The economic effects of EU membership for the UK:

revised storyboard

August 23rd, 2005

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Several studies claim membership of the EU is a significant cost to the UK up to 3.7% of GDP and possibly much more in the future

- IOD (2000): *EU membership: what's the bottom line?*
  - net cost to UK is 1.75 – 3.0% of GDP (although pamphlet argues that risks of withdrawal merit staying in EU and pushing for reform)
- IEA (rev 2001): *Better off out?*
  - Ongoing costs and benefits of EU membership are quite small. Net cost of withdrawal less than 1% of GDP
- Civitas (rev 2004): *A cost too far?*
  - UK would be £17 – 40 billion per annum better off (approx 3-5% of GDP) by leaving the EU, primarily due to easing of regulatory burden
- Minford and Mahambre (2005)
  - Ongoing costs of EU membership are around 3.2 – 3.7% of GDP

For example, IOD calculates significant net costs to the UK of EU membership primarily due to CAP, budget contributions and the ‘social model’

IMPACT OF EU MEMBERSHIP	**COST TO THE UK (% of GDP)**	**BENEFIT TO THE UK (% of GDP)**
EU budget	0.75	-
CAP	1.0	-
Customs Union	-	0.5
Single Market	0.0	0.0
Social model	1.0	-
FDI	-	0.5
TOTAL	**2.75**	**1.0**

Net cost of EU membership estimated at 1.75% of GDP per annum – almost £15 billion

In a similar vein, Minford calculates high, and potentially steeply rising, economic costs to the UK of EU membership with no off-setting benefits

		COST (% of GDP)
Current	Net UK contribution to budget	0.4%
	CAP costs	0.3%
	Manufacturing trade costs	2.5 – 3.0%
Future	Harmonisation	6 – 25 %
	Pensions (impact on public finances)	2 – 9 %
	Euro membership	Doubling of macro volatility

Net current cost of membership estimated to be 3.2 – 3.7% of GDP pa – plus larger potential costs associated with closer integration

However, there are a number of limitations with these studies

- Analyses are largely based on pessimistic assumptions and do not consider possible reform scenarios
- Analyses are usually static, focussed on direct costs and benefits, without paying much attention to the second-order dynamic effects that can be more important

Meanwhile other studies attribute significant economic gains to UK membership and, by implication, large losses through withdrawal

- **Gasiorek (2002):** ‘Accession of the UK to the EC’
  - The reimposition of tariffs could lead to a welfare loss of 2.1% GDP
- **Ray Barrell** of **NIESR** (cited in FT 2005) claims membership of the EU has raised UK GDP by 3-5%
  - includes Gasiorek estimate for 1973-86 plus an additional SMP effect
- **Pain and Young (rev 2004):** *Continent cut off? Macro-economic consequences of UK withdrawal*
  - GDP would decline by 2.25% permanently after withdrawal, primarily because of lower FDI leading in turn to lower technical progress
- Using European Commission data, **FCO** estimates
  - net budgetary *cost* per person in the UK is £50 per annum …
  - … but access to the single market *benefits* UK consumers by £300 pa.
- [based on European Commission estimates that single market has boosted EU GDP by 1.8%, equivalent to £20 billion to the UK each year]
- **Copenhagen Economics (2005)** estimate that liberalisation of the services sector could boost EU GDP by 0.6%.

For example, Pain and Young estimate significant cost to the UK of leaving the EU, because FDI growth would reduce, with spillover effects on productivity

		IMPACT OF WITHDRAWAL
costs	Reduction in stock of inward investment	1% fall reduces technical progress by 0.32% 10% fall reduces export volume by 0.75%
costs	Increased trade barriers with the EU	Tariffs of 6.7% plus customs paperwork to (approx 2% of transaction value) will hike relative price of all UK exports by 5%
benefits	Fiscal windfall	Net public expenditure is £3billion lower
benefits	Lower food prices	Aggregate prices of non-manufacturing imports prices drop by 5.25%

Net cost of withdrawal estimated to be GDP drop of 2.25%

And the evidence from other comparable European countries is generally much more strongly positive about the benefits of EU membership

- For example, the 1995 accession countries are comparable to the UK in income levels and have recently undertaken 10 year evaluations of impact of their membership:
  - Sweden
    - Swedish CBI estimates a 0.4% increase in trend growth. This is due to increased competition, a sharp increase in FDI inflows, and (to a lesser extent) an improvement in fiscal and monetary policy
  - Austria
    - Keuschnigg and Kohler (1996) forecast 2.6% GDP gain from membership
    - Breuss (2001?) identifies a welfare effect (due to lower prices) of 2% of GDP and higher growth of around 0.5% a year attributable to EU membership
  - Finland
    - EU membership boosted trade and investment and lowered prices for consumers. But joining EMU had a bigger overall economic impact

While those countries that have remained outside the EU often face economic penalties with little chance to influence policy

