key actors are willing to go

European integration is to a large degree controlled by its member states: they sign off each new EU Treaty that sets out what the EU should be doing, what should remain under member state control and how the EU should conduct its business. The member states have always been the most powerful actors in the EU and the crisis has shown that they are still in command.

Moreover, the member states – 28 in total – are not a homogeneous group; they have diverging views on what the EU should look like, and they all seek to maximise their own advantages by shaping the EU in their vision.

The final outcome will therefore depend on the overlap of these visions, with larger countries – such as the UK, France, Germany, Italy and Poland – holding more power than others. What they do have in common is that they all preside over an increasingly Eurosceptic public, with polls showing support for the EU at an all-time low.253

The EU’s own institutions also have a say in Europe’s future, but their power remains limited. The European Commission, the European Parliament and the numerous EU agencies influence the day-to-day political outcomes of the EU. However, the overall direction of the EU – including the level of integration pursued – is dictated by the details of the current EU Treaties and the priorities and policies of member states.

Furthermore, integration does not happen in a vacuum; historical events may necessitate a push for integration. The current crisis has instigated a new wave of reform, and future integration is highly dependent on how the crisis develops over the next few years. If pressure remains high, the incentive to reform will remain, but the likelihood of further change will be reduced if the currency union regains market confidence and growth returns in Europe.

For any substantial steps towards further integration, the EU will need Treaty change, which is a substantial obstacle for further integration. Although the EU can take steps through creative ‘outside-the-Treaty’ solutions, including intergovernmental treaties, there are legal limitations making Treaty change necessary if substantial powers are to be given to the EU. This would trigger an extensive process involving a long negotiation and referendums to ratify the agreement in several member states, including in the UK. Therefore a number of member states are hesitant to embark on Treaty change. As President Hollande’s adviser has said: “We will do a treaty change only if we have certainty about a successful ratification process. It would be too embarrassing to fail. The risk is bigger than on the Lisbon Treaty”.254
The Eurozone is unlikely to collapse

Although Eurozone governments have taken significant steps towards central supervision and integration, the currency union still struggles with design weakness and market distrust. There are therefore those who argue that, despite plans for further integration, it is not likely that member states will be willing to take the necessary steps forward – with the consequence that the Eurozone will break up.

Those who argue that a break-up is likely often believe that a monetary union comprising countries as diverse as Germany and Cyprus is simply unsustainable without a substantial degree of integration, including burden sharing between member states. If the periphery fails to act on productivity shortfalls, the core would have to tolerate indefinite transfers and the monetisation of debts to prevent competitiveness and balance of payment imbalances from threatening the existence of the euro.

Meanwhile, the periphery, lacking the option of currency devaluation, is enduring the huge pain of ‘internal devaluation’ in order to bring down debts and improve competitiveness. The core has done enough to contain the Eurozone crisis, for now, with programmes including the ECB’s Outright Monetary Transactions (OMT) and the European Stability Mechanism (ESM) as well as the moves towards Banking Union, but relatively little has been done to ease the pain of adjustment in the periphery. Without greater burden sharing – through, say, fiscal transfers or a tolerance of higher inflation in the core – one or a number of the periphery countries may perceive that the pain of remaining in the euro exceeds the risks of exit. The exit of a periphery member would be risky, potentially sparking further exits and even a full break-up of the Eurozone.

Any full break-up of the Eurozone would be hugely disruptive and carry severe macroeconomic consequences. Though the risks are likely to be somewhat smaller if the break-up is managed and planned for, substantial risks would remain, especially while Europe remains economically weak. Irrespective of UK membership of the EU, a full break-up would have substantial costs to the UK since its major trading partners would be thrown into a crisis.

A full break-up would mean that all countries would return to their national currencies. Then a devaluation or revaluation of all new currencies would take place, and all contracts, debt, pensions and wages would be redenominated. There are important legal dimensions to this analysis, including the legal jurisdiction of euro denominated assets and obligations in question. The importance of the size of euro obligations under English and New York law, in the form of Foreign Exchange (FX) swap and forward contracts, as well as interest rate derivatives, should not be underestimated. The sheer size of these markets illustrates that complications related to the redenomination process around such assets and obligations have the potential to cause very significant disruptions, with dramatic macroeconomic implications.

In addition to the economic consequences, break-up of the Eurozone would have a political impact on the EU as a whole. The euro is a major project for the EU and has had substantial political support. A break-up could reduce the legitimacy and support for the EU and could lead member states to withdraw further powers from the EU level. At the extreme, it could lead to a complete undermining of the EU as a project.

A Eurozone collapse is not a likely scenario. Ultimately, any full or partial break-up of the Eurozone would be a political decision – it cannot be forced by the markets directly (though they can impose costs on countries staying in). The past years have consistently shown that the Eurozone has political support to do ‘what it takes’, as the governor of the European Central Bank put it, at least at crunch points when break-up looks like an imminent danger. An influential German Social Democratic MP remarked in an interview conducted by Policy Network for the CBI: “Eurozone integration is inevitable and Germany will do whatever it takes to keep the euro afloat, even if this is costly for Germany”. Meanwhile, the periphery, to date at least, has shown a willingness to endure deep recession and eye-watering unemployment rather than risk ditching the euro.

However, substantial moves towards a federal superstate – likely to be based on designs intended to support the currency union – could alter the balance of benefits of EU membership.
The Netherlands’ government is convinced that the time of an ‘ever closer union’ in every possible area is behind us.

It is not likely that Europe will move towards a federal superstate

Elements of the debate about achieving a ‘genuine EMU’ involve substantial steps of integration which some have characterised as ‘federal’, and indeed proponents of a federal Europe have argued that much more integration is needed before Europe’s current challenges are solved.

The notion of achieving a fully federal European Union has been present from the very start of the European venture. The idea was already present in the Schuman declaration of 1951, and it was championed by several of the EU’s founding fathers, in particular Jean Monnet, who viewed national sovereignty as outdated. In the 1958 Treaty of Rome, the six founding members agreed that they were “determined to lay the foundations of an ever-closer union among the peoples of Europe”, and the commitment to ‘ever-closer union’ still remains part of the current Treaty, although it has been complemented by an increasingly large number of other priorities.

Proponents of a federal Europe argue that pooling sovereignty to the EU level to create a United States of Europe is the only way to accommodate the challenges facing the continent. Creating a federal Europe would mean a substantial pooling of powers to EU level in all areas:

**Full financial integration:** A fully federal Europe would have created a full banking union, including establishing a common resolution authority with widespread powers and a common scheme for deposit guarantees and bank resolution, sufficiently backed up by a common European fiscal resource.

**Full fiscal integration:** A federal Europe would mean a move to the very end of the spectrum of fiscal integration with the Eurozone issuing common debt, in the form of Eurobonds. The EU would likely be empowered to tax its population directly, for instance through a common EU VAT, which would create a basis for European own resources. This could substantially boost the EU’s budget, enabling the union to steer economic development and reform across the continent without needing contributions from member states. The EU would also likely to have established other ways to distribute fiscal resources across the Union - this is what is often described as a ‘transfer union’, in which the economically strong member states permanently support weaker member states in the same way that economically strong regions in the UK support less competitive areas.

**Full economic integration:** Central economic policymaking, such as labour market policy, would be given to the European level. A European Treasury function could take charge of Europe’s economic and fiscal policy, holding powers over member states to push through reforms with substantial sanctioning powers. This could be led by a specially appointed Commissioner in the role of a pan-European finance minister.

**Full political union:** In a federal scenario, member states would have given the EU competences in a number of areas necessary to a federal union. For instance, in a federal Europe, the EU would likely seek more majority decisions in the common foreign and security policy sphere, one single diplomatic corps, a European defence policy and potentially a European army with a single central command. A federal police could be put in place to deal with federal crimes (such as terrorism, organised crime, human traffic and federal taxes evasion). The EU could, in particular, be entitled to manage asylum policy and the control of external borders. A federal Europe would also mean that the member states would always be represented by the EU in international organisations, including the UN, which in practice would mean France and the UK giving up their seats on the Security Council. The European Council could also be disbanded in favour of a bicameral parliamentary system, a situation that would see all member states losing their ability to shape EU policy in their own interest.

Although not a majority, the federalists are a considerably powerful group, well placed to influence the EU’s development – with both the European federalist movement and a European Federalist Party (EFP), founded in 2005 after the European Union constitution was voted down by France and the Netherlands, in existence. More recently, in 2010 a group of MEPs launched the Spinelli Group, which seeks to ‘inject a federalist momentum’ into political decisions and policies of the EU (see Exhibit 55).
Exhibit 55: The Spinelli Group

The Spinelli Group supports a fully federal EU. It has more than 110 supportive MEPs, 44 active members (EU experts, NGOs and think-tank representatives, politicians, academics) and more than 5,000 signatories to their manifesto from all over Europe. British Liberal Democrat Andrew Duff MEP, former Belgian Prime Minister Guy Verhofstadt and former Italian Prime Minister Mario Monti are all members of its steering group.

The likelihood that Europe will become a federal superstate in the foreseeable future nevertheless remains limited. There are substantial legal obstacles to a fully federal Europe. The Treaty currently sets the limitations of the EU’s powers, and any changes to these powers would have to be approved by all EU member states in a negotiation for a new Treaty. Treaty change, or any further delegation of power to the EU level, would trigger referendums in several EU countries, including in the UK, and other countries that have similar ‘referendum locks’ in place, including Denmark, France, Ireland and Slovakia. This is not a preferred route for most EU member states. In fact, Professor Anand Menon, an EU politics specialist at King’s College London, has said that French President Francois Hollande would be among those most reluctant to hold a new referendum on the EU.259 Moreover, political support in key member states for a federal Europe is weak. The majority of member states have not proclaimed support for the federal idea; instead there seems to be a widespread ‘federal fatigue’ among EU member states. In particular, countries such as Germany and the Netherlands, both part of the ‘core Europe’, have been clear that a federal Europe is not a goal for the near future. The Dutch government has recently tested European legislation for subsidiarity and proportionality and come up with recommendations of how to ensure “Europe where necessary, national where possible”. The introductory remarks to this Dutch review point towards a potential slowing of the traditionally understood trajectory of EU development, allaying UK fears of the march of federal Europe: “The Netherlands’ government is convinced that the time of an ‘ever-closer union’ in every possible area is behind us. Even in the Eurozone, the stress is now put on co-ordination rather than on federal style integration, which now seems a highly remote prospect.”

It could also be difficult to push through the creation of a federal Europe – both for member states and the European institutions – with an increasingly Eurosceptic public. Figures from Eurobarometer, the EU’s own polling organisation, suggest that public trust in the EU is falling across Europe in both poor and better-off EU nations.260 The UK is not alone in being sceptical of further EU integration: while 66% of British voters tended not to trust the EU, the same is true for 72% of Spanish, 59% of German, 56% of French and 53% of Italian voters. The countries surveyed account for 350 million of the EU’s 500 million citizens, a worrying number for the EU, and polls have indicate that as much as a quarter or a third of MEPs could be ‘Eurosceptic’ after the next European elections.

It is therefore likely that the degree of integration that member states accept to support the single currency will fall far short of creating a federal state. The degree of integration will dictate the impact on the UK. But the UK will also have a choice about how much it takes part in this process – especially because of the referendum lock.
The UK has already clearly said it will not take part in full Banking Union co-operation.

5.6 The EU is likely to develop pragmatically in a way that will not fundamentally change the balance of advantages and disadvantages for the UK

Although the Eurozone is likely to remain intact and the measures taken to achieve that are likely to fall short of creating a federal state, the EU will take steps in the coming years to solve the challenges of the crisis, meaning further integration in Europe. It is in the UK’s interest that the Eurozone stabilises and returns to growth, but the question remains how compatible any change will be with the UK continuing to support the global trading role to which the UK aspires.

The steps likely to be taken – insofar as it is possible to predict – are not likely to fundamentally change the advantages and disadvantages of EU membership or the UK’s ability to influence the outcomes that affect the UK. Most importantly, the UK itself can make a difference as Europe is changing, both by influencing the overall direction of travel and by maximising its influence on the specific policies that impact the UK.

The EU will take further steps towards a Banking Union, but full financial integration seems unlikely

The UK will benefit from the efforts to increase financial stability in the Eurozone without having to take part in the closer co-operation.

Although there were signs of commitment to a full banking union in 2012, that support has declined, largely due to reservations among member states, especially Germany. Tensions were visible at the creation of a single supervisor in 2012, when German pressure reduced the scope of supervision to exempt its smaller savings banks from the ECB’s oversight. The common deposit guarantee scheme, although present in the early discussions, quickly disappeared from the debate. Furthermore, a common European bail-out authority backed by a fund, although seen as a priority, is currently facing objections from those who argue that the transfer of such substantial powers to an unelected authority requires Treaty change.

A number of financially strong member states do not seem willing to pay for other countries’ banks or lost deposits in the event of a failure. They believe that a common fiscal backstop for a banking union would create moral hazard because banks would have little incentive to remain solvent if the EU could bail them out. The ESM has been suggested as a source of funds for bank recapitalisation, through the provision of guarantees, credit lines or direct loans to national schemes. However, as well as requiring a resolution of issues around the provision of unconditional support, this would likely involve a change in the ESM Treaty.

Additionally, some argue that Treaty change would be necessary to give the EU necessary powers for a full banking union. Finally, some seem simply reluctant to lose power over their own banks. National banking markets, which differ widely across member states, could come under threat if national interests diverge from the views of European authorities. Also, if a European authority chose to resolve a bank against the wishes of a member state, the lost deposits would potential voters’ savings.

It therefore seems likely that the EU, instead of creating a full banking union, will rather enhance co-ordination for bank recovery and resolution with the final say to wind down banks remaining at national level. And, instead of a common deposit guarantee scheme or resolution fund, it is more likely that there will be a coordination of national schemes with European authorities mediating in cross-border situations and a potential backstop for the Eurozone schemes in the ESM.

There are, however, those who argue that anything short of a full banking union will fail to secure a stable future for the Eurozone. They argue that the ESM recapitalisation is far from enough and that, without a full banking union, the ‘vicious cycle’ between banks and sovereigns – where their interdependence drags both down into insolvency – will not be broken.
Practically though, the balance of power currently lies with the creditor nations, who lack domestic support to take further fiscal responsibility for the Eurozone. Future developments – particularly renewed market stress around the Eurozone’s weaker economies – could, however, alter this balance since an increased risk of a failure of the currency union as a whole would strengthen the motivation for reform in the more solvent member states. As a senior German official said in an interview conducted by Policy Network for the CBI: “What if a French or Italian crisis forces much earlier treaty change than anyone currently envisages? Europe will have to respond to market pressure in weeks not years.”263

Regardless of this, the UK has already clearly said it will not take part in full Banking Union co-operation. Irrespective of how far the member states of the Eurozone – and potential countries opting into the Banking Union in the future – are willing to go, the obligations only apply to them. The main risk for the UK – that of being outvoted in the EBA resulting in less influence and potentially suboptimal banking rules – is mitigated by the double majority lock until such time as the UK is one of fewer than four member states outside the single supervisory mechanism. There is significant uncertainty as to when this might occur, given the unclear pathways to joining the Eurozone of many member states (see Exhibit 58). The UK will thus continue to be able to shape the rules affecting its large financial services sector while also avoiding the financial obligations of a single resolution fund but benefiting from increased stability on the continent. The proposals and likely outcomes from financial integration therefore do not fundamentally affect the operation of the Single Market and concomitant advantages of EU membership for the UK.

The EU is likely to commit to limited structural support – conditional on reform – but stop short of permanent fiscal transfers

There are likely to be attempts to raise the levels of economic co-ordination in the EU, both to increase convergence between countries and to boost the overall competitiveness of the continent, but the UK will not have to contribute or be bound by any EU-recommendations unless it chooses to sign up.

Although the Eurozone has shown commitment to support failing countries, permanent fiscal transfers have fallen victim to the same reservations as the fiscal backstops for a banking union. Even bail-outs have started to change shape: the Cypriot bail-out came with a caveat that larger depositors, over €100,000, had to contribute to the rescue package through a ‘bail-in’ with losses of 4.2 billion euros.264 The former head of the Eurogroup publicly stated that this would be the new approach for future bail-outs and, although he clarified that there were “no models or templates” for future bail-outs,265 Cyprus marked a radical departure from the concept of simple transfers from economically stronger states to their weaker neighbours.

The Eurozone therefore seems less likely to take any further substantial steps towards a more permanent fiscal transfer mechanism such as common debt issuance like Eurobills or Eurobonds in the short to medium term. Instead, it seems likely that a limited instrument – such as the proposed Competitiveness and Convergence Instrument (CCI) – could be put in place to provide temporary support for structural reform in member states. Such an instrument is likely to be coupled with strict conditionality. In Germany and other creditor countries, stronger economic governance is supported insofar as it pushes countries to undertake necessary structural reforms of areas such as labour market or pensions. Firm contracts mandating reforms between member states and the Commission are therefore likely to become a condition for CCI funding.

It has been argued that, although economic governance has been strengthened, much more will have to be done to keep budgets of member state governments under control and keep momentum for structural reform going. The economic governance regime continues to be limited by a weak sanctions regime – both in theoretical range and in practical use - for those breaking the Stability and Growth Pact (SGP) or failing to enact reform. In addition, some argue that the lack of fiscal transfers – either to
Despite the concerns around the consequences of a lack of fiscal union in the Eurozone, there is simply not the political will to support fiscal transfers at this time.

Encourage reform or to directly support weaker member states – limits the ability of a number of Eurozone countries to return to growth.

Despite the concerns around the consequences of a lack of fiscal union in the Eurozone, there is simply not the political will to support fiscal transfers at this time. As long as fiscal burden sharing remains weak, the idea of fiscal union will remain off the table.

In the absence of moves towards creating a permanent fiscal transfer mechanism (that could underpin a more federal EU, either with greater control of UK budgets or with the UK not part of, but marginalised by, a more federal Eurozone bloc), the majority of the changes in this area will not impact the UK. Contracts for structural reform in return for financial assistance, such as contained in the CCI, place obligations only on those member states who sign up to these contracts, either as part of the Eurozone or voluntarily. It is the countries inside the currency bloc that will have to abide by the Eurozone rules and face fines of up to 0.2% of GDP if they do not. Those countries outside the euro will remain free to set their own budget and choose which economic reforms to pursue. The prospects and likely outcomes of the process of economic and fiscal integration will therefore not fundamentally affect the operation of the Single Market.

