Making the break

How Britain could fall out of the European Union, and what it would mean

Britain has never been too keen on tying the knot with Europe. It sat aside in the 1950s as Germany, France, Italy and the Benelux countries forged a single market in coal and steel, which became a broader common market. It eventually joined, in 1973, largely because Europe seemed to be where the money was. Britons still think of their relationship with Europe as a transaction. But their feelings about the costs and benefits of membership have changed utterly.

Europe is no longer the thriving economic club that Britain joined 40 years ago. The euro-zone crisis has exposed the lack of dynamism in much of Europe (though Britain itself is hardly booming) and the British also feel sidelined, as countries that use the single currency are pulled more tightly together. Britons have come to associate the EU with the uncontrolled immigration of Poles and other east Europeans, seemingly to every village. Although many political leaders are determined to stop it happening, a British exit from Europe is coming to seem ever more possible.

If Britain falls out of the EU, it may find itself completely outside the single market. It might try to stay in the European Economic Area (EEA), a free-trade club that also includes Iceland and Norway. Or it could leave both the EU and the single market, but attempt to recreate a free-trade relationship through bilateral agreements. In this article we explain what each would mean for British business and the economy. But, first, how could an exit happen?

Almost by accident

The likeliest trigger is a referendum. David Cameron, Britain's prime minister, is under enormous pressure to call one from his own Conservative Party, which dominates Britain's coalition government. Last year 81 Tory MPs voted for a referendum on Britain's EU membership. "It's moved very fast," says John Redwood, a veteran critic of the EU. "People used to call me an extreme Eurosceptic. Now I'm a moderate."

Truly fervent Eurosceptics seek a referendum because they want to quit the EU. Other Tories want one to spike the guns of the UK Independence Party (UKIP), which campaigns for an exit. UKIP, a once-minor party that came second to Labour in two by-elections on November 29th, takes votes from all parties but most terrifies Conservative MPs. If the party does well in the next European Parliament elections, due in 2014, the pressure on Mr Cameron will increase.

He is already bending. In September the prime minister hinted that Britons might have an opportunity to give “fresh consent” to their country’s place in a looser union—a rather fuzzy suggestion that is unlikely to dampen calls for a starker question. Some Tory cabinet ministers now expect the party to include a promise of an “In-Out” referendum on Europe in its 2015 general-election manifesto.

That might persuade Labour to follow suit—which is the second referendum scenario. Although the party is broadly pro-European, some Labour strategists have been urging Ed Miliband, its leader, to promise a referendum all the same, chiefly to pile pressure on Mr Cameron but also to stay on the right side of public opinion. “Whatever our position on Europe, we cannot be seen as the anti-referendum party,” a senior Labour figure says.

The third scenario is already in play, thanks to the 2011 European Union Act. Passed by the coalition, this dictates that a referendum must be held on any new EU treaty that shifts power from Westminster to Brussels. The EU is acutely aware of this obstacle, so where treaty change is envisaged, it is trying to focus it as narrowly as possible on the euro zone, of which Britain is not a member. But the EU’s creeping claim on its constituents’ sovereign powers suggests that this “referendum lock” could be activated. The next treaty change, which could take place in 2015 or 2016, will be the moment for Mr Cameron (if he is re-elected) to try to repatriate some powers from Brussels in the “new settlement” he seeks with Europe. If Britons voted to reject the revised treaty there would be redoubled pressure for a second referendum, on their membership of the European club.

There is a fourth scenario: simple diplomatic miscalculation. A year ago, at a summit where they agreed on a fiscal compact, almost all other EU leaders banded together to sidestep a British veto. If that were to happen again on an issue that Britons care more deeply about, Mr Cameron may face irresistible pressure to call an early referendum.

The early signs are that Britons would opt to push off. YouGov’s latest poll on the issue suggests that 49% would vote to leave, whereas only 32% would choose to stay (the rest are unsure). One senior Tory, who wants Britain to stay in, says blankly that it would be impossible to win a referendum at the moment.

The leaders of all three main parties, backed by business and trade unions, could try to woo Britons to Europe. But they would have plenty of opposition, and not just from other MPs. When Britain last voted on Europe, in 1975, every national newspaper except the Morning Star campaigned for an “In” vote. That will not be repeated. Britain’s two biggest-selling dailies, the Daily Mail and the Sun—combined circulation, 4.5m—are deeply Eurosceptic.

