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UK membership of the European Union
Political and economic considerations

1. Summary

- A referendum on the UK's membership of the European Union will take place by the end of 2017. Autumn or late 2016 currently seem like the most likely times for the vote.

- The government will put the results of its renegotiation of the UK's relationship with the EU to the country before the referendum.

- Since 1977 an average 53% of UK voters have wanted to remain in the EU and 47% have wanted to leave.

- The EU is widely thought to have significantly increased trade and competition in Europe. The benefits for consumers have come in the form of increased productivity, lower prices and greater choice.

- UK critics characterise the EU as an over-regulated, slow growth region. They point to the UK's growing net contributions to the EU budget and the cost of the Common Agricultural Policy. Some see the free movement of people in the EU as an unacceptable limit on the UK's ability to control its borders.

- A vote to leave would be the start of a long and complex process of negotiation as the UK sought to create a new position in the world. Leaving the EU is a leap into the unknown. There is no template for exit. The UK would need to decide on the balance between national sovereignty and access to overseas markets.

- Switzerland and Norway are the most widely cited models of successful European countries outside the EU. They make continued, albeit reduced budget contributions, are not members of the CAP, can negotiate their own trade deals and accept free movement of goods, services, people and capital.

- But these models would require the UK to accept EU regulation while having no say in its design. Moreover, they would offer the UK no control over the movement of EU nationals into the UK.

- Alternatively the UK could opt for a more distant relationship with the EU and forgo preferential access to EU markets. The UK could instead operate under the so-called most favoured nation (MFN) rules of the World Trade Organisation (WTO) and negotiate free trade agreements with other countries and trading blocs. This would allow the UK to remove itself from EU regulations and budget constraints.

- This would leave around 90% of the UK's goods exports to the EU facing new tariffs. The UK's ability to sell services into the EU – a sector where the UK has a trade surplus with the EU – could be significantly affected because of a series of non-tariff barriers to trade from non-EU nations.

- It is not clear that leaving the EU would improve the UK's ability to sell in faster growing regions of the world. The EU is focused on expanding trade with the rest of the world and has a number of such preferential trade agreements with fast-growing economies. It is negotiating a number of others, including the Transatlantic Trade and Investment Partnership (TTIP) with the US.

- Outside the EU the fundamental choices facing the UK would remain the same: the trade-off between autonomy and accepting regulation in order to gain access to overseas markets; the need to build relationships and improve access to markets; and, above all, the requirement to drive productivity and competitiveness at home.

- Ultimately the effects of leaving the EU hinge on two imponderables: the terms on which the UK leaves, in particular, whether the UK can retain access to EU markets; and the ability of the UK to exploit the freedoms and flexibility of being outside the EU.

- What is clear is that a referendum will create uncertainty for a probably prolonged period. The costs of exit would be seen very early on. Potential political and economic benefits from exiting the EU are more speculative and would likely be felt in the longer term.

- Some would argue that, even if accurate, such costs are a price worth paying to restore greater UK sovereignty. The UK faces a choice between access to European markets and national sovereignty. As ever in elections, economics only offers limited answers. Political judgements loom far larger.

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2. Political background

The last referendum on UK membership of the then European Economic Community (EEC) was held in 1975, just two years after the UK joined the EEC. The electorate voted by 67.2% to 32.8% to stay in.

Since 1975 the EEC has become the European Union, growing from 9 to 28 members, expanding into Central and Eastern Europe, creating the Single Market and the Single Currency. The EU of today is far larger and more integrated than the Common Market of the mid-1970s.

The Prime Minister has said that the forthcoming referendum on membership of the EU will be held by the end of 2017. To allow for the renegotiation that will precede the vote the earliest likely date for the referendum is June 2016 (the government has ruled out holding it on 5 May 2016, the same day as elections to devolved parliaments in Scotland, Wales and Northern Ireland and for London's mayor). Autumn or late 2016 are generally seen as the most likely dates for the referendum. A referendum in 2017 is perhaps a less attractive option, partly because it would extend the period of uncertainty about Britain's relationship with Europe. The UK is also likely to want to avoid its position in Europe becoming an issue in the French and German elections, due to be held in April/May 2017 and September 2017 respectively.

Voters will be presented with the conclusions of the government's renegotiation of the UK's relationship with the EU. Mr Cameron's list of aims includes protecting Britain's position in the Single Market, returning powers from Brussels, a role for national parliaments to block unwanted EU legislation and excluding the UK from the ideal of "ever closer union". The Conservative manifesto also called for measures to limit the access of migrants to the British welfare system.

