# EU Membership — What’s The Bottom Line?

*IoD Policy Paper*

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March 2000

ISBN 1 901580 38 5


Published by the Institute of Directors
116 Pall Mall, London SW1Y 5ED

COPIES AVAILABLE FROM:

Director Publications
Publications Department
116 Pall Mall
London
SW1Y 5ED
Tel: 020 7766 8766
Fax: 020 7766 8787

Price £5.00

# Contents

# Executive Summary

- The aggregate impact of the EU Budget, CAP, Customs Union, Single Market, EU Social Welfare Model and EU related Foreign Direct Investment is negative for the UK economy. Adding together all the current costs and benefits suggests there is a minimum net cost of £15 billion per annum to UK membership of the EU. Under an alternative scenario whereby FDI increased because of a lower cost and regulatory burden in the UK, the annual net cost of membership could increase towards £25 billion — around £1,000 per annum for every household.
- In the future, if the UK were to join the euro and engage in simultaneous monetary and fiscal policy harmonisation, tax harmonisation alone could double the net cost, even before the effects of lost output attributable to an inappropriate monetary policy.
- There are no simple solutions to our trading relationship with the EU. Withdrawal from the EU would place the UK outside the Customs Union. Whilst the direct tariff impact would be relatively small - following the Uruguay Round - non-tariff barriers might be more significant. One option would be to withdraw from the EU whilst remaining inside the European Economic Area (EEA). This would then free the UK to negotiate its own trade agreements with third countries and gain the benefits of lower world prices. The drawback to this approach is that it would open up the UK to Single Market regulation without a say in its construction. This explains why the IoD argues that the UK should fight for radical reform from within the EU.

EU Membership — What's The Bottom Line?
(% of GDP per annum)

| | Cost | Benefit |
|---|---|---|
| EU Budget | 0.75 | — |
| CAP | 1.0 | — |
| Customs Union | — | 0.5 |
| Single Market | 0.0 | 0.0 |
| Social Model | 1.0 | — |
| FDI | — | 0.5 |
| Total | 2.75 | 1.0 |

Net cost is 1.75% of GDP per annum — almost £15 billion per annum.

- IoD members strongly support membership of the EU because of the trading gains it bestows. Members also support the Single Market because it is seen as an important consideration for inward investors. As a result, the IoD is fully committed to membership of the EU. In every sense, IoD members wish to see the EU work. To work better for the UK and to work better for the 17 million unemployed across the EU.
- However, this report also shows that far too many EU policies damage British competitiveness. For British business to be globally competitive, major reforms are required in the EU's economic policies. This report follows on from previous IoD studies in calling for radical EU reform.
- Whilst the role of the EU in UK competitiveness is important, we should not forget that in the future it is very likely that globalisation and e-commerce will be the primary drivers of UK technical progress and total factor productivity growth.

# 1. Introduction

This research paper examines the costs and benefits of the UK's membership of the European Union. It complements two recent studies undertaken by the IoD Policy Unit, *The UK and the Euro — Better Out than In* (G Leach, IoD April 1999) and *A Competitive Britain in a Competitive Europe* (R Lea, IoD June 1999). If the EU is to work better for the UK, the present imbalance between costs and benefits will need to be addressed. *EU membership — What's The Bottom Line?* presents an analysis of EU economic policy in its entirety towards the UK economy.

The aim of this study is to show how a market led approach to EU policy provides the best way forward for the EU — as a means of reducing the 16 million unemployed across the EU. With this in mind it is the view of the IoD that the only sensible road to take is one leading towards a shallower, wider, lower taxed and lightly regulated EU economy. It is surely the case that a 'good European' needs to advocate policies which will reduce unemployment, reduce agricultural subsidies, widen the EU and tackle the unfunded pensions crisis. In none of these areas is there any sign as yet that the necessary reforms will be undertaken.

The paper is structured as follows:

- Introduction
- The EU Budget — a UK perspective
- The costs of the CAP
- EU enlargement
- The EU labour market
- The EU – external and internal trade liberalisation
- Future burden – tax harmonisation
- The EU — a cost-benefit analysis for the UK

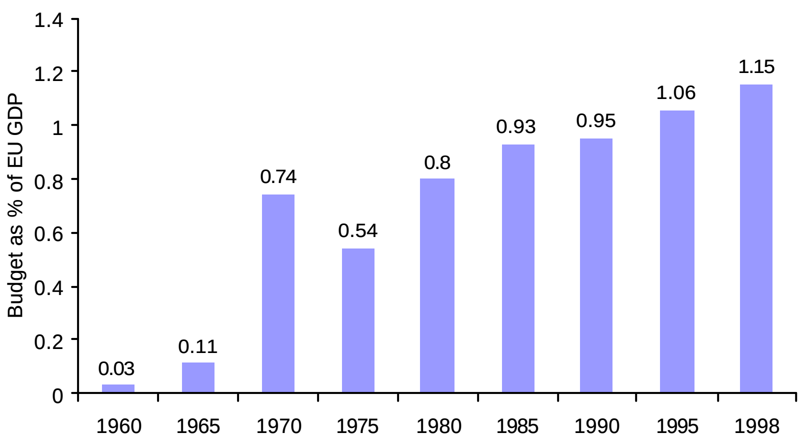
# 2. The EU Budget – a UK perspective

The EU budget is set at a maximum of 1.27% of EU GDP (by agreement at the Edinburgh European Council in 1992). In absolute terms the amount is large, but as a proportion of EU GDP it is obviously very low, since the largest areas of public expenditure remain under national control — health, education, social security, law and order and defence. The budget outturn has been an undershoot in expenditure against the agreed ceiling. However, as the figure below shows, over time there has been an inexorable rise in the EU budget as a proportion of EU GDP. By 2006 CAP spending is planned to be 2% higher in real terms than in 1999 *(2000-2006 Financial Perspective,* EU March 1999).

Planned expenditure showed the CAP accounting for 45% of EU spending in 1999. Structural operations accounted for 31% of planned expenditure in 1999. The remainder of the budget was taken up by administration costs, reserves and extra-EU action.

The financial accounts of the European Union are shameful. In 1998, for the fourth year running, the European Court of Auditors (ECA) rejected them as *"incorrect or incomplete"*. The normal 'quoted' fraud estimate is around 5% of the total budget and yet the ECA says it cannot quantify the total fraud level – suggesting it may be higher still. The ECA describes a *"significant incidence of irregularities"* in the 1998 accounts (*Daily Telegraph,* January 14th, 2000).

**The EU Budget (1960-1998)**




(Source data: The Community Budget: The Facts in Figures, EC 1998)

## Gross or net payments?

Since the UK joined the EEC in 1973, cumulative gross contributions to the EU budget have exceeded £120 billion (Source: ONS). Net contributions — after deducting public sector receipts and negotiated abatement funds — amount to more than £30 billion over the same period. This reveals a crucial insight and strong negotiating position:

> *"Britain is economically vital to the other Member States, both as a destination for continental exports and as a major net contributor to the budget"*
>
> (*The Future of Europe,* Rt. Hon. Michael Howard, Centre for Policy Studies, 1997).

In other words, UK membership is good for the EU.

Many commentators focus on the net figure when estimating the direct costs of membership. However, this is misleading. When estimating the domestic tax burden we do not deduct public expenditure from the total tax burden. We don't say income tax is zero because of spending on health and education. Consistency demands that we adopt the same policy towards payments — which are essentially a tax — to the EU.

Former Chancellor, Lord Lamont, has written (*Sovereign Britain,* Norman Lamont, 1995) that,

> *"it is like saying that the rate of income tax is not 20 pence but 2 pence in the pound because we receive a lot back in schools and hospitals".*

UK CONTRIBUTIONS TO THE EC BUDGET
(£million at cash prices)

| |
|---|
| Gross contributions exceed £120 billion since 1973 |
| Net contributions exceed £30 billion since 1973 |
| Gross contributions are around 1% of GDP per annum |
| Net contributions are around 0.5% of GDP per annum |

(Source: ONS and IoD estimates for 1999)

## The distribution of EU contributions and receipts

Another very significant fact is that the cost of EU membership is paid by all, but on the whole is received by few, via CAP payments and regional Structural Funds. Contributions to the EU budget are spread over the entire UK population. The same is not true for receipts.

The direct beneficiaries of EU payments are in the agricultural sector or those recipients of regional aid. It is estimated that the net cost to the UK of the CAP is between 1-1.5% of GDP per annum (Source: *Better Off Out? The Benefits or Costs of EU Membership,* IEA, 1998/*Britain and Europe: The Balance Sheet,* P. Minford, MCB University Press, 1996).

An additional distribution issue centres on efficiency. Since 1973 public sector receipts from the EU have been large. However, it is very likely that much of these receipts were not spent effectively. In other words, if HM Treasury had kept the money in the UK, it would have been unlikely to be spent on the same projects. Even better still would have been the scenario whereby the private sector had kept the funds via lower taxes.

The need for fundamental reform of the EU budget is most apparent in the distribution of net receipts per household across all member states. Figures quoted in Hansard (*Hansard Written Answers*, 10th November 1999) show that in 1997 the average contribution per household in the UK was £56. In contrast Ireland gained from receipts per household of £1,757!

## Fiscal failure

The EU budget is characterised by continued fiscal failure. By this we mean a lack of real commitment to reforming the CAP and Structural Funds. The issue is made more pressing by the desire for EU enlargement. New entrants could potentially increase the amount of agricultural land by 50% and double the size of the agricultural workforce. For Poland alone, it has been estimated that the costs of the CAP and regional aid could reach 7% of GDP per annum. The post war Marshall Plan amounted to about 2% of GDP!

Urgent fiscal reform of the CAP and Structural Funds is needed for a number of reasons:

- In order to reduce a national dependency culture, whereby membership of the EU is more attractive for hand-outs than for the competitive stimulus of market forces.
- In order to permit enlargement of the EU and to keep Structural Funds below a threshold of 0.46% of EU GDP. There are concerns that in order to meet this target, and allocate new money to new member states, there will not be a sufficient number of 'losers' of Objective One status after 1999. The cost of structural funds has increased fourfold since 1988.
- In order to meet the Uruguay Round of GATT targets – despite the completion of the talks in 1993!
- The 2.5% per annum EU GDP growth estimates of the European Commission may prove too optimistic. If EMU slows GDP growth, it will also slow enlargement.
- Asymmetric shocks — Eminent economists, such as Professor Paul Krugman at MIT, have argued that the euro is likely to lead to greater regional specialisation across Euroland. This restructuring process may raise already high unemployment levels in lagging regions.
- The costs of regional stabilisation may have to be funded from new sources, such as a Europe wide $CO_2$ emissions tax, or from the profits of the new European Central Bank. This potential extension of tax raising power must be resisted.

In October 1999 the so called 'Committee of Wise Men' reported to European Commission President Romano Prodi in a report entitled *'The Institutional Implications of Enlargement'.* The great concern for the UK must be that in seeking enlargement the EU extends the role of qualified majority voting. The worst case scenario is one where the UK is forced into accepting QMV before fundamental reform of the CAP and EU budget is undertaken. This could result in higher taxes in the UK to finance agricultural and structural reform subsidies in new member states.

For too long, many people in the UK have held a simplistic view of enlargement, believing that this widening of the EU would disrupt the momentum towards an ever closer and deeper union. What this view fails to understand is that advocates of deeper union also support a widening of the EU because of the removal of the unanimity principle in taxation that may result. The UK should give no ground here. The IoD believes that the Government should support enlargement, but not at any price. The support for enlargement should be conditional on:

- Fundamental reform of the CAP and Structural Funds.
- A fundamental reform of the EU budget in order to dramatically reduce fraud and mismanagement.
- No extension of QMV.

It is arguable that the best way to help prospective members of the EU is not to encourage them to join, but instead reform the CAP which ravages their economies at present. The current levels of subsidy mean that Germany manages to export more agricultural products to Poland than Poland to Germany.

Commenting on the impact of enlargement on the EU budget, Bill Jamieson, Economics Editor of The Sunday Telegraph, has written that (*A coming home or poisoned chalice?*, B Jamieson and H Szamuely, CRCE 1998).

> *"the next five years are set to create irresistible pressure for an increase in the EU budget with all that this implies: yet more to be spent on an outdated, inefficient and wasteful financial apparatus, corrupting in its operation".*

# 3. The costs of the CAP

The European Union's Common Agricultural Policy (CAP) has in recent years appeared all but indefensible. Indeed, the IoD would argue that this was always the case.

In a speech in the Hague in January 1998 Prime Minister Blair stated that,

> *"the CAP must be modernised … the present system is a manifest absurdity .. it is time to grasp fully the nettle of reform".*

In a recent briefing note from Global Britain (*The failures of the CAP,* 10th September 1999) it is shown that the CAP costs around £250 per person per year for every man, woman and child — split roughly between higher taxes and higher food prices.

As the end of 1999 a fresh EU crisis arose as a result of the Common Fisheries Policy (CFP). The CFP legacy has resulted in massive cuts in catches as quotas have been imposed to reduce dwindling fish stocks. It has resulted in the number of large UK trawlers shrinking from 10,000 in the mid 1970s to just 2,500 now (reported in The Daily Mail, 17th December 1999).

Two years after the Prime Minister's Hague speech the status quo seems more not less likely to continue — the CAP remains the most prominent policy among those implemented by the EU, absorbing some 49% of the Union's total budget in 1998 – some £26.9bn. Following the Berlin Summit in March 1999, radical reforms have again been ignored. In fact, the situation regarding the CAP has deteriorated, not improved. The Berlin Summit watered down the pre-summit agreement by agriculture ministers. The CAP still requires fundamental reform.

Commenting on the outcome, the Spring 1999 LBS/OEF Economic Outlook stated:

> *"CAP reform has, once again, had the perverse effect of raising the cost of agricultural support. Although some cuts in support prices have been accepted, these are more than offset by additional income support for farmers. The upshot is that, by 2006, CAP spending will be higher than it is today and will still absorb 46% of the EU budget".*

## Household costs

Hindley and Howe also note that this rough estimation may in fact represent a significant underestimation of the net cost, because the OECD data used omits many elements of the CAP in which Britain is a net loser — price support for products like tobacco, wine and cotton and rural infrastructure payments for example. Moreover, their estimate neglects the so-called 'dead-weight' welfare losses from the world and intra-EU price distortions arising from the CAP — the loss of welfare generated by changes in consumption patterns which, unlike the price changes themselves, are hard to quantify. Against these factors tending to lead to underestimation of the costs, the compensating effect of the UK's comparatively modest budget rebate is overwhelmed, even though its continued existence may depend politically on continued losses from the CAP. Hindley & Howe for example quote another study by Patrick Minford *(Britain and Europe: The Balance Sheet,* P Minford, MCB University Press, 1996) arriving at an estimated net cost of some £10bn.