What would make the vote unpredictable is that Britons cannot have what they really want. If offered a “detached relationship that is little more than a free-trade agreement”, according to the same YouGov poll, only 26% would still opt for the exit. The biggest group of respondents, 46%, would accept those looser terms. But continental leaders are unwilling to grant Britain full access to the single market without the costly bits. Germany’s chancellor, Angela Merkel, says she dearly wants to keep Britain in the EU—but “as a good partner”. In the run-up to a promised referendum, Mr Cameron could win only trifling concessions. That might convince some Britons that life outside the EU would be difficult; but it might equally inflame Eurosceptic opinion and make an “out” vote more likely.

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Very well, alone

If Britain walked away entirely—the most extreme scenario—it would quickly see some benefits. The country would no longer have to transfer funds to the EU to subsidise farm incomes or poorer regions. Treasury figures suggest it would be £8 billion ($13 billion) better off each year. Food could become cheaper. Under WTO rules, countries may slash import barriers unilaterally as long as they do not favour some countries over others. Britain could do this for agricultural produce. It would regain control over fishing rights around its coast.

Some irksome regulations could be ditched, too. First to go (if the Tories are in power when Britain leaves) would be the working-time directive. This limits how long people can be at work without a break or a holiday and caps the working week at 48 hours. The scrapping of the EU's agency-worker directive, which gives temporary staff the same rights as regular employees, would be cheered by business, too. Britain would be free to set itself a less exacting target for green-power generation than it is bound to under the EU's renewable-energy directive. That could mean cheaper power.

London's financial district would look to past glories. It thrived as an offshore centre for deposit-taking and loan-making in dollars long before Britain joined the EU. Outside the club, it would be freer to market itself as a freewheeling hub for emerging-market finance—a sort of Singapore on steroids. Free of the obligation to abide by ever-changing EU rules on alternative investments, hedge funds that have left London might be lured back. The burden of impending European Solvency 2 regulations on the insurance industry would become less onerous.

Yet a bonfire of regulations would smoulder rather than blaze. Domestic and global commitments to greenery constrain Britain's energy policy, for example. And EU regulations bite less hard than is commonly supposed. Britain already has one of the most flexible labour markets in the rich world (employees can opt out of the 48-hour week). This helps to explain why the unemployment rate is as low as in America or Canada, despite a more sluggish economy.

Product regulations would be harder to junk than labour laws. The British suppliers to Airbus, the Franco-German aircraft manufacturer, have to comply with exacting standards. But these exist not because of meddling by Brussels, but to ensure aircraft are safe. Similarly, a minimum standard of food safety stops a race to the bottom by competing firms. British ones

would still have to observe Europe's product regulations in order to export there. A separate set of regulations tailored for the home market would only add to red tape.

That goes for the City, too. Global finance favours common standards, such as the Basel accords on bank capital. And, far from racing to the bottom, countries with large financial sectors are now as likely to create even tougher rules. The Bank of England has hinted that Basel is not strong enough.

And some immediate gains would evaporate as special-interest groups redirected their attention from Brussels to Westminster. British farmers would lose £2.7 billion in EU subsidies once Britain left. They are a noisy lobby group, and it is unlikely that the government would hang on to all that cash. The farming lobby would also try to stand in the way of lowering tariffs on food imported from beyond Europe, potentially depriving the government of a bargaining chip in trade negotiations with big emerging markets such as Brazil and India.

If the benefits of leaving the single market are qualified, what of the costs? The price of exclusion is much smaller than when Britain joined in 1973. Tariff barriers across the world have been steadily lowered in trade deals brokered by GATT and its successor, the WTO. If import tariffs are weighted by the volume of trade in each product, the average faced by exporters from outside the EU into the single market has fallen to around 3%. Exporters routinely have to absorb cost increases of this size caused by a surge in the oil price or a jump in the exchange rate.

Even so, the impact on industries such as food and textiles, where tariffs are much higher than the average, would be far from mild. British dairy exports would incur an import tax of 55% to reach the EU market, with tariffs on some items of more than 200%. Cheddar cheese would face a tariff of €167 per 100kg; the mark-up on Stilton would be €141. Average tariffs on clothing would push up their price in European markets by 12%.

Parts of Britain's car industry would move out. British-based producers would face a 4% tariff on car-equipment sales to the EU, and there would be pressure to impose tariffs on components imported from it. Factories owned by carmakers with plants and supply chains in other parts of the EU would be most at risk. Vital car components might be held up by customs as they leave the continent. A cheap pound and a flexible workforce may not be enough to keep GM in Britain, for instance, even though it sells many cars there.

