Brexit and EU Regulation

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1 Introduction

Britain has been a comparatively economically liberal and sceptical participant in the EU's regulatory process, and many EU member-states have a greater appetite for regulating markets than the UK, which means that the British government must sometimes implement EU rules that are more restrictive than those it would have chosen itself. But the claim that leaving the EU's single market will liberate the supply-side of the British economy is wishful thinking. The truth is that the factors that weaken Britain's long-term economic growth are overwhelmingly domestic, not European; the impact on output from repealing European legislation would be minimal; and the economy's supply capacity would be impaired if divergent regulations between the EU and the UK curbed trade and investment.

The EU is to a large extent in the business of regulation, and some rules emanating from Brussels do indeed impose more costs than they confer benefits. For example, the cost of recycling waste electrical equipment, mandated by a 2012 directive, outweighs the savings from

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reduced landfill and recycled materials, according to an impact assessment by the British government.[1] And the Bank of England has found that capping bankers' bonuses at 100% of their annual salary has increased risk in the financial system: banks find it more difficult to slash salaries than bonuses in a downturn, which makes them more fragile.[2]

However, it is an extremely difficult task to calculate the economic effects of all EU rules to arrive at a 'net cost (or benefit) of Europe'. Some analysts have added up the costs and benefits of major EU regulations that can be found in UK impact assessments, in which civil servants attempt to quantify the economic impact of individual regulations. The think-tank Open Europe, for example, found that EU rules lead to marginally more benefits for the British economy than costs.[3] However, all impact assessments are uncertain estimations, and many do not calculate benefits, as these can be difficult to quantify.

Meanwhile, the method favoured by the EU's most trenchant critics can be crude: assign largely arbitrary, but invariably inflated costs to regulations; then imply that the UK would face none of these costs if it quit the EU.[4] It is a method designed to produce conclusions that have been determined before the exercise has been carried out.

The British debate about EU regulation accords with Dani Rodrik's globalisation 'trilemma'. Countries cannot pursue democracy, national self-determination and globalisation at the same time; one has to give.[5] The reason for this trilemma is that globalisation—that is, rapid growth in trade, as well as in capital and labour flows across national borders—requires countries to adopt common policies such as financial rules to govern capital flows across borders. Therefore, the democratic nation-state cannot simply tailor policies to domestic needs and preferences—a process which threatens democracy at the national level. To tackle this trilemma, governments have three choices. First, policy-making could move one level up, to a supranational democracy, with countries ceding national self-determination but preserving democracy and globalisation. Second, nation-states can act in ways that violate electorates' preferences in order to make their policies compatible with a globalised world. Or third, governments can limit the flow of goods, capital and people across their borders, and so preserve democracy at the level of the nation-state.

The EU is a regional form of high-intensity globalisation: a single market, common regulation, combined with, for some, a common currency. As a result, some policies—external trade agreements and some regulations—are entirely decided at the EU level. And, in terms of the single market at least, the EU and its member-states have ended up somewhere between Rodrik's first and second choice. The European Parliament is a supranational democratic institution in which MEPs, representing their constituents, amend and ratify the European Commission's proposed regulations and directives. The Council of Ministers and the European Council do the same, since ministers and heads of state of national governments vote on EU legislation or agree it by consensus. But, since 28 countries with varying political cultures are involved in the process, EU regulation is inevitably a compromise—and so the EU's member-states sometimes violate their electorates' preferences in pursuit of common rules, intended to reduce barriers to trade, investment and the movement of workers across national borders.

The 2016 referendum result showed that, alongside disatissfaction at high rates of immigration from newer EU member-states, the UK public were persuaded by the Leave camp's appeals to democracy and national self-determination. What is less clear, however, is whether the public understood—or if they did understand, agreed with—the economic rationale behind the EU's attempt to create common regulation. This chapter discusses whether the EU's single market process, launched in 1992, has done much to reduce the cost of trade in goods and services across the EU, and whether it has done much to boost trade flows. It also considers whether, if the UK decides to leave the single market as well as the EU, it would be something of a liberation to the supply-side of the British economy—a key argument of the Leave campaign. To understand whether an exit from the single market might reduce the cost of regulation, one must establish why regulations exist in the first place; appraise the extent to which the EU has a legitimate interest in regulation; honestly assess the effects of EU regulation on British economic performance; and consider whether the UK would escape the regulatory costs attributed to membership if the country chose to leave the EU.

1.1 Why the EU Regulates

Regulations can and do impose costs on companies, and ultimately on consumers (because companies often pass on these costs). When they are badly designed, the costs of such regulations can be unnecessary and damaging. But there are legitimate reasons why governments regulate markets. Markets are not perfect: they sometimes fail, producing sub-optimal outcomes. An unregulated market may, for example, generate negative externalities (such as pollution or congestion) because the social costs of activities are not borne fully by those who engage in them. In such cases, governments have a responsibility to intervene to correct the failure. If the end result is that a firm is made to internalise social costs which it had previously managed to externalise, the fact that its costs have risen is no bad thing.

