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**The UK and the new face of Europe**

Sir Richard Lambert

The question I want to discuss tonight is:

“Would Britain be a better place to do business if it were outside the European Union?”

The reason for putting this question is that the tone of the European debate in this country has changed significantly in the past few months. The Prime Minister has promised an in-out referendum in 2017. And the polls say that a vote today would have us heading towards the exit.

Would that, as the Euro sceptics claim, be a golden opportunity to shake off the costs and constraints of an economically and politically sick continent, and to build a prosperous future in a wider and much more dynamic world?

Or would it instead represent a reckless gamble?

In the spirit of full disclosure, I should say that I have always been a believer in Britain’s role in Europe. And as editor of the Financial Times back in the 1990s, I supported the case for the UK’s membership of the Euro.

I’d be happy to discuss the reasons why during the question period.

I should also acknowledge that pro-Europeans like me have had quite a few disappointments to cope with in recent years.

The failure to complete the single market.

The design flaws in the Eurozone that were so brutally exposed by the global financial crisis.

Today’s bleak economic outlook.

And so on.

So far, most of the arguments on either side of the debate have been based on questionable assertions, rather than hard data.

Wild estimates of the costs of membership on the one hand.

Improbable figures about the numbers of jobs that would be at risk if Britain left the EU on the other.

I’m going to focus entirely on the business story.

Nothing about security, governance, justice and home affairs, agriculture and fisheries, or the rest.

And I want to base my arguments as far as is possible on evidence. The picture is not as black and white as is often claimed by euro sceptics and enthusiasts alike.

But the evidence is clear enough for those who are willing to look for it.

From a business perspective, it suggests that the risks of leaving the EU would significantly outweigh the costs of staying inside.

My plan is to look first at the costs of membership, in areas like regulation, labour market constraints, and budget contributions.

I’ll then examine the economic benefits of being part of the world’s biggest trading block, measured in terms of foreign investment in this country, the prosperity of the City, trade, and the country’s strong science base.

I’ll suggest areas where reforms are needed, and are achievable.

And I’ll conclude with suggestions about where the national policy debate should be heading.

First, the costs.

In any kind of guessing game, the words red tape and Brussels comfortably fit alongside each other. Put them together on Google, and you get just over 1 million results.

Our euro-hostile media is constantly having fun with the latest daft ideas coming from the fringes of the European Commission, and businesses regularly complain that Britain makes a bad situation worse by gold plating the regulations, and thus making them more costly to follow.

But the fact is that if you are going to have a single market, you are also going to have to accept common rules. Much more effective than a free trade agreement, which simply gets rid of tariff and subsidy barriers to trade, a single market grapples with non tariff barriers – like different regulatory regimes – which are often a much bigger block to cross border trade than simple tariff barriers.

And for most people in this country, including our Prime Minister, this single market is probably the EU’s greatest achievement.

As Luuk Van Middelaar writes in a recent book: “The fact is that building a market, unlike a free trade area, continually requires new legislation which, even if mostly technical, at times involves deeply political choices.”

In Europe’s internet economy, who decides the rules on consumer privacy? In a European market for financial services, who picks up the tab when a bank goes bust? And so on.

Euro sceptics put dubiously large numbers on the costs of EU regulation to British business. But if you allow for the fact that some regulations would also be necessary if we were outside the EU, and that a good few of the rules bring business benefits - such as increased access to markets - the net cost is likely to be rather modest.

One way of judging this is to look at the latest OECD survey of the UK, which shows that in 2008 the UK was ranked the least restrictive not just of all EU countries but of all OECD members – including the US - when it came to product market regulation. And it’s also high up on the list among those ranked the least restrictive for overall administrative regulation: it comes in at number seven.

For its part, the World Economic Forum’s Global Competitiveness Report for 2012-13 put the UK at number 8 out of 144 countries for its overall competitiveness, hardly suggesting an economy that was being strangled by red tape.

It’s worth noting that four other EU countries – Finland, Sweden, the Netherlands and Germany, came in ahead of the UK on this table.