- **Norway** "*increasingly feels it is paying the price for remaining outside the club*" (FT 3rd May 2005)
  - As an EEA member, Norway must accept the acquis but has no say in its development. Pascal Lamy called it 'fax democracy'.
  - Norway has paid €225 million to EU over 5 years as contribution to central budget and contribution will more than double to €567m.
  - Commission has just imposed a 16% anti-dumping levy on Salmon (a key Norwegian export)
- **Switzerland** has also chosen to remain outside of the EU and negotiate special arrangements with Brussels
  - Negotiations began in 1994 and came into force only in 2001. [Government expects boost of 2% to GDP from closer integration]
  - Swiss Government estimates that EU border controls impose costs of between 0.5 – 1% of total value of transactions. Rules of origin paperwork impose additional costs

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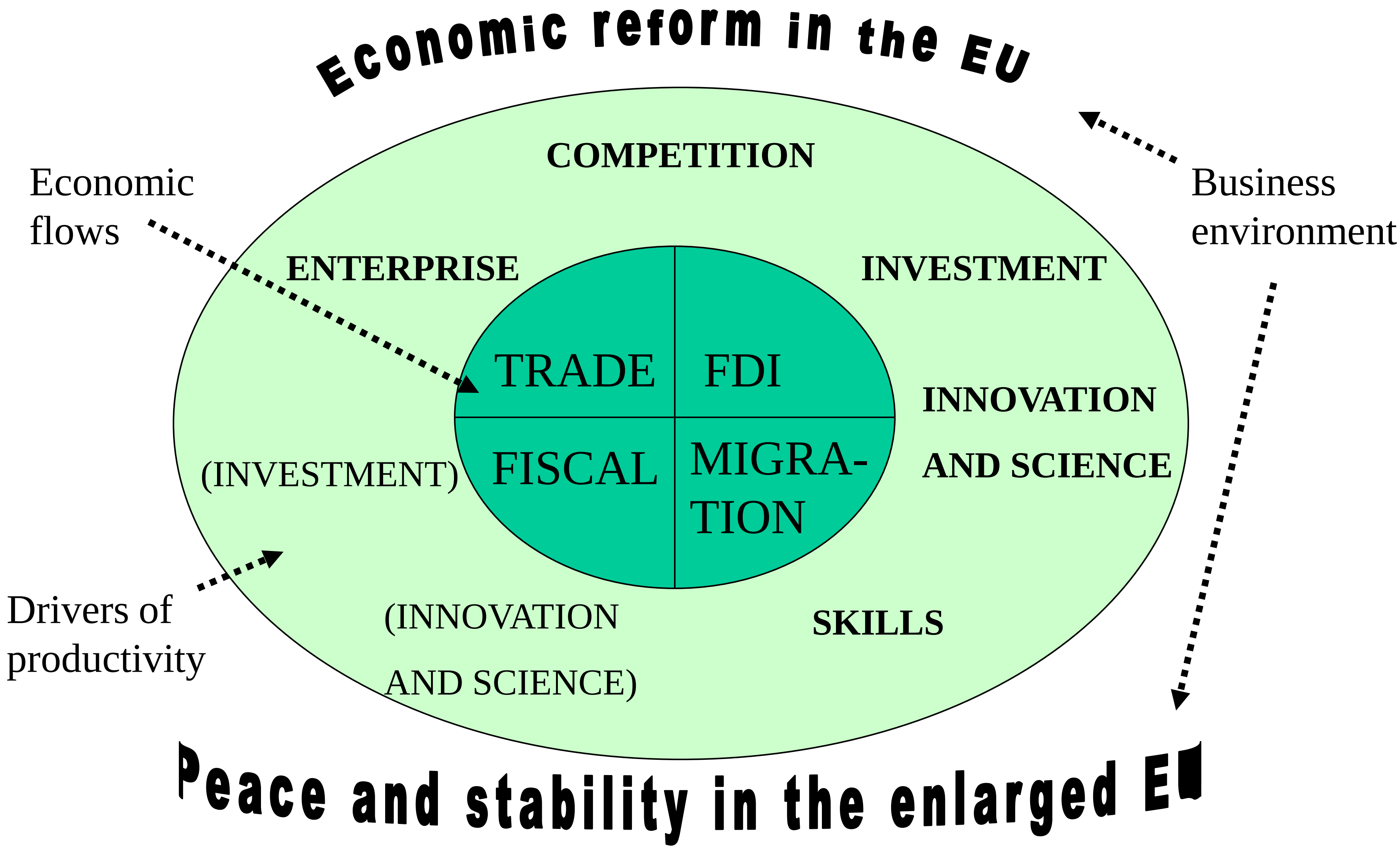
The literature suggests that membership of the EU has had wide-ranging impacts on the UK economy. We can broadly classify these impacts under three headings

- **economic flows**
  - associated with the ‘four freedoms’ and the fiscal transfers required of members
- **productivity drivers**
  - which improve (or impede) economic performance and change living standards in the long run
- **business environment**
  - associated with the context within which business operates and how this shapes corporate behaviour

This remainder of this section – and bulk of the presentation – considers the available evidence and what further work could be done

EU membership shapes UK economic flows, productivity drivers and business environment



To model the overall effects of EU membership we first need to examine the **economic flows**, and the extent to which EU membership has affected them

