Brexit: The pros and cons

John Greenwood
Chief Economist, Invesco Ltd.

With Prime Minister David Cameron's government committed to an "in-out" referendum on the UK's membership in the European Union (EU) before the end of 2017, the consequences of a vote to leave the EU (British Exit, or Brexit) need to be considered. This Insights looks at arguments for and against Brexit, as well as alternative arrangements for trade with the EU.

In brief: Brexit pros

The main arguments of the pro-Brexit camp are that the EU:

- Costs too much.
- Has grown too large.
- Has encroached too far into domestic policies, eroding national sovereignty.
- Stifles business through overregulation.

Brexit proponents believe that after a yes vote for Brexit, the UK can negotiate a new free trade arrangement, along the lines of the status enjoyed by Switzerland and Norway.

Prime Minister Cameron won the UK general election in May 2015 with a pledge to hold an in-out referendum on EU by the end of 2017. Since winning, he has stepped up efforts to secure a deal on treaty change and/or concessions to support his preference for staying in the EU. Consequently, the referendum may be as early as May 2016, if he can secure sufficient concessions – but it won't be held on the May 2016 date of assembly elections in Scotland, Wales, and Northern Ireland, which has yet to be decided.

In brief: Brexit cons

On the other side, Brexit opponents have emphasized the benefits that the EU has brought to UK business, crucially enabling London to provide financial and business services unfettered across Europe and thus become Europe's dominant financial center. Specifically, the consensus among business leaders appears to support continuing EU membership. For example, in 2013, the Confederation of British Industry found eight out of 10 of its members thought remaining in the EU was in the best interest of the UK's economy. Similarly, 85% of business leaders in the manufacturing sector and 84% in the financial sector considered it best to remain within the EU.[1]

Let's look more closely at the assertions by both sides.

In detail: Brexit pros

Cost of EU membership. By some estimates, the total economic cost (both direct and indirect) is as much as 11% of annual gross domestic product (GDP), or close to £200 billion.[2] These costs can be divided between direct costs, such as the UK government's contribution to the EU budget, and indirect costs arising from implementation of rigid EU regulations and the inefficiencies and distortions of the agricultural and employment markets that membership brings.

The UK spends an estimated 11% of annual GDP on EU-related costs

Nature of costs	% of GDP	Rationale
Direct fiscal costs	1.25	Gross payments to EU institutions.
Costs of regulation	5.2	Cost of employment, financial, dangerous substances and procedure regulations.
Costs of resource misallocation	3.25	Relating to CAP and EU Protectionism.
Costs of lost jobs	0.375	Job losses of UK born population, due to immigration from EU states.
Costs of waste, fraud and corruption	0.375	Fish discard due to fish quotas, bureaucratic inefficiencies, and corrupt officials.
Unforeseen commitments	0.25	Health and benefit tourism.
Total	**11**	

Source: Tim Congdon, "How Much Does the European Union Cost Britain?" September 2013

- **Direct costs.** In 2013, the British government's net contribution to the EU budget was estimated to be £8.624 billion, according to Her Majesty's Treasury[3] — net of the UK's rebate and UK public sector receipts. The UK's contribution amounted to 12% of the overall EU budget. Brexit proponents estimate the direct cost of EU membership to the average British household in 2014 was £759 per year, assuming 27 million households based on the 2011 UK census figures. The direct fiscal cost was an estimated £20.5 billion in 2014.[2]
- **Indirect costs.** Besides the direct costs of EU membership, pro-Brexit politicians and pressure groups emphasize the financial cost of red tape and regulation imposed by Brussels, location of EU headquarters. The London-based think tank Open Europe estimated that the cost of all regulation, including domestic, to UK subjects was £32.8 in 2009, with 59%, or £19.3 billion, of that figure imposed by the EU. The three areas of EU legislation highlighted as extremely costly and invasive are financial regulation, renewables and employment.