The EU has employed three tools to boost trade. First, it eliminated tariffs on goods. Second, it established the right of companies and people to sell their goods, services or labour, or to invest, in other member-states —the so-called 'four freedoms'. This right is enforced by the European Commission and European Court of Justice, institutions tasked with preventing national governments from passing laws—or providing subsidies or tax relief—that give domestic companies or workers a competitive advantage against companies or workers from other countries. Third, it has sought to reduce the cost of potential exporters having to comply with 28 national sets of regulations. The EU creates minimum regulatory standards, and then requires all member-states to allow goods that comply with those standards to be sold unhindered across the single market. It also harmonises product regulations.

Thus the EU largely sets the common minimum standards that are necessary for mutual recognition—the animating principle of the single market—to work. This basic premise is widely misunderstood in the British debate. For example, one recommendation of the British government's 'Business taskforce on EU red tape', which was asked to find regulations to scrap, was to push for the full implementation of the EU's services directive.[6] But deepening the EU market for services would be impossible without more EU regulation. Services markets tend to be more highly regulated than markets in goods. Consumers find it more difficult to assess the quality of a lawyer than an apple before they make a purchase, so the state intervenes to ensure legal standards are high. Member-states would not allow foreign companies, operating under foreign rules, to provide services to their citizens without common standards at the EU level.

Confusion also reigns over the reach of EU regulation. Before the referendum, Business for Britain, a cross-party business campaign for a renegotiation of Britain's EU membership, suggested that UK companies that do not export to the rest of the EU should be exempted from EU regulation.[7] That would be unworkable: many UK firms who opt against exporting are still part of the single market: they compete for British customers with firms from elsewhere in the EU. Meanwhile, some companies do not export directly, but supply parts, components and services to firms that do. By exempting non-exporters from EU rules, the UK would effectively be withdrawing from the single market.

Another reason why the EU has a legitimate interest in regulation is that there are times when collective action at a European level may produce better outcomes than countries acting independently at a national level. In policy areas like climate change, for example, collective action at an EU level should, in principle at least, produce superior outcomes by reducing the opportunity for individual member-states to 'free ride'.

Nonetheless, the EU's member-states retain broad powers to regulate their economies. Some of the costs that firms complain about arise when national legislatures impose regulatory burdens over and above those required by EU legislation (a practice known as 'gold-plating'). And if the EU did not exist, member-states would have to make their own rules: it is misleading to imply that all the regulatory costs associated with EU legislation would simply disappear if the UK left the EU. British banks, for example, would not cease to be regulated. The regulatory burden on them might not even fall, because the era of 'light touch' financial regulation is over: UK standards are now often stricter than those required by the EU.[8]

In short, if a regulatory requirement in force in Britain is to count as a cost of EU membership, at least two conditions must be satisfied. First, it must be shown that its costs outweigh its benefits. And second, it must be proved that the UK would have no such requirements outside the EU.

1.2 Has the Single Market Programme Achieved Its Objectives?

How much of the economic integration between the UK and the EU is down to shared regulation, as opposed to the absence of tariffs—or geographic proximity? The Bertelsmann Foundation in Germany has found that the UK's GDP was 1% larger thanks to the EU's single market programme, which started in 1992.[9] For its part, the Centre for Economic Policy Research concluded that the EU's single market programme boosted EU GDP by 2.2%.[10] The European Commission estimates that the single market programme produced around 2% growth in EU output. Facing greater competition, companies cut margins by around 1%. Productivity in labour, capital and land use increased by half a percentage point.[11]

The single market programme, then, is likely to have modestly raised national incomes of the participating member-states a little. And it is possible to directly observe changes in trade costs over time, which offers some evidence of the single market programme's effectiveness. Economists at the World Bank have put together a database that measures how costly trade in goods is between countries.[12] Trade costs can come in various forms. One cost is taxes on imports: tariffs. Another arises from non-tariff barriers, like quotas restricting imports or national regulations that prevent imported goods, made to different standards, from being sold. Still another is distance. It costs money to transport goods from one country to another, so distant countries will tend to trade less than neighbouring ones.

Chart 1 shows the World Bank's estimates of trade costs between Britain, the EU, the rest of the OECD and the eight emerging economies with which Britain conducts most trade: China, India, South Africa, Russia, Nigeria, Brazil, Malaysia and Indonesia (listed in order of how much they trade with Britain). Britain's trade with non-European members of the OECD is more costly than it is with the EU: barriers to trade with these countries are equivalent to 98% of the value of the goods traded, compared to the EU's 85%. In other words, these trade costs would add 98 pence to the price of a good produced in Britain for £1. The cost of trade with emerging economies is higher still. And costs have fallen less with Britain's most important trade partners outside Europe—both developed and emerging—than with the EU since 1995, the first year for which there is data.