Progress on political union will remain limited

There is backing for increasing the political accountability and legitimacy of the EU- meaning calls for increased forms of political union are likely to follow any steps towards further economic integration. However, there are few firm proposals on the table and any moves towards more federal institutions will be met with resistance by member states. Moreover, there are substantial limitations to the steps the EU can take towards political integration without Treaty change and, given the substantial objections to starting new Treaty negotiations, this is unlikely to happen in the next few years. For the UK, any further transfers of power to the European Union, which would undoubtedly include moves towards political union, would have to be put to the British people under the ‘referendum lock’ laid out in the European Union Act 2011.

5.7 The ‘multi-sphere’ Europe that emerges is not likely to leave the UK sidelined

Taken as a whole, none of the likely measures of further integration undermines the benefits of UK membership of the EU in itself. While there are risks, the Single Market will not inevitably be fragmented in terms of access for UK goods and services, nor will capital or labour flows necessarily be interrupted substantially. The main risk, therefore, is to the continued influence of the UK – that irreplaceable asset which allows the UK to navigate the EU policy process successfully to achieve those outcomes which support its global ambitions.

It has been argued that further integration risks marginalising the UK and other countries outside the Eurozone, as the ‘core’ outnumbers those on the outside and begins to dominate decisions by default. This marginalisation would be worsened if more non-Eurozone member states chose to join the Banking Union or single currency, potentially increasingly stacking the odds against the UK in its attempts to influence the direction of EU policy.

However, in reality, the UK can retain its influence in the most likely scenario of Eurozone integration. The journey to Eurozone membership is occurring at different speeds for different countries and, even when this collection of member states grows, there is little evidence that the Eurozone is likely to caucus as one bloc vote on every issue. The underlying desire to retain the EU as a ‘family of nations’ is likely to see a Union emerge from the crisis that practically safeguards the interests of all members and continue its day-to-day policymaking along the traditional lines of a ‘multi-sphere’ Europe.
There is a danger that the Eurozone will be able to outvote the UK and other countries outside the currency, but the diverse interests of EU member states means that the UK will still have allies.

From November 2014 the Eurozone, following the Lisbon Treaty, will have a qualified majority in the Council with more 65% of the EU population. This formally enables the Eurozone to caucus against those outside the currency bloc in all areas where decisions are made by majority voting, which in practice includes most EU policies (see Exhibit 56).

This majority is likely to grow over time, not least because each member state bar the UK and Denmark has committed (as a condition of joining the EU) to adopt the euro as their currency. This leaves these two ‘outsiders’ in an uncomfortable minority position. There are a number of countries set to join in the near future: Latvia is set to join in 2014, while Lithuania, which failed to meet the criteria to join in 2006, has joined the ERM II and is now set to join the Eurozone in 2015. Even Denmark is considering starting on a pathway to eventually joining the single currency. It is already part of the Exchange Rate Mechanism (ERMII), a mandatory regime for all entering countries (for a minimum of two years) which mimics the conditions of being a Eurozone member, and the current government has publicly stated that its exemption is outdated and that it would like to give Danish voters a say in a referendum within the present election term. Danish entry would potentially leave the UK alone on the outside.

However, although the borders of the currency are likely to broaden over the coming years, many countries are unlikely to join in the short-to-medium term, for both economic and political reasons (see Exhibit 57 overleaf), leaving the UK with a number of natural allies to balance the powers of the Eurozone as it integrates further.

Exhibit 56: The Eurozone will hold an ‘inbuilt’ majority of votes in the Council as of November 2014

<table>
<thead>
<tr>
<th>Current rules: under the pre-Lisbon system (number of votes)</th>
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<tbody>
<tr>
<td>European Union (213)</td>
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<tr>
<td>Romania (14)</td>
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<tr>
<td>Bulgaria (10)</td>
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<tr>
<td>Hungary (12)</td>
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<td>Lithuania (7)</td>
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<td>Czech Republic (12)</td>
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<tr>
<td>Poland (27)</td>
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<tr>
<td>Sweden (10)</td>
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<td>Latvia (4)</td>
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<td>Denmark (7)</td>
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<td>300</td>
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<td>345</td>
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<table>
<thead>
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<th>New rules: after 2014/17 (% of EU population)</th>
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<tbody>
<tr>
<td>European Union (66.04)</td>
</tr>
<tr>
<td>Romania (4.30)</td>
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<td>Bulgaria (1.52)</td>
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<tr>
<td>Hungary (2.01)</td>
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<tr>
<td>Lithuania (0.67)</td>
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<tr>
<td>Czech Republic (2.09)</td>
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<td>Poland (17.83)</td>
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<td>Sweden (1.85)</td>
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<td>Latvia (0.45)</td>
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<td>Denmark (1.10)</td>
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<td>UK (12.33)</td>
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<td>90</td>
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Exhibit 57: An uncertain future makeup of the Eurozone

All member states except the UK and Denmark are committed to joining the Eurozone as soon as they fulfil the required entry conditions. However, many of the countries outside the currency are unlikely to join in the next few years.

**Bulgaria:** The aim in 2010 was to join the Eurozone in 2013, but September 2012 saw both Bulgaria’s Prime Minister and Finance Minister signalling publicly that they had halted plans to join, as they saw “no benefits of entering the euro zone, only costs.” Given two years of ERM participation is necessary before entry to the Eurozone, the earliest possible entry date for Bulgaria is now 1 January 2016.

**Croatia:** As a new EU-member from 1 July 2013, Croatia is obliged to join the Eurozone. Although its central bank governor would like to see the kuna replaced by the euro as soon as possible, the country is years away from joining. It has not yet joined the ERM II and continued high government deficits are contributing to a significant build-up of public debt.

**The Czech Republic:** The lack of a compatible legal framework, low price stability and high public deficits – so high that the European Council has put the country under the ‘excessive deficit procedure’ – means that entry to the Eurozone is likely to be some way off for the Czech Republic.

**Hungary:** Prime Minister Victor Orbán said in April 2013 that Hungary cannot “seriously consider joining” the Eurozone until its average economic development reaches 90% of that of other Eurozone members. Moreover, Hungary’s legal framework lacks solidity and the country currently falls short of meeting the convergence criteria to join.

**Romania:** The country is scheduled to join in 2015, but entry by this date is unrealistic. Having been forced to seek financial assistance from the EU and IMF from 2009 to 2011, Romania is currently operating under the EU’s excessive deficit procedure and continues to struggle with price stability. The Commission highlighted in its convergence report in 2012 that Romania’s new bank law did not stand up to the legal criteria for entry. Romania’s President, Traian Basescu, said in March 2013 that joining in 2015 was unfeasible and suggested 2020 would be a more realistic date.

**Sweden:** An important ally for the UK, Sweden also has an exemption from joining the Eurozone – although this is not as definitive as the British and Danish derogations and does require adherence to the Maastricht rules on convergence. According to the latest progress report, Sweden has not yet made the necessary changes to its central bank legislation and it does not meet the convergence criterion related to participation in the Exchange Rate Mechanism (ERM II) to adopt the single currency. Politically, parties representing two-thirds of the seats in parliament officially still support Sweden joining the euro, but public support is at an all-time low – according to a poll in December 2012, fewer than one in ten Swedes wants their country to join the single currency.
The UK secured voting safeguards against Eurozone caucusing in the European Banking Authority

The creation of a single supervisor (SSM) for Eurozone banks risked the emergence of a joint Eurozone position on banking matters, which would have an inbuilt majority in the European Banking Authority (EBA) and therefore be able to dictate EU rules to the detriment of non-Eurozone countries. Although caucusing would not necessarily occur in practice – countries seek consensus on EBA decisions – the UK and other ‘outsiders’ were able to secure legal protection through alterations to voting practices in the EBA. Article 44 in the Regulation aligning the EBA Regulation with the new SSM details these safeguards, with a ‘double majority’ rule being put in place to ensure that EBA decisions are approved by a majority which includes a plurality of countries outside the banking union: at least a simple majority of its members from competent authorities of participating Member States and a simple majority of its members from competent authorities of non-participating Member State.280

This safeguard only applies as long as there are at least five countries outside the Eurozone. If the ‘outsider’ group is reduced to four or fewer, EBA decisions would require the vote of only one of the ‘outsiders’ to be approved. This is because member states, in line with the broader move away from unanimity, do not wish to effectively give a small minority a ‘veto’ on decisions.

The UK has also secured new legal safeguards to protect the Single Market in secondary laws on financial services to counter potential threats from Eurozone integration

The legislation securing changes to voting modalities also achieved new legal safeguards (contained in Article 1) against currency discrimination in banking and financial services that protect the Single Market in this area: No action, proposal or policy of the ECB shall, directly or indirectly, discriminate against any Member State or group of Member States as a venue for the provision of banking or financial services in any currency.281

A similar protection was also introduced during member states’ negotiations on the EU’s cornerstone in the regulation of financial markets – the Markets in Financial Instruments Directive (MiFID). The Council position281 states that no proposal from any regulator should directly or indirectly, discriminate against any member state (…) as a provision of investment services and activities in any currency. Although this might change following discussions with the Parliament, it shows that the UK can successfully get legal protections in secondary law.

These conclusions depend on a number of assumptions that could potentially change in the future. If the Eurozone stabilises, the incentives to join the currency – or at least the Banking Union – increase, which would in turn reduce the number of potential allies for the UK outside the single currency.

However, irrespective of the size of a potential Eurozone ‘caucus’, influence in the EU and the ability to best realise one’s interests are not only about formal voting power, as Chapter 4 set out. The European Council is driven by consensus and EU legislation is rarely enacted in the face of strong national reservations, especially on the part of big member states. Instead, the EU is about pragmatic co-operation: EU member states focus on finding common ground and acceptable solutions to concrete problems, often in the face of overarching ideological disagreement. This search for compromise is reinforced when one considers the wide-ranging and diverse interests of member states, whether inside or outside the Eurozone, and the desire of countries to keep the EU working for all its members.

Firstly, in the same way that the ‘outsiders’ understand the Eurozone’s need to integrate further to stabilise the currency, the Eurozone understands the need for safeguards for non-Eurozone members, and it has shown willingness to provide these (see Exhibit 58). It is not in the Eurozone’s interest to disregard the views of the other outsiders; most members seek a balance of power between the ‘ins’ and ‘outs’. As a senior Swedish official said to the CBI: “On the euro-in/euro-out question, there is a need for minority safeguards”.278 Indeed, this view is prevalent across Europe, most notably in Germany.

Exhibit 58: Safeguards are being secured for Eurozone ‘outsiders’
Exhibit 59: The current legal protection of the Single Market

The Single Market is enshrined and protected in European law. The EU shall "establish an internal market" in which "the free movement of goods, persons, services and capital is ensured" and restrictions on these freedoms shall be prohibited. However, the EU Treaties also make provision for other EU priorities, such as stability. There is a danger that further integration in one area risks fragmenting the Single Market as a whole – for example, restricting the free provision of financial services across the EU – if primacy is given to other EU priorities above the maintenance of the Single Market.

The current court case between the European Central Bank (ECB) and the UK government on the clearing of Euros is an illustrative case. The ECB has stated that "infrastructures clearing and settling sizeable amounts of euro-denominated securities and derivatives should be located in the euro area". This could force a number of clearing houses currently located in the UK to relocate to the Eurozone. The UK government has objected to the European Court of Justice (ECJ), arguing that this ECB statement "contravenes European law and fundamental Single Market principles by preventing the clearing of some financial products outside the euro area". The final outcome of this case will therefore be an important signal on the primacy of the Single Market vis-à-vis other EU priorities such as the Eurozone.

One senior German official stated in an interview in Policy network for the CBI: "We could consider the inclusion of a new clause to protect the UK against discrimination as a Euro-out." This rhetoric is backed up to some extent by a number of the safeguards that have already emerged from discussions around further integration. For example, the creation of a Single Supervisory Mechanism threatened to leave the UK in a minority in relation to banking supervision and decisions affecting the Single Market for financial services. However, the UK successfully negotiated safeguards through a ‘double majority’ lock. A recent agreement on the Market in Financial Instruments Directive (MiFID) again signalled that most European member states are supportive of an EU that works for all its members (see Exhibit 59).

Furthermore, if Eurozone members were to attempt to further their own interests at the expense of the whole EU, there are significant legal safeguards already in place from previous Treaties. It has been argued that the EU Treaties already firmly protect the Single Market against harmful initiatives. There is a question, nevertheless, as to whether these legal safeguards for the Single Market will stand up in court. The test case on Euro clearing (see Exhibit 59) – if it ever comes to court – could show if the EU Treaties provide sufficient support for the Single Market, or if other EU priorities such as the ‘stability of the Eurozone’ are now overtaking the Single Market in priority, thus requiring further legal protections for the UK if it is to continue to enjoy the benefits from EU membership.

Finally, even with changing voting weights and increased numbers within the Eurozone, there is no inevitability that those outside the single currency will be outvoted in practice. The Eurozone is not a club of like-minded countries. They do have a common currency, but in most other areas their interests still diverge – in some cases substantially. Germany’s interests are in many cases more similar to Poland and the UK, both currently outside the Eurozone, than to Italy or France.

The dividing lines on EU policies like renewable energy, and nuclear in particular, do not overlap with the borders of the Eurozone – nor are interests aligned in areas like trade and services, where the more liberal countries develop their ‘caucus’ against countries that take a more cautious position on market liberalisation. So, while securing safeguards for countries outside the single currency is important, the diverse interests and often divergent aims of Eurozone members mean that the occasions where these safeguards are used in practice are likely to be more limited than many might assume.

An EU that works for all its members

Overall, there is therefore no reason to suppose that the EU that emerges from the economic and currency crisis will not be able to encompass the interests of all its member states. Most importantly, the EU can take steps to safeguard the Single Market, partly because of the continuing clout of those countries outside the single currency to secure safeguards, but also because a significant number of EU countries want Europe to remain a union that works for all its members.

The Eurozone is not a club of like-minded countries. They do have a common currency, but in most other areas their interests still diverge.
In fact, members of the EU have long been integrating on a number of areas with different dividing lines, creating a Europe of flexible cooperation – a ‘multi-sphere’ rather than ‘two-tier’ Europe (see Exhibit 60). This is not simply a case of the Eurozone diverging in areas of integration from those countries outside the single currency. Nor is this differentiated integration a product simply of a small group of countries, often caricatured as being led by the British, always blocking moves to further integration. Both those who are bound up in the Eurozone project and those outside have been involved in slowing or quickening the pace of integration in various areas.

Member states have been able to create the Schengen Area and a common European patent without having to get agreement from every country, with the lists of countries signing up different for each. For example, while the Italians and Spanish were both founding members of the Eurozone, neither has chosen to adopt the EU’s unitary patent; while Ireland chose the euro and the UK did not, neither takes part in the Schengen Agreement; and while Germany and the Netherlands both share a common currency in the Eurozone, Germany has decided to join ten other member states in introducing a financial transactions tax (FTT) whereas the Netherlands has not.

Some have argued for using enhanced cooperation in other areas such as services and trade: a form of co-operation introduced in the Treaty of Nice allows countries to move ahead if a large enough minority wishes to do so. Although there are some who argue that flexible integration will fragment the EU, it seems to be a useful way to consolidate the diverging views on European co-operation within the 28 member states.

This process of variable integration is likely to continue. Policy Network research for the CBI indicated that even the French government appears relaxed about an increasingly differentiated process of integration, and it discerns no contradiction between deeper integration in the euro area and the involvement of the UK on issues such as the Single Market, external relations and defence co-operation. As a senior French official put it: “Eurozone integration should not lead to a distancing of the UK.”

This willingness on the part of other EU member states to develop the Union in this ‘multi-sphere’ tradition – including, on occasion, by allowing a subset of member states to come together to co-operate on those areas of shared national interest – can ensure that the UK does not become sidelined and can continue to realise its interests in a European Union working for all its members.
The UK must be alive to the dangers as the EU institutions evolve. But if the UK continues to build alliances across Europe to protect the Single Market, further integration is compatible with, and indeed can support, the UK’s global future.

5.8 The most likely scenarios for European integration will not undermine the Single Market or UK influence

The changing EU is not likely to fundamentally alter the balance of pros and cons of EU membership or the UK’s ability to influence. Neither a federal superstate nor a collapse of the Eurozone is a likely outcome; rather the EU is likely to develop pragmatically, integrating just enough to protect the currency. The divergent interests of Eurozone countries mean that they are unlikely to ‘caucus’ on areas beyond those relating to the currency. This does not mean that a changing EU does not have the potential to impact the UK, and the UK and other non-Eurozone states must be alive to the dangers that present themselves as the EU’s institutions and member-state relationships evolve. But if the UK continues to build alliances across Europe to protect the Single Market, as it has done in the past, further integration is compatible with, and indeed can support, the UK’s global future.

The spheres of integration in the EU allow the member states some flexibility over where to co-operate with other member states in pursuit of common interests. The direction of travel suggests that this will remain the case for the foreseeable future. This not only protects the UK from areas of unwanted integration but also brings significant opportunities. The EU Unitary Patent has already shown how variable integration can help the UK and benefit important UK industries such as hi-tech and pharmaceuticals. Co-operation with other EU member states on issues from financial regulation to deepening the market for services can bring enormous advantages for the UK, and these can still be realised in the EU that emerges from the economic and currency crisis.

However, even though the advantages of UK membership of the EU outweigh the disadvantages and this is not likely to be fundamentally altered by the period of upheaval that the EU is currently undergoing, it may be possible that an alternative relationship between the UK and EU could offer a better balance of advantages and disadvantages than full EU membership. These alternative options for the UK’s relationship with the EU are explored in Chapter 6.
CHAPTER 6

ALTERNATIVES TO EU MEMBERSHIP DO NOT OFFER GREATER ADVANTAGES OR INFLUENCE FOR THE UK
Some argue that the UK is best served by severing all formal links with the EU and going it alone, on the basis solely of membership of the World Trade Organisation (WTO), refocusing UK trade towards fast-growing markets and the Commonwealth. Advocates of halfway house options believe that the UK must leave the EU but remain closely intertwined, by joining the European Economic Area as Norway has done, by creating a framework of bilateral agreements as Switzerland has done, or by entering the customs union as Turkey has done. Others suggest a “UK–EU Free Trade Area option” where the UK, on leaving the EU, negotiates its own relationship through an Free Trade Agreement with the EU.

None of the alternative options can combine all of the benefits of EU membership with none of the costs. Such solutions are simply unrealistic. Whatever the nature of the UK’s relationship with its major trading partner, there will be a trade-off between what the UK wants and what the price of the trade to get it is. For businesses, the important test should be how each alternative option impacts on the economic factors that boost competitiveness and productivity, and the UK’s ability to influence these factors in its interests.

Attempting to change the terms of the UK’s relationship with the EU and seeking to establish a new relationship would create risks. Assessing alternatives is by nature speculative because predicting the consequences of a changed relationship is difficult. A UK departure would be such a large and complex event, it is impossible to say with certainty what the impact would be. However, British businesses are used to relating to future uncertainties and risks are an inherent part of doing business: they cannot be avoided, but they can be identified and evaluated.

