BREXIT: the impact on the UK and the EU

June 2015

Preface

Global Counsel

For the majority of businesses in Britain the possibility the UK might leave the European Union – Brexit – is a major source of concern. Both the break with the EU and the uncertainty associated with it would be bad for business and damaging to the UK economy.

A great deal has now been written on the economic consequences for the UK of Brexit. Some of this is impartial; much of it is partisan. Very little has been written on the consequences for the rest of the EU.

This report seeks to address this gap by systematically assessing the evidence on the impact of Brexit on both the UK and the rest of Europe.

At the heart of this analysis are ten distinct channels of impact. For each we consider in turn the impact on the UK and on the rest of the EU. We also assess the specific ways in which different member states are exposed through these channels.

We conclude that while the biggest impact of Brexit would be on the UK, there can be little doubt that there will also be a significant impact on the rest of the EU.

This report has been prepared by Global Counsel based on our interpretation or the politics of Brexit and our analysis of the best available economic evidence.

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About Global Counsel

Global Counsel helps businesses across a wide range of sectors anticipate the ways in which politics, regulation and public policymaking create both risk and opportunity. We also help businesses to develop and implement strategies to meet these challenges.

The firm was founded in 2010. Our senior team are former public policymakers who have worked at the highest level in the British government and European Union institutions. They draw on decades of experience and are backed by a global network.

The author of this report is Dr Gregor Irwin, Chief Economist of Global Counsel. Dr Irwin was the Chief Economist of the Foreign and Commonwealth Office from 2008 to 2013 and a Director of the FCO from 2011 to 2013. He has previously held senior positions at the Bank of England and HM Treasury.

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Executive summary

For the first time in a generation there is a serious prospect of a member state leaving the European Union. In Britain, the Conservative government, led by Prime Minister David Cameron, is committed to holding an in-out referendum by the end of 2017. This will be preceded by a renegotiation of the terms of EU membership and a lengthy referendum campaign. The opinion polls suggest that if a referendum was held tomorrow the outcome would be highly uncertain. A vote to remain in the EU is far from assured.

If the UK leaves the EU the impact would depend on the new relationship between the UK and the EU. We consider five models. Those at the extremes in terms of proximity to the EU are unlikely. The Norwegian model, involving membership of the European Economic Area, would not give the UK the political flexibility required to justify Brexit. By contrast, a much looser model in which the UK trades with the EU on a most-favoured nation basis would give flexibility, but seriously jeopardise trade and investment. The most likely models are either a Swiss-style series of bilateral accords governing access to specific sectors of the single market or a comprehensive FTA. Either would require prolonged negotiation followed by compromises and still impose sizeable costs. A lack of clarity over what would replace EU membership is just one reason why the path to Brexit - and beyond - would be long and uncertain, taking ten years or more.

The impact of Brexit through the trade and investment channels would be most severe in the UK. Regulatory divergence would increase over time, affecting trade volumes and reducing the attractiveness of the UK for investment. This would impact on European businesses invested or trading in the UK and supply chains involving UK firms, but the magnitude depends on the specific Brexit model and is impossible to predict.

The rest of the EU would also feel the impact through several other channels. The EU would lose an influential, liberalising member, shifting the balance of power in the European Council. It would become harder to block illiberal measures. Moreover, there would likely be a new regulatory dynamic with the UK outside the EU. The UK may seek to undercut the EU on standards impacting on the business environment; but this in turn may create a healthy regulatory competition by putting pressure on the EU from the outside to be more liberal in its policies.

There is little prospect of London being dislodged as Europe's leading international financial centre. This is sustained by inherent advantages and a large network of financial and professional services that are hard to replicate. However, existing EU regulations would make it harder for London to serve European markets, particularly (but not only) for retail banking and euro trading. Some business would be likely to move to Eurozone financial centres or be lost to Europe. Competition to take this business would be wasteful. While one or two centres may ultimately benefit, businesses and households across the EU would bear the cost in terms of higher charges and poorer products.

Brexit would impact on the position of both the UK and the EU in the world. In economic terms this would be most evident in trade policy. While the UK would likely be free to strike new trade deals based on domestic priorities it would have less leverage and be a lower priority than the EU for other countries. The UK would also face the huge challenge of renegotiating the existing EU deals that would no longer apply. The EU would likewise be a less attractive partner at a time when it is only second priority for the US and Japan and a lower priority for many emerging countries. The EU may, however, be able to take a tougher stance in negotiations without the UK and make more active use of trade remedies. In addition, the EU would lose substantial hard and soft power assets although Brexit could lead to greater EU political integration and more coherent external representation in institutions and on external policy.

The overall macroeconomic impact of Brexit is hard to quantify. This is because there are several unknowns and macro models do not capture many channels through which Brexit would impact on the economy. The majority of published studies find the impact on the UK would be negative and significant. The impact on the rest of the EU would be smaller, although no comprehensive macroeconomic estimate has been published.

There are three broader ways in which the UK and the rest of the EU would be affected by Brexit, which are not captured by macroeconomic models. The first channel is uncertainty. Surveys find many UK businesses are already worried about the impact of referendum uncertainty. Yet the process beyond a referendum - if the UK votes to leave - to the point of exit and then the establishment of a new stable relationship with the EU would itself be prolonged and highly uncertain.

The second way is through the political dynamic between large states in an EU without the UK. The UK's influence in the EU has been damaged both by the ambivalence of the UK government to the EU and by being outside the Eurozone. Even so, the UK remains one of the most influential member states. Brexit would change the relationship between other large states including, most importantly, France and Germany. It could bind them together; it could cement France's position behind Germany in terms of influence; or it could push them apart, with the UK no longer providing political cover to mask their differences.

The third way is through political contagion. Some of the tensions in the UK regarding the EU also exist in other states, even if they manifest themselves differently and to different extents. If the UK leaves, adopts a more independent policy in sensitive areas, and is seen to succeed, this could have far-reaching political ramifications for the rest of Europe. The 'proof of concept' of leaving the EU could liberate disintegrative, centrifugal forces elsewhere.

We conclude that the member states most exposed to Brexit are the Netherlands, Ireland and Cyprus. Each has very strong trade, investment and financial links with the UK and in the cases of the Netherlands and Ireland are closely aligned in policy terms. Among the larger member states Germany would be affected through several channels, but perhaps most profoundly by the loss of the UK as a counterweight to France in policy debates. France may welcome the absence of the UK in policy debates, but like Spain has substantial direct investments in the UK. Italy is less directly exposed to Brexit, while Poland's interests are concentrated on the impact Brexit would have on the EU budget and the large number of Polish residents in the UK. All member states would, however, regret the loss of international influence enjoyed by the EU without the UK and the damage that Brexit would do to the esteem of the EU globally.

Brexit models

The impact of Brexit depends on the relationship with the EU that follows. Five distinct models are set out below. What is most beneficial politically, in terms of policy independence, is also the most damaging economically. This is the Brexit paradox. The most likely models are the Swiss or the FTA-based approaches.

Norwegian-style EEA agreement	The UK joins the European Economic Area and maintains full access to the single market, but must adopt EU standards and regulations with little influence over these. The UK still makes a substantial contribution to the EU budget and is unable to impose immigration restrictions. **Verdict: does not address UK political problems with the EU**
Turkish-style customs union	Internal tariff barriers are avoided, with the UK adopting many EU product market regulations, but sector coverage of the customs union is incomplete. The UK is required to implement EU external tariffs, without influence or guaranteed access to third markets. **Verdict: a bad compromise for the UK**
FTA-based approach	The UK is free to agree FTAs independently and the UK's relationship with the EU is itself governed by an FTA. Tariff barriers are unlikely, but as with all FTAs the UK will need to trade off depth – which means agreeing common standards and regulation – with independence. **Verdict: possible, but it all depends on the deal**
Swiss-style bilateral accords	The UK and the EU agree a set of bilateral accords which govern UK access to the single market in specific sectors. Concern in Brussels about cherry picking may limit the sectors. The UK becomes a follower of regulation in the sectors covered, but negotiates FTAs separately. **Verdict: possible, but may not be attractive to the EU**
MFN-based approach	No need to agree common standards and regulation, but at the expense of facing the EU's common external tariff, which damages UK trade with the EU in goods as well as services. Non-tariff barriers may emerge over time to damage trade in services in particular. **Verdict: inconsistent with the UK's liberal approach to trade**

Implications of different Brexit models

Colours indicate attractiveness from a UK policy perspective

	EEA	CUS	FTA	BIL	MFN
Nearly no tariff barriers on trade in goods	√	√	√	√	X
Dynamic agreement	√	√	X	√	X
Rules of origin requirements avoided	√	√	X	X	X
Single set of regulations for exporting firms	√	X	X	√	X
Full single market access retained	√	X	X	X	X
Passporting of banks from the UK possible	√	X	X	X	X
Influence over EU regulations retained	?	X	X	X	X
Able to adopt own approach to regulation	X	?	?	?	√
Freedom to pursue trade deals independently	X	X	√	√	√
No contribution to the EU budget	X	√	√	X	√
Freedom to impose immigration controls	X	√	√	?	√

The path to Brexit

Brexit will only happen if a majority votes to leave the EU in a referendum. The outcome is highly uncertain as there are many unknowns including the timing of the vote and the outcome of the renegotiation. If Brexit happens it will be a long and protracted process. While some points on the road are fixed, others are not, creating additional uncertainty.

- The new Conservative government has promised an in-out referendum by the end of 2017 after renegotiating the terms of the UK's membership. A referendum bill is likely to be passed by the British parliament later this year. This will specify the process but not the actual date for a referendum. The bill proposes the question that will be put to the British electorate: "Should the United Kingdom remain a member of the European Union?"
- The Conservative renegotiation priorities are vague. David Cameron says he wants more controls on immigration from new member states, limits on benefits for immigrants, more powers for national parliaments to block EU legislation, less red tape, faster trade deals, power returned to member states and an end to "ever closer union". His ambiguity is partly tactical as he does not want to show his hand.
- The referendum date could be brought forward to 2016 if Cameron judges this is politically advantageous. Cameron is highly likely to support and in effect lead the 'Yes' campaign. The majority of the political establishment and British business will also support this. But the Conservative Party and the cabinet will be split, with a large faction supporting the 'No' campaign, along with some opposition MPs and large parts of the media.
- If the UK votes to leave then the government would have two years to negotiate a withdrawal agreement under Article 50 of the EU Treaty. The government itself would be weakened and the PM may be forced to resign. This would add to the uncertainty surrounding the long and complex process leading to Brexit.

The full process could take ten years

Brexit timeline

Autumn 2015	Referendum bill is passed by the British parliament	
	Negotiation between the UK and EU partners over a new settlement for UK membership of the EU	
2016 or 2017	The vote must take place by 2017, but the government may bring this forward	
	If there is a vote to exit the UK government has two years to negotiate the terms of withdrawal under Article 50 of the EU Treaty	
c. 2019	The UK formally exits the EU, but this is not the end of the process	
2025?	Further EU negotiations to define the relationship, particularly under a Swiss model of bilateral accords	The UK must pursue a number of third-party negotiations to replace treaties that no longer apply, such as FTAs.