## Effects on world food prices

Aside from the gross inefficiency for which the CAP is responsible *within* the EU, it is also fiercely contested by the EU's trading partners — thereby risking a wider trade war. The recent 'banana crisis' was just one example. The protectionist world-view underpinning the CAP risks undermining global free trade, as seen in the recent disputes over bananas, GM foods and the use of growth hormones. The level of protection afforded to EU agricultural products is ridiculous.

The CAP is responsible for 85% of the world's agricultural subsidies, which may well qualify as the largest distortion of any trade. (Comment by C Barshefsky, US Trade Representative, in testimony to the US Congress House Agriculture Committee).

Subsidising the food exports of European farmers, and selling or distributing as aid the EU's own intervention stocks has depressed food prices across the world even while it inflates the prices facing EU consumers. World food prices are lower than they otherwise would have been in the absence of the CAP. Despite the fact that agricultural protection in most countries lags liberalisation in other sectors, the reach and magnitude of the CAP has angered the other members of the OECD, and agricultural reform will need to feature prominently in future WTO talks. Moreover, it has savaged the agricultural exports of many third world nations whose farming sectors might well have been competitive if their products had been allowed to find an equilibrium price.

In the 1990s, as a result of the perverse incentives to over produce, the EU has accounted for around 30% of world food exports. A fundamental shift is needed so that the EU produces less food and the rest of the world produces more. As part of the next round of WTO trade talks there also needs to be a reduction in the EU's external tariff. However, it must also be noted that in certain instances — where quotas and special protocols keep the import price of foods higher than they otherwise would have been — liberalisation may drive down prices and undermine these overseas markets.

Notwithstanding this exception, the Catholic Institute for International Relations (CIIR) has reported that,

> *"the CAP is bad for developing countries. Agenda 2000 proposes to reform the CAP, so is Agenda 2000 good for developing countries? Actually it is not. The best that can be said of the proposals in terms of the broader task of reforming the CAP, is that they represent a step in the right direction, limited only by the political impracticality of achieving a consensus on more substantial moves in the short term. The case against would be that Agenda 2000 is concerned with the distribution within Europe of the modest cuts in farm support to meet the EU's Uruguay Round objectives. As such, it is only indirectly relevant to the fundamental question of liberalising European agriculture."*

The MacSharry reforms in 1992-1993 marked a move towards the decoupling of farm income support from output — by weakening the correlation between the amount of support received and the amount of food output produced. Despite the MacSharry reforms and the Blair House Agreement in the Uruguay Round, fundamental questions of principle and practice remain:

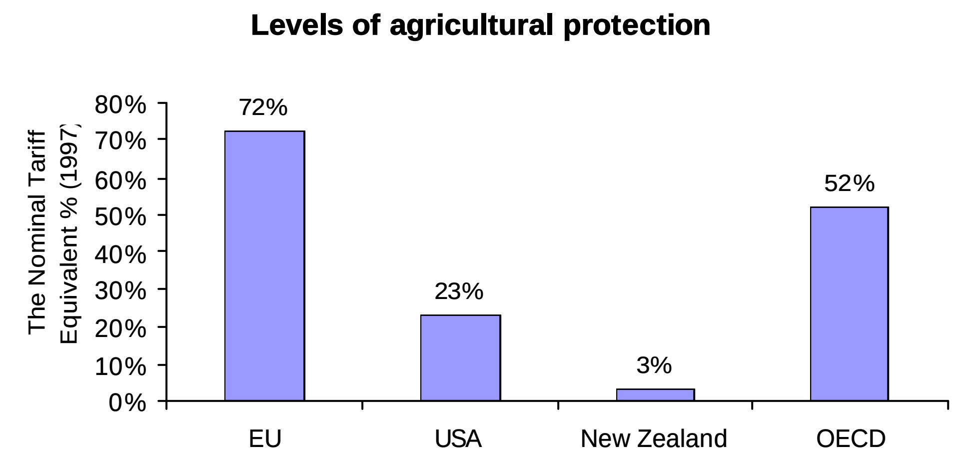
- A massive transfer continues to take place from consumers and taxpayers to farmers – equivalent to an average £12,500 per agricultural worker per year (Source: *Britain's Trade and Economic Structure: The Impact of the EU*, page 230, L. Moore, 1999). On what basis does the EU subsidise this sector to the exclusion of all others?
- The CAP is grossly inefficient. Less than 60% of the cost incurred by consumers and taxpayers reaches farmers (Source: Moore, 1999). It is also reported that over the 1993-1997 period the EU overcompensated cereal farmers by £6 billion for price falls that never occurred.
- EU politicians need to take courageous and politically difficult decisions. It is not sufficient to merely shuffle the pack by reducing support prices with one hand and raising direct payments to farmers with another. The CAP must be reformed and aid decoupled in order to make enlargement feasible. The candidates for enlargement display two expensive CAP characteristics. First, agriculture tends to account for a higher proportion of GDP than in the EU. Second, agricultural yields are poor in comparison with the EU, thereby providing a huge latent supply source within the CAP.
- The costs to consumers have fallen as a result of the Uruguay Round. However, consumers continue to pay well above world prices (although the world price is not independent in view of the impact of CAP surpluses) — as indicated by the nominal tariff equivalent comparisons shown in the figure above.

At the end of the 1990s, attempted reforms of the CAP continue to dominate negotiations among member nations. Previous attempts to curb its excesses have been largely emasculated by the political strength of farm lobbies, particularly in France – by far the biggest net beneficiary of the CAP – and in poorer southern Europe. True, the MacSharry reforms in 1992 prevented the CAP grabbing an ever rising share of EU funds (although they did not prevent expenditure continuing to rise in absolute terms), and put in place measures to alleviate its most absurd consequences, among them the growth of the notorious 'food mountains'.

The reforms proposed by Farm Commissioner Franz Fischler in July 1998, as a contribution towards Agenda 2000, offered largely quantitative, not qualitative change, yet again – cuts in support prices and direct aid to farmers, rises in production quotas. But at least the numbers looked like a concerted move in the right direction – towards the conditions prevalent in the world outside the cosy CAP umbrella.

Unfortunately, the news from the Berlin Summit in the Spring of 1999 was very disappointing. In the shadow of the Kosovo conflict which dominated discussion to the detriment of Agenda 2000, Nato's EU members weren't keen to be seen sparring furiously amongst themselves – to the delight of the French delegation and other fans of the present CAP.

So, overturning the deal done by farm ministers in March 1999 (itself much watered down from the Commission's original Agenda 2000 proposals), cereal support prices will be cut by only 15% over two years, rather than the 20% which would have bought them into line with world prices. Cuts in dairy prices have been delayed until 2005-6, and the quota regime will be with us until at least 2007-8. 'Co-financing' – an idea advocated by Germany devolving at least some responsibility for CAP expenditure to national governments – will not now come into play. So-called 'cross-compliance', attaching environmental conditions to subsidies, has been left to individual governments. Nothing has been done to set in motion the phasing out of compensatory payments to farmers, which more or less obviates the budgetary implications of price reductions.



(Source: The failures of CAP, Global Britain briefing note, 10 September 1999)

## What does this mean?

- It means that the EU will probably not manage to contain its CAP spending after all – as support prices fall, compensatory income payments will pick up the tab for farmers and spending may actually increase by 2%. The cost burden of the CAP has been weakened in recent years by higher world food prices — thereby providing temporary respite.
- Transfer costs from consumers will continue to exceed the taxpayer costs by a significant margin. Historically higher food costs have been more than twice

budgetary costs, and almost equal to the net benefits of producers. The transfer ratio is around 1.5.

- It means the EU has not met its obligations under the Uruguay Round (which ended in 1993), and has compromised possible progress at the forthcoming Millennium Round at the WTO. Export subsidies will have to continue, depressing world prices to the detriment of Third World producers and angering US Agriculture Secretary Dan Glickman, who argued that the 'reforms' were little more than a maintenance of the status quo. The debacle at the WTO talks in Seattle in November 1999 illustrates how easily the protectionist flames can be fanned still.
- It means that uncurtailed compensatory payments will continue to distort incentives for restructuring, without alleviating the plight of UK farmers.
- It means little will be done to enforce the environmental provisions of the CAP in many countries – a potent source of fraud.
- For Agenda 2000, many observers (though not the Commission) predict that the EU cannot now realistically hope to admit its aspiring applicants without yet another concerted effort at significant structural reform of the CAP. Agenda 2000 also fails to match recent reforms in US agriculture. The 1996 US Farm Act completely severed the link between production levels and government payments. This approach towards no price support and the dominance of intervention free world price levels is favoured by the IoD. We would also recognise that at least for an interim period there probably does have to be a certain level of income support in rural areas.

The EU faces a number of options. First, it can continue with the status quo and introduce a second tier CAP for new entrants, though this could hardly be called a Common Agricultural Policy. Second, it could adopt a radical approach — favoured by the IoD — involving deep cuts in price support. Third, and the most likely, is a continuation of the trend towards a weaker link between price support and direct payments.

# 4. EU Enlargement

The European Union today is of course a product of successive enlargements since 1973 — from its original six-member community, its most recent members — Austria, Sweden and Finland — having been admitted as recently as 1995. Plans to admit the former Communist states of Eastern Europe, along with Cyprus, predate these recent accessions; as early as June 1993 the European Council recognised membership of the erstwhile Eastern bloc as a long-term goal for policy.

The advantages of enlargement for the EU — in terms of broadening the single market, promoting stability in further regions of the continent and enhancing the Union's status in geo-political terms — are obvious enough. In the UK, the enlargement agenda is also viewed as a useful counterweight to that pursued by federalists on the continent, already preoccupied with the single currency project.

However, this view is too simplistic. For if enlargement also entails the extension of qualified majority voting (QMV), then 'widening' will entail simultaneous 'deepening' as well.

The next set of prospective new members do not share the same degree of economic and political sophistication as the current 15. The most obvious indicator of this is the fact that all the CEECs have lower per capita incomes than Portugal. In simple terms this would mean that the entire CEEC area would be eligible for Objective One Status.

The new admissions are dependent on their being able to satisfy three eligibility criteria:

- The development of democratic political institutions upholding the rule of law, human rights and respect for minorities.
- The existence of a broadly market-orientated economy capable of thriving in the context of the Single Market.
- Possession of institutional structures equipped to assume the responsibilities and ethos of membership, including a commitment to EMU and to adopting and enforcing the 90,000-odd pages of Community Law across the range of its jurisdiction.

Many of the applicants, of course, are still struggling to conform to these criteria, and all are in the process of major adjustments in order to fully comply with them. Possible entry has forced the EU to recognise that its own institutional structures — and particularly the budgetary framework of the CAP and the Structural funds — are instead likely to prove the major stumbling block.

In its Agenda 2000 report, the European Commission decided in July 1997 to move ahead the following year with negotiations among only a 'first wave' of applicants — those deemed ahead of the pack in meeting the eligibility criteria.

Accession negotiations for favoured applicants (Poland, Hungary, the Czech Republic, Slovenia, Estonia and Cyprus) started in March 1998. Accession negotiations will begin in February 2000 for Bulgaria, Latvia, Lithuania, Malta, Romania and Slovakia. The Helsinki European Council meeting in December 1999 also recognised that Turkey is a candidate for membership.

## Budgetary implications of enlargement

Agenda 2000, presented by the Commission to the European Parliament in July 1997, attempted to spell out the reforms necessary to the EU's budgetary framework in order to permit the eastward expansion of the EU in the new millennium. At the top of the list were the consequences for the Common Agricultural Policy and the Structural Development and Cohesion funds. Already generous in the context of the advanced service-oriented economies of western Europe, these two chief pillars of EU spending cannot be extended to the prospective new members in their present form without budgetary increases the like of which few existing member states are likely to countenance.

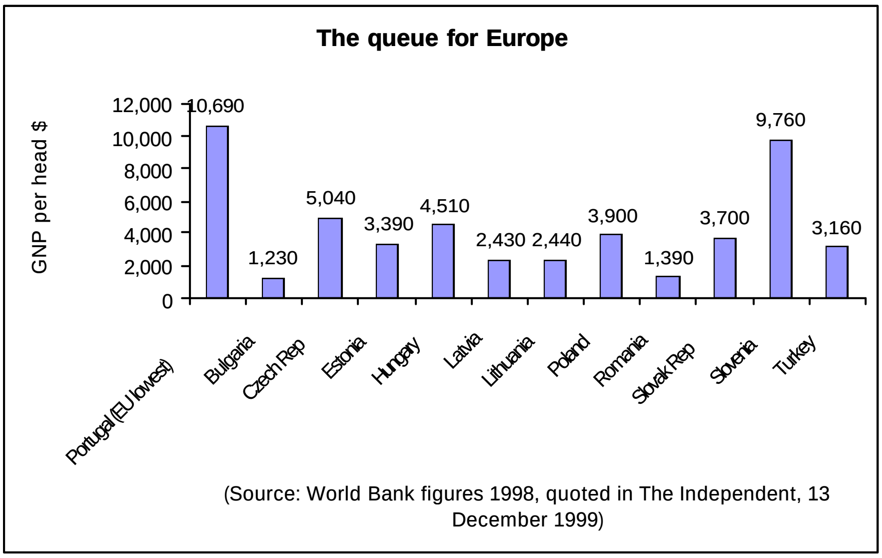
The inclusion of eastern Europe's farmers would more than double the agricultural workforce of the EU, presently 8 million, and swell its farmlands from 140 million to 200 million hectares. In Poland one quarter of the workforce still works in agriculture! All these countries have agricultural sectors larger than the EU average. With their much larger and more backward agricultural sectors, some studies have estimated that the entrants would cost, under the present CAP regime, in the region of £30 bn a year more in intervention buying, export subsidies and the like — adding a further 50% to current CAP expenditure which already consumes nearly half the EU budget. With Germany and Holland deeply dissatisfied with the scale of their net contributions already, and the UK determined to retain its rebate, this extra cash is just not available. Naturally the Commission takes a more optimistic view, arguing that the present budgetary ceiling of 1.27% of GDP would be sufficient to absorb perhaps four or five new member-states.