Financial regulation. A particularly sensitive area of regulation for Britain is financial regulation. Brexit proponents cite red tape, ill-informed tax initiatives, protectionist policies and high costs of the EU's regulation of financial markets.

Many commentators have the general perception — rightly or wrongly — that Germany and France are anti-finance and envious of the London's position as Europe's de facto financial capital. As a result, they maintain, Brussels is either indifferent to the impact of EU financial regulations on the UK's most crucial industry or is willfully targeting the UK's dominance of Europe's financial industry. For example, the EU has proposed taxes of 0.1% on financial transactions and 0.01% on derivatives in the aftermath of the financial crisis, although implementation has been postponed until January 2016. In a highly competitive, low-margin industry, these transaction taxes are widely viewed as an onerous imposition on London's trading activities. The EU has also sought to regulate the compensation structure in finance by imposing caps on bonuses.

Such regulation and perceived interference has led to calls for leaving the EU so UK financial authorities and Parliament can formulate a regulatory framework that is more accommodating to London's needs and ensure its continued financial dominance. Combining Brexit with a free trade agreement (FTA) between the EU and the UK that includes financial services would enable Britain to enjoy continued access to Europe's markets.

Nonfinancial regulation. EU regulations also hinder the nonfinancial sector of the UK's economy. For example, regulations designed to prohibit dangerous substances and processes are considered extremely costly for businesses, forcing some suppliers to go out of business and others to introduce expensive changes to their business operations or products. These regulations have also raised prices for consumer goods. In total, EU regulations are estimated to cost between 5% and 6% of UK GDP per year.[2]

Common Agricultural Policy (CAP) and protectionist trade policies. Many consider CAP — long a bugbear for opponents of British EU membership — hugely wasteful and costly because it fosters an uncompetitive domestic agricultural sector dependent on subsidies to survive. Free market supporters are also critical of the EU's protectionist trade policies, such as anti-dumping measures, which the EU imposes when it suspects that unfair subsidies are making imported goods considerably cheaper than their EU-made equivalents. The total cost of these trade-distorting polices, including CAP and trade protectionism, is estimated at 3% of the UK's GDP.[2]

Immigration and benefit tourism. One of the most emotionally charged issues for Britain is immigration. Due to the EU's founding principle of free movement of people — along with the free movement of goods, services and capital — the UK has no control over immigration from other EU member states. Since the 2004 membership accession of eight Baltic and Eastern European states — the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, known as the EUA8 — there has been a noticeable wave of migrants from these countries. This is hardly surprising, with income levels in Poland, for instance, at just one-fifth of those in the UK. By 2011, EUA8-born residents accounted for nearly 1.7% of total employment in the UK.[2] Evidence suggests that these migrants, employed primarily in low-skilled sectors, have suppressed wage growth in those sectors and increased unemployment levels among the UK-born population. During the global financial crisis and the years immediately following, employment among the UK-born population fell sharply, while it increased among the EUA8-born population.[2]

"Benefit tourism," or migrating to the UK for welfare and health care benefits, is one of the key issues that Prime Minister Cameron wants addressed in his negotiations with the EU. Figures from January 2012 show that of a total of 5.5 million welfare recipients, 371,000 were foreign-born, and 118,000 were from the European Economic Area (EEA), which provides for the free movement of people through EU states.[2] There is also concern that citizens of EU states with poorer health services will travel to the UK to take advantage of the free services available through the country's National Health Service.

In detail: Brexit cons

Let's take a closer look at the arguments for the UK to stay in the EU.