The ten channels

Brexit impact through the ten channels: summary

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Impact scale moderate significant severe

	Impact on the United Kingdom			Impact on the European Union
Trade within Europe	significant	Regulatory divergence grows over time increasing the cost of trade, impacting on volumes and the UK place in supply chains	EU trade matters more for the UK than UK trade for the EU, but some states with big bilateral surpluses feel a macro chill from Brexit	significant
Foreign direct investment	severe	The UK is less attractive as a gateway to Europe, as a base for corporate HQs and as a location for investment from Europe	Businesses find it costly to relocate investment from the UK and there is a risk the UK attempts to undercut the EU on standards to attract FDI	moderate
Liberalisation and regulation	severe	The UK loses influence over EU regulation without gaining much freedom to regulate independently	The balance in the European Council shifts away from liberalisation and it becomes harder to form a blocking minority against illiberal measures	severe
Industrial policy	moderate	The UK gains flexibility over industrial policy, but loses the benefits from scale and influence in some areas	There could be a weakening of competition policy, looser collaboration in education and research and impacts on public procurement	moderate
Immigration	significant	Immigration is tightened, damaging competitiveness, particularly of London, but how much depends on the Brexit model	Some countries are affected by the impact on remittances or diverted migration, with the extent of political contagion a big unknown	moderate
Financial services	severe	The UK retains a strong competitive edge, but most likely loses business as it becomes harder to provide certain services to EU markets	One or two financial centres may benefit, but businesses and households suffer from the loss of liquidity and increased cost of financial services	severe
Trade policy	significant	The UK has less leverage, is a lower priority partner in trade negotiations and finds it harder to resolve trade disputes	The EU is a less attractive trade partner without the UK in the deal and loses a member state that puts its political weight behind negotiations	significant
International influence	significant	The UK loses the benefit from being able to influence both in and through the EU, impacting on economic and foreign policy interests	The EU loses substantial soft and hard power assets, but may be able to act more coherently externally and in international institutions	significant
Budget	moderate	The UK gains financially, but how much depends on the model, and variation in the net impact across the UK regions complicates Brexit politics	The EU loses a budget disciplinarian and a major net contributor, with the gap needing to be filled by higher contributions or less spending	significant
Uncertainty	severe	Brexit is a protracted process lasting several years with uncertainty over the endpoint, impacting on businesses	Uncertainty is bad for business in the EU, but the biggest risk is political contagion from the 'proof of concept' of leaving the EU	severe

Trade within Europe

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Impact on the United Kingdom

The impact on UK trade with Europe will depend on the relationship between the UK and the EU after Brexit. In the most likely scenarios - either the Swiss model, or an FTA-based relationship - regulatory divergence that adds to the cost of trade is likely to increase over time, damaging bilateral trade volumes and the UK's position in European supply chains. The costs will be borne by consumers as well as businesses.

- EU membership is estimated to have boosted British goods trade with other member states by 55%, equal to £130bn in 2013.(1) Overall, the evidence does not suggest this has been at the expense of trade with non-EU states, but this may be a factor in individual protected sectors, such as agriculture, footwear and clothing. Costs for consumers might fall in these sectors, but rise overall.

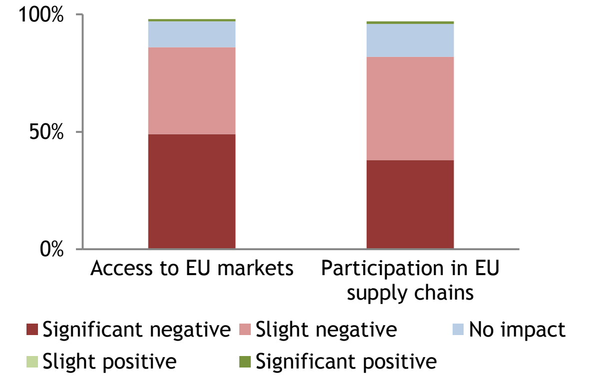
- Under either a Swiss-style accord or an FTA-based relationship the UK would negotiate the terms of access for specific sectors, including the standards and regulations that apply in those sectors. The EU tradition of harmonization rather than mutual recognition means the choice for the UK is likely to be either to adopt EU standards or for firms to bear the cost of meeting two sets of standards. The UK would be less able to influence the future development of the single market, particularly in services where regulatory barriers remain significant and where full liberalisation could add 7% to UK GDP.(2)

- The single market provides opportunities for economies of scale, competition and innovation, which enhance productivity and which would be hard to replicate fully through trade outside Europe. There is a strong relationship between exporting and productivity: between 1996 and 2004 the productivity growth for UK exporters was 1.3%, compared to 0.8% for non-exporters.(3)

- Supply chains are becoming more important for competitiveness, but tend to be geographically concentrated. About half of EU imports to the UK are intermediates.(4) The high ratio of trade in gross relative to value-added terms suggests that much UK trade with Europe is connected to supply chains.

Firms worry Brexit will damage trade

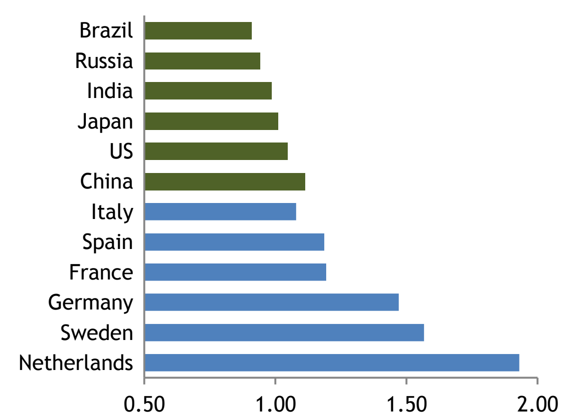
Business opinion of the impact of Brexit on EU trade



Source: CBI/YouGov (June-July 2013)

EU supply chains are important to the UK

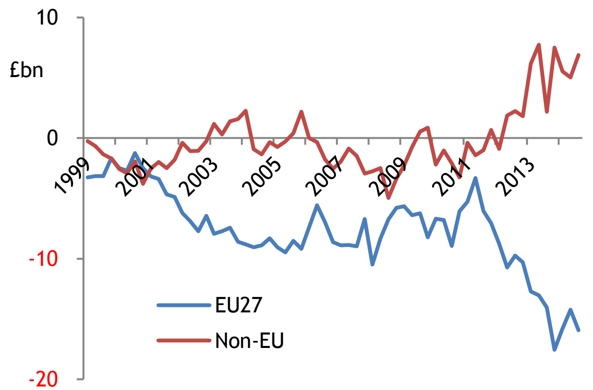
Gross exports divided by value-added exports by destination



Source: OECD, GC calculations

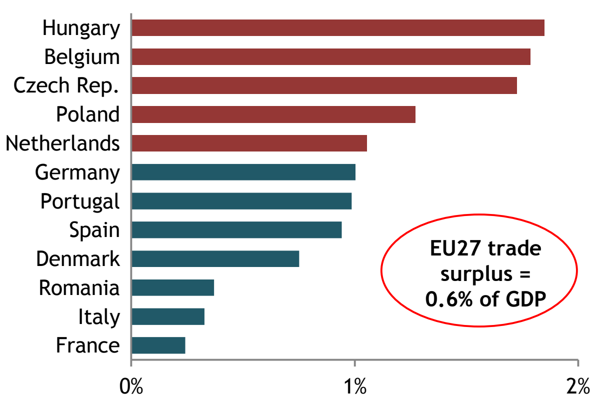
Trade within Europe

The UK's deficit with Europe is growing
Trade balance in goods and services (quarterly, SA)



Source: ONS

The UK is a major source of demand
Trades surplus with the UK (% of GDP, 2013)



Source: ONS, Eurostat, GC calculations

Post-Brexit outcomes which reduce trade or increase the cost of trade between the UK and the rest of Europe will be damaging for both sides. The EU is a more important trade partner for the UK than the UK is for the EU. But UK demand is very important in macro terms for many EU countries. The UK runs large bilateral deficits against several member states.

- The UK accounts for just one sixth of the EU economy.[5] One-tenth of EU exports are to the UK, whereas half of UK exports are to the EU. However, the imbalance in the trade relationship is such that the UK is an important source of demand for the rest of the EU. The UK's trade deficit with the rest of the EU has grown substantially in recent years and was €66bn in 2013, the equivalent of 0.6% of the GDP of the EU27 countries.[6]

- In value terms the trade surpluses with the UK are concentrated in a small number of countries, notably Germany, which exported €78bn to the UK in 2013 and imported €50bn.[7] However, as a percent of GDP the trade surplus with the UK is important many countries. This exceeds 1% of GDP in the Netherlands, Poland, Czech Republic, Belgium, Hungary, Latvia, Lithuania and Slovakia.[8]

- Only a few EU countries run a trade deficit with the UK, notably Ireland at 6.2% of GDP in 2013.[9] But the UK is an extremely important bilateral trading partner with many Irish firms exporting into UK supply chains.

- UK companies are relatively upstream in global supply chains, compared to companies in other European countries. The importance of the UK in international supply chains is particularly concentrated in a small number of sectors. In 2009 the UK exported almost $54bn of business and financial services into the supply chains of other countries, with companies in other EU countries accounting for a large proportion. In the same year the UK exported over $30bn of mining and chemical products and over $20bn in the transport, telecom, and wholesale and retail sectors into international supply chains.[10]

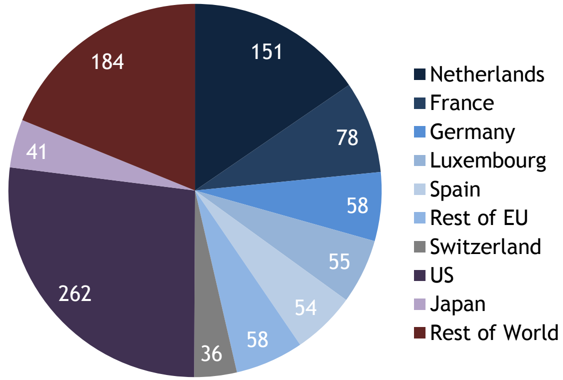
Foreign direct investment

Impact on the United Kingdom

The UK is the largest recipient of FDI in the EU. Brexit could reduce the attractiveness of the UK as a gateway to Europe. It could also lead to a reduction in investment from the rest of the EU, which is the biggest source of FDI in the UK. It may become harder to attract corporate HQs.

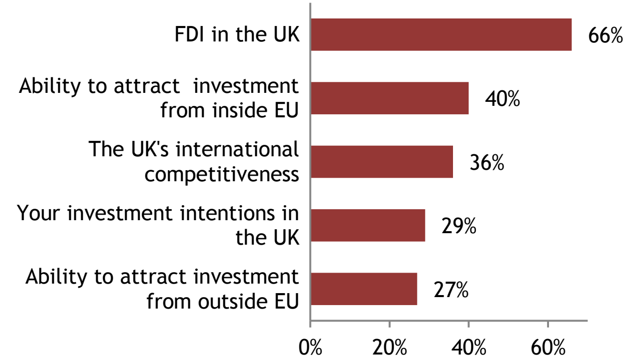
- The EU was the source of 46% of the stock of FDI in the UK in 2013. This dependence has fallen somewhat in recent years, with the EU share down from 53% in 2009.(1)
- The UK has many advantages that would be unaffected by Brexit such as language, light regulation and deep capital markets. Even so, the UK may struggle to attract as much new investment following Brexit. Other locations inside the EU are likely to be more attractive for marginal investment decisions.
- A poll of British firms suggests the impact of Brexit will be damaging not only to FDI, but also to the investment intentions of UK firms, with 29% more saying it will have a negative than a positive impact.(2) However, the EU features low down the list of important factors according to a separate poll, with fewer than 1% of firms saying the UK needs to focus on access to the European market to remain a major global destination for investment.(3) Opinions are likely to vary across sectors. Investment in vehicle production, for example, appears particularly dependent on the single market, both for sales and due to long European supply chains.
- Half of all European headquarters of non-EU firms are in the UK, with the UK hosting more HQs than Germany, France, Switzerland and the Netherlands put together.(4) This could become harder following Brexit given the favourable tax treatment available to member states through the Parent-Subsidiary Directive. The UK would either need to negotiate third-country treatment under the directive or a series of new double taxation agreements with member states. That would take a considerable amount of time.

