

MAYOR OF LONDON

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# THE EUROPE REPORT: A WIN-WIN SITUATION

AUGUST 2014

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# THE EUROPE REPORT: A WIN-WIN SITUATION

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## Message from the Mayor – Europe Report

I am delighted that Gerard has synthesised the arguments in this report for those who wish to engage with the debate about our relationship with the EU over the next eighteen months. This report will help guide you through the thicket, and will help us as a city to plot our own course as we determine the best possible form of governance for Londoners.

A handwritten signature in black ink, appearing to read 'Boris Johnson', with a long horizontal flourish extending to the right.

**Boris Johnson**  
Mayor of London

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# Foreword

## by Gerard Lyons

The world economy is changing dramatically with new economic powerhouses like China, India, Nigeria and Mexico, new trade corridors with flows of goods, commodities, remittances, portfolio and direct investment flows between more and more regions of the world. There is greater potential innovation and investment, medical advances and new technology. There are many more people too, as populations grow, people live longer, new consumer markets emerge to sell into, and there are new networks of people across the globe.

London, the UK and Europe need to ensure they position themselves in this changing and growing global economy. Cities, countries, companies and citizens need to play to their strengths, adapt and change and embrace this new globality.

It is in this context that the issue of the UK and the European Union needs to be addressed.

The origins of the EU were in an era few may think is anything like now. In the wake of the Second World War Europe was in tatters. The desire to avoid another war, a dependency upon US Marshall Aid and the early stages of the Cold War were the environment in which in 1951 The European Coal and Steel Community was founded at The Treaty of Paris. At that time Clement Attlee was the British Prime Minister. The Treaty of Paris was signed by six countries, Belgium, France, Italy, Luxembourg, Netherlands and West Germany and they agreed to a common market in iron and steel. The forerunner of the European Union was formed. Six years later the same six countries signed the 1957 Treaty of Rome and the European Economic Community was founded. There has been no turning back since.

That is the economic model that has driven Europe since. Ask yourself is that the economic model for the changing world of the 21st century?

In the early 1970s the UK joined the Common Market. We believed the European economic growth model was a success. We were told Europe's Common Agricultural Policy would be changed. Now, Europe's economic growth model disappoints, while the common agricultural policy, even after reform, accounts for a massive one-third of the European Union's budget.

We should not kid ourselves that all is great with the London or UK economy and we can't blame Brussels or Europe, as sometimes happens, for all our problems. Despite increased investment now, over many recent decades the UK has not invested enough in its infrastructure or in building houses. Our university system is world

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class yet we still have an education system where many leave without basic skills to cope in a competitive global economy. London itself hosts some of the UK's poorest boroughs and one in five of its workers earn less than the London Living Wage. Youth unemployment is high, although now thankfully is falling. Despite all this, there is so much exciting about what lies ahead, certainly for London and the UK. London's economy looks set to grow strongly.

It is not a case of choosing between Europe and the rest of the world. Our geography, history and culture mean Europe will be a big part of our future whether we are in the EU or not, but so too should the rest of the world be a big part of our future. London is a global city and the UK is an open, trading, outward looking economy.

This report was commissioned by the Mayor to look at the issue of the UK and Europe and help inform him on the key issues, including what it means for the London economy. There are six sections. First, we consider the key issues. Second, we look at the London economy. Third, we review and summarise what has already been said on the UK-EU topic. Fourth, we outline longer-term economic forecasts. Five, we outline what needs to be reformed and sixth, what happens if the UK leaves. The appendix contains much more detail on London and the economic scenarios. An executive summary follows this foreword.

The debate on the UK and Europe has raged on for some time, and I have seen it evolve at first hand. In 1997 I wrote in a column in the *Financial Times* that currency union in Europe could not survive unless it became a political union, and that issue remains with us now. Then in 1999, when chief economist at DKB International, I was the co-author of the Report of the Commission on the £ Sterling, commissioned by the then Leader of the Opposition William Hague to look at the pros and cons of joining the euro.<sup>1</sup> Despite widespread enthusiasm at that time among the City and business community to ditch the pound, that report concluded the UK should not touch the euro with a barge pole.

Today, in the UK, there appears little enthusiasm for the European Union. But there is a fear of going it alone. Ideally, it seems, we would like a few things in Europe to be fixed, less intrusion from Brussels, a bit more power returned to Westminster, some control on immigration flows and then we would be content to take our chances and stay, protected from the ways of the world. There may be variations on this, but for most, the status quo in terms of our relation with Europe is not where we want to be. This report provides some answers.

The title of this report is a 'win-win situation', to reflect the positive options ahead if the UK can help reform the EU into a competitive economy or if the UK leaves and pursues a reformed, outward looking, open economy policy outside the EU.

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<sup>1</sup> 'Britain and the Pound: A prosperous future for Britain', Report of the Commission on the £ sterling, 1999.

The UK can only achieve serious reform if it is serious about leaving, and it can only be serious about leaving if it believes this is better than the status quo of staying in an unreformed EU. It is.

The best economic outlook for the UK over the next twenty years is if it remains in a reformed EU. This report calls this scenario a 'Brave New World'. But it needs serious reform, as we outline here. The issues that arise from this are whether the EU will reform in a way in which it can play an even more important global economic role, and also within this whether the UK can engage more with the EU to play a leadership role within the EU. If it can play a leadership role to push through reform then, from both a future European and also a domestic UK perspective it should. London is a global city and is also Europe's financial centre and, as such, can benefit from any policies that both increase its openness and international appeal.

If the UK cannot achieve reform in the EU it should leave. If the UK leaves the EU and retains good relations with the EU and if the UK pursues growth focused policies then this will provide a better economic outlook for the UK than the status quo of remaining in an unreformed EU. The second best scenario for London is a reforming, open UK that we call 'One Regime, Two Systems' and this is far better than the third best scenario for London of the UK remaining in an unreformed EU, which we call 'Business as Usual'. The worst outcome is to leave and become inward looking.

The future economic and financial success for London and the UK will not depend solely on whether the UK is in the EU or not. Much of the debate gives the impression that the UK will succeed either if it is in the EU - that is the yes campaign - or will succeed only if it leaves - that is the no campaign. It is more complicated than this. If the UK remains in the EU, future success will be heavily influenced by whether the EU reforms successfully, or not. Likewise, if the UK leaves the EU, its future economic performance will be heavily influenced by how the UK positions itself, not just with the rest of Europe in terms of the exit terms, but also with the rest of the world, and on the policies then pursued. The status quo is not an option.

**Gerard Lyons,**  
Chief Economic Advisor  
6th August 2014.

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## Acknowledgments

A number of acknowledgments and thanks are necessary. First, to Nicholas Garrott, my economic assistant, who helped with this report. Second, to the economics team at the Greater London Authority, who carry out excellent work on the capital, and whose work is incorporated in this report and who are under the direction of Andrew Collinge and led by Matthew Waite. Third, as part of this report we wanted some longer-term model driven economic scenarios and we commissioned a report from Volterra. Their work, which forms an important part of the analysis, was led by the economists Paul Ormerod and Bridget Rosewell. Fourth, under the direction of Sarah Gibson, head of government relations at City Hall, London is lucky to have an excellent, small team in Brussels, and thanks to them including Ian Catlow who heads it up. Fifth, thanks to a small steering committee formed in the early stages of this report, and including Mark Kleinman, Shaun Lowthian, Sarah Gibson, Dharmina Shah and Amy Selman. Sixth, thanks to my previous senior PA at City Hall, Helen Hill and to my current one Duncan MacVicar for arranging countless meetings and many other details linked to this report. Seventh, thanks to Helen Booth for proof reading the report.

## About the authors:

Dr Gerard Lyons is Chief Economic Advisor to Boris Johnson, the Mayor of London, taking up this new role in January 2013. His first book 'The Consolations of Economics' was released by Faber & Faber in June 2014. Previously he spent 27 years in senior roles in The City, at Chase Manhattan, Swiss Bank, DKB and most recently at Standard Chartered where he was Head of Global Research, Chief Economist and Economic Advisor to the Board. Lyons has testified to the US Senate and Congress, UK Parliamentary Committees & spoken at Davos, the IMF and other global fora such as the EU-China Summit in Beijing. He has regularly topped forecasting polls and was one of only two UK forecasters predicting an imminent deep recession ahead of the financial crisis. In contrast, at the start of both 2013 and 2014 he was upbeat, predicting an imminent recovery, with the UK economy growing two per cent in 2013 and 3.5 per cent in 2014. Twitter: @DrGerardLyons

Nicholas Garrott is Special Economic Assistant to the Chief Economic Advisor to the Mayor. He studied at Manchester University in economics, history, politics and the European Union and carried out PhD research on urban development. He then worked in The City for a number of years prior to taking on his current role in early 2013. He sits on the British Chamber of Commerce Economic Advisory Group and advises the Education and Employers Task Force on international issues linked to youth unemployment.

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APPENDICES AVAILABLE ONLINE ([www.london.gov.uk/europereport](http://www.london.gov.uk/europereport)):

APPENDIX A: THE LONDON ECONOMY AND EUROPE

APPENDIX B: SCENARIOS

APPENDIX C: KEY SPEECHES

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# Executive summary

## Section 1: Overview

The title of this report is a win-win situation, to reflect the positive options ahead if the UK can help reform the EU into a competitive economy or if the UK leaves and pursues a reformed, open outward looking economic policy outside the EU. The UK can only achieve serious reform if it is serious about leaving, and it can only be serious about leaving if it believes this is better than the status quo of staying in an unreformed EU. It is.

The best economic outlook for the UK over the next twenty years is if it remains in a reformed EU. This report calls this scenario a 'brave new world'. The issues that arise from this are whether the EU will reform in a way in which it can play an even more important global economic role, and also within this whether the UK can engage more with the EU to play a leadership role within the EU. If it can play a leadership role to push through reform then, from both a future European and also a domestic UK perspective, it should.

The future economic and financial success for London and the UK will not depend solely on whether the UK is in the EU or not. Much of the debate gives the impression that the UK will succeed either if it is in the EU - that is the yes campaign - or will succeed only if it leaves - that is the no campaign. It is more complicated than this. If the UK remains in the EU, future success will be heavily influenced by whether the EU reforms successfully, or not. Likewise, if the UK leaves the EU, its future economic performance will be heavily influenced by how the UK positions itself, not just with the rest of Europe in the exit terms, but also with the rest of the world, and on the policies then pursued.

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## Section 2: The London economy and Europe

While this report focuses on the relationship with Europe, the economic prospects for London should be seen in a combination of global, regional and national influences. The global message is the need for London's economy to retain its competitive edge and to remain open to international trade, investment, people and ideas. Globally, more of economic growth is emanating from cities. From a regional perspective, London is Europe's financial centre and also home to many firms' regional or global headquarters. Within the UK, London has a dominant role, although it also faces similar challenges as other regions of the UK, with one in five workers employed on less than the living wage and a number of poor boroughs. In addition, in recent years, London has not been immune to wider problems impacting the UK economy, such as high numbers of young unemployed, although the numbers are now falling. Stronger economic growth is one important way to help address such problems.

In terms of Western Europe, London is the ninth biggest economy. The eight western European countries that have economies bigger than London are Germany, France, the UK (of which London was a big part), Italy, Spain, Turkey, Poland and the Netherlands. Encouragingly for the UK a report by European Commission in 2013 showed that three of the five most competitive regions within the EU were in the south of England, including Surrey and Sussex seen as the fifth most competitive region in the EU and Buckinghamshire, Bedfordshire and Oxford in third. In fact these were the only two regions in the top ten that were not centred on cities but in large part that is because both regions are heavily interlinked with London, which itself was ranked second. Utrecht was first.

The key sectors in London's economy are: finance and insurance (19.8 per cent), professional, scientific and technical services (11.7 per cent), information and communication (11.6 per cent), real estate (9.8 per cent), wholesale and retail trade (8.3 per cent), administrative and support service activities (5.4 per cent), human health and social work (5.3 per cent), education (4.7 per cent), construction (4.5 per cent), transport and storage (4.3 per cent), public administration and defence (3.9 per cent), manufacturing (2.7 per cent), accommodation and food services (2.6 per cent), arts (1.7 per cent), primary and utilities (1.6 per cent) and other service activities (1.6 per cent). We outline the interaction of these sectors with the EU, both in section two and in a detailed appendix.

## Section 3: Summary of previous reports

This section provides a flavour of the vast literature debate on the topic of the UK and Europe. We look at the recent literature on the pros and cons of EU membership and at the specifics of Chancellor Gordon Brown's five economic tests on possible membership of the euro. The scale of the literature means that there is almost something there for everyone, with views both supporting and challenging the consensus. The possible downside to this is it that it can make it easier for decisions to be delayed, even not addressed. There is also the complexity of considering issues from the legal as well as political and economic context. In this section we outline ten documents that provide a good snapshot of the state of the debate, including a couple of publications from the Continent that give a flavour of the debate there. Also, it is necessary to look at these issues between the UK and EU over a sufficiently long time period given that decisions need to be based on more than the current economic cycle and must reflect the underlying structural changes and a future vision.

## Section 4: Economic scenarios

This section provides some long-term economic forecasts. We commissioned a leading, independent economic forecaster Volterra to use their forecasting models to look at four economic scenarios. The work was led by economists Paul Ormerod and Bridget Rosewell. Their excellent report is contained in its entirety in the appendix, which also explains the analysis and forecasts in more detail. Parts of this analysis are also summarised in section four. The economic scenarios are called 'Brave New World', 'Business as Usual', 'One Regime Two Systems' and 'Inward Looking'.

The implications for London are dramatic. London is considerably more oriented towards both innovation and the world economy than is the rest of the UK and large parts of Europe. The strengths of the economy of the capital are best shown in the two scenarios in which institutional reform takes place. In contrast, London would suffer in an environment in which there was a lack of reform. This is especially the case in the 'Inward Looking' scenario, in which we envisage a gradual long-term relative decline, recalling memories of the dismal economic performance of the period in which the UK joined the Common Market and prior to the supply-side reforms of the 1980s.

London's economy at present represents some 22.5 per cent of the total economy of the UK and its size is £350 bn. Over the next two decades the potential divergence in future size for London under different scenarios and hence in living standards is huge: in the 'Brave New World' scenario it grows to £640 bn; 'One Regime Two Systems' £615 bn; 'Business as Usual' £495 bn; 'Inward Looking' £415 bn. The best economic scenario is in a reformed EU, the worst outside the EU and inward looking.

It is perhaps in the other two scenarios that this report may surprise. We determine that leaving the EU and both having good future relations with the EU and with the rest of the world is better, in economic terms for the UK, than remaining within an EU that does not reform. That is, leaving and pursuing sensible economic policies would deliver considerably more in growth and jobs than the status quo.

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## Section 5: Reform

Section 5 outlines some of the broad issues in terms of where the EU should reform. The completion of the UK Government's Balance of Competencies report over the next year may outline other possible reform areas. It should be stressed that reform needs to be seen in the context of not only what is desirable from a UK perspective (this has been called an à la carte approach) but, crucially what is needed by the EU to allow it to achieve better economic performance and address concerns about a possible democratic deficit. In this section we have outlined a broad range of possible reform areas: 1. Accept the case for economic reform; 2. Halt the process towards ever closer union; 3. Have a timetable for reform; 4. Reform the relationship between the Eurozone and the non-Eurozone; 5. Complete the Single Market and address issues in services, people and regulatory intrusion; 6. Sector specific reform - examples important for London highlighted here are the digital services market and financial services; 7. Other economic reforms are outlined, relating to halting unnecessary regulation, reforming the EU budget, the options for social and employment legislation and other areas; 8. Non-economic reform, with areas to consider including the supremacy of UK courts in non-Single Market rulings.

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## Section 6: What happens if we leave?

This section looks at the consequences of a UK exit from the EU. Leaving the EU would lead to considerable near-term uncertainty, but as we have outlined here for the UK economy to be successful it would also lead to the need for a clear framework of policy planning, in order to both create a future enabling environment for business and a clear strategic vision for the economy. In the event of a No vote in a referendum, Article 50 may be like a nuclear weapon - the threat of its use may be a more powerful weapon than its actual use - as invoking it could start an irreversible process and it cedes power to EU institutions to decide the terms of our exit. The UK needs to be proactive in determining the terms of its future relationship with the EU, which should be positive. The future relationship between the UK and EU is discussed.

Overall, if the UK can take a lead role in reforming the EU, or if it pursues an open and business friendly approach outside the EU, then it can succeed. It is a win-win situation.

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# Section 1: Overview

This report looks at the UK's relationship with Europe from an economic and financial perspective. There are two aspects of this report that differentiate it from the plethora of other reports that have appeared on this subject: a strong emphasis on London; four possible economic scenarios are presented.

This report is divided into six sections, followed by appendices with more detail.

- This section is an overview of the key issues and a summary of the analysis.
- Section two looks at some key aspects of the London economy and its relationships with the rest of Europe.
- Section three provides a review of the key research on this topic to date.
- Section four outlines four economic scenarios based on the UK remaining in or leaving the EU.
- Section five asks if the UK was able to reform the EU what should it aim to reform?
- Section six asks what happens if we leave?

The appendix contains: a detailed report commissioned from leading independent consultants Volterra that looks at the economic outlook for the UK and EU; a detailed analysis of the London economy; and finally the text of speeches on this subject made by The Mayor in December 2012 and by The Prime Minister in January 2013.

## ▪ This report has a number of conclusions

The best economic outlook for the UK over the next twenty years is if it remains in a reformed EU. This report calls this scenario a 'Brave New World'. The issues that arise from this are whether the EU will reform in a way in which it can play an even more important global economic role, and also within this whether the UK can engage more with the EU to play a leadership role within the EU. If it can play a leadership role to push through reform then, from both a future European and also a domestic UK perspective it should.

London is a global city and is also Europe's financial centre and, as such, can benefit from any policies that both increase its openness and international appeal. As this report outlines, two of the biggest sectors of the London economy are heavily intertwined with Europe: the City and the professional services sector.

The gains from genuine reform of the EU are potentially very significant in economic terms, both for the EU and the UK. One of the key issues for London and the UK economy is whether the institutional structures that drive our economy and attitudes

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evolve to become flexible enough to prosper in the challenging environment of the world economy. Can we do this in the EU, or outside?

The worst economic scenario is where the UK leaves the EU and does not pursue a growth focused economic policy, we call this 'Inward Looking'. While much of the attention in this report is about the EU reforming, in this worst case scenario it is the UK that does not reform, or innovate sufficiently and so is not open enough to prosper in the world economy.

Table 1.1 summarises some of the key figures from the different economic scenarios.

### 1.1 Estimates of London's size and employment levels in 20 years

Current size of London economy	£350bn
Future size in 20 years under the different scenarios:	
A. Business as usual	£495bn
B. Brave new world	£640bn
C. One regime, two systems	£615bn
D. Inward looking	£430bn

Note: These figures are in real terms and take out the influence of inflation

Indicative London employment levels in 20 years	
A. Business as usual	Rise of 200,000
B. Brave new world	Rise of 1 million
C. One regime, two systems	Rise of 900,000
D. Inward looking	Fall of 1.2 million

Source: Volterra (See Appendix)

If the UK cannot achieve reform in the EU it should leave. If the UK leaves the EU and retains good relations with the EU and if the UK pursues growth focused policies then this will provide a better economic outlook for the UK than the status quo of remaining in an unreformed EU. The second best scenario for London is a reforming, open UK that we call 'one regime, two systems' and the third best scenario for London is if the UK remains in an unreformed EU, which we call 'business as usual'.

It is this latter point that is perhaps the most controversial aspect of this report, as most surveys show a strong desire from business to remain in the EU, even though the same surveys frequently show deep discontent with many aspects. Business seems to want the Single Market but little else, and the trouble is that may not be achievable within the EU.

The title of this report is a win-win situation, to reflect the positive options ahead if the UK can help reform the EU into a competitive economy or if the UK leaves and pursues a reformed, open economy policy outside the EU.

The UK can only achieve serious reform if it is serious about leaving, and it can only be serious about leaving if it believes this is better than the status quo of staying in an unreformed EU. It is.

The debate about the UK and EU needs to be seen in the context of a changing global economy, with the emergence of new bigger economies led by China, every likelihood of a reinvigorated US, and other key economic drivers including new trade corridors and rapid urbanisation. This is a vital part of the future issue as to how to ensure that London, the UK as well as the EU position themselves to prosper and grow in the changing, growing and increasingly interconnected world economy. That is the essence of the future economic debate.

This report outlines possible areas where the EU needs to reform. The aim of a reform agenda should be economic. When the UK voted to remain in the Common Market in 1975 there were many factors that determined the outcome but at that time the European economic model was seen as working. Now there are serious questions about that European economic model reflected in its high unemployment, particularly among the young, and lack of innovation, plus the challenges of a currency union such as the euro.

In the reform section we outline eight points: 1. Accept the case for economic reform; 2. Halt the process towards ever closer union; 3. Have a timetable for reform; 4. Reform the relationship between the Eurozone and the non-Eurozone; 5. Complete the Single Market and address issues in services, people and regulatory intrusion; 6. Sector specific reform - examples important for London highlighted here are the digital services market and financial services; 7. Other economic reforms are outlined, relating to halting unnecessary regulation, reforming the EU budget, the options for social and employment legislation and other areas; 8. Non-economic reform, with areas to consider including the supremacy of UK courts in non-Single Market rulings.

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From this there are four areas of reform, in particular, in Europe that the UK should focus on:

- (A) The future relationship between the Eurozone (EZ) and non-Eurozone members of the EU (non EZ) and safeguarding the future rights of the non EZ not to be outvoted by the EZ. This is a vital area for The City of London if the UK remains in the EU. The City remains vital to the future success of the London and UK economy, and it already needs to be wary not only of a shift of regulation from the UK towards the EU, but also that this regulation may be unsympathetic and that this imposes a regulatory burden that hampers the City versus other global financial centres. In addition to this, in the wake of the financial crisis, the City needs to safeguard its position within Europe, hence the need to focus on the future relationship between the EZ and non EZ.
- (B) Ensuring the Single Market works and in doing so address issues relating to services, to people and to preventing regulatory intrusion. From the perspective of London the Single Market needs to work in its four areas of services, people, goods and capital. The idea of movement of people needs to change to be take account of the fact that the expansion of the EU to the east has resulted in huge variations in income levels, pay and benefits between economies such as the UK and others in Eastern Europe. In two sectors of the London economy one in four workers are from elsewhere in Europe, these are construction and the accommodation and food sector, while in the finance and insurance sector it is one in eight. One of the important areas for the London economy is to ensure there is continued free movement of people with appropriate skills within the EU. In order to maintain public confidence in EU free movement, EU rules need to respect differing national welfare systems that have developed through national democratic choices. A clear and enforceable timetable to complete the Single Market would be ideal, but may be unachievable and thus ensuring the Single Market works may be the best option possible.
- (C) Change the mindset to make Europe more innovative, productive, outward looking and competitive. Unlike reforms (a) and (b) mentioned above that are specific, this reform is qualitative, and therefore hard to quantify. It is about ensuring that Europe thinks less about process and more about progress. This has many different facets to it, such as trying to halt unnecessary future regulation, devolving more powers to national governments where it makes sense to do so, and thinking about the global opportunity for Europe in a multipolar world, thus reforming the EU to achieve stronger economic growth and create sufficient jobs. Although in the near-term it is the threat of deflation and the lack of domestic demand that is Europe's immediate problem, the further ahead one looks it is the need for Europe to compete, create jobs and fund its welfare system. The key is the need for an economic model that succeeds in the 21st century.
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(D) The fourth area of reform is non-economic, and while we have not focused on this in detail in this report, this area has a number of aspects, such as the need to reestablish the supremacy of UK courts in non-Single Market related rulings. The focus on the roles of the European Court of Justice and the issue of human rights, while important, highlight that it is not just economic issues that are relevant in this debate. There is a fear among some businesses that a referendum may be based on 'emotional' not economic criteria. Naturally it is up to people themselves to decide why and how to vote but this fear does highlight the need to both have a vision for what the country would look like in the future in either an in or out scenario and also reflects the need to incorporate non-economic issues, where relevant, in the reform process. After all, public sentiment may be driven by more than economic issues.

The world economy would benefit from a multi-polar world, with a strong Europe alongside a strong US and China and an emerging India, and increased growth across the rest of the world. Given the clear economic benefits that the forecasts in this report suggest follow from a reformed EU, the UK needs to make clear that such reform is in the EU's best interests, not just the UK's. In pushing for reform, there are many aspects of the EU that are accepted as having had a positive impact, not least the gains in social legislation and also the strong trade negotiating position that the EU is able to achieve. All four of these reforms outlined here would appear to be essential. There is a need for the EU to be more outward looking and to compete globally.

There should be no hiding from the near-term uncertainty if the UK were to leave. Article 50 of the Lisbon Treaty could be invoked, but it may not need to be and may not be the best policy. The downside of invoking Article 50 is that other remaining members of the EU would determine the terms on which we leave, but at least there is a two year time-frame that acts as a transition. We outline some action steps for The Mayor of London but many of the issues are national in nature.

It should not be a case of the UK choosing between the EU and the rest of the world. It is possible to have good relations with both, whether the UK is in or out of the EU. If the UK were to leave it would need to ensure it is as global as possible in its focus, however the challenge of negotiating new trade deals and doing so quickly cannot be overestimated.