And claims by business that the UK gold plates EU regulations are also exaggerated. A study earlier this year from the Department of Business showed that gold plating, if it ever existed, doesn’t any more.

Product market regulation is irritating enough for the Euro sceptics. Labour market regulation is even worse. Their hostility is understandable. The working time directive, which requires a maximum working week of no more than 48 hours, was introduced in the very different political climate of the early 1990s to make the single market more acceptable to trade unions.

It’s had a real impact on the public sector, especially on British hospitals that rely heavily on junior doctors to care for patients out of hours. But the consequences for British businesses today are very limited. That’s because they can use an opt-out allowing individual workers to put in more than the 48 hours a week.

The working time directive, along with its associated agency workers directive, is a pain in the neck. It needs reforming.

But it’s not important enough in economic terms to be a casus belli with Brussels. And the British would not be alone in seeking for change. Implementation of the directive is patchy across the EU, and some 16 countries are now using an opt-out of one kind or another.

That can hardly be beyond the reach of sensible negotiation.

The more important point, however, is that the UK’s labour market has become a lot more, not less, efficient and resilient in the past few decades thanks in good measure to the reforms set in train by the late Baroness Thatcher.

Private sector employment in this country has held up astonishingly well over the past five years, as workers have been willing to trade wages for jobs. That’s in marked contrast to what happened in both of the last two recessions. As a result, the unemployment rate is currently running way below the EU average at 7.8 per cent, compared with over 12 per cent in the euro zone.

And an index of employment protection legislation, again published by the OECD, shows that the UK regime is only slightly more restrictive than that of the US and Canada, and a very great deal less than it is elsewhere in the EU.

When it comes to labour market rules, Britain belongs firmly in the Anglophone rather than the European camp. It’s not in the same league as the likes of Spain or France.

Finally on the costs side comes the UK’s contribution to the EU budget. In net terms, that works out at around £8bn a year, or around a half of one per cent of GDP. On a per capita basis, the figure emerges at E180 a year, compared with an EU average of E205 and E241 for Germany.

It’s most unlikely that we would save all our £8bn net contribution in the event of a British exit. To take one example, farmers receive EU subsidies of around £2.7bn a year from the EU. They are a formidable lobbying group, and would be pressing hard for compensation from the taxpayerin the event that these funds were withdrawn.

And anyway it’s probably wrong to look at the EU contribution in such simple book keeping terms. Membership of a 500 million strong single market brings tangible economic benefits.

But the truth is that it’s just as difficult to calculate the benefits as it is the costs of EU membership to us all.

So rather than dreaming up numbers on either side of the argument, it’s probably safest to suggest that in the context of an overall economy with annual output of around £1,500 billion, the costs of membership after taking everything into account is plus or minus close to neutral.

And those who argue that the costs of EU membership are crippling British business have to answer the German question.

How is it that a country with a more regulated market for products and services, a more restrictive market for labour, and a higher EU budget contribution has turned itself into the world’s most successful export nation?

What about the benefits?

The most obvious is foreign direct investment – international companies building up business activities in this country. This has never been more important than it is today.

With household budgets under pressure and government cutting back, private sector investment will be a vital driver of growth and job creation in the years ahead.

Foreign owned businesses are also a very important source of innovation and productivity growth. They are much more research intensive than their British-owned counterparts: they account for 25 per cent of all business R&D in the UK, which is more than five times the figure for foreign-owned companies in Germany.

And they have transformed whole sectors of the British economy, all the way from motor vehicle manufacturing to financial services, in the past few decades.

Inward investors now account for around half of UK manufacturing and just over two fifths of output in the services sector, although it’s true that their shares in gross value added and employment are rather lower than that due to their greater use of purchased inputs and relatively low labour intensity.

Roughly half of all European headquarters of non-EU firms are based in the UK – more, in fact, than those in Germany, France, Switzerland and the Netherlands put together.

The UK has been the leading destination for inward investment in Europe for many years and for all kinds of reasons – language, location, the legal system and so on.

A survey by UK Trade and Investment of the companies that it helped to locate in the UK during 2011-12 shows that for them the two most important factors when considering the UK as an investment location were that other similar businesses were already successful here, and that skilled workers were available.