The cost of Britain's trade with the EU, on the other hand, dropped by 15 percentage points between 1995 and 2010—although the decline stopped after 2006. And since the EU is Britain's largest trading partner, this fall is more valuable than the smaller reduction in the cost of trade with the non-EU members of the OECD (trade costs with emerging economies have been static). Chart 2 shows by exactly how much. It weights trade costs between Britain and other countries by the amount of

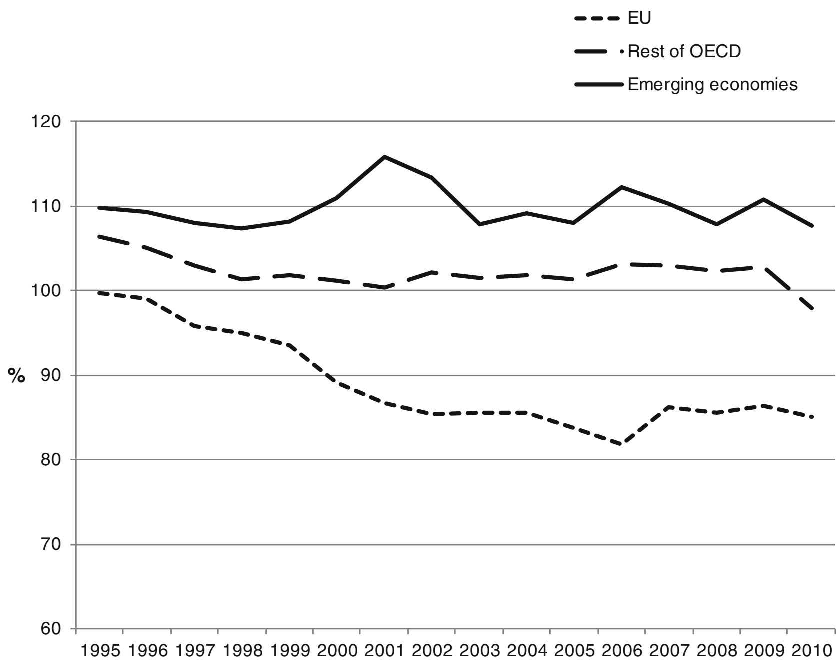

Chart 1 Trade costs between Britain and the EU, the rest of the OECD, and emerging economies. *Source* World Bank ESCAP dataset

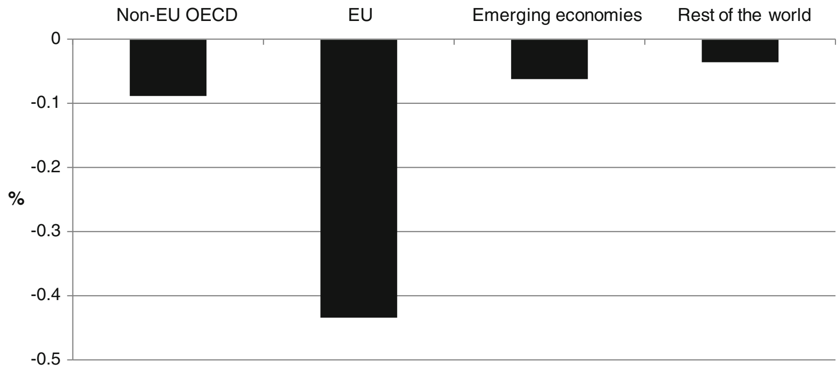

Chart 2 Annual average change in trade costs between Britain and the EU, the rest of the OECD, emerging economies and the rest of the world. *Source* World Bank ESCAP dataset

trade conducted with them. Since around a half of all Britain's trade is with the EU, that fall has cut the total cost of Britain's trade by 0.4 percentage points a year. The small declines in the cost of trade with the rest of the OECD, emerging economies and the rest of the world are less valuable, not only because they have been smaller, but also because Britain conducts less trade with those economies.

However, this is all about the past: one might argue that, after it left the EU, the UK could simply sign an FTA with the Union to secure the existing economic benefits of European integration. Although a Britain outside the EU might be able to negotiate such an agreement, British goods and services could only be sold in EU markets if they met European rules. If Britain's antipathy to EU rules led over time to its adopting different rules for products sold on the domestic market, trade costs with the EU would increase.

Consider an optimistic scenario after a British exit. The EU does not impose the common external tariff on Britain's goods, but trade costs do not fall as quickly with the EU as they had before, because Britain refuses to sign up to all future rules of the single market in order to secure access. And let us assume that the fall in trade costs forgone would only be worth 0.2 percentage points a year, since initiatives to deepen the single market have stalled since 2007. In 10 years, this would amount to a missed opportunity in the form of a 2 percentage point reduction in the total cost of Britain's trade.

Furthermore, it is unlikely that the UK can easily sign FTAs with the rest of the world to make up for any forgone reduction in the cost of trade with the EU. While Britain's trade with the rest of the world is growing faster than with the EU, Europe will continue to be its largest trade partner for decades to come. The rest of the world's contribution to the total reduction of Britain's trade costs was less than one-third that of the EU, between 1996 and 2010 (Chart 3). This means that any attempts to reduce the cost of trade through FTAs with non-EU countries would have to be very comprehensive to make up for forgone trade with Europe.