- Trade
- FDI
- Migration
- Fiscal transfers

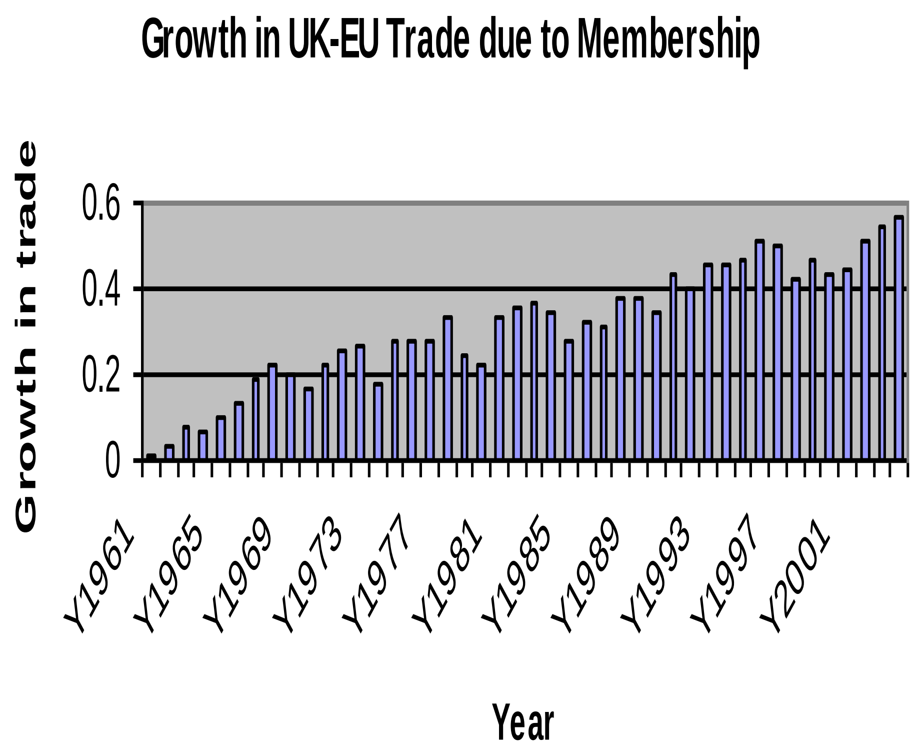
And under each of these headings there are specific questions we need to address

TRADE

UK trade has benefited from EU membership on accession in 1973, and also from increasing integration through the single market

- UK trade with EU estimated to have been boosted by 7% from joining the EU:
  - total EU trade boosted by c.40%)
- a further 7% increase due to the single market (note caveats).
- Some trade diversion, but outweighed by trade creation
- Welfare benefits for UK: 1% increase in trade → 0.2% increase in GDP per cap.
- Evidence of limited price convergence - contestability