London is the ninth largest economy in Western Europe after Germany, France, the UK (of which London is a quarter), Italy, Spain, Turkey, Poland and the Netherlands. Although there are 12 countries in Europe where their capital city accounts for a bigger proportion of the country's economy than London does in the UK these are small to medium sized economies. For larger countries, London dominates the UK in a way in which other capitals do not, with Berlin four per cent and Paris 9.6 per cent of their respective economies. Thus the outlook for London has a clear bearing on the prospects for the UK economy.

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There is a big fear in the City, London's financial district, about what would happen if the UK left the EU. Hence the City is not keen to embrace such a risk. On the face of it the case for The City to remain in the EU may appear compelling. After all, in the EU the Single Market in financial services relies on the principles of mutual recognition and a 'single passport', a system that permits financial services operators legally established in one Member State to establish/provide their services in other Member States without further authorisation requirements. Moreover outside the EU the UK would need to reestablish trade deals where the City's role was protected, and that would likely take time. Leaving would also be very complex in legal terms.

However, the City, it should be noted, was enthusiastic about joining the euro, then fearing London would be displaced as Europe's financial centre if it didn't and that fear proved misplaced. London is Europe's financial centre. It needs to retain its global focus - being the financial centre of the world as well as of the EU, and positioning itself as it is in new growth markets such as the offshore renminbi. Completing the Single Market in services would likely help the City, as too would ensuring the position of non EZ members versus those in the EZ. Although increasingly much financial regulation is global in nature, one issue is whether London's global competitiveness may suffer from further intrusions because of EU membership such as increased European regulation and the fact that the European Court of Justice appears prepared to opt in favour of the Eurozone over the Single Market. There is a real threat of future erosion of competitiveness.

Despite all this, history shows us that the City has retained its competitiveness by evolving to suit the circumstances of the time, embracing change, and being open to trade. Outside the EU, it is possible that despite all the uncertainty the City retains its international competitiveness, overcoming the initial phase of uncertainty.

Finally, even though we fully accept that there is an economic case for leaving, one has to ask why the UK does not try and play a bigger leadership role in the EU? It seems less engaged than others, more passive than active, consequently not safeguarding the interests of its key economic sectors. Over the next thirty years, a number of Western European economies will see their populations shrink. Not the UK and not London. They will grow. In turn, further gains in productivity could see the UK displace Germany as the largest economy in Europe. Such potential should give the UK greater confidence in seeking to achieve its aims in reforming the EU. It would also allow it greater confidence should it choose to leave.

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▪ **The background to this report**

The origin of this report is that during 2013 The Mayor released two strategic reports, linked to the future economic and financial outlook for London. One was the '2020 Vision', focusing on the strategic future issues facing London. The second was the independent cross party 'London Finance Commission' focusing on the case for devolving greater financial powers to London and other cities, or regions. While these reports addressed important issues, a frequently repeated question by the end of 2013 was what would be the impact on London if the future relationship between the UK and Europe remained the same or changed? Hence the Mayor commissioned this Report. Its focus is on the pros and cons for London of the current debate about the UK's future relationship with Europe. Following the release of two strategic reports last year, this Europe report follows the release in July 2014 of a strategic report by The Mayor on London's infrastructure plan until 2050.

The analysis within the Report should be seen in the context of the Prime Minister's January 2013 speech on Europe, in which he stated, 'The European Union is a means to an end – prosperity, stability, the anchor of freedom and democracy both within Europe and beyond her shores – not an end in itself.' And 'I don't just want a better deal for Britain. I want a better deal for Europe too.' He outlined the challenges as, 'First, the problems in the Eurozone are driving fundamental change in Europe. Second, there is a crisis of European competitiveness, as other nations across the world soar ahead. And third, there is a gap between the EU and its citizens which has grown dramatically in recent years. And which represents a lack of democratic accountability and consent.'

Central to the Prime Minister's strategy is the offer of a possible referendum, with a clear question, along the lines of should the UK stay in or leave the EU? It is important to stress that this is the policy of only one party, the Conservatives, and is not a future commitment of a UK government. Other major parties are not committed to a referendum, although that could change. This report, therefore, does not take it as a given that there will be a referendum. Whether there is, or isn't a referendum, the issues that underpin the economic debate are key ones for the London economy, both now and in the future.

On 5th June 1975 the UK last held a Referendum on Europe, on whether the UK should remain in the Common Market. 67.2 per cent voted in favour, 32.8 per cent against. The turnout was 65 per cent. That referendum followed a partial renegotiation by the new Labour government of the terms on which the UK had joined the European Economic Community – or Common Market as it was known – under the Conservatives in 1973.

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**▪ Global influence**

The relationship between the UK and EU must be seen in a global context. The world economy is changing, with increasing interconnectedness in areas of business and economics, finance and policy. The impact on London is already apparent, both feeding and influencing the very dynamic of the city. These global influences are creating opportunities for London's fast moving economy but also raising challenges as well as opportunities for London's policy makers. Such issues cover how to seize all opportunities for the capital, covering areas such as transport infrastructure, housing, the science base, education and culture and realising the potential of its people, among others. This global influence was very evident in preparing this report, with many of the aspects of the UK–EU and of the London-EU debate needing to be seen in a global context.

The world will continue to change, regardless of how the UK chooses its future relationship with the EU. In many respects, one issue that dominates is how London, the UK as well as the EU position themselves in the changing, growing and increasingly interconnected world economy. That is the essence of the future economic debate.

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# Section 2: The London economy & Europe

In 2013, London's economy is estimated to have grown by 3.4 per cent in gross value added and is forecast to rise by 3.8 per cent in 2014. Growth appears to be gathering momentum. The numbers who are employed working in London is at an all-time high of 5.5 million in May 2014.

The changing shape of the world economy has been a big plus for London, as its economy has continued to grow, as London has benefited from increased inward investment and it has attracted large numbers of high skilled workers from across the globe. Few, if any, would challenge the idea that London's global brand and reputation has soared in the wake of the 2012 Olympics. Even allowing for the inevitability of future swings in both the housing market or in the business cycle, many longer-term economic drivers would suggest a positive outlook for London's economy.

The infrastructure of the London economy means it is well placed to gain from the changing global economy. It needs to continue to adjust to ensure that this remains the case. We would argue that there are three types of infrastructure: hard, soft and institutional. All are important. The hard infrastructure covers areas such as housing, transport, power and communications. London has seen huge investment in all, but with a population that is growing significantly and for its economy to continue to grow strongly it needs to see further expansion and investment in all. One of London's biggest challenges, and great opportunities, is to boost its housing supply to ensure the cost of renting and buying in London is affordable. The soft infrastructure, reflected in London's creative economy, is highlighted by its skills and education. Then there is the institutional infrastructure, often taken for granted, which has been a hallmark of London and the UK's success, and reflected in its legal system, its common law, and in its open international approach. It is important this remains the case.

While this report focuses on the relationship with Europe, the economic prospects for London should be seen in a combination of global, regional and national influences. The global message is the need for London's economy to retain its competitive edge and to remain open to international trade, investment, people and ideas. Globally, more of economic growth is emanating from cities. From a regional perspective, London is Europe's financial centre and also home to many firms' regional or global headquarters. Within the UK, London has a dominant role, although it also faces similar challenges as other regions of the UK, with one in five workers employed on less than the living wage and a number of poor boroughs. In addition, in recent years, London has not been immune to wider problems impacting the UK economy, such as high numbers of young

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unemployed, although the numbers are now falling. Stronger economic growth is one important way to help address such problems.

There is much comment that if the UK were to leave the EU it would be terrible for the UK economy. We will examine the substance behind such comments but in recognising this we should acknowledge similar type comments were made ahead of the debate on the whether the UK should join the euro. Then the misplaced fear was the UK would suffer if it remained outside the euro. In the event, not joining the Eurozone proved positive for the UK economy. Given this it is important to look at the facts. Remaining in or leaving the EU is a far more important issue than Eurozone membership but the lesson from the past is relevant, namely the need to examine the argument and not be swayed by the consensus and to do what is in the best long-term interests of the UK economy.

In any analysis, the counterfactual is always difficult to determine. That is, we can't say with certainty what would have happened if we choose to pursue a different approach. Accepting this, in this Report we try to minimise the uncertainty by outlining clearly our current relationship and what could happen. It becomes clear, in doing that, that the UK can very much influence every outcome, in some way, by pursuing proactive policies.

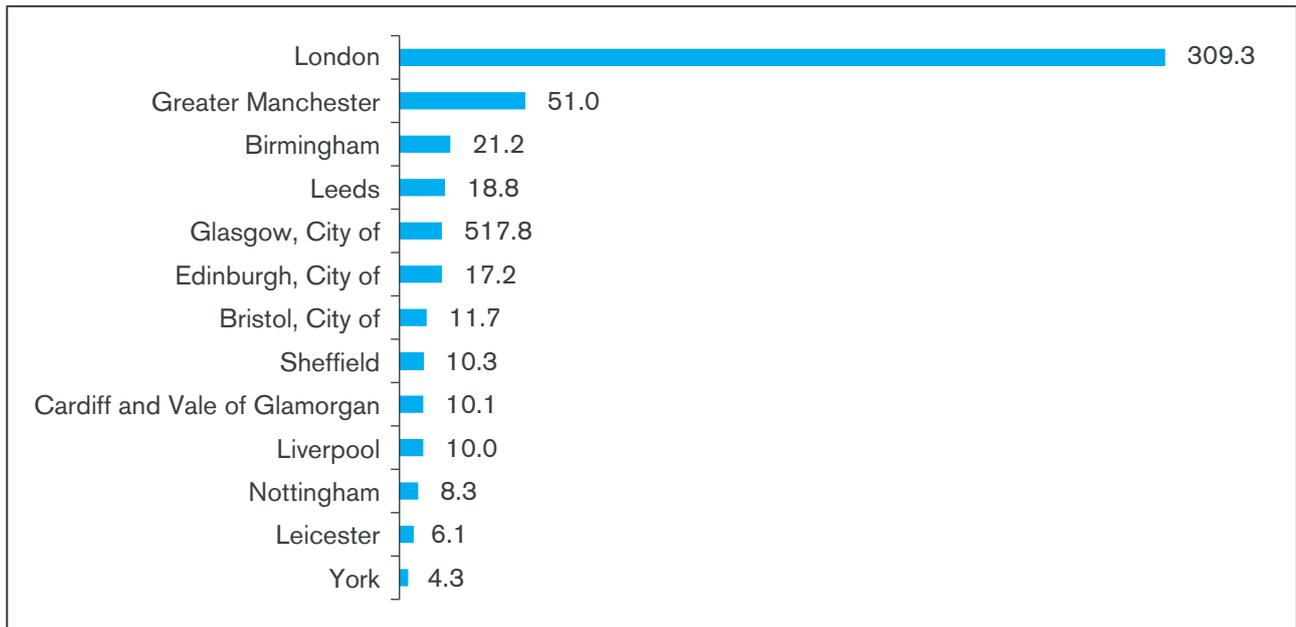
London's economy has a close interaction with many different aspects of the EU. While that, on the face of it, may argue in favour of a close relationship between London and the EU, it should also be recognised that London has close relationships with many other parts of the world. Put simply, it is a global city.

This immediately raises the question whether London's success to date can be sustained, and built upon, whether the UK is in or out of the EU? To answer this question, and to determine the best future relationship it is necessary to get a clear insight to London's economy, its drivers, and how these interact with both the rest of the UK and the world.

London has a £309bn economy based on the latest available data from 2012. It has grown since, but official data is yet to be released that covers every sector. In relation to the UK, London accounts for 22 per cent gross value added, effectively one-quarter of the economy.

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## 2.1 Regional GVA of selected NUTS regions in the UK (£ billion)

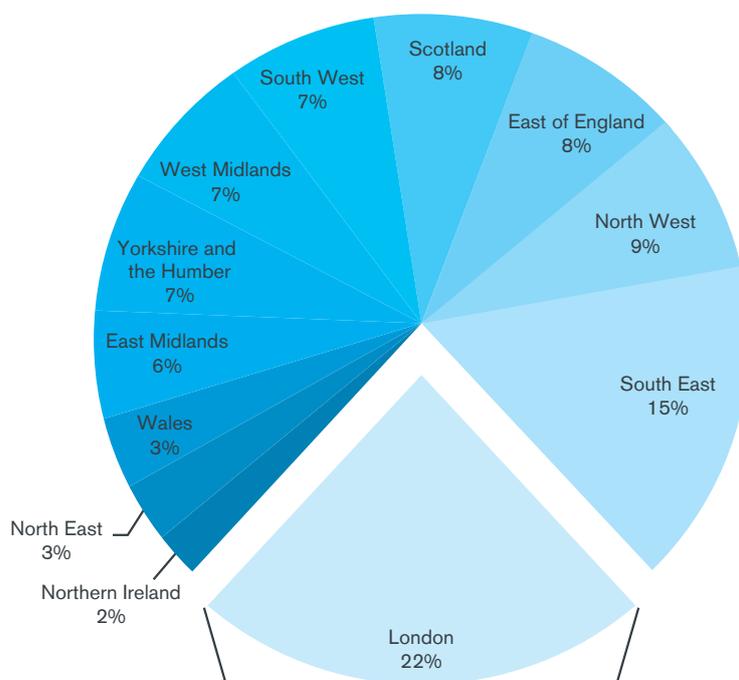


Source: ONS

Figure 2.1 shows London in relation to other UK cities and Figure 2.2 shows contributions of different regions to UK gross value added. The south-east, with a £203bn economy, accounts for 15 per cent, and is, naturally, heavily interlinked with London, as indeed are parts of the economy of other regions.

## 2.2 London's Share of UK GVA by region

Headline Workplace GVA in 2012, £ billion	
Northern Ireland	29
North East	42
Wales	47
East Midlands	80
Yorkshire and The Humber	93
West Midlands	98
South West	102
Scotland	106
East of England	116
North West	131
South East	203
<b>London</b>	<b>309</b>
Inner London	216
Inner London - West	140
Inner London - East	76
Outer London	93
Outer London - East and North East	25
Outer London - South	21
Outer London - West and North West	47



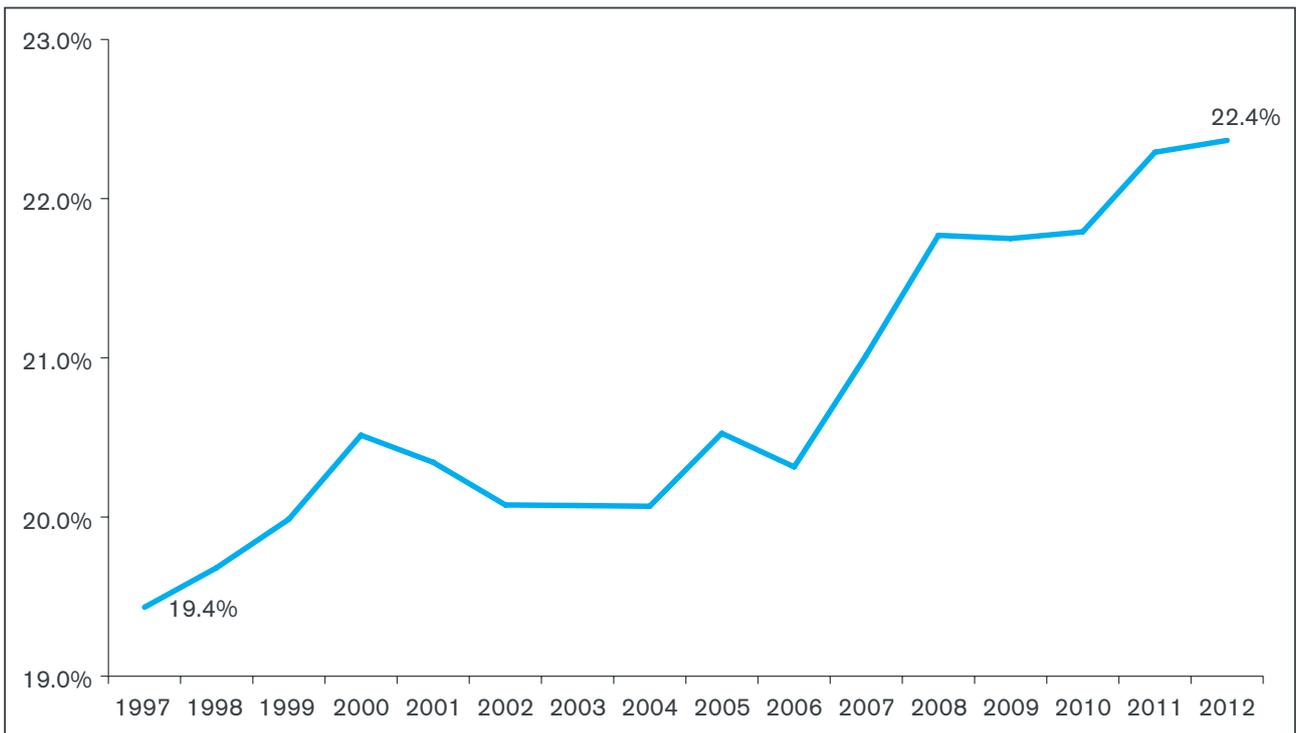
Note: Numbers may not add due to rounding



Source: GLA Economics based on data from Office for National Statistics

Figure 2.3 shows London's rising share of the UK economy, as measured in terms of gross value added (GVA). The financial crisis of 2008/09, which might have been thought would upset this trend, has not prevented further expansion, with the London economy proving to be resilient. This resilience has been widely attributed to it being outward looking, open to innovation, benefiting from labour mobility and being strongly oriented towards services.

**2.3: London's share of UK headline GVA, 1997-2012**



Source: ONS Regional Accounts

In terms of Western Europe, the size of the London economy is equally impressive. Table 2.4 lists the size of both London and the 19 largest national economies. In both 2007, the year immediately before the financial crisis, and 2011, the latest comparable data, London would have been the ninth biggest economy. The eight western European countries that had economies bigger than London were Germany, France, the UK (of which London was a big part), Italy, Spain, Turkey, Poland and the Netherlands.

## 2.4: Rank of European economies (including London) in 2007 and 2011

	2007 rank	2011 rank
1	Germany	Germany
2	United Kingdom	France
3	France	United Kingdom
4	Italy	Italy
5	Spain	Spain
6	Turkey	Turkey
7	Netherlands	Poland
8	Poland	Netherlands
9	London	London
10	Belgium	Belgium
11	Sweden	Switzerland
12	Switzerland	Sweden
13	Austria	Austria
14	Greece	Romania
15	Romania	Norway
16	Norway	Greece
17	Czech Republic	Czech Republic
18	Portugal	Portugal
19	Denmark	Denmark
20	Ireland	Hungary

Source: GLA Economics calculations based on Eurostat Purchasing Power Standard figures

Within Western Europe it is not uncommon for some countries to see a large proportion of their gross value added emanate from their capital city. Using data from 2010, and it is unlikely to have altered much since, 12 countries see a bigger share of their economy explained by their capital, see table 2.5, led by Latvia, Greece and Ireland. However these can all be referred to as small to medium sized economies and in terms of the bigger economies the figures are lower. In the larger economies, the comparison shows the remarkable extent to which London dominates the UK, in a way in which the capitals of other large economies do not. London's share of the UK is far higher than Paris in France or Berlin in Germany for example, with 9.6 per cent of French gross value added coming from Paris and four per cent of Germany's from Berlin.

## 2.5: Share of EU countries' GDP (in current prices purchasing power standards) generated in their capital city areas (defined by NUTS), 2010

Country (NUTS capital city area)	NUTS region % share of country GDP, purchasing power standard, 2010
Latvia (Riga)	53.2
Greece (Attiki)	48.0
Ireland (Dublin)	42.2
Lithuania (Vilniaus apskritis)	38.5
Hungary (Budapest)	37.9
Croatia (Grad Zagreb)	33.3
Portugal (Lisboa)	31.8
Sweden (Stockholm)	29.7
Slovakia (Bratislavský kraj)	27.8
Austria (Wien)	26.4
Czech Republic (Praha)	25.7
Romania (Bucuresti)	22.6
United Kingdom (London)	21.2
Belgium (Région de Bruxelles-Capitale)	19.0
Spain (Madrid)	17.9
Denmark (Byen København)	17.7
Poland (Miasto Warszawa)	13.5
France (Paris)	9.6
Germany (Berlin)	4.0
Bulgaria (Sofia)	3.6

Source: Eurostat

Encouragingly for the UK a report by European Commission in 2013 showed that three of the five most competitive regions within the EU were in the south of England, including Surrey and Sussex seen as the fifth most competitive region in the EU and Buckinghamshire, Bedfordshire and Oxford in third.<sup>3</sup> In fact these were the only two regions in the top ten that were not centred on cities but in large part that is because both regions are heavily interlinked with London, which itself was ranked second. Utrecht was first. So, with three in the top five, there is a strong argument to say southern England is the most competitive region within the EU, and that London plays an important role in driving growth outside the capital. What is it that drives this, and can it be replicated across both the rest of the UK and also with the context of reform, across Europe too?

A survey in 2013 by consultants Deloitte suggested certain cities attracted high numbers of 'high-skilled knowledge based jobs', with 1.5 million in London and 1.2

<sup>3</sup> European Commission, EU Regional Competitiveness Index 2013

million in New York but these were way ahead of the next highest of 784,000 in Los Angeles, 630,000 in Hong Kong and 425,000 in Boston. This suggests that, in terms of the scale of such high skilled knowledge based jobs, London has no effective competition in Europe.

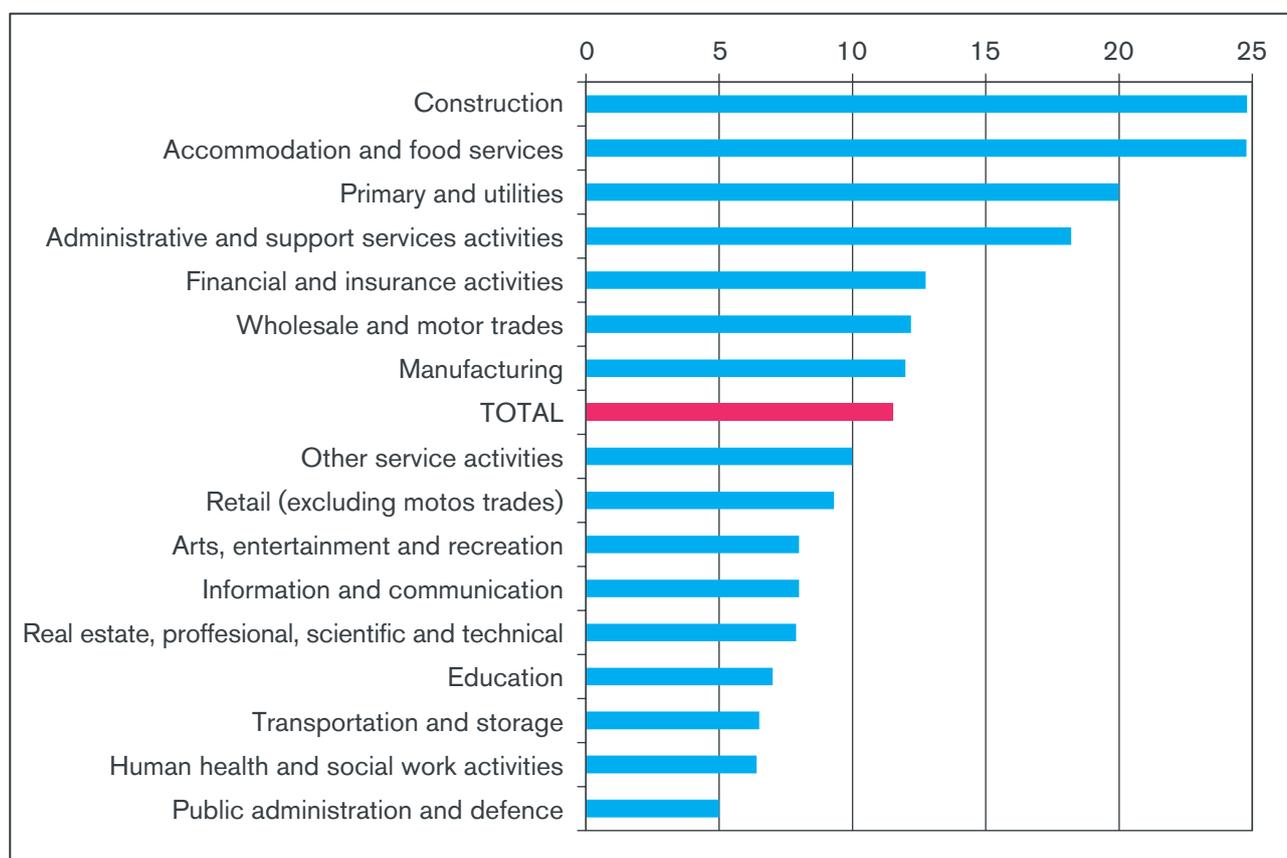
The above gives some insight into the relative position of London, consider now its interactions with the rest of Europe.

Part of London's success is its people, contributing to the vibrancy of the city, in terms of its multiculturalism and their economic contribution. One of the key aspects of Europe's Single Market is the free movement of people. But, even now, while a member of the EU, this is being called into question by some in the UK, with guidelines on immigration numbers being considered. This issue needs to be resolved. Moreover, if the UK were to withdraw from the EU, an important area of future negotiation would need to be immigration. So, in or out, London could be heavily impacted by changes to migration numbers. It is difficult to fully quantify, but an analysis by sector may shed some light.