Mr Cameron had previously stated that he believed "proper, full-on treaty change"[1] would be required to make some of these aims legally binding, although he has since softened his stance in the face of European opposition. The European Commission President Jean-Claude Juncker has publicly ruled out any treaty negotiations on Britain's relationship with Europe until two years after any referendum. Downing Street has now conceded that the changes it seeks would not lead to treaty change before Britain votes in its referendum. Instead the official position is that Britain would aim for an "irreversible" and "legally binding" guarantee that agreed changes will be attached to the treaty in the years following a referendum.

In the event of a No vote the UK would invoke Article 50 of the Lisbon Treaty requiring the EU to negotiate a withdrawal agreement. The regulation allows for two years of negotiations, and more by mutual consent, during which time existing EU regulation would apply. The terms of Britain's exit would need to be agreed in negotiation with the European Commission and other member states.

3. Public and business opinion

UK voters have consistently been among the most euro-sceptic in Europe. Nonetheless, in the last 40 or so years the public has been more likely to support staying in the EU than leaving. Since Ipsos MORI started polling the public in 1977 on average 53% of voters in a simple yes/no poll have supported membership of the EU and 47% have opposed it. Public support for the EU fell between a low of 26% in 1980 and a high of 63% in 1991. Over the last two years support for membership has averaged 52% with the latest Ipsos Mori poll showing 61% in favour of continued membership.

Business opinion tends to be more favourable to the EU than public opinion. The second quarter 2015 Deloitte CFO Survey showed strong support among the UK's largest corporates for continued EU membership. Nearly three-quarters of CFOs (73%) favour remaining in the EU, with 23% believing it is still "too early to say" (depends on results of the renegotiation), 1% "don't know" and just 3% of those polled preferring exit. A recent British Chambers of Commerce survey (published Q1 2015) shows a clear majority of companies view withdrawal from the EU as an undesirable outcome. Chambers' members see continued membership of the EU with some powers being transferred back to the UK as the ideal outcome.

However, small businesses are more likely to be split on the issue. Polling for the Federation of Small Businesses shows 47% of small businesses in favour of EU membership, with 41% opposed and 11% undecided (September 2015). The greater euro-scepticism of smaller businesses illustrates how the costs and benefits of EU membership are distributed unevenly, with smaller businesses less likely to export and also often less able to deal with potentially costly or time consuming regulations.

1. http://www.theguardian.com/politics/2013/jan/23/david-cameron-eu-speech-referendum, 23rd January 2015

The major British business groups (including the CBI, the Engineering Employers Federation, the Chambers of Commerce, the Institute of Directors, the British Bankers' Association and CityUK) favour continued membership of the EU and a renegotiation of Britain's relationship with the EU. There are also both pro-EU (e.g. Business for New Europe) and anti-EU (e.g. Global Britain) business lobbies. Open Europe and Business for Britain argue for fundamental, pro-market EU reform and an EU referendum.

4. EU or not EU

The most powerful economic argument for the EU is a simple, free market one: economic theory and experience show that trade and competition raise growth rates and incomes. Increased trade and competition put pressure on business to drive efficiency, improve products and reduce prices. The result is that consumers get better products at cheaper prices. It was for such reasons that Mrs Thatcher campaigned to keep Britain in the Common Market in 1974 and was a staunch supporter of the European Single Market.

The Single Market, which launched in 1992, was one of the great integrating measures in the history of the EU. With the enlargement of the EU to Central and Eastern Europe in 2004 and 2007, it now provides access to a market of 500 million consumers. This market has supported the emergence of the City of London as the financial centre of Europe and the UK's position as the main destination location for foreign direct investment into Europe. The EU is by far the UK's single largest export market, accounting for 45% of all UK exports. The creation of the world's largest free trade area is widely judged to have materially supported growth in the UK and the rest of Europe.

There are, of course, also drawbacks to EU membership. UK critics argue that the EU has excessively curtailed the sovereignty of national parliaments and has over-regulated. They point to the UK's growing net contributions to the EU budget, now equal to 0.6% of UK GDP, or £140 per head of the population, and the cost of the Common Agricultural Policy. Some also see the free movement of people within the EU as being inconsistent with UK sovereignty over who settles and works in the UK.

In the referendum voters will be choosing between a known, if evolving, relationship with the rest of Europe and leaving the EU. A vote to leave would be the start of a long and complex process of negotiation as the UK sought to create a new position in the world.

The next section demonstrates that if the aim of the UK's negotiators were to retain access to, and the benefits of, the European Single Market, they would almost certainly have to continue to make budget contributions and accept a high proportion of EU regulation.