While the UK could undoubtedly survive outside the EU, exploring the details and inherent risks of some of the alternatives to EU membership shows that none of the alternatives offers a clear path to an improved balance of benefits or greater influence over the terms of UK interaction with its nearest neighbours. It also offers a challenge to those arguing the UK would be better off out of the EU: creating a credible alternative means providing not only a detailed description of how the alternative ensures the right conditions for the UK but also a detailed plan for how best to achieve it that takes into account the risks involved. Only then can there be a credible, open debate about alternative options for the UK’s relationship with the EU.

6.1 Leaving the EU is legally possible, but an assessment of alternatives must focus on how each would support British business in realising its global future

It is practically possible for the UK to leave the EU but it is uncharted territory with no guarantees for a future relationship. A UK withdrawal from the EU is legally possible and would be effected through the ‘exit clause’ in the Lisbon Treaty, following the steps in Exhibit 61. Although might seem a straightforward process, leaving the EU would involve a number of uncertainties because the two parties would be dividing after a 40-year long relationship. No one can therefore describe with certainty how an exit would look and the impact it would have on the UK. The exit terms are up for negotiation, and there is no guarantee of securing a favourable future UK relationship with the EU.

Were negotiations with the EU over the withdrawal agreement to fail, there would...
be a risk that the UK could find itself outside the EU involuntarily with no access rights to its markets. The Treaties have an in-built notice period stipulating that the UK would no longer be bound by the Treaties from the date provided for in the withdrawal agreement or, failing that, two years after notification of its intention to withdraw. This provision is a safeguard for both the EU and the leaving member to make sure that no party holds up negotiations, but there is a risk: failure to reach an agreement would mean that the UK would be automatically ‘out’ within two years. Departure becomes automatic even if the question of the future relationship unresolved.

As the exit clause has never been used, there are a number of uncertainties related to the process. The ‘withdrawal agreement’ would set out the process and the practical realities of an exit (the transitional measures that would wind down the UK’s EU obligations) and benefits. But the content of this agreement is not straightforward. It would, for instance, have to set out and solve the logistics of the UK’s budget contributions while phasing out EU funding to UK regions and UK participation in various EU programmes, remove the UK as a signatory from free trade agreements, and determine under which rules UK airlines could operate flights to and from EU destinations. As a former UK judge at the European Court of Justice, Sir David Edward, has noted, there would likely be a long negotiation period as the UK went about the “unravelling of a highly complex skein of budgetary, legal, political, financial, commercial and personal relationships, liabilities and obligations”.289

Moreover, it is not clear whether negotiations would include all necessary details about a future UK-EU relationship. The Treaty states only that the agreement has to ‘take account of the framework for the future relationship the country will have with the Union’, but it has been argued that it is not in itself a renegotiation agreement for a new relationship. Instead, the UK might have to negotiate a separate agreement to set out its new relationship after the exit was completed, with details depending on the chosen alternative.

But it is what might happen next that would be important as the UK tried to redesign its relationship with the EU, and what that would mean for its global future. Businesses care about how any alternative would impact on the economic factors that boost UK competitiveness and productivity and the UK’s ability to shape these factors in its interests. Only by looking at these details and answering the questions posed can the credibility of an alternative for British business be determined.

**Exhibit 61: Leaving the EU – a break-up in four steps**

The EU Treaty has an ‘exit clause’, first set out in Article 50 in the Treaty on European Union, which sets out the basic steps for a withdrawal.

1. The member state wishing to leave informs the other member states of its intention.
2. The other member states create guidelines for the negotiation between the EU and the leaving member state.
3. The leaving member state and the EU begin negotiating a treaty framework, a so-called ‘withdrawal agreement,’ which will regulate the time frame and details of the ‘divorce’. The two parties have two years to finalise negotiations.
4. If the two parties agree, the country is allowed to exit the EU on the terms of the withdrawal agreement. If there is no agreement, after a two-year notice period, the leaving member state will simply then no longer be bound by the Treaties, and the other member states will not be bound by their various Treaty obligations to the leaving member state.

All alternatives must be measured on the degree to which they:

1. **Support openness and productivity by enabling businesses to trade with both Europe and the rest of the world, based on the six aspects of openness analysed in Chapter 3**

2. **Enable the UK to be an influential player setting the rules and standards British businesses must follow**

3. **Address the risks of leaving, including any up-front costs, the political and economic impacts of a period of dislocation, the likelihood of the alternative and its long-term sustainability.**

It must also be considered how the EU might change upon a UK departure, as the grouping of member states in the EU Council which supports liberal free trade policies loses a powerful member and the balance may shift away from the free trade end of the spectrum.
After leaving the EU – its obligations and benefits – the UK could refrain from entering into any formal relationship with the EU and simply rely on the global multilateral trading system through the UK’s direct membership of the WTO, pursuing its own external trade agenda. In reality, however, the ‘WTO option’ alone is not sufficient: free movement of capital would technically remain, but in practice capital flows would be hit; regulatory compliance with EU rules would be likely to continue to avoid non-tariff barriers arising; and trading with third countries would require lengthy negotiation over access.

Advocates argue that the UK’s economic strengths and global power makes it well placed to ‘go it alone’ in trading with emerging markets. They argue that relying just on the WTO would provide the benefit of absolute flexibility to trade with whomever the UK wished to trade without having any regulatory burden from the EU. This would enable the UK to refocus its trade away from Europe and towards emerging markets and historic ties with the Commonwealth. The UK could also continue to take a lead in driving the multilateral trade agenda. Leaving would also help the City, according to proponents of the ‘WTO option’, as freeing the financial services sector from the EU’s regulatory burden would give the UK a stronger base to become a hub for Middle East, Far East and emerging markets’ business.

Access to European markets on WTO terms would hit British exporters and importers with tariffs

Under the WTO framework, the key principle of non-discrimination requires members not to treat any trading partner less advantageously than any other, unless covered by a free trade agreement or laws giving developing countries preferential access.

For goods, this means that tariffs applied to the ‘most-favoured nation’ (MFN) must apply to all other countries too. The EU could therefore not apply discriminatory or punitive tariffs after a UK exit above or below its MFN levels. As Exhibit 62 shows, the EU’s average MFN tariffs have fallen consistently over time, and so the WTO framework would prevent the tariffs imposed on the UK from being as high as they would have been 20 or even 10 years ago. Nevertheless, new tariffs of economic significance would still be imposed on around 90% by value of the UK’s goods exports to the EU, causing most UK exporters to become less price competitive than their EU competitors or companies from countries with which the EU has signed FTAs.

If the UK – having negotiated in the WTO as part of the EU – were to inherit the EU’s common external tariffs as a starting point for its own tariffs, companies importing from the EU would be hurt as import tariffs would rise from the zero level for intra-EU trade to the level of the EU’s external tariffs. The implications of a move to an MFN trading arrangement for exporters and domestic consumers would vary considerably by sector. For instance the UK runs a £2.9bn trade surplus on liquefied natural gas that would be hit by a 4.1% tariff.
Trade in services between the UK and EU would also be governed under a WTO framework, the WTO General Agreement on Trade in Services (GATS). Under this agreement, all WTO members again have to respect the principle of non-discrimination, and varying levels of binding liberalisation commitments are made by WTO members in individual services sectors. As a ‘stand-alone’ WTO member, the UK would be faced with the same level of access to the EU services market as all other WTO members in line with the EU’s GATS commitments – a much lower degree of access to the free movement of services which is a central facet of the Single Market enshrined in the EU Treaties.

As tariffs and quotas have become less prevalent barriers to global trade, non-tariff barriers have become increasingly significant (see Exhibit 63). For example, a direct consequence of leaving and not preserving a common regulatory agenda with the EU would be that regulatory divergence would creep in over time and British businesses could face new non-tariff barriers that would harm trade with the EU.

It is worth noting that British business operating in the EU, and European companies in the UK, might be partially protected by the ‘acquired rights’ principle, which allows a number of rights to be retained on withdrawal under international law. However, there are many uncertainties linked to this principle, both whether it would be applicable in this particular case and to what extent rights might be sustained over time as the EU continues to change.

By leaving the EU, UK firms would also lose a channel for settling disputes. If a UK firm today meets unlawful trade barriers in another member state, it can complain to the European Commission and, as a last resort, take the case to the European Court of Justice. Outside the EU, the UK would have to rely on WTO dispute settlement, which business experience suggests is less efficient and more politically charged than the EU’s settlement system.

Exhibit 62: EU external tariffs have fallen consistently since the early 1990s

Exhibit 63: The imposition of barriers to trade on UK exit from the EU

On exit from the EU, British businesses could face new barriers to trade such as burdensome customs procedures, discriminatory tax rules and practices, duplicate technical regulations, standards and conformity assessment procedures, sanitary and phytosanitary measures (SPS) and barriers to FDI.

According to a House of Commons note, market access for UK services exports would be “far more limited” were the UK to leave the EU and not retain access to the Single Market. This would hit the UK’s best-performing category of exports to the EU, which expanded 43% in real terms in the decade to 2012.

No longer a member, UK firms would thus not have the right of commercial establishment which is guaranteed under EU Treaties and which significantly facilitates trade in services provided via the commercial presence of a foreign firm.

Firms enjoying passport rights – the right to establish in another member state while continuing to be regulated by the authorities in its home country – are likely to be affected. Several other restrictions forbidden within the internal market, such as different documentation rules or testing requirements, still apply to third countries and would therefore apply to the UK.
The ‘WTO option’ would give the UK power to pursue FTA negotiations with any country of choice, but this freedom is offset by the risk of a period of dislocation and less advantageous deals.

On exit, the UK would no longer have any other trade agreements because its agreements with other countries are negotiated through the EU. Although they are so-called ‘mixed agreements’, which need the consent of member states, none would be applicable to the UK without renegotiation upon withdrawal. This would mean that the UK would neither have agreements with South Africa, Colombia, Korea, Norway, and Mexico nor be party to the potential future FTAs with the US and Japan. It would therefore have to start renegotiating the 30 agreements currently in place depending on the strategic priorities of its industries. Companies dependent on trade in these markets would face a period of uncertainty and dislocation until new agreements were settled, which would depend on how the UK managed to set up and drive through its own trade agenda in a competitive world. The increased flexibility would mean that the UK could, if it wanted, prioritise FTAs with countries currently missing from the EU’s ‘completed FTA list’, including Australia, Brazil, India, Russia and China.

In practical terms, to begin to pursue its independent trade agenda, the UK would first have to build up national capacity to replace its current predominant reliance on the European Commission for trade negotiation expertise; it is more than 40 years since the UK itself negotiated a bilateral trade deal, and FTAs have become increasingly complex to negotiate in that time. Moreover, the government would face significant pressure during the first few years given the sheer number of trade agreements necessary to avoid interruption in trade for businesses.

Beyond the practical short-term challenges, there are also a number of substantial risks relating to attempting to sign global trade agreements outside the EU. It is not certain that partner countries would prioritise negotiating agreements with the UK, nor on what terms they would negotiate. The time it would take is also unclear.

On the one hand, as was pointed out in Chapter 3, it is likely that starting FTA negotiations would be quicker as the UK would no longer have to agree priorities between 28 member states. However, on the other hand, the UK is a substantially smaller market with less to offer to potential partners in negotiations than the EU, which alone contributes a quarter of world GDP. Whether the UK has enough to offer could impact on the quality and depth of the FTAs the UK could manage to secure.

The draw of greater access to the Single Market allows the EU to conduct negotiations from a position of strength, which is ever more critical given that many trade barriers are increasingly difficult to get at, are often attributable to divergent regulations and standards, and can require political commitment and engagement at the highest level to achieve positive results. Critically, any commitments that could be secured on non-tariff barriers, such as standards convergence, would be of less benefit to UK exporters than if such benefits could be secured on an EU basis.

In many sectors, the EU has been a leader in advancing regulatory harmonisation at the global level, and it has pushed key trading partners to recognise global standards or ‘equivalent standards’ in EU FTAs. This has opened up possibilities for UK producers to manufacture a product which is fully compliant with product regulations both in the EU and in overseas markets, such as Korea. However, in the UK stand-alone scenario, it is very difficult to envisage how the UK could seek to break down such long-standing regulatory barriers except on the basis of common standards with its most important trading partner – the European Union.

It is worth noting that the UK’s global trade and market penetration does not rest exclusively on the existence of FTAs. For example, UK trade with China and Russia currently takes place without an EU FTA, meaning that market access would not be directly harmed through dislocation by the UK withdrawing from EU. However, given German export performance to China – selling four times more than the UK – under the same de facto market access parameters as the UK, there is little to suggest that leaving the EU would immediately result in an uplift in trade to these nations.
In the short run leaving the EU is not likely to reduce the availability of capital to companies, but lack of market access may decrease investment over time.

Capital movement is the only freedom going beyond the boundaries of the Internal Market, as it also covers the movement of capital between member states and third countries. From 1 January 1994 all restrictions on capital movements and payments between EU member states were prohibited, as were restrictions between EU member states and third countries. Therefore, in the short run, operating under WTO rules would not remove companies’ rights to move capital between the UK and EU.

However, for one of the world’s largest financial centres, the City of London, leaving the EU would involve a number of risks (for further detail, see Exhibit 66 in “The UK option”). The UK’s financial services sector is closely linked to the EU: the UK accounts for 74% of the EU’s foreign-exchange trading and 40% of global trading in euros, 85% of the EU’s hedge-fund assets, 42% of its private-equity funds, half of its investment bank activity, and half of its pension assets and international insurance premiums. Losing access to provide financial services in the Single Market on equal terms to companies from other member states would risk eroding the City’s position over time. The UK could still seek access as a third country provider of financial services, but lack of ‘passport’ opportunities and the added costs of ‘equivalence’ – where the EU gives the UK market access only once it has determine that UK rules are as strict as EU rules – would mean a substantial risk of losing out to competitors in Frankfurt or Paris.

Beyond the City, operating under WTO rules alone would impact on investments into the UK. The direct impact on FDI from an exit from the EU is hard to analyse. Investments are made for a number of reasons, and while a number of firms see the UK’s place in the EU as essential for their investments, others argue that the UK’s legal environment, time-zone and language are the dominant reasons for investment, suggesting that a UK exit would not necessarily harm FDI. Although not explicitly advocating a UK exit – along ‘WTO-option’ lines or otherwise – some analyses such as EY’s 2013 UK attractiveness survey have gone further, suggesting that less integration with the EU might in fact make the UK a more attractive destination for some foreign investors primarily from outside the EU.

Nevertheless, those foreign investments that do depend on UK membership of the EU would decrease over time. For example, investment in companies producing goods that are likely to face tariffs under a WTO regime, such as cars, may well decrease. Moreover, lack of certainty due to trade deals and new tariff regimes could also lead to a period of uncertainty, which is not conducive to investment.

Leaving the EU would give the UK complete control of its borders, but business would want to see the free movement of people continue.

Leaving the EU would give the UK complete control over its own borders. The UK government would have to create a new national immigration policy, deciding who comes in from the EU and on what basis. Similarly, other EU states would be able to determine a new basis for allowing access to UK citizens.

However, many businesses in the UK today are dependent on either sourcing labour from the EU or deploying staff there. This varies across sectors, and therefore the reduced availability of high and low-skilled workers for businesses would be felt differently. It would particularly impact on sectors which currently employ a higher share of EU migrants in their workforce, such as accommodation and food services (9%), manufacturing (7%), financial services (6%) and ICT (5%). A reduction in free movement of labour would be particularly harmful for the exporting services sector, where trade is facilitated by the presence of people in the territory of another economy. Moreover, British citizens could no longer work and travel freely across EU member states.

Some European citizens might be entitled to stay in the UK depending on the acquired rights principles – and their rights could be specified in the withdrawal agreement with the EU – but overall, disruptions to labour flows could seriously impact on the ability of British business to fill skill shortages, bring the best talent to the UK or deploy staff abroad.
The UK could repeal all EU regulations, but the need for continued trade would point against doing so

Leaving the EU would free the UK from all its obligations to the EU, including implementing and following its rules. Companies exporting to the EU would still have to comply with EU product standards. Companies operating just in the UK would only have to comply with UK rules, while firms exporting elsewhere would only have to comply with the relevant rules of their trading partners. This could be a benefit if EU standards are perceived as costly to implement, reducing the cost of domestic production and non-EU exports.

However, this diversification of standards between companies in the UK could mean a reduction in overall exports. Some companies are set up to export and would therefore align their products to the relevant rules, whether they are European or global. But, although these ‘born global’ companies are increasing, most companies move from the domestic to a global scene. A company wanting to export to the EU would find the move more difficult if their processes and products were not already aligned with EU rules. The freedom to choose simpler domestic rules therefore becomes a disincentive to export. This is especially true for small and medium-sized firms, and could harm UK ambitions to boost the export performance of SMEs.

Added to this, the impact of leaving the EU would be felt differently across legislative areas - and would depend on the government in power. It is not a given that the UK would remove all legislation. In some areas, such as employment law, an exit is likely to spur a debate about the direction UK legislation should take outside of the EU. The UK government would face pressure from businesses to repeal or amend certain elements of more controversial laws, like the Working Time Directive or agency worker regulations, but not all elements would be removed as a significant amount of legislation is broadly supported by many parties. Taking the example of the Working Time Directive, few employers believe that paid rest breaks or holiday should be scrapped, nor do employers believe workers should lose the choice over the hours they work. It is thus clear that the current burden of regulation would not be wholly lifted outside of the EU.

In certain areas, the UK has been driving EU legislation and would be likely to keep the current rules, and possibly even go beyond in areas where the EU has restricted UK legislation. In other areas, rules have come from international commitments – such as those signed up to as part of the G20 – where the UK would remain a signatory even on exit. For instance, in financial services the UK has both pushed reform via international channels and taken a lead domestically and, as a House of Commons Library paper on an EU exit found, it is likely that a significant amount of this legislation would remain in place after a withdrawal – including the majority of rules on capital requirements and obligations on the clearing of over-the-counter derivatives.

Operating under WTO rules would free the UK from EU budget contributions, but the network benefits of European projects would be lost and the UK would lose influence over where the EU targets funds

Leaving the EU would mean that the UK would no longer have to contribute to the EU’s budget, saving the country £7.3bn a year. The UK would need to set up new funding arrangements in a number of areas based on UK priorities, but this would both take time and create winners and losers, as many UK businesses, regions and other stakeholders receive EU funding.