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Figure 2.6 shows the proportion of working age people employed in different sectors across London that were born outside the UK but within the European Economic Area (EEA).<sup>4</sup> It is just over one in ten workers across London, and rising, although in two sectors, one being construction, the other being accommodation and food services, the ratio is one in four. That is, in each of these sectors one in four workers is from the rest of the EU. It is high in a number of other sectors too, with one in eight workers in the finance and insurance sectors, which account for about one-fifth of London's economy. So the importance of workers who are European but not from the UK cannot be overestimated, particularly in certain sectors.

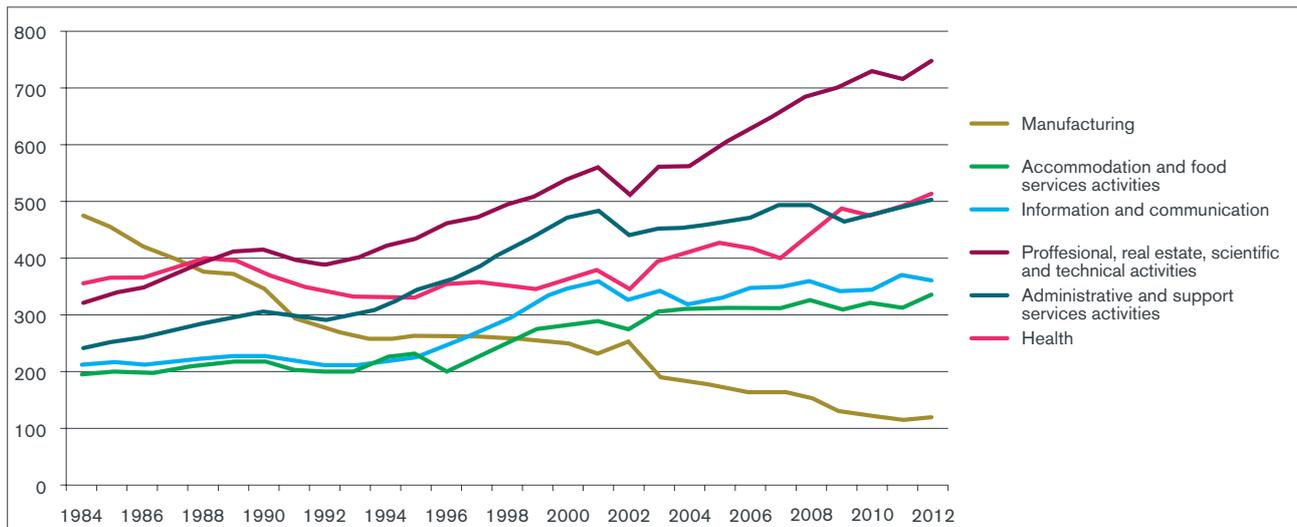
**2.6: Proportion (%) of people aged 16-64 employed in London in 2012 who were born in the EEA (excl. UK) by sector of main job**



Source: Eurostat

<sup>4</sup> The European Economic Area comprises EU countries plus Iceland, Liechtenstein and Norway who are members of the European Free Trade Association (Switzerland is the fourth member of the EFTA but is not in the EEA)

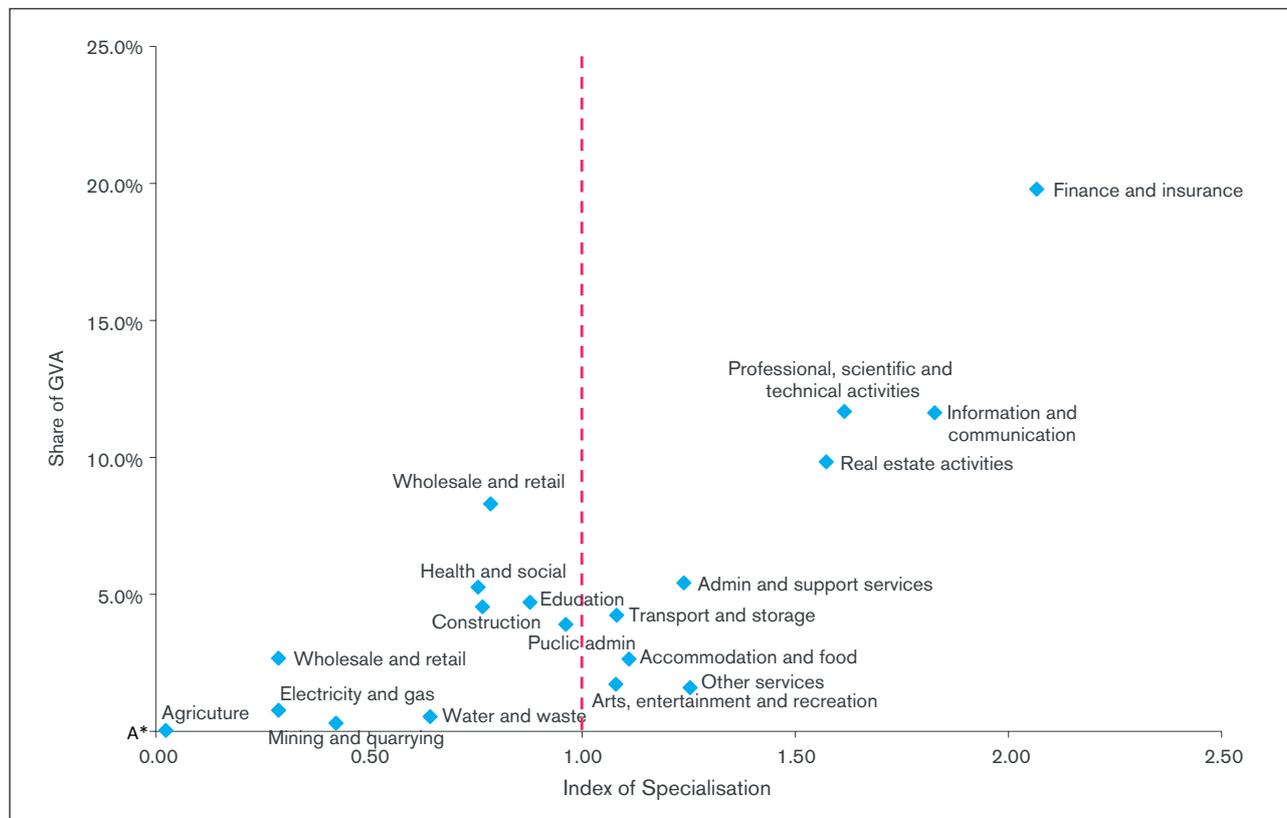
## 2.7: Employment in London by sector over time (thousands)



Source: 1996 to 2012: ONS Workforce Jobs series; before 1996: GLA Economics using various ONS sources and modelling assumptions

In terms of jobs, figure 2.7 identifies some clear trends, with some sectors not impacted greatly by the recent recession. The index of specialisation illustrated in figure 2.8 highlights where London's economic focus is relative to the rest of the country. If the index of specialisation is greater than 1, London has a greater share of its total jobs in the sector being examined than does the rest of the UK. As such it can be regarded as an area in which London has some specialisation versus the rest of the UK.

**2.8: London’s broad sectors: Index of specialisation<sup>5</sup> (relative to the rest of Great Britain<sup>6</sup>) and share of London’s total output (2012)**



Source: ONS: Business Register and Employment Survey; UK Regional Accounts

London’s specialisation relative to the rest of the UK is highest in finance and insurance and in the information and communication sector. The latter being a sector that has developed transformative technological innovations. Another sector where London specialises is in professional, scientific and technical activities, with the capital well placed to profit from opportunities here. Meanwhile the specialisation in real estate activities is a reflection of the reality of London’s housing challenge and of its international appeal. Overall, London’s economic advantage in services suggests that it may have the potential to gain from the Single Market in services working fully, especially as trade in services across the EU is relatively low.

London’s role in service sector trade is a distinct advantage to the UK as a whole and is an area where the UK has a positive balance of trade as Table 2.9 shows.

<sup>5</sup> The index of specialisation is calculated as: (London employment in sector/London total employment)/(Rest of GB employment in sector/Rest of GB total employment). Therefore if the index of specialisation is greater than 1, then this shows that London has a greater share of its total jobs in the sector being examined than does the rest of GB. As such it can be regarded as an area in which London has some specialisation.

<sup>6</sup> Great Britain is considered in this instance because the data used for the index of specialisation is only available at the ‘Great Britain’ level.

## 2.9: Trade in services (UK and region of the world) 2012 by service type

£ billion (2012)	Exports		Imports	
	EU-27	World	EU-27	World
Transportation	8.1	22.1	12.2	21.0
Travel	10.3	23.2	18.2	32.6
Financial	18.0	46.0	4.0	11.2
Computer and information	4.5	9.4	2.4	4.3
Other business services	20.0	56.5	14.4	31.0
Other services	11.1	36.2	9.0	19.3
Total services	72.0	193.4	60.2	119.4

Source: The PinkBook 2013, Table 9.11: Trade in services by type of service 2012

London's creativity has to be an important plus, and one would expect this to be retained, in or out of the EU. As too should its innovative potential, which is a hallmark of a number of international cities, requiring both effective supply chains and face to face communication in which ideas can be developed and established. The evidence suggests that this process is best enabled in cities. The high tech cluster of firms in and around San Francisco is the strongest example of how this process continues today even where digital communications are most favoured. In London, the area now known as Tech City, stretching around the northern edge of the City of London is performing a similar role. Similarly, across the UK there are clusters of economic activity, often linked with universities and areas of excellence.

London's competitive edge cannot be taken for granted. It is based on service sector exports, and the support of business innovation, in turn supported by traditional strengths in law and finance. The mix of stable and changing geography at London's heart illustrates this. Law firms and finance houses remain located in their traditional bastions to the west and the east of St Paul's. Emerging technology businesses emerged in cheaper locations around Shoreditch and the City fringe.

This success story can be derailed, however. Establishing innovation is extremely hard and distraction is a major risk. Management time and attention is always limited and it is easy to put off hard decisions. The more barriers to change and to making hard decisions about change, the more likely they are to be put off or deemed to be too risky. Systems of taxation, regulatory pressure, business as usual difficulties can all contribute to an unwillingness to try something new.

Regulatory pressure and controls inhibit innovation. In putting together the package of activity – financial, technical and strategic – which constitutes a successful innovation there can be distractions at every level. Since much regulation emanates from the EU,

this is a major issue, as creating a standard regulation that will be appropriate for all the economies of the EU is impossible. So the debate around regulation will involve enormous time and attention from all concerned.

Moreover, such debates will also be a distraction from developing trade with the wider world beyond the EU.

The more difficult it is to do business, or the more difficult it appears to be do business, in London, the more attractive other cities will become. With the weight of economic growth moving East, the central meridian between East and West could become not London but another global centre, perhaps Hong Kong or Singapore.

The difficulty of doing business is a mix of characteristics, from local planning and infrastructure, to law and finance, property rights, and taxation, access to markets and skilled labour. The places in which we wish to do business are far flung and London needs a regulatory and business environment which encourages that international and global focus. It does not need one which is inward looking. The EU is currently in that position, focused on internal issues and what it means to be European. It needs to focus on what it means to be international.

Migration - like demographics - can be a big economic benefit if planned for. However, if unplanned, it can cause significant challenges and problems, especially in terms of housing, transport, education, and health infrastructure. The age and skill set of migrants also needs to be considered in terms of the economic impact.

Where migrants have skill sets that compete with those of the domestic population, and these are seen as a direct substitute, there is downward pressure on wages. Where they complement and fill existing skill gaps then the impact on wages should be limited.

As part of the Single Market, the UK would need to accept EU rules on migration. That has been the case to date. Outside the Single Market the UK would be able to impose its controls on EU and EEA migration, but likewise the rights of UK citizens to visit or move to an EU or EEA Member State would depend on the visa requirements those states choose.

Employment and social legislation has been an important aspect of UK membership. This broadly covers working conditions, manifesting in EU directives on working hours, how part-time and full-time employment should be structured, equality, health safety, and the posting of workers to other EU economies. It sets minimum standards but the UK has managed to secure an opt out of the Working Time Directive as it constrains seriously employer and employee flexibility in areas such as night work, long shifts and other roles that require extended time in the place of work. While the UK opt-out is viewed as relatively safe it does attract attention from the Commission and is by no means as secure as the euro opt-out.

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## 2.10: London's and the UK's employment (2012) and output (2011) by sector

Sector	London employment	% of London total	UK employment	% of UK total	London GVA	% of London total	UK GVA	% of UK total
Financial and insurance activities	383,250	7.5%	1,144,250	3.6%	60,027	19.8%	116,363	8.6%
Professional, scientific and technical activities	627,500	12.3%	2,504,000	7.9%	35,418	11.7%	96,655	7.1%
Information and communication	364,750	7.2%	1,231,500	3.9%	35,310	11.6%	88,035	6.5%
Real estate activities	120,750	2.4%	497,500	1.6%	29,849	9.8%	143,641	10.6%
Wholesale and retail trade; repair of motor vehicles and motorcycles	627,750	12.3%	4,844,500	15.2%	25,176	8.3%	151,785	11.2%
Administrative and support service activities	506,000	9.9%	2,543,000	8.0%	16,427	5.4%	62,156	4.6%
Human health and social work activities	518,250	10.2%	4,055,750	12.7%	15,982	5.3%	104,026	7.6%
Education	374,750	7.4%	2,769,000	8.7%	14,268	4.7%	84,556	6.2%
Construction	270,500	5.3%	2,043,000	6.4%	13,778	4.5%	86,789	6.4%
Transportation and storage	260,000	5.1%	1,510,250	4.7%	12,905	4.3%	59,179	4.3%
Public administration and defence; compulsory social security	225,000	4.4%	1,578,250	5.0%	11,883	3.9%	70,400	5.2%
Manufacturing	122,750	2.4%	2,567,000	8.1%	8,137	2.7%	140,539	10.3%
Accommodation and food service activities	339,250	6.7%	1,999,750	6.3%	8,015	2.6%	36,554	2.7%
Arts, entertainment and recreation	168,000	3.3%	891,750	2.8%	5,220	1.7%	20,410	1.5%
Primary and utilities	31,250	0.6%	787,500	2.5%	4,965	1.6%	74,107	5.4%
Other service activities	130,000	2.6%	787,000	2.5%	4,828	1.6%	19,787	1.5%
Total	5,069,750	100%	31,754,000	100%	302,188	100%	1,354,982	100%

Sources: Employment: ONS Workforce jobs series 2012 (includes self-employment); GVA: ONS

Table 2.10 shows the sectorial breakdown of the London economy.

The third column from the right shows the importance of each sector to London's economy and these are listed from the most important at the top: finance and insurance (19.8 per cent), professional, scientific and technical services (11.7 per cent), information and communication (11.6 per cent), real estate (9.8 per cent), wholesale and retail trade (8.3 per cent), administrative and support service activities (5.4 per cent), human health and social work (5.3 per cent), education (4.7 per cent), construction (4.5 per cent), transport and storage (4.3 per cent), public administration and defence (3.9 per cent), manufacturing (2.7 per cent), accommodation and food services (2.6 per cent), arts (1.7 per cent), primary and utilities (1.6 per cent) and other service activities (1.6 per cent).

We have looked at the relationship with the EU for these sectors. A few key issues are identified. The first of what could be termed as the 'regulatory paradox'. Despite much noise about the regulatory burden of EU membership, the regulatory gains from leaving are not likely to be significant for any one sector, although smaller firms appear hopeful of an easing in the regulatory cost. This is in part, because many regulations are enshrined in UK law, and because there would be a need for regulations anyway, from a UK perspective.

To understand fully table 2.10 consider the line for 'real estate activities', the fourth line down. Reading along this line, the figures show: there are 120,750 employed in this sector in London, which is 2.4 per cent or one in 40 of those people who work in London, this compares with 497,500 who work in this sector in the UK, which is 1.6 per cent of total UK employment. Next is that this accounts for £29.849bn of London's gross value added, which is 9.8 per cent of London's total, while across the whole UK, in the last two columns, this sector accounts for £143.6bn, or 10.6 per cent of the UK total.

Two sectors in particular would seem to benefit more than other through EU membership, these are finance and insurance and also the professional, scientific and technical sector, which both combined constitute around a third of the London economy. Let's consider here some of the main issues for both of these sectors. For the City having passport access to carry out financial services across Europe is one of many important issues. These two sectors fear that they may have the most to lose if the UK leaves, and in turn perhaps may have much to gain if the UK adopts a leadership role in the EU driving a reform agenda. All other sectors are covered in detail in the attached Appendix.

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## Sector-specific issues relating to the EU and withdrawal from the EU:

### • Finance and insurance:

#### 2.11 Financial Services Sector Summary

Sector	Legal instrument(s)	Current impact	Implications for UK/London of leaving EU
Financial services (19.8% of London's GVA, 7.5% of London's employment).	Very wide range of legislation, in particular focusing on banks since financial crisis.	Single Market principles and single rule book across EU have enabled business for the City across the EU. Banking union in the Eurozone risks a two-tier regulatory framework evolving, though there are some safeguards to prevent any measures undermining the internal market.	Would be subject to basic rules at international level (G20, BIS, OECD, WTO). Loss of guaranteed access to Single Market could undermine attractiveness of London as a location for head offices of financial services companies. Possible attempts by other Member States to prevent certain transactions (for example those denominated in euros) from taking place in London; in absence of UK influence and safeguards for the internal market (especially on banking) EU financial services legislation might gradually drift away from UK interests.
<b>Key questions:</b>		<b>Our assessment:</b>	
How complete is the EU's internal market for this sector?		Wholesale markets substantially complete; retail still incomplete.	
What would be the cost to London of losing access to it?		High. UK banks would need to be authorised in an EU Member State to benefit from passport.	
What's the value to London of the UK's seat at the table?		High – but under threat.	
Regulatory gains from leaving EU?		Medium – on the one hand, most regulatory rules are international and would be required whether in or out. Conversely, some EU-specific rules would not apply and the UK would not have to undertake costly legal action (for example the UK is challenging in the European Court EU limits on bankers' bonuses and has also challenged the proposed Financial Transactions Tax).	

#### 1) Background

London is Europe's financial centre. It is also one of the world's largest financial centres. How can it retain this status and continue to benefit in the future - as in the past - in the face of a changing global economy and increased international competition? Not only does London need to learn the right lessons from the crisis but it also needs to continue to position itself as an open, outward looking financial centre, at the heart of global and European finance. As stated before, being global and European need not be at odds with one another.

In 2013, the world's largest net exporters of financial services were: UK \$71bn, US \$27bn, Luxembourg \$22bn, Switzerland \$21bn, Hong Kong \$13bn and Singapore \$12bn.<sup>7</sup> While these figures reflect the international strength of the UK led by London they also suggest no major competitor within the EU. That too, as was seen during the financial crisis, can create a challenge as the size of the UK financial sector in relation to the UK economy is huge. It helps explain why it is vital for London to get its regulation right.

London is in a strong position. Within Europe, there are strong national financial centres in Amsterdam, Edinburgh, Frankfurt and Paris, strong niche financial centres in Geneva and Zurich, offshore centres in Dublin, Guernsey, Jersey and Luxembourg and emerging centres in Istanbul and Moscow. None rival London.

The UK financial sector covers a huge range of areas, many of which are international and thus could be located anywhere. These include banking, insurance, equity and bond markets, fund management, commodities trading, maritime services as well as legal services, professional and business services, accounting services and management consultancy. Yet, the fact that London remains responsive to new ideas and manages to position itself well in growing markets such as Islamic finance, sovereign wealth, the offshore Chinese currency market, in carbon markets, dispute resolution and even the increase in global regulation is a growth area for London. It really is impressive. It highlights London's global reach. The City's view on Europe has to be taken seriously, but an important point raised is that the time frame over which business looks can be relative short, up to five years, and in that business model there is a bias towards the status quo and to avoiding unnecessary uncertainty. Hence the City was pro the UK joining the euro as our competitors were doing that and in a similar vein is pro remaining in the EU given the uncertainty and legal complexity of leaving. Yet, many of the factors that underpin London's attraction would likely prove resilient if the UK were outside the EU. It is how the economies of Europe and the UK perform over the next couple of decades that is important, particularly in the face of future opportunities, growth and competition in the US, Asia and globally.

There are risks: one is that within the EU is that the principle of qualified majority voting could prevent the UK from protecting the City from unsympathetic regulation or that banking union gives greater power to EZ members over non-EZ members like the UK to drive legislation; another is that leaving the EU undermines some of the attraction of being in London and encourages the growth of a regional rival, most likely in Frankfurt or Paris. Of course, if the UK itself imposes excessive regulation or taxes or the cost of living in London soars too much then London could lose some of its attraction, whether in or out of the EU. That is, the ability to create a competitive environment, as well as to impose hurdles to future growth can be heavily determined by what the UK does itself, not blamed on the EU or international factors.

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<sup>7</sup> See CityUK 'Key Facts about the UK as an International Financial Centre', June 2014

## **2) Existing EU legislation:**

In the European Union the Single Market in financial services relies on the principles of mutual recognition and the 'single passport'. This is a system permitting financial services operators legally established in one Member State to establish/provide their services in the other Member States without further authorisation requirements.

Regular surveys suggest the City is overwhelming in favour of continued EU membership, although it appears that this is less to do with an enthusiasm for the EU itself and more the widely held belief that London and the City might suffer if outside. The issue can probably be best addressed by asking how would the City suffer being outside rather than in and, from a global perspective, what's needed to ensure London remains a leading global financial sector and does the EU help or hinder this?

Participants in the CityUK's survey of financial and related professional services leaders expressed some reservations in regard to the benefits to the UK's competitiveness stemming from European Union membership. Sixty five per cent for example said that 'regulatory changes from the EU' are the most significant challenge to their business.<sup>8</sup>

There are many areas of regulatory overlap for London with the EU. There is the Capital Requirements Directive IV (CRDIV) and the Capital Requirements Regulation (CRR). Another important provision is MIFID, the 'Markets in Financial Instruments Directive', which replaced the Investment Services Directorate and provides harmonised regulation for investment services across the 31 EEA Member States. For the insurance sector, the Single Market also relies on the principles of mutual recognition and the 'single passport'. The current major piece of European legislation covering insurance is the Solvency II directive, which seeks to codify and harmonise EU insurance regulation. Importantly it concerns the amount of capital that insurance companies based in the EU must hold to reduce the risk of insolvency. The European Parliament voted in March 2014 to bring the Solvency II directive into effect by January 2016, though this date has been pushed back several times.

There is a danger in looking at the relationship between the UK and EU from the perspective of the financial sector solely in terms of legislation and regulation. If the European and UK economy were growing strongly, there would be an enhanced need for financial services.

Given the global importance of finance, there is an increasing desire to have global regulatory approaches to all the key issues. That being said, it is clear that regional (in this case the EU or European Central Bank) or national (UK) regulatory approaches can be different, adding an additional complication. Given London's global reach, international competition also matters.

<sup>8</sup> CityUK: The City Speaks, <http://www.thecityuk.com/research/our-work/reports-list/the-city-speaks-a-milestone-study-of-the-views-of-financial-and-related-professional-services-leaders-on-the-eu/> November 2012

The CityUK lists the following as factors underpinning London's status as an independent financial centre: a fair, proportionate and consistent independent regulatory environment; a business climate that facilitates new products and ideas; easy access to markets internationally for trade and investment; a tradition of welcoming foreign firms; concentration of financial institutions; high quality professional and support services; a highly regarded and impartial legal system based on common law; a focus on soft infrastructure such as exchanges and on hard infrastructure such as transport; a skilled and diverse labour force; a consistent politically neutral legal system; a central geographic location and time zone. While all are important, it is worth stressing the importance of common law which as CityUK states, 'Common law tends to be more flexible in respond in to the development of financial services and is the prime reason why over half of the world's commercial contracts are governed by English law and why the UK is a global leader in both judicial and non-judicial dispute resolution.'

### *3) How complete is the internal market?*

Not complete – Cross-border banking and insurance for companies and in wholesale markets is more advanced than in retail markets. The 'Single Supervisory Mechanism' will give the European Central Bank the responsibility for supervising the largest Eurozone-based banks. By providing uniform supervision this should help to make the market more complete in the Eurozone but feeds into the concern we express below about the Single Market versus the Eurozone. Banking Union provided an important role in helping rescue the euro, but there is uncertainty about its future path and it could pose a threat to The City.

There have also been areas of recent tension impacting the City, including a cap on bankers' bonuses and eleven members of the Eurozone agreeing a financial transaction tax (FTT) of 0.1 per cent on trading of stocks and bonds and 0.01 per cent on derivatives. The tax would apply if any party to the transaction in euros was based in a participating Member State – regardless of where the transaction takes place. If implemented this would affect London which is a major centre for euro trading. Although small, it is the process that led to this which is the concern.

### *4) Cost of losing access*

A global regulatory response was always seen as the most desirable to avoid the so-called 'Balkanisation' of the financial sector and also to avoid regulatory arbitrage. It would be wrong to view the City's relationship with Europe through a regulatory lens, as so much is unfolding. European Commission policies in the field of regulation of banks and financial conglomerates are based on the principles of mutual recognition and the 'single passport'. This is a system that allows financial services operators legally established in one Member State to establish/provide their services in the other Member States without further authorisation requirements. This implies that banks

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headquartered in the UK would need to seek authorisation for a branch within the EU in the event of a UK exit from the EU. For the bank to then access the rest of the EU with the 'single passport', there needs to be a further agreement with the EU. This could take some time to achieve; it would include the EU banking authorities satisfying themselves that the UK's supervision is 'equivalent' to that in the EU. The impact of departure would very much depend upon the business model of individual banks. However the position could become more difficult. Despite there being no comprehensive services accord, the Swiss financial sector has, so far, benefited from largely unfettered access to the EU market, often through its presence in London. New EU regulations could change this. Tighter regulations would mean third countries constantly having to amend their parallel legislation, in line with any changes in Single Market legislation, in order to maintain equivalence over the course of time. And – like Switzerland – if the UK was to withdraw from the EU, it would lose the ability to influence EU banking legislation.