Economic benefits. Arguably, the benefits for Britain of staying in the EU are primarily economic. Consider:

- The EU is a large market, accounting for 25% of world GDP, as well as the UK's biggest trading partner — 45% of UK exports are to the EU, and 50% of imports are from the EU.
- The UK's attractiveness as a destination for foreign direct investment (FDI) is enhanced by the country's EU membership and access to its markets. In 2012, the UK received FDI amounting to £937 billion, while UK firms invested £1,088 billion abroad. Nearly 50% of UK FDI, both inward and outward, is EU-related.[1]

The UK, being a service-based economy, enjoys huge potential gains from membership in the Common Market, formed by European countries to reduce trade barriers and increase cooperation among members. Services account for 75% of world GDP, but only 20% of world trade. The EU has taken major steps to liberalize trade in financial services in particular, launching the Financial Services Action Plan — intended to open a single market for financial services in the EU — in 1999.[4] Beneficial results have spread across a range of financial services. For example:

- Cross-border payment costs for a typical €100 payment have been reduced from €24 in 2001 to €2.50 in 2005.
- The number of passported prospectuses — which are share offers, including unit trusts, that can be distributed across the EU — increased by 50% between the second half of 2005 and the first half of 2008.[1]
- The use of cross-border funds has exhibited strong growth since 1999.[1]

These developments show that fund managers and associated investment professionals have been able to take advantage of the EU to expand their business.

In addition, the Financial Services Market Act 2000 entitles authorized firms in any EEA member state to participate in permitted activities in any other member state either by exercising the right of establishment (of a branch and/or agents) or providing cross-border services.

The financial services sector's importance to the UK's economy and the impact an exit would have on it is central to the Brexit question. Financial services and related professional services accounted for 11.8% of UK GDP in 2013 and employed over 2.1 million people. Financial services accounted for 11.5% of total tax receipts for 2013 and 2014. In addition, the financial sector generated a trade surplus of £67 billion in 2013, more than all other net exporting industries. FDI in the industry was £100 billion.

A major reason why London has been able to grow and maintain its prominence, and become the main financial center in Europe, has been its ability to operate and sell its services throughout the EU. London is home to more than 250 foreign banks, many of which use the city as a base for their main European subsidiaries to take advantage of the automatic passporting rights to sell their products and operate across the other 27 countries in the single market. Brexit supporters argue that Britain would still have the same access to the European markets if it joined the EEA and the European Free Trade Area — but this is not certain.

Immigration. Proponents of continued EU membership cite favorable statistics supportive of the principle of the free movement of people, including:

- Immigrants to the UK from the EU are better educated than UK nationals — 32% have a degree, compared with 21% of UK subjects — and are less likely to be in the lower education category.[1]
- They tend to be younger than the native UK population, averaging 32.3 years compared with 40.8 years in 2011, a benefit when many countries are struggling with a rapidly aging population.
- Immigrants from the EEA arriving since 2000 have contributed 34% more in fiscal terms than they have received. That equates to a net contribution of £22.1 billion in 2011 terms, compared with the native population contributing only 92.6% of the amounts they received in transfers and benefits.[1]

Alternatives to full EU membership

What alternatives would Britain have if it votes to leave the EU?

The EU has entered into three main types of agreements with non-EU countries:

1. Membership in the EEA
2. Membership in the EU's Customs Union
3. Free trade agreements (FTAs)

While it would naturally be in their interest to establish a preferential trade agreement with the UK, it would also not be surprising if the EU member countries sought to penalize the UK for leaving the union. The motivation might be to ensure that other member states see a cost to exiting the union. Such a punishment could restrict access for certain sectors, with the financial sector an obvious candidate. The agreement between the EU and Switzerland excludes financial services, which is thought to have limited growth of the Swiss financial sector. Post-Brexit negotiations over an agreement between the UK and EU would be bound to cause risk and uncertainty and could drag on for years, in my view.

Let's examine the implications of each type of agreement.

EEA membership. The UK would still abide by current domestic regulations imposed by Brussels and retain access to the Common Market. However, Britain would lose its "seat at the table," relinquishing influence in negotiating regulations. It's likely that the UK would still be expected to contribute to the EU budget, albeit at a reduced rate, similar to the EU's relationships with Norway, Liechtenstein and Iceland.