But next highest on the UKTI list came the UK’s potential as a gateway to other markets in the region: nearly three quarters of investors rated this as either very or fairly important.

For the Japanese motor manufacturers in particular, the UK has been a very attractive launch pad for sales into Europe. That’s why a number were lobbying vociferously for UK membership of the Euro back in the 1990s. Their investment has rebuilt what was a moribund sector in this country, and turned it into a major export earner with a heavy focus on Europe.

Four-fifths of the cars made in the UK are exported, and the bulk of them go to other members of the European Union. In 2012, a bad year for the European car market, 75 per cent of Toyota’s UK exports went to the EU.

There’s a similar story in finance.

A survey by CityUK of 147 location decisions between 2006 and 2012 found that more than two-fifths of financial firms gave access to European markets as a core reason for choosing London.

Financial firms also place a high premium on London’s attractions for talented workers from across the European Union and beyond. I should declare an interest here, as senior independent adviser to Deutsche Bank.

You only have to look around you to see that London is the place where many of the brightest young people in Europe want to study, work, and live.

But the country’s success in this respect cannot be taken as a given.

Ernst & Young publishes today (June 6) its annual survey of the UK’s relative attractiveness for inward investment. It shows that Britain retained its lead in Europe last year, with healthy increases in the number of projects secured and in its European market share.

But the survey also contains some worrying features.

It shows that for the first time the UK slipped behind Germany in 2012 in terms of new projects secured, as opposed to reinvestments from existing investors. Ten years ago, the UK secured more than three times as many new inward investment projects as Germany. Now, global investors rank us behind Germany as Europe’s most attractive country for foreign direct investment, or FDI, over the next three years.

And Germany has maintained its lead over the UK in attracting projects from emerging economies like China.

Here again, there’s a German question for the Euro sceptics. Why is China choosing a country that is not only locked into the heart of what they see as a moribund union, but which also speaks a language that is almost as impenetrable as its own?

There’s more. Today’s EY survey shows that inward investment in this country is increasingly concentrated in the South East – investment in England outside London in 2012 was nearly a quarter below the level two years earlier.

And the most attractive sectors for foreign investors are seen as business and financial services, together with software. With a few spectacular exceptions, the country is struggling to secure FDI in sectors like manufacturing, chemicals and electronics.

So there is now a question mark over the flow of inward investment.

And unless you believe that leaving the EU would create enormous cost savings and new dynamism for business in Britain - and I’ve tried to suggest that it wouldn’t - then it’s hard to think of any reason why the current debate about leaving Europe should be anything other than damaging to the UK’s attractions as a location for foreign investment.

Financial services are one of the prime sources of inward investment in the UK, and make up one of the sectors where the UK has real global strength.

And there are today strongly opposed views in the City on the European question.

If you believe the gossip columns, prominent hedge fund managers are becoming close to the UK Independence Party. And Lord Lawson in his article in the Times last month claimed that escaping from what he called the frenzy of financial regulations emanating from Brussels would be one of the prime economic reasons for quitting the EU altogether.

On the other side of the argument, Gerry Grimstone, chairman of Standard Life and of CityUK has said that “It is really poppycock to believe that the City can survive in its present form if it is not an integral part of the European financial services framework. London must have complete and unfettered access to the wholesale Euro markets.”

Growing Eurosceptism in the City partly reflects the broader national mood, as reflected in the opinion polls.

But there are more specific reasons for a more hostile attitude.

One is the view that the regulations which have come from the European Union since the financial crisis have been shaped at least in part by the idea in continental Europe that the financial catastrophe was a consequence of the excesses of Anglo Saxon capitalism.

As Francois Hollande said in his election campaign last year, “Finance, c’est l’ennemi.”

Regulations that City critics believe have been influenced by this prejudice include the Alternative Investment Fund Managers Directive.