The EU budget has been negotiated until 2007 but it makes no provision for direct payments to farmers in accession countries. This means that entry in 2003 will be impossible. It could be possible to join later, say 2005, providing there was a transition period delaying full payments of subsidies – transitional relief is of course opposed by potential member countries.

A recent study *(The Costs and Benefits of Eastern Enlargement — the impact on the EU and Europe*, R. Baldwin, J. Francis and R. Portes, Economic Policy, Vol 24, April 1997) argued that the costs of enlargement would not be too onerous. Their conclusion was that enlargement would entail *"small costs for the west and large gains for the east"*. Central to their argument is the notion that at present, investors pay a risk premium for investing in the Visegrad economies. It is therefore argued that EU membership would drastically reduce the risk premium, thereby encouraging greater investment and substantial dynamic economic gains. Their model suggests that under a conservative scenario the CEEC economies would raise income by 1.5% within the EU. Their more optimistic dynamic scenario suggests that the income gain could be almost 19%. This study is way too optimistic.

Various estimates exist as to the costs of enlargement for the CAP — from 5 to 50 billion ECU! Of these, the more recent studies have converged around 10-15 bullion ECU. There are two key elements in these calculations. First, farm productivity assumptions and the strength of output. Second, the impact of the 1988 EU ruling that CAP expenditure growth should be capped at 74% of EU GDP growth. A recent study by the Centre for European Policy Studies (reported in The Financial Times, 4th January 2000) suggested the extra cost might be of the order of 6 billion euro.

With regard to structural funds, there are also serious concerns, since Ireland, Greece and Portugal receive 2.5-4.0% of GDP in structural funds. Structural funds for these countries has been allocated on the basis of ECU 200 per capita. However, the Edinburgh Summit agreed to double this figure to ECU 440 per capita by 1999. This was financed by an increase in the EU budget from 1.2 to 1.27% of EU GDP. At ECU 400 per capita, the cost of additional structural funds for the Visegrad countries would amount to almost ECU 27 billion. There are two problems with these estimates. First, because of the costs on existing members. Second, because of the required matching funds for any future Visegrad members of the EU — which would be unrealistically large as a proportion of GDP.




Based on more realistic structural fund estimates, together with ECU/farmer and ECU/hectare estimates for existing EU members, the net cost of enlargement may be around ECU 20 billion. However, whichever way one looks at the final cost, the fact remains that whilst the cost will appear low as a proportion of EU GDP, it will also appear very high in relation to the existing EU Budget.

The CAP reforms agreed in Berlin were but a shadow of what should have been considered fairly modest proposals in the first place. It is now unlikely that CAP spending will remain within the budget set by Agenda 2000.

Even more intractable, many believe, is the question of how to pay for the demands made of the Structural Development programme once the newly-capitalist states of eastern Europe fall within the EU fold, with their per-capita GDPs barely one-third that of the incumbent 15. Moreover, this gap in living standards is likely to persist for at least 20 years. Estimates of the likely consequences of extending the existing Structural Fund framework are of the same order of magnitude as those for the CAP, in the region of £20 to £25 bn.

Again, sums of this size are just not available. Added to the hostility to increased contributions in wealthier northern Europe, is the wariness of the existing net beneficiaries whose relative positions would not look nearly so impoverished next to those of the applicants. At Berlin, the governments of southern Europe, notably Spain, jealously guarded *their* receipts from the programme — and the birth of the Euro gives them extra justification for doing so on the grounds of promoting convergence and reducing the possibility of asymmetric shocks within Euroland. Unsurprisingly, not even Ireland, with its booming economy and per-capita GDP almost comparable with Britain's, could bring itself to part with its huge net receipts from the

EU, around 4% of its GDP — the lion's share of which arrive by way of Structural Development funds.

If this seems a problem with no visible solution, it probably is. In mid 1999 much of the optimism of the previous two years regarding the prospects for enlargement looked redundant. The Helsinki Summit at the end of 1999 rekindled the flames of hope, but this was a triumph of rhetoric over reality. If enlargement goes ahead without fundamental reforms, EU budgets are likely to burst. Forcing the pace of enlargement now is an attempt by federalists to force the issue of qualified majority voting on fiscal matters.

# 5. The EU labour market

This chapter brings together a large number of studies on the failings of the EU labour market.

To the casual observer in the late 1980s and early 1990s, every EU summit was characterised by a communique calling for the creation of more jobs — as if by fiat politicians could create such a blessing. The Delors Report *(White Paper on Growth, Competitiveness and Employment,* EC 1993) in 1993 called for the creation of 15 million new jobs by 2000. This interventionist and regulatory approach has continued to be in evidence, notably in the Employment Chapter of the Amsterdam Agreement in 1997. According to the French and German Governments the EU social model, based on heavy and intrusive regulation, is a *"trump card not a handicap" (Handicap, Not Trump Card,* Keith Marsden, CPS 1999).

The Centre for Policy Studies (CPS) argues quite the opposite view. The CPS report shows with great force that the Franco-German model does more harm than good. The report's conclusions are unequivocal:

> *"the Franco-German model must be rejected and governments must stop intervening in labour markets".*

Comparing the EU social model with that in the UK the report highlights key differences. The analysis below provides a broad overview of the attributes of each model. The CPS report shows that:

- There is a clear correlation between higher government expenditure and lower employment. In 1997 the government share of GDP in the US was 22% points below that of France but its employment ratio was 15% points higher. The UK's public spending level was 8% points below Germany's yet its employment ratio was 7% points above.
- The private sector is a more efficient provider of training. The German Government spends eight times more on training than the US Government and yet German youth unemployment is on the rise.
- Early retirement programmes fail to increase the number of jobs available to younger workers since the taxes on workers must increase to support the higher number of dependents.
- The implicit tax rate on compensation for employed labour averages 27% in the UK compared with 44% in France and Germany. (*Eurostat, Statistics in Focus, Economy and Finance*, 1997).

- Collective wage agreements do not lead to higher incomes. Average net incomes (as measured at PPP) are higher in the US and UK than in France and Germany.
- Government attempts to harmonise health & safety regulations do not lead to fewer accidents. Both the US and the UK have fewer occupational accidents in relation to France and Germany.
- Liberating the commercialism of the private sector is the key to economic success. Government attempts to foster innovation are weak in comparison. As an illustration, the US is well ahead of its rivals in terms of the number of patents filed, receipts from royalties and licence fees, the scale of high technology exports.
- During the period of de-regulation under previous Conservative Governments over the 1979-1997 period, total factor productivity growth in the UK exceeded that in the US, Germany and France.

The failings of EU labour markets have been highlighted by the OECD *Jobs Study* (OECD, 1994) and many others. Four contrasts between the UK and EU labour markets stand out:

- The UK has the lowest rate of unemployment in the EU's largest economies, at 5.9% (ILO standardised definition). In contrast, the EU average is 9%, with the rate at 10.5% in France and Italy and 9.0% in Germany. Figures for 1996 show that if headline ILO unemployment was adjusted for labour market policies which have the effect of temporarily removing individuals from the unemployment totals – so understating the underlying extent of the problem – dramatic changes occur in some countries. In France the unemployment measure jumped to 20%.
- The extent of the problem within the EU labour market is shown in long term unemployment rates. The OECD Employment Outlook 1999 reports that only 8% of US unemployment is long term. In the UK the proportion is a third whilst the EU average is a half. In Germany the proportion is 52%, in France 44% and in Italy 67%.
- The UK has the highest employment-population ratio in the EU, at 71%. In contrast, the ratio is 66% in Germany, 62% in France and 54% in Italy. (Labour Market Statistics, ONS February 2000.)
- The UK has the lowest share of taxes and social security contributions in the EU, at 36% of GDP. In contrast, the proportion in France is 43%, in Germany 42% and in Italy 40% (Source: *Eurostat, Taxes and Social Contributions 1983-1994*). In the UK an employee needs to work until mid June in order to pay off total taxes and stop working for the government. In the EU the so called 'freedom day' is the end of July, and in Germany it is towards the end of August.

Despite these failings, there is no sign of the necessary reforms required to reduce unemployment across the EU. A recent European Commission publication highlights the failure in the political process. *The Treaty on European Union — The Meaning of Amsterdam* (European Commission, 1997) opens with policy proposals to help create more jobs. Commenting on the Treaty of Amsterdam's introduction of several new measures, the document focuses on the co-ordination of strategies and the production of an annual report on the employment situation in the EU. It also talks of a pro-active role for the Council of Ministers, in encouraging the exchange of national information on evaluating innovative job creation schemes. Whilst the Treaty is supposed to result in an assessment of the employment impact of EU policies, there is no sign whatsoever of any significant change in direction. Or as our American cousins would say: *"smell the coffee"*.

Comparative Labour Market Performance
(1997 figures)

| | EU | UK | US |
|---|---|---|---|
| Employment rates | | | |
| All | 60.5% | 70.8% | 74.0% |
| Youths (15-24) | 35.9% | 55.7% | 52.0% |
| Older people (55-64) | 35.9% | 48.5% | 57.2% |
| % of unemployed long-term | 50.1% | 33% | 8.0% |

(Source: EC Employment Rates Report, 1998; OECD Employment Outlook, 1999)

The European Commission, and many MEPs like to make size comparisons between the EU and US economies. They are less willing to talk about labour market comparisons. Over the 1970-1998 period, private sector employment in the US increased by 70%. In the euro area the increase was just 5% over the same period. (*Chronic Unemployment in the Euro Area: Causes and Cures,* in IMF World Economic Outlook, May 1999.)

The actual unemployment rate flatters the efficiency of EU labour markets – because of unregistered unemployed. The proportion of Europe's working age population with jobs stands at 60.5%, compared with 70.8% in the UK and 74% in the US (*Europe's dismal jobs record could undermine the euro and is a strong reason to deter the UK from joining,* DKB International, November 1998). The UK unemployment rate is less than half that in Euroland.

Gerard Lyons, Chief Economist at DKB International has stated (Politeia lecture, *EMU and the Labour Market,* November 1998) that,

> *"this poor jobs performance in Europe has not been a short term development. It has been a sustained problem …EMU will make Europe's jobs problem worse. EMU stands for Even More Unemployment".*

A recent report, *EMU Facts, Challenges and Policies* (OECD, 1999) has stated that,

> *"Euro area labour markets overall have performed badly over the past couple of decades. Job creation in the private sector has been virtually non-existent and the employment rate has declined from an already relatively low level of 64% in 1970 to around 57% in 1998, despite a secular increase in female participation".*

The same report goes on to show that replacement rates – the relationship between incomes in and out of work are particularly high in Euroland. For both gross and net measures, the replacement rate is lowest in the UK. The table shows that typically the replacement rate on the continent is double that in the UK.

Replacement rates

| Country | Net unemployment replacement rate (1994) Single | Couple, no children |
|---|---|---|
| UK | 23 | 36 |
| Germany | 68 | 61 |
| France | 67 | 70 |
| Italy | 36 | 42 |
| Spain | 72 | 73 |
| Ireland | 34 | 49 |

(Source: OECD, EMU Facts, Challenges and Policies, 1999)

The IMF estimate (*The case for fundamental labour market reform*, D Coe and D Snower, IMF Staff Papers volume 44, no 1 1997) that over the past decade structural unemployment has fallen from 9% to 6% in the UK, whereas in the EU it stands at 9% — an increase. The authors argue that piecemeal reforms in the EU are doomed to failure because of the way labour market rigidities reinforce one another.

## The EU Social Model

Social Europe

Employment protection/regulation

- *UK model*
  Greater freedom to hire and fire
- *EU model*
  Stringent restrictions on job dismissals

Collective bargaining

- *UK model*
  Detailed terms of pay and conditions left to employers and employees. Workplace and individual bargaining. Union influence much reduced since 1970s. Little use of formal consultation. Low minimum wage.
- *EU model*
  More national and sectoral bargaining between 'social partners'. Collective agreements often extended by law. Organised labour influence strong. Statutory consultation common. High minimum wage.

Welfare system

- *UK model*
  Low flat rate benefits. Financed out of general taxation. Benefits indexed to prices rather than earnings.
- *EU model*
  Benefit levels normally related to previous earnings. Safety net financed by high statutory social insurance charges on employers and employees. Benefits often open ended but increasingly conditional.

(Source: Social Europe, epi Economic Report, October 1999)

One recent report is very pessimistic regarding the potential damage to UK employment from adoption of the EU social welfare model *(Britain and Europe: Choices for Change*, Bill Jamieson and Patrick Minford, A Politeia and Global Britain publication, 1999). Jamieson and Minford estimate that the costs of implementing a full EU regulatory model (Franco-German) will be huge – a rise in unemployment over five years of more than a million and a loss in GDP growth amounting to 7% points. One can debate the precise figures but the orders of magnitude are surely instructive. A recent NIESR study (*Continent Cut Off?* Nigel Pain and Garry Young, NIESR, 2000) argues that the impact of labour costs on inward investment is small because of large outward investment by UK companies in the EU. We believe this view is mistaken.

The costs of Social Europe on the UK economy are already being felt via The European Works Councils Directive, The Parental and Family Leave Directive and The Working Time Directive (the latter through Health & Safety legislation, not the Social Chapter). Surveys undertaken by The Institute of Directors (*Flexible Labour Markets: Social Europe and the Minimum Wage,* R. Lea, IoD Research Paper, 1997) show strong misgivings towards Social Europe. The IoD found that:

- Two thirds of Directors were opposed to EU social and employment regulations being binding in the UK.
- 60% of Directors believed EU social and employment regulations would hinder international competitiveness.
- 54% of Directors believed EU social and employment regulations would hinder job creation.

Simply stated, how can we expect companies to create jobs when the costs of one factor of production rise compared to the other?

Professor S. Nickell (*Unemployment and Labour Market Rigidities: Europe versus North America,* Journal of Economic Perspectives, Vol. 11, 1997) finds a positive relationship between employment protection and long term unemployment and the non-employment rate, but not with the total unemployment rate. Nickell has also estimated (Economic Journal, May 1998) that a 10% increase in the replacement rate and an increase in the duration of benefits of one year would result in a 25% increase in unemployment – though he is sceptical of his own findings.