The calculation would be slightly different for other carmakers. Only a small fraction of the 300,000 cars Jaguar Land Rover makes in Britain are destined for the EU market. A lot of Minis, made in Britain by BMW, are also sold outside Europe, where they attract an import tariff anyway. Much of what distinguishes a Jaguar from a Mercedes is that it is designed and made in Britain (as are lots of components). There would be little benefit, but huge costs to the brand, in shifting production elsewhere. Japanese carmakers would suffer: most of their British output is sold in the EU, says John Leech of KPMG, a consultancy. But they cannot easily switch production to continental factories, and many of their supplies come from Japan. They would stick around longer than many think.

Over time, though, the general drift of business investment would be away from Britain and towards the continent. That goes for finance, too. If London wants to be the regional hub for trading China's currency, it will need to retain its position as the main centre for settling trades of cash and derivatives in euros. Some in Europe resent this: the governor of France's central bank complained this week that euro deals should be done in euroland. Without the shield of single-market rules, London could lose out to rival EU centres.

Financiers from today's rising economic powers, in Asia and Latin America, are keener on access to a European market of 500m than on the light regulation that drew American banks to London in the 1950s and 1960s. TheCityUK, a lobby group, studied 147 siting decisions between 2006 and 2012. It found that more than two-fifths of finance firms gave access to European markets as a core reason for choosing London. Although the single market in financial services is still a work in progress, "passporting rights" entitle investment firms,

banks and insurers based in Britain to establish branches or provide services throughout the EEA.

Aerospace is another industry that relies on frictionless trade with the rest of the continent. Britain has the world's largest industry outside America, but it would lose ground to France. The high-tech bits of production, such as the making of carbon-fibre wing spars, could not speedily be replicated elsewhere. But suppliers of basic parts, such as metal brackets, would be vulnerable. Big manufacturers like Airbus prefer to keep supply chains simple. They might sponsor entry by new suppliers in the EU to avoid a customs barrier.

These reallocations of fixed capital would take years or decades. By contrast, Britain and its erstwhile EU partners would have to decide quickly how people on the wrong side of newly erected barriers to the free movement of labour should be treated. Around 2.3m people from EU countries were living in Britain in 2011, up from 1.1m in 2004; around 1.7m Britons have gone the other way. The rights of residency for such migrants would no longer be automatic. Forced repatriation would be damaging to all countries.

The simplest solution would be to offer citizenship to all those resident in Britain at a particular date, in return for a similar offer to Britons living in other parts of Europe. Anticipation of such an amnesty would spur a rush to and from Britain in the run-up to its exit. As the drawbridge eventually rose, businesses would suffer. London's growing tech cluster, as well as the City, relies heavily on the free flow of young workers from other parts of Europe.

Another huge disruption would be to trade beyond Europe. Britain would swiftly have to negotiate bilateral deals with dozens of countries. The experience of Iceland, Liechtenstein, Norway and Switzerland, which make up the European Free Trade Association (EFTA), a club of

European refusers loosely linked to the EU, suggests it is usually possible to obtain similar terms to those won by EU negotiators. The EFTA countries tend to rush in behind the EU, though in some cases—South Korea, for example—they go first. But the bigger club can win slightly better terms. “The EU is more powerful than we are,” says Didier Chambovey of Switzerland’s state secretariat for foreign affairs. A deal with Britain would be top of few countries’ priorities.

Britain would have less diplomatic and military clout, too. For the Americans, a Britain that is disengaged from the rest of Europe would be a much less useful and influential ally. For NATO, a Britain that is semi-detached from Europe would weaken the ties that bind the continent and its defence to the United States at a time when those ties are already under strain because of slashed defence budgets and America’s strategic “rebalancing” towards Asia. Another likely casualty would be the budding Anglo-French defence treaty, seen by both countries as a way to help themselves continue to punch above their weight.

Viking spirit, or Swiss rules?

Although a complete exit from Europe is certainly possible, few British Eurosceptics want it. They view the common market as a pearl surrounded by a dismal encrustation of European bureaucracy and regulation. What they would really like to do is pull back until Britain’s relationship with Europe becomes one based on free trade, with the minimum necessary regulation. In effect, they want to create the kind of Europe that British Conservatives fought to join in the 1970s. Once it became clear that Britain was falling out of the EU, they could grab at two halfway options: a Norwegian one and a Swiss one.

Together with Iceland and Liechtenstein, oil-rich Norway is about as close to the EU as it is possible to be without actually becoming a member. It simply belongs to the EEA. The EU is broadly happy with the arrangement, partly because Norway pays into its coffers (indeed, it pays slightly more per head than Britain). A similar arrangement might well be obtained.