EU states are the biggest source of UK FDI
Inward stock of FDI in the UK (£bn, 2013)



Source: ONS

Brexit would damage investment prospects
Balance of CBI members who say the impact is negative



Source: CBI/YouGov (June-July 2013)

Foreign direct investment

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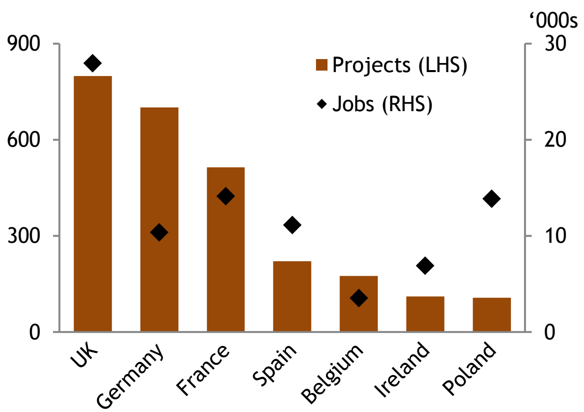
EU firms are invested across sectors in the UK
2013 data

Sector	EU FDI $m	EU share	Biggest EU investors
Retail, wholesale	66,443	62%	NE, DE, FR
Mining, quarrying	61,708	73%	n/a
Financial services	55,850	24%	NE, DE
ICT	39,190	34%	FR, DE, LU
Utilities	34,989	90%	n/a
Transportation	31,125	75%	DE, NE, ES
Food, beverages	23,555	41%	NE, FR, LU
Total	452,525	46%	NE, FR, DE

Source: ONS, GC calculations

The UK is currently very competitive
FDI projects and jobs secured in 2013



Source: EY

Many large European corporates are heavily invested in the UK and the commercial logic for this investment could be affected by Brexit. The cost of adjustment for European corporates could be considerable. The UK may seek to compete more aggressively for investment by undercutting the EU on taxation and the business environment.

- FDI in the UK from the EU comes disproportionately from a small number of host countries, including France, Germany, Spain and Ireland, although the picture is distorted by FDI routed through third countries, such as the Netherlands and Luxembourg. The EU share of FDI is much higher in the energy, retail and wholesale trade, transportation and manufacturing sectors than it is in financial and professional services.(5)

- The success of the UK in attracting FDI projects and jobs creates opportunities and risks for other EU countries if the UK leaves the EU. Whether they can seize the opportunity depends on how they respond to the loss of UK competitiveness that Brexit would likely represent. One particular challenge would be to attract European headquarters for multinationals away from the UK, but this will depend as much on the business environment in individual European countries.

- The UK would almost certainly seek ways to restore the competitiveness of the FDI offer. The UK might attempt to 'undercut' the EU further on social regulation and taxation, but probably not on environmental legislation. The risk to the EU is of the UK acting 'like Ireland' but over ten times bigger and largely liberated by the constraints and obligations of EM membership.

- This could impact in one of two ways in the rest of the EU. It could distort location choices and draw investment away from the rest of Europe over time. Or it could benefit firms elsewhere in the EU to the extent that it puts pressure on their governments to be more liberal and to take steps to improve the environment for investment.

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Liberalisation and regulation

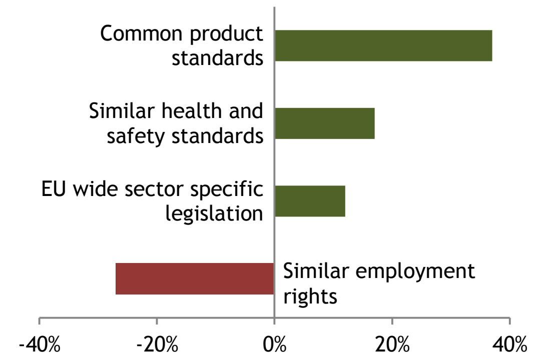
The UK has championed the single market, but outside the EU would no longer be an effective advocate of further liberalisation. UK critics often complain about EU regulatory excesses, but many regulations are intended to create the level playing field the single market requires. A paradox of UK euroscepticism is that following Brexit the UK would lose influence over EU regulation without gaining much freedom to regulate independently.

- One estimate suggests national regulation is 2.5 times more cost effective than EU regulation.(1) EU processes are criticised for being opaque and hard to influence, particularly for SMEs.(2) However, under most Brexit scenarios the UK must choose between adopting EU rules or being excluded from the single market. Neither the Norwegian nor Swiss models avoid this dilemma. Common regulations are necessary for the single market in goods and services, which is a UK priority. An FTA scenario is only marginally different. This would give the UK more flexibility to choose whether to adopt EU regulation, but as TTIP shows the biggest prize for modern FTAs is regulatory convergence.

- The public debate in the UK often fails to recognise the benefits from EU regulation. The 100 most expensive regulations cost the UK economy £27.4bn each year, whereas the benefits total £57.1bn, according to UK government impact assessments. Some individual regulations appear particularly costly, such as the Agency Workers Directive, which has a net cost of over £500m each year.(3) The figures are contestable as the benefits are hard to estimate and some of the costs are due to gold-plating of standards by the UK.(4)

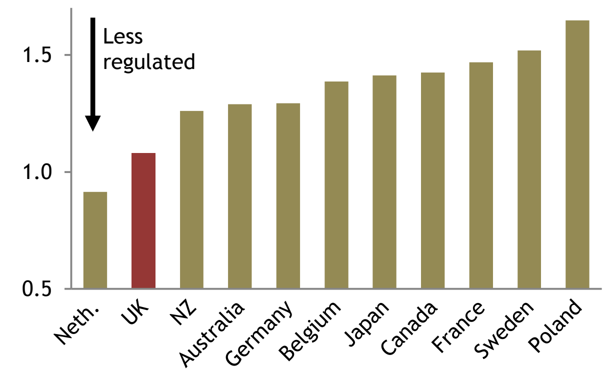
- The OECD regards the UK as the second least regulated product market after the Netherlands. Labour market regulation is comparable with the US, Canada and Australia and is much lower than other EU countries.(5) This suggests there is no conflict between EU regulations and a highly-liberal market economy. Moreover, the OECD observes that one of the most heavily regulated areas in the UK - and one of the most damaging for productivity - is the system for obtaining planning permission, which has nothing to do with the EU.

Business views on EU regulation are mixed
Balance of CBI members who say the impact is positive



Source: CBI/YouGov (June-July 2013)

UK product market are less regulated
Economy wide indicator of product market regulation



Source: OECD

Liberalisation and regulation

The challenge of forming a blocking minority

Votes shares by member states, with the UK in or out

UK in	Member state	UK out
13%	UK	-
3.3%	Netherlands	3.8%
2.1%	Czech Rep.	2.4%
1.9%	Sweden	2.2%
1.1%	Denmark	1.3%
1.1%	Finland	1.2%
1.1%	Slovakia	1.2%
0.9%	Ireland	1.0%
0.6%	Lithuania	0.7%
0.4%	Latvia	0.5%
0.3%	Estonia	0.3%
16%	Germany	18%
13%	France	15%
12%	Italy	14%
9.2%	Spain	10%
7.6%	Poland	8.7%
3.9%	Romania	4.5%
2.2%	Belgium	2.5%
2.2%	Greece	2.5%
2.1%	Portugal	2.4%
1.9%	Hungary	2.2%
1.7%	Austria	1.9%
1.4%	Bulgaria	1.6%
0.8%	Croatia	1.0%
0.4%	Slovenia	0.5%
0.2%	Cyprus	0.2%
0.1%	Luxembourg	0.1%
0.1%	Malta	0.1%

UK in: Liberal bloc & Germany = 41%; Liberal bloc = 25%

UK out: Liberal bloc = 15%; Liberal bloc & Germany = 33%

A blocking minority requires 35% of the vote

Source: Eurostat, GC calculations

After Brexit the balance in the European Council on economic policy debates would shift, with the loss of a large member state supporting liberalisation. Germany, in particular, would find it harder to assemble a blocking minority or to act as the swing state in regulatory debates. Germany would become more exposed politically, by having to lead opposition to illiberal measures.

- The UK is one of the most economically liberal states and along with the Nordics, the Netherlands, and Ireland can be relied upon to oppose illiberal proposals in the Council. Under the voting rules introduced in 2014 the liberal states can typically secure about 25% of the votes. If Germany votes with the liberal states this provides enough votes to achieve a 35% blocking minority. This puts Germany in a powerful position as a swing voter in the Council.

- If the UK leaves the EU this will shift the balance of power in the Council away from the liberalisers, who will find it harder to assemble a blocking minority, even with German support. The combined votes of Germany plus the ten most liberal states would by itself be insufficient to achieve the necessary 35% of votes. It can be argued, however, that traditional divides in the Council are becoming blurred, with states like Spain becoming more liberal.

- Germany often values having the UK to counterbalance France in regulatory debates. This allows Germany to position itself at the centre of policy debates as a voice of reason that is seeking collaborative outcomes. Germany would be much more exposed and sometimes forced to take a more adversarial position without the UK.

- The UK has also played a significant role of shaping policy debates in the EU in ways that matter irrespective of the UK's voting weight. The UK has on several occasions used its clout to frame a policy debate in liberalising terms. This has been evident in major, set-piece liberalising initiatives, such as the services directive, and also in specific pieces of regulation, such as the REACH for the chemicals sector.

Industrial policy

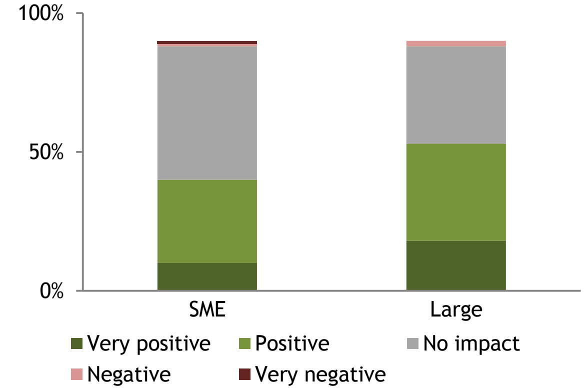
Impact on the United Kingdom

UK industry benefits from research collaboration in Europe and researchers have done well in EU competitions. While the UK would gain flexibility over industrial policy outside the EU it would lose the benefits from scale and influence over policy in areas such as energy.

- The UK receives more funding from the European Research Council than any other country and 50% more than Germany, allowing UK universities to fund more than 10% of project-based research from EU contributions.[(1)] Ten of the top twenty universities in the FP7 programme are in the UK, including the top three.[(2)] UK researchers benefit from the pan-European collaboration encouraged by programmes like Horizon 2020. 49% of CBI members say access to EU research funding helps their business.[(3)] The automotive, aerospace, pharmaceuticals, and chemicals sectors are among the beneficiaries.
- In early 2014 restrictions were placed on Swiss researchers accessing European Research Council grants following a dispute with the EU over free movement of persons. While the UK would most likely access science funding outside the EU, the Swiss experience shows this cannot be taken for granted. The UK is also likely to have less influence over research priorities following Brexit.
- The UK would gain leeway to run a more active industrial policy unconstrained by EU state aid rules under some models. This might include reinstating a public interest test for takeovers, or introducing more comprehensive R&D tax credits. State aid rules have constrained UK policy in several areas including investment in Hinckley Point, renewables support schemes and the British Business Bank. The UK would, however, still be bound by WTO rules and even an FTA-based approach would impose disciplines in this area.
- The UK would also remain subject to the Third Energy Package if British firms continue to trade energy into the EU. This would limit the scope for vertical integration in the UK energy sector. The UK would lose influence over this policy area, including the development of any fourth package in future.

Business values access to EU funding streams

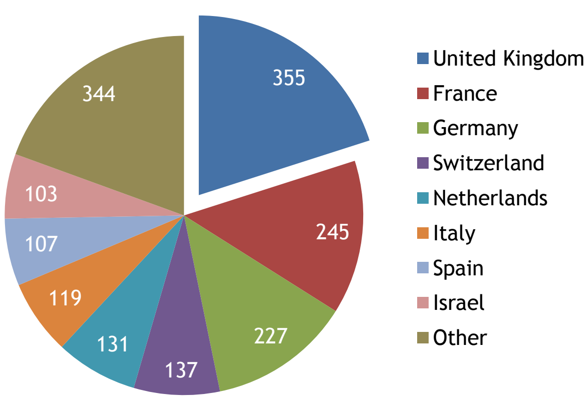
Impact of sector-specific aid, EIB funds, research support



Source: CBI/YouGov (June-July 2013)

UK-based researchers have done well

ERC grants by host country, 2007 to 2010

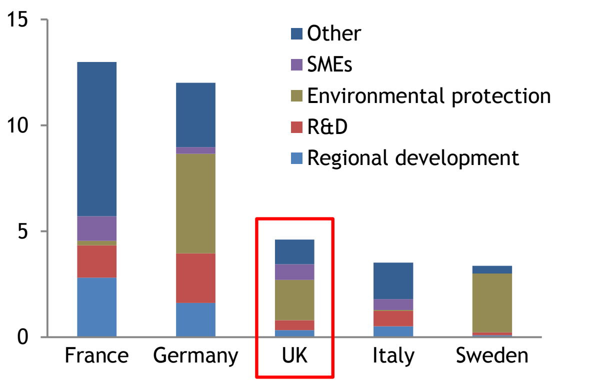


Source: European Commission

Industrial policy

The UK is relatively restrained on state aid

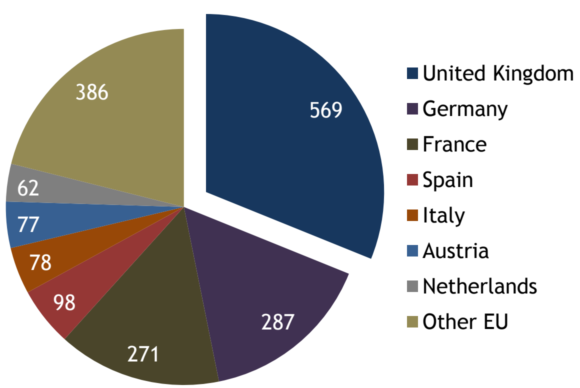
Non-crisis state aid in 2013 (€bn)



Source: Eurostat

The UK is a draw for foreign students

International student populations in 2012 (thousands)



Source: Eurostat

The impact on industrial policy in the EU depends on the Brexit model, but we may see a weakening of competition policy, looser collaboration in education and research, and fewer EU students in the UK. The UK government may intervene more in high-profile and politically sensitive procurements.