In particular the MiFID II proposals are likely to make provision of financial services to the EU from outside the EEA increasingly difficult. After 2019 offshore (that is non-EEA) providers will only be able to offer a more limited range of services, and that only on condition that they register with the European Securities Market Authority.

For the insurance sector, there is a feature of Solvency II which has the potential to handicap UK insurers, should the UK leave the EU. For global insurance companies the most important question concerns whether third country regulations will be considered 'equivalent' to those in the EU. If it is not – or if the reporting requirements featured in draft Solvency II interim measures do not allow insurance companies to take proper account of equivalence assumptions - then EU-based insurers would effectively have to meet capital requirements for their non-EU business twice over: once in the US according to National Association of Insurance Commissioners (NAIC) rules and once in the EU according to Solvency II rules.

The UK attracts more inward foreign direct investment (FDI) than any other EU Member State and the financial services sector attracts a large slice of this. In the CityUK's survey of financial and related professional services leaders, over eight in ten respondents said they think staying in the EU is the best option for the competitiveness of the UK as a financial centre and almost three quarters agree that their firm benefits from UK membership of the EU. Crucially, 38 percent said their firm was certain or likely to at least partially relocate out of London if the UK left the Single Market. However, it must be said, that this figure mirrors comments made by City leaders on the effect of the UK not joining the euro.

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*5) Value of a seat at the table*

Having a seat at the table clearly can have benefits if the UK is able to protect its interests, but as we outline in detail in the reform section below, we already feel that this is becoming a challenge and is an issue that needs to be addressed – and that is even with the UK within the EU.

*6) Regulatory gains from leaving EU*

There are other EU prudential regulations in the financial services sector which the UK might be obliged by competitive pressure to adopt, even if it leaves the EU. An example is MiFID, the Markets in Financial Instruments Directive. Switzerland for example did not adopt MiFID and some commentators believe this was a mistake which caused its banks and asset managers to lose some EU business. Again - if the UK leaves the EU it will forfeit its chance of shaping the legislation (the 'seat at the table'). There are proposals in the MiFID Review – for example – that have the potential to restrict access to services provided by non-EU countries, and provisions in AIFMD (Alternative Investment Fund Managers Directive) which limit European firms' ability to contract with third party asset managers.

Outside the EU, London could become an even more competitive financial centre, remaining truly global. If the UK left the EU, would the EU seriously push ahead with all its proposed regulatory changes, such as in limiting bankers' bonuses or the financial transactions tax? To do so would further add to the attraction of London. Yet, over time, an increasing amount of financial services regulation is international rather than EU-based.

▪ Professional services sector

## 2.12 Professional (scientific and technical) services sector summary

Sector	Legal instrument(s)	Current impact	Implications for UK/London of leaving EU
Professional, scientific and technical (11.7% of London's GVA, 12.3% of London's employment).	Directives (like Services Directive) enable mutual recognition of qualifications awarded in other Member States to allow professionals to provide services.	System of automatic recognition for doctors, nurses, dentists, vets, midwives, pharmacists and architects; general system for professions not covered by specific rules of recognition.	Providing professional services in the EU without this system would be more difficult; possible impact on NHS use of doctors and nurses from other EU Member States.
<b>Key questions:</b>		<b>Our assessment:</b>	
How complete is the EU's internal market for this sector?		Partially complete	
What would be the cost to London of losing access to it?		High	
What's the value to London of the UK's seat at the table?		High	
Regulatory gains from leaving EU?		Low	

### 1) Existing EU legislation:

The Services Directive enables the establishment by business service providers in another Member State and eases the way for them to provide their services on a cross-border basis. It covers a large number of business services, with a few exceptions, such as private security services, services of temporary work agencies and notaries. The Services Directive was established in late 2006. However its implementation by Member States has been slow and patchy. The UK with its comparative advantage as a service sector economy has put particular emphasis on full implementation of the Services Directive, describing it as 'the first priority for boosting competitiveness in services.'

The Professional Qualifications Directive enables the recognition of professional qualifications for EU professionals wishing to work in another EU country. Professions such as accountants, lawyers, consultants and engineers, offering their services to a large extent to businesses, are regulated in the majority of Member States.

*2) How complete is the internal market?*

The Commission states that the level of intra-trade in services is significantly lower than that in goods, a point we make elsewhere in this report. Although progress has been slow, the Commission states it is committed to completing the internal market in services. The gains, for the UK and EU, if it does so could be significant.

*3) Cost of losing access*

If the UK withdrew from the EU, these provisions for UK-based professionals would need to be renegotiated.

One of the professional groups affected would be the scientific and high tech community. The likely issues would be the mobility of research staff within Europe and the future of EU funding of R&D projects.

The EU plays a major role in the financing of UK research and technological development in the form of the Framework Programme (FP) - the EU's primary funding instrument for supporting collaborative, transnational research and development. Programmes such as ERASMUS and the European Investment Bank also support scientific projects in the UK. As we mention in the section below on exit, the economic shock to those areas from losing EU funding would need to be likely substituted by UK funding.

*4) Value of a seat at the table*

The UK and London have a comparative advantage in some services sectors and the UK has been among the most diligent of Member States in applying the Services Directive. The UK has a large surplus of £16.5 billion in services with the EU. The lack of progress to date in liberating services fully highlights that even when you have a seat at the table progress is by no means guaranteed.

In the reform section below we highlight areas that need to be addressed.

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▪ **Other Sectors:**

In Appendix A we examine each sector's linkages with the EU. Table 2.13 sums up the picture, asking how complete is the Single Market in that sector, the cost of losing access to it, the value of a seat at the table in the sense of being able to influence the agenda within the EU and the regulatory gains from leaving.

**2.13 Costs and gains to London of UK exit from EU**

	Proportion of London's GVA	Proportion of London's Employment	How complete is the Internal Market?	Cost to UK of losing access to it?	Value of seat at table	Regulatory gains from leaving?
Finance and insurance	19.8%	7.5%	Wholesale complete, retail incomplete	High	High – but under threat	Neutral
Professional, scientific and technical	11.7%	12.3%	Partially complete	High	High	Low
Information and communication	11.6%	7.2%	Incomplete	Medium	Medium	Low
Real estate activities	9.8%	2.4%				
Wholesale/retail	8.3%	12.3%	Incomplete	Low	Medium	Low
Administrative and support service activities	5.4%	9.9%	Incomplete	Medium	Medium	Medium
Health and social work	5.3%	10.2%	Incomplete	Medium	Medium	Medium
Education	4.7%	7.4%	Incomplete	Medium	Medium	Low
Construction	4.5%	5.3%	Substantially incomplete	Low	Medium	Medium
Transport/storage	4.3%	5.1%	Partially complete	High	High	Low
Public administration	3.9%	4.4%	Partially complete	Low	Medium	Low
Manufacturing	2.7%	2.4%	Incomplete	Low	Low	Low

Accommodation & restaurants	2.6%	6.7%	Incomplete	Low	Low	Low
Agriculture and food	2.1%	3%	Substantially complete	Low	Low	Medium
Arts, entertainment and recreation	1.7%	3.3%	Partially complete	Low	Low	Medium
Primary & utilities	1.6%	0.6%	Incomplete	Low	Medium	Medium

Sources: Employment: ONS Workforce jobs series 2012 (includes self-employment); GVA: ONS

‘Finance and insurance’ the most important sector in London’s economy is shown in the top line of the table. How complete is the internal market for this sector? Our view it is complete for wholesale business services, but incomplete for retail services. The cost to the sector of the UK losing access to the Single Market could be high – although as we outline below, in these situations it does depend upon the path the UK chooses were it to leave, that is, it is a dynamic situation. The value for this sector of being able to influence the EU agenda, the so called seat at the table, is high, and the regulatory gains from leaving are ‘medium’, as opposed to high or low, given the global influence in this sector.

Table 2.13 provides a summary of the costs and gains to each sector of possible EU exit. Whereas there is no disagreement in the numbers, the last four columns of this table are more subjective, and thus it is possible that some other experts may wish to draw slightly different conclusions. We would, however, be surprised if there was a widely divergent interpretation and these are, in our opinion, a fair reflection of the present situation.

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# Section 3: Summary of previous reports

This section summarises the debate on the UK and EU based on what has been written in other reports. The last period of intense discussion on Europe before the current one was in 2003-2007, in the run-up to the December 2007 Lisbon Treaty.<sup>9</sup> After the Lisbon Treaty, the debate was mainly concerned with monitoring the effectiveness of implementing the Lisbon reform agenda. The large amount of technical change in the running of institutions post-Lisbon absorbed a good deal of research time and analytical scope, such as interest in the growth of new processes such as the 'trilogue' co-decision mechanism. Trilogues are informal three party meetings attended by representatives of the European Parliament, European Council and European Commission. While, at that time, institutional and general criticism of Europe remained apparent in elements of the press and existing Eurosceptic bodies, it was not effectively challenging the status quo.<sup>10</sup> In the wake of the 2008 financial crisis and the subsequent 2009 Eurozone sovereign debt crisis the bigger questions around membership have returned to the centre of the debate and have continued to attract increased focus.

From 2009, the situation in Europe, by necessity, has been one of reaction to crisis, attempted reform and broad sweeping change. This has emboldened critics, many of whom felt vindicated on the euro as public support for the EU dropped across the Continent. It has also rallied supporters, who have felt the need to make a social and business case for a European model that is clearly in trouble. This makes the point that it is time that the UK influences institutional reform in its favour, making links stronger and in the process helping the EU. This has led to a pronounced and observable upsurge in publications.

As such, this section of this report seeks to critique the current state of the debate, and alongside this identify key documents and how they are shaping the UK domestic narrative as we move to a period of possible renegotiation and reform. We surveyed every major release of the past 36 months, and a large number of works from the period pre and post Lisbon. In all, this covered over 100 major pieces of work and several hundred smaller releases and supporting documents.

The following ten documents outlined here offer a good snapshot of the state of the UK-EU debate, and include a couple of publications from the Continent that give a flavour of the debate there.

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<sup>9</sup> Among this large number of documents being issued of special consideration should be given to the House of Commons reports: *The Convention on the Future of Europe* series which were notable in attempting to put treaty reform in a very long term perspective.

<sup>10</sup> This includes various think tanks and individuals within political parties alongside impressive work done by Various Lords Committees and All Parliamentary Groups that have highlighted many issues, being critical where needed, including Competencies Drift, Regulatory Over-reach and lack of proper accounting at an EU level.

**1. HM Treasury, *Literature review – economic costs and benefits of EU membership*, December 2010**

A useful snapshot of where the state of the debate was in 2010. It shows that the narrative has not really been shaped by the impact of Prime Minister Cameron's veto in 2011, but the 'volume' of the analysis has increased. Obviously battle lines in the debate have been drawn for some time, but this source is an interesting look at how iterative in nature publications can be over time. Its conclusions, pointing out the political and economic issues with the slow pace of reforms in the Single Market in services and the frustrations of small business with regulation, are as apparent in the years up to 2010 as they are now.

**2. Herman Van Rompuy, President of the European Council, *Towards a Genuine Economic and Monetary Union*, December 2012**

Herman Van Rompuy (President of the European Council), in close collaboration with three other European Presidents Jose Manuel Barroso (European Commission), Jean-Claude Juncker (Eurogroup) and Mario Draghi (European Central Bank), set out their views on the different stages of monetary union, ending in, 'Improving the resilience of EMU through the creation of a shock-absorption function at the central level.' It indicates how important the 'trilogue' process has become in the thinking of European power-brokers. This piece is important as it gives an insight into the uniformity of thought at the top end of the European elite. It is important to see the cohesion in the political goal of 'ever closer union' between the primary organs of European government – or to put it another way, the survival of European monetary union above all else.

**3. House of Commons Select Committee, *The Future of the European Union: UK Government policy*, September 2013**

This is the supporting document for the Prime Minister's initiation of the UK's current phase of EU relations after his December 2011 veto. This is an essential publication that gives a clear steer to the current government's policy direction on Europe. It is however light on solutions, both in how reform is to happen, and what is specifically to be reformed. Even the end result of a renegotiated relationship is vague. It is surprising that a list of key issues and reforms was not worked up and on hand for this sort of contingency and represents a lack of focus on the issue prior to 2011. Arguably that lack of focus remains in the UK approach to Europe today, this document was after all published sometime after the veto.

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#### **4. Dutch House of Representatives, *Democratic legitimacy in the EU and the role of national parliaments*, October 2013**

The Dutch Parliament's response to their own competencies review, lays out some reasonable subsidiarity based reforms that have clearly helped shape UK government thinking.

In the paper on the role of national parliaments in the EU, the Dutch lower house of parliament states that 'legitimacy and support for the EU decision making process should be established bottom-up (from the citizen)'. The report calls for the EU's so-called 'yellow card' procedure to be made stronger. This includes a 'decrease of the threshold' of the number of national parliaments required to activate the mechanism, which forces the Commission to review an EU proposal if a sufficient number of national parliaments object to it.

Other proposals include a 'green card' whereby national parliaments could propose 'to amend or recall existing' EU legislation and a 'late card' to give national parliaments a say on EU legislation after negotiations between national ministers and MEPs, rather than simply once a Commission proposal is tabled, as is the case now.

#### **5. CBI, *Our Global Future*, November 2013**

This report forms the cornerstone theme for the UK's main business advocacy group. In broad terms it argues for in with reform, not out with no influence. This mantra is represented in all their subsequent media releases and literature.

The report implies that there is a tacit acceptance that if significant reform is not reached the current status quo (or indeed further integration) is vastly more preferable than the worst case scenario for leaving that they have constructed.

Whether or not parts of the report lack balance is less important than its position as the prime representative document for how advocacy groups will be pitching the demands of business and industry to the government. This is the core backing document to the pro-membership side of the debate.

#### **6. Open Europe, *Gaming Europe's Future: Simulating the negotiations that could determines Britain's place in Europe*, February 2014**

'War games' play an important part in strategic security issues, and this report shows that such a forum can be useful in political matters. The reform focused think tank, Open Europe, carried out a war game scenario in which they took the common complaint that our relationship with Europe has lacked a coherent strategy and turned it on its head. The report shows that without a coherent strategy for British exit or Brexit, the outcomes for the UK will be sub-optimal. By taking politicians and stakeholders through a series of scenarios, where EU institutional veterans and experts played a variety of supporting and opposition positions in negotiations, far more positive

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outcomes were reached. The conclusion showed that the UK currently falls short in both appealing to a pan-EU audience and in having a convincing narrative for reform.

This is the sort of activity which is useful for exposing policy plans to intense pressure and criticism and an aggressive environment. It is exactly the sort of policy stress testing that should (and indeed may) be happening behind closed doors at the Treasury and the Foreign and Commonwealth Office with EU policy. Most importantly the event and subsequent report showed that if the UK is to reform the EU it needs a credible exit strategy.

### **7. IEA, *A Blueprint for Britain – Openness not Isolation*, April 2014**

This report is listed here as it was chosen by the Institute for Economic Affairs as their Brexit Prize Winner, written by Iain Mansfield a UK diplomat. It offers a set of pragmatic proposals for the UK if it voted to leave the EU in 2017. Interestingly the author does not over-engage with the technicalities that many reports obsess over and instead opts for the stance that this is new ground and solutions will be found because they must be (echoing the extra-legal steps taken during the Eurozone crisis). As such, the piece avoids the trap of short termism. It understands the need to shape a general post-exit pan-governmental policy narrative, constructing a highly believable scenario for success over the long-term.

### **8. CityUK and Clifford Chance, *A Legal Assessment of the UK's Relationship with the EU: A Financial Services Perspective*, April 2014**

This paper is probably the most nuanced of the 'in even if no significant reform' documents yet published and engages the legal implications of leaving with a forensic eye. It is an excellent document and a companion piece for many existing government documents, being an exhaustive and comprehensive analysis of the possible outcomes for the UK if the minutia of law trumps political expediency.<sup>11</sup> The legal complexities for the City of leaving are highlighted. The message is that the current relationship with the EU is legally complex, being very difficult but not impossible legally to unwind if we were to leave. Future new relationships might be time consuming to create.

In essence it lays out an intriguing argument for why the UK should be glad for the smallest margin of reform and should not expect more. The certainties and guarantees of membership, as well as the inescapable nature of market integration are presented in a dispassionate legalistic manner. After all as the report states the 'EU is founded on treaties and therefore legally based'.

### **9. Roger Bootle, *The Trouble with Europe*, May 2014**

This is the only book on this list. It puts forward a comprehensive, evidenced and well thought out rationale for leaving the EU, if *very significant* reform is not possible. Given the ease with which a short term business and political case can be made for

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<sup>11</sup> For instance: the Leaving the EU, Research Paper, House of Commons, 1 July 2013.

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maintaining the status quo (especially with minor reform) it takes a significant amount of context setting to put in place a successfully argued narrative for thinking about much longer term implications.

Boote's conclusions over the myriad and built in failings of the European Union's institutions are compelling and set out in terms of failures at a slow pace that governments change over at too fast a pace to catch. Most compelling is his cautious warning that the EU, whilst a huge economic weight, may end up resembling the Soviet Union in its inability to innovate and keep pace in the global race. This mirrors some of the research on innovation by Volterra contained in this report, and in the appendix.

#### **10. UK government, *Balance of EU competences review, (ongoing) 2012-2014***

Finally, this extensive series of documents is being released in stages over a series of years and looks at the balance of competences between the EU and UK. It has to tread the line carefully between the analysis of political and departmental legacies while providing a comprehensive picture of the true nature of Britain's policy relationship with the EU. The analysis is predicated on balancing the former with the later. A number of the published sections tend to have reflected too much integration here, not enough there but the mix is just about right. The July 2014 tranche of releases contained a number of indicators showing that the direction of travel has changed, as releases on freedom of movement and financial services regulation contained clear challenges to the EU regulatory balance, with suggested avenues of reform and key red lines to further competence erosion. It suggested a more assertive approach.

When this work is finished it will be supremely useful as a guide to both what each individual department of government's stance is and to the real level of competency loss to the EU that the UK has been subject to, both in the run up to the Lisbon Treaty and in its wake.

#### *London*

As well as the points raised above there were some other general takeaways from these works, and the broader literature search. Some positive points from the literature search were that:

- London and its key financial services sector are very well represented in all relevant documents. The importance of London for the UK and EU economy is well argued and supported by data.
- The supporting role that London plays in enabling trade and business in other EU economies is well documented.
- The benefits of the London and UK knowledge economy, creative and cultural sectors are also acknowledged in domestic and European reports.

There were also a number of generic points one could make from the literature search.

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Documents focusing on business and the economy tend to operate from the position and idea that the EU functions primarily as an economic union, not a political union. It could be said that this allows the analysis to focus on the economic issues but precludes the idea that anti-business views or those politicians in Europe who are wary of the City and financial services can and will set elements of the policy agenda. This needs to be highlighted as a continuing issue with membership and modeled into expected outcomes.

Reports across the board generally present binary outcomes to support their political or business vested interests. A more nuanced approach is needed on both sides of the debate, as outcomes do not just depend upon membership, or not, although are heavily influenced by this. There is a vast body of recent literature that has tended towards the presentation of a best versus worst case scenario and the analysis and context setting are tailored to put this position across, sometimes resulting in headline grabbing figures of cost/benefit. In reality the nature of market forces and the ability of governments to enable policy reform mean that whilst there is a chance for the best/worst outcome there could also be any number of middling scenarios.

Although there are many excellent reports, including some of those highlighted above, there are also some reports that are in topic silos. While many reports can claim a good to excellent level of analysis on narrow specifics some can fail to approach the European institutional mechanisms with enough breadth to fully account for the influence that indirect regulatory and directive pressure from non-related Commission and European Parliamentary bodies can have on their area of interest. While we understand that specialists are aware of the non-related pressures this is generally undiscussed because it involves complex or direct criticism of how the EU functions.

There is a general issue as to whether reports are generally too short term. It is easy to make a business case for the EU over a 24 month forecast as an exit would lead to considerable near-term uncertainty and intense policy debate. Similarly it is easy to make the case for very limited EU reform, with politically expedient quick fixes. Engagement with longer term horizons of ten, 15 or 20 years provide not only for more interesting conclusions but opens up the debate to discussing the reforms that are needed to maintain long term political and economic success and achieve what we have outlined in the rest of the report, namely the key need to position the EU in a changing global economy. Alongside this, documents are presenting a cost/benefit analysis of legislative and treaty decisions in a short term manner, even though they will affect the country for decades to come. Appropriate emphasis needs to be given to the reasoning as to why EU membership will always be beneficial to UK business and industry. This criticism is broadly sidestepped by pieces advocating leaving which by their nature primarily focus on the long to ultra-long term.

Also, the vast majority of UK literature seems to take it as a given that there will be no further integration, or only very limited non-political integration for market reasons. Given that this is not set in stone, and indeed many of the plans to reform Europe

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presented by the institutions are in turn calling for more Europe in some areas this is an incorrect assumption. There is clearly remaining integration momentum among the European Commission and a significant proportion of the European Parliament.

#### *Polls and surveys*

Many reports analysed had polls and surveys to provide an evidence base for their argument. It is clear from various polls with London and UK business that they overwhelmingly desire to stay in a renegotiated Europe Union. The London Chambers of Commerce and Industry (LCCI) and CBI polls showed a majority of business would vote to remain as part of the European Union. Very few offered a follow up question outside of reform or status quo. This means it's difficult to gauge how business feels about an EU continuing to politically integrate.

Several reports presented the evidence that businesses supporting market access were in turn advocating support for the EU as a whole. It is one thing using such poll results to lend support to the Single Market and it is quite another to suggest that British business backs the EU as a totality. Perhaps work needs to be done on the specific wording of surveys to better differentiate between Single Market access and EU membership.

There are recent signs that this trend is changing. The May 2014 poll by the Institute of Directors was conducted with the multi-layered question criteria needed to actually tease out how business feels. They found that whilst business was broadly supportive of remaining in a reformed EU there was an important follow up question on whether they would stay if no reform was forthcoming. In this case 60 per cent suggested they would no longer support membership of the EU. Only 31 per cent responded that they would stay in under any circumstance.

#### *Lessons from the Continent*

This literary analysis has thrown up the issue of understanding the nature of the EU, and how that differs within EU Member States, and the importance of non-economic goals. The Commission and treaty literature have hardly attempted to push supra-nationalism by stealth - it's been bluntly apparent since 1957 - but these aspects remain the least engaged with and most easily dismissed by the UK literature, including those from business advocacy groups.<sup>12</sup> The far-reaching integration implications of the 2004 European Constitution were massively downplayed domestically against far more frank appraisals from the Continent. Indeed, the UK has only sought to remove the totemic phrase 'Ever Closer Union' since 2013.

There remains significant intent for further integration in the European Commission, European Parliament and among influential sections of national European polities. The current trend in much of the UK debate is to state that no further non-bank integration or loss of sovereignty will happen because there is no appetite for it among existing Member States. Except that whilst integration has slowed it has not stopped, and the nature of necessary fiscal union within the EMU has shown that the ECJ is capable of

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ruling against the UK's interests. Over time, the creeping institutional inertia and drive to a uniform bureaucratic area has done little to prevent new controls from biting away at the edges of sovereignty.

Indeed, as shown in the decision by all but two Member States to support the appointment of the federalist Jean-Claude Juncker as the new President of the European Commission very little is being done to affect a complete stop on integration. Indeed, there are many dormant or low key elements of the Lisbon Treaty. It has an expansive number of articles that are aimed at a policy of further integration and legitimisation of the EU as a supranational federal body. Ratchet clauses, qualified majority voting and federalist senior figures mean there is no guarantee that integration has stopped. It can continue, albeit at a slower pace, without support from all national governments.<sup>13</sup>

Very little if any of the key works venture into realms of validity, legitimacy and political desirability of EU membership, whilst these are subjects engaged with in the general discourse on the Continent. It could be asked if the legitimacy debate is something lacking in the UK political and public discussion. There is a certain belief that nothing else matters to the public than the pounds in their pocket. But as with the rapid expansion of the immigration debate in British public discourse since 2010 – purely economic arguments are only part of the picture. In reality people as economic actors are able to make a priced decision as to where their ideology lies as part of a cost benefit analysis. For instance few if any papers ask the question as to whether people would rather be worse off outside of the EU if it meant they had a fuller control of their political destiny. Of course, as our scenarios show, economic success and political independence are possible.

Quite the opposite is true on the Continent, much of the Frexit (French Exit) debate is centred on whether the surrender of national sovereignty, and by extension the rights and powers of the citizen, for financial gain has been worth it. François Heisbourg – *La Fin du Rêve Européen* (The end of the European dream) – challenges whether the cost of fiscal union is bearable if Europe is to progress to a more important goal of political union and the end of the nation state.

Is there a more nuanced European debate flowing on the Continent? There is a better engagement with the politics of the relationship, but has this led to a higher quality of debate? That question remains unanswered, but an injection of analytical direction that takes issues such as the costs of losing democratic legitimacy in hand with the economics would certainly lead to a more nuanced debate.