But the two initiatives that have been the source of particular rage in the City have been the proposed cap on bankers’ bonuses and – above all – the proposed Financial Transactions Tax, or FTT. Although the UK itself will have no part of such a tax, the Commission has made it plain that the FTT – if and when it comes – will apply to transactions in the City if the counterparty has its headquarters within the FTT zone.

This is seen as the crudest kind of intervention into the workings of our financial markets.

A second reason for growing tensions in the City stems from the nature of the Eurozone crisis itself.

Eurozone members are being forced to contemplate deeper integration to hold the system together. This would include a banking union, of which the UK would not be a member. One concern is that the integrity of the single market could be jeopardised by the actions of the eurozone core.

Another is that the core countries could attempt to discriminate against non-members, an example being the European Central Bank’s wish to locate clearing houses handling euro-denominated business within the eurozone as opposed to London.

So how to unpick these arguments?

There is no doubting the EU’s importance to the City. Wall Street flourishes on the back of the vast US domestic economy. London, with no comparable domestic support, is built instead on the European economy. In 2011, £17.6bn of the UK’s £46.7bn trade surplus in financial services was derived from business with other EU member states.

The single market is of crucial importance to non-EU firms locating a subsidiary in London and operating across the EU through branches of most types of financial services. That’s because, like firms from within the EU, the single market gives them a passport to carry their services across all 27 countries in the Union. If they are cleared to operate in one country, they can do business in them all.

If that passport was taken away in one country, there would be a strong temptation to move to another to do business.

If the UK were to leave the European Union, the strongest voices in financial regulation would be those which have a cultural bias against what they see as London’s casino-type capitalism, and which would be looking for ways to weaken its competitive advantage.

And London for its part would not be able to turn its back on an economic region which accounts for such a large part of its business.

Much better for the UK to retain a seat at the regulatory table, working with allies to retain liberal and open capital markets. It’s not a lost cause – witness the way in which the Financial Transaction Tax is now being delayed and whittled down in the face of pressure from all across Europe. In the end, it may turn out to be not that much more threatening than the stamp duty which has been imposed in this country on share transactions for many years past.

And our European partners will need us there. As bank lending shrinks across Europe, companies are increasingly seeking to raise money in the capital markets, and the US model is becoming much more relevant.

There, banks account for only about a fifth of long term company financing. In the big European countries, by contrast, the proportion is nearer to 60 or 70 per cent. Europe will need a bigger and more active corporate bond market to finance its future growth, and London is much the best placed in Europe to deliver it.

It’s a great opportunity for the City, provided we stay in the game.

What if we don’t?

The lights won’t go out.

In the words of Richard Gnodde and Michael Sherwood, co-chief executives of Goldman Sachs International, the threats “would manifest themselves over time, not overnight. It takes years for businesses to move headquarters and for other cities to build the houses, schools, office space and services needed to handle a new cadre of workers.”

But, they conclude, “Large international and European companies see a Britain divorced from the EU as a much less attractive place. Threats to British involvement in the EU are threats to British business.”

It’s one thing for a hedge fund manager to respond to unwelcome tax or regulatory changes by jumping on a plane to Switzerland: these people are highly mobile, and can easily shift back and forth.

It’s quite another for a large international bank, with thousands of employees in the City. And these are the ones who are most likely to see a British exit as a serious threat to their British-based business.

Trade is the next big area to examine from the business perspective.

Here the facts are reasonably easy to establish.

Roughly half of British exports go to the EU, a proportion that has been declining in recent years as the emerging economies have gathered steam and Europe has languished. Between 2008 and 2012, exports of goods to the EU rose by just over 6 per cent, whereas those to the rest of the world jumped by more than a third over the same period.

However, exports to the fast growing emerging economies are still comparatively modest. We sell more to Sweden than to India: more to Denmark than to Brazil. The main reason for this is that we don’t produce enough of the goods and services that these countries now want.

The OECD has analysed the export structure of the UK and Germany and compared this to the import structure of the BRIC countries of Brazil, Russia, India and China. What this shows is that Germany is very strong in precisely those sectors where countries like China are most hungry for imports, especially machinery and transport equipment.

The UK is strongest in areas where imports to the BRIC countries are least important and in some cases face heavy protectionist barriers, such as financial and business services.