Results of gravity model



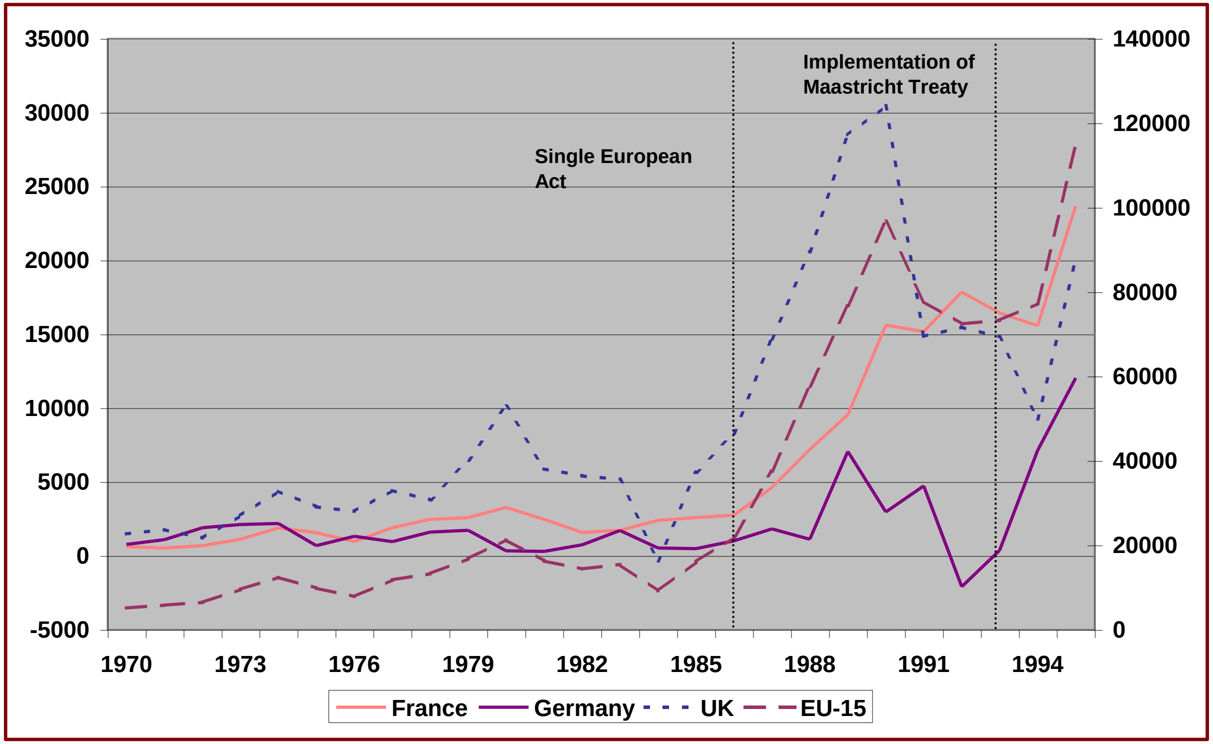
Overall assessment

FDI

Foreign Direct Investment flows into and from the UK have also been substantially boosted by EU membership, enabling firms to restructure and boost efficiency

- Global FDI took off in the late 1980s, at the same time as the single market programme.
- Econometric studies suggest significant inward flows to the UK are linked to EU membership
- Findings apply to US and Japanese investors but also some intra-EU companies especially German firms

- FDI boosted at each stage of integration and Single Market boosted catch-up with US

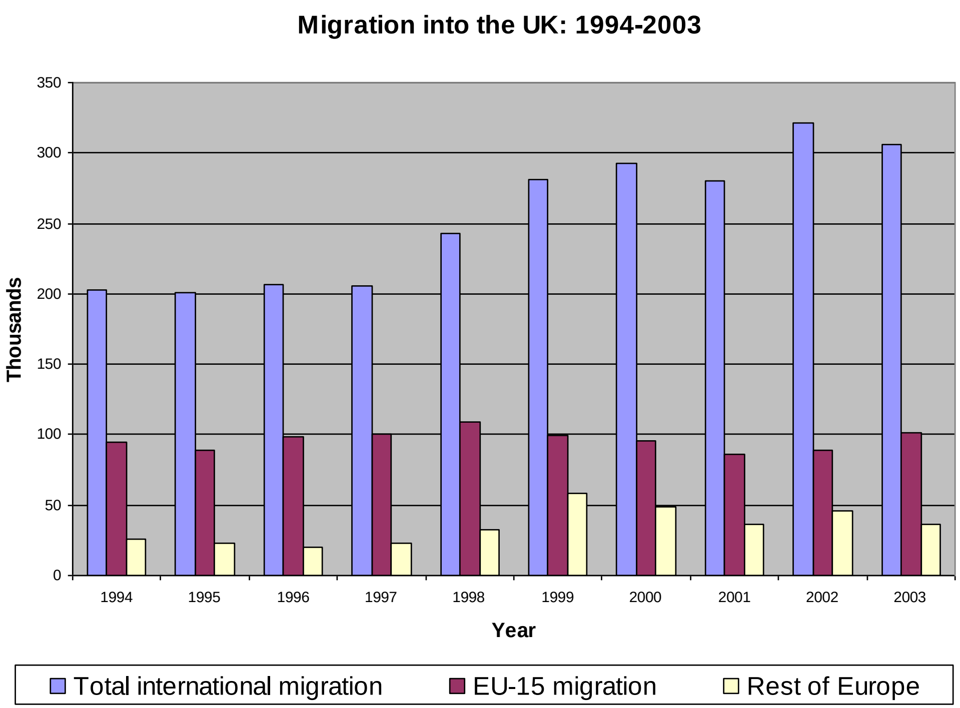


Overall assessment

Migration

Patterns of migration do not appear to have been greatly affected by EU membership, although this may start to change with latest accession

- Although data is limited, very little intra-EU migration appears to occur
  - 0.1% of EU population move between member states each year
- Around one million **EU nationals** live in the UK (OECD)
  - Many would have come even without EU membership.
  - Some benefits at the top and bottom end of labour market
- Since 2004, more than 230,000 workers from A10 have registered
  - little evidence of ‘benefit tourism’
  - Their fiscal impact is also likely to be positive (est. £240m.) as are mostly young, skilled and single
  - Many were in UK prior to 2004



Overall assessment

-

Fiscal

UK has paid in more than it has taken out, and increasingly so as UK became comparatively richer. But overall fiscal balance is quite small in proportion to GDP

UK net government contribution, 1973-2004, in *current* prices

Item	£ billion
Gross contribution	166.3
minus abatement and refunds	-40.4
Gross contribution after rebate	**122.7**
***minus* Public sector receipts**	-71.8
Plus EIB	0.3
minus ECSC grants	-0.7
minus Attributed aid and CSFP	-7.6
Net payments to community institutions	**42.8**

Source: Departmental Reports of the Chancellor of the Exchequer's departments; Government Expenditure Plans

- Currently UK pays in similar amounts to comparable member-states
- But UK receives much smaller payments under the CAP and structural funds.
- With rebate, UK's effective net contribution only 0.25% of GDP
  - estimated to be only 0.19% with private sector receipts accounted for.