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<sup>12</sup> 'Ever Closer Union' has been a part of all European Treaties since the 1957 Treaty of Rome. Whilst this phrase has been dismissed by subsequent British governments it has remained the position of all European supra-national institutions from that point onwards. It is a mantra that has played a key role in shaping policy and critically, the nature of key personnel appointments.

<sup>13</sup> There are number of federalist articles that are yet to be fully activated, for instance Article 188j, calls for an EU National Service Programme, whilst Article 176a, includes Europe wide energy exploitation and policy controls which could impact directly on the UK's exploitation of gas reserves. The Reform Treaty was expansive and codified many 'soft' elements of the EU institutions.

Most importantly, we should be more prepared to admit that there are no absolutes when dealing with Europe? In that vein a recent report does help to explain the uniformity of opinion. The Balance of Competences review of the UK and Single Market has an interesting appendix item (reproduced below in table 3.1) – where it looks at key academic papers that form the theoretical basis of European economic analysis by government, business advisory and other groups. It inadvertently calls into question the methodological underpinning of a great deal of the economic literature. It looks specifically at how they account for the Single Market's GDP impact on the UK economy, and finds that nearly every piece takes a similar explanatory angle.

Most reports take the benefit/cost of the Single Market as a function found by dividing the implied benefit of the Single Market to Europe by a factor related to the UK (population, size of economy etc.), not by directly attempting to compile that benefit from the UK side. The UK being an advanced European economy may not benefit from market opening in the same way that less advanced economies may gain – clearly gains across the EU will not be even. Methodological approaches differ significantly. The only work identified to have approached the topic from a UK accounting exercise, by Minford, found dramatically different (negative) results compared to the others surveyed.

### 3.1 Summary from balance of competencies study on UK and the Single Market:

Study	Headline Results	Geographical coverage	Time period
Cecchini (1998)	+4.25-6.5% of GDP	EU12	5-6 years
Baldwain	+0.3-0.9% of GDP	EU 12	Long-term
Monti (1996)	+1.1-1.5% of GDP 300-900,000 jobs	EU12	Impact to 1994
Minford (2005)	-3% of GDP remaining in EU	EU15	Forward looking
Iizkovitz (2007)	+2.2% of GDP in 2006	EU25	1992-2006
Boltho & Eichengreen (2008)	+5% GDP in 2008	EU25	Impact to date

Source: Balance of Competencies (abridged)<sup>14</sup>

### *The Five Tests*

The Major government of 1990-1997 had secured an opt-out of mandated entry to European Monetary Union (ERM) during the EU Maastricht Treaty negotiations and subsequent ratification (1991-1993). Significant political and public apathy to the European Union led the 1997 Blair government to specify that before joining the UK would have to pass five Economic Tests and then the public would have a referendum on the issue.

1. Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
2. If problems emerge is there sufficient flexibility to deal with them?
3. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
4. What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
5. In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

The Treasury (HMT) reported on the UK tests in October 1997, June 2001 and June 2003. They concluded in 2003 that:

- The UK passed one test clearly, number four, that the City would benefit from joining EMU.
- Tests three and five that encompassed investment and growth, stability and employment were caveated that EMU membership may increase these indicators but only if convergence and flexibility were sufficient.
- In terms of flexibility and business cycles, tests one and two, the view was that the UK had made significant progress on conversion between 1997 and 2003 but that there remained significant structural differences, especially in the housing market.

The HMT conclusion on the tests was backed by a number of published supporting studies and by the International Monetary Fund. Although the issue of euro membership then and EU membership now are different, at least these tests showed that the decision could be based solely on what was in the best interests of the City. This is a point worth noting now, given the importance of the financial sector for the London economy now and the argument put forward for continued EU membership. A key factor at the time of the Brown tests was a wider recognition that a currency union, like the US needed both labour mobility and fiscal flexibility to cope with shocks, adding to worries about one size fits all.

These studies highlighted the fact that EMU lacked a conventional adjustment mechanism to deal with imbalances and asymmetric shocks. Relative wage and price movements would be the only mechanism to compensate within the system for a lack of exchange rate adjustments, and as we have seen in recent years these have do been deflationary, squeezing demand as well as costs. These would be achieved with a complex system of fiscal controls. The 2003 report concluded that the lack of potential for true fiscal federalism in Europe (where one state can borrow from the rest of the EMU to offset shocks), would not be able to function as a union.

In conclusion this section has tried to provide a flavour of the vast literature debate on the topic of the UK and Europe. This ranges from the specifics of Gordon Brown's five economic tests on possible membership of the euro to the large recent literature on the pros and cons of EU membership. The vast literature means that there is almost something there for everyone, with views both supporting and challenging the consensus. The possible downside to this is that it can make it easier for decisions to be delayed, even not addressed. There is also the complexity of considering issues from the legal as well as political and economic environment. Also, issues must be looked at over a long enough time period given that decisions need to be based on more than the current economic cycle and should reflect underlying structural changes, the future vision and end game.

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# Section 4: Economic scenarios

The future economic and financial success for London and the UK will not depend solely on whether the UK is in the EU or not. Much of the debate gives the impression that the UK will succeed either if it is in the EU - that is the yes campaign - or will succeed only if it leaves - that is the no campaign. It is more complicated than this. If the UK remains in the EU, future success will be heavily influenced by whether the EU reforms successfully, or not. Likewise, if the UK leaves the EU, its future economic performance will be heavily influenced by how the UK positions itself, not just with the rest of Europe in terms of the exit terms, but also with the rest of the world, and on the policies then pursued. The key question facing the UK economy over the next two decades may not be whether we are in or out of the EU. Rather it is if the institutional structures that drive our economy and attitudes evolve to become flexible enough to prosper in the challenging environment of the world economy.

This section provides some long-term economic forecasts. We commissioned a leading, independent economic forecaster Volterra, with the work led by economists Paul Ormerod and Bridget Rosewell, to use their forecasting models to look at four economic scenarios.

Their excellent report is contained in its entirety in the appendix, explaining the analysis and forecasts in more detail. Their outcomes are summarised here in this section. The four scenarios are called brave new world, business as usual, one regime two systems and inward looking.

When one tries to predict an economy's performance over any time frame up to a couple of years ahead - which one can call the short-term - the outcome depends upon the interaction between economic fundamentals such as consumer spending and business investment, policy and confidence. Predicting the components of these, let alone how they may interact together, is difficult. Moreover, the openness of the UK economy means it is heavily influenced by external factors, whether in Europe or beyond.

There's also the stage of the economic cycle in which an economy finds itself. Currently the UK is at the stage of the economic cycle where it is recovering, and has the potential to grow strongly, taking up the economic slack seen in the recession. In contrast, the euro area is at a weaker stage of the cycle, suffering, overall, from weaker demand, although it too has sufficient slack, as seen in high unemployment, to rebound if demand recovers.

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All of these variables influence an economy's longer-term prospects, too, but the further ahead one looks the more likely it is that an economy's average performance will closely resemble its longer-term growth rate and that reflects its underlying productive potential.

There is a strong consensus that the main proximate determinant of long-term growth in developed economies is innovation. This covers a plethora of areas, from ideas, to putting them into practice. Europe lags way behind the US on innovation. This is important. In the 1975 Referendum it was widely believed that Europe's growth model was successful and the UK could benefit from being tied into it, but that is not necessarily the case now.

The rate of innovation is by no means fixed. Much depends upon both the institutional structure of a country, and on the attitudes towards innovation. Innovation can be disruptive, leading to new companies and industries, at the same time as it might destroy existing ones. The willingness of a country to embrace rather than resist change is crucial to future economic success, as is the ability of a country to play to its strengths.

Population growth also influences potential. This is very evident in some economies that rely on low wages and labour intensive industry, but in advanced developed economies it will also have a future influence. Outside of Western Europe, the US has a young, growing population, Japan an old ageing population. As populations age, or even shrink, economies tend to grow at a slower pace. In contrast, the faster a population increases the more an economy must grow in order to keep living standards the same.

The UK, almost alone among Western European economies, faces rapid population growth. France, too, may see some rise, although not on the scale of the UK. In contrast, many other Western European countries will likely see their populations both age and shrink. This will exert further pressures on the costs of pensions and welfare systems, although even the UK will not be immune to these pressures. It adds to the pressure for stronger economic growth, to keep debt to GDP levels down and to fund public spending. According to the UN, Germany's population is expected to shrink from 83 million in 2010 to 73.1 million by 2050. In contrast, the UK's population will rise over the same time frame from 62 million to 73.1 million, overtaking Germany.<sup>15</sup> In fact, official UK scenarios suggest the population rise may be far greater.

A further factor to consider is the resilience of an economy in the face of large shocks, such as the recent financial crisis, which are not always possible to predict. The average annual rate of growth over a period as long as 20 years can be adversely affected if an economy lacks the resilience to recover quickly from such shocks. What matters most is an economy's ability to recover from them.

<sup>15</sup> UN World Population Prospects – Medium Growth Variant (2012 Revision)

In the 1970s and early 1980s, the UK floundered and our prospects were gloomy. The supply-side reforms of the 1980s, embracing labour market reforms and deregulation, transformed the economy. In the 1990s and early 2000s, Germany inherited our title as the sick man of Europe. But, again, major supply-side changes revitalised their economy, contributing to its relatively strong performance. Demand, too, is important. In recent years, the UK and Germany have both suffered from weak demand across Western Europe, and indeed given the size of their economies, both contributed to it as well.

All of this matters in terms of the European economic debate.

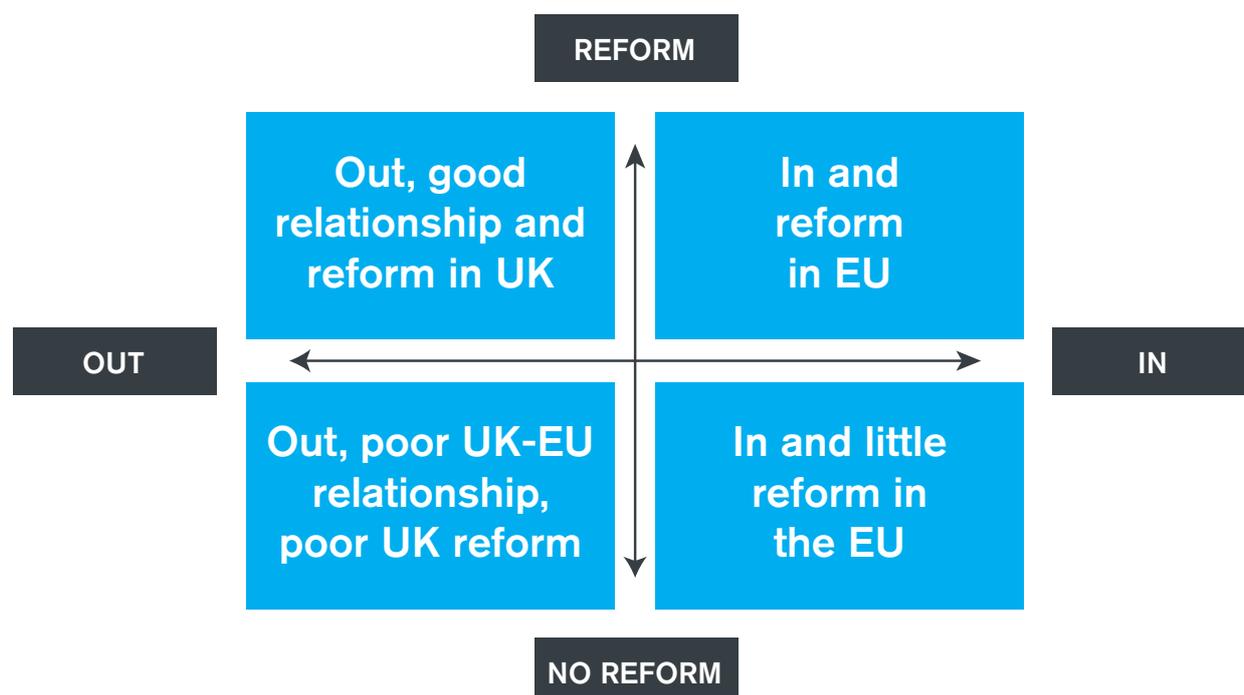
Four different scenarios capture the choices and options ahead, two of which capture the UK remaining in the EU, two leaving.

- A. The UK remains within an unreformed EU, which we call 'business as usual'
- B. The UK stays in the EU, but there are substantial reforms – 'brave new world'
- C. The UK withdraws, but does so with goodwill on both sides – 'one regime, two systems' – and the UK pursues a pro-growth, reform agenda
- D. The UK leaves, but the UK suffers from a combination of a poor post exit<sup>1</sup> relationship and inability to position itself, globally - 'inward looking'

One can try and picture these scenarios in a four sector diagram, capturing the key drivers: in or out; reform policies - with the focus on future EU reform if the UK remains in the EU and future UK reform if the UK leaves; and also the future relationship between the UK and EU in an exit scenario. We discuss possible EU reform and also exit strategies in sections below.

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#### 4.1 Four sector diagram showing our scenarios



In the out scenarios the two main variables are the terms of the future relationship and the future policies pursued. Scenario a. is a continuation of where we are now. Scenario b. is the sought after scenario, which would be beneficial for both the UK and Europe.

A key question for longer term scenarios for the UK's future economic relationship with Europe is the extent to which both the UK and the EU can take advantage of the potential for growth in the world economy. Even though the relative importance of the EU to the UK will continue its trend decline, the EU will still be a substantial trading partner in 2035. Much more importantly, however, within the EU the UK will be subject to the regulations and institutional frameworks set by the EU.

In recent decades, a gap has opened up between the US and the EU as a whole on productivity growth. Since the mid-2000s, however, an increasing divide has opened up within the EU between the German led northern economies and the Mediterranean cluster, of which France is becoming increasingly a member. This is separate from the problems which arose during the financial crisis and which still persist in Italy, Spain, Portugal and Greece. These economies are at serious risk of being trapped in a debt-deflation spiral, as weak growth in years reflects, although now there are signs of improvement. In the 1990s and early 2000s, Germany was seen by many as the new 'sick man of Europe'. Between 1991 and 2005, for example, GDP growth averaged only 1.2 per cent a year, compared to 3.3 per cent in the UK. Since then, however, the German economy has revived quite dramatically. Germany is in many people's eyes the economic and political centre of the EU.

The example of Germany illustrates that, in many ways, the key question facing the UK economy over the next two decades is not so much whether we are in or out of the EU. Rather it is whether our institutional structures and attitudes evolve to become flexible enough to prosper in the challenging environment of the world economy. In principle, the UK is very well placed. Our labour market structures are flexible. We are moving away from dependency on the EU in terms of markets in which we trade. Our economy and our exports are much more strongly oriented towards the services sector than any other developed economy, with the exception, of course, of the US. But no economy, no institutional structure can stand still.

Our definition of reform is essentially a supply side one. A reformed EU would, for example, offer free trade in services on the basis of passported regulation, rather than wanting to set a universal standard. We also imagine that such reforms would equally apply inside the UK, which would not 'gold plate' new regulation and would encourage trade in services across the globe.

All forecasts are average figures over a 20 year long term forecast horizon. Economies experience cycles, and in the case of departure from the EU there would be a negative near-term economic impact. Thus a twenty year forecast aims to capture the longer-term underlying trends.

The 'Business as Usual' scenario reflects a continuity of the recent trend with a relatively sluggish output and productivity performance versus pre 2008.

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## 4.2 Business as usual

Average annual GDP growth	1.9%
Inflation	2.5%
Employment growth	0.2%
Export growth	3.5%
London's annual average output growth	1.8%
London's employment growth	0.2%

Source: Volterra

In this scenario, the growth potential for London is stifled rather than realised, one of moderate relative decline in world terms, along with the rest of the EU.

**The 'Brave New World' scenario** is the opportunity. This scenario is what can be realised, and within it Europe positions itself to benefit fully from the changing world economy. This is the scenario in which Europe reforms - possibly with UK leadership.

## 4.3 Brave new world

Average annual GDP growth	2.75%
Inflation	2.0%
Employment growth	0.7%
Export growth	5.0%
London's annual average output growth	3.1%
London's employment growth	0.9%

Source: Volterra

This is the most favourable scenario for London, and we envisage its economy sustaining an average growth rate over the 20 year period which is as high as the UK as a whole obtained over any similar time period during the whole of the 20th century. It could even be higher.

The **'One Regime, Two Systems' scenario** is similar to the brave new world, except that the UK votes to withdraw from the EU. Leaving the EU inevitably has a short-term negative impact relative to what else might have happened, as the increased uncertainty ahead of and immediately after a referendum could defer business investment. It is also possible some firms may decide to relocate, although that was also the fear, albeit to a lesser extent, but not the reality when the UK chose not to join the euro. The renegotiated status does not introduce many new constraints, which in any event are counter-balanced by the UK being able to adapt more rapidly. This

scenario envisages an initial slowing of growth because of the uncertainties around the UK's new status.

#### 4.4 One regime, two systems

Average annual GDP growth	2.5%
Inflation	2.5%
Employment growth	0.5%
Export growth	4.2%
London's annual average output growth	2.9%
London's employment growth	0.8%

Source: Volterra

This scenario emphasises the key importance of reform for the dynamic, service sector oriented economy of London, and the gap between the growth of London and that of the rest of the UK is slightly larger than in the brave new world scenario.

In the **'Inward Looking' scenario**, the UK votes to withdraw, but instead of reacting positively, we retreat into a comfort zone. The key essence here is an inability to reform, and it might well include a larger state sector handing out subsidies to its clients. The outcome under this scenario is one in which the underlying growth rate gradually declines, so that by the end of the period we are contemplating trend growth even lower, similar in fact to those of the 1920s.

#### 4.5 Inward looking

Average annual GDP growth	1.4%
Inflation	4.5%
Employment growth	-0.2%
Export growth	2.4%
London's annual average output growth	1.1%
London's employment growth	-0.4%

Source: Volterra

In this scenario, following the logic of our arguments, London enters a period of decline relative to the UK as a whole.

The percentage differences in growth rates between the scenarios may seem rather small, but over a 20 year period, they cumulate into very substantial numbers.

By 2035, for example, the absolute level of real GDP is envisaged as being over £500bn higher in the brave new world scenario than it is under the inward looking one.

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These absolute differences are also stark in terms of employment. There are currently just over 32 million workforce jobs in the UK. In the inward looking scenario, this falls by 1.25 million. In brave new world, employment in 2035 is nearly five million higher.

Like all forecasts these are indicative, aimed at giving a sense of scale as opposed to claiming pin point accuracy.

But it is the other two scenarios that offer an interesting contrast. We believe the UK could do better outside the EU than in an unreformed EU.

In terms of the projections for London, Table 4.6 sets out estimates of the size of the London economy and employment under the different scenarios in 20 years' time. The size of the economy are in real terms, thus taking out the impact of inflation.

#### 4.6 London: economic size and employment in 20 years' time

Current size of London economy	£350bn
Future size in 20 years under the different scenarios:	
A. Business as usual	£495bn
B. Brave new world	£640bn
C. One regime, two systems	£615bn
D. Inward looking	£430bn

Indicative employment levels in 20 years	
A. Business as usual	Rises 200,000
B. Brave new world	Rises 1 million
C. One regime, two systems	Rises 900,000
D. Inward looking	Falls 1.2 million

Source: Volterra

The implications for London are even more dramatic. London is considerably more oriented towards both innovation and the world economy than is the rest of the UK. The strengths of the economy of the capital are best shown in the two scenarios in which institutional reform takes place. In contrast, a lack of reform hampers London. This is especially the case in the Inward Looking scenario, in which we envisage a gradual long-term relative decline, recalling memories of the dismal decade prior to the supply-side reforms of the 1980s.

London's economy at present represents some 22.5 per cent of the total economy of the UK. In the inward looking scenario, this falls to 21.3 per cent, and rises to 23.6 per cent in Brave New World. But in real terms, the London economy in 2035 is 48 per cent bigger under the latter than the former, equivalent to around £200bn at today's

prices.

In employment terms, the four different scenarios have a potentially dramatic and divergent impact in employment, with two of them ('Brave New World' and 'One Regime, Two Systems') being very positive for jobs, one ('Business as Usual') being mildly positive and the fourth ('Inward Looking') very negative.

It is perhaps in the two scenarios 'Business as usual' versus 'One regime, two systems' that this report may surprise. We determine that leaving the EU and both having good future relations with the EU and with the rest of the world is far better, in economic terms for the UK, than remaining within an EU they does not reform. That is, leaving and pursuing sensible economic policies would deliver much more than the status quo.

If you do not believe the EU can or will reform then there is a powerful economic case for the UK leaving the EU.

In conclusion, this section has focused on the long-term economic scenarios and takes into account the underlying economic drivers of growth. The methodology and analysis are contained in much more detail in the commissioned report produced by Volterra that is in the appendix. A longer-term time frame of twenty years helps bring out the key economic issues. Although the initial differences between scenarios can appear small, over a twenty year time frame the cumulative effect can be huge. The London economy could be vastly different in size, with implications for employment and living standards. Two scenarios are very positive: the UK in a reformed EU and the UK outside the EU, on good terms and pursuing an outward looking economic policy. It is not a case of choosing between Europe and the rest of the world, but seeking to ensure an innovative policy agenda for the UK that is focused on growth.

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# Section 5: Reform

The big issue is can the EU reform and what needs to be reformed? The scenarios we have outlined in this report suggest that economic and other reforms are necessary.

The need to reform is at centre of the UK Prime Minister's aims, and the desire for a reformed EU is frequently repeated. Reform is also the key to the future economic success of Europe. The only issue is that there is a lack of clarity - or agreement - on what needs to be reformed. It has been said that reform is a process, not an event. There is therefore a need for some quick wins to get Europe on the right track and then the need to instil the right process.

In the wake of the May 2014 European elections there has been renewed focus on this, including the need for Europe to withdraw from where it is ineffective, and allow greater autonomy to national governments. The trouble is the sheer scale and detail of EU treaties and institutions means that the debate on reform is complex.

## ▪ Laws

Part of the discussion in the UK focuses on the amount of EU legislation that the UK has to implement, but it is important to keep this in perspective. The amount of legislation that emanates from Brussels is hard to quantify. In one respect, it appears significant but relatively small. From 1997 to 2009, according to the House of Commons Library, this amounted to 6.8 per cent of primary legislation (Statutes) and 14.1 per cent of secondary legislation (Statutory Instruments). Yet, as the Library stated.

'Excluding those Acts that made only a passing reference to the EU, 10.1% of UK Acts included the incorporation of one or more EU obligations. Only 1.4% exclusively implemented EU obligations and this category includes the five Treaty amendment Acts and five accession Acts passed during the period. These are a distinct kind of Act: they have far-reaching legal and political consequences, but do not implement individual EU laws. Amendment acts give rise to many new obligations both directly (eg citizenship of the Union, the principles of equal treatment, freedom of movement and respect for human rights) and indirectly (through subsequent legislation).'

The European Communities Act 1972 (the ECA) authorises the government to implement EU law by either primary or secondary legislation. Relatively little primary legislation is needed to implement directives, regulations or decisions, although some EU obligations, especially Common Foreign and Security Policy (CFSP) and Justice and Home Affairs commitments, have required primary legislation for their implementation..... Based on data from the UK Statute Law database, from 1980 to

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the end of 2009, out of 1,302 UK Acts between 1980 and 2009 (excluding those later repealed), 186 Acts or 14.3% incorporated a degree of EU influence.<sup>16</sup>

However, the Swedish government has carried out an in-depth study on the actual legislative burden.<sup>17</sup> It found that the share of legislative proposals in 2012 originating in the EU stands at 43 per cent - a dramatic increase compared to 2010 when the share was 28 per cent. Of the 104 laws that so far have been proposed by the Riksdag this year, about a third originate in the EU. Critically it found that in 2010 between 40 - 60 per cent of local government law originated from EU regulations and directives.

From this research we can hypothesise that while the UK receives at least one tenth of legislation from the EU in the form of regulation law a year, the vast majority of EU law is in the form of directives that must be transcribed through domestic courts and thus the figure is inevitably far higher – the key point being that the legislative burden changes on an ongoing basis – some years see more domestic or European legislative activity so there is unlikely to be a firm annual percentage, but the overall figure is significant and the direction of travel appears to be one way.

In the preparation of this report a number of discussions contained the comments that there was too much regulation emanating from Brussels, but all too often those that made such comments were not able to cite which regulations should be abolished. Some that were cited included the Working Time Regulations 1998 and Working Time Regulations 2003 or the Agency Workers Regulations 2010. There were others, we mention these not necessarily because they should be rescinded - more work is needed on the pros and cons - but because it indicates there may be some quick wins that are possible. More generally the issue was the scale of regulation rather than specific ones, yet it may be wrong to see this as an EU issue only. It is also a national issue and in all likelihood regulations that emanate from Brussels might need to be substituted with similar ones from Westminster were the UK to leave. It is also probably inappropriate to conclude that because regulations or legislation originates in the EU that they are either not necessary or wrong. Many may be needed or appropriate and it is difficult to generalise. It must be stressed that the process is fraught with issues due to the scale and scope of making one size fits all law for every Member State simultaneously. The one size fits all is a common problem across European policy or legislation.