Many businesses would hardly notice the difference. But a few would suffer minor irritation. Although EEA countries are part of the single market, businesses must complete customs and VAT forms when goods are shipped into and out of the EU. For big companies serving big customers, this is no problem. For smaller ones it can be a nuisance. Moods of Norway, an echt-Norwegian fashion company (its logo is a tractor), has solved the problem by setting up a small subsidiary in Sweden, which is a member of the EU. The subsidiary handles customs clearance for the European boutiques that carry Moods of Norway’s clothes. Small, export-oriented British businesses would end up doing the same.

If Britain were to join the Norwegian club, though, it would remain bound by virtually all EU regulations, including the working-time directive and almost everything dreamed up in Brussels in future. Once out of the EU, the country would have little say in the regulations and laws that would continue to bind its industry. It would be consulted by the European Commission but would have no voice in the increasingly powerful European Parliament, and no vote. In Euro-jargon, it would be a decision-shaper, but not a decision-maker.

Officials and lobbyists would frequently be unaware of discussions about legislation that could affect British industry, except at second hand, through officials in a friendly nation. “We take our Scandinavian colleagues out to lunch and ask them what happened,” explains Petter Brubakk of NHO, Norway’s main business lobby. It would depend on other countries to fight its corner, as Norway now relies on Britain to resist proposed EU legislation on offshore oil-drilling. It would be as though Britain maintained a golden fax machine linked to Brussels, which cost billions of pounds a year to run and from which regulations issued ceaselessly. It could ignore the faxes about farming and fishing: members of the EEA are allowed to run their own agriculture policies. But it would have to obey the others.

The Norwegian option could well fail for domestic reasons. As soon as British MPs learn that Norway has to swallow almost every regulation that comes out of Brussels, despite having

virtually no power to shape them, they will waver. When they also learn that Norway has to pay for the privilege, they may reject it outright.

Britain might, however, seek a more distant relationship. It could steer clear of the EEA but join EFTA, which it helped to set up in 1960. Optimistically, it could come to look rather like Switzerland.

Switzerland does business with EU countries through bilateral deals, and by routinely aligning its regulations with those made in Brussels. To an extent, it can pick and choose. In the same position, Britain could drop some irksome labour rules. It could also move to co-operate more, and trade more freely, in some areas than in others. Switzerland has a comprehensive bilateral agreement with the EU covering trade in goods, but no equivalent agreement for financial services.

Switzerland has got into the occasional trade dispute with the EU, over Gruyère cheese for example. Still, for the most part it has secured good access to European markets so far. Its firms have subsidiaries in EU countries through which they can trade freely. And non-membership of the EEA means Switzerland has remained partly aloof from financial regulations emanating from Brussels. But the Swiss have come up with their own, often extremely stringent, financial regulations, partly in fear of losing access to EU customers.

And the country is not beyond the reach of Brussels. The Swiss are currently exercised over several European directives, including those covering finance, chemical factories and the movement of labour. Switzerland is hampered by the lack of an accord with the EU on financial services and by its lack of representation in Brussels. In the broader fight against protectionism and financial over-regulation in Europe, it relies on an informal alliance with another country that also has a big financial-services industry, as well as a valuable seat at the negotiating table: Britain.

In any case, it is unlikely that Britain could get similar treatment. The EU is already trying to muscle Switzerland out of its special niche and into an arrangement more like Norway's, where EU legislation would be speedily taken up by the country. Relations have become more fraught since the EU expanded eastward. The EU used to be a club of Western nations which share a broad culture with Switzerland (many share a border with it, too) and tolerated its peculiarities. The club is now bigger and more bureaucratic, and includes east European countries which were forced to swallow much unpalatable stuff as the price of entry to the club. There is little chance that Britain, a far bigger country with a history of being difficult, would be allowed to squeeze in alongside Switzerland.

And don't come back

No country has ever left the European Union (though Greenland, an autonomous dependency of Denmark's, voted to leave in 1982). The halfway options of Norway and Switzerland were offered largely in hopes of tempting both to become full members one day. Britain would be travelling in the opposite direction, without a map. In this, as in so many other ways, leaving the EU would be a colossal gamble.

The British would doubtless try to negotiate a special deal with their former partners, using the argument that trade benefits both sides and that Britain is itself a large market for many. But the process could take many years (it took a decade for the much smaller Switzerland). Europe might well be more of a fortress with Britain outside. And even the country's closest friends, who would rather keep Britain in to bolster liberal voices inside the EU, would be unlikely to be generous to a country that had chosen to leave.

The most likely outcome would be that Britain would find itself as a scratchy outsider with somewhat limited access to the single market, almost no influence and few friends. And one certainty: that having once departed, it would be all but impossible to get back in again.

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