So it makes no sense to suggest, as do some Euro sceptics, that if only British businesses were less preoccupied with Europe they could do a lot better in the faster growing economies of Asia.

The stuff we are best at, these countries often don’t want – for the moment, at any rate.

Coming back to Europe, I’ve already suggested how the single market benefits financial services, through the passporting rules. Let’s look at a very different industry: Scotch whisky. An analysis in the Economist magazine earlier this year argued that “the EU is now the industry’s essential sword and shield for conquering world markets.”

The EU still accounts for around two fifths of total Scotch sales. When a new country joins the single market and removes its trade barriers, its consumption of whisky tends to shoot ahead. And whisky makers prefer common EU rules to lots of national regulations on everything from bottle sizes to labels.

Above all, the EU’s weight in global trade negotiations is crucial to an industry which still faces roughly 600 protectionist barriers around the world. Indians consume almost as much whisky as the rest of the world put together. But they mainly drink local stuff that would make the true Scot faint away in horror. And they impose whacking tariffs of around 150 per cent on imported whisky, putting the real thing beyond the reach of all but the rich.

Small wonder that the distillers are hoping for big things from the Free Trade Agreement that the EU is now negotiating with India. The UK on its own would not have anything like the same clout around the negotiating table.

This is a vital point to emphasise. According to CBI data, the EU has negotiated trade agreements that cover around 30 per cent of trade outside the EU area, and discussions are in train that could take this figure up to around 70 per cent.

In other words, British exporters don’t just benefit from access to the single market. They also gain from free trade arrangements that the EU has negotiated with much larger parts of the globe. The big one that’s on the table now, of course, is a potential free trade agreement between the EU and the US.

An independent assessment last month of the impact of a successful Transatlantic Trade deal concluded that it could benefit the UK by between £4bn and £10bn a year.

No one knows what the UK’s position would be so far as these trade deals are concerned if it were to break away from Europe. Would it have to negotiate them all again separately, and if so how long would it take and what might the terms be?

Everything would depend on the conditions of an exit.

One option might be to become a Norway, and join the European Economic Area. Let me quote briefly from an official Norwegian government report last year: “The most problematic aspect of Norway’s form of association with the EU is the fact that Norway is in practice bound to adopt EU policies and rules on a broad set of issues without being a member and without voting rights.”

“ This” the report adds coyly, “raises democratic problems.”

This is not a prospect to set anyone’s heart beating.

Or we could become a Switzerland, and do business with EU countries through a whole series of bilateral deals. But that would be painfully hard work, and would involve trade offs. With no agreement for financial services, for example, the Swiss have come up with their own very stringent set of rules. It’s unlikely that the EU would offer similar treatment to an economy of the UK's size, especially in the aftermath of a painful divorce.

And countries outside the EU, like Norway and Switzerland, don’t benefit from its Free Trade agreements.

The Prime Minister has rightly knocked both these ideas on the head.

Lord Lawson goes a step further than Norway or Switzerland. He argues that “the relevant economic context nowadays is globalisation, including global free trade with the World Trade Organisation as its monitor”.

But of course the WTO does not offer free trade, and does not cover services as fully as the single market.

UK car manufacturers effectively saved the equivalent of £1,100 per vehicle exported to the EU in 2009 by not having to pay the common external tariff.

They wouldn’t shut down shop if they were faced with such trade barriers.

But would they add to their existing investment in this country?

Europe is a vital market for food and drink, the UK’s biggest manufacturing sector. Nine out of the top ten markets for UK exports of food and non-alcoholic drinks in 2011-12 were in the European Union. World Trade Organisation or not, tariffs on sales to the EU in important sectors like dairy products would simply be prohibitive if the UK was out of Europe.

There would also be pressure from domestic producers, such as farmers or car manufacturers, to impose tariffs on imports both from the EU and the rest of the world, with damaging consequences for consumers.

That’s why a prominent eurosceptic like Lord Leach argues that exit would be a big mistake: instead, he believes, the UK should stay in the Union and fight for reform.