5. The Swiss and Norwegian options

The two most widely discussed alternatives to the EU are membership of the European Economic Area (EEA) or the European Free Trade Area (EFTA). Norway, Iceland and Liechtenstein's relationship with the EU is governed by their membership of the EEA. Switzerland is outside the EEA and its relationship with the EU operates through EFTA.

The EEA is essentially an extension of the EU, and was formed to extend the Single Market to Iceland, Liechtenstein and Norway, while enabling them to opt out of certain elements of the EU, such as the Common Agricultural and Fisheries Policies and the EU's Common Foreign and Security Policy. It gives its members access to the Single Market, with zero tariffs, and provides for the application of almost all EU legislation, including the free movement of people, goods, services and capital. Members make significant EU budget contributions, at about 83% of EU members' rates, and are subject to almost all EU regulation while having no say in shaping it.

Switzerland's membership of EFTA in theory offers a more distant relationship with the EU. In practice Switzerland has signed up to a high proportion of EU regulation, including the free movement of people, in return for access to the Single Market. Like Norway et al, Switzerland is outside the CAP and can negotiate its own trade deals. But Switzerland's budget contributions are lower, at around 40% of full EU rates, compared to the 83% of EU rates faced by Norway et al.

Following the model of Switzerland or Norway would not give the UK greater control over the movement of people. On the contrary, these EU 'outs' have signed the Schengen agreement, which has eliminated passport checks for EU citizens within the EU, a measure from which the UK secured an opt-out. The EU 'outs' also subscribe to the free movement of people within the EU. For this reason some UK advocates of leaving the EU reject EEA and EFTA membership on the grounds they may be inconsistent with national control over borders.

Switzerland's recently troubled relationship with the EU over free movement illustrates the difficulties the UK may face in trying to opt out of this area of EU policy. In February 2014 the Swiss narrowly voted to opt out of their agreement with the EU on the free movement of people, and to impose quotas on migrants – in contravention of the bilateral agreement signed with the EU in 1999. The EU has so far refused to negotiate with Bern on this issue, instead suggesting that Switzerland may have to go back to voters with another referendum. To its detractors in Europe Switzerland's approach smacks of "Europe a la carte" – the notion that it is possible to have the most desirable parts of the EU and omit less popular aspects. Britain is likely to find itself up against a similar sentiment during its renegotiation with the EU.

Switzerland, Norway et al have little influence over EU regulation outside the EU. But as relatively small countries they would probably have fairly limited influence even as EU members. The UK, by contrast, is one of Europe's major economies with significant influence in the EU. Losing direct influence over EU regulations and the ability to push for trade liberalisation, especially in services, are particular risks for the UK. The financial sector is especially concerned that the UK retains a strong voice in European financial regulation to avoid measures that could disadvantage the City.

6. The Most Favoured Nation option

An alternative path for the UK would be to seek a more distant relationship with the EU and forgo preferential access to EU markets along the Swiss or Norwegian lines. This would allow the UK to remove itself from EU regulations and budget contributions. The UK could instead operate under the so-called most favoured nation (MFN) rules of the World Trade Organisation (WTO). Many countries operate under MFN, and also negotiate free trade agreements with other countries and trade blocs to improve their access to other markets.

Advocates of the UK MFN route point out that the average maximum tariff to which UK exports could be subject has fallen from 5% in 1990 to 1% today. Liberalisation of world trade in the last quarter of a century has reduced barriers to trade and opened up new markets, in the process reducing some of the advantages of membership of a free trade area, such as the EU.

MFN tariffs could be imposed on around 90% of the UK's goods exports to the EU, meaning a loss of competitiveness. And while average tariff rates have fallen over time, they vary by sector. For instance in a number of sectors where the UK runs a trade surplus with the EU exports would be subject to tariffs of up to 13%. Moreover, the UK's ability to sell services into the EU – a sector where the UK has a trade surplus with the EU – could be significantly affected because of a series of non-tariff barriers to trade from non-EU nations.

Yet Britain would not be the only loser from the imposition of such tariffs. The UK ran a trade deficit with the EU in goods and services equivalent to 3.4% of UK GDP in 2014. So EU nations exporting to the UK would also lose out from the imposition of tariffs. It is possible that the EU concludes that it needs access to the UK market as much as the UK needs access to EU markets, giving it an incentive to reach some sort of Free Trade Arrangement with the UK.