Overall assessment

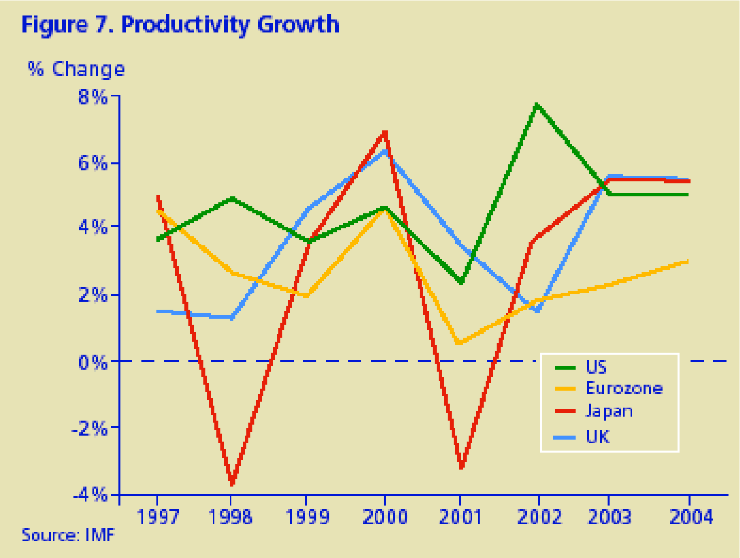
X

In summary, the overall balance of these flows is likely to be somewhat positive, but there is potential for greater gains – and smaller losses - with further reform.

TRADE FLOWS	Britain's trade with EU grew significantly after accession, and again following the Single Market. This appears to have been trade creation although there may have been some trade diversion from rest of world. There are also benefits from increased market contestability not shown in trade flows. Welfare benefits likely for the UK.	✓
FDI FLOWS	FDI took off in the late 1980s at the same time as the single market programme. But as much as one third of investment into the UK could be attributable to membership of the EU. This reflects the fact that membership has affected Britain's FDI relationship with the whole world – inward and outward - positively.	✓ ✓
LABOUR FLOWS	Until very recently only limited intra-EU migration has occurred and unclear how much is attributable to membership. Some benefits at the top and bottom end of the labour market and little evidence of 'benefit tourism' to date.	–
FISCAL FLOWS	UK has paid in more than it has taken out in terms of tangible receipts, and increasingly so as we have got comparatively richer as a country. But overall fiscal balance is quite small in proportion to GDP	X

Alongside economic flows, we need to consider the impact of EU membership on productivity drivers which shape long-term growth prospects

- Competition
- Investment
- Science and Innovation
- Enterprise
- Skills



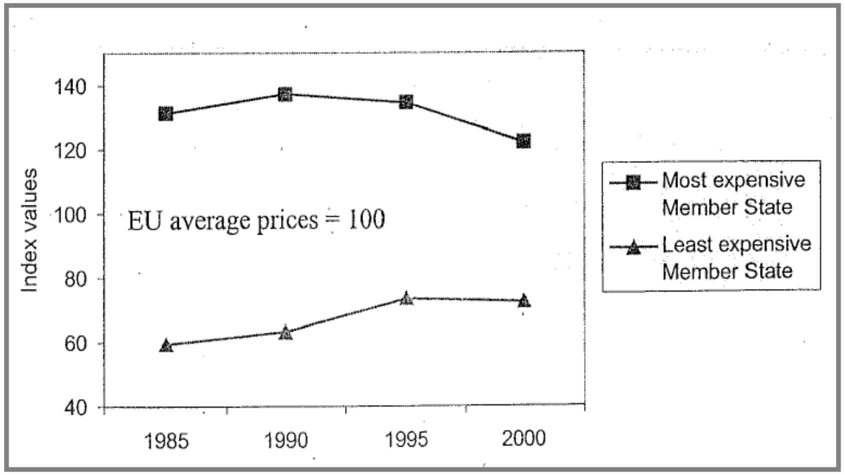
Under each of these headings we need to consider the impact of EU membership

UK has had a long-standing productivity gap with major competitors, but some evidence of catch-up in recent years.

Competition is one of the key drivers of productivity that has increased due to EU membership – especially since the creation of single market…

- Single market has increased pressures on firms to:
  - Reduce prices by increasing efficiency
  - Increase quality in order to differentiate products
- Price competition has led to an average fall in prices of 3.9% in manufacturing for big 4 member states (Allen et al)
- Single market has reduced margins by 0.2% per annum since 1987 and increased productivity by 2% (London economics)
- However, ECB estimates that lack of competition in euro area is costing 12½% GDP
  - lack of structural reform is preventing interest rate reductions)