The preceding analysis has focussed on goods. But is there any evidence that the EU has boosted Britain's services exports? The UK has a strong comparative advantage in the trade of services, with its leading exports being financial and related business services, such as accountancy, law and consulting. In 2015, services exports made up 44% of Britain's total exports.[13] Free movement of capital and unrestricted trade in services constitute two of the four freedoms of the EU's single market, and the EU has made successive attempts to reduce barriers to trade in these areas. Have these attempts worked?

Britain's services trade with the EU has grown at 1.4 times the rate of EU economic growth since 1998 (see Chart 4)—a faster rate than with most other countries and regions. (Since fast-growing economies trade

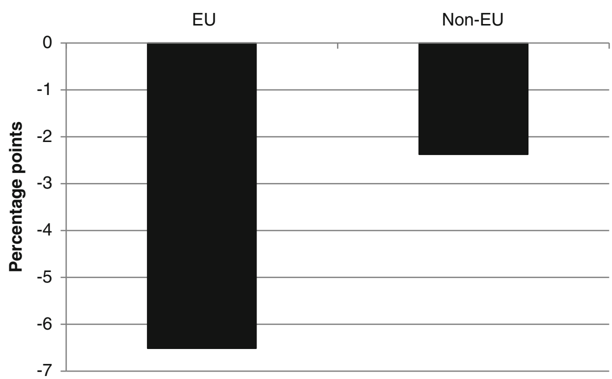

Chart 3 Countries' total contribution to falling UK trade costs, 1996–2010. *Sources* World Bank ESCAP database and ONS UK trade data

more with each other, the only way to tell whether efforts to free up trade are working is to compare the rates of growth in services trade and GDP.) Services trade with the US grew at a similar rate. Britain's services trade with emerging economies rose rapidly between 1998 and 2015, but trade with these countries did not grow at a faster rate than GDP.

However, while Britain's services trade has grown faster with the EU than with any other region, it is not especially impressive. Given the EU's attempts to liberalise services, trade might be expected to be growing at a faster pace. While the EU has made some progress in lowering barriers to trade—the 2004 services directive reduced them by about one-third—there is more that could be done.[14]

The rationale for the fourth freedom of the single market—the free movement of capital—is twofold. First, by allowing financial institutions to move into new markets, it is intended to raise the level of competition, and so drive down prices for consumers. Second, international capital flows allow savings to flow to where they may be most profitably invested, giving savings-constrained but potentially fast-growing countries more capital to invest.[15] How much integration has occurred in retail and inter-bank markets, and with what economic consequences?

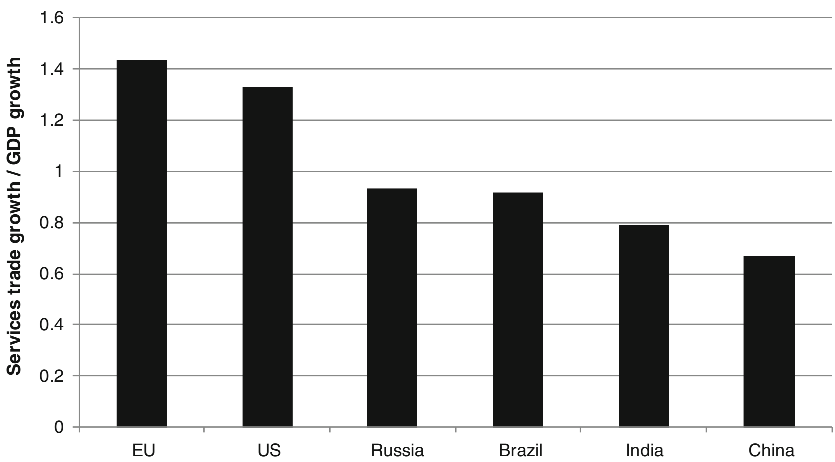

Chart 4 UK services trade growth with major partners, 1998 to 2015. *Source* ONS Pink Book and IMF World Economic Output database

Declining transport and communication costs have driven globalisation. But their impact across economic sectors has not been uniform. In the manufacturing sector, for example, supply chains have displayed a tendency towards increased geographical dispersal across the globe. In the financial sector, by contrast, the reverse has often been the case: lower communications costs have coincided with financial services—and wholesale financial services in particular—becoming increasingly concentrated in a small number of 'global cities'.[16] The City of London has been one of the principal beneficiaries of this trend.

For Britain, the biggest impact of the single market in services and capital has been on the City of London as an international financial centre. The development of the single market, as well as the reduction in barriers to capital flows across the developed world, led to larger cross-border flows of savings looking for investments, and the growth of European bond and equity markets. (The British government and its officials were leading advocates for the single market programme, and its architects: the advantages of a liberalised European financial system for the City of London were obvious.) UK-based banks now preside over a quarter of all EU banking assets.[17]

As well as being the largest global financial centre in the EU, the City of London is also at the centre of the eurozone's financial system. Over the last economic cycle, the City integrated faster with the EU than with markets elsewhere. Chart 5 shows British banks' lending to the EU, the US, Japan and emerging and developing economies.[18] UK-based banks built up heavy exposures to both the eurozone and other EU member-states, with the scale of flows growing much faster than eurozone or EU GDP between 1999 and 2008. The financial integration between the UK and the eurozone was five times greater than with the US, adjusted for economic size, in the depths of the euro crisis in 2012.