### ▪ **EU approach**

Subsidiarity is seen in many other countries as the possible path to reform, as there is less enthusiasm for Treaty change, or repatriating powers to countries. This concept – enshrined in the Treaty on European Union – holds that the Union should act only when doing so achieves better outcomes than member-states acting separately at the national level. Subsidiarity is not an instrument for repatriation, since it accepts the division of competences, but where the treaties are ambiguous it does allow

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<sup>16</sup> Open Europe: How many of our laws are made in Brussels <http://openeuropeblog.blogspot.co.uk/2009/04/how-many-of-our-laws-are-made-in.html>

<sup>17</sup> Riksdag & Departement <http://granskning.eu/post/65617064429/statistiskt-bevis-fran-riksdagen-om-vaxande-eu-makt>

greater flexibility in deciding where powers lie, and it is a check on an overly ambitious Commission. As the UK based Centre for European Reform noted, in March 2014, Germany's Foreign Minister Frank-Walter Steinmeier and Dutch Foreign Minister Frans Timmermans called for an EU that is more selective in the issues it tackles, saying it 'Should be big on big issues and small on small issues.'<sup>18</sup> Stronger enforcement of subsidiarity, they say, would cull unnecessary initiatives from the Commission and reduce the EU's democratic deficit since national parliaments would become more involved: better use of 'yellow card' procedures would allow European Parliaments to cooperate and block Commission initiatives they deem unnecessary or inappropriate. The two ministers continue that if Commissioners were to work in clusters, rather than pursuing 28 separate dossiers, the EU would be more focused and effective, and increase its legitimacy with the European public.

'Enhanced cooperation' and 'Variable-geometry' are sometimes cited as alternatives to integration. Variable-geometry Europe is the idea of a method of differentiated integration which acknowledges that there are irreconcilable differences between states on further integration and allows for a permanent separation between one group of integrating Member States and others who wish to pursue a direction of no or very limited integration.

The enhanced cooperation mechanism could be used as an option for those countries in the Union who wish to pursue different intergrationalist pathways - perhaps the EZ and non-EZ is an example. The trouble is it can only be used by states wishing to reinforce the integration of the union, as such, the onus would be on the EZ to use it; non-EZ states, even if their numbers allowed, would be unable to pursue an enhance cooperation agenda. In principle at least nine states must be involved in enhanced cooperation and remains open to any state that wishes to participate at a later date. It is considered an option of last resort, after it has been established within the council that the objectives of cooperation cannot be attained within a reasonable period by the union as a whole. Any acts that are adopted within the framework of such cooperation are binding only on the participating Member States and does not constitute a part of the *Acquis Communautaire* - sometimes referred to as the *acquis* and which means that which has been agreed upon of the Community and which is the accumulated legislation, legal acts and court decisions that constitute the body of European Law.

Democratic legitimacy should be enhanced as part of any reform process. In any country there are bouts of discontent over leadership and institutions, and some of the calls for reform in the EU link into general comments heard at national level - such as political accountability - as well as probably reflecting discontent about recent economic performance. The issues over which there is discontent are not new. They are raised consistently. In December 2001, for instance, just before the introduction of the euro, 'The Laeken Declaration' on 'The Future of the European Union' argued there needed to be reform to address challenges of localism and subsidiarity, stating,

<sup>18</sup> Handelsblatt Op-Ed, A Strong Europe with the right priorities <http://www.government.nl/government/documents-and-publications/speeches/2014/03/18/a-strong-europe-with-the-right-priorities.html>

<sup>19</sup> The Laeken Declaration and the Convention on the Future of Europe December 2001 <http://www.parliament.uk/documents/commons/lib/research/rp2002/rp02-014.pdf>

‘European institutions must be brought closer to its citizens.’<sup>19</sup> Its main thesis was that, ‘Within the Union, the European institutions must be brought closer to its citizens. Citizens undoubtedly support the Union’s broad aims, but they do not always see a connection between those goals and the Union’s everyday action. They want European institutions to be less unwieldy and rigid and, above all, more efficient and open. Many also feel that the Union should involve itself more with their particular concerns, instead of intervening, in every detail, in matters by their nature better left to Member States’ and regions’ elected representatives. This is even perceived by some as a threat to their identity. More importantly, however, they feel that deals are all too often cut out of their sight and they want better democratic scrutiny.’

In terms of democratic accountability a further issue is the idea of mortmain, the so called dead hand of EU legislation. This is a double edged sword. The idea is that once regulations and directives are adopted they are very difficult to change. This is understandable, if legislation had been debated and agreed to help achieve harmonisation then it would be counterproductive for different states to then repeal as they saw fit. But the flip side of this is that if the UK or another domestic electorate and their representatives then wants a law repealed it is hard to do this - the Commission has the sole right of initiative to propose a change and then it requires a QMV of the states and European Parliament. In short, once in place, the laws are hard to change at national level. Perhaps the lesson is to ensure the UK is fully engaged in the legislative process, arguing their case from the start.

Perhaps, as part of a constructive process, all this needs to be taken into account in terms of where future boundaries and competencies should lie between Member States and the EU. The EU can only act within the limits of the competencies conferred upon it. The EU’s competencies are outlined in the EU Treaties, which are signed by all countries and as one might expect there a lot of them. Consider the Treaties in which a competency was mentioned for the first time:

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## 5.1 Table of competency growth in the European Treaties over time

Treaty of Rome 1957	<ul style="list-style-type: none"> <li>Customs Union</li> <li>Free movement of goods</li> <li>Common commercial policy</li> <li>Free movement of persons, services and capital</li> <li>Common agricultural policy</li> <li>Common transport policy</li> <li>Competition</li> <li>Coordination of economic policies</li> <li>Common market</li> <li>European Social Fund</li> <li>European Investment Bank</li> </ul>
Single European Act 1986	<ul style="list-style-type: none"> <li>Single Market</li> <li>Environment</li> </ul>
Maastricht Treaty 1992	<ul style="list-style-type: none"> <li>Common foreign and security policy</li> <li>Justice and home affairs</li> <li>Economic and monetary union</li> <li>Education</li> <li>Culture</li> <li>Cooperation and development</li> </ul>
Amsterdam Treaty 1997	<ul style="list-style-type: none"> <li>Employment</li> <li>Social policy</li> <li>Discrimination</li> </ul>
Lisbon Treaty 2007	<ul style="list-style-type: none"> <li>Space</li> <li>Energy</li> <li>Civil protection</li> <li>Data protection</li> <li>Sport</li> </ul>

Source: Europa, Journal of Common Market Studies<sup>20</sup>

The UK government is carrying out a review of the EU competencies, across Whitehall, coordinated by the Cabinet Office, in cooperation with the Foreign Office. The review will provide a comprehensive analysis of the entirety of transfer in competencies to Europe in the post-Lisbon Treaty environment. However, the review is not intended to be a critical analysis and only alludes to necessary reforms or competency transfers. As useful as this review is, it will be the follow up to it that is key. This UK review differs from other balance of competencies reports taking place in Europe, such as the Netherland's Parliamentary review, which lays out firm reform goals.

While there are specific regulations that some business and people may highlight, the primary concern appears to be the constant barrage of rules being pushed down. A common criticism of the EU is not specific regulations, but the amount. Reform needs to focus on bringing the number and amount of regulation under control – the EU is an imperfect legislative system, countries need to bring down their transcription deficits and the iterative legislative mechanisms necessary in harmonisation are damaging to UK business given that the British government is viewed as one of the best performing economies in accurately transcribing EU directives to the fullest possible extent.

<sup>20</sup> Journal of Common Market Studies: The End of Creeping Competence? Mark A Pollack, 2000. [http://graduateinstitute.ch/files/live/sites/iheid/files/shared/executive\\_education/Readings\\_IA2009/Dupont\\_Pollack\\_End-of-creeping-competence.pdf](http://graduateinstitute.ch/files/live/sites/iheid/files/shared/executive_education/Readings_IA2009/Dupont_Pollack_End-of-creeping-competence.pdf)

Earlier reference was made to the various and key EU treaties. Three stand out in terms of the debate on reform, and these are The Treaty of Rome in 1957, the Maastricht Treaty of 1992 and the 2007 Lisbon Treaty. And while the latter is widely interpreted as moving the EU to ever closer union, the Maastricht Treaty makes clear that EU Competencies are governed by the principle of conferral and that this in turn means the EU must act within the limit of its powers and respect the principles of subsidiarity and proportionality. A challenge to the EU on subsidiarity - that the EU should not undertake actions that are better at the national level - has never succeeded and ones on proportionality - where the EU must not take action in excess of that needed to achieve the aims of Treaties - have, but not often.

What then are the areas the UK could seek to reform if it were to remain within the EU? It is important that reform is seen as being in the EU's best long-term interest, as opposed to being a UK a la carte approach. The reforms that are needed include:

### **1. Accept the case for economic reform**

There is a need to unlock the barriers to growth both in the UK and EU to boost innovation, investment and competitiveness. This is not something that can be institutionalised but it goes to the heart of Europe's present problems, namely the weak economic performance in recent years in the post crisis world. Implicit in it is the recognition of the need for the European economic model to deliver stronger growth, more jobs and improving living standards in order to position the EU in a changing global economy. What macro-economic and supply side reforms are needed to achieve this? We address this in the economic scenarios mentioned above and developed further in the appendix. The present weakness of demand needs to be addressed alongside appropriate supply-side reform, with the balance of adjustment falling not only upon economies in difficulty. When the UK joined the EU in the 1970s one of the many factors was a focus was on the superior economic performance of Europe then versus the UK. This is not the case now.

Perhaps this goes to the heart of the debate, that the EU was established in a very economic and political climate and needs to change, to make it fit for purpose in the 21st century, addressing worries about the democratic deficit, ensuring it addresses peoples' worries about social policy and protection of rights and, above all, the need to ensure that the economic model works and is successful.

The EU owes its origins to the 1951 Treaty of Paris that established the European Coal and Steel Community and was signed by the original six of Belgium, France, Italy Luxembourg, Netherlands and West Germany. In the post war environment, peace was the main aim. There were further evolutions with the European Economic Community (EEC) created by the 1957 Treaty of Rome, whose aim was economic integration and a common market.

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The reality is that the environment under which the Common Market was formed is so different to now. While the benefits of peace and economic cooperation are clear there is now a very different global economic and political outlook. Given this, one could say that reform is a substitute for saying there is a need to make the EU both fit for purpose and successful. It must build on the positives of the past, not be constrained by them.

## **2. Halt the process towards ever closer union**

This is the biggest challenge as every closer union is at the centre of the treaties and for many is the binding influence. To stop it may well require a new treaty and - at the moment - that is unlikely. Moreover, how would ever closer union be replaced? This links directly into the issue of EU competencies versus those of national parliaments and where the balance lies between them. To see reform in the area of ever closer union necessitates a debate about (a) competencies (b) the relationship between national and EU legislative powers (c) possible reform of EU legislation (d) and although it is separate to the issue of repatriation of powers to national governments, that too is linked into this.

This requires not just cast-iron guarantees but also a willingness on the part of the Commission to show that the direction of travel in Europe is not only moving in one direction towards integration. This would be an important step in the debate about more or less Europe.

## **3. Have a timetable for reform**

Identify a clear timetable for reform, centred on a spectrum of areas where reform may be warranted. These include:

- The relationship between the Eurozone and non-Eurozone economies
- The Single Market
- Other economic issues
- Non-economic issues

When it applies to London, it is the importance of the first two of these that merits most attention, although all four are important. What are the issues and reform possibilities and options in each?

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#### **4. Reform the relationship between the Eurozone and non-Eurozone**

This is a crucially important part of the relationship between the City and the EU.

Eighteen countries are currently members of the euro area. These are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia and Spain. It is a requirement of countries that wish to join the EU that each must adopt the euro, once they achieve certain criteria - although it should be said the original entry criteria were relaxed. Of existing EU countries, only two are exempt from having to adopt the euro and these are the UK and Denmark, although it is widely believed that Sweden is unlikely to. In recent years, ensuring the survival of the euro has become a focus of the European Central Bank (ECB) and the President of the ECB has taken all the steps needed to protect the euro. It could be said, its survival is a cornerstone of the European project.

One of the biggest immediate dangers facing the euro area is the threat of a deflationary environment, in which prices fall. This exposes the gap in competitiveness between members of the euro area. There are always options for any country to correct a poor competitiveness position. Within a currency union, however, a country with a poor competitive position cannot devalue. Instead it must undergo what economists call internal devaluation, boosting competitiveness in other ways, largely by squeezing costs and shedding staff. Sometimes inflation can ease the pain, as a country with a poor competitive position can correct for some of its shortfall via higher inflation although its inflation rate would still need to rise at a slower pace than others. But in deflation, it is forced to cut its costs by more than others. This does not mean inflation is the solution. Rather it highlights the problems in a currency union especially if there is a lack of demand. The present focus is thus on the macroeconomic policies being implemented to protect the euro. For the UK, and London, it is important that our biggest trading partner, the rest of the EU, rebounds strongly.

It is the relationship between the Eurozone and non-Eurozone members in other policy areas that is critical. As with a number of issues in this debate the question is whether it is a perceived, or a real, threat. The relationship between the EZ and non-EZ is of vital importance for the City of London and the UK financial sector if the UK stays within the EU, or leaves.

Currently there is the concept of a 'double majority' - this means that for legislation to be binding it requires both a majority by voting weight of all EU members plus a simple unweighted majority from both EZ and non-EZ members. But this is to be reassessed if and when the number of countries outside the EZ falls to four. The worry is that the UK financial sector is left exposed in a way in which the French would not leave their agricultural sector exposed. The City, as Europe's financial centre, needs protection and if only two countries the UK and Denmark are exempt from having to join the euro then the double majority should apply if there are only two non-EZ countries.

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This can be tied into European banking union that comprises a single supervisory mechanism, a single resolution mechanism and a single deposit insurance scheme. Not all members agree with all aspects, but the net result is a potential conflict between the supervision of the 18 country euro area versus the European Banking Authority's role in setting standards for banks across the 28 country EU internal market. There is still much uncertainty about how the European banking union will evolve, but there needs to be greater weight and protection given to the City, as Europe's financial centre. We examine this further just below, when under Step 6 we look at financial services.

## **5. Complete the Single Market**

The Single Market has to be a central part of the reform process. Often it is said that the key is for the UK to ensure that the Single Market works properly. In saying this, the focus is usually on only one part of the Single Market - namely four areas that are sometimes known as 'the four freedoms' and these are the free movement within the EU of goods, services, people and capital. But there is another aspect of the Single Market and this is the harmonisation of laws and regulations at a European in order to remove barriers to trade that arise because of different national laws. When one combines both these aspects of the Single Market there are a number of issues that arise for the UK, not all positive.

The Treaty of Rome which established the EEC in 1957 had set its sights on creating a common market. That came into being in 1968 with the creation of a customs union. But it took much longer to take the leap towards a Single Market

The EU was commonly referred to as the Common Market in the UK, and in economic terms a common market is a stepping stone to the Single Market. A common market has common external tariffs on goods from outside, and a customs union has no formalities across internal borders. However, members of a customs union surrender their separate international trade arrangements, and give up the right to sign trade agreements. Instead, trade negotiations are conducted, and treaties signed, by the bloc as a whole.

The Single European Act signed in 1986, finally set a deadline of 1992 for the Single Market to be up and running. It also streamlined the decision-making process to take account of successive enlargements and to speed up legislation to implement the Single Market. In the end, the Single Market was launched on 1 January 1993, though some of the legislation was still not in place.

A free trade area has goods checked at internal borders and only goods that originate within are tariff free. The Single Market is a free trade area plus common policies and regulations. Trade negotiations are conducted, and treaties signed, by the bloc as a whole.

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The Single Market set up four freedoms:

**Goods:** Companies can sell their products anywhere in the Member States and people can buy where they want with no penalty.

**People:** Citizens of the Member States can live and work in any other country and their professional qualifications should be recognised.

**Capital:** Money and capital can flow freely between the Member States and European citizens can use financial services in any Member State.

**Services:** Professional services such as banking, insurance, architecture and advertising can be offered in any Member State.

Now, the Single Market in goods and in capital appears to work well and it makes sense to keep it that way. It is the Single Market in the other two freedoms that is the problem.

### ***Address issues in services***

- It makes sense for both the EU and for the UK for the Single Market in services to be completed. As Open Europe states, 'Europe is sitting on a huge amount of untapped potential growth and employment in the services sector.' They claimed in April 2013 that liberalisation of services would produce a permanent increase to EU-wide GDP of up to 2.3% or €294bn. This is in addition to the €101bn already gained under the Services Directive. In this area the reform that is needed is twofold. One is to implement what should have already happened, namely implementing the Services Directive and introducing a new country of origin principle. The second is to boost trade in services, which account for 70 per cent of Europe's out-put but only around 23 per cent of European trade. Part of the problem appears to be the ability of Member States to hide behind a provision in the Services Directive that allows them to impose barriers on services for, 'reasons of public policy, public security, public health or the protection of the environment.' At the same time, the Recognition of Professional Qualifications Directive has not been effectively implemented. In February 2012 twelve EU countries, including the UK, but not France and Germany, signed a 'pro-growth' letter to open up services.<sup>21</sup>

### ***Address issues in people***

- The idea of movement of people needs to change to be take account of the fact that the expansion of the EU to the east has resulted in huge variations in income levels, pay and benefits between economies such as the UK and others in Eastern Europe.

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<sup>21</sup> Open Europe, 'Kick-starting growth: How to reignite the EU's services sector' April 2013

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- This is a difficult balancing act for the UK. The British people appear keen for a cap on immigrant numbers, but as a member of the EU, the UK is not able to limit immigrant flows from elsewhere in the EU while it may want to attract immigrants from elsewhere in the world such as qualified students, business people or investors.
  - One of the important areas for the London economy is to ensure there is continued free movement of people with appropriate skills within the EU. Yet, as in other areas of the four freedoms, the spirit of the Single Market is to have free movement for whoever wants to move. This, however, needs to be seen alongside the sensible economic need to discourage benefit migrants, while allowing a free flow of people. In order to maintain public confidence in EU free movement, EU rules need to respect differing national welfare systems that have developed through national democratic choices. Some countries across Europe have not fallen into the trap the UK has because they have a better link between economic contributions and access to benefits, and perhaps it is this link that needs to apply across the EU. Notwithstanding that the UK Prime Minister made some significant and sensible changes to address this issue from a UK perspective, announcing last year measures that included a three month qualifying period for benefits, which would then be payable for six months, European migrants falling below a certain income threshold would lose access to some benefits, newly arrived job seekers would not be able to claim housing benefit. Incentives matter and can have a big economic impact, and the underlying issue with free movement of people is both to allow such movement, as people need to be able to move and economies, as seen in London, can benefit from this, to provide some sort of safety net, but to discourage the benefit migrant. The rights of EU migrants to reside in another Member State should be more closely linked to a person being in work or self-sufficient. National discretion to set these rules should explicitly apply to all state welfare.
  - The UK government's Balance of Competencies review published its analysis on the impact of free movement of people in July 2014. It concluded that while there is a broad consensus that the free movement of highly skilled migrants has been beneficial to the UK it suggested that there is less agreement regarding low skilled migration. Critically, it argues that the scope of free movement rights has expanded past the original intent, that of a single economic market for labour, to include a number of concerns over welfare pressures, exploitation of services and other issues. It cites that the ECJ has been overly broad in interpreting the remit of free movement arguing that, 'without reform, legitimate public concern about how EU migrants access social security in other Member States is likely to significantly undermine support for the principle of free movement.'<sup>22</sup>

### ***Address issues in regulatory intrusion***

- The idea of harmonisation makes sense in principle but the way in which it is being implemented is running counter to this. The danger is that the combination of qualified majority voting and then interpretation and enforcement by the European Court of Justice are resulting in what has been described as, 'intrusive detailed control of national laws and markets' and as a result the EU can effectively take control of trading relations with non-EU countries.<sup>23</sup> As part of the reform process it has to be asked whether this regulatory intrusion can be halted, after all it is not necessary for the Single Market to work fully, moreover any gains it may make towards achieving the Single Market appear to be more than offset by problems it brings. Single Market reform needs to focus on market opening.

## **6. Sector specific reform - examples important for London**

### **(A) *The digital Single Market***

One example for the London economy may be the digital Single Market. London is the UK hub of technology and research and the European centre of the digital revolution. There are 34,400 digital technology businesses in London (a 28 per cent increase over last five years) and 155,600 digital technology employees in London (a 31 per cent rise over five years). From 2010 to the end of 2013, over 340 London-based tech companies attracted investment of over £1.47bn. Since 2010 there has been a 75 per cent increase in the number of information communications and technology companies investing in London from overseas. Over the next decade, London's digital tech sector is expected to grow at a rate of 5.1 per cent per annum, creating an additional £12bn of economic activity and 46,000 new jobs in the capital.

The E-commerce Directive, adopted in 2000 at the EU level and brought into UK law in 2002, set up an internal market framework for electronic commerce. The EU has accepted the importance of the digital economy at a Commission level with several working groups for most, if not all, aspects of the digital economy and infrastructure. The EU has previously committed itself to completing the digital Single Market by 2015. Despite this, the European digital economy still remains fragmented, with 28 completely different markets all with their own national copyright and privacy regimes.

Given the importance of the digital economy, a valid economic case could be made for even having a Digital Commissioner in the Commission to champion the completion of the digital Single Market. If not, at the very least the current Single Market Commissioner could prioritise this area. This could include prioritising EU institutional support for digital entrepreneurs operating against vested national interests, championing the importance of 'digital literacy' in education (both school and adult education), as well as pushing through the digitisation of industry and public administration in all EU economies. This is an area UK based digital

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<sup>23</sup> See Politeia discussion paper by Martin Howe, 'Zero Plus: The Principles of EU Renegotiation', 2014

<sup>24</sup> Source for all, GLA Economics research in association with the ONS

<http://www.londonandpartners.com/media-centre/press-releases/2014/12032014-tech-city-launch>

<http://www.londonandpartners.com/media-centre/press-releases/2014/140616-mayor-of-london-and-leaders-of-global-tech-scene-come-together-to-launch-london-technology-week>

firms would stand to gain a number of contracts from. The EU could benefit from harmonizing EU wide digital copyright and digital privacy legislation.

Removing barriers to digital infrastructure improvements is also part of this. The European Commission has ruled that they do not consider there to be any market failure when it comes to the provision of broadband in cities. This means that the GLA cannot invest in supply side infrastructure, such as fibre networks or 5G tech, without being restricted by state aid provisions, and therefore risking litigation by communications providers should government invest in infrastructure in an area that they intended to expand to in the future. This forces us to use demand side measures, such as the SME Broadband Voucher Scheme, to invest in demand stimulation measures that will not distort the market, rather than supply side intervention.

Given the role of digital in the day to day life of all European business and personal spheres, digital infrastructure should be considered a utility in the same way we consider water provision. That is with the appropriate regulatory considerations for the development and growth of traditional utilities.

The new European Commission President, Jean-Claude Juncker has indicated that he intends to make Digital Europe in general and the Digital Single Market in particular his top priorities. A possible UK reform agenda should prioritise locking this direction of travel against the vested interests of other Member States, given the importance of the digital economy for London and the UK as a whole.

### **(B) *Financial services***

The UK needs better guarantees that the financial services industry is viewed as utterly critical to the British strategic interest, and, as such need opt-outs and vetoes of all related financial services legislation. The recent bankers' bonus and Financial Transaction Tax rulings showed that both our status and existing guarantees are not enough to prevent damaging rulings for the UK being made in 'the European Interest'. Whilst the UK has played a prominent place in the creation and implementation of all EU financial services legislation, such as AIFMD, MIFID (I, II) and others, far too many elements of these directives are directly at odds with the competitive advantage and long-term health of UK financial services. One size fits all for Europe does not reflect the sheer scale and scope of the UK financial services sector – London is a global banking and business services hub, on a scale very different to any other centre in Europe.

The UK has no veto to protect the City. The Lisbon Treaty allowed the Commission to impose a new regulatory blueprint that has seen them propose, for instance, a European Systemic Risk Council and a European System of Financial Supervision, the latter being embodied in three newly created institutions, The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Authority, all of which can override national authorities, even

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those empowered and legislated in the UK.<sup>25</sup> The powers of these European institutions are determined by qualified majority voting in the EU Council of Ministers. Is it possible for the UK to seek to safeguard its financial services sector, in a similar way to how the French appear able to protect their core interest of agriculture? It seems harder for the UK to do this, not least because if something goes wrong in the financial sector there is the danger of contagion to the wider economy, as the crisis showed. These concerns about contagion cannot be dismissed, best addressed through appropriate regulation addressing the issues. There is also a need to differentiate between the banks versus the rest of the financial sector, and hence the UK's independent banking Commission has pushed for policies to ensure a safer banking sector within the UK. All this is important as the size of the City means it needs to be regulated appropriately. If this European approach is aligned with a popular perception that holding back the financial sector does not restrain wider economic growth then it seems there will be a built in asymmetric bias to push regulations and controls in only one direction, damaging London. The implication, therefore, of a permanent shift in regulation from the UK to the EU is, 'extra costs, tighter controls and reduced competitiveness for the UK's financial services sector.'<sup>26</sup> This would suggest City organisations should think twice about its enthusiasm to remain in the EU at all costs. As economist Tim Congdon notes, 'Left to themselves, current pay differentials argue that the UK is likely to specialise in these areas, which might be termed "international business services." If not, then such business will likely migrate elsewhere.'<sup>27</sup>

A recent analysis from CityUK caught the issue well, '...the increased role of regulation at the EU level, in particular with respect to the euro area and banking union, means that there are a number of potential conflicts between the supervisory aspect of EU level regulation and the standard setting and regulatory convergence aspect of creating a coherent Internal Market in financial services within the EU. This tension is of paramount concern and one where the UK should play an active role in ensuring the integrity of the Internal Market.'<sup>28</sup>

So the issues are very much about the Single Market. Yet when we look at Europe from the perspective of the financial sector, the wholesale market across Europe works as well as one could imagine, and the relationship between the Bank of England and the ECB appears very good, an issue highlighted in a recent House of Lords Report on the EU debate.<sup>29</sup>

There is a legitimate case for the UK having a fully recognised 'Luxembourg Compromise' over financial services legislation and regulation. The Luxembourg Compromise, signed in January 1966, provides that, 'Where, in the case of decisions which may be taken by majority vote on a proposal of the Commission, very important interests of one or more partners are at stake, the Members of the

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<sup>25</sup> For a good discussion on these issues see, 'The City of London in retreat: The EU's attack on Britain's most successful industry', by Professor Tim Congdon, published by The Bruges Group, 2014

<sup>26</sup> 'The City of London in retreat, Congdon'

<sup>27</sup> *ibid*

<sup>28</sup> page 47 of 'A Legal Assessment of the UK's Relationship with the EU' by TheCityUK and Clifford Chance, April 2014

<sup>29</sup> House of Lords EU Sub Committee A – Economic and Financial Affairs, Bank Structural Reform – Evidence 26th June 2014

Council will endeavour, within a reasonable time, to reach solutions which can be adopted by all the Members of the Council while respecting their mutual interests and those of the Community'.<sup>30</sup> For the UK this needs to be similar in nature to the one France has deployed over the Common Agricultural Policy. The UK needs to be in a position where it can block Commission and European Parliamentary decisions that disproportionately affect UK business over and above the rest of the Continent.