Price convergence in the EU

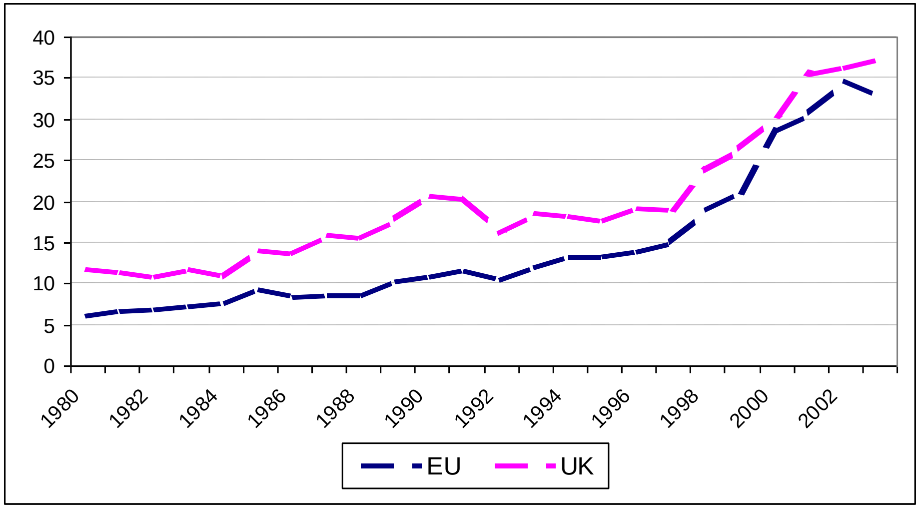


Expensive member states (such as the UK) have fallen more towards the EU average, bringing welfare gains for consumers. But convergence still has some way to go (see chart),

Investment into the UK from around the world has increased as a result of EU membership, boosting productivity through reorganisation of EU businesses

- Cross border investment grew seven fold as a share of EU GDP between 1992-2000
- Many firms restructured through FDI (especially M&A) to exploit comparative advantage across the EU through integrated production
- Over period of EU integration, EU & US-owned firms have increased in the UK, and account for a greater share of value-added. Evidence that foreign-owned multinationals have higher labour productivity than British firms

Inward FDI for EU and UK as % GDP



- Productivity spillovers from FDI should benefit the UK: estimate that a 10% increase in foreign presence in UK raises TFP of domestic plants by around 0.5%

- Looking forward, clustering and agglomeration economies should reinforce benefits for UK

…with spillover benefits for innovation and science through stronger networks, although the impact of the EU's own R&D spending has been modest

- Barcelona Council set target of 3% GDP to be spent on R&D, but EU currently spends only 1.9%, lagging both US and Japan
  - 3% spending on R&D would boost GDP by 1.7% by 2010 (Commission)
- **EU R&D public funding** has created research networks, facilitating innovation
  - A recent DTI study estimated that €10bn annual EU R&D investment could add €85bn to annual output over the long term.
  - UK participants secured 16% of the FP5 (€2bn), second highest volume behind Germany.
- Some evidence of **private multinational R&D** activity linked to EU membership
  - Increased market size, and wider network of researchers, increases quality of research and benefits from exploitation
  - Significant expenditure more likely when shared between MS
- But the EU could still do more to create right environment for R&D activity
  - E.g. resolve impasse on community patent

EU has boosted enterprise in the UK through inward investment and greater export opportunities… but in some areas *regulation* may have held back growth

- Creation of single market has boosted both trade and investment as companies seek out new opportunities
  - Single market estimated to have boosted EU trade by 7%
  - 10% rise in stock of FDI increases the volume of exports by 0.75% (Pain)
- Mutual recognition means companies can do business across the EU by complying with the rules in their home state
- EU red tape widely seen as a drag on growth.
  - Civitas estimate 1–3% of GDP
  - Dutch Government estimate 2% of their GDP
- But UK has lower regulatory burden than other member-states, so EU cannot be only source of burden
  - RIU/BRE estimate 50% of significant new regulations come from EU