The Institute of Economic Affairs has recently published a detailed overview of the impact of European labour market regulation (*Regulating European Labour Markets: More costs than benefits?* JT. Addison and WS Siebert, Hobart Paper 138, 1999). The IEA's review of the literature shows that employment protection legislation is positively associated with total unemployment rates, youth unemployment rates, long term unemployment rates and non-employment rates.

The IEA's summary shows a powerful impact on joblessness from regulation. Estimates suggest that a 10% increase in the employment protection index results in a 5.2% to 10.4% increase in the youth unemployment rate. This reflects a general finding that employment protection laws have a stronger impact on youth and long term unemployment. Addison and Siebert conclude that,

> *"the net effect of employment protection and analogous rules on labour demand (and supply) does seem to be lower employment and greater and longer unemployment for some".*

Press reports at the end of 1996 suggested that the European Commission's own research had reached similar conclusions. The Financial Times (November 8th 1996) reported that the European Commission's own findings showed high unemployment linked to labour market rigidities. The media furore surrounding the report was based on two charts. One showed a trade-off between employment and regulation across the EU, whilst another showed a trade-off between termination salary costs and employment.

A recent report (*Unemployment, a trans-Atlantic perspective*, D Cohen, A Lefranc and Gilles Saint-Paul, Economic Policy 25, CEPR 1997) showed that unemployed French workers take five times longer than US workers to find new jobs, and at the same time French workers are five times less likely to become unemployed.

## Labour market rigidity

This final section brings together various measures of labour market rigidity across the EU. One survey was undertaken by the European Commission in 1995. A second presents an OECD (1994) index of the stringency of employment protection laws. A third presents the Grubb-Wells index (1993) of restrictions on overall employee work.

In all these studies the common denominator is far less labour market regulation in the UK economy, as compared with our EU partners.

This message is reinforced by a recent study (*Institutions and Labour Market Performance in Western Europe*, P. Teague and J. Grahl, Political Studies XLVI 1998). Whilst the authors question the link between greater flexibility and improved economic performance (a view the IoD would disagree with) they have nonetheless constructed a synthetic index of labour market regulation in Europe comprising working time, working conditions, employment protection, minimum wages and employee rights. Notwithstanding the subjective element to any such measure, their index does show very clearly that the UK labour market has a far lower intensity of regulation – although this advantage has been eroded since 1997.

Employment Protection Legislation

| | Overall EPL strictness indicator |
|---|---|
| Austria | 13.0 |
| Belgium | 5.0 |
| Denmark | 4.0 |
| Finland | 9.5 |
| France | 6.0 |
| Germany | 9.5 |
| Greece | 12.0 |
| Ireland | 3.0 |
| Italy | 14.0 |
| Netherlands | 7.0 |
| Norway | 8.0 |
| Portugal | 16.0 |
| Spain | 15.0 |
| Sweden | 11.0 |
| Switzerland | 1.0 |
| UK | 2.0 |

(Source: OECD Jobs Study, Part 2, 1994)

Synthetic Index of Labour Market Performance
(higher index indicates greater regulation intensity)

| | |
|---|---|
| Belgium | 10 |
| Denmark | 5 |
| France | 11 |
| Germany | 11 |
| Greece | 10 |
| Ireland | 6 |
| Italy | 9 |
| Netherlands | 10 |
| Portugal | 7 |
| Spain | 10 |
| UK | 3 |
| Austria | 11 |
| Finland | 8 |
| Norway | 8 |
| Sweden | 11 |
| Switzerland | 4 |

(Source: P Teague and J Grahl, Political Studies, XLVI 1998)

European Labour Market Regulation

| | Grubb-Wells index of work restriction (ranking) | Koedjik-Kremers labour market index (ranking) |
|---|---|---|
| Belgium | 5 | 5 |
| Denmark | 2 | 3 |
| France | 6 | 6 |
| Germany | 7 | 6 |
| Greece | 10 | 10 |
| Ireland | 3 | 2 |
| Italy | 8 | 9 |
| Netherlands | 4 | 4 |
| Portugal | 11 | 8 |
| Spain | 9 | 11 |
| UK | 1 | 1 |

(Source: K Koedijk and J Kremens; Economic Policy, 1996 and D Grubb and W Wells, OECD Economic Studies, vol 21)

## EMU and the need for regional flexibility

The lack of structural reform is deeply worrying because within the Euroland zone problems will arise because of the lack of wage flexibility, labour mobility and fiscal transfers. As The Economist has pointed out (*EMU Survey*, April 11th 1998),

> *"the theory [of optimal currency areas] concludes that for a currency area to have the best chance of success … there should be no cultural, linguistic or legal barriers to labour mobility across frontiers, there should be wage flexibility and there should be some system of stabilising transfers. The absence of these instruments raises serious questions as to the viability of EMU".*

It is possible that one can over emphasise this particular point. A recent study (Redistribution versus insurance: Does Europe need a fiscal federation? Antonio Fatas, Economic Policy 26) suggests that nowadays only 10% of any fall in state GDP in the US is compensated by the Federal Government – earlier estimates in the 1980s suggested the figure was 40%. Also, labour mobility is extremely limited not just between EU countries, but within them as well, but a single national currency is still able to function. In another paper (EMU countries or regions, A Fatas, CEPR discussion paper 1558) Fatas also makes the point that,

> *"the correlation of regions across national borders has been increasing over time while the cross regional correlation within countries has*

*decreased. As a result, the economic significance of national borders has been greatly reduced".*

However, there is still concern. An INSEAD paper (Regional Labour Market Dynamics in Europe, A. Fatas and J Decressin, INSEAD 1996) revealed that

*"in the US when a state undergoes a recession, one generally sees US workers uprooting themselves and moving themselves to those states in economic boom. In contrast, European workers drop out of the labour force and tend to stay in the depressed region … this result is discouraging for the future of EMU, because given the low level of labour mobility, there is no natural mechanism of adjustment … different national currencies and exchange rates could help with these disparities".*

Work by Baddeley, Martin and Tyler (*European Regional Unemployment Disparities: Convergence or Persistence?* University of Cambridge, Department of Land Economy, Discussion Paper 73, 1996) argues that,

*"regional unemployment disparities across Europe appear to be characterised by a high degree of persistence … our results suggest that in labour market terms there is little evidence of any widespread convergence amongst regions, but rather of persistent disparities. This implies that monetary integration could well exacerbate the scale of regional unemployment across member states … the forces that underpin these disparities must be quite deeply rooted in the economic and institutional fabric of the areas concerned."*

If the Single Market and the Single Currency are to have any chance to operate effectively, then Euroland will have to reform labour markets. The European model continues to be characterised by a high level of labour market rigidity and a high level of social protection. EU labour markets are over regulated with red tape and employment costs. Over recent decades the US economy has created tens of millions of jobs. In contrast, the EU economy has generated only a few million, and most of these have been in the public sector. However, there is little evidence that EU governments are committed to reform. Indeed, the introduction of the 35 hour week in France and the recent handing out of state aids in Germany, suggests that if anything the recent election of left of centre governments across the EU has moved policy in the other direction.

The New European Way has all the signs of the old socialist way. The reform route, offering less regulation and lower social protection remains an anathema for EU governments who see it as 'social dumping'. EU governments are worried that if social dumping went unchecked — in order to attract inward investment — the end result would be a race to the bottom, with lower social protection all round.

A key issue is how labour market regulation interacts with product market regulation. The OECD has constructed a synthetic index of employment protection legislation together with an index of product market regulation. The essential message from the chart is that the UK is clearly a much more liberalised economy compared with our EU partners, since it has the lowest product market regulation and employment protection legislation. This advantage has of course been undermined by the raft of regulatory legislation introduced under New Labour.

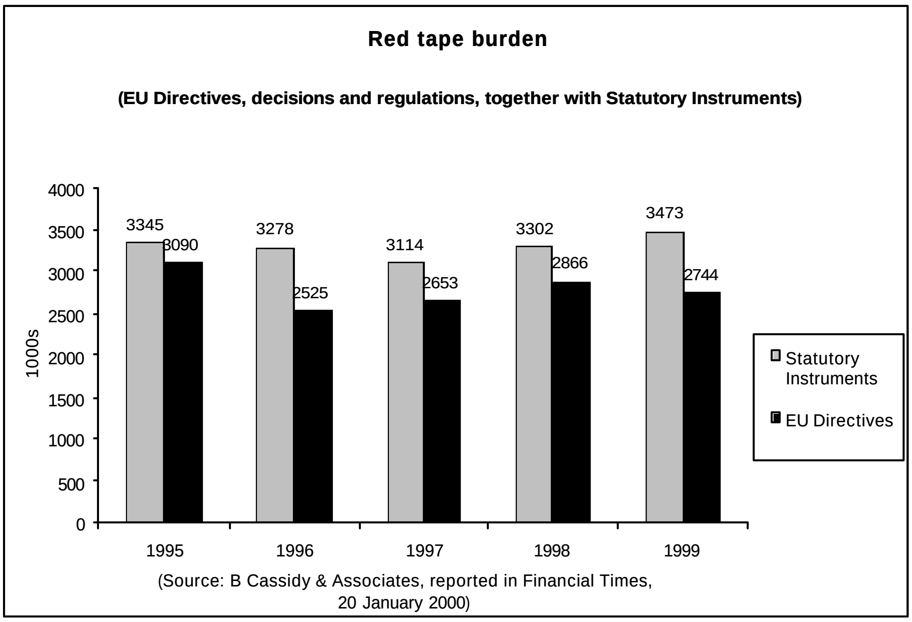
Research (*Market Opening, Regulation and Growth,* K. Koedijk and J. Kremers, Economic Policy 23, October 1996) shows a powerful link between the degree of regulation in the economy and growth in output. Over recent decades deregulation in the Anglo-Saxon economies has not been matched in the EU economies. The work of Koedijk and Kremers shows the UK has a high ranking - light regulation – in both product and labour markets. Koedjik and Kremers show that there is a strong link between the degree of regulation and economic performance. Cluster analysis shows the various economic models in terms of regulatory burdens – Anglo-saxon, Iberian, Rhineland and Mediterranean. Country level analysis shows a clear trade-off between higher regulation and lower economic growth. Econometric modelling by Koedjik and Kremers suggests that product market regulation is the strongest influence on performance – an impact roughly twice that of labour market regulation. However, labour market regulation is very significant also.

Greater competition can raise economic growth via improvements in productivity. Koedjik and Kremers show there is a powerful trade-off between overall productivity growth and product market regulation. They conclude that,

> *"labour productivity is hampered by product market regulation, whilst capital productivity is hampered by labour market regulation".*

The simple and obvious conclusion of this chapter is that any further transformation in the UK labour market towards the EU model will entail very heavy economic costs.

The New Labour Government has increased regulation as a central plank of policy. Press reports (*Blair's Red Tape Record,* The Sunday Telegraph, 16th January 2000) state that in 1999 there was a regulatory avalanche in the UK with 3,438 issued by the Government – a new record.



In combination with the rising tax share (*Budget 2000: Take No Chances,* R. Baron & G. Leach, IoD, January 2000) the raft of expensive regulatory measures has produced a very damaging effect on economic incentives. Since coming to power New Labour has instigated the National Minimum Wage, Working Time regulations, increases in unfair dismissal compensation limits, Parental Leave regulations, European Works Councils, Working Families Tax Credit and the new Stakeholder Pension. The IoD estimates – using official Government figures – that the combined compliance cost of these regulations alone will be around £5 billion per annum (*Reg Alert,* IOD Regulation Comment, July 1999). But New Labour is not the only source of regulation and extra costs on companies and consumers.

# 6. The EU – external and internal trade liberalisation

## External trade liberalisation

In general terms it is widely accepted that liberalised markets tend to outperform overly regulated markets. The OECD (Open Markets Matter, OECD 1998) has stated that,

> *"the results speak for themselves ... liberalisation from the Uruguay Round has delivered a global tax cut worth more than $200 billion per annum ... the cost to consumers of protection in OECD countries has been estimated to be as much as $300 billion per annum ... the costs to consumers of a job protected exceeds the wages of employees who are saved".*

A recent report (*Measuring the Costs of protection in Europe*, Institute for International Economics, 1999) suggests the costs of enforcing 'Fortress Europe' may be higher still. The study estimates that despite the creation of the Single Market and the completion of the Uruguay Round in 1993, the costs of protection could still amount to 7% of the EU's GDP – some $600 billion. The table below shows the scale of anti-dumping duties and average EU tariff levels in 1997. EU consumers foot the bill for this protection by paying higher taxes and higher prices and consuming less than they would if trade were free – the effective tariff is much higher than the average industrial tariff on EU imports of around 3.6% in 1998.

As much as two thirds of the costs of protection are said to fall on consumers. In the 22 most protected sectors the study estimated that only 200,000 jobs were safeguarded at a cost of over $200,000 per job! The study also showed that even this figure could be a gross underestimate of the true per capita cost.

Liberalisation covers deregulatory impacts both within and without the economy. Certainly, in an international sense, countries that have been more open have achieved double the average rate of growth of others (OECD, 1998). It is reasonable to assume that this competitive dynamo applies to the degree of internal regulation as well. In simple terms, liberalisation means a bigger economic pie.

Internationally the average tariff level has fallen from around 40% when the GATT was formed in 1947, to less than 4% in the late 1990s - post Uruguay Round. The absence of tariffs within the EU customs union is widely cited as an example of the benefits of liberalised trade. However, there is ambiguity as to the veracity of such a view. To the extent that the EU sees itself as a regional trading bloc — with individual EU countries negotiating as one — then it is possible that EU policies have prevented even more progress towards liberalised trade — especially when the impact of the CAP on other countries is considered.