- Business would need to bear the cost of mergers being separately reviewed by the UK and EU authorities.[4] The application of EU competition policy may change with the UK no longer playing an influential role in the European Competition Network. While the UK has advocated the principle of undistorted competition within the EU, the UK may seek to exploit its freedom from the constraints of state aid policy under some Brexit models.
- The UK may adopt a different approach to procurement following Brexit with government discretion being used more freely, particularly when under political pressure. The potential is evident from the controversy surrounding the Thameslink competition between Bombardier and Siemens.
- The UK was an important influence on the 2030 targets for emissions reduction, calling for tighter targets, while successfully fighting off calls for additional binding targets for renewables and energy efficiency. This would have added to the cost to business of meeting the emissions targets.
- UK influence over the culture and style of regulation in key sectors, including the utilities, would be likely to diminish following Brexit. UK bodies such as Ofcom, Ofgem, Ofwat and the Intellectual Property Office have provided a model for similar bodies in several EU states.
- Access to UK universities could become more difficult for publicly-funded students, who benefit from the Erasmus programme, and privately-funded students, given the risk that the UK tightens migration controls. Science collaboration could suffer following Brexit, with friction between the EU and the European Space Agency potentially complicating projects like Galileo.

Immigration

Global Counsel

Impact on the United Kingdom

Immigration is a fraught political issue in the UK both because the costs and benefits are not distributed evenly and as perceptions have become disconnected with reality, partly due to hostile media coverage. The scope to tighten immigration depends on the Brexit model. This risks damaging competitiveness, particularly of London, and being economically costly.

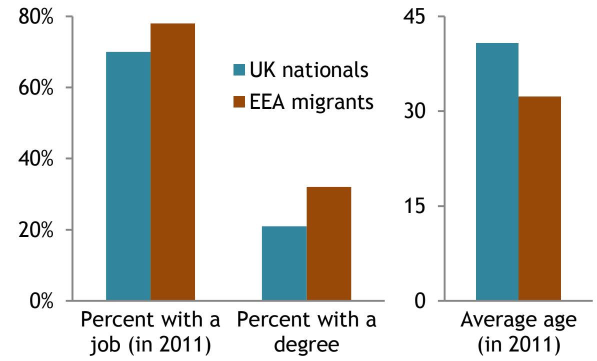
- Immigration helps address skills shortages and the consequences of an aging population. Free movement allows UK firms access to specialist skill that are increasingly important to high-value added industries. 63% of CBI members say free movement has benefitted their business.(1) It is estimated that 1.5m new jobs will be created in higher-skilled jobs popular with EU15 migrants by 2022. Few new lower-skilled jobs will be created, but there will be a high demand for labour to replace retirees in these areas.(2)

- According to the OECD migrants are more likely to be net contributors to public finances if they are younger, in work and skilled. The evidence suggests that on average EU migrants make a net contribution to public finances and the OBR estimates the net contribution will be large in future.(3) However, A8 migrants will increasingly have families and put pressure on education spending. They also exacerbate the shortage of affordable housing. On average migrants have contributed 34% more in fiscal terms to the UK than they have taken out, or £22.1bn in total in 2011 terms.(4)

- If the UK adopts the Norwegian or Swiss models the UK would still need to sign up to the free movement of labour. Under the other models the government could choose to align EU immigration with the non-EU points system. Tier 1 (highly skilled, entrepreneurs) and Tier 2 (skilled, graduate) immigration quotas would need to be raised significantly if the flow of immigration in these categories is not to be seriously disrupted.(5) Tier 3 (unskilled) quotas are currently closed. The impact of immigration restrictions will be felt disproportionately in London and impact on the competitiveness of businesses located there.

Immigrants are young, educated and employed

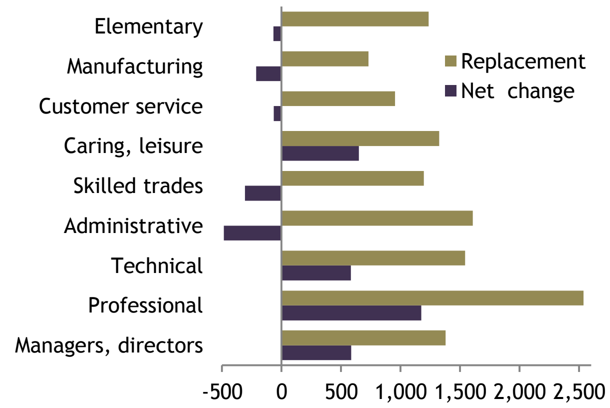
Profile of EEA immigrants to the UK



Source: Dustmann and Frattini (2013)

Future job growth varies across skill segments

Job creation and replacement, 2012 to 2022

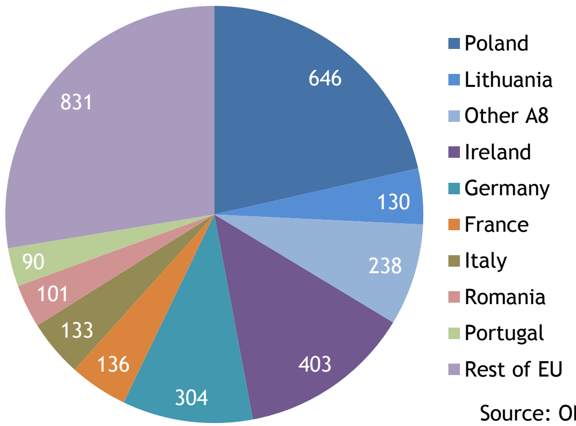


Source: UK Commission for Employment and Skills

Immigration

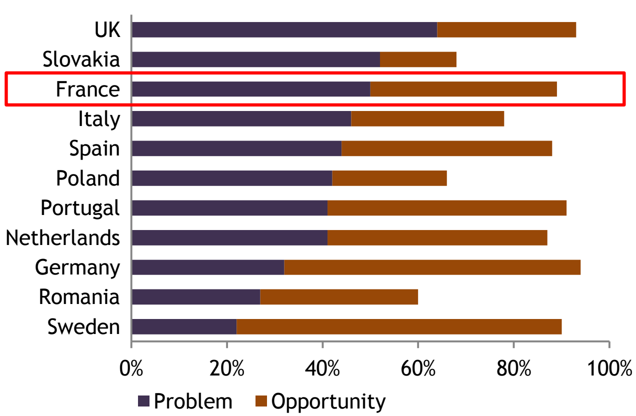
Impact on the European Union

Poland is a major source of UK immigrants
EU immigrants to the UK by country of birth



Source: ONS

Immigration concerns are high in other states
Attitudes on immigration as opportunity or problem



Source: Ipsos MORI, 2013

Businesses operating elsewhere in Europe can largely work around any restrictions on the free movement of labour imposed by the UK. However, changes to the labour supply and the flow of remittances will impact on some countries. Perhaps the biggest risk, but the hardest to predict, is of 'political contagion' elsewhere in Europe if the UK tightens border controls.

- The biggest costs from UK controls will be borne by EU firms invested in the UK as operations based outside the UK can always substitute for UK labour. There is no limit to inter-company transfers under Tier 2 for salaries above £40k.(6) This would reduce the negative impact on EU firms invested in the UK.

- There would be a significant effect on countries that are major sources of immigration to the UK, such as Poland. It would impact positively on skills and the supply of labour, but negatively on remittances. There could be an indirect impact on other countries, such as Germany, if UK immigration is 'deflected' there. The economic consequences will depend on the scale and composition, but are likely to be net positive if unevenly distributed.

- There may be fiscal benefits for some countries if the rules on entitlement to public services are changed for UK immigrants in other member states. These benefits would be concentrated in countries, like Spain, that are home to a large number of British retirees. But these countries also benefit from the pension payments remitted to British residents from the UK.

- The biggest risk for the rest of the EU is that UK restrictions increase hostility towards immigration in other states, both because of deflected immigration and how UK policies impact on the policy debate elsewhere. Polling shows concerns are already high in several states. Immigration will be a factor in the French presidential election in 2017, where there might be pressure to follow UK immigration controls. However, there is one important difference between the UK and other member states. In the UK the contentious issue is intra-EU immigration, whereas elsewhere it is mostly extra-EU immigration.

Financial services

Impact on the United Kingdom

Established advantages and agglomeration effects mean the UK has a strong competitive edge that would be hard to dislodge. However, existing EU regulations would make it harder for London to serve European markets, particularly for retail products and in euro trading. Business could move.

- Under the Swiss or FTA models the UK must negotiate access to EU markets in financial services. The EU only allows access to countries with equivalent regulations. The approach currently varies across directives. No access is allowed in some areas, such as UCITS (undertakings for collective investment in transferable securities). The logic is that retail consumers need additional protection. By contrast, the EU takes a flexible approach to wholesale banking, where equivalence is defined largely by reference to international standards. This matters for the UK given its dominance in wholesale banking. In many other directives the EU takes an intermediate approach. For example, the EU evaluates the equivalence of insurance regulation 'line-by-line' under Solvency II, although the impact is softened by transitional arrangements.

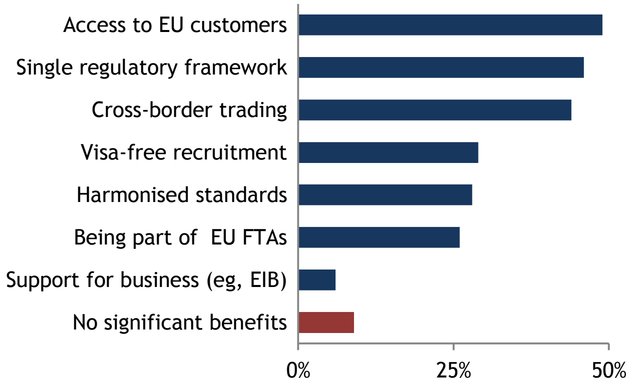
- The Swiss experience highlights the risks to the UK. They have equivalence under AIFMD, are being assessed under Solvency II and will try under MIFID. But they have failed under EMIR, ostensibly due to capital requirements, but with a suspicion that the real problem is Swiss immigration policy.

- The UK is the leader in euro-denominated wholesale banking, but Eurozone countries and institutions want this activity to move to the Eurozone and be overseen by the ECB. This would be much more likely following Brexit, as the UK would no longer be protected by ECJ enforcement of single market rules. The UK might also suffer an opportunity cost from being absent from future liberalising initiatives such as Capital Markets Union, which could open up new markets in areas such as securitisation and covered bonds.

- The impact in the UK would be felt beyond London in financial centres such as Edinburgh, Leeds and Glasgow, as well as in the Crown dependencies.