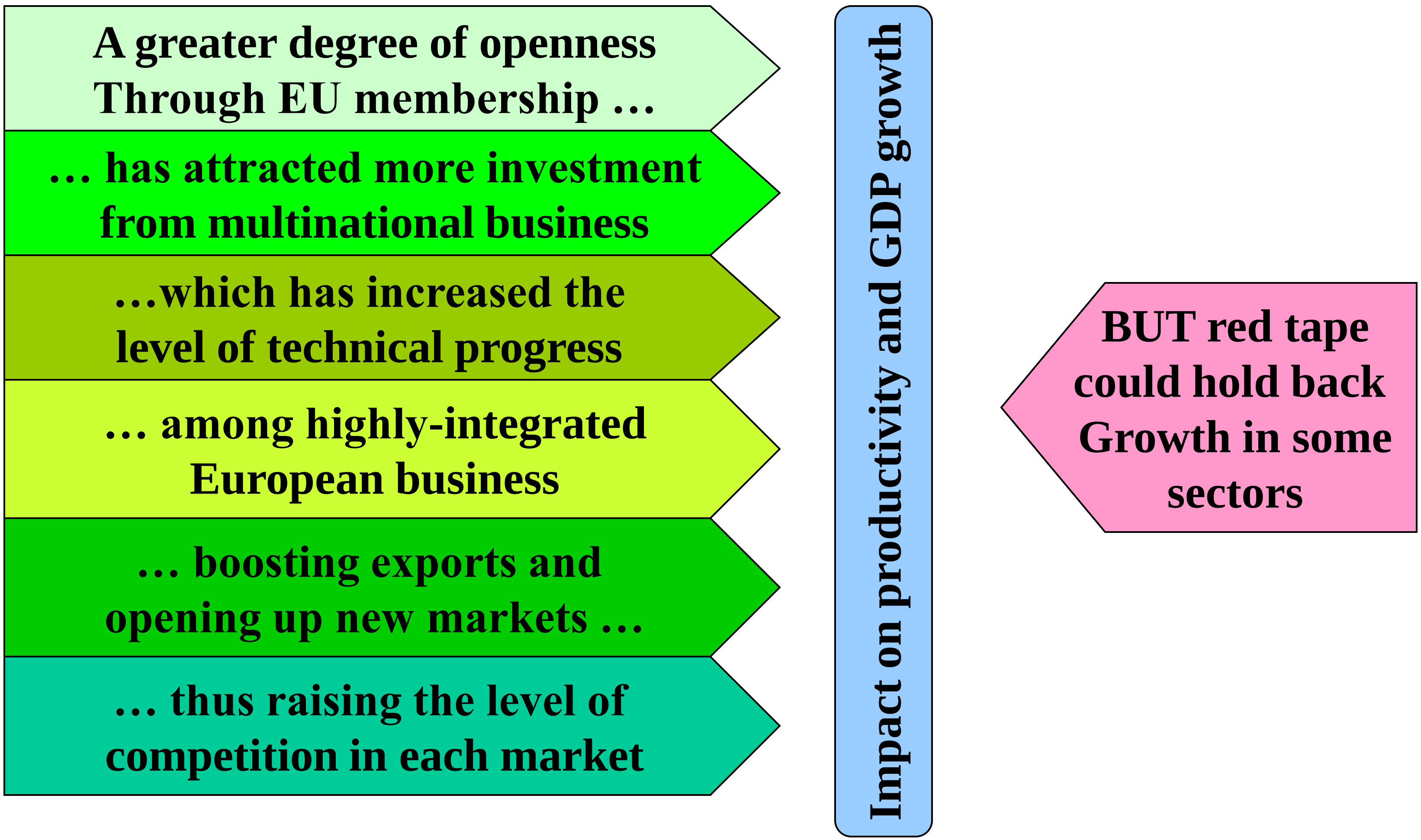
Membership of the EU has little impact on skill levels in the UK, except by small number of qualified immigrants from other EU states

- The EU has no direct effect on skills of indigenous workforce
  - Small numbers of UK students participate in EU exchange programmes
  - Skills of UK workforce primarily shaped by national policies
- Intra EU migration has boosted skill levels at top and bottom tiers of labour market
  - But very small part of total labour market

So the impact of the EU on the drivers of productivity is likely to be broadly positive in aggregate – particularly for competition and investment

- Competition ✓ ✓ ✓
- Investment ✓ ✓
- Science and Innovation ✓ ?
- Enterprise ✓ / X
- Skills —

… but these productivity effects are often cumulative and dynamic, driven by the behaviour of firms, and hard to disentangle from each other



The impact of EU membership is also likely to vary widely across different sectors of the economy

ILLUSTRATIVE!

- **Agriculture**
  - CAP has been harmful to UK producers and consumers
- **Low value-added manufacturing** *(e.g. textiles)*
  - In long term decline, but transition probably cushioned by trade protection and structural adjustment funds
- **High tech manufacturing** *(e.g electronics / automotive sectors)*
  - Likely to be most affected because of tradeability across EU
  - Buigues estimated 40 out of 120 manufacturing sectors affected by single market (around 12 – 18% of EU GDP)
- **Low value-added services** *(e.g retail / distribution)*
  - Little observable benefit from Single Market programme to date (hence need for new directive!) but possibly additional regulatory burdens
- **High value services** (*e.g financial services)*
  - Increased export opportunities for UK firms offset by rising regulatory burden

And because EU economic growth has direct benefits for the UK, the government has focused on improving the wider business environment

- **Single Market programme** (*1986 – 1992*)
  - Driven through by Lord Cockfield and British Government of the day under QMV rules
  - Estimated to have boosted GDP by 1.8% (Commission)
- **Enlargement** (*1989 – 2004*)
  - UK championed recent accession with benefits for EU economy measured at around 0.7% of GDP (Commission):
    - Increased exports to fast growing markets
    - competitiveness business location for FDI
    - lower spending on security, defence, etc.

> "*Because 50 per cent of our trade is with Europe and because through increased trade an extra 1 per cent of growth in the eurozone can give an extra fifth of a per cent of growth in Britain, reform matters not just for all of Europe but for Britain too*".
>
> –Chancellor's speech to CBI, 17 May, 2005

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The impact of EU membership can also be seen in a broad historical context, with different phases of integration having different effects

	1970s	1980s	1990s	2000s
External context	Oil crisis / stagflation	First wave of Globalisation	- IT boom - Fall of Berlin Wall	-Emerging Asian economies - Enlargement
UK-EU relationship	Accession to EEC	Single Market programme	Creation Of the EU	Constitutional Treaty?
Economic Policy framework	Customs Union	Removal of internal trade barriers	Regulatory Convergence And EMU	Lisbon Agenda and Open Method
Economic Outcomes For the UK	Increased **trade** and competition	Increased foreign **investment** and corporate restructuring	Further corporate restructuring and some increased **migration**	Increased global Integration and outsourcing opportunities?