In sum, the evidence suggests that the single market programme has achieved some of its aims—although the degree of integration in goods markets has been markedly higher than that achieved in services sectors. The result has been a modest boost to UK national income, and to that of the EU as a whole.

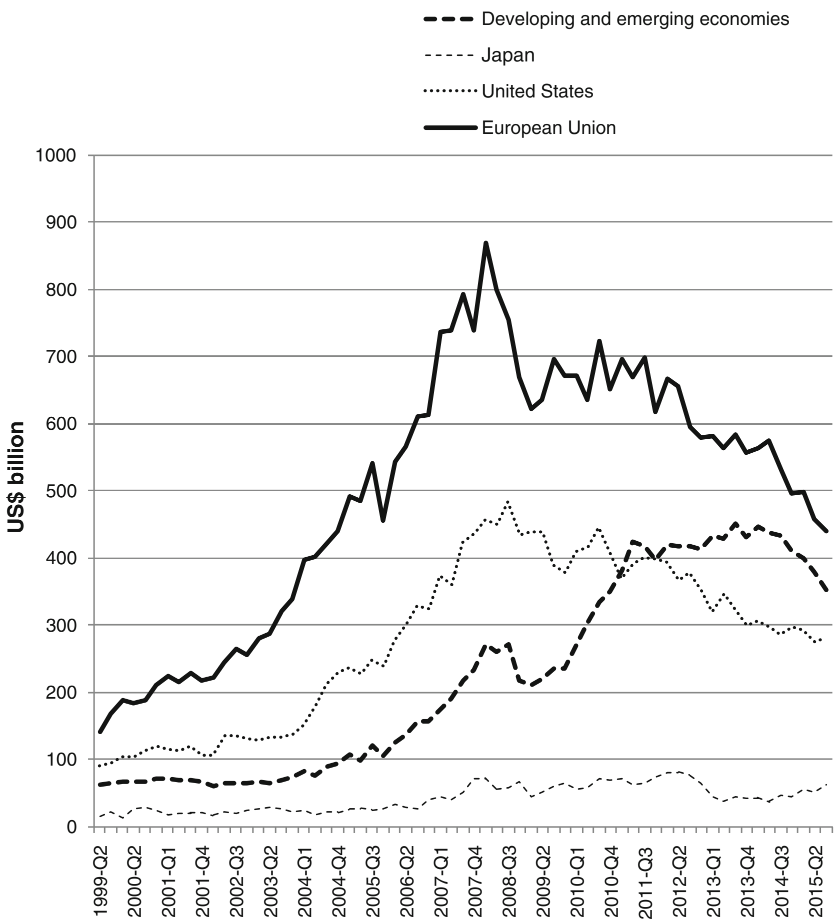

Chart 5 UK banks' international assets. *Source* Bank of International Settlements

1.3 The Gains from 'de-Europeanising Britain'

It follows, then that the gains from 'de-Europeanising Britain' are unlikely to be as large as British critics of EU regulation imply—and, if British and EU regulation after Brexit diverges in a manner that raises trade costs, national income is likely to be lower than would otherwise be the case, not higher. The evidence that follows suggests that the EU does not impose rigid harmonisation upon its member-states economies; some of its most iconic directives, such as the 'working time directive', are not as costly as its opponents argue; the largest supply-side constraints on the British economy are the result of domestic policy; and Britain, out of necessity, is likely to retain many EU rules even after it leaves the Union.

After Brexit, the UK could in theory be freed to regulate its own product and labour markets as it sees fit (although if it wanted to continue to export to the continent, its firms would have to match many European standards). There may be some benefits from less costly rules in some sectors. But the comparative indices of the OECD for product and labour market regulation show that British markets are already among the least regulated in the developed world.

Chart 6 shows the overall level of product market regulation for the UK, the EU and the OECD. British markets for goods and services are the second least regulated in the OECD, behind the Netherlands, another EU member-state. Rules at the EU level are designed to create common standards in order to make products more tradable: a lawnmower made in the UK can be sold in Germany without having to be manufactured according to German specifications, for example. But the chart shows that EU rules do not appear to impose rigid harmonisation upon the union as a whole: under EU directives, member-states are able to impose higher standards on their own firms if they wish, and over time, other member-states have moved towards Britain's liberal approach, rather than the other way round. It is hard to argue that Britain's product and services markets are highly regulated as a result of EU membership.