Financial sector firms value EU membership

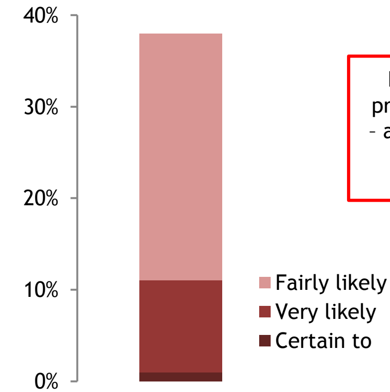
The benefits according to TheCityUK members



Source: Ipsos MORI (August-October 2013)

Jobs could move

Likelihood of relocating jobs if the UK leaves the single market



Financial services provides 3.9% of jobs - almost 1.2 million - and 7.9% of GDP in the UK [1]

Source: Ipsos MORI (August-October 2013)

Financial services

Global Counsel

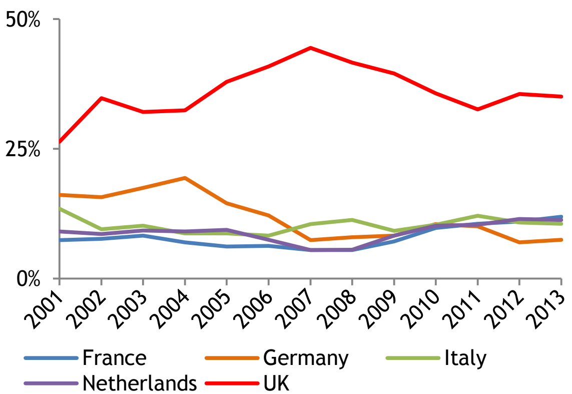
The UK leads in most financial services
International market share by country

	UK	FR	DE
Cross-border bank lending	17%	9%	9%
Foreign exchange turnover	41%	3%	2%
Exchange-trade derivatives	7%	---	8%
Interest rate OTC derivatives	49%	7%	4%
Hedge funds assets	18%	1%	---
PE investment value	10%	5%	2%
Fund management	8%	3%	2%
Marine insurance	22%	4%	5%

Note: various time periods in 2012 and 2013

Source: TheCityUK

UK dominates wholesale financial services
Share of EU wholesale financial services GVA



Source: London Economics, Eurostat

Brexit may impact on the location, liquidity and cost of financial services in Europe if it undermines London's competitive position. This would be costly for businesses and households across Europe. Most large European banks have major operations in London which would be costly to relocate. Only a small number of financial centres elsewhere may benefit.

- The UK is highly integrated into the European financial system. Total UK claims on the EU15 alone are $880bn with most of the credit to households and firms, but some also to governments and interbank lending. European bank exposure to the UK is even greater at $1.7tn in total.(2) It would be costly for European banks to relocate wholesale banking activity away from London.

- London is not just a European financial centre – it is an international centre with a dominant position in many product areas. However, London's international position could be damaged if large amounts of European business migrate following Brexit. There is a risk that some business, particularly more mobile activity such as derivatives, may leave Europe altogether.

- The most likely beneficiaries in the EU are Paris, Frankfurt, Amsterdam and Dublin. But they cannot replicate overnight the advantages of the London 'ecosystem' supporting financial services, including skilled staff, legal services and market infrastructure. Competition between them borne out of new barriers to trade with London would be disruptive and costly. Businesses in Europe would lose due to higher charges, poorer products and less liquidity. European corporates would, for example, find it more inconvenient and costly to raise capital in London, which currently provides a one-stop shop.

- Brexit would likely change the balance of financial regulatory debates in Europe. The UK now takes a more interventionist and risk-averse approach to regulation. Even so, the UK largely avoids politically-motivated interventions. Initiatives such as the Financial Transactions Tax and the cap on banker bonuses would have found an easier passage in an EU without the UK.

Trade policy

Impact on the United Kingdom

The UK would be free to set its own trade policy priorities under some Brexit models, but these are unlikely to be much different from the EU's. The UK would have less leverage and be a lower priority trade partner than the EU for the major economies. The UK would lose the strength in numbers at the WTO when settling disputes with countries like China.

- The EU has considerable experience negotiating deep and comprehensive trade agreements. The EU is a signatory to over 30 bilateral and regional agreements with over 50 partners. The EU is currently negotiating trade deals with the US, Canada and Japan, which would improve access to markets worth \$23tn in total. The EU is negotiating an investment agreement with China.(1)

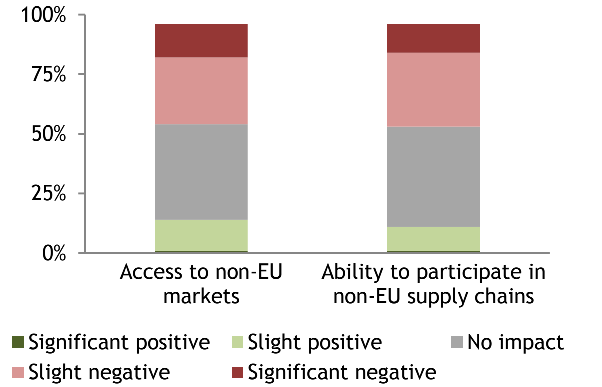
- The UK would gain flexibility in negotiating trade deals and in particular be less encumbered by agricultural protectionism. However, economic size matters given trade negotiations are increasingly bilateral or regional, rather than multilateral. The UK gains leverage when addressing irritants or concluding FTAs through the EU. This is particularly important in services, where regulatory obstacles often need resolving to gain meaningful access to markets. Evidence from UK business suggests the UK benefits from the EU's negotiating weight when concluding bilateral deals on intellectual property.(2)

- If the focus ever shifts back to the WTO the UK will find it no longer has influence at the top table. Moreover, the UK may find itself more exposed when seeking to settle disputes at the WTO. While many cases are technical some can take on a political dimensions and provoke retaliation.

- The UK would have to renegotiate EU trade agreements as these would not automatically apply. This would require considerable diplomatic effort before the UK could turn to new deals. The eurosceptic vision of an 'Anglosphere' trading bloc is overblown. The EU is already negotiating with the US and Canada. Moreover, the UK would not find it easier to close a deal with India, particularly given concerns over mode IV and migration.

Accessing markets will be harder after Brexit

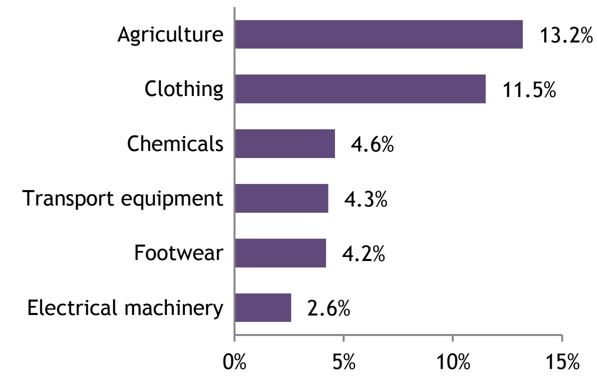
Business opinion on the impact of Brexit on market access



Source: CBI/YouGov (June-July 2013)

There is room to cut duties

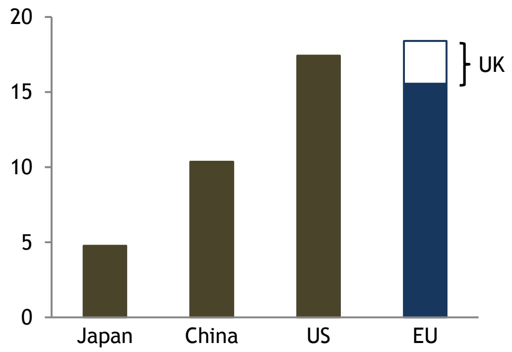
Average MFN duties applied by the EU by tariff line



Source: WTO

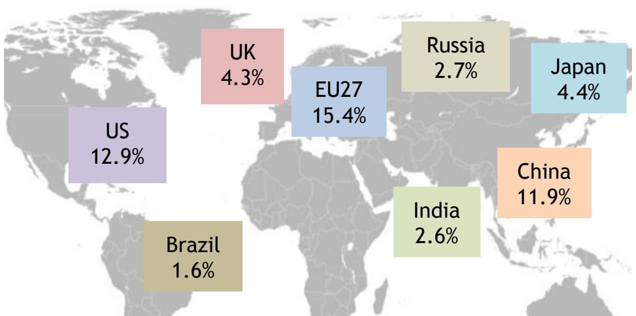
Trade policy

The EU would remain a large economic bloc
Nominal GDP in 2014, $trillion



Source: IMF WEO

The EU would be a diminished trade bloc
Share of global trade by country/bloc, 2013



Note: (1) the UK figure includes EU27 trade while the EU27 figure excludes intra-EU27 trade; (2) these figures have been corrected following an error in a previous version.

Source: World Bank , Eurostat, GC calculations

The EU has an open, liberalising approach to trade policy, in part due to UK influence. The UK, more than any other state, has put top-level political weight behind trade negotiations. The EU would be a less attractive partner for trade agreements if the UK was no longer part of the deal.

- The EU's top trade priorities are the Transatlantic Trade and Investment Partnership (TTIP) with the US and the Economic Partnership Agreement with Japan. But the EU is not the top trade priority for either the US or Japan, who are preoccupied with negotiating the Trans-Pacific Partnership (TPP).
- EU GDP would be around 15 percent lower without the UK.[3] While the EU will remain an attractive trade partner, its appeal will be reduced. The external trade of the EU 27 would be about 15% of the global total compared to 4.3% for the UK. [4]
- The UK has championed a liberalising agenda for the EU. The UK was one of the strongest advocates for launching TTIP and wants an investment agreement with China to lead to a full FTA negotiation. The UK was also the strongest supporter of the Doha round. Successive UK Prime Ministers have invested political capital in the completion of trade deals.
- The EU may, however, turn out to be a tougher negotiating partner that is better able to extract a good deal without the UK. This is arguably most true with China, where the UK has been criticized for rushing to launch negotiations, without obtaining prior commitments. The UK has also used trade as part of its development policy.
- The UK leaving the EU may shift the balance in favour of more active use of trade remedies. While some industries would welcome this and regard trade remedies as a legitimate means to counter unfair competition, this would disadvantage consumers and firms that rely on imported intermediates, particularly from emerging markets. It also risks a protectionist response.

International influence

Global Counsel

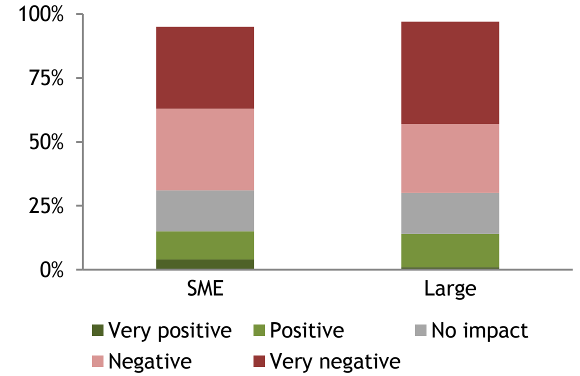
Impact on the United Kingdom

The UK currently enjoys considerable influence both in and through the EU. This would be diminished if the UK leaves the EU. There are, however, risks to the UK's influence even if the UK stays inside the EU. This is both because of a generational change of staff in key institutions and the risk that the Eurozone caucuses against the UK.

- The UK's formal influence comes from the power of veto, albeit in a diminishing number of policy areas, and voting power in both the Council and the European Parliament. The informal influence comes in the Commission and by forming alliances with other states. The UK has shaped the EU agenda in a number of areas and has rarely been isolated, although this is now more common. 74% of British firms believe the UK can continue to be influential.(1)
- The number of Brits in the European Commission is declining and there is likely to be a serious shortfall in coming years once the current generation nearing retirement leaves. The UK's technical expertise in certain policy areas and economic heft in others, such as financial services, is also a source of influence, as is the position of the UK in many international institutions such as the G20 and the UNSC.
- The combined voting strength of Eurozone countries is sufficient to prevent a blocking minority under QMV. In theory, this means the Eurozone could impose changes on other EU members. Double majority safeguards have helped assuage concerns about caucusing against the UK in banking. The UK would not enjoy the same protection outside the EU.
- The UK may lose influence in international fora, such as the UNFCCC, where collaboration among EU states has helped the UK influence international negotiations. The UK may also find its diplomatic heft is reduced. While the UK would remain a significant military partner for the US, it may be less able to leverage this to pursue broader international objectives and would often no longer be the European partner of choice on non-military matters.