What regulations need to be reformed in the financial sector? Here there is a need to appreciate the complex interaction between domestic, regional and global regulations. In the wake of the financial crisis it was widely accepted that the best future approach to financial issues would be global, as the crisis highlighted that the fall-out from the crisis was global. At the same time, the global approach is not only important in terms of looking at the downside, and the need to avoid global contagion, but also in terms of London it is very relevant on the upside. As a global financial centre London has to compete with other global financial centres in a way in which other European cities do not. London is thus very sensitive to regulations, or policies, implemented at the regional European level or the domestic UK level that are not implemented at the global level. Now, there will be occasions when the UK or Europe may take a tougher regulatory line, and while that could penalise the competitiveness of London, if there are wider benefits - and hence the regulation is the right type of regulation - then it is appropriate. The important thing is to have the right type of regulation not always the cheapest and lowest amount of regulation. There is, however, a concern in the financial sector that European regulation may add to costs without making the system safer, and that if such regulation is being adopted in Europe, and not globally, it will undermine the competitiveness of the City.

## **7. Other economic reform - general areas**

### **(A) *Halt unnecessary regulation***

Cut out unnecessary regulation should be an aim. There is a need for the EU to call a halt to unnecessary legislation, which is complex and intrusive and which does nothing to address the need to improve economic performance, by growing, creating jobs and improving competitiveness.

### **(B) *Reform the EU budget***

The EU budget has to be seen as a future line of focus in curbing the centralising powers in Europe. In 2013, for the first time, the European budget was cut in 'real terms'. The Multiannual Financial Framework (MFF) for 2014-20 saw expenditure down from €1,025bn in the MFF for 2007-13 to €996.8bn. The amount cut was small but the principal was set, with the UK being joined by a number of others including Germany in seeking a reduction. That being said, there still appears to be huge scope for further squeeze in the future. An important, sensible part of the budget is the ability to transfer money to poorer, newer members. Yet there is also much recycling of funds within the same and often richer country, via Brussels,

<sup>30</sup> The Luxembourg Compromise, signed on 30 January 1966

and also still huge amounts are spent on the Common Agricultural Policy and also running the system. The main spending areas are: regional and cohesion funds €325,149m, CAP (direct) €277,851m, Europe 2020 €125,614m, CAP (other) €95,328m, Administration €61,629m, Foreign Policy €58,704m.<sup>31</sup> The amount of the CAP is now just under one-third, and although huge, it was almost 47 per cent in 2006, and the next stage of its reform is to make it 'greener and fairer', but perhaps it should still be smaller. The Council presents the expenditure in a way that highlights an increase of 37 per cent in spending on 'competitive areas for growth and jobs'. So, reform on the budget is already happening but more still needs to be done, particularly in curbing the size further and spending more on the growth agenda.

### **(C) Social and employment legislation**

EU social policy has the potential to become a political hot potato for the UK. To understand why, consider that it was the Maastricht Treaty that introduced the so-called Social Chapter covering a range of social and employment issues. The UK, under Prime Minister Major opted out from the EU 'Social Protocol'. In 1997 the UK under Prime Minister Blair ended the opt-out. By 1999 the social protocol was integrated fully into EU Treaties. Since then the UK has been bound by European social and employment legislation. This includes articles 151-161 of the Lisbon Treaty, plus a number of other articles, and with this area being a mixed competency the UK or any Member State can take action only if the EU has decided not to.

An important area of potential reform is social policy. The question is whether it can be reformed at EU level, as it is a difficult area to push for reform in. Europe's high rate of unemployment may be as much due to a lack of demand, as opposed to supply side measures such as social policy. The challenge with such social policy is getting the balance right. In a competitive global economy it is important to avoid a race to the bottom on costs and wages, yet the reality is also the need to remain competitive. Increased regulation that adds to the costs of employing people will likely hit smaller firms harder and, other things being equal, add to unemployment. The top heavy regulation may be just too costly.

The question with social and employment legislation is whether it is repatriated, repealed or remains?

Remains would be to leave it as it is, set at a European level, useful for large cross border firms and guaranteeing those in work a large range of benefits. Of course, it is costly and does not help small firms or those unemployed. The case to repatriate it could be made strongly. Repatriate would reflect that safeguarding workers' rights is vital and would answer the question that this is better suited to national level. The argument is that the UK needs to repatriate as much employment and health and safety regulation as possible, as recent concerns in the UK about the Working Time Directive (WTD) and Postal Workers Directive (PWD) reflect. If repatriated there

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<sup>31</sup> Europa EU Budget [http://ec.europa.eu/budget/index\\_en.cfm](http://ec.europa.eu/budget/index_en.cfm)

would be specific aspects that could be repealed such as the WTD and PWD. But, overall, even if repatriated many aspects of social and employment legislation would likely stay in place.

#### **(D) Other**

Areas which we may not chose to opt out of, such as EU regional funding, still need to see significant reform before they are of a satisfactory arrangement to the UK government and the UK tax payer. The UK needs to gain better control of where, when and how its portion of regional funding is allocated.

Continued UK membership of elements of the EU such as the Common Agricultural Policy is a constant domestic political issue and perpetuates inefficiencies in the market place. It is not in long term the benefit of the EU to force the UK to maintain obligations, such as the CAP, where the pace of reform is still too slow.

There is a need to view regulations from the perspective of smaller firms, given the cost of compliance. Obviously, trade with other Member States in products and services are going to have to comply with all EU regulations (environmental and non-environmental) but this is a decision to be borne by the exporter. As most SMEs are focused on domestic consumption they should have the ability to provide goods and services to the UK market at a regulatory position set by the UK government.

### **8. Non-economic areas that need to be reformed**

Although the focus of this report is on the economic issues, it is important to stress that reforms in non-economic areas may prove to be important in determining the outcome of any referendum, as well as being important in their own right. Thus they cannot be overlooked. Indeed it could be stated that it is not much good to achieve necessary economic and financial reforms that benefit the future of the EU, if the reforms are not achieved in the non-economic area which proves so unpopular that the UK votes to leave.

Halting the process towards ever closer union was mentioned as reform two above. This links into a number of other areas, namely legal and institutional.

One issue is the future relationship between national and European law, and the case for re-establishing the supremacy of UK courts in some areas and how they relate to the rulings of the European Court of Justice. Likewise, the European Court of Human Rights, though not technically a part of the EU's institutions, appears to only generate negative sentiment in the UK, possibly outweighing any positives it brings. Leaving it might eliminate it as an excuse for poorly drafted or implemented domestic UK legislation.

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Another issue is the institutional challenge of more versus less Europe, and how this addresses the built-in bias within treaties to ever closer union, as this naturally cedes more power to EU institutions. The debate about ‘more versus less Europe’ - or just better Europe - goes to the heart of the relationship between national parliaments and the Brussels based institutions, particularly the European Parliament. Table 5.2 reflects the creeping and increasing power of the Parliament at a time when the public debate has been about more power reverting back to national parliaments.

A possible option is to allow national parliaments to block proposed EU legislation. It has been suggested that through a ‘red card’ system national parliaments could be able to group together to permanently block proposed EU legislation. National parliaments, working collectively with other Member States, should also be able to amend or repeal existing EU legislation.

## 5.2 Evolution of the European Parliament’s powers

<b>1957 – Treaty of Rome</b>	Members of the European Parliamentary Assembly were selected by their national parliaments. The Parliamentary Assembly was to be consulted, and give its opinions to the Council of national governments
<b>1977 – Treaty of Brussels</b>	Parliament secured the right to reject aspects of the community budget and scrutinise accounts at the end of each year
<b>1979 – First European Elections</b>	MEPs directly elected for first time
<b>1987 – Single European Act (SEA)</b>	EP’s legislative powers increased with the introduction of the ‘cooperation and assent’ procedures
<b>1993 – Maastricht Treaty</b>	Legislative powers increased with introduction of ‘co-decision’ procedure, which gave MEPs equal status with national ministers. Entire Commission must be approved by the EP
<b>1999 – Amsterdam Treaty</b>	Use of co-decision extended to more policy areas. EP given the right to approve the European Commission President
<b>2003 – Nice Treaty</b>	Further extended co-decision in areas such as justice and home affairs and industrial policy
<b>2009 – Lisbon Treaty</b>	With a few exceptions, put the European Parliament on an equal footing with national governments by further extending co-decision, notably in setting the EU budget, agriculture policy, justice and home affairs, and energy

Source: European Parliament

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We are constantly aware of the quality of life arguments, and in terms of the EU debate why should it be any different in the sense that how people approach it may not be driven solely by economic variables. It is up to people themselves how much weight they place upon factors, which while they will clearly have an economic impact may be viewed as non-economic such as national sovereignty, defence, the environment, among others, and in many instances this may be the determining factor.

There are other areas that also matter for the UK debate. Elements of the EU's political aspirations as a superstate directly impinge on UK areas of competitive advantage, for instance supporting the growth of a European foreign policy service (the External Action Service) actively diminishes the importance of the UK as a prime soft power exporter in Europe which brings indirect benefits to the British economy through national brand strength. Similarly the push for an expanded expeditionary Eurocorps and additional supporting elements (naval and air) in EU Common Foreign and Security Policy (along with European Defence and Security Policy's Helsinki Goals) only serves to diminish and supplant the regional importance of the UK, which is one of only two European powers able to deploy and sustain a major military force in expeditionary warfare and peacekeeping independent of allied support. This may have an impact on UK defence exports over time, as 'defence diplomacy' is a key component of the sector's sales appeal.

The UK and London has seen a significant shift on environmental issues, from a situation of being regarded as the Dirty Man of Europe in the 1970s to now having a situation where green businesses account for a currently small but significant and rapidly growing part of the economy. EU membership has had a clear impact on this, as the UK was forced to respond to external pressure, but now the UK has robust environmental legislation and there appears to be public support for addressing environmental issues, while in the case of London environmental policy covering many areas is an important part of future strategy. The issue then with the EU is where best should future regulation sit? The EU's energy and carbon emission mitigation regulation is weaker than that which the UK government and the GLA have proposed. Much of the regulation sets up a framework with which to implement the Kyoto Protocol, to which the UK government is a signatory. Regulations which pertain to activity, which by its nature is transborder should remain at EU level, for instance air quality legislation. However, when it doesn't, for example with inland waterways, repatriation should be the preferred option.

It is in the hands of politicians to deliver a suitably robust and far reaching proposal on non-economic factors, but it is very important to emphasise that without significant non-economic reform, there is every chance that even if economic issues are renegotiated successfully to allow the EU to reform, it still may put the outcome of any referendum in doubt.

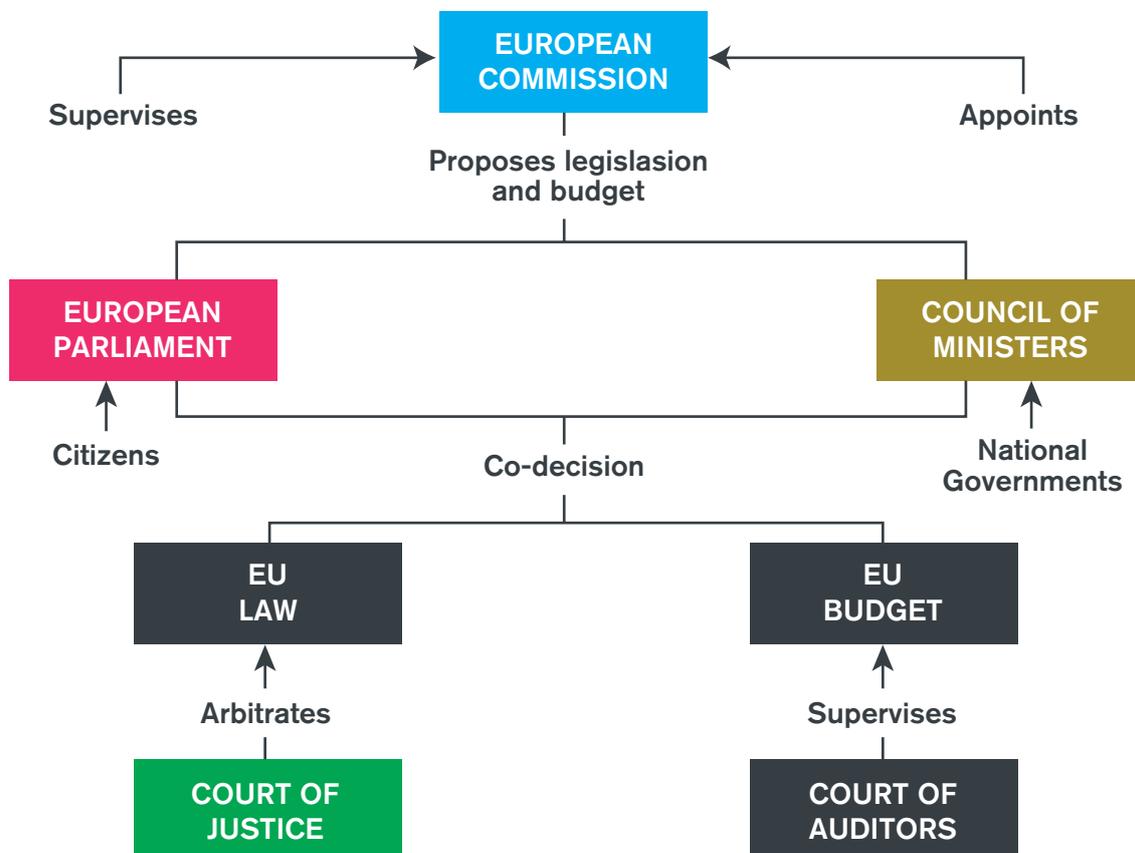
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▪ **Can the EU Institutions be reformed?**

Institutional reform may also be necessary to help improve how the EU operates. The aim would be to make the EU less bureaucratic and more democratic. This, too, is a very complex area and for that reason we provide a brief summary of current key institutions, processes such as the trilogue and relationships for reference. The aim with reform here would be to reduce bureaucracy and waste, improve accountability and governance and in turn address the worries about the democratic deficit. In the wake of the European elections a valid area is whether the way the Commissioners work could be better improved, moving away from 28 separate portfolios, one for each Commissioner, to groups of Commissioners working together on the key specific areas.

The trilogues are informal tripartite meetings attended by representatives of the European Parliament, European Council and European Commission. The level and range of attendance, the content and the purpose of trilogues may vary from very technical discussions (involving staff level of the three administrations) to very political discussions (involving ministers and Commissioners). They may address issues of planning and timetable or go into detail on any particular substantial issue. Any agreement in trilogues is informal and 'ad referendum' and will have to be approved by the formal procedures applicable within each of the three institutions.

**5.3 How the EU institutions function**



Source: BBC

**The European Commission:** The Commission represents and upholds the interests of the EU as a whole. It drafts proposals for new European laws. It manages the day-to-day business of implementing EU policies and spending EU funds. It oversees and implements EU policies by:

1. Proposing new laws to European Parliament and European Council
2. Managing the EU's budget and allocating funding
3. Enforcing EU law (together with the Court of Justice)
4. Representing the EU internationally, for example, by negotiating agreements between the EU and other countries.

**The Council Of Ministers:** Also informally known as the EU Council, this is where national ministers from each EU country meet to adopt laws and coordinate policies.

1. Passes EU laws.
2. Coordinates the broad economic policies of EU member countries.
3. Signs agreements between the EU and other countries.
4. Approves the annual EU budget
5. Develops the EU's foreign and defence policies.
6. Coordinates cooperation between courts and police forces of member countries.

**Voting in the EU Council:** This is generally taken by a qualified majority, with larger countries (by population) having more votes, but the numbers are weighted in favour of the less populous countries:

- Germany, France, Italy and the United Kingdom: 29 votes
- Spain and Poland: 27
- Romania: 14
- Netherlands: 13
- Belgium, Czech Republic, Greece, Hungary and Portugal: 12
- Austria, Bulgaria and Sweden: 10
- Croatia, Denmark, Ireland, Lithuania, Slovakia and Finland: 7
- Cyprus, Estonia, Latvia, Luxembourg and Slovenia: 4
- Malta: 3

**The European Parliament:** This is directly elected by EU voters every five years and has three main roles:

1. Debating and passing European laws, with the council
2. Scrutinising other EU institutions, particularly the Commission, to make sure they are working democratically
3. Debating and adopting the EU's budget, with the council.

**The European Court of Justice:** The European Court of Justice interprets EU law to make sure it is applied in the same way in all EU countries. It also settles legal disputes between EU governments and EU institutions. Individuals, companies or organisations can also bring cases before the court if they feel their rights have been infringed by an EU institution.

Source: Europa

▪ **A possible mechanism for EU reform:**

In crafting this aspect of the report we are appreciative of the input of Open Europe, who had some practical proposals on how to change EU treaties. While there are several different procedures to change the EU treaties but the two most relevant for any UK renegotiation are the so-called ordinary revision procedure and simplified revision procedure.<sup>[1]</sup> The former can be used to change any aspect of the treaty while the latter can only be used to make changes to the part of the treaties that deals with the EU's internal policies and must not increase the EU's competence. The former also involves more political hurdles, including the agreement of a majority of EU governments' to get the process started.

▪ **Ordinary revision procedure**

*Step 1:*

Any national government, the European Parliament or European Commission can make a proposal for treaty change. The European Council (heads of state or government) votes whether to examine the proposal – a simple majority amongst EU Member States is required in order to proceed to the next step.

*Step 2(a):*

The default scenario is that a Treaty Convention composed of representatives of national parliaments, heads of state or government of the Member States, the European Parliament and the European Commission, is called to debate the proposals. National leaders can vote by simple majority to skip this stage but the European Parliament must also agree to do so.

*Step 2(b):*

Following a Convention (or not), EU leaders then meet to debate and agree the proposed changes by unanimity at an Intergovernmental Conference (IGC).

*Step 3:*

Treaty changes must be ratified under the domestic law of all Member States in order to take effect. In some countries this could require a referendum, depending on the extent and content of the treaty change. It is often this need for a public endorsement in some countries that undermines support for treaty change.

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<sup>[1]</sup> See European Commission, 'Revision to the treaties; [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/lisbon\\_treaty/ai0013\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/lisbon_treaty/ai0013_en.htm); and, CEPS, 'How to Change the EU Treaties: an overview of the Revision Procedures under the Treaty of Lisbon', o Broin, P., October 2010

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## ▪ Simplified revision procedure

### *Step 1:*

Any national government, the European Parliament or European Commission can make a proposal for treaty change.

### *Step 2:*

Because it does not constitute 'full blown' treaty change, the process simply requires the European Council (heads of state or government) to agree and approve by unanimity the proposed treaty amendments, after consultation with the European Parliament.

### *Step 3:*

As in step 3 above, treaty changes must be ratified under the domestic law of all Member States in order to take effect. In some countries this could require a referendum, depending on the extent and content of the treaty change.

In conclusion, Section 5 has outlined some of the broad issues in terms of where the EU should reform. Within Section one, we have taken a subset of these to present a minimum level of reform that the UK should seek. The completion of the UK government's Balance of Competencies report over the next year may outline other possible reform areas. It should be stressed that reform needs to be seen in the context of not only what is desirable from a UK perspective (this has been called an à la carte approach) but, crucially what is needed by the EU to allow it to achieve better economic performance and address concerns about a possible democratic deficit.

It is also important to stress that the UK does not always have the right answer to all of the issues – this may be obvious, but it probably needs stating. Social legislation in Europe is popular for many, although it may be more appropriate for it to be set at a national level. Likewise, Britain's productivity puzzle where productivity levels lag those in the US in particular, suggest that the UK cannot blame the EU for all its challenges. The UK's low rate of long-term investment and desire for more national champions mean that there is still much to be said for working with other EU Member States to reform the EU. As a result in this section we have outlined a broad range of possible areas: 1. Accept the case for economic reform; 2. Halt the process towards ever closer union; 3. Have a timetable for reform; 4. Reform the relationship between the Eurozone and the non-Eurozone; 5. Complete the Single Market and address issues in services, people and regulatory intrusion; 6. Sector specific reform - examples important for London highlighted here are the digital services market and financial services; 7. Other economic reforms are outlined, relating to halting unnecessary regulation, reforming the EU budget, the options for social and employment legislation and other areas; 8. Non-economic reform, with areas to consider including the supremacy of UK courts in some non-Single Market areas.

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# Section 6: What happens if we leave?

One of the biggest issues about the EU debate is what would happen if the UK chose to leave?

The immediate impact of any decision to leave cannot be over-estimated. There would be considerable uncertainty. Some may view it as a liberating experience and be positive from the start, but the likelihood is that the bulk of the economic, business and financial community would view it as a great unknown. What then are the issues and implications?

For many aspects of the London economy, the day after any No decision in the referendum would be little different in economic terms from before, especially for those focused on the domestic economy. The financial market impact, however, could be very different.

Although the likelihood is that if there is a referendum then all major political parties will agree to abide by the result, it is also likely that the scale of the margin of victory would have a clear bearing on subsequent events. Given that we are focusing in this section on a No vote, if this was of the two to one scale of the 1975 Referendum then it would suggest a clear mandate to leave, and there would need to be a full focus on the need to do so and in the process make the right decisions for the country. In contrast, a small margin of victory would likely complicate subsequent developments. It might be seen as making it being possible to have another future referendum, it might be seen as keeping open the option of re-entry, and who knows how it would impact the subsequent discussions between the UK and EU. There could even be further discussions to allow the UK some concessions to try and keep them in.

For instance Article 50 (discussed below) may not be invoked if there is a narrow vote. So, even with a No vote the outcome and future path taken may be far from clear-cut. Here though we will focus on the likely path on the basis of a No vote that is binding and that will not be reversed.

The UK government would need a clear strategy. One would hope that this would be in place, based on previous scenario planning behind closed doors, but if not then it would need to be in place soon, allowing for natural evolution as events unfold and circumstances change. Given that a referendum is a national issue, the administration of London and City Hall would need to react to the referendum, but it would make sense to have scenarios in place to know: (a) what needs to be said to the people and to businesses, including domestic and international investment and (b) any actions that

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need to be taken. Contingency planning is always necessary in order to know how to respond to shocks and with something like this one would expect in the run-up to the referendum there to be more detailed planning in place - at least in terms of the first steps to be taken.

▪ **The key aims of policy planning for London:**

- (A) The most important thing would be to get the message out that for a global city like London this provides an opportunity to reaffirm its openness to the world. Above all, a clear positive and realistic vision would have to be outlined, something along the lines of the 'world's global city'.
  - (B) London would need to have a clear plan of action in terms of inputting into the UK government ahead of its renegotiation process. This would be based on a clear analytical assessment of the London economy and its interactions with Europe, as touched on above and as outlined in the appendix.
  - (C) For the Mayor to have a clear list of stakeholders with whom he or she should liaise to address immediate concerns and issues - ideally these would have been earmarked in advance and plans put in place. This should include big investors and employers in London, as well as the business organisations representing different sectors or different sized firms.
  - (D) Given that the referendum period, and most likely the months ahead of it have been a period of political purdah on this topic, there will be a clear need to outline a positive vision for London aimed at people, businesses, and investors. The near-term challenges could not be ignored, but the longer-term opportunities would need to be highlighted. The near-term challenges would include ensuring that the thinking that went into pushing for areas to be reformed before the referendum would be used to push to deliver the economic scenario of one regime, two systems as opposed to the inward looking scenario.
  - (E) A plan of action on trade deals would be important. London would need to reiterate its claims to be a great global city, where opportunities have been enhanced by what has occurred, that it is not choosing the rest of the world over Europe but that it is a global city to Europe and to the world, and that it would be pressing the UK government to engage on new trade deals.
  - (F) As outlined in this report, the key issues would be linked to the City, to potential inward investors that use London as a regional hub or global headquarters, to immigrant workers especially from Europe, given likely concerns over the Single Market.
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- (G) Identify most at risk areas. It would not be a surprise if other counties - both within the EU and, depending upon the sector, outside the EU sought to take advantage of any uncertainty, trying to entice business and investment their way. This should include any sectors that might suffer an economic shock, including those that would lose EU funding.
- (H) Likewise, identify areas with most opportunities, and entice business to London.
- (I) Work closely with other cities and regions in the UK to push, as now, for policies that are pro-growth, pro-business at the local level. If not already implemented by now, push for the recommendations of the 2013 independent London Finance Commission aimed at devolving more financial power to the local level. As that commission highlighted, the UK is a particularly centralised economy. In a post EU world the need for regions of the UK to be flexible and open should reinforce the case for greater local power.
- (J) An important part of the UK's EU membership has been the social policies, seen by the UK trade unions as an important benefit of membership. Outside the EU it would be important to be aware of any unintended consequences of exit in terms of the impact on social welfare. Moreover, it should reinforce the need to push for both continuation of the UK's effective minimum wage legislation (16 years old this summer) and for greater use of the London Living Wage.
- (K) Preparation for any possible changes to domestic law. London – like the UK - would need to be clear about how European laws that impact would be impacted and what this implies for domestic law. Upon withdrawal it may the case that some laws would lapse automatically. There are three categories of EU laws that would need to be reviewed and what, if anything, may need to be put in their place.<sup>32</sup>

London would need to remain receptive to inward investment, and in most likelihood it will. But as outlined earlier in this report the challenges to London's future success include many issues not linked to the EU, such as the cost of housing, and likewise the factors that account for its success are both non-economic as well as economic. The things that could change if the UK left could include worries about the receptive attitude towards immigrants if the freedom of movement towards Europeans was changed, but more likely there would be some substitution aimed at attracting skilled immigrants from all over the world, and if so London's appeal would not diminish, perhaps even be enhanced.