There are parts of the UK that are current net recipients of EU funding, such as Wales, where there is a large agricultural sector and many areas are eligible for the highest level of regional funding. Wales currently receives £163 per head, compared to the £123 per capita contribution from the UK to the EU budget. Based on 2009 figures, Wales would lose around £207 million in structural funding and £290 million in agricultural funding upon an EU exit. England, on the other hand, receives £52 per capita which means that it is a net contributor, and it would therefore gain from an exit. It would be possible to fund any regional or agricultural subsidy programmes using the dividends from net contributing regions, but the UK would lose the benefits of pan-EU research and funds.

Being outside the EU would remove all formal tools of influence over EU strategies and policies and severely limit informal influence channels

Leaving the EU would mean no voting power at the Council, no MEPs in the Parliament, and no absolute right to staff in the Commission. While the UK could still seek to build alliances to influence European decisions, its negotiating position would be seriously weakened. The UK would speak for itself rather than through the EU in a number of global bodies – including the WTO – so in theory would be able to exert influence on the EU and global trading rules unilaterally. However, the UK’s absolute influence in those forums would, in practice, likely decrease; it may be able to voice its objections more noisily alone, but it would be less able to achieve concrete results in shaping the agenda in these institutions, in part because it would lose its large voting weight that allows it to currently anchor alliances and push UK interests more widely.
Being outside would mean a loss of influence over Europe’s future and its rules. But the UK would no longer have any influence over the rules and standards that ultimately companies would have to apply to sell and operate in the EU. As many UK companies would still be dependent on trade with the EU for the reasons set out in Chapter 1, this lack of influence would be a disadvantage.

Relying solely on WTO rules would not give the UK an overall better deal than EU membership

Relying on WTO rules is not a model that would assist the UK in achieving the global trading role to which it aspires. There are some advantages, but these benefits would come at a substantial cost to the economy as a whole and for a number of key sectors in particular.

As the analysis shows, ‘going it alone’ would give the UK the flexibility to design its own framework for trade, capital, labour and funding. Moreover, the UK would no longer have to pay into the EU’s budget or directly apply EU rules at home.

However, British exporters and importers – and those in their supply chain – would face tariffs and non-tariff barriers reducing competitiveness in European markets, particularly harmful in services sectors such as financial services. The UK would also be likely to continue implementing EU rules in many areas to ensure that products were allowed into European markets. The UK would have less influence over the making of these rules, making Britain a standards taker. In other areas, the UK government would be likely to continue to regulate and, as in several cases in the past, it may even go beyond the EU level, applying stricter rules to its own industries and reducing their competitiveness.

The UK would gain the ability to negotiate its own FTAs, but is likely that it would struggle independently to get the agreements on its own that truly open up markets for British business. The UK’s £9bn budget contributions to the EU would end, but universities and companies would lose access to innovative European networks. The threat of tariffs combined with a likely reduction of FDI in the medium term, the risk of capital restrictions harming the City, and reduced flexibility for companies in accessing European labour markets make the WTO option an unattractive model for the UK.
The agreement gives full access to the Single Market in return for implementation in national law of EU legislation covering goods, services and capital, as well as the free movement of people. It also covers cooperation in other areas such as research and development, education, social policy, the environment, consumer protection, tourism and culture, collectively known as ‘flanking and horizontal’ policies. Policies relating to trade policy, customs union, the monetary union and agriculture and fisheries, however, are outside the agreement.

In the areas covered, all new EU rules must be implemented into national law. The governance of the EEA Agreement is conducted through separate EEA institutions mirroring the EU’s institutions, such as the EFTA Court and the European Surveillance Authority, which monitors the implementation and enforcement of the agreement.

Supporters of the ‘Norway option’ believe that the agreement would secure exports of goods and services to the EU through full access to the Single Market without having to be bound by areas of legislation perceived by some as costly or unnecessary, such as the Common Agricultural Policy, the Common Fisheries Policy, the European Court, Commission or Parliament, justice and home affairs and the Common Foreign and Security Policy. By leaving the EU and joining the EEA, the UK would also reduce its funding burden to the EU and regain the power to explore signing free trade agreements bilaterally with any country it chooses.

However, leaving the EU and opting for the Norway model of membership of the EEA would not solve many of the challenges some see with the UK’s current relationship with the EU. It would mean that businesses would still have to follow EU rules, but it would remove the UK’s ability to influence those rules by relinquishing its seat at the table in Brussels. In addition, this option does not in any way accommodate those who want to see a reduction in Brussels’ influence on the UK and its regulatory development.

The EEA would give British business almost complete access to the Single Market, but customs controls would impede UK goods exports and practical obstacles to trade are likely to surface.

Having access to the Single Market has been invaluable for Norway, Iceland and Lichtenstein, the three EEA EFTA countries. A comprehensive Norwegian analysis found that access has substantially benefitted the Norwegian economy and businesses, with more than two-thirds of Norwegian exports and imports going to the EU.298

Although access for goods and services is theoretically guaranteed, the practical realities can create challenges. Not being part of the customs union, EEA EFTA exporters and foreign companies exporting to them have to go through customs procedures such as import/export declarations, including rules of origin for all goods exports and payments of VAT.299 A report published this year by the Swedish Chamber of Commerce on trade between Norway and its closest neighbour Sweden concluded that businesses see trading between the two countries as cumbersome.
despite the theory that it should be straightforward within the EEA. Moreover, the lack of knowledge about the EEA across the EU means that trade barriers exist in practice. At a CBI roundtable event in Oslo, Norwegian businesses shared experiences of difficulties with custom officials at border crossings across Europe causing severe delays and lost profits.

For the UK, the major benefit of the agreement would be that, in theory, British companies could continue to operate within the EU in largely the same way as before. However, as seen above, practical obstacles are likely to surface which would be particularly damaging to UK goods exports.

To get full access to the Single Market the UK would have to implement all the EU rules in the areas covered in the agreement

The regulatory impact for EEA EFTA countries is less than that of an EU member state. For example, the agreement excludes the Common Agricultural Policy (CAP) and Common Fisheries Policy (CFP), so the countries have the opportunity to protect their primary industries by adjusting policies to meet national priorities on fish-stock preservation and regional policy. However, this also means losing on market access in these areas. In the Norwegian case, this has led to most of Norway’s fish-processing industry relocating within the EU, principally to Scotland, to continue to benefit from full market access.

In addition, membership of the EEA still involves a considerable obligation in terms of EU regulation. Norway has implemented around 6,000 EU legal acts, and the EEA countries must implement regulations such as the Working Time Directive, the Capital Requirements Directives for banks and directives covering public procurement.

Were it in the EEA, the UK would therefore be free of some areas of regulation but, in order to retain market access, it would have to continue to apply all pieces of legislation relating to the Single Market, including employment and social rules. Moreover, it is worth noting that Norway’s review of the EEA Agreement found that the EFTA Court is stricter than its EU equivalent, the European Court of Justice (ECJ).

The UK would be able to negotiate access to global markets through the 24 Free Trade Agreements signed by EFTA, but would risk a period of dislocation

The EEA-EFTA countries do most of their free trade agreements through EFTA as the countries have not signed up to the EU’s common trade policy. The 26 FTAs have secured companies preferential access to markets of around 440 million consumers beyond the 500 million consumers of the European Union, and approximately 80% of EFTA’s total merchandise trade is today covered by preferential trade arrangements. However, the UK could not join these agreements en bloc; it would need to renegotiate each one separately.

Being part of EFTA could provide more flexibility in signing trade agreements for the UK, given that there are fewer countries in EFTA than in the EU and therefore agreements are likely to be reached faster. For a long time this was not the case, with EFTA signing agreements alongside the EU. However, after 1998, EFTA began a more independent FTA strategy and concluded FTAs with Canada and Singapore ten years ahead of the EU and with South Korea five years before the EU. Although EFTA’s agreements are in some cases as good as or better than those of the EU, they can often be weaker. This seems to reflect the characteristics of the countries within EFTA. Sometimes they get better deals because their economies are not seen as a threat to the third country’s industry; at other times EFTA has less to offer than the EU, particularly when it comes to market size, an important factor for many developing economies.

The countries are also free to conclude their own free trade agreements, with Iceland recently concluding an FTA with China. This flexibility can be exaggerated as most trade negotiations concluded by EFTA follow in the EU’s footsteps and major countries have been unwilling to negotiate with EFTA before they get an agreement with the EU. For the UK, the EEA Agreement would mean the UK could set its own trade agenda and sign FTAs independently. This would, however, be dependent on the interest of other countries in the UK market and, as described in the section on the WTO option, the UK’s clout would be reduced, risking lower quality in UK FTAs compared with those of the EU. Moreover, given the differences between the small and fairly specialised EFTA states and the UK, a much more complex and diverse economy, each negotiation is likely to take around 3–5 years, depending on the depth of the agreement.
Free movements of people and capital would be unaffected under the ‘Norway option’, but perceptions of lower market access and a lack of influence over rules may reduce investment in the medium term.

Free movement of labour with the EU is a condition of EEA membership and has helped fill skills shortage in the three small EEA EFTA states. Norway’s evaluation of the agreement concluded that its economy has substantially benefitted from labour migration from the EU because it has contributed to increased efficiency. For the UK, the ‘Norway option’ would mean a continuation of the current arrangements for free movement of people. This would represent a positive for business but not for those people who argue that control over labour movements in the EU is a reason for withdrawal.

The EEA also allows the free movement of capital, which has been important for the EEA countries. Most Norwegian investment abroad is in the EU, with EU-owned businesses accounting for 24% of the country’s GDP and employing close to 20% of the workforce. Lichtenstein’s government also concluded that 15 years’ EEA membership had improved its location attractiveness for foreign investors and companies.

On the other hand, Norwegian companies argue that the ‘outsider’ status and its limitations mean that they lose out on investment as EU countries are seen as better locations for operations, even though the EU and EEA offer identical market access in theory. The examples from the current EEA suggest a risk that investments could shift from the UK to EU member states simply because it is perceived to be better to be formally within the EU.

The UK would continue to pay a membership fee to Europe.

The EEA countries do not pay directly into the EU’s budget. However, they do contribute to a separate EEA Grant, amounting to €988.5 million for the 2009–14 period, while Norway in addition finances the Norway Grants of €800 million. Norway is thus the tenth highest contributor to the EU, despite not being a member, with per capita contributions of €100, well over half of the UK’s contributions (€180).

In addition, the countries pay directly for participation in EU programmes, and EEA EFTA contributions to EU Programmes in 2013 are estimated to be €284 million. Taking part in these programmes is seen as vital in all EEA EFTA countries to bring both capital and knowledge, in particular boosting turnover in the area of research. Becoming a member of EFTA would also mean budgetary contributions to the funding of the Secretariat, which in 2013 had a budget of approximately £15 million.

Although the UK would likely see its absolute contributions to ‘European’ budgets fall were it to leave, the relative contributions it would have to make if it pursued the ‘Norway option’ would still be significant.

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“**If you want to run the EU, stay in the EU. If you want to be run by the EU, feel free to join us in the EEA.**”

- Nikolai Astrup MP, spokesperson on European Affairs for the Norwegian Conservative Party

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5,000

The number of EU legal acts Norway has implemented
The EEA option would dramatically reduce the UK’s influence over rules it has to follow

Although they have to follow all the rules, the EEA EFTA states have no formal sway over decisions made in Brussels: they have no Commissioner, no members in the European Parliament, no votes in the Council or participation in most expert groups and agencies. Their governments are often left out of the information loop and risk missing out on early-stage discussions when EU member states begin new initiatives or are formally consulted by the Commission.

This lack of formal involvement has led to a knowledge gap and low prioritisation of EU issues among politicians and civil servants in the EEA EFTA countries and working on EU issues is not considered a useful career route, which has led to a lack of experience of the EU among civil servants. Being outside the EU with no formal channels for influence is particularly harmful to SMEs who, unlike the larger companies, cannot afford to lobby in Brussels and are therefore left unrepresented.

The countries are allowed to participate as observers in some bodies. For instance in 2005 Iceland had access to 418 committees and specialists’ advisory bodies, although they participated in only 184 of them.305 This access has, however, been reduced over time and there has been a gradual shift towards a much narrower interpretation on the EU side resulting in the exclusion of Iceland, Norway and Liechtenstein from many committees and advisory bodies in which they had participated previously.306

Added to that, the EEA is becoming increasingly less important to the EU. EU foreign ministers, for example, rarely show up for meetings in the EEA Council as was expected in the beginning. And increasingly the European Commission ‘forgets’ to involve specialists from the EFTA EEA states when new legislation is being prepared.307

For the UK, the lack of influence would be a major weakness of the ‘Norway option’. The UK cannot be a passive ‘standards-taker’ if it wishes to maximise its opportunities for global trade; it has to be able to set the rules to support business and should seek active involvement in standards-setting as an opportunity to influence EU and global standards to open markets for UK firms.
Another option for the UK would be to continue its economic relationship with the EU through a framework of bilateral agreements in a way similar to Switzerland. After the Swiss public narrowly rejected the EEA Agreement in a referendum, Switzerland decided to negotiate bilateral trade agreements with the EU building on their 1972 free trade agreement.

After six years of negotiation Switzerland was able to conclude a package of seven bilateral agreements in 1999, usually referred to as ‘Bilaterals I’, which are mainly liberalisation and market opening agreements and covered free movement of persons, technical trade barriers, public procurement, agriculture and air & land transport. This was complemented with a further nine agreements in ‘Bilaterals II’ in 2004, which strengthened co-operation in the economic sphere and extended cooperation, including Schengen, taxation of savings, environment, pensions and measures to combat fraud. In total there are now over 120 agreements in force between Switzerland and the EU.

The Swiss agreements exclude the Common Agricultural Policy and, more importantly, services, where the parties have not been able to reach an agreement beyond parts of the insurance industry, despite evidence of a positive impact for both Switzerland and the EU.

Advocates argue that the Swiss model would enable the UK to pick and choose the pros without the costs, in particular being free from the regulations emanating from Brussels. Swiss exporters must still meet EU standards when selling to the EU, but they are not obliged to apply these standards to the domestic economy or to non-EU exports. They are also free to negotiate their own free trade agreements and do not contribute to the EU budget.

The Swiss model seems at first an attractive way to sign agreements on areas of national interest while exempting areas where it is important to keep control at national level. However, the time it would take for the UK to renegotiate an agreement similar to the Swiss would mean a significant period of dislocation as negotiation takes place. Moreover, looking at Switzerland, there is no guarantee that the UK would achieve agreements on all its prioritised areas while keeping other challenging elements out, as there are two parties to the agreement. The UK would be likely to end up having to accept a balanced package of rules related to the Single Market in order to get market access. It is also an illusion that the Swiss option would enable the UK to choose freely when to update the agreement. Although bilateral agreements are static, and the UK would have the power to ‘say no’ to new regulations, it would be in the UK’s national interest to continue updating UK rules reflecting changes in EU law in areas covered by the agreement to ensure that businesses retained market access. This would then be done without the UK having any say in the policymaking process of these rules.

British companies would enjoy access to the Single Market, but only in limited areas where it could sign bilateral agreements and was prepared to follow EU rules

While capital flows between Switzerland and the EU are fully open, Swiss companies only enjoy tariff and duty free access to the EU’s Single Market – and right of establishment within it - in those areas covered by the bilateral agreements. Direct savings have been made both through reduction in trade barriers and, more importantly, through simplification of rules on testing and admission of products for the entire European market which is carried out by a single certification body. Swiss
merchandise exports to the EU are concentrated on a few sectors, particularly chemicals and medicinal products, machinery, instruments and watches.310 However, this option would only provide British businesses with access to those parts of the Single Market covered by the content of the agreement. In the Swiss case, the areas covered by bilateral agreements fell short of Swiss ambitions for access and were limited to those suggested by the Council rather than those pushed for by the Swiss.311 Were the UK to struggle to get an agreement on services, a substantial part of its economy would be left outside the Single Market with companies in these sectors having to pay the price of leaving the EU. This would be particularly true for financial services.312 Moreover, the UK would have to apply EU rules as agreed in the bilateral agreement and although, much of the regulatory implementation is ‘voluntary’, the UK would have to continually update UK law to fit with changing EU regulations to retain market access for its companies. The alternative would be to maintain two regulatory regimes, one for domestic products and another for those being exported to the EU, which would be extremely undesirable from a business perspective. It is simply not true to state that the Swiss are ‘spared the regulatory burden of Brussels’ while retaining full access to the Single Market as many argue.

By signing agreements that cannot be amended substantially without renegotiation, Switzerland has retained formal control over which EU rules they chose to be incorporated into Swiss law. However, for Swiss businesses to be allowed to continue to export, they need to follow the rules of the EU. This is only guaranteed as long as the EU rules remain the same as when the agreement was made; if the EU’s laws are changed, Swiss businesses lose access unless Switzerland adjusts its rules accordingly. Switzerland therefore opts to ‘autonomously introduce’ similar measures to the EU to make sure its industry doesn’t have obstacles in accessing the EU market.313 According to the European Commission, “the on-going implementation of these agreements obliges Switzerland to take over relevant Community legislation in the covered sectors.”314 Although there is some flexibility in how these pieces of legislation are implemented, moves towards the further harmonisation of rules between EU member states has meant it is becoming increasingly difficult for Switzerland to secure exemptions to implemention.315

As with Norway, the Swiss option would enable an independent UK trade agenda, but its limitations and the risk of dislocation make the flexibility less attractive for British business

Switzerland is able to freely negotiate trade agreements with other countries by choosing not to take part in the EU’s common trade policy. It has chosen to make many of its FTAs through EFTA, both because it gives them a stronger hand in negotiations and also because it can rely on the trade negotiation competence in the EFTA Secretariat. It has also individually signed FTAs with Japan and China. However, as stated in the previous section on the ‘WTO option’, signing FTAs is not only about numbers – it is about quality, including how many areas are covered and how deep the agreement is. The quality of a deal depends on the balance of power between the parties. In the Swiss case, a KPMG study of the agreement stated that it appears that more market access opportunities have been granted for Chinese products being imported into Switzerland than vice versa. Looking at the structure of the tariff reduction schedule, nearly all of China’s major exports to Switzerland – textiles, light consumer goods, and equipment – will immediately enjoy benefits when the FTA becomes effective.316

As with the EEA option, the UK could sign FTAs with other countries in the world. This is a more flexible solution compared to negotiating with 28 EU member states. However, as the Swiss–Chinese FTA illustrates, being able to sign trade agreements doesn’t mean that the final result would necessarily be in the UK’s interests. Compared to the EU, the UK is a much smaller market and might not offer enough opportunities for other countries to see the value of signing an FTA on the UK’s terms.