Business fears the impact on UK influence

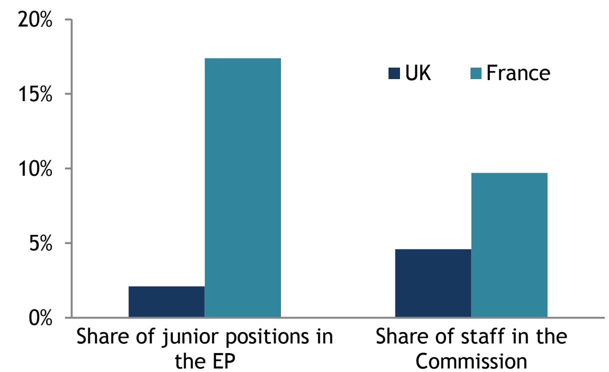
Impact of Brexit on UK influence over policies affecting you



Source: CBI/YouGov (June-July 2013)

UK influence in EU institutions is weakening

Proportion of UK nationals in key institutions

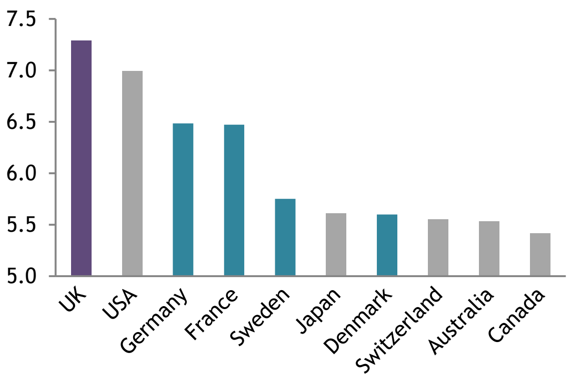


Source: CBI

International influence

Global Counsel

The UK is a soft power asset for the EU
Index of soft power



Source: IfG-Monocle Soft Power Index, 2012

Britain remains a big military spender
Military spending in 2013

Rank		Country	$bn	%GDP
1		United States	600	3.7
2		China	122	1.2
3		Russia	68	3.1
4		Saudi Arabia	60	8.0
5		United Kingdom	57	2.4
6		France	52	1.9
7		Japan	51	1.0
8		Germany	44	1.2

Source: International Institute for Strategic Studies

The EU would lose clout in foreign policy and military terms, with the loss of one of top two European powers, alongside France, that is a permanent member of the UN Security Council.

- Soft power is the ability of a state to change the behaviour of others through the means of attraction and persuasion, rather than coercion or payment. The primary sources of soft power are culture, political values and diplomacy. The UK consistently ranks highly in international surveys of soft power and this is a source of influence for the EU. If the UK leaves the EU, this will not only diminish the bloc's soft power assets, but also damage perceptions – and hence the soft power - of the EU itself.

- The UK also has hard power assets – military, financial and foreign policy – which provide an additional source of influence. The UK is the fifth biggest military spender and the second largest source of development funding at $18bn per year, behind only to the US.[(2)] It is debatable how much the rest of the EU benefits from this. However, the rest of the EU most likely benefits from the UK position in international institutions, including the G8, the G20, the IMF, the World Bank, the OECD, IEA, the UNSC, the FSB, and the UNFCCC. In Europe this is matched only by France. The UK also gives the EU more leverage when applying sanctions, particularly in the financial sector.

- If the UK leaves the EU it is likely that Germany, in particular, will come under pressure to play a bigger role in the Common Foreign and Security Policy. Germany is already playing a leading role in the EU's diplomacy with Russia, but this is the exception rather than the rule. It is, however, possible that Brexit may lead to greater political integration and more coherent external representation in international institutions and on external policy.

- Steps by the UK and France to increase joint defence procurement could be at risk if the UK seeks to collaborate more with the US, given US security concerns. This may have broader implications for the defence industry.

Budget

Impact on the United Kingdom

The direct financial cost of EU membership is relatively easy to quantify. However, the financial benefit from leaving the EU depends on the Brexit model and the outcome of the negotiation between the UK and the rest of the EU. There would be significant variation in the impact across the UK, with some parts gaining, while others lose.

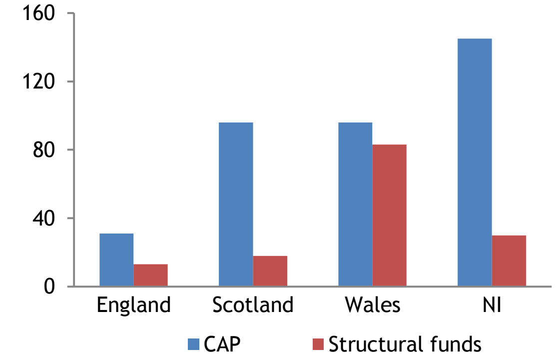
- The OBR estimates the UK's annual net contribution to the EU will be between £8.5bn and £9.5bn from now to 2019, which is equivalent to around 0.5-0.6% of GDP.(1) However, the EU requires budget contributions from countries like Norway and Switzerland. If the UK's net budget contribution is calculated on a similar basis to Norway it would fall by just 9%. If calculated on a similar basis to Switzerland it would fall by 55%.(2) The UK's position in a negotiation may be complicated by the loss of the rebate, which reduces the net contribution to the EU by almost a quarter.(3)

- The aggregate figures mask considerable variation across the different parts of the UK. Two of the largest components of EU spending are agricultural and regional structural funds. Receipts per capita are much higher in Scotland, Wales and Northern Ireland than they are in England. Moreover, within all parts of the UK the benefits are concentrated in agricultural areas and poorer communities. The UK would need to choose whether to substitute in full or in part for this funding. The UK would have more flexibility to determine how this funding is allocated as well as its level. The UK government is, however, likely to come under political pressure to compensate those that lose out, particularly as this might impact on the continuing debates about devolution and independence within the UK.

- The UK would still need to cooperate with the EU on VAT collection. This cannot be entirely separated from the question of the EU budget, as a proportion of VAT revenues directly fund EU spending.

EU spending varies across the UK

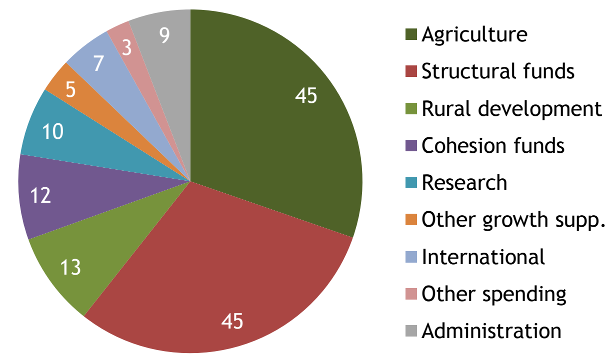
Spending per capita, 2014-20



Source: CER

EU spending priorities do not match the UK's

EU budget, €bn, 2013

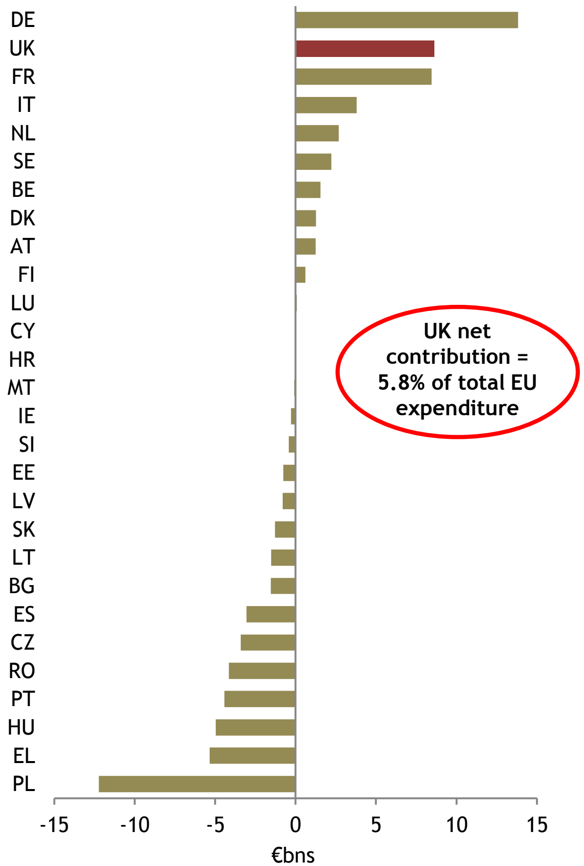


Source: European Commission

Budget

Global Counsel

The UK is the second biggest net contributor
Net operating budgetary contribution, 2013



Note: The UK figure takes account of the rebate

Source: European Commission

The EU would lose a significant net contributor to the EU budget. This gap would need to be filled either by higher contributions from other states or less spending. There would likely be a shift towards support for higher spending in the European Council, with the loss of a budget disciplinarian, and weaker support for continuing efforts to shift spending towards supporting growth.

- The UK is currently the second largest net contributor to the operating budget of the EU in absolute terms, behind Germany, and the fourth largest as a percent of GNI, behind Sweden, Denmark and Germany.[(4)] This is after taking account of the UK's controversial budget rebate.

- The extent to which the UK's net contribution falls outside the EU will depend on the UK's relationship with the EU and the outcome of financial negotiations. The EU would need to either cut spending or increase contributions by other member states, up to a maximum of 5.8% of current levels, in order to make up the difference.

- The UK strongly opposed higher spending during the last round of budget negotiations. If the UK left the EU other countries would need to step up their pressure to maintain budget discipline, or accept higher spending and the increased contributions that go with it. The balance of the debate is likely shift towards French, southern and Eastern priorities with Germany and the Netherlands, in particular, losing an ally in budget decisions.

- The UK has also championed the reallocation of spending away from administration and supporting agriculture, towards programmes that support innovation and growth, including R&D. That was only partially successful in the last budget round. It would be even harder to move the EU in this direction in the next round, without the UK among those making the case at the negotiating table.

Uncertainty

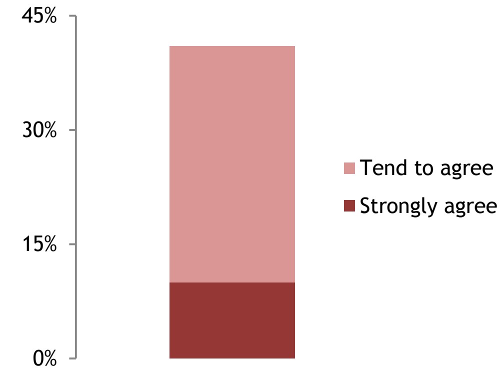
Impact on the United Kingdom

Brexit would be a protracted process, lasting around ten years. The endpoint for the UK-EU relationship would be subject to a negotiation. Business would face high and increasing levels of uncertainty during this process, impacting on investment decisions and with macroeconomic consequences.

- The referendum will be held in 2016 or 2017 following a renegotiation of the terms of the UK's membership. The outcome is uncertain because the outcome of the renegotiation is uncertain and plebiscites can often end up being about something else, particularly if the government loses popularity.
- Business surveys show that political stability is one of the most important factors in making the UK an attractive investment location.(1) Businesses are already concerned that referendum uncertainty is affecting their decisions.(2) A referendum could reduce UK GDP growth by 0.4pp in 2016 and by 0.5-0.7pp in 2017 by one estimate.(3) However, a vote to exit would by no means end the uncertainty given the need for a further negotiation.
- Under the 'exit clause' in Article 50 of the EU Treaty the leaving state and the EU have two years to negotiate a 'withdrawal agreement' that sets out the timeline and details of the divorce. EU decisions on the withdrawal terms would be taken by QMV. The European Parliament would have the final say, reducing the UK's leverage in a negotiation. If both parties are unable to agree the terms of a withdrawal then after a two-year notice period the leaving state is no longer bound by the treaties and the rest of the EU no longer has obligations to the leaving state under the treaties.
- The uncertainty for the UK would be exacerbated under a Swiss model, given the considerable time it would take to negotiate individual accords to ensure on-going market access in different sectors. This would be damaging for both investors and exporters. There would be further uncertainty under most Brexit models as, for example, the UK would need to renegotiate FTAs.