The same story broadly holds true for the labour market (see Chart 7). The OECD's indices of employment protection legislation show a greater level of diversity among the countries surveyed, with continental European countries embracing markedly higher levels of employment protection than the English-speaking countries outside Europe. So where does this leave the UK? The answer is that membership of the EU does not prevent the UK from belonging firmly to the Anglophone camp. According to the OECD's indices, employment protection legislation is only slightly more restrictive in the UK than it is in the US or

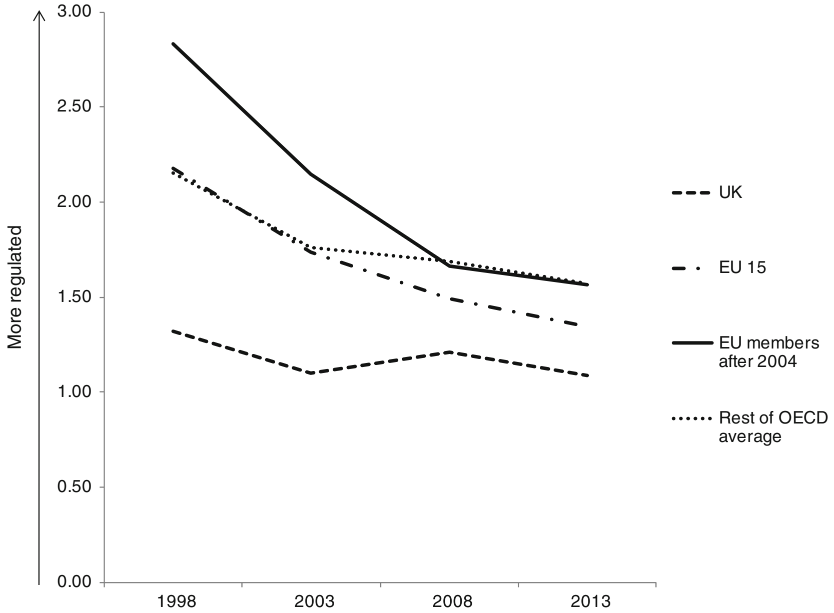

Chart 6 Levels of product market regulation. *Source* OECD

Canada, and less so than in Australia. It is, of course, much less restrictive than in continental European countries like France or Spain.

Some totemic EU rules, such as the 'working time directive', have a surprisingly limited impact. This directive violates the principle of subsidiarity: there was no need to regulate working hours or conditions at EU rather than national level, because there was little evidence that EU member-states were trying to improve economic competitiveness by driving down labour standards. Working hours across the EU were in decline even before the introduction of the directive.[19] Nonetheless, the working time directive's negative effects are marginal at best, not least because of the opt outs the UK has negotiated.[20] Chart 8 shows how many British people work more than 40 h per week. There is a spike at 40 h: 14% of British workers work 8 h a day. There are further spikes at 45, 50, 55 h and so on (because people tend to work 9, 10 or 11 h days, 5 days a week). But there is also a spike at 48 h—the working time limit under the directive. This is evidence that it has an impact on the labour

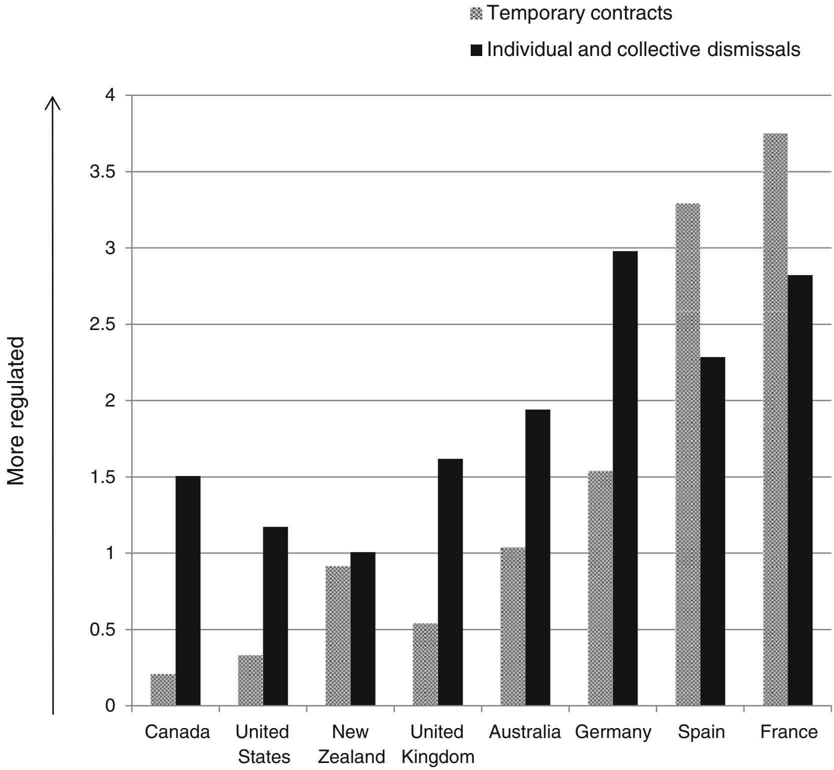

Chart 7 Levels of employment protection. *Source* OECD

market: there is no other reason why a larger proportion of people work 48 h rather than 46. But the spike is small, making up only 1.5% of workers. It follows that the gains in economic output that would flow from the abolition of the working time directive would be small: at best, 1.5% of British workers may work a few more hours a week.