Switzerland has to accept free movement of people but is allowed to introduce quotas on EU migrants

Like Norway, Switzerland had to accept free movement of people to gain access to the Single Market. According to the Swiss government, the biggest economic impact of the bilateral agreements results from the liberalisation of the movement of persons, making it easier to transfer Swiss staff to positions in the EU states and also to recruit workers for the Swiss labour market.317 Switzerland has some autonomous control over its borders and immigration through the safeguards clause which it obtained in the negotiations. The clause gives it
the right to cap immigration over a limited period of time if the number of EU arrivals in a given year exceeds the average for the three preceding years by at least 10%.

This has recently been used by Switzerland to introduce quotas on certain residence permits, initially only for eight EU member states including Poland and Hungary, but in May 2013 extended to 17 countries including Germany and the UK. However, the EU argues that Switzerland is breaking the rules on free movement of people because they discriminate between groups of countries within the EU, and it has indicated that there might be restrictions on market access if the quotas continue. The Swiss business lobby Economiesuisse urged the Swiss government to prevent the quotas doing further damage to Switzerland’s difficult relations with the EU and warned that this could hurt the country’s businesses as many employers have a shortage of skilled employees and may face hiring problems.

For the UK, adopting arrangements similar to Switzerland’s would mean a continuation of free movement of people. While this would be a positive for British business, it would not be a positive for those who want to leave the EU to reduce immigration. The Swiss example is a good illustration of the difficulty of cherry picking in the EU. Switzerland initially did not want the free movement of people; in fact, it was a key reason for the Swiss rejection of the EEA Agreement. Yet, Switzerland still had to accept this when they negotiated the first package of bilateral agreements because the EU saw this as essential for the operation of a Single Market.

The UK may well be able to get an agreement on quotas in line with the Swiss situation although the need for quotas for Switzerland is arguably higher than for the UK because the level of immigration relative to its population is far higher than the UK’s.

The UK would pay substantially less to the EU’s budget, but would equally lose access to funding programmes unless it chose to make the required contribution.

Switzerland does not contribute to the EU budget, but does take part in the EU’s Research Framework Programmes. Participation in this is optional and dependent on contributions. The participation is legally based in the 1999 Research Agreement, but Switzerland has to negotiate the contributions it has to make for each new programme to enjoy full participation. Switzerland’s contribution to the seventh framework programme is approximately €220 million per year over the seven year period. According to the government, in the sixth programme Switzerland achieved a return on its financial contributions of more than 100% in the form of project support for researchers in Switzerland.

An evaluation report from 2009 argued that participation was positive because the collaborative international approach is essential for numerous cutting-edge research fields. In particular, integration into international research networks provides access to specialist expertise abroad and a better knowledge of the competitive environment.

Participation in this is optional and dependent on contributions. The UK could choose to remain outside and fund research nationally, or it could pay to be part of the programmes if it deemed them worth the costs.

The UK would have even less influence over European rules in the ‘Swiss option’ than were it to join the EEA, making the UK almost as much a standards taker as if it opted for the WTO option.

Switzerland has to follow all the rules on the areas covered by the bilateral agreements, without being able to set the agenda and influence the development of those rules. Like Norway, Switzerland has no formal say in EU decision-making. Moreover, as a general rule, Swiss experts are not even allowed to sit on EU expert groups. Lack of information on, and notification of, new EU legislative proposals that involve even the fields covered by the bilateral agreements limit the possibility of the Swiss participating in the decision-shaping process. As with Norway, the result of the Swiss not being involved in the practical aspects of EU decision-making is that certain developments go unseen by the national administration.

For the UK, the Swiss option would be even worse than the EEA option, as the latter at least provides some opportunity to input while policies are being drafted. As stated in the previous section on Norway, it is not in the UK’s national interest to reduce itself to a standards taker.

The Swiss bilateralbs involve complex – and time-consuming – negotiations with the EU, which the union is not keen to replicate.

The Swiss relationship with the EU is not a formal model that lends itself to being readily replicated and there are several practical challenges with the UK opting for a ‘Swiss solution’. 
Negotiating trade agreements is a complex and time-consuming process, meaning costs to businesses due to uncertainty. Bilateral took more than six years to negotiate, from proposing negotiations in 1993 to concluding in 1999, and it did not enter into force until June 2002, meaning that Swiss businesses were without the level of access they desired for nearly a decade after negotiations began. Were the UK to leave the EU and opt for a Swiss option, a substantial period of dislocation is therefore likely.

The process and administrative system surrounding the management of the agreements is viewed as burdensome, with 27 Joint Committees in total. In some cases it has proven to be a challenge to determine under which committee a certain sectoral agreement falls, causing delays that could be costly for businesses, such as the case of mutual recognition of driving licences, or customs formalities in relation to provision of services, or standards for wooden containers.323

The lack of any formal dispute resolution mechanism with sanctioning powers – with the exemption of the area of air transport, where the Commission and ECJ has been given competition powers over Switzerland – means that it is difficult for businesses to get clarification in case of disagreement.324 There is no official institution to interpret the sectoral bilateral agreements in a universal manner. This creates legal uncertainty and poses a potential barrier to trade.

Finally, sustainability of the Swiss option has been questioned, as it is not a model favoured by the European Commission or by EU member states. The pressure for change from the Commission focuses on getting a better overall framework for the large number of agreements. Switzerland and the EU are currently discussing changing the relationship by adopting a more comprehensive and coordinated approach encompassing all current bilateral issues between Switzerland and the EU. This could include a type of surveillance mechanism and a dispute settlement mechanism, similar to the EEA institutions that govern the Norwegian EU relationship. Given the direction of travel of the EU–Swiss relationship, it is unlikely that the UK could achieve a relationship on the same basis, even if it were desirable.
The customs union, a core element of the European project since 1968, implies that no duties are imposed on goods and services within the union. For this to be possible, the members operate a number of common practical rules, including removing the need for complex rules of origin, establishing common procedures on warehousing and operating common rules on customs transit. The customs union also involves a common external trade policy and common external tariffs, although there are some limitations to the benefits of EU FTAs to companies that are in the customs union but outside the EU. Even if this was, as some have argued, what the UK voted to remain a member of in 1975, a return to this would be an inappropriate and insufficient economic stance in the modern global economy – the UK needs a deep Single Market to underpin its global future.

Advocates argue that this option would enable us to trade with the EU as part of the customs union without needing to sign up to standardised regulations across the EU. It would also enable the UK to negotiate external services trade agreements independently of the EU. As with the Swiss and Norwegian options, the customs union would exempt the UK from the CAP, CFP and EU-wide regional policy and budget contributions. The UK would also be free to regulate its labour market independently of EU social and employment law.

Some argue that a customs union is what the UK signed up to when deciding to remain in the European Economic Community in 1975. In fact, the UK joined after it had already become clear that the other member states were set on going beyond this towards creating a Single Market. Moreover, with non-tariff barriers now replacing tariffs as the major obstacle to trade, a customs union would not support the UK’s trading ambitions in the modern global economy with its complex supply chains.

Moreover, opting for the customs union option would not free the UK from having to comply with EU regulation. The UK might be exempt from the CAP and CFP, but access to the customs union would mean implementing a number of rules relating to the free movement of goods, including competition policy and state aid. Were the UK to seek a broader agreement than Turkey’s, further regulatory requirements would be likely, as with Switzerland and Norway.

It would not be in the UK’s interest to be a silent partner in the EU’s trade policy, allowing other countries to set the tone for Europe’s openness to the world and the details of its trade deals, which would define the daily framework for the UK’s global trade. The UK needs to be at the table setting the mandate and approving the final agreement.

Finally, an agreement has two parties and it is clear that the Turkish model was designed as a step towards full EU membership and not as an end itself. The EU is conceding certain benefits to a country that is intending to become a full member of the EU, including the Eurozone. It is not clear whether the EU would be interested in offering a similar deal to a country leaving the EU.
The customs union gives some access to the Single Market, but there would be substantial exemptions, including services. The customs union agreement gives market access for Turkish businesses, but a significant number of areas are missing. While it covers all industrial goods, the agreement does not cover the services sector or public procurement. The Council has agreed on negotiating guidelines on the liberalisation of services and public procurement, but these negotiations were suspended in 2002 with no finalised deal.

Agriculture is another area not covered by the agreement, with the exception of processed agricultural products, although bilateral trade concessions apply to some agricultural products. The agreement does not cover trade in steel and coal products, although in 1996 a free trade area was established between Turkey and the European Union for products covered by the European Coal and Steel Community. Extending the coverage of the customs union is therefore a pressing issue for Turkey.

In addition, the agreement gives the parties the ability to initiate, investigate and impose anti-dumping and countervailing duties, and a 2004 study estimated that the continuation of EU anti-dumping duties has led to welfare losses of up to $70 million for Turkey. Being part of the customs union would mean that a car produced in the UK can circulate as freely within the EU as a car produced in an EU member state. However, not all parts of UK business would be covered in an agreement; notably services would be excluded. The concept of a customs union for goods is somewhat outdated and not compatible with a modern economy like that of the UK, whose reliance on services trade with the EU and beyond is increasing. The UK could argue for a deal on services, in particular for financial services, but it is not certain that the EU would be willing to allow UK firms to access the customs union freely without requesting compliance with a number of key EU regulations in these areas in return.

While being exempt from social and employment laws, among others, the customs union option still involves regulatory compliance in return for market access. There are areas where Turkey does not have to apply EU regulation, reducing the regulatory burden on Turkey compared to that of an EU member state. For instance, Turkey is exempted from the Common Agricultural Policy (CAP), the Common Fisheries Policy (CFP) and the EU’s Regional Policy. It also does not have to apply EU social and employment law. Turkey has, however, had to adopt rules over which it has no influence. The agreement with Turkey addresses regulatory areas of so-called ‘deep integration’ because the intention was to further both parties’ commercial association and pave the way for future full membership. For example, the agreement requires Turkey to adopt detailed provisions on technical barriers to trade and product regulation. Turkey had to harmonise commercial policy, which included adopting rules on competition and state aid in line with EU practice. It also had to adopt Community legislation on the administration of border procedures including rules of origin, and to approximate other laws such as rules on intellectual property (mainly ensuring its laws are compatible with international agreements for the protection of intellectual property rights) as well as taxation.

Although the UK would certainly lose some of the regulatory obligations by leaving the EU and joining the customs union, it is uncertain what a customs union agreement would entail in terms of regulatory compliance. Looking at the Turkish option, it is clear that access – as with the Norwegian and Swiss options - would not come without costs.

“\nThe agreement requires Turkey to adopt detailed provisions on technical barriers to trade and product regulation.\n”
The benefits from EU Free Trade Agreements (FTAs) would depend on a separate voluntary agreement with the third country in question, while the UK would have to open up its own markets to all EU trade partners.

In practice, the customs union relationship allows the EU to negotiate and sign FTAs with third countries which Turkish exporters do not necessarily benefit from. When the EU signs an FTA, Turkey is not involved in designing the mandate for the negotiations, nor is it around the table when the final agreement is approved. This means that Turkish priorities might be completely overlooked in the EU’s FTAs.

Moreover, any EU FTA partner does not have to provide preferential access for Turkish exporters, despite its own exporters having full access to Turkish markets. Although the EU has started to use a ‘Turkish clause’ in its new bilateral trade agreements such as the one with South Korea, in which it asks its trading partners to negotiate a similar agreement with Turkey, this clause is not legally binding. There is thus no guarantee that the same level of concessions as those extracted by the EU can be negotiated for Turkey. In the case of the EU–US FTA, Turkey’s Prime Minister, Recep Tayyip Erdoğan, recently wrote to President Barack Obama to ask for parallel Turkey–US trade talks, but to date there is no suggestion that the US is interested in such a proposal.

One benefit is Turkey’s ability to negotiate external agreements in areas not covered by the customs union agreement, such as agriculture. Turkey has signed a number of FTAs with countries such as Korea, Israel, Morocco, Georgia, Albania and EFTA. This is a small advantage when compared to the disadvantage of being excluded from the EU FTA talks on all the areas that are covered by the customs union.

Turkey’s access to EU markets helps attract FDI but the customs union does not facilitate free movement of people

The customs union agreement, combined with the country being a candidate country and a large populous neighbour country, has supported a massive inflow of foreign direct investment into Turkey; the EU generates about 70–80% of foreign direct investment and around 14,000 companies are based in Turkey. While the customs union has been important for Turkey, the UK is already a substantial receiver of FDI and is not likely to receive additional investment by being in the customs union. The result is more likely to be a potential reduction due to the limitations of the customs union compared to full access to the Single Market.

The customs union itself does not provide for free movement of people although negotiations between the UK and the EU could include commitments around this. The Turkish agreement stated that the two parties should work towards progressively securing freedom of movement for workers between them, and European Court of Justice rulings have given Turkish nationals the right to remain or switch employment if they are legally employed in an EEC member state. These limits on free movement would be an advantage for those who wished to withdraw from the EU in order to have more control over the UK’s borders but they would be a major impediment for British business.

The UK would have no influence over rules that it had to follow and particularly no influence over trade deals

Turkey has no influence over the rules of the customs union or the other rules it has to implement to comply with the customs union agreement. As with Norway and Switzerland, it has no votes in the Council, Commission or Parliament and, like Switzerland, it does not participate in the expert groups that can informally influence EU decision-making.

This lack of influence would be negative for the UK. The development of the customs union rules itself is crucial to UK businesses, as issues such as achieving a centralised customs clearing can illustrate. The EU has recently modernised its rules to make them fit for the digital age, involving changes important for UK businesses. Were the UK to be outside the EU but inside the customs union, it would be faced with a situation where it could not influence the rules of the game to serve its interests. In addition, as described above, the UK would play no role in negotiating trade deals with third countries, opening up UK markets to foreign competition but not guaranteeing reciprocal access.
Turkey has no influence over the rules of the customs union or the other rules it has to implement to comply with the customs union agreement.”
Each of the previous options provides useful lessons about the alternatives other countries have chosen for their relationship with the EU. All of them have significant drawbacks and do not provide the relationship with the EU that the UK – the world’s sixth-largest economy – requires in order to pursue its global trade ambitions. Were the UK to leave the EU, it is not likely to adopt an off-the-peg solution; rather, it would negotiate a bespoke relationship with the EU, reflecting its unique economy. The final option that should be considered is therefore a ‘UK option’ seeking to keep a relationship with the EU through an ambitious UK–EU Free Trade Agreement.

It is possible to set out a ‘best-case’ scenario if the UK were to leave the EU, incorporating the best aspects of all the alternative models, and analyse what would be possible to achieve and whether this would be better for British business than the type of relationship the UK currently has with the EU.

Advocates argue that, rather than replicate existing models – after all, the UK is not Norway, Switzerland or Turkey – the UK should be seeking its own unique deal, one that suits British business for jobs, growth and trade by repatriating UK competence on regulatory issues from Brussels while at the same time preserving the benefits of EU membership in terms of market access. The argument runs that the UK is more than capable of negotiating a bespoke deal that maintains market access without the membership fee.

Given the high level of economic integration between the UK and Europe, which has deepened since the UK joined the EU, as well as the importance of intra-industry and regional trade for reasons explained in Chapters 1 and 2, the UK is highly likely to secure a Free Trade Agreement with the EU, and such an agreement would be likely to be negotiated at an extremely high level of ambition relative to other FTAs.

However, negotiations would not be like any other trade negotiation: the UK would be trying to strike a deal with the very organisation it had just exited. Unusually, the ambition for negotiators would be to protect the level of openness that the UK and EU already share, rather than seeking to break down existing trade barriers. Whether negotiators would be successful in doing that would rely on the nature of UK withdrawal from the EU. A withdrawal could be constructive and diplomatic, but it is more likely that some level of political fallout could be expected among EU leaders and, even if dealt with diplomatically in public, this could easily be felt at the negotiating table. Poland’s Foreign Minister Radek Sikorski argued in The Times: “If you believe Britain could negotiate a trade deal that preserved all the advantages of the Single Market without any of the costs of membership. Don’t count on it. Many states would hold a grudge against a country that had, in their view, selfishly left the EU.”

An advanced UK–EU Free Trade Agreement, while addressing some of the costs of EU membership, would fail to secure vital benefits for business.
Nevertheless, looking at the long-term and factoring in the likelihood of political fallout from a British withdrawal, it can be assumed that the UK and EU would seek to negotiate some sort of Free Trade Agreement, given the economic importance of securing such an agreement for both the UK and, to a lesser extent, the EU. However, as Sikorski implies, the EU is not likely to give any country a deal that in practice is better than EU membership with all the advantages and none of the costs. That would undermine the very existence of the EU and could provide an economic incentive for other members to consider withdrawal options as well.

Chapter 3 detailed how the EU’s size and clout makes it better positioned than the UK to sign deep and ambitious FTAs with third countries. The same argument would apply were the EU negotiating with the UK regarding a bilateral FTA and there are a number of factors that give the EU a stronger negotiating hand in any future trade talks between the two parties:

- The EU28 (excluding the UK) has a 445 million market, compared to the UK’s 63 million, while its economy is almost seven times the size of the UK’s.343
- The UK is more dependent on the EU for its trade than the EU is on the UK. Around half of the UK’s total trade is with the EU, while just 8% of EU trade is with the UK.344 The fact that the UK happens to run a deficit in exports with the rest of the EU is much less relevant in terms of which economy is more dependent on the other than the relative proportion of total trade for each.
- The open-market, free trading philosophy in the UK would likely lead to a default position on exit of low tariffs for all its trading partners (its WTO ‘Most Favoured Nation’ (MFN) bound and applied tariff rates). This would mean that, during UK–EU FTA negotiations, the EU may not feel pressured into lowering its own tariffs towards UK business, because it could (reasonably) assume that the UK would – no matter what the terms of the UK–EU FTA – pursue a unilateral open-market policy to all trading partners, including the EU.

Tariff-free access for the UK in goods and services would not be straightforward

A key demand from British business with a UK–EU FTA would be to retain market access to Europe. For goods trade, most FTAs, particularly those negotiated by the EU, substantially decrease or eliminate tariffs, and so a UK–EU FTA could be expected to also include such measures. However, while a zero tariff on all UK–EU goods trade would be the optimal outcome for business protecting the existing level of market access for UK goods to the EU and vice versa, this could not be guaranteed, and it should be noted that all EU FTAs, even the most ambitious such as EU–Korea, include exceptions from full tariff elimination and therefore do not provide complete coverage.

As a result, simply to achieve duty-free access in an FTA between the UK and the EU, something that many people assume would be a given, may not be straightforward and would actually set a new gold standard that has not been fully replicated by any EU FTA partner, or by Norway, Switzerland or Turkey in their respective models. Even in Turkey, where a customs union with the EU is in effect, agricultural goods are not included within the scope. Furthermore, following UK exit from the Single Market, UK goods exports would be met with increased border bureaucracy and, as with the Norway and Swiss options, burdensome rules of origin would be necessary.