Uncertainty is impacting on business

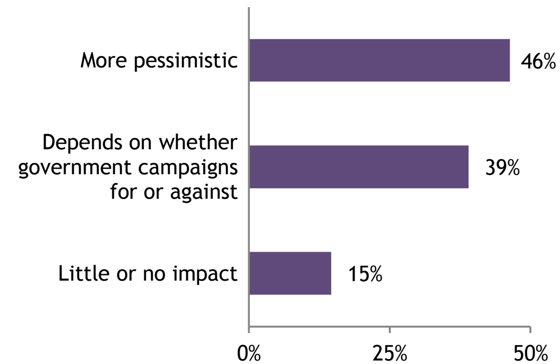
Referendum uncertainty is affecting business decisions



Source: Ipsos MORI (August-October 2013)

Economists worry about a referendum

Impact on UK economic forecasts of calling a referendum

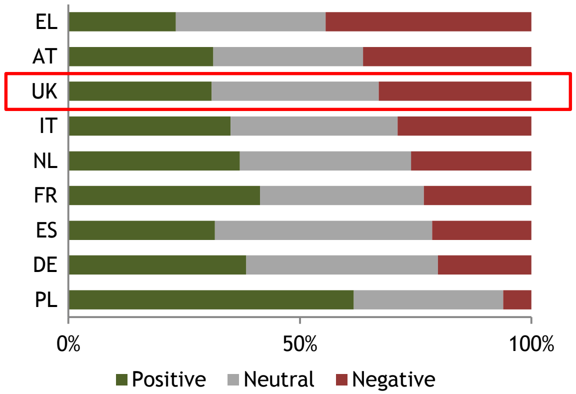


Source: FT economists' survey, 2015

Uncertainty

A wider perception problem?

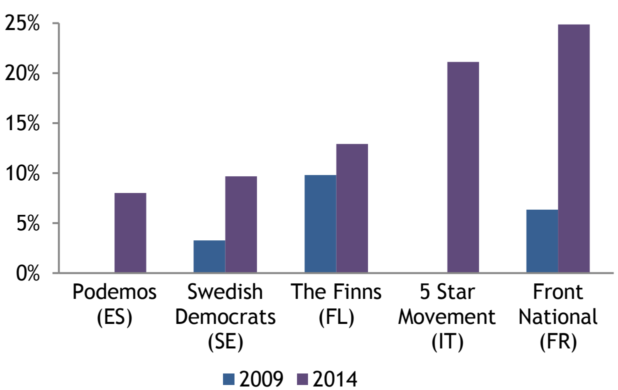
Does the EU conjure up a positive or negative image?



Source: EU Barometer, autumn 2014

Growing support for disintegrative forces

Share of vote in EP elections



Brexit could create an extended period of uncertainty that damages confidence and the appetite for both domestic and inward investment in the rest of the EU. But perhaps the biggest risk is political contagion from the ‘proof of concept’ of leaving the EU, with Brexit encouraging disintegrative political forces elsewhere in Europe.

- A protracted renegotiation, followed by a vote to exit in a UK referendum and the negotiation of a withdrawal agreement under Article 50, leading to a radically redefined relationship between the UK and the EU, would dominate the attention of the European institutions and, for significant periods of time, political leaders in Europe, distracting them from other priorities.

- The uncertainty that would impact on the UK would also impact on the rest of the EU, even if not to the same extent. But with confidence low, and growth prospects weak, the effect may may nonetheless be significant.

- Uncertainty over Brexit could have a particular impact on EU trade policy. It would be much harder to conclude a deal on, for example, TTIP, if the US is unsure who the other party to the agreement will be. It may greatly complicate other important policy areas, such as financial services, which is overseen by a Commissioner who was nominated by the UK.

- Brexit may have broader political implications. The EU might be strengthened with the departure of a sometimes awkward member. But European leaders may also worry about political contagion – Brexit could liberate centrifugal forces in the EU, particularly if the UK leaves on favourable terms or succeeds outside the EU. This is arguably the biggest risk to the rest of the EU.

- This may mean the EU has an incentive to raise the cost of exit by refusing to negotiate a special deal for the UK, or by excluding the UK from parts of the single market. The latter, particularly if it is politically motivated, would raise the direct economic costs of Brexit for the EU and the associated uncertainty.

The exposure of member states

Who is most exposed?

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Brexit will impact on member states through some channels, such as international influence, to largely uniform extent. For others the impact will vary depending on connectedness with the UK, alignment with UK policy objectives, or underlying vulnerability to shocks. The extent of exposure is revealing not only about the risks to member states, but also how much they have invested in keeping the UK in the EU.

High exposure	Three countries stand out for having the highest exposure – the Netherlands, Ireland and Cyprus. Ireland is no surprise, given its proximity to the UK. The Netherlands and Cyprus, like Ireland, share very strong trade, investment and financial links with the UK. These countries also tend to be closely aligned with the UK in terms of regulatory and trade policy objectives.
Significant exposure	Several countries have a significant exposure including Germany, Belgium and Sweden. Germany is in the middle of the pack across most metrics, suggesting Berlin will not only be influential, but also a good gauge of the wider EU interest in preventing Brexit. Sweden is particularly vulnerable due to a close policy alignment with the UK, while Belgium has close trade links.
Niche exposure	France and Poland are among a group of countries that are more exposed to Brexit in specific areas. In the case of France mid-level trade, investment and financial linkages are balanced by often conflicting policy objectives with the UK. Poland is most exposed through migration and the EU budget.
Low exposure	Italy is among a small group of states in the south-east of the EU with little direct exposure to Brexit. This reflects their distance and different political cultures, which means there is less alignment of policy interests. Italy in particular may be indirectly affected by the impact of Brexit on political dynamics in the EU.

States ranked by exposure to Brexit
Score based on multiple metrics (see next page)

Rank	Country	Score
1	Netherlands	28
2	Ireland	25
3	Cyprus	23
4	Portugal	17
5=	Greece	16
5=	Malta	16
7	Sweden	16
8	Denmark	15
9	Czech Republic	14
10=	Belgium	13
10=	Latvia	13
10=	Lithuania	13
13	Germany	13
14	Luxembourg	12
15=	Slovakia	12
15=	Spain	12
17	Finland	11
18=	Estonia	9
18=	France	9
18=	Hungary	9
21	Poland	8
22	Bulgaria	7
23	Austria	7
24	Romania	5
25	Italy	5
26=	Croatia	4
26=	Slovenia	4

Exposure metrics

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	Exports to the UK % of GDP, 2013	FDI stock in the UK % of GDP, 2013	Regulatory policy alignment subjective	Residents in the UK % popln, 2013	UK bank links[a] % of GDP, 2014	Trade liberalising alignment subjective	Net budget contribtn. % of GNI, 2013	Output gap % potential, 2015	EU perception % negative, 2014	Overall Score[b]
Austria	1.3%	0.8%	No	0.2%	6%	Swing	0.4%	-1.1%	36%	7
Belgium	6.8%	4.9%	No	0.1%	21%	Swing	0.4%	-1.2%	22%	13
Bulgaria	1.9%	0.0%	No	0.7%	8%	Swing	-3.9%		18%	7
Croatia	1.2%	0.0%	No		6%	Swing	-0.1%		19%	4
Cyprus	7.1%	23.0%	No	4.0%	77%	Swing	-0.2%	-2.8%	38%	23
Czech Rep.	3.9%	0.0%	Swing	0.4%	3%	Swing	-2.4%		22%	14
Denmark	3.2%	1.9%	Yes	0.4%	12%	Yes	0.5%	-1.2%	18%	15
Estonia	1.5%	0.0%	Swing		1%	Swing	-4.3%	-0.6%	7%	9
Finland	1.8%	0.8%	Swing		16%	Swing	0.3%	-3.2%	17%	11
France	2.0%	4.3%	No	0.2%	25%	No	0.4%	-2.8%	23%	9
Germany	2.8%	2.4%	Swing	0.2%	19%	Swing	0.5%	0.0%	20%	13
Greece	1.7%	0.3%	No	0.4%	24%	Swing	-2.9%	-6.7%	44%	16
Hungary	3.7%	0.4%	No	0.7%	4%	Swing	-5.3%	0.0%	18%	9
Ireland	11.8%	7.5%	Yes	7.1%	174%	Swing	-0.2%	-1.4%	16%	25
Italy	1.4%	0.6%	No	0.2%	10%	No	0.2%	-4.2%	28%	5
Latvia	3.6%	0.0%	Swing	4.4%	3%	Swing	-3.4%		11%	13
Lithuania	3.4%	0.0%	Swing	5.3%	1%	Swing	-4.5%		6%	13
Luxembourg	4.1%	142.1%	No		365%	Swing	0.2%	-0.1%	16%	12
Malta	7.8%	11.8%	No		67%	Swing	-1.3%	0.3%	8%	16
Netherlands	7.6%	27.6%	Yes	0.4%	63%	Yes	0.4%	-4.0%	26%	28
Poland	2.8%	0.1%	No	1.9%	4%	No	-3.3%		6%	8
Portugal	2.6%	0.3%	No	1.3%	21%	Swing	-2.7%	-3.1%	25%	17
Romania	1.5%	0.0%	No	0.6%	2%	No	-3.0%		9%	5
Slovakia	3.2%	0.0%	Swing	1.0%	2%	Swing	-1.8%	-1.7%	19%	12
Slovenia	1.2%	0.0%	No		2%	Swing	-1.2%	-0.9%	17%	4
Spain	2.5%	6.0%	No	0.2%	8%	Swing	-0.3%	-3.5%	21%	12
Sweden	2.5%	2.2%	Yes	0.4%	14%	Yes	0.5%	-0.5%	22%	16

medium | high | n/a

[a] This is the sum of UK bank liabilities and bank claims in the member state.
[b] Each channel is given a weight of 1 (moderate), 2 (significant) or 3 (severe), according to the grading in page 8. These are multiplied with scores from this table of 1 (medium), 2 (high) or zero corresponding to each channel. As the output gap and EU perception both relate to uncertainty an average score is used.

Sources: ONS, Bank of England, IMF, European Commission, EU Barometer Survey autumn 2014, CEIC, GC calculations

Exposures of selected member states

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Netherlands

- Dutch firms have direct investments worth €177bn in the UK, earning over €9bn in 2013, equivalent to almost 1.5% of Dutch GDP.[1] Unilever has headquarters in Rotterdam and London. Royal Dutch Shell is headquartered in the Hague, but incorporated in the UK. Philipps has manufacturing, sales and research operations in the UK.[2] The Netherlands exported €42bn in goods and €7bn in services in 2013, running a surplus of €6.8bn.[3] It has among the most intensive financial sector links to the UK with bank loans from Britain totalling €236bn in 2014.[4] Major Dutch banks such as ING have substantial operations in the UK. While Amsterdam may take business from London following Brexit, the disruption to Dutch banks and businesses would be substantial.
- The Netherlands is closely aligned with the UK in many EU policy debates. Both favour less regulation, more liberal markets, and opening up external trade. They have, for example, collaborated closely on the better regulation agenda, with the UK promoting the Dutch model in the face of French, Italian and Spanish resistance.
- The Netherlands is vulnerable to the potential political consequences of Brexit. Dissatisfaction with the EU has been growing with just over a quarter of the population viewing the EU negatively. The strongly eurosceptic PVV may seek to capitalise on the political fallout from Brexit. The party won over 15% of the vote in the 2010 parliamentary elections, although is support fell back to 10% in 2012.

Ireland

- Ireland is the only member state to share a land border with the UK and is the most deeply integrated with the UK in terms of trade, supply chains, migration, language and culture. Ireland exported €14.8bn of goods and €5.8bn of services to the UK in 2013, the equivalent of almost 12% of GDP and substantially higher than any other member state. However, Ireland was one of only seven countries to run a trade deficit with the UK, importing €22.3bn in goods and €9.1bn in services. The investment relationship is both broad and deep, with Irish firms having over €13bn invested in the UK, earning over €800m in 2013, equivalent to almost 0.5% of GDP. Irish investment in the UK is, however, small compared to UK investment in Ireland, which stood at €51.2bn in 2013 or the equivalent of nearly 30% of Irish GDP.[1]
- Financial links are strong, with a history of banks operating in both countries, including Ulster Bank, which has 111 branches in the Republic of Ireland.[2] Several international banks have Dublin operations that are closely integrated with London. Similarly, many hedge and private equity funds operate out of Dublin but with close links to the UK. Brexit would create costs, but also opportunities for these firms to take business from London.
- The number of Irish national living in the UK is estimated at 329,000, second only to Poland among EU member states, but much larger as a share of the Irish population.[3] The UK and Ireland share similar approaches to economic policy, making them instinctive collaborators.