Fortress Europe

| Anti-dumping duties on selected products, 1997 % | | Average EU tariff on selected products, 1997 | |
|---|---|---|---|
| Footwear | 29.1 | Beef and Lamb | 87.7 |
| Industrial chemicals | 28.3 | Beverages | 22.2 |
| Iron and Steel | 29.3 | Cereals | 67.8 |
| Leather products | 22.9 | Clothing | 12.0 |
| Metal products | 44.4 | Dairy products | 57.7 |
| Motorcycles and bicycles | 28.4 | Food products | 26.9 |
| Office and computing equipment | 19.5 | Sugar | 61.8 |
| Printing and publishing | 18.6 | Tobacco | 58.8 |
| Radio, TV and Communication | 23.2 | | |

(Source: The Economist/EC May 22nd 1999)

## Internal trade liberalisation

Any assessment of regulation and deregulation within the EU is fraught with difficulties. These difficulties surround issues of definition (eg. regulatory area or body), type (eg. environment or product) and impact assessment (direct, indirect or induced effects). These issues are compounded in an assessment of EU regulation on the UK economy. Ideally, one would want to examine every piece of regulatory legislation and estimate the direct, indirect and induced effect on costs and employment. Such a body of research does not exist in the UK, let alone for the rest of the EU. What's more, in order to be precise, one would wish to estimate the additionality in any EU legislation. This requires some form of counterfactual exercise to estimate what domestic legislation there might be in the absence of EU requirements.

The European Policy Forum has produced a report on the costs of regulation on EU business (*The Hidden Costs of Regulation in Europe,* EPF, September 1995). The report states that,

> *"if unemployment in Europe is to be reduced and manufacturing and services are to remain competitive in world markets the place to start cutting the costs of doing business is with regulations. It is ironic that so much effort is spent on the single currency where the cost savings are estimated at less than half of 1% of GDP, while costs many times larger are imposed on business through regulation".*

Government has a choice in deciding how to intervene in economic life or whether to intervene at all. For example, it can decide to target low income earners with additional income support (thereby increasing public expenditure) or by legislating for a minimum wage (thereby increasing intervention without increasing expenditure). The concern over 'stealth' interventionism is most apparent at the EU level where the European Commission's budget is restricted to 1.27% of pan-EU GDP.

Concern over the regulatory threat from the EU is further highlighted by public choice theory which shows how regulation benefits well organised interest groups. It is estimated that 72% of the EU budget and at least 78% of EU legislation is devoted to interest groups (*The Public Choice Analysis of European Integration,* R. Vaubel, European Journal of Political Economy, 10, 1994). Andersen and Eliassen (*European Community Lobbying*, European Journal of Political Research, 20, 1991) have argued that:

> *"the EC system is now more lobbying-orientated than any national European system".*

Peter Stein (*Measuring the Costs of Regulation,* in EPF 1995) provides a useful overview of the international literature on the aggregate impact of regulation:

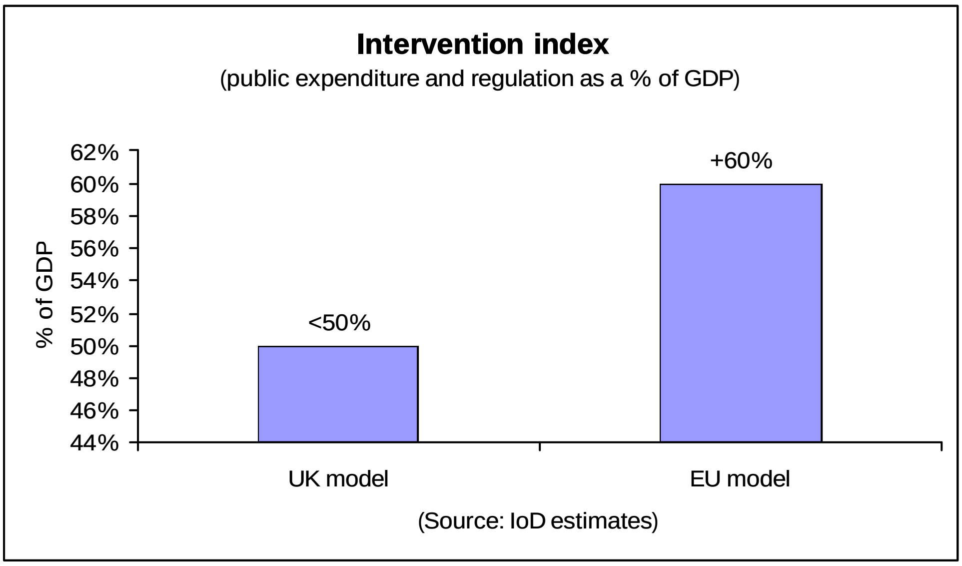
> *"The studies demonstrate persuasively that contrary to popular assumptions these direct costs are very big indeed ranging from an annual cost of one to four percent of GDP. When indirect costs are added the combined total of indirect and direct costs together rise to 8-9% of GDP. These figures pertain to the US from where most data exist. We know however that most, if not all European countries are more heavily regulated. It is therefore likely that similar studies on Europe would reveal figures at the top end of the range or of even greater magnitude".*

A 1995 report by the European Observatory for SMEs (Third Annual Report, The European Observatory for SMEs, EIM, The Netherlands, 1995) estimated that the direct costs of national administrative regulatory burdens together with mandatory EU policy amounted to between 3-4% of GDP.

Available evidence strongly suggests that the regulatory burden falls most severely on SMEs. A European Commission report gives further evidence of the disproportionate impact on SMEs (*The Group of Independent Experts on Legislative and Administrative Simplifications,* European Commission, 1995). This report estimates that (in 1993 prices) the average cost of the administrative burden was 1,800 ECU per employee for all enterprises, but it amounted to 3,500 ECU per employee in enterprises with one to nine employees but only 600 ECU per employee for those with more than 100 employees.

Taking the US as an example, the direct and indirect costs of regulation could be huge, amounting to 9% of GDP in the UK. The studies cited above strongly suggest that the combined impact of public spending and regulation – the Intervention Index — is rapidly approaching 50% of GDP under New Labour. On the continent the figure is likely to be well in excess of 60% of GDP.

Moreover, the EU Intervention Index is likely to rise much further in the future as a result of unfunded pension obligations and the extension of labour and product market regulation. These findings represent a substantial distortion to the market process.




## The Single Market

So external wall and internal regulations have a clear cost, but is this outweighed by the Single Market? Many, including former Prime Minister Margaret Thatcher, had high hopes for the Single Market. Indeed, because the price of the Single Market was the extension of QMV in matters relating to it, there had to be significant gains to justify the diminution in the veto.

IoD members have been supportive of the Single Market. One member survey in the mid 1990s found that 79% of businesses were in favour and 40% felt they had gained from the Single Market. It would be foolish to deny that the Single Market has brought benefits for certain companies. However, when looked at in totality, the impact of the Single Market probably mirrors the experience of IoD members. Whilst many companies reported benefits from the Single Market, many also reported significant costs.

The Single Market aimed at far greater freedom in the movement of goods and services, capital and labour through the harmonisation of measures across physical product and fiscal activities. Much was expected from the 300 specific measures attempting to harmonise an estimated 100,000 product specifications that then existed. The Single Market set the objective of removing all restrictions that impeded goods, services, capital and people from moving freely within the EU. Physical and technical barriers to the movement of goods were to be knocked down. Public procurement, state aid and competition policy were to be reformed in order to eliminate distortions. Impediments to the free movement of people and investment were to be abolished.

The Cecchini report (European Commission, 1988) projected one-off gains such that EU GDP would be higher by 4.5%, prices would be lower by 6% and employment would rise by 1.8 million because of the Single Market. The main driving force to this favourable scenario was the dynamic and competitive stimulus from greater competition and the exploitation of economies of scale. A more optimistic scenario suggested that the medium term impact could be to raise EU GDP by 7% and create 5 million new jobs.

The European Commission has stated that the eight year Single Market programme from 1985-1992 was *"the most ambitious target the European Community ever set itself"*. The Cecchini Report faced criticism on a number of fronts. Some commentators attacked what they believed was a rosy view of the benefits, whilst at the same time downplaying the costs of the Single Market. Other commentators criticised the study for underestimating the dynamic gains of the Single Market – as greater competition encouraged greater investment and economic growth in a virtuous upward spiral — the view that there will not only be a level change in GDP as a result of the Single Market, but that there will also be a rise in the rate of growth in GDP. The trigger for this being greater saving and investment increasing returns to scale.

In contrast, pessimists argued that the Single Market would have an in-built deflationary effect, as companies in peripheral regions became less competitive and unemployment rose against a backdrop of very low labour mobility.

We should not be surprised that these initial studies sketched an alluring picture of a future single market. The objectivity of the studies was undermined by the need to promote the Single Market. The studies were as much about marketing as about economics. The Commission's studies on *'The Costs of Non-Europe'* have been widely criticised as incorrigibly optimistic.

## Reviewing the Single Market

In 1996 the European Commission undertook a Review of the Single Market (*The Single Market and Tomorrow's Europe,* M. Monti, European Commission, 1996). Commenting on this Review, McDonald and Dearden (*European Economic Integration*, Longman, 1999) state that,

> *"the SM tends to paint a rosy picture of the effects of the integration process. In nearly every case the Review could not identify benefits of the magnitude that were suggested by the Cecchini report …the Review does not indicate that the SM programme has had no significant effects; rather it suggests that these have been fewer in number than was expected by the Cecchini Report".*

All the fine words of the late 1980s were followed within a short period of time by statements to the contrary. Mario Monti, EU Commissioner in charge of the Single Market Programme, stated in 1996 that,

> *"the Single Market has not developed as we had hoped at the macro-economic level"*

The EC's assessment of the Single Market in 1996, showed employment gains of 0.3-0.9 million, with an increase in GDP of just 1%. It is quite probable that these figures err towards excess and one is left with the question of how bad would EU growth have been in the absence of the Single Market?

Frontier controls were abolished on January 1st 1993. However, the transition to a new system also involved heavy costs. The introduction of the Intrastat system is estimated to have cost companies ECU 2.3 billion. It had the effect of replacing one system of red tape with another. In the UK, HM Customs & Excise produced a 750 page guide for the new regulations! The removal of technical regulations also had a mixed result. The Review included a survey of 20,000 EU companies.

Percentages of enterprises agreeing or disagreeing with the following statements on the single market

| Statement | Industry | | | Services (excluding distributive trades) | | |
|---|---|---|---|---|---|---|
| | Agree | No opinion | Disagree | Agree | No opinion | Disagree |
| The single market has been successful in eliminating obstacles to EU trade in your sector | 41 | 39 | 20 | 22 | 65 | 13 |
| The single market programme has been successful in creating a genuine internal market in your sector | 23 | 43 | 35 | 6 | 67 | 26 |
| Additional measures are needed to eliminate obstacles to EU trade | 27 | 61 | 12 | 18 | 75 | 7 |
| Additional measures are needed in this sector to create a genuine internal market | 25 | 61 | 14 | 17 | 76 | 7 |
| The single market programme has been a success for your firm | 33 | 40 | 27 | 16 | 63 | 21 |
| The single market programme has been a success for your sector in your country | 25 | 44 | 31 | 16 | 62 | 22 |
| The single market programme has been a success for your sector in the European Union | 29 | 51 | 20 | 15 | 71 | 14 |

The Review showed that the results of the Single Market are mixed at best, and that a lot more needs to be done if EU companies are to fully exploit the Single Market. The OECD (*EMU Facts, Challenges and Policies,* OECD 1999) has stated that,

> *"implementing and enforcing a Single Market in all sectors … so far remains largely elusive. A European Commission report estimated that significant barriers to market access remained in sectors accounting for about half of EU GDP."*

*The 5th Single Market Scorecard* (European Commission, December 1999) reported that infringement levels were still high, obstacles to integration have not disappeared and significant price divergence remains between states.

The limited time period over which to make an assessment and the difficulties in measuring the effects of the Single Market leave one with real doubts as to whether it has had a quantifiable effect. Doubts remain as to the precise impact of the Single Market. One commentator has written that,

> *"these estimates are subject to a considerable degree of possible error … however, they are [still] significantly lower than the estimates given in the Cecchini Report"*

(The Review of the Single European Market Programme, in *European Economic Integration,* edited by F.McDonald and S. Dearden, 3rd Edition, 1999).

The Review found that intra-industry trade had grown strongly over the 1985-1994 period. However, given that most of the growth occurred pre-Single Market, it is difficult to identify its impact on intra-industry trade. With regard to the impact of greater competition, the Review tended to show that the Single Market increased firm size in many sectors, but this did not lead to an erosion in competition – as measured by price cost margins – because of the liberalisation effects of the changes. However, the competitive influence varied by sector, with certain sectors not showing beneficial effects from the Single Market.

One study (*The Competition Effects of the Single Market in Europe,* Economic Policy 27, October 1998) did claim strong evidence of the impact of the single market. The study pointed to the increase in the intra-EU share of world merger and aquisition activity between 1985-1987 and 1991-1993. However, it is by no means clear how much of this increase was additionality attributable to the Single Market. Evidence on price-cost mark-ups and price dispersion either pre-dates 1992 or raises similar questions of additionality. Moreover, where estimates are available of trade creation within the Single Market, it seems that EU and non-EU producers have gained by similar proportions. In other words the Single Market has either opened up the markets for all, and/or alternatively there are other forces such as globalisation at work. There is little correlation between the size of demand effects and the estimated competition effect of the Single Market.

To the extent that the Single Market eliminated trade costs and market access restrictions, then it would be expected that it should influence trade volumes. Intra-EU trade should increase and exports from the rest of the world should be diverted to intra-EU imports. However, intra-EU trade does not seem to have responded in this manner. Only when EU imports are adjusted to take account for assumed under-reporting of intra-EU trade — following the introduction of the Intrastat system — is the EU share seen to rise post 1992.

This trend is also apparent in disaggregated statistics. Trade statistics do not suggest reasons to believe that the Single Market has had an important impact on trade — thus far. Over the period 1992-98 the USA has increased its merchandise exports to the EU at a faster rate than the UK!

With regard to the modelling approach — both econometric and computed general equilibrium models — employed in the *Economic Policy* paper, serious concerns have been voiced as to its accuracy. These concerns centre on the inappropriate use of dummy variables and perverse results that non-EU producers had benefited more than EU producers from the Single Market. A generous comment on this paper would be that methods of estimating the effects of the Single Market are either deficient or insufficient time has elapsed since the Single Market came into being. If the Single Market had generated substantial gains, then surely a naked eye test of trade flows would have been sufficient?

This conclusion is supported by an OECD study (OECD Proceedings — *Regulatory Reform and International Market Openness*, OECD 1996). This Single Market sector study of intra-EU trade flows and price dispersion concluded that,

> *"overall, it is hard to detect either from prices or from intra-EU trade flows any strong effect from integration".*

Whilst it would be fair to say that any precise interpretation would require knowledge of the counterfactual (in the absence of the Single Market) this is partly answered by an assessment of trade flows and price changes across all manufacturing sectors — which is very similar .