The other bugbear, the Agency Workers Directive, has also had a surprisingly modest impact. The rules, which came into force in 2011, give employment agency workers the right to the same pay, holidays and working conditions as equivalent permanent workers once they have worked for the same company for 12 weeks. Before it came into force, businesses and the Conservative leadership warned that it would make

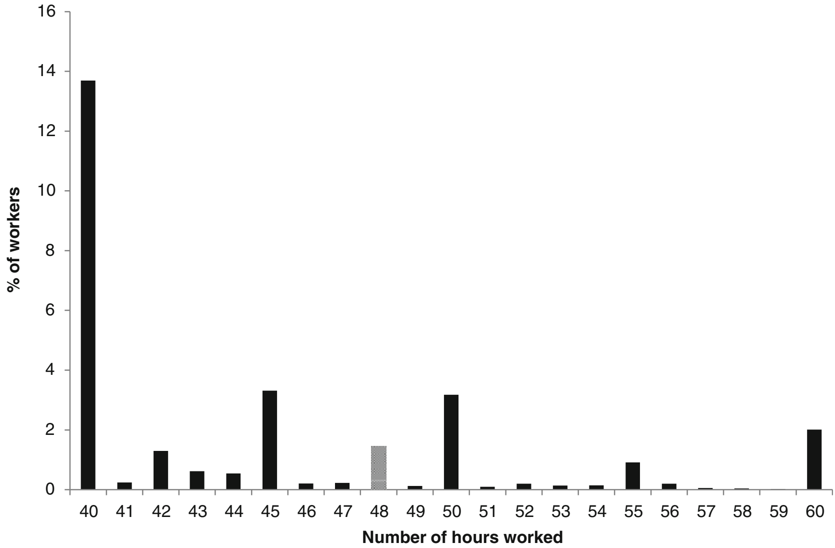

Chart 8 The British working week. *Source* UK Labour Force Survey, Q1-Q4 2013

companies less willing to take on agency workers. But between 2011 and 2015, the proportion of temporary workers who found work through an agency grew from 19 to 20%: the regulations did not lead employers to switch from agency temps to other temporary workers.[21] Chart 9 shows that agency employment continued to climb after the rules came into force. The chart also shows that businesses continued to make use of a loophole that allows an exemption from the right to equal pay if workers are formally employed by the agency, not the company they are working for. Two-thirds of agency workers were employed by agencies, not employers. The largest potential cost of the regulations—equal pay—therefore only applies to a minority of agency temps.

All this suggests that the most valid criticism one can make of the Working Time and Agency Workers directives is that, thanks to opt outs and loopholes, they fail to meet their stated objectives.

Alongside its labour and product market indices, the OECD has compiled an index of the quality of countries' regulatory regimes

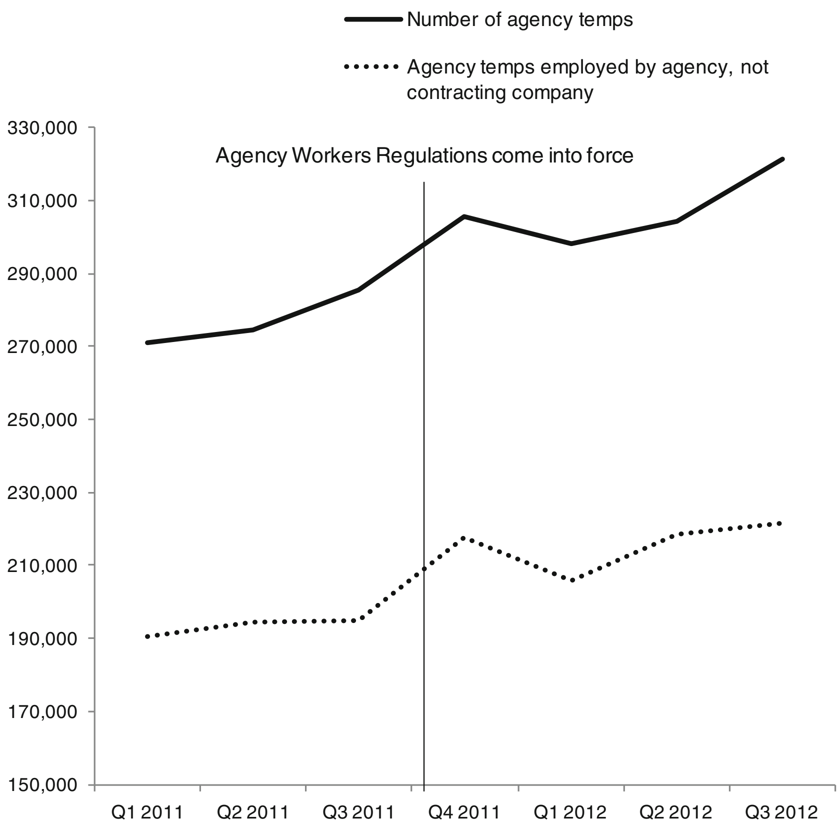

Chart 9 The impact of the agency workers directive. *Source* Chris Forde, 'The effects of Agency Workers Regulations on agency and employer practice', ACAS, 2014