Exposures of selected member states

Country	
Cyprus	▪ Cyprus is small and geographically remote from the UK, but closely linked due to a number of historical and cultural factors, making Cyprus one of the member states most exposed to Brexit. Cyprus exported €1.3bn to the UK in 2013, over 7% of GDP, although Cyprus ran a small trade deficit and, unusually, the vast majority of Cypriot exports were in services.(1) This in turn reflects the extensive financial sector links between the two countries, with many of the larger Cypriot banks maintaining substantial operations and taking deposits in the UK. UK-based banks have borrowed in total the equivalent of over 40% of Cypriot GDP and lent to entities in Cyprus an amount equal to more than 30% of GDP.(2) ▪ The UK-Cypriot relationship is unusual among EU states in many regards. Cyprus is a member of the Commonwealth, was a British colony until 1960 and is still today the home for two sovereign British military bases. People-to-people links remain strong, with over one million British visitors to Cyprus each year and 34,000 Cypriot nationals and as many as 300,000 people of Cypriot descent living in the UK, equivalent to over one third of the current population of Cyprus.(3) ▪ 38% of Cypriot's view the EU negatively, largely a legacy of Cyprus' economic crisis and bail-out programme.(4) Cyprus' strong links to not just the UK, but Greece, make the country very exposed to the potential contagion effects of Brexit.
Sweden	▪ Sweden is closely aligned with the UK in policy debates largely because of a similar policy tradition, but also because neither country has adopted the euro. The two countries collaborated during the review of state aid for banks in 2012 to ensure this encouraged the bail-in of creditors in the face of pressure from France for more policy flexibility. Both countries are strong supporters of trade liberalisation and recently collaborated to block the expanded use of trade remedies in the EU which they regard as protectionist. ▪ Sweden has substantial trade and investment relationships with the UK, although financial sector links to the UK are less strong in comparison to those of France or Germany. Sweden exported €9bn in goods and €2bn in services in 2013, equivalent to 2.5% of GDP, but ran a small trade deficit. The stock of FDI is around €9.6bn.(1) State-owned energy firm Vattenfall has more than €2.5bn invested in the UK and in 2013 alone invested €600m in two new wind farms.(2) ▪ There is a significant eurosceptic strain in Swedish politics that could be emboldened by Brexit. The far-right Swedish Democrats, who won 14% of the seats in the Riksdag in 2014, want to renegotiate the terms of Sweden's membership of the EU.

Exposures of selected member states

Belgium	▪ Belgium enjoys strong trade links with UK, exporting €24bn in goods and €3bn in services during 2013, equivalent to 6.8% of GDP in total. The country has one of the largest trade surpluses with the UK, equal to 1.8% of GDP in 2013.[(1)] This trade relationship is particularly important to Belgium now as the country is still recovering from the after-effects of recession, with an output gap estimated at 1.1% this year.[(2)] The Belgian investment position is similarly strong, with €19.4bn invested in 2013, the equivalent of nearly 5% of GDP, with earnings of over €1bn in 2011, 2012 and 2013.[(3)] Belgian financial links with the UK are substantial, with Belgian entities owing €31bn to UK banks in 2014, although this is only one third of the level in 2007, before the financial crisis.[(4)] ▪ There is a surprisingly strong strain of euroscepticism in Belgium for a country that is so central to the EU. 22% of the population view the EU unfavourably.[(5)] While it seems inconceivable that the fall-out from Brexit could ever lead to a serious challenge to Belgium's place in the EU, Belgium would be directly affected if other countries consider leaving, given that so much EU activity is located in Brussels.
Germany	▪ The German trade surplus with the UK – at over €28bn in 2013 – dwarfs that of any other country and is the equivalent of 1% of GDP. German manufacturers alone exported €67.5bn to the UK or 2.4% of GDP. But Germany is also a significant exporter of services, particularly business services, which amounted to over €4.1bn.[(1)] ▪ 40% of German investment in the UK is in the transportation and storage sector, accounting for 58% of total EU investment in this sector in 2013.[(2)] BMW alone has more than €1bn invested, producing both BMW and MINI cars in the UK, and is continuing to invest more in what is the company's fourth largest market. German firms E.ON and RWE own two of the big-six British utility firms. BASF has ten UK manufacturing sites.[(3)] In total German firms have €68bn invested, behind only the Netherlands and France, and earning €8.5bn or 0.3% of German GDP in 2013.[(4)] Most large German banks have substantial operations in London. Deutsche Bank employs 9,000 staff but has set up a group to consider moving some of its British operations to Germany if the UK leaves the EU.[(5)] ▪ Germany and Britain are often but not always aligned in EU policy debates. However, the absence of the UK would be felt in Berlin as Britain often acts as a counter-weight to France allowing Germany to act as the decisive swing voter in many policy debates. Brexit would pose particular challenges for German foreign policy. Germany might have to do more itself, which would be politically unpopular, or accept that the EU would be much less significant on the global stage, at least in terms of hard power.[(6)] ▪ The political class and the public in Germany have a long tradition of being pro-European, but recently scepticism has risen, with the Alternative für Deutschland party falling just short of the 5% threshold to enter the Bundestag in the 2013 Federal election.

Exposures of selected member states

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Spain	▪ Spanish firms have made some high profile direct investments in the UK. Ferrovial operates four airports including the largest, Heathrow. Iberdrola owns Scottish Power, one of the big-six utility firms in the UK. Santander owns the fifth largest bank in the UK. In 2010 British Airways and Iberian Airlines merged in the form of the International Airlines Group.(1) In total Spanish investment reached €63bn in 2013, with earnings that year of €3.7bn. The stock of Spanish FDI is similar in scale to Germany's and up from less than €7bn in 2004.(2) ▪ Spanish exports in 2013 were €14.7bn in goods and €11.1bn in services with a trade surplus of almost €10bn or 0.9% of GDP. Tourism helps explain the large share of services in exports, with travel services revenues of €7bn.(3) Over 12 million British people visit Spain each year, accounting for around one quarter of all foreign visitors. Around 800,000 Britons live in Spain.(4) The number of Spanish nationals resident in the UK is much smaller, at just 90,000, but has been growing.(5) ▪ Spain is only just recovering from suffering one of the deepest recessions in Europe and with still high unemployment and an output gap estimated at 3.5% of GDP this year is in a weak position to absorb any macroeconomic consequences from the uncertainty that might follow Brexit.(6)
France	▪ French exposure to Brexit is largely due to direct investment, finance and trade links. French investment stood at €91.6bn in 2013, second only to the Netherlands. This is equivalent to 4.3% of GDP.(1) French firms are involved in some high profile infrastructure projects, such as EDF Energy's proposed construction of two new nuclear reactors at Hinkley Point in a £16bn project. Areva, Airbus and Alstom are all among the major French investors. Saint-Gobain alone has more than 17,000 employees in Britain and Ireland.(2) ▪ France exported €28.8bn in goods and €14.2 in services in 2013, equivalent to 2% of French GDP.(3) Financial linkages are also relatively strong with loans from banks in the UK totalling €343bn in 2013 or 16% of GDP.(4) BNP Paribas has been operating in the UK for nearly 150 years, has 7,500 employees, with London acting as a major hub for both corporate and retail services.(5) ▪ Despite the attention given to the number of French residents in London, there are estimated to be less than 150,000 French nationals in the UK, similar to the number of British nationals in France and unlikely to be a factor influencing French concerns about Brexit.(6) France, like other countries, would feel the pinch if the EU lost a major budget contributor like the UK, but as a net contributor France is likely to be more insulated than most. Paris would almost certainly welcome not having the UK in the room when European policy is being set, given often deep ideological divisions with the UK, although the French may be concerned if Brexit leads to less defence or foreign policy collaboration with Britain.

Exposures of selected member states

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Poland	

- Migration is the single factor that stands out in defining the relationship between the UK and Poland. There are estimated to be 726,000 Poles now living in the UK, making this the single biggest group of foreign nationals.(1) Most are young, many are skilled and the majority are economically active. Many send remittances back to Poland, estimated to amount to €1.1bn in total each year.(2) They and other immigrants from central Europe are a central issue in the Brexit debate, with the right to access to in and out-of-work benefits being challenged and causing tension in the relationship between the UK and Poland.
- While there is little Polish investment in the UK and few strong financial linkages between the two countries, Polish exports to the UK are significant with Poland exporting €11.2bn in 2013, the equivalent of 2.8% of GDP, and running a large trade surplus with the UK equal to 1.3% of GDP.(3) Poland is the largest net recipient from the EU budget, receiving €12bn more than it paid in during 2013. This could come under pressure if the UK was no longer paying in a net sum of almost €9bn.(4)
- The current government is unlikely to be concerned by the loss of UK influence in Brussels as it is often on the other side from the UK in EU policy debates. However, the main opposition Law and Justice Party is closer to the Conservatives on many issues and the two parties work together in the same group in the European Parliament.

Italy

- Italy has the lowest direct exposure to Brexit of all the large member states, but this does not mean that Italy would be fully insulated nor avoid the indirect consequences of the UK leaving the EU. Italy exported €18bn in goods and almost €5bn of services to the UK in 2013 and enjoyed a trade surplus of over €5bn. However, as a percentage of GDP only a few EU states export less to the UK. Italian FDI was worth €8.4bn in 2013, a little over half Belgian FDI, but a substantial increase on three years earlier nonetheless, when the stock of investment was less than €1bn.(1) The two largest Italian banks – Unicredit and Intesa Sanpaolo – have a very small footprint in London and the stock of UK bank liabilities and claims in Italy is relatively low.(2)
- The biggest risks to Italy from Brexit are mostly indirect. Italy often takes a different position to the UK in policy debates concerning regulation, market liberalisation or trade policy. Even so, Italy may be concerned about the destabilising impact that Brexit could have on the relationships between large member states in Europe and on Italy's ability to influence outside of Europe. Italy is also exposed to potential political and economic contagion from Brexit both because of the fragile state of the Italian economy - which is only just beginning to recover after a protracted slump - and because the eurozone crisis and the pressure this has put on Italian politics and society has led to a deterioration in attitudes towards Europe, with 28% of the population viewing the EU negatively, only marginally below the proportion in the UK.(3)

Conclusions

Conclusions

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A referendum on Brexit is now certain. While the outcome is far from a foregone conclusion, a vote for Britain to leave the EU is very possible.

The impact of Brexit on British businesses, the UK economy and wider British interests would be severe and felt across multiple channels. Both the path and the endpoint, in terms of the new relationship between the UK and the rest of the EU, would be uncertain, compounding the costs to the UK.

The direct impact on the rest of the EU would also be significant. The export, supply chain, investment and policy interests of many large corporates would be adversely affected, but perhaps the single biggest impact will be on the cost of raising finance in Europe which is likely to increase.

Brexit would have a wider political impact on the EU, both by disrupting internal political dynamics and because of the risk of political contagion if the 'proof of concept' of leaving the EU encourages disintegrative forces in other member states. Europe would also lose esteem and influence around the world.

Member states would be affected in different ways and to different extents. This will most likely influence ways in which states are willing to engage and accommodate the UK during the pre-referendum negotiation.

All member states would, however, feel the impact of Brexit, both politically and economically.

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Global Counsel can help businesses understand what the issues identified in this report mean for them.

The possibility of Brexit creates many risks and some opportunities. We can help businesses follow and interpret political developments, identify the risks and opportunities in their sector and develop strategies to respond to these risks and opportunities.

If you would like to find out more please contact the author of this report at g.irwin@global-counsel.co.uk.

You can visit our web site at www.global-counsel.co.uk.

Endnotes

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