EU Customs Union membership. The UK would remain outside the Common Market but retain some trade benefits of membership, in particular for the trade in goods. However, the UK would lose the benefits of freedom of movement and freedom of establishment.[5] The service sector would likely be severely hampered by this outcome, with its EU business activities curtailed. This would clearly make the UK a less attractive location for FDI investment. The EU and Turkey have this type of relationship.

FTA. The EU has a large number of FTAs with various countries. These are similar to custom unions but are generally agreed on a product-by-product basis. An FTA with the EU would not interfere with the UK's existing FTAs with other non-EU countries. However, there is serious risk that the EU would not include goods and services that the UK wanted. Because the EU hasn't been happy with its FTA with Switzerland, particularly with the issue of dispute resolution, it may be hard to achieve a similar deal.

The UK's most drastic alternative would be not agreeing to a bilateral agreement with the EU and instead relying on most favored nation status, which grants specific trade advantages, under World Trade Organization rules.

The Scottish question

If Britain does decide to leave the EU, what could the consequences be for the union between England and Scotland? Following the UK general election in May 2015, the Scottish National Party (SNP) holds 56 out of Scotland's 59 seats in Parliament and appears likely to maintain its control of the Scottish Parliament in next year's assembly elections in Scotland. The SNP is emphatically pro-Europe, and if Britain voted to leave the EU, there would doubtless be calls for another referendum on Scottish independence. Given the relatively small margin of last year's referendum result — 55.3% versus 44.7% — I believe the likelihood of a vote to leave the UK following a Brexit would increase dramatically.

Prime Minister Cameron's objectives

The Cameron government is seeking changes to several areas of EU regulations and entitlements for EU citizens, including:

- A four-year waiting period before EU migrants can claim in-work benefits and a six-month limit on jobseekers' benefits if they haven't found work. The latter is legally achievable, according to The Telegraph,[6] with Germany and Spain also seeking similar tightening of immigrant benefit entitlements. Changes to in-work benefits, however, may be harder to achieve due to the argument that this may be in breach of the principle of freedom of movement, a major tenet of the Common Market.
- Introduction of an income test for the non-European spouses of EU migrants. This will also be troublesome as it would require treaty change and would directly contravene the freedom of movement principle. European leaders are against such a treaty change as it could require ratification across the union — including destabilizing referenda in their own countries — around the time many of these leaders are running for re-election.[6]

The government's objective appears to be this: Secure enough changes in EU laws, regulations or practices so that the prime minister can make the case that these changes justify continued British participation in the EU. Among other things, this would include abandonment of the objective of "ever-closer union" — at least for those nations, like Britain, that are not members of the single-currency arrangements.

By contrast, members of the European currency union do need to achieve an ever-closer union to avoid the kind of crises that have bedeviled the monetary union over the past five years. Therefore, agreeing on one formula for nonmembers — such as Britain, Sweden and Denmark — that is compatible with a different formula for members will certainly be immensely challenging. Although the prime minister may secure only part of that objective, in my view there is little doubt that Britain would do best by maintaining free trade with and full access to the EU, while remaining outside the eurozone.

1 Source: The City UK, Analysing The Case for EU Membership, "How Does the Evidence Stack Up?" April 2014
2 Source: Tim Congdon, "How Much Does the European Union Cost Britain?" September 2013
3 Source: Her Majesty's Treasury, European Union Finances 2013, statement on the 2013 EU Budget and Measures to Counter Fraud and Financial Mismanagement, November 2013
4 The European Commission, Financial Services: Implementing the framework for financial markets: Action Plan, May 1999
5 The freedom of establishment, set out in Article 49 (ex Article 43 TEC) of the Treaty, and the freedom to provide cross border services, set out in Article 56 (ex Article 49 TEC), are two of the "fundamental freedoms" that are central to the effective functioning of the EU Internal Market. Source: The European Commission
6 Source: The Telegraph, When is the EU Referendum? June 28, 2015