## More Red Tape

One of the greatest concerns surrounding the Single Market has been the replacement of national regulation with supra-national regulation. The NIESR (*Single Market*, Volume 2:1998) has commented that,

> *"the enduring impact of the SM has been more in the way it has recast regulation and rule-making in Europe".*

The NIESR has also commented that whilst in some domains single market rules have indeed liberalised markets, there are other areas where the scope of regulation has been accentuated. The real concern is that in many instances there has been abolition of national regulation in one sector to be replaced by EU wide regulations affecting all sectors.

These findings should not be surprising. The regulatory reforms in the EU over the past decade have aimed to adopt a new approach. The old approach — which still applies in some areas — involved detailed requirements. The new approach aimed to adopt mutual recognition with minimal requirements — so called conditional recognition. The problems of course are the strings attached to those conditional directives — hundreds of which have been introduced in the 1990s, often each covering a wide range of products.

The red tape associated with the Single Market is heavy and burdensome. The OECD has reported that the evidence is that,

> *"procedure is intensive in standards which take time to develop ... the discretion offered to member states in the transposition of essential requirements can be abused; the effect of the directive can be weakened by the development of additional, perfectly lawful, regulations and finally, the decentralisation of certification can also be abused ... in all the cases that we have looked at, some significant impediment has arisen".*

## The UK and the Single Market

With regard to the impact of the Single Market on the UK economy, this too seems to have been over hyped. A Hansard Written Answer (30th March 1999, Column 32) suggests a minimal effect. The Government reported that,

> *"There are no meaningful figures on the effect of European single market legislation upon net UK job creation between 1993 and 1997".*

The crucial point is surely that competition is the key to maximising efficiency. If one creates a single currency area that is still weighed down by regulatory burdens, then the competitive stimulus will be small. The resulting policy prescription is that there needs to be more deregulation and a more effective single market, not a single currency. Significant barriers still remain in services even though this sector accounts for two thirds of EU GDP. Public procurement, state aids and the simplification of rules all require urgent attention. The political will however seems to be elsewhere – all the focus of recent years has been on a single currency.

# 7. Future burden – tax harmonisation

The Single Market, and now the euro, have increased the pressures for tax harmonisation. It is true that various ideas regarding tax harmonisation have been around for many years, and haven't yet been implemented, but the key point is that a single market and a single money provide added momentum to this process. The recent proposals for the Withholding Tax and taxing the art market are but two examples of the damage future tax harmonisation could inflict on the UK economy. Future measures towards harmonisation are likely to involve both rates of taxation and the tax base.

The start of the 2000 IGC and the recent debate over enlargement has also raised the issue of the extension of QMV and the loss of the national veto in tax affairs. Tax harmonisation was the centrepiece of the Austrian Presidency of the EU in 1998. Jean-Claude Juncker stated in late 1997 that he expected *"the harmonisation of EU business taxes"*. The late 1990s surge in left of centre Governments across the EU encouraged the publication of The New European Way. The document refers to *"further efforts to avoid harmful tax competition"*. Professor Rudiger Dornbusch (MIT) has written that it is *"a sharp tilt to the left, not just for Germany, but continental Europe as a whole"*. Commenting on the New European Way, Sunday Times economics editor, David Smith (Sunday Times, 22nd November 1998) has written that

> *"The endgame, Europe wide budgetary policies to balance Europe wide monetary policy, may not be that far away".*

Press reports of one survey of Labour MPs suggested around 60% wanted all fiscal policy handled at the EU level. It is not just the euro that has recently accelerated moves for greater tax harmonisation. The launch of the euro has cleared a hurdle so that the rest of economic integration can go ahead. The European Foundation (*EU tax harmonisation plans — Moving on up*, EF, October 1998) has recently highlighted the role of the European Court of Justice. KPMG's D. Evans and A. Munro have stated that

> *"the possible impact of EU law on UK direct taxation cannot be underestimated".*

Increasingly the European Court of Justice is applying the non-discrimination principle — which is accepted and implemented in the field of indirect taxation – to the area of income tax, as a logical extension of the Single Market. The Court has recently used a Single Market provision, Article 59, to attack Sweden's insurance company tax legislation, and in so doing use existing legislation to end distortions. This development will work to accelerate demands for tax harmonisation and the abolition of the veto in this area. In 1997 the European Parliament's Economic and Monetary Affairs Committee called for majority voting on tax matters, no less than three times, stating

> *"harmonisation …will ultimately render the principle of unanimity superfluous".*

There is a classic pincer movement at work. The argument for harmonisation is based on the idea of a single EU tax system. But that would destroy the clear accountability of each national government to its own electorate for its own taxation decisions.

Elements of fiscal harmonisation are already in place. Firstly, as a result of the Growth and Stability Pact. Secondly, as a result of the formation of the Euro 11 Group of Finance Ministers. It is sometimes argued that because the Growth and Stability Pact relates to the size of deficits and not the levels of public spending and taxation, then sovereignty is retained. This is absurd. OECD estimates suggest that a 1% shortfall in GDP growth normally pushes up the budget deficit by half a percentage point. This creates problems since over the past ten years low GDP growth meant that Germany would have had to pay fines in three years and France in four years (*EMU Survey,* The Economist, April 11th 1998).

There can be little doubt that, in the words of Professor Tim Congdon *"a fundamental shift in power is in prospect"*. Moreover, the Pact needs to be considered alongside moves towards tax harmonisation. It is not operating in isolation, but instead in tandem towards fiscal harmonisation.

In the future we are likely to see further moves towards fiscal harmonisation as a result of the need for regional transfers. The CEPR has pointed out that the Growth and Stability Pact

> *"may lead to the loss of automatic stabilisers whereby deficits widen during recessions and thus cushion the decline in demand"*

*(Instability Pact?* B. Eichengreen and C. Wyplosz, European Economy Perspectives Special Issue, September 1998).

Following the introduction of the euro, lagging regions will face added competitive pressures as a result of the removal of the devaluation option. This will almost inevitably raise demands for greater regional aid. At present, the European Commissions budget amounts to less than 1.5% of Euroland GDP. Alexandre Lamfalussy, the first President of the European Monetary Institute believes EMU will require a much bigger EU budget (reported in The Economist, April 11th 1998). The MacDougall Report (European Commission, 1997) noted that existing monetary unions disbursed around 20% of GDP centrally, and that any EMU would need at least 5-7% of GDP. Prominent EMU supporters in the UK, such as Lord Haskins, have stated that they believe the EU GDP share would need to rise to around 5% of GDP. Whether this does/does not lead to extra taxation, it will involve a centralisation in fiscal policy at the European Union level.

Following the SPD's election victory in Germany, in recent months we have seen far greater emphasis on tax harmonisation. Before Christmas, the comments of the German Finance Minister, Oscar Lafontaine, were front page news for almost a week, as a heated debate ensued as to whether there would or wouldn't be tax harmonisation in the future. As yet there are few firm proposals on the table. But for the future, The Economist has written (The Economist, December 5th 1998) that:

> *"stories that the EU may bully Britain into raising tax levels are exaggerated in the short term. As for the long term? [quote ends]."*

There were a number of angles to the debate, which we will now consider. Certainly in the short term the threat of tax harmonisation is limited because to some extent the harmonisation of taxes will need to await the harmonisation of expenditure. Andrew Dilnot, Director of the Institute for Fiscal Studies (Public Finance, December 11th 1998) has stated that:

*"we are in danger of looking down the wrong end of the budgetary telescope ... we will have higher taxes only if we first decide to have higher public spending. People do not raise taxes frivolously and then decide how to spend the money".*

Harmonisation to date has varied by tax. Clearly the fact that the EU is a customs union means ex-EU imports pay the same duties regardless of country. VAT is also affected by EU law, with countries having to levy a standard rate of at least 15% (with a lower rate permitted on certain items). We have also seen EU an agreement on the end of duty free. There is also fierce controversy over German proposals to introduce a withholding tax on Eurobonds.

With regard to the 'old story' assertion, surely the key point is that EU politicians wouldn't be raising these issues if they didn't want to see something happen. Tax harmonisation was the centrepiece of the Austrian Presidency of the EU in 1998, and politicians such as Lafontaine have merely taken up the batton and continued running. Both Oscar Lafontaine and Dominique Strauss-Kahn have alluded to the desire to set minimum levels of corporate taxation across Europe to prevent harmful tax competition. Kahn has stated that *"fixing minimum corporate tax rates was the whole idea behind tax harmonisation".* The motive being to maintain the European social model and prevent what the EU left sees as social dumping across borders.

The December 1997 code of conduct on business taxation — which identifies 80 measures to combat 'harmful tax competition' — focuses on areas such as artificial incentives for location, tax subsidies etc — but it is clear that France and Germany see this as only the beginning of tax harmonisation. They think that low overall corporate tax rates should also qualify as unfair tax competition – any aspect of competitiveness seems to be deemed 'unfair'. Le Monde (28th January 1999) has reported that the New European Way manifesto for the forthcoming European elections reaffirms the need to strengthen the code of good fiscal behaviour in order to avoid 'fiscal dumping' – politician speak for tax harmonisation.

This is clearly only the beginning. Over time harmonisation is likely to evolve from unified regulations to unified rates. Bundesbank President, Tietmayer, has written that,

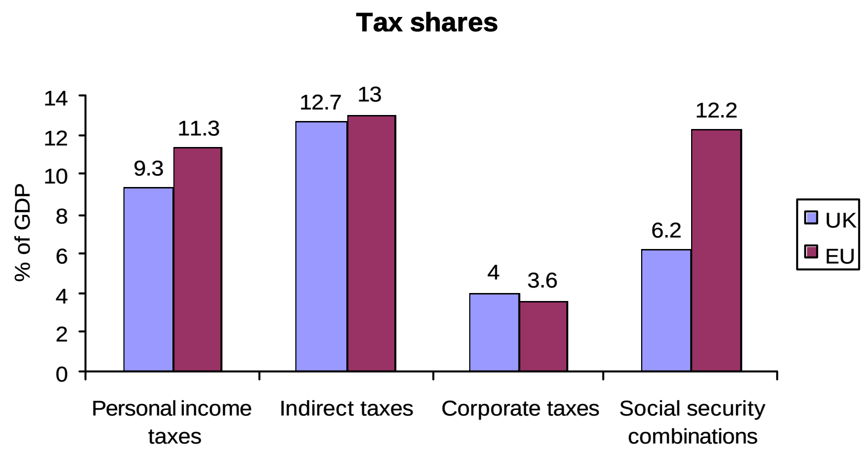
> *"it is an illusion to think that states can hold on to their autonomy over taxation policy".*

The Bundesbank has long argued that all previous monetary unions in history had collapsed because of a lack of centralised control over the national budgets of participating states — the so called free rider problem.

In response to such views some commentators have argued that in the United States, despite a monetary union, there are differences in tax rates between states. This is a straw man. The overwhelming tax share in GDP is accounted for by taxation at the federal (personal income and corporation tax). There are differences in state sales and income taxes but these represent a much lower proportion of GDP. with regard to the EU The Economist has written that a minimum withholding tax could be

> *"the first foray by the EU into income tax".* (*The Economist,* November 28th 1998).

As yet there is no attempt at placing income tax on the European Commission's agenda.



(Source: Lombard Street Research, February 1999)

What does this mean for the UK? As in the case of Ireland, it is clear that low tax rates have attracted inward investment into the UK. Lower taxation should also have encouraged a more dynamic economy over the past two decades. Maurice Fraser (LSE) has written that,

> *"the idea of higher and harmonised rates of corporation taxation go right to the heart of Britain's supply side revolution and what the last 20 years are supposed to have been about". In contrast, Lafontaine has stated that "unfair practices — such as attracting foreign companies with very low tax rates — are rightly criticised at the EU level" (Financial Times, December 17th 1998).*

Ireland also provides a very recent case study. The European Policy Forum states:

> *"… the positive impact of tax incentives is quite clear. However, in a new interpretation of EU state aid rules, the EC has decided that Ireland's preferential business tax regimes no longer comply. In response the Irish Government has announced the introduction of a new single rate".*

It could be argued that the Irish agreement with the EC shows the continuation of sovereign fiscal policy. However, this would be an erroneous interpretation. As yet the unanimity requirement regarding taxation means that no change could have been forced on Ireland. Instead, the EU has used alternative competency to interfere. If a future EU agreement on tax harmonisation is reached, entailing a switch to qualified majority voting, then Ireland's tax attraction will almost certainly be further undermined.

Simple comparisons of tax rates across countries can be misleading — for example due to the availability of legal provisions and depreciation allowances which influence the amount of tax actually paid – since the share of corporate profits subject to tax also tends to be higher in the UK. In other words the total tax liability is a function of the tax rate and the tax base. The IoD believes that the UK should seek low tax rates and low allowances/reliefs. Too many allowances distort economic incentives.

Research by Paine Webber (quoted in The Independent, by Diane Coyle, Economics Editor, December 7th 1998) shows that effective taxes on capital (average effective tax rate on capital taking account of allowances, includes property taxes and capital gains tax) are not low in the UK.

Figures (OECD estimates for 1997, published in Sunday Business, 14th February 1999) show that corporate taxes in the UK contributed 4% of GDP, compared with 2.7% in the US, 1.8% in Germany, 2.1% in France, 2.2% in Italy and 2.6% in Spain – these are provisional figures. Confirmed data for 1996 show the UK corporate tax contribution at 3.8% of GDP. Commenting on these figures, Sunday Business Economics Editor, Martin Essex, stated:

> *"while much comment so far has suggested that if business taxes are harmonised, UK companies would suffer, the latest data suggests that if both tax rates and reliefs were harmonised they would in fact benefit".*

However, the issue is somewhat more complicated than a simple GDP share analysis suggests. Firstly, because it is possible that if one used very punative tax rates, such as a marginal rate of 90%, then tax evasion would be high and the share of taxes in GDP low. Secondly, it may be the case that company profits are higher in the UK than France, because employees take a lower share of GDP in the UK. In other words because the share of labour in GDP is smaller, the share of profits will be higher.