Advocates of leaving the EU argue that the region is a slow growth area and the UK should reorientate its trade towards faster growing markets elsewhere. Certainly Europe is no longer the booming region it was when Britain joined the European Community more than 40 years ago. EU growth averaged over 3% in the 1970s but is forecast to be less than half this rate in the next ten years. Indeed for the last 20 years the UK has been one of the EU's faster growing major economies, a situation that is widely expected to continue. While the EU is by far the UK's single largest export market, accounting for 45% of all UK exports, this share has shrunk from 54% in 2006 as faster growing emerging markets absorb a larger share of UK exports. Oxford Economics estimates that if current trends continue the EU will account for just over 40% of UK exports by 2019.

Yet it is not clear that leaving the EU would improve the UK's ability to sell in faster growing regions of the world. The EU is very focused on expanding trade with the rest of the world and has a number of such preferential trade agreements with fast-growing economies. It is negotiating a number of others, including TTIP with the US.

7. Brexit: No escape from regulation?

Regulations are not just a cost and a hindrance. Aside from social and welfare considerations, regulations are needed to set common standards within a single market. As well as creating costs, this process has also brought considerable benefits for the UK. The Centre for European Reform has estimated that UK trade with other EU countries is 55% higher than would have occurred in the absence of current EU trading arrangements. Liberalisation of European trade in services – currently covered by the EU Services Directive – would be of great value to a net exporter of services like the UK. The think tank Open Europe has suggested that further opening up European services trade could boost EU GDP by €300 billion, and benefit the UK significantly.

Leaving the EU is unlikely to offer a silver bullet for the problem of excessive or ill designed regulation. After 40 years of EU membership much of the UK's regulatory structure is EU inspired and much would remain even if the UK left the EU. To retain unfettered access to the Single Market it is likely that the UK, like Switzerland, would need to sign up to a significant amount of EU regulation.

Moreover, the UK does not appear, by international standards, to be a highly regulated economy. OECD research shows that that UK product and labour markets are among the most lightly regulated in Europe. Even within the EU, nations have a considerable degree of control over domestic regulation. The World Bank's Doing Business report scores countries on the ease of doing business in those economies. They rank Denmark, an EU member, in fourth position, just below Hong Kong while Greece is in 61st place, just one place ahead of Russia. It is not necessarily the case that exiting the EU would trigger a bonfire of regulations.

8. Role of Foreign Direct Investment in the UK

In recent decades the UK has tended to invest a smaller proportion of GDP than its main competitors. The relative weakness of domestic investment makes foreign direct investment (FDI) particularly important for the UK economy.

On this front the UK's performance is strong. The UK is the main destination for FDI in Europe and FDI accounts for 21% of UK investment, more than twice the level of other developed economies.

The EU now accounts for 46% of the stock of FDI in the UK. Nearly a third of FDI into the UK comes from overseas banks and other financial companies, of which about half are lenders and institutions with their European base in Britain.

FDI helps support jobs, but also assists in the transfer of technology and management techniques, and in so doing boosting domestic productivity.

Membership of the EU is one of many factors which investors routinely cite as supporting their decision to invest in the UK. The uncertainty associated with exiting the EU, especially in the short term, is likely to weigh on the willingness of foreign investors to commit capital to the UK. Those who favour UK secession from the EU might observe that Switzerland has done very well attracting FDI outside the EU (Switzreland's stock of FDI is equivalent to 107% of its GDP, twice UK levels). However, there is free movement of goods, services, people and capital between Switzerland and the EU and Switzerland has developed its relationship with the EU over more than 60 years.

9. Financial Services and the City of London

Globalisation and increased European integration, particularly the free movement of capital, have consolidated London's position as Europe's financial centre. The statistics are impressive. The UK is the world's largest net exporter of financial services with a surplus of $95 billion in 2014, more than twice the US surplus of $36 billion. Over 250 foreign banks operate across the UK and the UK is the world's leading foreign exchange market.

The City enjoys a number of inherent strengths – the international benefits of the English language, a competitive corporate tax regime, attractiveness as a place to live and work, clusters of skills, and deep and liquid financial markets.

These advantages would remain outside the EU. Moreover some feel that financial services firms and banks are over-burdened with regulation that limits growth and innovation. Approximately 80% of UK financial services regulation is from the EU. Three EU agencies have since been created covering banking, insurance, securities and markets, with binding powers that can overrule a British veto on key matters in extremis, effectively passing final control over City regulation to Brussels.

But by seceding the UK would raise a fundamental question about Britain's access to European markets. There have already been moves in the EU to keep euro-denominated transactions within the euro area – moves that fell foul of the EU's rules on the free movement of capital. The Chancellor is also seeking guarantees from the EU that the City of London will be protected against discrimination by the countries of the euro area. Were the UK to exit the EU it seems inevitable that the UK would face greater hurdles accessing European financial markets.