The eurosceptic think-tank Open Europe came to a similar conclusion last year. After a detailed study, it concluded that “from purely a trade perspective, EU membership remains the best option for the UK.”

Or as the Prime Minister put it in January, “Continued access to the single market is vital for British businesses and British jobs.”

It’s impossible to put numbers on the potential risks to UK trade of an EU exit. But I think it’s fair to suggest that they would be substantial.

Finally under my list of benefits, let me touch briefly on a subject that deserves more debate than it’s been getting, which is science.

Britain’s strong research base has made it a major beneficiary of EU science funding – nearly £5bn of so called Framework 7 funding and £1.2bn from the European Research Council, which in the latter case is more than a fifth of the total. Earlier this year it was announced that 80 out of the 302 senior researchers awarded a share in the latest tranche of Research Council money would be based in the UK, twice as many as the next most successful country.

Some of our most globally successful research universities now get a fifth or more of their research funding from Europe.

Research collaboration across borders, in projects like the EU-sponsored Innovative Medicines Initiative, is also very important, and so is the free movement of scholars.

Sir Paul Nurse, president of the Royal Society, points out that it was easier for our recent Nobel prize-winners, the Russian born Andre Geim and Kostya Novoselov to come to the UK because they were already working in the Netherlands.

In Sir Paul’s careful words, “Looking at it from the perspective of science in the UK, it would be hard to make a case for us being better off outside the EU.”

This matters for the economy, given the importance of research and brilliant graduates to innovation and productivity growth.

So where do things go from here?

The good news is that there is now a growing appetite around the capitals of Europe for reform, both in terms of the governance and the operations of the EU. This is something which is both important and new.

Europe badly needs growth, and the current crisis provides an opportunity for changes that might not have been politically possible in easier times.

Although the arguments for reform stretch well beyond the economy, there’s a lot to go for in the business sector. The single market remains incomplete, notably in services. These now account for around 70 per cent of employment and value added within the EU, but for only 20 per cent of intra-EU trade – indicating the low tradability of services across borders.

The 2006 directive left national governments with too much discretion to decide what constitutes a barrier to the provision of cross border services, and there are all kinds of areas where increased competition would boost productivity and quality. Construction and retail are obvious examples.

Employment law could, as I’ve said, be made much less intrusive to reflect today’s changed economic circumstances. EU-wide recognition of professional qualifications in a much wider range of profession than now available is also important.

Among other things, we should work to:

Create a fully functioning digital single market, as well as a single market in information and communications technology.

Be more ambitious in liberalising the energy market, and sort out the mess that is the European Emissions Trading Scheme.

Push for more Free Trade Agreements, and above all nail a deal with the US. This would provide a great platform for those who argue in favour of continued EU membership for the UK.

Press further on the better regulation agenda. Make it easier to scrap redundant legislation – at present, getting rid of a redundant law seems to be almost as difficult as passing a new one.

Create an independent authority to vet proposed legislation for its impact on growth and competiveness, and do a better job of holding back legislation like the Financial Transactions Tax, which has been pushed forward for political reasons despite the obvious questions about its economic consequences.

Much will depend in the next few years on how the Prime Minister plays his hand. He knows that the way to achieve progress in Brussels is through consensus rather than by threats. And he also knows that he is not alone in his wish to deliver what he described in his speech in January as “a more flexible, adaptable and open European Union in which the interests and ambitions of all its members can be met.”

He has potential allies right across the continent.

The risk right now is that the only voices urging him on from this country UK will be those of the Euro sceptics, and that political pressures will drive him to negotiate with one hand behind his back – setting out too many red lines and in the process unsettling too many potential allies.

And this is where the business voice will be important.

Business leaders prefer to keep out of the political spotlight, especially if it’s likely to expose them to the wrath of our aggressively Euro-hostile media.

But what they are paid for is to assess, manage and where necessary mitigate risk.

So if they believe – as I do - that the risk to British business of EU withdrawal does indeed exceed the costs of membership by a wide margin, and has the potential to cause lasting economic damage to our country, they have a responsibility to speak out.

Now.

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