Notwithstanding such influences, the UK clearly has a lower overall tax burden that the rest of Euroland. The UK standard rate of corporation tax is amongst the lowest in the EU. Figures from Ernst and Young (UK employees suffer least pain on Europe's taxing misery index, Sunday Business, December 6th 1998) show that when account is made of individual income tax, corporate income tax, employee social security and employer social security contributions, then the UK has the lowest tax misery index in the EU. The misery index (UK=100) peaks at 180 in France, stands at 140 in Italy and 139 in Germany.

Tax harmonisation can only mean higher tax rates in the UK (because of the current cost of the EU welfare model and the future costs of unfunded pension liabilities on the continent). Taxes account for 38% of GDP in the UK, compared with 45% of GDP in the EU. Germany pays 45% of GDP in taxes, Italy pays 47% and France pays 50%. Virtually all of this gap is explained by far higher social security contributions on the continent.

Part of the reason EU governments want to push ahead with tax harmonisation is a realisation that without it, they may well end up having to tax their citizens substantially more. The reason is that within Euroland, foreign direct investment is likely to gravitate towards the lowest tax areas, such as Ireland. Because capital is generally more mobile than people, this will mean that there are intense pressures to cap any growth in corporate tax rates, in favour of higher rates on consumers. This has obvious unpleasant political consequences. However, if tax harmonisation produces a levelling up in Euroland tax rates to similar levels, then the intra-Euroland divergence of capital will be far less, and the burden could more easily be passed on to business.

EU politicians are clearly aware of the damaging effect of higher employer social security taxes on employment. Instead of seeing the solution to this problem as lower public expenditure, it seems that instead they have chosen to re-shuffle the pack, by merely cutting taxes in one area only to raise them in another. Time will tell. The Commission's logic is wrong. In 1996 the EU Single Market Commissioner, Mario Monti submitted a discussion paper (*Taxation in the EU*, EC, April 1996) to EU finance ministers. The paper pays lip service to the principle of subsidiarity, whilst at the same time making clear the EC's aim to tackle this area of national sovereignty. The EC's view seems to be that higher taxes in the EU have arisen because certain countries exploited lower taxes – unfair competition — in a non-communautaire manner. It is alleged that lower taxes attract the relocation of taxable bases. The theory runs that in response to this, Governments have been forced to tax labour more, because it is less mobile. The final stage of the argument is that labour has then been driven into the black economy, further eroding the overall tax base.

The theory that falling corporate taxes have forced up social security taxes is fundamentally flawed. Corporate taxes account for around 3% of EU GDP and are too small to account for the substantial shift in the tax burden on labour. In fact, the corporate tax share has increased not decreased over recent decades. The EPF state that

> *"the EU countries that have increased the total tax burden …on their labour forces in particular, have done so for their own reasons, not because they were driven to do so".*

Tax harmonisation will undoubtedly mean higher rates for the UK. However, this is by no means the end of the story.

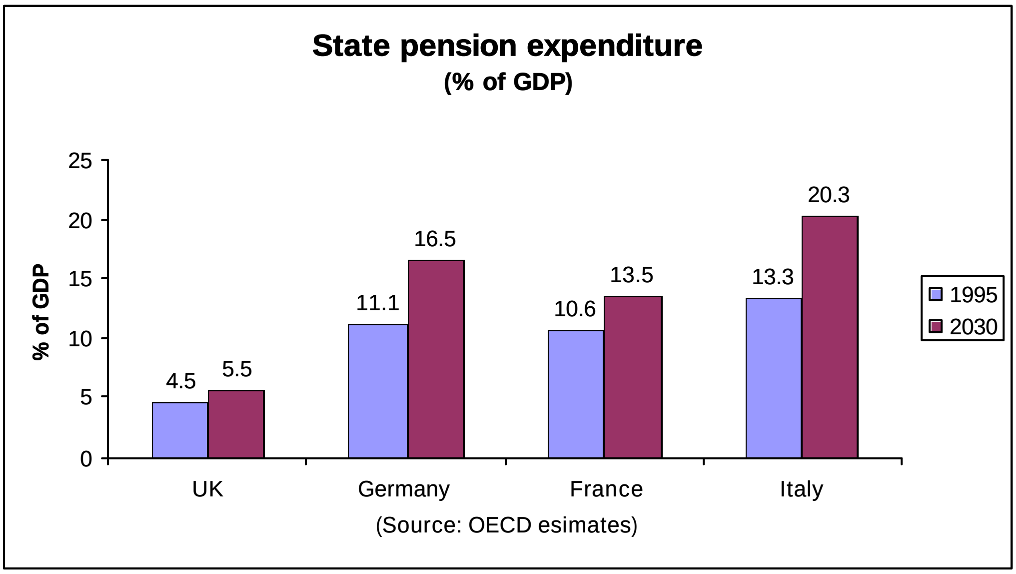
## Unfunded pension liabilities

The unfunded pension liabilities on the continent are enormous, and whilst future projection are sensitive to a number of parameters, the basic story remains the same. The unfunded liabilities extend into the trillions of pounds — even with planned reforms such as higher contributions, higher retirement ages and lower payouts. The House of Commons Social Security Select Committee, having reviewed the evidence, reported that

> *"[British taxpayers] could find themselves subsidising the large unfunded pension liabilities of other member states".*

Article 104b of the Maastricht Treaty (the no bail-out clause) specifically rules out the sharing of liabilities. However, in an environment of tax harmonisation, this clause would be rendered meaningless, because there would be an across the board upward levelling of tax rates.

The following OECD estimates illustrate the magnitude of the expected liabilities and the future competitive advantage to the UK. The end year chosen is 2030, because it is reasonable to assume that in order to ease the problem then, higher social security and taxation will be required in the first decade of the new millennium. Elderly dependency ratios – population aged 65 plus as a % of working population – in Germany will rise from 21.7% in 1990 to 49.2% in 2030, in France from 20.8% to 39.1%, in Italy from 21.6% to 48.3% and in the UK from 24% to 38.7%.




Moreover, future dependency projections are notoriously unreliable (*Older getting wiser*, P Johnson, IFS/ICA, 1998) with the errors tending to be in one direction owing to the under prediction of the numbers of elderly as a result of improvements in mortality. Moreover, declining participation rates in the male 50-59 age group over the past decade provides an added concern, because participation rates are held constant in the OECD projections.

With this in mind the fiscal implications of recent scientific discussion are horrendous (*Today's babies can expect to live to 130*, Sunday Times, 14th February 1999). Reporting on a survey of 150 leading scientists the article stated that they believed that by 2050 scientific advances will be adding 50 years to the current average age of 75 for men and 79 for women.

However, it is not just demographics, but the inherent flaws in the design of unfunded schemes that is so serious. State pension spending in Germany – as a % of GDP, 1995 base year – is projected to increase from 11.1% to 16.5% in 2030, in France from 10.6% to 13.5%, in Italy from 13.3% to 20.3% and in the UK from just 4.5% to 5.5% of GDP (OECD estimates, published in *Crises in public pension programmes in the OECD*, R Disney, University of Nottingham Discussion Papers in Economics, November 1998).

What does all this mean for the ratio of taxes to GDP by 2030? The OECD estimate that in order to keep the net debt to GDP ratio constant — remember that it is already very high across most of the EU, as shown by the number of EU countries which failed to satisfy the outstanding debt criteria laid down in the Maastricht Treaty – the tax share will need to rise by 9.7% of GDP in Germany, 7.1% in France, 11.4% in Italy and only 3.5% in the UK. IMF estimates (*Ageing populations and public pension schemes*, IMF occasional paper no. 147, 1996) tell a similar story, although because they exclude additional health care costs, the total estimated fiscal adjustment is less than shown by the OECD.

These projections are sensitive but the central message is not. The future unfunded liabilities are huge. If anything the estimates may underestimate liabilities because they don't fully capture public sector employee occupational pension liabilities which also tend to be unfunded and met from current revenues – the public sector is a much larger employer in the EU than in the UK.

One final issue is that higher financial liabilities will tend to raise real interest rates, but the simulations do not account for the subsequent knock on effects on GDP growth – and the implications for pension spending as a proportion of a lower GDP level. Despite the uncertainty associated with projections over a long time horizon, there are grounds for believing that the alarming deterioration could in fact still be too cautious.

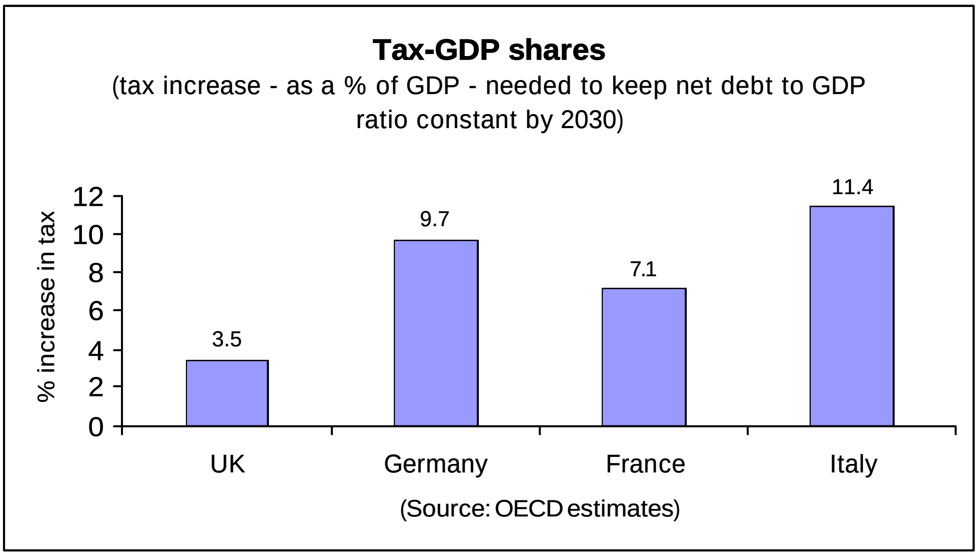
## The Swedish scenario

There is the so called Swedish model to consider — and this one is far from attractive. In October 1998, Ericsson moved part of its business to London, because of the difficulty in getting high paid executives to work in Sweden, owing to high rates of taxation. This is a lesson we should remember.

The Swedish model refers to the fact that Swedes pay around 60% of GDP in taxes. Tax harmonisation could well lead to the same impact in the UK. In the ultimate extreme scenario the impact of tax harmonisation could mean the equivalent of almost £150 billion in extra taxes each year (in today's prices) — around 20% of GDP. We are not stating that this will occur. Instead, it is presented as an illustration of the future fiscal imbalance in Euroland, and how it provides a huge potential competitive gain to the UK. There are various stages to this argument:

- Stage one — The tax share goes up to EU levels (from 38% - 45% of GDP). Cost £52 billion (1999 prices)
- Stage two — Implementation of the MacDougall report on fiscal transfers. In order to finance enhanced regional aid, the UK taxpayer has to find an extra 5% of GDP. Cost £37 billion (1999 prices)
- Stage three — Unfunded pension liabilities (increasing Euroland's tax share by around 8% of GDP). Cost £59 billion (1999 prices)

Many commentators argue that EU treaty provisions only allow for the harmonisation of indirect taxes. However, the analysis of this chapter, together with the stated aims of the European Commission, as expressed early in 2000 by EU President Prodi, show that a far greater agenda is at work.


Tax-GDP shares
(tax increase - as a % of GDP - needed to keep net debt to GDP ratio constant by 2030)
% increase in tax
0
2
4
6
8
10
12
3.5
9.7
7.1
11.4
UK
Germany
France
Italy
(Source: OECD estimates)

# 8. The EU – a cost benefit analysis for the UK

*We must emphasise that the IoD is using this cost-benefit analysis as an empirical benchmark. The IoD states emphatically that it does not favour withdrawal from the EU. This study suggests that unless there is fundamental EU reform, pressure will grow in the UK to review existing treaties with the rest of the EU.*

In order to quantify the current impact of EU membership across the whole of the UK economy the analysis needs to cover the CAP, budgetary contributions, the customs union, the single market, the EU social model and foreign direct investment. In the future membership of the EU raises a new set of costs and benefits tied to possible monetary and fiscal policy harmonisation. It is a daunting task. The only areas of consensus being the recognition that the EU budget and CAP have negative effects on the UK economy.

The traditional Conservative view of EU membership was that the gains from FDI and trade outweighed the costs of the CAP, provided that the UK stayed outside the Social Chapter. With the election of New Labour the calculation has changed since the UK has signed up to the Social Chapter. This suggests that New Labour see the Social Chapter as a plus to the UK and/or they perceive the benefits from FDI and trade have increased.

The IoD believes that the Social Chapter clearly adds to the costs of doing business in the UK. As a result, it is likely to undermine the relative attraction of the UK economy for inward investors. Part of the FDI attraction of the UK has been the lower wage and non-wage costs labour costs, combined with access to the EU customs union. Signing up to the Social Chapter, together with other regulatory burdens introduced by New Labour over the past three years, chip away at the FDI benefits and increase the cost of EU membership at the same time.

## Previous studies

Contrary to public perception the impact of the EU on the UK's trade position was assumed to be negative from the outset. Moore (*Britain's Trade and Economic Structure, the impact of the EU*, L. Moore, 1999) reports on four major studies undertaken at the time of original entry, including the 1970 White Paper, which all pointed towards a deterioration in the trade balance in manufactures (see also: MH Miller in *National Institute Economic Review - NIESR*, August 1971). Only the 1971 Government White Paper assumed that there would be no effect.

Accession substantially increased Britain's manufacturing exports to Europe, but not by as much as it increased British imports from Europe. By joining the then EEC the UK entered a customs union with a common external tariff. This obviously worked to skew trade relations towards the EEC and away from traditional markets which now incurred tariffs.

There have been a number of studies in recent years on the costs and benefits of EU membership for the UK. The first was a study by Professor Patrick Minford (*Britain and Europe - the balance sheet*, Liverpool Macroeconomic Research, 1996). The second was a study by Brian Hindley and Martin Howe (*Better off out? The benefits or costs of EU Membership,* IEA Occasional Paper 99, Institute of Economic Affairs, 1996).

Most recently, Nigel Pain and Garry Young have published a report for the NIESR in 2000 (*Continent Cut Off? The Macroeconomic Impact of British Withdrawal from the EU,* N Pain and G Young, NIESR 2000).