A recent survey by Deloitte showed that London hosted an estimated 40 per cent of the European headquarters of the world's top companies. Alongside 60 per cent of top non-European companies have their regional headquarters in London.<sup>33</sup> London cannot control the competition, but other European cities may try and compete to attract business, but that in turn might be influenced by the issue of 'market access' which has been a positive in the past. In our view, the ability for the UK to reform and reorientate

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<sup>32</sup> For a discussion on the legal aspects of withdrawal see Politeia discussion paper by Martin Howe, 'Zero Plus: The Principles of EU Renegotiation'

<sup>33</sup> Deloitte: London Futures – London Crowned Business Capital of Europe, May 2014, <http://www.deloitte.com/assets/Dcom-unitedKingdom/Local%20Assets/Documents/Market%20insights/UK%20Futures/uk-london-futures-london-crowned-business-capital-of-europe.pdf>

its economy, remaining open, would suggest market access remains a plus, but the future relationship with Europe is important.

Where appropriate London needs to be engaged in the national process, which is outlined here:

First, if the UK were to leave, what is the process?

▪ **Article 50**

The first thing a No vote would likely deliver is uncertainty because if it is decisive it would probably require the UK to invoke Article 50 of the Lisbon Treaty, and out of this would then follow the terms of exit. Article 50 explicitly states that the other remaining members of the EU would decide the terms of the exit, not the country that is leaving.

Invoking Article 50 is like a nuclear weapon - the threat of its use may be a more powerful weapon than its actual use - as invoking it could start an irreversible process (as there is then no way back into the EU except with the unanimous consent of all other Member States) and it cedes power to EU institutions (remaining Member States are in control of the timetable with the European Parliament having a veto over any new agreement) and thus the deal may not be in the UK's best interests (particularly if some areas saw it as an opportunity to make inroads into the UK's lead position in services and in the financial sector).

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## 6.1 Article 50

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.  
A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.
5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

Source: European Commission, Europa

There are some key phrases here: the notification period is widely accepted as being two years but it could be extended if agreed 'unanimously'; part 4 states the UK 'shall not participate' in the discussions. This naturally makes it possible the UK could suffer badly as a result, but there is no reason to think it would. It all depends. One would expect a combination of mature negotiation as well as one or two countries trying to steal a competitive edge.

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- **Not invoking Article 50 may make more sense**

Notwithstanding the terms of Article 50, one would not expect or want the UK to be passive. Instead one would expect the UK to be proactive in seeking an amicable separation. Perhaps for these reasons not invoking Article 50 would make more sense. This could be seen as starting with a clean slate in determining the future relationship with Europe. There are a number of areas that would need to be pursued simultaneously.

- **Economic shock**

Leaving the EU would constitute an 'economic shock' and like any shock some areas are better able to cope than others, and some may suffer badly. It would be expected that in terms of the London (and UK) economy any such areas are identified in advance, such as those who are recipients of EU funding, examples being in the scientific or research field. The UK government would need to decide how to handle such sectors - whether they needed explicit help, for instance substituting any future withdrawal of EU funding with domestic funding. As outlined, while some areas of the domestic economy could be directly impacted there will be indirect effects, as people, firms, domestic and international investors and the financial markets adjust their behaviour. After all, despite many threats ahead of the decision whether to join the euro, firms did not leave the UK.

The market reaction if the UK left the EU may not prove to be in line with expectations. Sterling's departure from the exchange rate mechanism in 1992 (ERM) was widely predicted in advance to lead to a weaker currency, higher interest rates and recession. The currency did fall, but so too did interest rates and the economy rebounded. In terms of an EU exit, financial markets may well anticipate and thus discount the outcome ahead of the vote. Generally speaking, economists would expect the uncertainty and prospect of a protracted departure to lead to a weaker currency, higher market interest rates and that some international firms put investment on hold ahead of the referendum and even some choosing other European locations in which to invest. While this may not prove too far from the truth it is also likely to be the case that the narrative and vision that accompanies the referendum outcome and the terms of the exit will be the determining factors.

Reform will still be needed, but whereas within the EU it was a case of pushing EU wide reform, here it is just the UK we need to worry about. There would have to be a paradigm shift in the way governance and the UK economy interacts as competencies and regulatory control flood back to the UK.

There is, like many of the issues, some overlap between the issue of reform and exit. What needs to be reformed in the EU was considered above. Naturally, if the UK were outside of the EU it may wish to address some of those areas as well, in particular the relationship between the Eurozone and non-Eurozone, as outside the EU there is still the likelihood of London being Europe's financial centre, but there would be no certainty as to how that might unfold in the future, and what business may or may not

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be lost. Much would depend on the business model of firms, and on the relationship that follows between the UK and EU, and between the UK and the rest of the world.

Many regulations would need to remain in place even if the UK left the EU, as they may already be written into UK law, or be necessary for the economy. To suggest that the UK would be freed from regulations would thus be misleading. But it is important to recognise that this is a dynamic and fluid situation, and outside the EU the UK would be able to determine its own, future regulations, and not tied to implementing future EU regulations.

Moreover, one of the issues business currently has with the EU is the weight of regulation, shortening the chain of regulatory creation, implementation, feedback and revision allows for a far more dynamic economy. The Appendix goes into great detail on the need to remain flexible to new technological shifts and not to constrain nascent industries. Regulatory freedom means the UK is not constrained by the slow and often misguided attempts of European institutions that stifle innovation through centralised policy control and a need to weigh up impacts for every Member State.

Yet one of the lessons of the financial crisis was that light regulation may not always be the right economic outcome. Regulations need to be appropriate, not always light, and the right answer to this need not depend upon EU membership.

### ▪ **Issue is weaker, or stronger**

Worries about the UK outside the EU are largely based on a combination of concerns about the UK's access to the European market, future political influence and about its bargaining power in trade negotiations. The fear being that access, influence and bargaining power would be less.

At first inspection the logic may appear compelling, and goes along the lines that the EU is bigger, will have a stronger voice, while the UK outside would be smaller than the EU and thus less likely to be listened to.

On the political influence, such thinking can be challenged. The UK is still one of the five members of the UN Security Council and still carries considerable political influence, albeit not as much as before. This, though, is hard to quantify.

London as an international city could ask itself, what would be different? Many of the factors that contribute to London's attraction could be said to be independent of our EU relationship. These include non-economic issues such as the London Vibe, the English language, law, its acceptance of different nationalities, safety, sheer energy and innovation. In short, all the 'C's of culture, conversation, contracts, cosmopolitan, (low) crime and creativity.

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The debate on which regulations to keep could mirror that on which parts of the EU needed to be reformed. There is a significant difference between EU directives and regulations. The UK would find it relatively easy to repeal regulations, if it chose to do so. That is because EU regulations have direct legal effect and do not necessitate UK laws to be passed to put them into effect. As such, they could be rescinded, if Parliament chose. In contrast, it is EU directives that require each individual Member State to put them into effect and in the case of the UK this requires Acts of Parliament. Thus such EU directives would still be binding unless each specific Act of Parliament is repealed. Given that it would require some detailed analysis and discussion, one can imagine the degree of uncertainty that might prevail.

#### ▪ Trade with Europe

Leaving the EU does not make it suddenly easier or harder to make trade deals. It changes the debate. It sounds easy to say the UK can renegotiate alternative trade deals, but the reality is it will be potentially complex, time consuming and difficult. On the negative, there is a potential execution problem - whether the UK has enough people with the necessary skill sets to negotiate a host of new trade deals - the number of deals that would need to be agreed - and the speed with which these could be negotiated. There is also the legal complexity of deals linked to the financial sector.

In addition, one worry some have is that trade deals may be harder because we no longer have the full weight of the EU behind us in seeking deals, but that need not be the case.

Against this has to be set that there are many countries across the globe, many smaller than the UK, that have successful trade deals.

Also, the UK can focus on trade areas that would benefit the UK, as opposed to EU type deals that cover a huge range to suit the many different Member States. Thus the UK specific set of asks going into a future trade deal are likely to be far smaller than a pan EU list. This should allow the UK to be nimble and fast acting, and be able to engage with iterative deal making, that is a template that can be fine-tuned for a number of countries. Although an independent UK would not have the economic weight of the EU, its size with the competing interests of members is not always a guaranteed winner at the negotiating table. It could slow down some negotiations and certainly makes them harder to iterate in future. This, the other side of the debate, is that less comprehensive deals offer the UK the ability to get its way over time, instead of being part of a competing set of voices at protracted negotiations.

It would be up to us to make the new arrangement work, but to repeat, it may take time and be legally complex in financial areas.

There are different aspects to future trade deals: the future terms of the relationship with the EU and the potential trade opportunities with the rest of the world. The UK is

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already an open, trading nation and as stressed earlier, for the UK this is not a case of close trading ties with Europe versus close ties with the rest of the world, but the need to have both, whether in or out of the EU.

If the UK left the EU, one would imagine that a future trade deal with the EU on goods would be far easier to reach than in services or in financial products, for the very reason that it would suit both sides to reach a deal on goods – given the large UK trade deficit with the rest of the EU. When it comes to services and to financial products it is far harder to predict the likely bargaining process.

If we were to leave the relationship with the EU would need to be negotiated. Table 6.2 summarises the potential options, and these are compared with the present situation of EU membership. This covers all sectors of the UK and London economy. Hitherto, there have been three main types of trade deals the EU has with other countries: membership of the Single Market; membership of the customs union; a free trade agreement.

At the same time as the UK and EU are determining the future terms of their relationship, there would be a need for the UK Parliament to decide which EU laws and regulations it wishes to keep, change, or rescind. This is by no means clear, and if the majority in favour of an exit was small then there is every likelihood of the process and any debate on the laws to be kept being long and drawn out. If so, it would feed financial market and business uncertainty.

All of the above will take some time. Yet there should be an explicit desire to move as quickly as possible to the new future relationship. Once the direction of travel is agreed upon a great deal of the uncertainty risk will arguably disappear. Much of the business concern is that the UK Government will be unable to act effectively in this situation. If it shows itself capable then confidence and the mood would likely pick up.

### ▪ Trade with the rest of the world

If the UK were to leave, various suggestions have been made as to the future course of UK trade, all along the sensible lines of deepening ties with countries elsewhere:

One suggestion might be for the UK to establish a formal 'EU out-group' of European countries outside the EU but with close trading arrangements, to allow these countries to speak with a stronger voice in discussions with the EU.

Alongside this, a sensible one might be to negotiate membership of the European Free Trade Association (EFTA), though remaining outside the European Economic Area. The precise degree of closeness should be somewhere between the positions of Switzerland and Turkey, outlined in table 6.2.

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In addition to this, the UK should seek closely ties with other regions, forging new relationships with emerging powers in Asia and Latin America as well as Africa. In many respects this reflects current UK policy, and it is something that should be pursued anyway even if the UK were to remain in the EU - although naturally in that case trade deals would be part of the EU approach. Alongside this, in deepening the network of ties and relationships with countries in the rest of the world, this may open up potential ties with Commonwealth countries in a way in which we have not pursued fully before.

Outside the EU, the UK would need free trade agreements with major trading nations such as China and the USA, with a particular emphasis on the service sector. Given the major UK presence in the service area globally it would be operating from a position of relative strength, and the removal of many of the other elements of EU negotiations, such as in areas like agriculture, textiles, other manufactured goods might allow for fast treaty negotiation.

The UK may also wish to cultivate bilateral strategic relationships with traditional allies such as Australia and Canada. The UK can pick from nations with clearly aligned geopolitical goals to boost its own global agenda.

The EU has 33 existing free trade agreements. It is waiting for one to come into force (Singapore) and is negotiating at least eight further agreements.

The UK would have to renegotiate all of these. Some of the existing agreements could be replicated quickly and with a minimum of hassle, for instance the UK has historic and current links with countries such as Chile and South Africa and it is difficult to foresee significant barriers being placed in the way of a bilateral arrangement. Korea, Mexico and some of the other Central and Southern America deals may take more time to push through. Overall, in recent years, the UK has shifted its attention in recent years towards the rapidly growing emerging economies and so the areas we need to focus on, in addition to ties with the EU and US, should be clear.

The length of time it has taken to bring TTIP negotiations to something approaching a close has been a huge task that began in the early 1990s. Economic barriers between the EU and the US are already low thanks to the WTO and various other agreements alongside the scale of investment historically and currently, but that said the TTIP should lead to an additional small boost in investment.

A significant EU-China free trade agreement has not shown any sign of significant movement for several years. This together with the length of time TTIP has taken to progress to near conclusion show that despite the size of the EU, and the size of their presence in a market, this does not necessarily mean a rapid conclusion to negotiations. Would the UK be able to push for any of these agreements by itself? Possibly not in terms of far reaching expansive agreements, but it is clear that elements of the process could be used for smaller mutually beneficial arrangements.

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On the positive side, the UK, independent of the EU, would regain its seat on the WTO and be in a position to use the institutional machinery of the WTO to negotiate bespoke free trade agreements.

The UK, unlike other European nations with the exception of France, has significant soft and hard power capabilities twinned with extensive global presence and experience. Not enough emphasis is given to the economic relationship between global presence and optimal outcomes. It is more than historic trading relationships, but the fact that the UK has important geo-political positions and immense soft power capabilities - examples include a UN Security Council seat, a leading role in NATO, popular cultural heavyweight - the UK would not be starting from scratch in the world, nor relying purely on historical good will.

### ▪ Inward investment

There is no doubt that leaving the EU would create uncertainty, both ahead of any decision, and after any vote if there was a decision to leave. Uncertainty can affect decision making in many ways. In this context, there are two forms: (a) uncertainty about inward investment into the UK; (b) decisions about regional or global headquarters that are based in the UK.

Part of the difficulty with assessing things, is that the EU is just one of many factors. Others include tax, access to staff, good communications, and also the cost and quality of living in London. If the UK were to leave the EU, it would be hard to quantify the potential impact on either of these areas, but we could qualify the impact. That is we could say what direction the impact would be, but not how big. In qualitative terms, the immediate impacts in both cases could be negative, but we cannot say by how much. But over time, with a good economic performance, we would expect any near-term negatives to be fully reversed. We would also expect inward investment to rise, if UK growth is strong and all the factors that contribute to London's success now, remain a magnet for inward investment and for attracting people.

Under the relevant Single Market directive, a firm authorised in an European Economic Area (EEA) Member State is entitled to carry on permitted activities in any other EEA Member State by either exercising the right of establishment (of a branch and/or agents) or providing cross-border services. This is referred to in Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) (FSMA) as an EEA right and the exercise of this right is known as 'passporting'.

The activities that are 'passportable' are set out in the relevant EU Single Market directives. Activities that are not covered by the directives and are not 'passportable' will require the firm wishing to carry on such activities to contact the relevant competent authority of that host Member State in order to determine whether direct authorisation is needed. The legal complications of an exit were highlighted in one of the ten papers we cited earlier, in the literature search that looked at the legal

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assessment of the UK-EU relationship by CityUK and Clifford Chance. As it stated, 'The EU financial services passport is relevant in the following areas of financial services: banking services, non-life insurance, life assurance, reinsurance, insurance mediation, investment services, management and offering of UCITS, alternative investment funds, payment services and electronic money.' Thus their report concludes the danger to UK financial services is "uncertainty, reduced market access and loss of influence." These therefore are, where possible, the areas the UK needs to try and address, but over and above that the best way to keep business in London is to make it as competitive as possible. One of the areas would be to find a quick solution that allows a passporting arrangement to continue.

#### ▪ **The future relationship between Britain and the EU**

Comparisons are often made with the trade deals that Switzerland, Norway or Iceland have and the pros and cons of each. This is relevant as a benchmark for the UK, but the reality is that we are far bigger and more important economy than each of these countries, and so it is feasible the UK could negotiate a more suitable deal for both the UK and EU. The latter is particularly so given that the UK is such an important trading partner for them, as they are for us. Indeed, the EU has a substantial trade surplus with the UK. This is not something the UK would have viewed positively in the past, but in the event of an exit it might work in the UK's favour, as a trade deal that penalised the UK would likely hit EU exporters to the UK, too. The UK trade deficit with the EU was £65 billion in 2013 and perhaps as many as four million jobs on the Continent may be dependent upon both British trade and investment.

##### *The Norwegian option:*

This is not an option for the UK. The Norway Option is widely seen in the UK as not being a suitable future option for the UK, and rightly so. When this option is often discussed in the UK it is often overlooked that the terms of the Norwegian Option were negotiated by Norway in anticipation of joining the EU, but its people subsequently decided not to join. Thus it would not be appropriate to think of it as an option that the UK leaving the EU would want. Norway is not a member of the EU, but is a member of the European Economic Area. The one benefit is that Norway is not part of the common agricultural policy, but in most other respects this option would not be appropriate for the UK. As an EEA member Norway has access to the Single Market (which the UK would want) but it is subject to a rules of origin constraint to limit goods from the rest of the world accessing the EU via Norway and avoiding any necessary customs duties (that would not be appropriate for an open economy like the UK). Norway has to abide by EU rules, without getting to vote on them. Some call it diplomacy by fax.

##### *The Swiss option:*

The fact that Switzerland is neither a member of the EU or of the EEA and yet was able to negotiate a bilateral trade deal should suggest that the UK would be able to agree a far better deal if it chose. The Swiss Option is not suitable for the UK as it does not

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have full access to the services component of the Single Market. Switzerland earlier this year rejected the free movement of people element of the four freedoms and there has since been a focus on whether the Swiss deal will be renegotiated.

### *The Turkey option:*

Turkey joined the EU customs union in 1995. Turkey has full access to the EU Single Market for goods but not services or agricultural produce which are not covered by the Customs Union. Whilst it has to apply all EU product regulations and the EU import tariff on industrial goods, membership of this arrangement is free. The Turkish position was negotiated with an eye to industrial manufactures, which make up the bulk of their exports, it was not a service sector driven economy in the 1990s. Turkey benefits from not having to enact any of the EU Social and Employment legislation, nor any element of EU CAP, CFP and other regional policy. In return the ability of Turkey to influence regulatory and other market policy on goods is limited. However, as this arrangement is broadly an evolutionary mechanism for possible Turkish entry into the EU it is not really a valid choice for a post-exit Britain which would be looking to distance itself from the EU, not position itself for possible future membership.

### *The WTO option:*

In an Open Europe simulation exercise, referred to in the literature search section above, after initial hostility, 'other Member States recognised the need to strike a new trade deal with the UK with economic incentives trumping political rhetoric'. Britain is unlikely to face what some may call a worst case scenario of having to fall back on World Trade Organisation rules. The challenge will be a new deal replicating fully access to the Single Market.

### *The UK option:*

There is no reason why the UK needs to be constrained by the deals other countries have with the EU. As the sixth biggest economy in the world, a country with whom the EU will wish to trade, and also as an economy that has the potential to be the biggest in Western Europe, even larger than Germany within a generation, the UK should have the ability to forge a favourable deal. As President Barroso acknowledged in April 2014, the UK is different. Some provision for either full service sector access or with limited barriers is critical.

The UK negotiation should be framed with one possible intention being little EU influence in the realm of anything other than specifying specific goods and services regulation to allow exports into the EU market. As far as possible, the conduct of the British government, people, or business should be removed from EU control or influence. Otherwise the benefits of leaving are undermined over time and it would be a case of short term gain dragged back over time by a regulatory heavy model.

Single Market membership via the EEA means that many negative aspects of European membership remain. This means the relationship with the Single Market needs to be reframed in a bespoke negotiation.

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Thus the most likely UK option has to be a comprehensive free trade agreement, with its negotiation improved by the threat of Article 50 – clearly the UK would push for full market access. It is unlikely this will be granted. Whilst it is not optimal to lose full services market access, the UK competitive advantage in services means that Europe may impose some barriers to market entry. On the flip side a bespoke negotiating relationship will give the UK the broadest possible operating environment from which to pursue its post exit future. UK business would decide to mirror EU regulations on products and services to allow ease of selling into the market – but these would be business decisions, not something imposed by a centralised bureaucracy. Existing social and employment legislation would need to evolve to suit the UK's domestic needs.

In conclusion, this section looked at the consequences of a UK exit from the EU. Leaving the EU would lead to considerable near-term uncertainty, but as we have outlined here for the UK economy to be successful it would also lead to the need for a clear framework of policy planning, in order to both create a future enabling environment for business and a clear strategic vision for the economy. As our earlier economic scenarios demonstrated, the future performance of the UK economy will not be determined solely by whether it is in the EU, or outside. If the UK were to leave the EU, our economic scenarios suggest that the path ahead would differ considerably if the UK adopted the inward looking path in contrast to the far more desirable, outward looking scenario that we have called One Regime, Two Systems. Outside the EU, the UK can no longer look to blame Brussels and Europe for any economic problems. The UK would need to realize its potential standing on its own two feet and seeking to position itself well in a growing global economy. London, as an open, dynamic capital city, would have much to gain in this scenario. Overall, if the UK can take a lead role in reforming the EU, or if it pursues an open and business friendly approach outside the EU, then it can succeed. It is a win-win situation.

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## 6.2 Possible alternative relationships between Britain and the EU

	Access to EU Single Market	Non-EU trade	EU social + employment legislation	EU product regulations
<b>EU</b> Full EU membership	Full access via the customs union. Additional “four freedoms”: labour, capital, goods and services.	Conducted under the EU’s Common Commercial Policy (CCP) and EU FTAs.	All	All
<b>EEA</b> The EEA – nearly but not quite an EU member	Full access via EEA agreement subject to rules of origin (ROO). <sup>34</sup> Four freedoms.	Conducted under EFTA’s FTAs or separate bilateral agreements, or most favoured nation (MFN) basis.	All	All
<b>Switzerland</b> A tailored bilateral free trade deal	Access in most areas subject to ROO. Limited access in services. Free movement of labour (skilled), capital and goods.	Conducted under EFTA’s FTAs or separate bilateral agreements, or MFN basis.	None	No but, in practice, internal standards mirror EU to enable exports.
<b>Turkey</b> A stripped back customs union with the EU	Full access for goods. Agricultural products and services are not covered by the customs union, as customs unions only cover physical goods.	Subject to the EU’s tariff for industrial goods and processed agricultural products but not agricultural produce. Must conclude own FTAs.	None	All
<b>WTO only</b> A clean break	All trade conducted under Most Favoured Nation (MFN), with tariffs applied on EU trade subject to any Free Trade Agreement (FTA) negotiated.	MFN, trade conducted by UK acting alone at WTO.	None	EU regulations only for exports to the EU.
<b>Comprehensive Free Trade Agreement?</b>	Access in areas set down in the agreement, which could potentially cover services and goods, subject to ROO.	Conducted under FTAs, separate bilateral agreements, or MFN basis.	None	Voluntarily for exporters.

<sup>34</sup> Rules of Origin are often complex and form an important part of a preferential trade agreements. In the case of the EU they often impose strict rules on a proportion of inputs from outside the Single Market.

EU budget contributions	EU's CAP, CFP and regional policy	Sovereignty	Impact on London
Yes	Yes	Ability to influence and vote (or be outvoted).	Positive and negative elements of the relationship discussed before continue.
Contribution for areas of participation on a % GDP basis. + 'Voluntary' contribution to EEA grants fund.	No	Limited influence and no votes. Regulations legally enforceable.	Similar economic activity with the Eurozone but the City is at increased risk.
'Voluntary' contribution to Swiss development fund and EU infrastructure.	No	Bilateral adoption of regulations.	Large impact on goods and services trade for London's SMEs. Financial services gains some protection from regulation.
No	No	Product regulations apply. Limited scope to influence CCP in goods.	Massive impact on London's service sector. Goods sector unchanged
No	No	Full sovereignty, but no influence on EU.	Difficult short term – long term all of London's sectors may benefit and lose out in varying amounts.
Might be a condition of a deal.	No?	Bilateral agreement, which might include a dispute mechanism.	Has the possibility of being the best result if the UK negotiates well.

Source: Adapted from a number of sources