(Chart 10). The OECD tested the European Commission's rule-making process alongside those of other countries, and found that it is of better quality than the OECD average—and similar to that of UK and Australia, which the OECD ranks highest. There can be little doubt that some proposals are forced through the EU's legislative machinery without proper assessment of the potential costs, but it is far from clear, on the basis of the OECD's index at least, that the EU does this more than the UK itself.

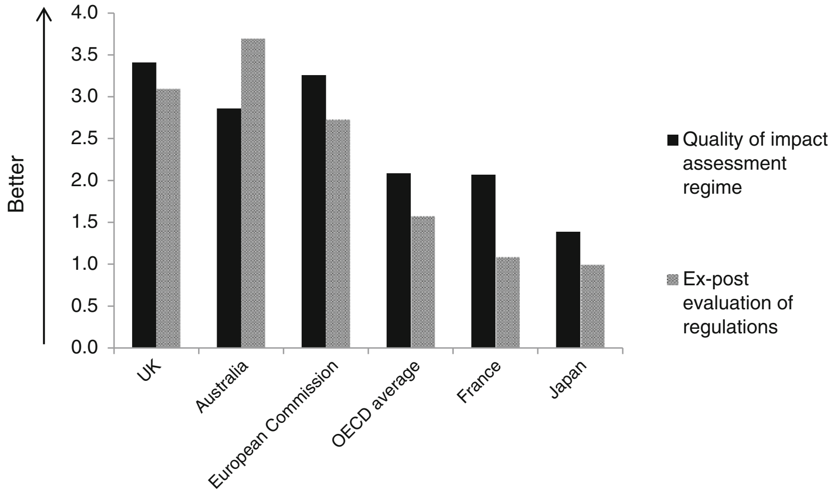

Chart 10 The quality of regulatory regimes. *Source* OECD

At a macroeconomic level, then, any gains from leaving the EU are likely to be limited: a bonfire of European rules would not transform Britain's economic prospects. European rules are not major supply-side constraints upon the British economy: according to the OECD, the largest of these constraints are the result of poor domestic policy.[22] The OECD is especially critical of Britain's rigid planning rules and its restrictions on making land available for development. These rules help to explain why, despite rapid growth in the population, housing construction is running at half the level of the 1960s; why the average size of new homes built is smaller than anywhere else in the EU; why office rents are the highest in the EU; and why Britain's transport infrastructure is so congested and expensive to build.[23]

The OECD also criticises Britain's education system, which is a vital public good, given the importance of human capital to economic prosperity. The UK's record in this area is patchy. It has assets, such as the best of its universities, which are world class. But its rates of literacy and numeracy at age 15 are only around the EU average, as are its rates of graduation from secondary education. Add to this the longstanding weaknesses in vocational training, and the result is that Britain has a comparatively large number of people with low skills—a failing that constrains Britain's labour supply to a far greater degree than EU employment rules.

Is it not possible that the UK could become more attractive as an investment location after Brexit? Outside the Union, would the British authorities not be free to reduce the cost of doing business in the UK, by lowering social and environmental standards, for example? Britain would certainly be freer to introduce less onerous regulatory requirements for new technologies, such as nano-technologies, the life sciences, genetically modified agriculture, space vehicles and interactive robots. This could increase the attractiveness of the UK as an investment location for these sorts of activities.[24]

There may, therefore, be some gains from more relaxed standards in particular sectors, especially in technologies that may drive up productivity. But any small benefits that arose from better regulation must be set against the costs incurred by British exporters and the loss of foreign investment.

Besides, it is far from certain that Britain will reduce most environmental and social standards after withdrawal. After all, some environmental standards in the UK are more stringent than those required by the EU. Britain has, for example, introduced a far more ambitious system of carbon pricing than that countenanced by the EU as a whole. And any UK government would face fierce domestic opposition to further erosion of labour and social standards. It could, of course, choose to live without any equivalent to the EU's working time directive, but it would be a brave government that explained to Britons why they should lose their statutory right to 4 weeks' paid holiday a year.

Brexit will force the British government to choose either lose further sovereignty in order to maintain single market access—or gain power over regulation and lose that access. If it seeks a close economic relationship with the EU, Britain will have to sign up to many of the EU's rules. As a non-participant in the EU's institutions, it will have little say over the rules' drafting—and without the UK's liberal principles informing the regulation-setting process, EU rules may be more restrictive than they are now. If it leaves the single market entirely, the British government will be unconstrained by EU regulations and directives, but will face higher barriers to trade with the EU. The politics points in one direction and the economics in another: the British government faces a Herculean labour to satisfy both.

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