10. Conclusion

Outside the EU the fundamental choices facing the UK would remain the same: the trade-off between autonomy and accepting regulation to gain access to overseas markets, the need to build relationships and improve access to markets, and above all the requirement to drive productivity and drive competitiveness at home.

The decision to leave the EU would involve short-term costs, uncertainty and disruption. A period of two years or more of negotiations following a vote to exit would be a time of elevated uncertainty. Some companies and investors would hold back from expansion awaiting clarity on the UK's future. The UK is the world's second largest destination for foreign direct investment and it accounts for a fifth of all investment in the UK. The risk of losing unrestricted access to European markets would remove an important attraction for foreign capital investing in the UK. The switch to different systems and regulation is likely to involve disruption and costs. Uncertainty and change caused by exiting from the EU would likely slow growth in the period following a vote to secede.

Costs and disruption in the short to medium term seem inevitable, but advocates of exit believe that this will pave the way for longer term gains as the UK exploits new freedoms outside the EU. The UK, as a net importer of food, and with large, relatively efficient farms, would benefit from the lower food prices that would prevail outside the Common Agricultural Policy. If the UK gave up or failed to win continued, unfettered access to EU markets, it would also save on budget contributions equivalent to 0.6% of GDP and would be master of its own regulations and borders. It would also have the right to strike trade deals with fast growing markets.

Ultimately the effect of leaving the EU hinges on two imponderables: the terms on which the UK leaves, in particular, whether the UK can retain access to EU markets, and the ability of the EU to exploit the freedoms and flexibility of being outside the EU. There is no definitive answer to these questions. Much of the supposedly economic debate veers into the realms of politics. As with the Scottish independence debate, those who favour exit see gains and vice versa.

What is clear is that the referendum will create uncertainty for a probably prolonged period. The costs of exit would be seen very early on. Potential political and economic benefits from exiting the EU are rather more speculative and would tend only be felt in the longer term.

Potential gains and losses from exit are also distributed unevenly. Larger, more international businesses focussed on European markets are more likely to be net losers. Domestic, smaller businesses with less capacity to cope with complex regulation could benefit. The UK financial sector would face particular difficulty retaining full access to European markets; it would be easier for manufacturing to do so. The farming sector and lower income regions would need new, domestic funding to plug the gap left by EU grants and subsidies.

Estimates of the costs and benefits of EU membership are subjective and vary widely. A CBI literature review (2013) found the net benefits arising from EU membership in the region of 4-5% of GDP. A recent estimate from the London School of Economics (2014) puts the net cost of leaving the EU over ten years at 1.1-3.1% of UK GDP. This would mean annual UK GDP growth would be reduced from an average of 2.5% per year to somewhere between 2.2% to 2.4% a year. Open Europe, a think tank, has produced more sanguine estimates (2015). They believe a realistic range would be between a 0.8% reduction in GDP and a 0.6% gain.

Some would argue that, even if accurate, such costs are a price worth paying to restore greater UK sovereignty. The UK faces a choice between access to European markets and national sovereignty. As ever in elections, economics only offers limited answers. Political judgements loom far larger.

Appendix

UK's options outside the European Union

		EU member	EEA (Single Market only)	EFTA (Free Trade Agreement)	MFN
		28 European member nations	Norway, Lichtenstein, Iceland	Switzerland	e.g. Australia
Free movement of goods, people, services and capital		YES	YES	YES	No
Free to negotiate trade deals and set tariff levels with non-EU countries		No	YES	YES	YES
EU laws and regulations	Influence	YES	Slight/ indirect	No	No
	Compliance	YES	YES	YES but some opt-outs	No
Fiscal contributions		YES	YES (83% of full rate)	YES (40% of full rate)	No
Common Agricultural Policy (CAP)		YES	No	No	No

Looser ties with Europe

UK public opinion on EU membership

		Stay	Leave
Ipsos Mori	1977-2015 average	53%	47%
Ipsos Mori	Trough support for EU (June 1980)	26%	74%
Ipsos Mori	Peak support for EU (June 1991)	63%	27%
Ipsos Mori	June 2015	61% (Highest since 1991)	39%
	Sept 2015	49%	51%

* Ipsos Mori question: "If there were a referendum now on whether Britain should stay in or get out of the European Union, how would you vote? ('Don't knows' removed).

Sept 2015 Survation question: "Should the UK remain a member of the European Union or leave the European Union?" ('Don't knows' removed).

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