Other possible scenarios are unlikely to have produced better outcomes for the UK (1)

- <u>If the UK had not joined the then-EEC in 1973 but had stayed in EFTA, then …</u>
  - UK would not have had **tariff-free access** to common market until 1978, or access to single market until 1994, implying lower trade and FDI benefits
  - UK goods would still be subject to costly **customs controls** and other protectionism **(e.g. anti-dumping measures)**
  - UK would be **subject to the rules** of the single market (including most social legislation) but would play no part in deciding them
  - UK would still make a substantial **budgetary contribution** to EU programmes, but would not receive any funding itself
  - UK would have to negotiate **on its own in the WTO** and to reach bilateral trade agreements - less influence than as part of EU

Other possible scenarios are unlikely to have produced better outcomes for the UK (2)

- If the UK were we to leave the EU now (or substantially renegotiate terms)
  - Minford argues that UK could leave the EU at little cost
    - Not necessary to negotiate any privileged trading relationship.
  - But others forecast substantial economic disruption and legal uncertainty for many years to come
    - Unprecedented negotiations across a huge range of policy spheres would consume enormous political resources
    - Many businesses might start to relocate their production facilities elsewhere
    - Pain and Young estimates reduction of FDI stock in UK of one third over time
    - Hard to forecast exactly what the nature of UK's continuing relationship with the EU would be

Other possible scenarios are unlikely to have produced better outcomes for the UK (3)

- <u>If the UK were we to leave the EU and join NAFTA instead</u>:
  - US ITC (2000) estimated that the long run GDP impact on UK of withdrawal from the EU would be negligible (0.01%)
  - Philippidis also estimates a tiny drop in real income (-0.06%)
    - If the UK stays <u>in the EEA</u>, then real income *rises* by 0.12%
    - Substantial shifts in agricultural, and especially food-processing, sectors (but only account 8% of UK GDP)
    - NAFTA members gain, EU14 lose
    - Findings are heavily caveated however

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Liberalisation and economic reform will further boost both the economic flows and productivity drivers linked to EU membership

- Barriers in most sectors continue to hinder the potential benefits which could be realised in a reform scenario
  - **Agriculture:** CAP particularly damaging to UK economy as UK is a net importer of food (cost estimated at 0.5 percent of UK GDP, Minford 2005).
  - **Services:** Liberalisation would boost UK exports by 18%, and inward FDI stocks by 20%, unlocking an additional 0.6% to EU GDP (Commission)

TRADE

FDI

Lisbon Economic Reform Strategy

- UK leadership has driven economic reform agenda aimed at producing 3% annual growth across EU by, inter alia:
  - Better regulation through six presidency initiative
    - potential GDP boost of 2 - 8.6% GDP
  - Reaching 3% R&D target by 2010
    - boosts GDP by 1.7% (Cion)
  - Integrating financial markets
    - could boost GDP by 1.1% (Londecon)

With the UK championing an outward-looking '*Global Europe*' agenda, other key policy objectives are more likely to be realised

- **<u>US-EU economic relationship</u>:**
  - **barrier free transatlantic market place** *(2004 -)*
    - OECD estimates increased GDP growth in EU of up to 2% per year by removing the remaining impediments to the $2.5 trillion transatlantic economic relationship with the US, which provides over 12 million jobs on both sides of the Atlantic.

- **<u>Global economic outlook:</u>**
  - A competitive and outward-looking EU can shape international policy to achieve shared objectives in the social, environmental as well as economic sphere
  - Global liberalisation of markets does not negate the advantages of EU membership, but strengthens the necessity of continuing reform
  - Reduction of global barriers is unlikely to match intra-EU liberalisation, so Single Market will remain key stimulus for productivity drivers, particularly in industries where distance matters, e.g. logistics, distribution, services

The <u>negative</u> consequences of EU membership in terms of additional constraints on business and Government can probably be managed

- **Regulatory burden**
  - UK businesses must comply with rules determined by QMV that may go beyond what UK would do for own domestic markets
    - But UK's regulatory burden is widely estimated to be much lower than other member-states (OECD), primarily because enforcement responsibility lies with the member-states
  - Through UK lobbying, the EU rule-making machinery is starting to improve and will be a priority for our presidency
    - And some regulation would be necessary even outside of EU
- **Loss of policy autonomy**
  - UK no longer able to negotiate own arrangements in international forum, e.g. WTO
    - But unclear whether UK would we get a better deal than can be negotiated by the EU

So focus of policy should be reform of the EU from within, consistent with current presidency agenda

- Promote **Lisbon agenda** as key to maximising benefits of EU membership and ensure an outward-looking Europe
  - High levels of innovation
  - Liberalised, open and competitive markets
  - Better regulation to boost enterprise
  - Active labour markets and reformed social model
- Promote **enlargement and regional stability** as a basis for economic growth in wider Euro-sphere
  - Balkans, Turkey, North Africa, Former Soviet Union.
- Promote outward-looking **Global Europe** to deliver our wider objectives
  - WTO and co-ordinated development programmes
  - Enhanced transatlantic dialogue
  - Tackling climate change