For market access in services, it would be in the UK’s interest to secure a very ambitious agreement to ensure minimal disruption to services providers across all sectors, building on the WTO GATS framework. However, services trade negotiations are extremely complex, because the provision of services exports not only relies on the ability of a company to provide a service ‘cross-border’ from a base in the UK (e.g. to provide legal advice via phone or email) but can also rely on the ability of a service provider to set up an office overseas (Mode 3 – establishment overseas) or to ensure that its staff can physically move across borders (Mode 4 – temporary movement of persons).

In order to preserve the same benefits as the UK currently gets from EU membership in terms of services trade, noting in particular the freedom to

The EU is not likely to give any country a deal that in practice is better than EU membership with all the advantages and none of the costs.
provide cross-border services as set out in Article 56 of the Treaty on the Functioning of the European Union (TFEU) and the freedom of establishment in Article 49 of the same Treaty, as well as the 2006 Services Directive and the ECJ’s role in enforcing the directive, the UK and EU would have to negotiate an FTA that goes way beyond any other EU FTA that has been negotiated to date. While such an FTA may set a world standard globally, with – in a best-case scenario – more sectors fully covered under ‘right of establishment’ and longer permissible temporary movement of persons than seen before in other FTAs, this would still represent a severe deterioration from the status quo, even accounting for the incomplete nature of the current internal market for services.

Furthermore, there could be practical restraints that prevent the EU from agreeing to such a high level of ambition, even if this was the desired outcome. For example, in the EU–Korea FTA, there are clear provisions implying that, were the EU to negotiate more ambitious commitments on trade in services with another FTA partner, those benefits would have to apply to Korea as well (unless as part of a regional agreement). Consequently, even if the EU was to agree to very ambitious FTA commitments on trade in services with another FTA partner, those benefits would have to apply to Korea as well (unless as part of a regional agreement). Consequently, even if the EU was to agree to very ambitious FTA commitments on trade in services with the UK, it would have to open up these benefits to its other FTA partners as well, which could present problems for the EU, especially given that the pro-free trade voice inside the EU itself would have been weakened considerably following the UK’s departure from the EU. To avoid this, the EU could adopt an approach whereby it offers the UK the same terms as its model FTA partners, which cannot be compared to the current internal market for services.

**The UK would no longer be in a position of strength in FTA negotiations with key trading partners.**

To avoid this from happening on many key regulatory issues, there is a huge risk that the UK would get pushed into being a ‘standards taker’, forced to align its own regulatory standards with the EU on issues such as safety standards and environmental regulations, yet would lose influence over how the EU rules are set without a say in the EU Council, Commission or Parliament.

There are provisions in other EU FTAs backed up by dispute settlement procedures that do seek to prevent new NTBs from arising. In modern EU FTAs, action to reduce existing NTBs that constitute a major trade barrier with a third party are increasingly important for the overall success of negotiations (the ongoing EU–US and EU–Japan negotiations are set to be major examples of this). However, commitments made on NTBs between two parties cannot be compared to the common laws and standards that exist inside the EU. The EU would not be likely to open its borders for British goods and services unless these standards were deemed to fulfil rules of equivalence, which could be established in three ways:

**Following EU rules:** The UK could continue to voluntarily adopt EU rules as they are outlined by the EU. This would mean that any regulatory burden would remain as if the UK were still a member, as happens to Norway.

**A system of equivalence:** The UK might be able to negotiate a system where the EU would acknowledge UK national laws as equivalent to its own. Such a regime – in principle the same as the EU’s own principle of mutual recognition – would, of course, have to be constantly updated as EU law changes. If a UK regime was thought outdated, market access would be at stake until the UK could satisfactorily prove equivalence was restored. This system would, however, mean that the final decision of whether UK rules are ‘equivalent’ would be up to the EU and could therefore fall victim to politically motivated assessments.

**A system of independent authorities:** The UK and the EU could set up independent authorities similar to that of the EEA to authorise and monitor whether the UK’s regime is equivalent. This would take some of the powers away from the EU, but an independent body would be likely to involve costs. Moreover, for the EU to trust the body, it would have to be empowered with enough resources and powers to keep the UK’s
regulatory development in line with the EU’s. In this scenario, the UK would find itself supervised by another body, which would not address the concerns of those arguing that leaving the EU would give the UK more power to set its own rules.

**The UK would have an independent trade policy but suffer dislocation of market access as it negotiated many new agreements simultaneously, with no guarantee of securing market access on favourable terms**

As with the Norway, Swiss and WTO options, being outside the EU would enable the UK to pursue its own external trade agenda, with the potential opportunities, risks and limitations that this entails. The UK would be able to pursue its own FTA negotiations with the trading partners it chooses, and could take forward its own strategy, factoring in its historic ties and long-term economic interests.

However, there remains an open question as to what would happen to EU FTAs with other third countries that are currently applied to UK businesses. At some point, perhaps after a short transitional period, these FTAs would have to be renegotiated, and the uncertainty around this issue is a key cause for concern for many exporting businesses. It would take time for the UK to first regrow the capability to negotiate FTAs and there would be a period of dislocation – perhaps for many years – while new UK bilateral deals were finalised.

In addition, the UK would no longer be in a position of strength in negotiations with key trading partners. Depending on the commitments it takes at the WTO on a multitude of trade issues (for example, the applied and bound MFN tariff rates it sets, its commitments under GATS and the GPA), the UK would not necessarily have much to ‘trade off’ in a negotiation, which could make the practical feasibility of concluding negotiations to get the best result for Britain increasingly difficult. Furthermore, the UK would become one of nearly 200 other WTO members when pushing its issues on the multilateral agenda and when defending its borders from trading practices by third countries that were inconsistent with WTO rules: its influence on global trade and related economic matters on the international stage would inevitably decline.

**Investment is likely to drop, even with a deep Free Trade Agreement, and the impact on the UK’s financial services sector would be significant**

In the event of a British exit, investment and capital flows would be likely to be disrupted as the legal basis for the UK investing in the EU, and vice versa, would change. Article 49 of the TFEU on the freedom of establishment would cease to apply, and the UK would need to secure new commitments protecting the ability for UK companies to invest in the EU with legal certainty, across all sectors.

Typically, EU FTAs do include provisions on capital movement – for instance to ensure that payment operations remain unrestricted and that transactions related to direct investment remain free of restrictions – although there are also clauses allowing for time-limited safeguard measures in case of serious difficulties for the operation of monetary and exchange rate policy.

A major concern, however, is that, even with a very ambitious UK–EU FTA that incorporated the above commitments and very ambitious provisions on ‘right of establishment’ to permit UK companies to attain the same equity stakes in other European companies as is possible today (and vice versa), there could still be a net capital outflow in this scenario, with overseas investors preferring to relocate their activities within the EU trading bloc.

It is possible that the City could remain as an offshore capital market for some EU companies. However it is more likely that, over time, rival capital markets inside the currency area would emerge and there would be political pressure following UK withdrawal from the EU in this direction to restrict EU dependence on the UK.
The lack of free movement of people would hamper business

In a UK–EU FTA scenario, there would no longer be free movement of people across borders. Businesses would lose the ability to plug skills gaps and draw talent from across the European labour market. The only provisions related to the movement of persons in a conventional FTA would be for temperately movements of staff, whereby the UK and EU would agree to the amount of time that intra-corporate transferees, seasonal workers and business visitors can spend in another country in the context of providing a service in another country.

The UK government would have more control on migration numbers from the EU in this scenario, although it should be noted that, if any new work permit or visa requirements were applied by the UK government on EU nationals, then they are also likely to be applied as a reciprocal measure by the EU to the detriment of any UK citizens seeking to work in, or UK companies seeking to post employees to, the EU.

Even the best-case UK–EU Free Trade Agreement fails to deliver for British business in supporting its global ambitions

The ‘UK option’ is the most difficult to evaluate since it has no existing ‘model’ to assist the analysis. Its composition is highly uncertain because a deal with the EU depends on what the remaining member states would be willing to negotiate with a withdrawing UK.

The analysis nevertheless shows that the likely outcome is not one of costless benefits. The quality of the FTA depends on negotiations with the EU and, although the UK would undoubtedly have some clout, the UK’s negotiating hand is less than that of the EU because of the relative dependence of each on the other. Any rights of access granted would come at a price, with considerable regulatory compliance being required in return for market access. The inability to shape these rules given the loss of representation in EU institutions that would occur is a significant downside to any deal for business. This is not least because the UK’s complex modern economy relies on setting the rules of the game if it is to pursue a global future – from rules governing financial services, through intellectual property and patent law, to regulations designed to take on the common challenge of climate change.

The option would enable the UK to pursue an independent trade agenda, but that is no guarantee of increasing on-the-ground market access for business around the world, in either developed or emerging markets. Missing out on the benefits of potential upcoming deals with developed markets such as the US and Japan would be a blow. Moreover, the coverage of any bilateral UK FTAs is likely to be narrower in scope than if the UK were negotiating within the EU, severely limiting the ability of the UK to break down those non-tariff barriers that are, in reality, the practical obstacles for UK businesses to harnessing global trends and seizing new market opportunities around the world.

With the high risks and uncertainty relating to this model – as well as very little evidence of advantageous outcomes compared to the existing model – the UK should look to improve the existing package it holds as an EU member rather than embark on trying to draft an alternative UK–EU agreement.

“Market access is unlikely to come without obligations on the regulatory side, including the likely adoption of EU rules without any ability to influence them.”
Exhibit 64: The UK’s financial services sector would be damaged if the UK left the EU, hampering business growth

Businesses right across the EU have benefitted from having a world-class financial centre inside the Union. While the City of London would survive in some form were the UK to leave, remaining in the EU – while using UK influence to impact its future, focus its policy approach to financial services and ensure Eurozone integration does not hit the UK’s financial sector disproportionately – remains the best option for the British financial services sector to flourish.

Although it is difficult to make conclusive judgements on the impact of UK withdrawal on the UK’s financial services, it is possible to outline some of the potential impacts.

A number of companies would be likely to relocate parts or all of their operations

A number of foreign financial services companies are located in the UK to get the benefits of being part of a world-class financial centre combined with the benefits of the EU’s Single Market. After a UK withdrawal, the UK would lose aspects of its attraction as a financial centre.

While far from every firm would leave, companies for which the benefits of the EU are crucial for their investments in the UK would move operations, in part or in full, to a financial centre within the EU. In a City UK report, decision-makers specifically cited access to markets in the EU as a core reason for choosing the UK over other financial centres in over 40% of the UK-positive investment cases considered. European banks, currently holding 17% of total assets of banks in the UK (nearly £1.4 trillion), would have a particular incentive to move back home.

Leaving the EU could force some firms to relocate to the continent: in particular, European firms could relocate ‘back home’, as could foreign firms which depend on the deep access to the EU that membership provides. As Goldman Sachs said in the Evening Standard, it could leave its trading desk in London but most of its employees would move to the Continent to secure the benefits.

The sector could lose certain types of financial activities

In the medium to long term, with the UK outside the European Union, particular areas of trade would be likely to move from London, some potentially to other financial centres such as New York or Singapore and others within the Eurozone as rival capital markets inside the currency area could emerge.

The European Central Bank would be likely to push through rules securing that clearing of euros happened only within the EU (see Exhibit 62 in Chapter 5), undoubtedly harming the City. Euro trading in the UK has increased nearly fourfold over the past decade with twice as many euros traded in London today than in all the euro-area countries combined, while average daily turnover in the UK in euro-denominated over-the-counter (OTC) interest rate derivatives totalled $668bn in April 2011, accounting for 62% of all such trading worldwide and representing a sixfold increase over the past decade.

The UK would lose its regulatory influence and reduce its ability to be a place to do global business

London’s place as a global financial centre rests partly on its position at the crossroads of the competing regulatory regimes of the US and EU, which allows it to be the place where global business can take place. The importance of the UK’s regulatory influence in financial services is twofold. First, it allows the UK to shape EU rules to keep the UK (and Europe) competitive in the face of global competition from East and West. But perhaps more importantly – over the past 20 years but especially in the aftermath of the financial crisis – the UK’s position in the EU and subsequent regulatory influence has helped avoid regulatory divergence with other important regulatory regimes, most notably the US. This keeps regulation broadly ‘global’, minimises the expensive regulatory duplication that occurs with divergent regimes, and has allowed the UK to emerge as the modern economy’s global financial centre. Maintaining this position is therefore based in part on retaining the UK’s ability to develop market-leading regulatory standards that are globally competitive. Outside the EU, the UK would lose its influence on EU policymaking on financial services issues, which would potentially reduce the importance of London as a global financial centre.

Withdrawal from the EU would hit UK financial services, broader business and the wider economy

The impact of UK withdrawal would harm the financial services sector; London would still be a financial centre but would have to make substantial changes to retain its global role and European footprint. It would also hit the wider UK economy: around 40% of the tax take from UK financial services is from international businesses operating in the UK, and their exit would also reduce sources of finance for the broader business community.

The issues would not be addressed by an FTA

A UK–EU FTA could attempt to offset some of these disadvantages by including market access for financial services as a key element in negotiations. However, market access – in particular the type of access that passport regimes provide – is unlikely to come without obligations on the regulatory side, including the likely adoption of EU rules without any ability to influence these.

The EU could be willing to deem the UK’s regulatory regime ‘equivalent’ to its own but, following the financial crisis, the distrust in the UK as a suitable regulator for financial services could lead to EU demands for full UK compliance with EU rules, for instance on bankers’ bonuses or capital requirements. Moreover, future EU rules would no longer be developed with UK participation, potentially making them less liberal and favouring the ‘continental’ model.
Were the UK to leave, the EU may potentially move towards a more inward-looking posture, to the detriment of its openness to the world — with the result that EU trade deals would likely be less ambitious."
6.2 Irrespective of which type of alternative relationship is chosen, a UK withdrawal risks creating a more inward-looking EU

Withdrawal from the EU means the UK leaving the table where the future of Europe is decided. The UK would lose most of the tools for influencing the policies of the EU and its path of integration. This matters because, as outlined in Chapter 1, economic fundamentals dictate that the British economy will need a trading relationship with its European neighbours regardless of UK membership status. Co-operation with the EU is necessary in most areas and, at the very least, British exporters are dependent on sales to EU markets for which they must meet EU regulatory conditions.

It is therefore important for the UK that the EU continues to remain an open market for goods and services from third countries, that it pushes for new trade deals and that it creates effective and efficient rules. In many ways a result of UK influence, the EU today is a liberal market economy with the Single Market at its heart.

Were the UK to leave, the EU may potentially move towards a more inward-looking posture, protecting its own industries to the detriment of openness to the world – with the result that EU trade deals would likely be less ambitious. At the moment, both the ‘northern bloc’ (Germany, the UK, the Netherlands, the Czech Republic, Sweden, Denmark, Finland, Ireland, Latvia and Estonia) and the Mediterranean block (France, Italy, Spain, Greece, Portugal and Cyprus) have a permanent blocking minority in the Council of Ministers. If the UK left, however, the northern bloc would lose its blocking minority, with a far greater risk of it being outvoted on trade and EU budget issues (see Exhibit 65).

Exhibit 65: The ‘northern bloc’ of liberal market economies would lose their majority were the UK to leave the EU

A more inward-looking EU could reverse progress made on the Single Market and introduce new tariff barriers for third countries. This is why representatives from other member states have emphasised the importance of having the liberal-minded UK in the club. In a Policy Network report for the CBI, a senior Swedish official said that “it is difficult to see how the EU could be open and dynamic without the UK.”

“It is difficult to see how the EU could be open and dynamic without the UK.”
- Senior Swedish official
6.3 No alternative form of relationship with the EU offers a better global future for UK business than full membership

The UK would undoubtedly survive outside the EU, but the assessment of five potential alternatives to full UK membership has shown that none of them is able to improve the overall balance of advantages and disadvantages to EU membership.

All alternatives mean a significant period of dislocation while the UK renegotiates with not only the EU but every existing partner in a Free Trade Agreement. All options except the EEA option offer unsatisfactory access to European markets. They would involve one or more barriers to trade – such as higher tariffs, burdensome rules of origin, border controls or other regulatory barriers – which would hit UK goods trade with the EU for both exporters and importers, and undermine the UK’s services sector’s ability to continue its increasingly important contribution to UK export performance.

This reduction in market access would not necessarily offer a substantial reduction in the rules the UK would have to apply. Most of the major regulations currently viewed as burdensome would continue to apply were the UK to leave. Most crucially, the UK would also lose its influence over the creation of these rules and over the global standards that the EU, as the world’s largest Single Market, helps to shape. UK global competitiveness rests, in part, on ensuring that businesses from around the world are playing by the same rules, and the loss of influence felt on exit would affect the ability of UK business to take advantage of its strengths on the world stage.

Full membership of the EU is a better vehicle for harnessing the global trends reshaping the world economy than all the alternative options put forward. If the form the UK’s current relationship takes is the best option, then working to improve this – changing the details rather than the type of relationship – through co-ordinated reform with other member states in the EU must be the priority to help the UK realise its global future. The UK business community’s priorities for reform are set out in the conclusion to the report.
CONCLUSION

A REFORM AGENDA THAT SUPPORTS THE UK’S GLOBAL TRADING FUTURE
Business wants to remain in the EU – it is better than any realistic alternative as a means to achieve British growth ambitions through increased openness. But the EU has to change. If the UK engages in the right way, it can work with allies to reform the EU in a way that supports the UK’s global future.

The world’s economic geography is being reshaped as emerging markets industrialise, urbanise and a middle class develops – growing rapidly and contributing a greater share of global growth. In the developed world growth will remain lower in the foreseeable future, although opportunities remain. Creating new trade patterns will be key for the UK, but it doesn’t face an ‘either–or’ choice between developed and emerging markets – it can do more to create trade and investment links to high growth markets while keeping links to established economies.

To exploit these opportunities, the UK must tackle the challenge of falling productivity by maximising its openness to the global economy. Although the multilateral agenda has helped boost openness, bilateral and regional trade deals have now taken the lead.

The EU has, to date, been by far the best vehicle to maximise openness for the UK, with benefits of membership significantly outweighing the costs. The EU has opened up markets in Europe and abroad and secured access to capital, labour and funding. While there are aspects of the EU that are less positive – the costs of membership in terms of budget contributions and regulation – they are a price worth paying. In fact, the UK has been actively influencing the EU, driving it towards liberalisation and competitiveness and helping to create the very benefits it has enjoyed.

However, the EU is changing, pushed by the largest crisis since its establishment, and the contours of a new Europe are emerging. Although a more integrated Eurozone could see the UK potentially sidelined, it is perfectly possible for the UK to continue to shape the EU in a way that meets its goals of boosting trade and investment, but only if the UK keeps a seat at the table and joins its colleagues across Europe to reform the EU to achieve growth and competitiveness.