What characterises all these studies is the conclusion that the cost-benefit balance is not large, although Minford did argue that should the UK join the Social Chapter the net costs of membership would rise significantly. His report therefore accords with the IoD. Hindley & Howe err towards the view that membership imposes a small net cost. Pain & Young towards the view that membership provides a small net benefit and withdrawal would be mildly deflationary.

Commenting on the costs and benefits of EU membership Hindley & Howe report,

> *"a sure gain from leaving the CAP; a probable loss from imposition of EU barriers on UK exports to the EU; a probable loss from a reduction in the flow of inward FDI. Their net effect therefore is small in relation to GDP. So far as these items are concerned [they] would probably give rise to an economic benefit for the British economy but might give rise to a loss. In either case, the gain or loss is small - almost certainly less than 1% of GDP".*

In their recent report Pain & Young argue that the major long term influence as to whether withdrawal from the EU would have a negative effect is the impact on inward investment and productivity. The NIESR study emphasises the influence of FDI on stimulating technical change and total factor productivity growth. Their cost benefit analysis quantifies the impact of withdrawal on the UK economy by 2020. NIESR state that,

> *"as the experience of the 1960s indicates, there is no reason why being outside the EU should necessarily involve mass unemployment... if withdrawal from the EU did not lead to a reversal of …inward investment in the UK, then output would settle down at a similar level to that which would have been reached if Britain had remained in the EU".*

Furthermore, NIESR argue that if withdrawal was without inward investment and tariff effects then,

> *"the UK benefits from a lower price level and from a better budgetary position. In the short run this adds to the level of activity in the economy, although it has no long lasting beneficial effect."*

However, even these finding may be too pessimistic. The average tariff level used in the NIESR study is based on mid 1990s levels and is, we would argue, therefore too high. Moreover, in the short term it would be very easy to offset any deflationary effects from withdrawal by lowering interest rates. Finally, whilst the NIESR do not claim that inward FDI is the only driver of technical change, we would argue that there is good reason to believe that future growth in B2B e-commerce will be as effective as direct inward investment in fostering global best practice. The IoD would also argue that the NIESR study is too optimistic regarding the impact of the EU social model on the UK economy. Chapter 5 of this report shows very clearly that labour cost factors are significant to location, though not necessarily to the same degree across all sectors.

In this study the IoD has attempted to broaden the EU cost-benefit debate in order to examine whether the introduction of additional influences more clearly tilts the membership cost-benefit balance.

## Quantifying the costs and benefits of EU membership

The IoD's cost-benefit analysis shows that at the present time the costs of EU membership outweigh the benefits significantly. Moreover, because of the significance of the CAP, there is a huge discrepancy between those who receive (farmers) and those who give (taxpayers). This means that at an individual level the costs of EU membership outweigh the benefits by an even wider margin.

### *The EU Budget*

Chapter 2 examined the UK's contributions to the EU budget. Since the UK joined the then EEC in 1973, cumulative gross contributions have exceeded £120 billion (includes IoD estimate for 1999). Net contributions, after deducting public sector receipts and negotiated abatement funds - amount to more than £30 billion over the same period (includes IoD estimate for 1999).

In Chapter 2 we highlighted the fact that net contributions should be seen as a minimum cost estimate owing to the fact that the gross contribution could have been used more effectively if it had remained in the UK. In order to allow for this effect we have chosen a mid-point estimate between gross and net contributions - 0.75% of GDP per annum.

## The CAP

Chapter 3 described the very substantial costs to the UK economy and consumers of the CAP. With regard to the CAP, consumers pay not once, but twice. First, by higher food prices. Second, by higher taxes to fund the CAP. This all adds up to around £800 per annum for an average family, and a burden that is particularly regressive - hitting the poorest most - in its impact.

Hindley & Howe suggest a net cost from participation in the CAP of around 1% of GDP. They go on to note that this estimation may in fact represent a significant underestimation of the net costs, because the OECD data used omits many elements of the CAP in which Britain is a net loser - price support for products like tobacco, wine, cotton and rural infrastructure support.

Their estimates also neglect the so called 'dead-weight' welfare losses of the world and intra-EU price distortions arising from the CAP - the loss of economic welfare generated by changes in consumption patterns which, unlike the price changes themselves, are hard to quantify. Again, these factors tend to lead to the underestimation of costs. Hindley & Howe also quote the Minford study which suggests the net costs of the CAP and EU budget contributions at around 1.5% of GDP. We have therefore estimated that the annual impact of the CAP is around 1% of GDP.

## Customs Union

The benefits to the UK economy from residing inside the EU customs union are not clear cut. For example, since joining the UK has run a very substantial trade deficit with its EU partners. However, if the UK were to reside outside the customs union, it might then incur tariffs. We stress the term might, because the nature of the trading relationship established with the EU is such that it would be in the EU's own interest to maintain open access. However, in order to quantify the trade effect in a worst case scenario, it is necessary to apply the EU's average industrial tariff on that proportion of GDP taken by trade with the EU. Average tariff levels have fallen significantly since the UK first joined the Common Market. As a result of the Uruguay Round, the EU's average industrial tariff on imports from outside the EU was 3.6% in 1998 (*Eurofacts*, A Global Britain Publication, March 2000). Latest estimates suggest trade with the EU accounts for around 13% of GDP (Michael Artis in *NIESR Review*, Quarter 1 2000). This suggests the maximum net cost of being outside the customs union - net benefit of membership — is around 0.5% of GDP per annum.

Moreover, as we have seen, there are good reasons to believe that the UK could negotiate an even more favourable arrangement - we are not saying that the UK should leave the EU, merely that in this key area the net benefits are minimal. Other offsetting factors include an accommodatory monetary policy in the short term and real wage adjustment in the long term.

We have therefore estimated that the maximum net benefit of the customs union is 0.5% of GDP per annum. Chapter 6 highlighted the possible costs of 'Fortress Europe' and non-tariff barriers to the UK. It is difficult to say how significant a problem this would be. An OECD study (*The European Union's Trade Policies and Their Economic Effects:* OECD Economics Department Working Papers No. 144, 1998) stated that 19% of tariff lines in the EU were subject to non-tariff barriers. Withdrawal from the EU would leave the UK open to negotiate its own external tariff. However, in order to avoid non-tariff barriers, if they were significant, the UK would also need to remain a member of the European Economic Area (EEA). This then raises the issue of 'regulation without representation' (*EU Enlargement and the World Trade System,* J Rollo, European Economic Review, 1995). This reinforces the IoD's views that the UK needs to fight for radical reform from inside the EU.

## *The Single Market*

The issue of regulation, deregulation and re-regulation was examined in Chapter 6. One of the greatest concerns surrounding the Single Market has been the nature of the development of supra-national regulation. The NIESR (*Single Market*, NIESR Quarterly Review, Vol. 2 1998) has commented that,

> *"the enduring impact of the Single Market has been more in the way it has recast regulation and rule-making in Europe".*

The NIESR has also commented that whilst in some domains the Single Market rules have indeed liberalised markets, there are others where the scope of regulation has been accentuated. In chapter 6 we showed — excluding FDI — the analysis underpinning our view that the impact of the Single Market on the UK economy has been neutral.

Hindley & Howe have pointed out that,

> *"the cost of the Single Market regulations falls upon 100% of the British economy. In crude terms, in order for these less tangible elements of the Single market to produce a net benefit to the UK economy, it is necessary in percentage terms for the benefits of market access in the industries which benefit from it to be seven times [assuming EU trade accounted for 14% of GDP in 1996] as great as the costs of EU regulation falling on British industry as a whole. This seems a demanding target. There must be serious doubt whether it can be achieved".*

The EC Single Market Review found a one-off *level* change of roughly 1% of GDP. However, EC surveys, academic studies and evidence from HM Government - cited in Chapter 6 - suggest a minimal Single Market effect for the UK. This should not be surprising given that there is evidence that non-EU companies have gained as much, possibly more, from the Single Market as have EU companies. For example, over the 1992-1998 period, the USA from outside the Single Market, increased its merchandise exports to the EU at a faster rate than the UK (*Eurofacts*, A Global Britain Publication, March 2000).

## *Foreign Direct Investment and the EU Social Model*

In their NIESR study Pain & Young place primary emphasis on the impact of EU withdrawal on foreign direct investment and future growth in total factor productivity. Their analysis suggests the UK does not have a significant cost attraction for inward investors. For example, they state that over the long term any social model burdens will eventually be borne by the employee and not the employer. Whilst wage formation studies do point to the absence of these so called 'wedge-effects' in the very long term, the IMF has also argued that the social welfare model will clearly influence unemployment in the short term (possibly the next decade) and may permanently affect participation rates (*Chronic Unemployment in the Euro Area: Causes and Cures*, IMF World Economic Outlook, May 1999).

The IMF study also highlights another crucial yardstick. Since 1970 private sector employment in the US has increased by 70%. In the euro area it has increased by a mere 5% over the same period.

The IoD believes that the lower social cost burden on UK employers is significant in attracting foreign direct investment - for example the late 1999 German survey cited in Chapter 6 which suggests one in seven German companies had considered relocation, with the UK the most favoured destination (survey of 7,000 German companies reported in *The Daily Mail*, 15th December 1999). In 1998 the tax gap between the UK and the EU was around 6% of GDP - mostly accounted for by social costs on employers.

Research by Koedjik & Kremers (*Market Opening, Regulation and Growth*, Economic Policy 23, October 1996) shows a powerful link between the degree of regulation in the economy and growth in output. Minford & Jamieson (*Britain and Europe: Choices for Change*, Bill Jamieson and Patrick Minford, Politeia, 1999) also describe the very damaging impact of regulation on the EU economy. Jamieson & Minford estimate that there could be a 7% point loss in GDP by introducing the EU social welfare model in the UK.

We have conservatively estimated that the annual cost to the UK economy of the EU social welfare model is around 1% of GDP. This burden is based largely on the burden of new regulation introduced under New Labour. This figure understates the true burden in two ways. First, by excluding other social model burdens introduced prior to 1997 under health and safety legislation etc. Second, the regulatory cost estimates are based on administrative and compliance costs. The true regulatory burden encompasses all direct, indirect and induced effects from regulation.

Our analysis suggests that lower costs on employers might actually increase not decrease FDI into the UK. However, it is also arguable that despite the costs imposed by the EU social model, the withdrawal from the EU would concern inward investors sufficient to prevent some inward FDI. The effect however is not likely to be large.

A recent study (*Inward Investment: the irrelevance of the Single Market*, Global Britain Briefing Note, March 2000) argues that 70% of inward investment goes into services. The report argues that inward investment in energy, financial services and distribution is unrelated to membership of the EU. The report also highlights how non-EU countries successfully trade with the EU - exporting $800 billion of merchandise in 1998. The study estimates that less than 4% of all inward investment into the UK is influenced by access to the Single Market. One tenth of inward investment in manufacturing is shown to be dependent on the Single Market.

The IoD has employed a more conservative estimate. ONS figures show that inward investment into the UK rose by 90% in 1998 to almost £39 billion - split roughly two thirds one third between services and manufacturing. We have assumed that one third of the annual growth in manufacturing FDI would be lost if the UK were to withdraw from the EU. This suggests that the average FDI gain to the UK economy is around 0.5% of GDP per annum.

Adding together all the current costs and benefits suggests that there is at present a minimum net cost to UK membership of the EU of £15 billion per annum. Under an alternative scenario whereby FDI increased because of a lower cost and regulatory burden in the UK, the annual cost of membership could increase towards £25 billion.

As we show below, future membership of the euro and tax harmonisation would dramatically worsen the net costs of EU membership to the UK.

EU Membership — What's The Bottom Line?
(% of GDP per annum)

| | Cost | Benefit |
|---|---|---|
| EU Budget | 0.75 | — |
| CAP | 1.0 | — |
| Customs Union | — | 0.5 |
| Single Market | 0.0 | 0.0 |
| Social Model | 1.0 | — |
| FDI | — | 0.5 |
| Total | 2.75 | 1.0 |

Net cost is 1.75% of GDP per annum — almost £15 billion per annum.

## *Future costs and benefits*

### Monetary and Fiscal harmonisation

Lord Simon, former Minister for Europe, has argued that the price transparency afforded under the euro would trigger a competitive boost to the UK economy within EMU. Whilst the launch of the euro has coincided with many media reports of the boost to transparency afforded by the euro, these commentators have missed the fundamental point. It is already possible outside the euro. That is why we see price comparisons of UK goods now.

Previous IoD studies (see Chapter 1 — Introduction) have examined the costs and benefits of UK participation in the euro. These studies suggest that entry would be damaging to the UK economy for the forseeable future.

Minford (1996) has estimated that,

> *"across all economic shocks [world and domestic] … floating gives substantially less instability than EMU. There is a 60% deterioration in the overall misery index [inflation and unemployment rates] in EMU relative to floating".*

The IoD would argue that the 'Misery Index' is at its lowest level in decades in the UK and we should not take risks therefore with economic policy. A recent study by the Bank of England (*Bank says joining EMU could reduce output by £9 billion*, reported in The Financial Times, 17th December 1999) suggested the economy could suffer a permanent output loss equivalent to 1% or more of GDP through the loss of control of monetary policy. The estimate uses an admittedly simple model, but when considered alongside the output losses attributable to ERM membership in the early 1990s, the potential risks are obvious. It is very difficult to say what the precise lost output costs might be, but they would be considerable.

The future net costs of euro participation should also include the loss of foreign exchange reserves to the ECB. Available estimates also suggest that the costs of conversion to a single currency will vastly outweigh the transaction cost gains for almost two decades. (IoD analysis based on press reports of conversion cost estimates produced by KPMG and Chantrey Vellacot.)

For the purposes of this study we have assumed that staying outside the euro is neutral in terms of its impact on the City (*The UK and the Euro - Better Out Than In?*, IoD Research Paper, 1999).

Chapter 7 showed the future overall cost-benefit gap of EU membership will deteriorate sharply if the UK was to move towards EU levels of taxation. If moves on tax harmonisation halved the tax gap with our EU partners the share in GDP would need to rise by 3% — around £25 billion per annum.

The IoD estimates that the current costs of EU membership are a minimum of £15 billion per annum and could be as high as £25 billion. In the future, moves towards tax harmonisation alone could double this figure, even before the effects of lost output attributable to an inappropriate monetary policy.