Business wants the UK to remain a member in the EU; it is better than any realistic alternative as a means to achieve British growth ambitions. But the EU has to change. Business wants an EU that is outwardlooking, open and competitive; an EU rooted in member-state priorities, working for all its members, both inside and outside the single currency, and respecting the boundaries of power granted to it; and an EU in which the UK is a committed member working with allies through an active EU–strategy. Reform is essential if the UK is to fully realise its global future. Without it, the EU cannot hope to compete with the rising economic giants.

The UK is not alone in wanting a better EU for the future, nor can it achieve its objectives without the help of others. The differences between 28 member states should not be underestimated, but there is a growing consensus around the need to change the EU to meet the challenges of the 21st century. As Chancellor Merkel has said, “If Europe today accounts for just over 7 per cent of the world’s population, produces around 25 per cent of global GDP and has to finance 50 per cent of global social spending, then it’s obvious
that it will have to work very hard to maintain its prosperity and way of life”. The CBI believes that the right approach is to champion reform for the whole of the EU, not on the basis of negotiating a special deal for the UK. It is important that the limits of the Commission’s responsibilities are clearly defined, but British business sees the principle of ‘subsidiarity’ as the right mechanism to achieve this, rather than unpicking the existing balance of competences. An unrealistic attempt to repatriate powers rather than reform the whole EU could lead to the exit door by default. The changes underway in the EU and global economy represent an opportunity for the UK to push for a more market-orientated EU that can support the UK’s global trading future. This reform agenda has support from a number of member states across Europe.

Putting trade at the heart of the EU’s strategy

Following European elections in 2014 and the formation of a new College of Commissioners, the EU should ensure that an open trade policy remains at the forefront of the EU’s long-term growth strategy. The new Commission should set out an ambitious trade agenda in the Commission President’s political guidelines and the first State of the Union in 2014, and embed clear trade targets in the Commission’s first work programme for 2015.

The EU should negotiate and sign deep Free Trade Agreements with key established markets and sources of FDI for the UK such as the US and Japan, with the conclusion of the Transatlantic Trade and Investment Partnership (TTIP) negotiations a priority for business. Given that tariffs with these markets are already low in many cases, the scope of negotiations should be broad and conducted at a high level of ambition, containing binding provisions to reduce non-tariff barriers. FTAs should open up trade for sectors of the future including high-tech goods and environmental technologies, and the EU should use these FTA negotiations as an opportunity to develop compatible approaches to regulatory formulation and compliance that help set the standards for global trade.

Chapter 1 highlighted that the UK also needs to do better at exporting to high-growth emerging markets. The EU has a major role to play to help UK companies access these markets, whether this is through FTA negotiations to reduce trade barriers or through other formal engagement strategies. While the EU has successfully concluded FTA negotiations with emerging markets such as Singapore, Colombia, Peru and Central America, moves to improve links with the BRIC economies have been less successful.
As desirable as concluding comprehensive FTAs with the BRICs and other key emerging economies within a short timeframe would be, the reality is that this is not always politically feasible. Ultimately, high-quality FTA negotiations need to reflect a willingness of both negotiating partners to take decisions that increase openness and expose industry to greater competition. The negotiating weight of the EU – and the prize of access to the large Single Market – is the best vehicle for encouraging emerging economies to open themselves to trade.

When FTAs are not possible in the short term, there are other tools of bilateral engagement that the EU can use that can help set the path for future negotiations, in much the same way that the Transatlantic Economic Council (TEC) with the United States has helped prepare the ground for the TTIP negotiations. Many bilateral working group structures to discuss economic issues have already been set up between the EU and key emerging markets, which the UK has often helped to promote. However, a more co-ordinated approach at a European level is needed to help exploit these structures further. For example, while EU–China economic relations are promoted through formal dialogues such as the Joint Committee and the High Level Economic and Trade Dialogue, and many other bilateral initiatives also exist, an overall clear strategy of engagement with China is currently lacking. In the long-term, building a clearer strategy could help ensure that market access barriers in services trade, public procurement and FDI restrictions can be addressed.

Continuing the push for global solutions at the WTO
The WTO faces a major challenge to stay globally relevant in the wake of a very long round of negotiations that has yet to deliver on its agenda. The ‘single undertaking’ approach and lack of political compromise and engagement at crucial times have so far blocked progress. However, it is important to stress that the WTO and its rules-based mechanisms remain a key force against protectionism, and it is essential to maintain the credibility of the multilateral trading system. WTO members urgently need to demonstrate how the organisation is going to move forward in order to preserve the reliability and treaty-based discipline of the organisation. The EU must remain a leader in making the case for trade liberalisation commitments at the WTO level, while also taking advantage of other international forums like the G8 and G20 to support the objective. The EU should continue its detailed monitoring work such as the Trade and Investment Barriers Reports (TIBR) and the yearly Report on Potentially Trade-Restrictive Measures (RPTRM) to hold other trading partners to account on their WTO commitments.

Protecting the market openness of the EU
In addition to opposing protectionist measures in third countries, the EU also has a job to do to maintain its own level of openness to trade and investment. Recent proposals such as overly strict third country rules for financial services, measures regulating third country access to the EU’s public procurement market and mandatory origin marking, all contain elements that could run counter to the UK’s trade policy priorities if approved. The UK needs to remain vigilant to ensure that the EU follows through on its trade policy narrative.
Signs of progress could include:

1. The EU should successfully conclude a high-quality Free Trade Agreement with Japan, and sign the Transatlantic Trade and Investment Partnership (TTIP) agreement with the US. According to conservative studies, a TTIP deal could give the UK economy a boost of £10 billion each year. The final agreement should include ambitious commitments to:
   - Eliminate tariffs
   - Liberalise trade in services
   - Improve access to US public procurement contracts
   - Reduce any remaining barriers to foreign direct investment
   - Reduce current non-tariff barriers to trade in key sectors like automotive, chemicals and pharmaceuticals upon entry into force of the agreement
   - Prevent new non-tariff barriers to trade from arising in the future
   - Simplify customs rules and administrative procedures to facilitate trade.

2. The EU should push forward a more dynamic trade agenda with key emerging markets to support member-state trading ambitions.

7.2 An open and competitive EU: updating the Single Market for the 21st century

Chapter 3 demonstrated that the Single Market has provided substantial benefits to the UK economy and further improvements, particularly in the services market, could create new opportunities for business, adding potentially up to 7.1% to UK GDP. The EU must continue to exploit its main strength – the 500 million people strong consumer market – by advancing key initiatives and tackling obstacles that impede growth. Continued efforts should therefore be put into delivering the Single Market Act I and II, with a particular focus on proposals that will substantially improve growth and competitiveness, including legislation on infrastructure, the deployment of high-speed broadband and access to long-term investment funds.

Chapter 3 also showed that regulation can enable Europe’s companies to harness economies of scale, but inadequately assessed or badly designed rules can stifle growth and competitiveness. The EU’s regulatory approach is integral to maximising access to markets here and abroad, and there needs to be a better approach to regulation at EU level to help business and support enterprise.

There is appetite across Europe for a push on EU competitiveness. In 2012 the UK signed a letter with 11 other countries – including the Netherlands, Sweden, Denmark, Finland, Estonia, Poland, Lithuania and Latvia – calling for EU with ambition and commitment to global trade, a push on services, a truly digital market, completion of the internal energy market and reduced burden of regulation. But this new drive for competitiveness could also receive significant support from countries that have historically been less aligned with the UK on these issues. For example, a senior French official echoed these calls for fresh impetus to the Single Market: “On the Single Market, we need a strategic discussion at leaders’ level. Why is there such a gap between the UK and France? Our economies are comparable, so why don’t we have the same interests [on a Single Market focus]?”
Making further progress on unlocking the Single Market for services

The Commission should look to further open up the EU’s Single Market for services which could substantially advance the EU’s competitiveness as Europe exits the crisis. The EU needs a renewed high-level political commitment to the liberalisation of services markets across the 28 EU member states supporting the implementation of existing rules and taking new action where necessary. The EU and its member states must commit to:

**Ensuring implementation and enforcement of the Services Directive:** The Commission and member states should continue to push for progress through the Annual Growth Survey, the mutual evaluation process and scorecards of national performance, but other means could be envisaged including more formal enforcement measures by the Commission.

**7.1%**

Potential boost to UK GDP from improvements to the Single Market.

**Improve the framework for regulated professions:** There are currently 800 regulated professions across the EU - 25% of which are regulated in only one member state (including "photographers, barman, corset makers or chambermaids"). This non-tariff barrier reduces the ability of domestic firms to offer their services right across the EU. More work should be done to substantially reduce the number of regulated professions in member states, particularly focusing on those regulated in only one or a few member states and ‘specialisation’ requirements fragmenting the provision of certain services. This could be done through member-state level action recommended as part of the Country recommendations in the European Semester and monitored by the Commission.

In a number of member states – including Germany, Sweden, Spain and the Netherlands – governments are ready to do more to promote the integration of services, although few are ready to contemplate new legislative initiatives. As Chancellor Merkel has put it: “We have a Single Market of goods, but not quite a Single Market for services. We still have to work at it”. The first step for many member states is to ensure that the Services Directive is fully implemented, with the former Spanish Economic Minister, Elena Salgado, calling this “the most important structural reform” the country will make, and the Swedish Minister for Trade, Ewa Björling, hailing it as “a fantastic vitamin injection for the EU economy”.

However, if action across the EU28 remains impossible, the use of enhanced co-operation should be considered for a smaller group of countries to move ahead to break the political deadlock on services. According to Open Europe, use of enhanced co-operation here could still produce a boost to EU GDP of €147.8bn. Although the impact would have to be further assessed, this indicates that there are potential benefits of moving ahead with a smaller group if action at the EU level remains impossible.

The EU economy urgently needs a more integrated, deepened Single Market for services.

-European Commission
Focusing on sensible progression of the Digital Single Market

Digitalisation is revolutionising the way firms do business, generating a large ‘online’ consumer base and opening up new opportunities for job creation and retention, but cross-border online trade remains stubbornly low.

The EU has acknowledged the importance of the growing digital economy to the EU’s future competitiveness pushing ahead to complete the Digital Single Market in Europe. The CBI supports a sensible approach to completion – a pragmatic exercise which identifies barriers to the Single Market where these legitimately exist, while keeping competencies at national level where necessary.

The CBI recommends the EU looks to:

Remove barriers to e-commerce to boost trade and investment, by: easing cross-border trade through supporting technological innovation in payment systems; establishing an ‘e-commerce’ test in impact assessments for all forms of new EU regulation, to ensure that regulation does not hinder the ability of firms (particularly SMEs) to access cross-border online markets; and encouraging member states to collaborate on how they can streamline different national requirements for retail products.

Boost connectivity for business and consumers by driving the roll-out of digital infrastructure. This would include:

Establishing digital infrastructure as a funding priority and streamlining financing arrangements through the prioritisation of financing for digital/communications networks during future Multi-annual Financial Framework (MFF) negotiations, as well as encouraging the European Investment Bank to make greater use of project bonds alongside other sources of EU funding to support private capital expenditure in telecommunications.

Working with competent national authorities to harmonise long-term arrangements for the allocation of spectrum in order to support the Single Market. The growth in mobile data represents a significant opportunity for the global digital economy. To make the most of this opportunity, operators in Europe will require swift and efficient access to spectrum in order to deliver in-demand services to businesses and consumers alike.

Focusing on network access to come up with a more competitive offering for businesses and consumers in the EU through pursuing plans to introduce a ‘virtual’ European network access broadband product which complements existing domestic regulatory settlements and which preserves national ‘physical’ access remedies where these already exist; moreover, the European authorities should engage with industry on a common European product for business connectivity including a focus on, for example, ‘lease-lines’.

Ensuring policies on ‘digital demand’ keep up with the supply-side, perhaps through the establishment of a forum by DG Connect to enable member state governments to ‘swap notes’ on digital inclusion strategies, allowing the UK government to feed in perspectives from its current work to develop a cross-government strategy on this issue.

Recognise the fundamental economic worth of IP to EU businesses by supporting a robust and rewarding environment for content at home and abroad, by: the government ensuring that the EU uses its economic weight to press for robust IP protection provisions in international trade negotiations. This requires active and transparent UK engagement on IP initiatives in the EU, including copyright.

Ensure that regulatory frameworks support FDI and innovation through being flexible, adaptable and outward-looking, by: avoiding the creation of standards which contradict, exceed, or run contrary to international practice; and not pursuing a prescriptive approach to data protection and cyber security regulation that undermines business competitiveness.

Signs of progress could include:

3. The EU member-state leaders should organise a high-level symposium on the Single Market by the end of 2015 to give political impetus to the completion of the Single Market. The symposium will take stock of progress achieved by the last Commission during the crisis – in particular with the Single Market Act I and II – and set out priorities for the further development of the Single Market, enabling the next Commission to focus on delivering on the opportunities that lie in more open services and digital markets.
Regulating for a modern, globally competitive EU

Although a Single Market needs commonly agreed rules for all, there is no doubt that a number of rules at EU level do not work on the ground, reducing public legitimacy for the important regulatory framework at EU level. The EU needs to ensure that all regulation (new or revised) supports Europe’s growth. Particularly at a time of crisis, the overall burden of regulation matters as companies are working to drive recovery through investment and job creation. The Prime Minister’s Business Taskforce report on EU regulation in October 2013 was a welcome kickstart to this debate, and the EU Commission must respond to the broad thrust of this agenda. For the CBI, rules must be made with the aim of making the European regulatory framework more competitive, commensurate and considered.

Competitive: Making rules work in a global context

If it is to stay competitive, the EU must not take a regulatory approach that puts European companies at a disadvantage or shut the EU off from the world. The EU should introduce a ‘Think global first’ test to make sure that proposals support the EU’s global competitiveness. It should be applied throughout the policymaking process, particularly in the impact assessment phase where currently international competitiveness is only one of many criteria. This could be done by rethinking the EU’s competitiveness proofing tool to increase the weight of global competitiveness and make the use of the tool mandatory in the impact assessment for all proposals, including once the proposal has passed through the legislative process into a final text.

Commensurate: Reducing the burden, particularly for SMEs

The EU should focus its attention on the minimum level of regulation needed for the Single Market to operate. A change of culture is needed in all institutions, including EU authorities and agencies, to make sure that rules adhere to the principles of proportionality and subsidiarity. This should include a mindset that sees flexibility in the labour market as a strength, not a weakness.

The EU must continue its work to reduce the overall burden of regulation. The Commission 2007 target to reduce administrative burden of 25% was fully achieved, and the REFIT exercise on regulatory fitness has been helpfully introduced. The proposals announced in October 2013 are a good first step, but much more needs to be done. The new Commission should continue this work and put the smart regulation agenda high on its list of priorities, and the Parliament also has a role to play to ensure that all EU institutions are focussed on creating a regulatory environment that is not overly burdensome.

The Commission must particularly continue and strengthen its work to make rules appropriate for SMEs and microbusinesses. Although the Single Market provides opportunities to these companies, not all of them are able to take advantage of it: only 8% of SMEs engage in cross-border trade and about 5% have set up subsidiaries or joint ventures abroad. The 2008 Small Business Act, the ‘SME test’ for new regulations and ‘reversal of burden of proof’ principle for microenterprises have been helpful initiatives. Work should now be taken forward on the ‘top-ten’ list of regulations that are burdensome to SMEs and other challenging rules. In particular, SMEs would like to see:

- Improved access to public procurement
- Suitable exemptions in data protection rules
- Better guidelines to make REACH clearer to complement the March reduction in fees
- Exemptions in the Waste Framework Direction
- Calibrated ways to assess environmental impact
- Access to finance for SMEs to be given greater consideration in financial services regulation, such as in the Prospectus Directive and the Markets in Financial Instruments Directive
- Proportionate rules under the Temporary Agency Work Directive
- Easier EU VAT rules.

“A change of culture is needed in all institutions to make sure rules adhere to the principle of subsidiarity.”
This push for a reduction in regulation is gaining traction across Europe, including in Germany, where a senior German official has suggested that “Germany might be prepared to countenance the abrogation of some secondary legislation.” As Wolfgang Schmidt, member of the German Parliament, put it: “We’re not always happy with the way Brussels works and what comes out of the system. It seems like many Commissioners are just doing business as usual and want to pass their “nice-to-have” laws rather than concentrating on what is really necessary in these times of crisis. One could get the impression that we’d need a moratorium on new initiatives, at least until the Euro-crisis is properly sorted.”

Considered: Adequately assessing the regulatory framework

The Commission must take a new look at its impact assessment and processes for evaluation. Too many rules are being put forward with unconvincing evidence of the overall benefits or with weak assumptions and a weak evidence base. Others are put forward without proper evaluation of existing rules, or introduced at such a speed that countries are yet to implement one set of regulations before new rules are proposed.

To improve quality and legitimacy, the Commission should, as part of a continued process for improvement:

- Introduce an independently verified annual statement of the total net cost to business of regulatory proposals issued by the Commission — and consider a move towards a more independent impact assessment structure outside the Commission to avoid bureaucratic capture.
- Strengthen the role of the Impact Assessment Board (IAB) by giving greater consideration to IAB opinions on Commission Impact Assessments before it adopts a proposal, and by making regular use of independent expert knowledge. In particular, there should be a requirement for new regulatory proposals to have a positive opinion from the Commission’s IAB before they can emerge from the Commission.
- Increase transparency by publishing Impact Assessments during the consultation stage providing estimates of the net cost to business of regulatory proposals, instead of publishing the impact assessment together with the proposal.
- Commit to give more serious consideration to alternatives to regulation.
- Improve evaluation of proposals and existing legislative frameworks. A first priority should be to do a fitness check on the existing stock of financial services regulations, including those adopted in the last reform programme, to determine whether the framework – its accumulated impact, overlaps, inconsistencies and/or obsolete measures – sufficiently enables the financial services sector to perform its role in providing capital and financial services to businesses across Europe.

Signs of progress could include:

4. The new Commission should bring forward to the Council a target for burden reduction to be achieved within its five year term, with mid-term objectives and a fitness check for the current stock of financial services legislation a priority. This should add to targets to minimise the administrative burden and compliance costs, as well as sectoral targets, to minimise burdens in those sectors that are vital for EU growth, as called for by the European Council in March 2012. It should also include a specific measure for cost reductions for SMEs and microbusinesses.

5. The new Commission’s work plan should include clear commitments to improve the way in which impact of proposals is assessed, with a requirement for a positive opinion from the Impact Assessment Board before Commission proposals are published for consultation.
Each member state is different and the EU...is more diverse than it was a decade ago.

Europe 2020

7.3 An EU rooted in the priorities of member states: striking the right balance between the EU and its member states

Chapter 5 highlighted that the changing nature of the EU, driven by the integration of the Eurozone, presents a potential risk to the influence of states outside the single currency such as the UK. It is essential that the ‘new Europe’ that emerges from the economic and currency crisis continues to work for all its member states. That needs an EU that allows some members to integrate but others not to, without compromising the integrity of the Single Market. It also needs an EU that is better aligned with member states’ priorities and respects the borders of its power set by the Treaties. That requires a more focused EU, prioritising areas where the EU adds most value. The recent Dutch declaration that “the time of an ‘ever closer union’ in every possible policy area is behind us” offers a positive indication that other member states are also looking at how to refocus the EU, rethinking the areas the EU needs to be involved in and those it should leave to member states to pursue.

Ensuring the EU works for all its members

The Eurozone needs to take steps to strengthen the Economic and Monetary Union and countries outside the currency bloc have supported many of the measures for further integration needed to achieve this – a stable Eurozone returning to growth will benefit all European countries, the UK included. However, with an increasingly integrated EU ‘core’, legal and procedural safeguards should be put in place to ensure that the Single Market is not affected for countries outside the Eurozone.

This is not about ‘protecting the UK’ but about ensuring the benefits of the EU remain available to all. If the Single Market no longer provided for the free movement of goods, services, labour and capital, it would seriously weaken the business case for the EU supporting the UK’s global trading ambitions.

The legal safeguards obtained in the Markets in Financial Instruments Directive (MiFID) that guarantee non-discrimination, and the procedural double majority voting safeguard adopted as part of the Single Supervisory Mechanism, should be replicated where possible in future financial services legislation, particularly in rules relating to the Banking Union and EU-wide financial supervisors. These safeguards could be replicated in other areas and should also be a key aspect in any future Treaty change.

As Chapter 5 suggested, these safeguards are achievable given the willingness of the Eurozone member states to ensure that moves towards further integration to strengthen the single currency do not adversely affect non-members. As a senior French official covering European affairs put it: “Eurozone integration should not lead to a distancing of the UK”.

Signs of progress could include:

6. EU leaders should adopt a declaration that explicitly calls for steps to be taken to ensure that further Eurozone integration does not undermine the Single Market and protects non-members from discrimination. This should then be formalised in any new Treaty.

7. Procedural safeguards such as the double majority voting rules created for the Single Supervisory Mechanism should be introduced for remaining supervisors in the upcoming review of the European Supervisory Authorities and the proposed MiFID legal safeguard should act as a precedent in other areas of legislation where there is a threat to the integrity of the Single Market. Legal safeguards should be enshrined in any new Treaty.
Respecting the boundaries set by member states

The mindset in the EU and its institutions needs to change; the EU has moved too far from ‘adding value’ to ‘adding functions’ resulting in ‘mission creep’ in several areas.

The Treaty sets out what tasks are to be done at EU level and what should be left to member states. However, in a large number of areas, under ‘shared competence’, the EU can legislate but has to respect the principle of subsidiarity. This dictates that the EU may only intervene in a particular policy area if it is able to act more effectively than member states. A strong principle in theory, the Treaty’s Subsidiarity Principle has proven more difficult to apply in practice, and judicial reviews have taken a very narrow view of what the Commission must do to show it has respected the principle. This puts the responsibility with the Commission and other EU institutions to honour the principle, but the sheer volume of EU legislation and lack of respect for subsidiarity has undermined its legitimacy in many member states.

Member state leaders and governments must restore the principle of subsidiarity in EU policymaking by signalling to the Commission that it must refocus its activities so that it intervenes in a particular policy area only if it is able to act more effectively than member states. A strong principle in theory, the Treaty’s Subsidiarity Principle has proven more difficult to apply in practice, and judicial reviews have taken a very narrow view of what the Commission must do to show it has respected the principle. This puts the responsibility with the Commission and other EU institutions to honour the principle, but the sheer volume of EU legislation and lack of respect for subsidiarity has undermined its legitimacy in many member states.

The CBI believes the best way of achieving European consensus on issues like this is by working within the current framework rather than attempting to unpick the existing balance of competences through Treaty change, especially to see progress in the short term. Such attempts are less likely to achieve the outcomes sought by the UK business community and, given there is limited appetite for Treaty change in other member states, could lead to a UK withdrawal by default. There are undoubtedly some areas of EU legislation where UK government and business would seek a different settlement and thus prefer national control. However, the overall balance of benefits of EU membership remains positive, and CBI members are ultimately willing to accept these disadvantages in the interests of remaining in the club.

That said, the Commission itself should look to introduce a moratorium on any new rules in areas where arguments for subsidiarity are strong, including:

- Social and employment laws: For example, the proposed EU action to ensure quality of traineeships is an area where national solutions are better suited – the EU should only facilitate sharing of best-practice.
- The Working Time Directive is another example in this area, where currently 18 out of 28 countries are using the opt-out on hours worked. There is a strong argument for making this permanent, allowing members states to set their own rules in accordance with the realities of individual labour markets. Similarly, member states should be free to determine for themselves if on-call time counts as working hours or if employees who are ill while on holiday should have this holiday time reinstated.
- The Agency Workers Directive is an example of poorly justified EU regulation. Many businesses agree that agency workers who spend long periods in a single user firm deserve protection, but the EU law goes too far in applying it immediately rather than after a reasonable qualifying period. The UK managed to get a slightly longer period – 12 weeks – before it applies, but this is nothing like the 12 months that businesses say is the real point at which workers can reasonably be said to be associated with the user firm as well as the agency. Protection for agency workers was justified by the EU as a balancing measure to liberalisation of the market for agency work across the EU, but this liberalisation in other member states hasn’t happened. In the short-term, the UK government must make its implementation of the directive more flexible, but the EU can help by rejecting attempts to make this anti-growth measure even worse by removing the exemption for temporary workers who are paid between assignments and, in doing so, will weaken the rationale for the opt-out.
- Lifestyle regulation: The EU’s attempts at introducing lifestyle rules such as rules on diets and gambling are good examples of how the EU is stepping into areas where an EU-wide solution is not necessary and solutions could be better found at member-state level.

Reducing the extraneous regulation coming from the Commission would help increase its legitimacy in those areas where it should have competence. Currently, as one senior Swedish official put it, “the Commission is seen as over-interfering. In Sweden, we have issues with
The Dutch government recently carried out a Subsidiarity and Proportionality Review across ministries, which suggested a halt to any new initiatives in the field of environmental and social protection. The review concluded that the EU should take a backseat approach and allow member states to take action in a number of areas:

- **Social security systems and working conditions**: The EU co-ordinates and supplements national policy, but the member states must shape the fundamental principles of their labour market and social security systems themselves (including their financial balance).
- **Health & safety and welfare legislation**: EU legislation in this area is highly detailed and specific about means, rather than ends. This can limit the options for tailoring implementation to national circumstances and lead to higher implementation costs.

In many cases, the EU unnecessarily involves itself in the process of how agreed outcomes are delivered; it should step back and allow member states to find the best individual means for their particular economies and societies to achieve these commonly agreed ends. For example, in the absence of a global deal to tackle carbon emissions, an emissions target set at the European level provides a helpful driver for low-carbon investment and emissions reductions across Europe. However, while it is the EU’s role to provide the overall framework for emissions reductions, it should be up to individual member states to decide the best way to meet the target in order to reflect the differences in their own national circumstances. For the UK, this means a diverse energy mix, with nuclear power, gas and renewable energy all having important roles to play.

It is important to be aware of the fact that law can be made by precedent as well as legislation, and that the ECJ has frequently taken an expansive view of EU powers. The Council and the Commission need to pay attention to this, by playing a stronger role in interpreting the law as drafted for courts, and addressing unlooked-for consequences of particular judgements.

**Creating a better functioning EU that prioritises growth and competitiveness**

Part of the driver for the tendency of the EU Commission to regulate is the large number of Commissioners and Directorates. Today, the Commission’s 27 different portfolios – each with a separate commissioner with an agenda for change – are hindering prioritisation and horizontal co-ordination. There is a natural tendency for post-holders to seek to use their term of office to effect change and thus to regulate.

A decision was made in 2013 not to implement the Lisbon Treaty obligation to reduce the number of Commissioners by two-thirds. However, it would still be possible to tighten the organisation of the Commission by pairing ‘junior’ and ‘senior’ Commissioners on single portfolios. Some key portfolios, such as external trade and the Single Market, could have a number of Commissioners, similar to the UK’s departmental model of a secretary of state supported by a team of junior ministers.

The Commission should also redistribute resources at lower levels to Directorates responsible for the EU’s key priorities, such as trade and the Single Market. For example:

- Currently the Directorate responsible for trade, an exclusive EU competence, has 533 staff – half as many as the Directorate responsible for development, only a shared competence, with 1,174 staff.
- The Directorate responsible for environment policy, at 448 staff, has almost the same headcount as the Directorate responsible for every aspect of the Single Market, with 495 staff.

**Signs of progress could include:**

8. Member state leaders must work to restore the principle of subsidiarity. Until this is fully restored, there should be a moratorium on any new regulation where adequate legislation already exists or there is a strong argument for national decision-making, including in the area of social and employment law. The opt-out from provisions of the Working Time Directive should be made permanent.
The EU must allocate its resources in a way that reflects the economic realities of its member states. In light of the current crisis, the EU institutions must seek to rationalise the EU bureaucracy in the short term, especially given the pressures on national governments to do the same. Establishing a single seat for the European Parliament is an important contribution to this process, although it is necessarily a longer term aim as it requires Treaty change. Furthermore, funding priorities in the EU need to continue to move towards supporting a dynamic and competitive economy that can successfully face the challenges of a globalised world. The government should be congratulated for its part in achieving the recent reduction in the EU budget at the same time as protecting the Framework Programme 7, although this was tempered by the significant reductions in broadband roll-out funding. The European Investment Banks’s initiatives should be further supported and extensions explored, for instance around project bonds and other forms of guarantees to incentivise lending to the economy.

Signs of progress could include:

9. The Commission should reduce the number of portfolios in order to increase the number of Commissioners in key priority areas for the EU. Senior and junior Commissioners could be used to effectively push progress in a number of areas within a portfolio – such as having one Commissioner each in DG Trade for trade deals with developed and emerging markets.

10. The EU must keep its budget in check, rationalise its bureaucracy, and focus funding on supporting a dynamic and competitive economy.

7.4 A fully engaged UK: helping the EU achieve its global future

Chapter 4 highlighted that the UK has been influential in the EU, securing significant overall benefits from membership. However, it also signalled that the UK cannot take this influence for granted and needs to improve its approach to maximising influence by working in Brussels, in other capitals and back home to ensure that the EU continues to provide net benefits for British business.

Securing a reformed EU will require the UK to build alliances both in Brussels and with other member states. The UK should strengthen its presence in EU institutions and develop a greater role for the UK parliament in EU affairs. The UK government should also improve the way it implements EU legislation.

Reforming how the UK engages with EU institutions

Across the board, UK representatives need to engage positively in Europe, finding co-operative solutions by using UK expertise, building up credibility and showing willingness to build alliances that benefit British interests and support its key sectors.

The UK should step up its ministerial engagement in Europe, building links with other member state capitals and increasing the number of ministerial visits to Brussels at key points in the policy process. At a working level, the UK must prioritise resources to enable the UK permanent representation and the civil service in London to sufficiently follow the development of EU rules, use their expertise and build alliances in Council dialogues. The UK government should draw up comprehensive plans for engaging with the European Parliament, and UK political parties should look to increase the accountability of UK MEPs at home for the output from the legislative process as well as better supporting UK MEPs to build alliances with MEPs from other member states.

The UK must also substantially increase the levels of British nationals in the staff of the major EU institutions. As a House of Commons report recently acknowledged, the UK faces a “serious problem with respect to its declining representation among EU staff.” Improving this will need concerted efforts in assisting new entrants, including fixing weaknesses in the Fast Stream programme that to date have generated no additional permanent generalist EU
This is an achievable reform agenda. If the UK engages in the right way, it can help shape the EU for the 21st century.

official since its launch in 2010. The UK government’s EU Staffing Unit in the FCO, established in April 2013, should be a helpful tool, working to place additional seconded national experts in the short term and increase the number of permanent officials in the longer term by promoting recruitment opportunities to students, graduates and professionals. The government must also prioritise engagement in the EU by ensuring that the undertaking of secondments into EU institutions by UK civil servants is encouraged and formally recognised in terms of career development and progression.

The House of Lords should continue its extensive scrutiny of EU law-making, but the UK government and parliament as a whole should also seek best practice from other European parliaments. For example, the German, Danish and Finnish parliaments hold their governments accountable for the positions they take at the European Council and at the Eurogroup, a model which is increasingly duplicated in other Eurozone countries.

The parliament should also strengthen informal ties with like-minded national parliaments and seek to use the Yellow Card Procedure (see Exhibit 47 in Chapter 4) more frequently where EU level proposals infringe the principle of subsidiarity. In 2011, the UK Parliament attempted to use this procedure once, compared to twice in France, Germany, Portugal and Spain, five times in the Netherlands, eight times in Poland and sixteen in Sweden. However, for the Yellow Card to be effective, two-thirds of national parliaments are required to attempt to use it. Inter-parliamentary co-operation remains weak in the EU, so the UK should attempt to build links with other parliaments to improve co-operation and ensure that the Yellow Card Procedure is an effective tool to uphold the principle of subsidiarity.

Although the mechanisms for interaction between UK government, civil service and civil society already exist, improvements could be made to assist the co-ordination of lobbying efforts in Brussels so that the full range of UK stakeholders can, where possible, speak with one voice.

The UK should strengthen the dialogue between the government and UK businesses in Brussels, and could consider business secondments to the UK Permanent Representation, formalised dialogues and informal network events. In the UK, a European business advisory group could be established to

Signs of progress could include:
11. The UK government must set out a detailed EU engagement strategy. This should include an ambitious target for UK presence in EU institutions in the medium-term - slowing the negative trend of a six-year long decline of UK nationals on the staff of the European Commission by the end of 2015, and beginning to reverse this decline by 2017 – as well as comprehensive plans for how government intends to engage with the increasingly powerful European Parliament to best support UK interests.

Improving engagement with EU issues at home to underpin influence in Europe

The UK should increase interaction with European issues, policy and politics at home to allow for better engagement in Europe and a better relationship with the EU overall.

A more active UK parliament can improve the EU and increase its legitimacy at home. National parliaments must play a greater part in the EU policymaking process, and the government should consider looking at how to give the parliament enough time for parliamentary scrutiny, particularly in the case of negotiations and informal trilogues. Proper scrutiny creates not only informed decisions but an informed public as the UK media tend to cover UK parliamentary priorities more than developments in the EU.

Signs of progress could include:
12. The UK Parliament should strengthen informal ties with like-minded national parliaments and seek to use the Yellow Card Procedure more frequently. The UK Parliament should take the initiative by creating an informal network of like-minded national parliaments to improve co-ordination on the Yellow Card Procedure.
provide business views on current EU affairs and guide strategic aims for UK engagement in Brussels.

Finally, with nearly half of UK businesses perceiving UK ‘gold plating’ as the main challenge with EU regulation, the government must use the flexibility given at EU level when transposing legislation and ensure that it does not put the British economy and businesses at a disadvantage. Although progress has been made in this area, the government must address new legislation on a case-by-case basis to ensure that transposition does not put UK firms at a competitive disadvantage.

7.5 Summary of the signs that progress is being made to reform the EU

The EU has helped open up markets in Europe and abroad and secured access to capital, labour and funding that drives the competitiveness of UK firms. The changing nature of openness has, in part, pushed the UK to debate whether the EU can continue to deliver these benefits – especially in the context of the internal changes required to stabilise the Eurozone, potentially at the expense of those outside the single currency. However, British business is convinced that, by working with its European partners, the UK can help achieve reforms to the EU that will put it on a path to sustainable growth and global competitiveness – maintaining EU membership as the cornerstone of the UK’s open posture in the 21st century.

Business wants an EU that is outward-looking, open and competitive; one that is rooted in the priorities of its members and respects the boundaries of power granted to it. This reform agenda attempts to fashion such a union, in an achievable way that can work for the whole of the EU. Discussions around these ideas are already occurring in member-state capitals and EU institutions in Brussels. This reform agenda indicates the first steps on a journey that the EU must undertake to compete in the global economy.

This is an achievable reform agenda. If the UK engages in the right way, it can help shape the EU for the 21st century. For that reason, 8 out of 10 CBI members – including 77% of SMEs – said that they would vote for the UK to remain a member of the EU in a referendum if held tomorrow. Proactive, positive and permanent UK engagement will secure the outcomes that can support our global future.

The UK needs to see the following signs of progress to demonstrate that reform of the EU is underway to support our global future:

An outward-looking EU: opening up new trade opportunities for business
1. The EU should successfully conclude a high-quality Free Trade Agreement with Japan and sign the Transatlantic Trade and Investment Partnership (TTIP) agreement with the US
2. The EU should push forward a more dynamic trade agenda with key emerging markets to support member-state trading ambitions

An open and competitive EU: updating the Single Market for the 21st century
3. EU member-state leaders should organise a high-level Symposium by the end of 2015 to give political impetus to the completion of the Single Market
4. The new Commission should set a target for the reduction of the regulatory burden to be achieved within its five year term
5. The new Commission’s work plan should include clear commitments to improve the way the impact of proposals is assessed

An EU rooted in the priorities of member states: striking the right balance between the EU and its members
6. EU leaders should adopt a declaration that explicitly calls for steps to be taken to ensure that further Eurozone integration does not undermine the Single Market and protects non-members from discrimination. This should then be formalised in any new Treaty

7. Procedural safeguards should be introduced to maintain the integrity of the Single Market for all members, and legal safeguards should be enshrined in any new Treaty
8. Member state leaders must work to restore the principle of subsidiarity. Until this is fully restored, there should be a moratorium on any new regulation where adequate legislation already exists or there is a strong argument for national decision-making, including in the area of social and employment law. The opt-out from provisions of the Working Time Directive should be made permanent
9. The Commission should reduce the number of portfolios in order to increase the number of Commissioners in key priority areas for the EU
10. The EU must keep its budget in check, rationalise its bureaucracy, and focus funding on supporting a dynamic and competitive economy

A fully committed UK: helping the EU achieve its global future
11. The UK government must set out a detailed EU engagement strategy. This should include an ambitious target for UK presence in EU institutions in the medium-term and comprehensive plans for engagement with the European Parliament
12. The UK Parliament should strengthen informal ties with like-minded national parliaments and seek to use the Yellow Card Procedure more frequently
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