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# MAKING THE PIECES FIT

Reforming Britain's relationship  
with the EU

Philip Booth and Ryan Bourne  
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the  
**Paragon**  
initiative

**iea**  
Institute of  
Economic Affairs



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# The Paragon Initiative

This publication is based on research that forms part of the Paragon Initiative.

This five-year project will provide a fundamental reassessment of what government should – and should not – do. It will put every area of government activity under the microscope and analyse the failure of current policies.

The project will put forward clear and considered solutions to the UK's problems. It will also identify the areas of government activity that can be put back into the hands of individuals, families, civil society, local government, charities and markets.

The Paragon Initiative will create a blueprint for a better, freer Britain – and provide a clear vision of a new relationship between the state and society.

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# Summary

- There is a noble classical liberal case for a European economic federation. However, the European Union as currently constructed goes way beyond the role necessary or desirable for a supranational body to guarantee economic freedom. The EU is inherently a political project.
- Instead of allowing diversity and competition between member states, underpinned with the use of courts to prevent trade barriers, the EU has at its core a centralising, harmonising agenda. This risks raising the overall level of regulation higher than is necessary and embedding systemic risks.
- It is unclear that the EU is the ideal level for the necessary provision of public goods or dealing with externalities, given that these tend to be either global or highly local in nature. The EU dilutes influence for the UK on major international bodies, whilst taking control where local decision-making would be more appropriate.
- Although the EU has been somewhat successful in preventing nationalist interests from obtaining favours from governments, the centralisation of more power in Brussels makes the EU easier to lobby for sectional or country-group interests. In future, the UK could become subservient to the euro-zone countries within the EU institutions.
- The EU has high levels of external protection, particularly in agriculture and manufacturing, which raise prices for UK consumers. There is some evidence too that a common external trade policy reduces the likelihood of the UK enjoying 'free trade' deals with major growing economies.
- Constraints on government action imposed by institutions such as the EU can be a welcome means of preventing harmful policy change. But if bad policies become entrenched, a system of government unresponsive to public demands for change can lead to sub-optimal policy.



- Many of these problems could be overcome if the UK left the European Union, provided steps were taken to ensure Britain became and remained a liberal, outward looking nation. This would require the long-term aim of instituting genuine free trade, maintaining liberal labour markets and constraining government interference in the economy.
- A Brexit may also be the jolt the EU needs to change course in its own agenda, leading to a re-think of the whole centralising nature of the project, with more powers devolved back to nation states.
- If the UK votes to remain in the EU, Britain should focus on changing the overall institutional structure in a more free-market direction. This agenda should focus on institutional change rather than the repeal or refinement of particular directives.
- It will probably take a long time for Britain to disentangle itself from the EU or at least EU policy. Moving towards a more classical liberal Britain is therefore a long-term endeavour. It seems likely in the event of a Brexit that the government and civil service will push for the UK to join the European Economic Area. This brings with a repatriation of some powers, but does not fully restore control across a range of economic areas. To realise the true gains from Brexit, the EEA must, in these circumstances, be very much a transitional arrangement.

# Introduction

The case for an economic federation within Europe has a rich classical liberal history, founded on the insights of some of the most significant liberal thinkers. In 1939, the future Nobel laureate F. A. Hayek outlined how an economic union of states, in which trade barriers were eliminated and factors of production and goods and services were able to move freely under a single currency, would help to deliver prosperity and, ultimately, peace (Hayek 1939).

The theory was simple. Nationalist interests were the biggest threat to economic liberty. A federation comprised of a zone with rules eliminating tariff barriers and instituting freedoms to move and trade would increase prosperity through gains from trade, increasing interdependence and providing more resources to protect from outside threats. Importantly, a federation would prove a strong counterweight against nationalist protectionism. The banning of tariffs and the discipline of internal competition created through states being able to vary their tax and regulatory systems would prevent and deter governments using national interest arguments to justify protectionism or intervening too much in economic activity. It would be far less likely that French and German politicians would be willing to be persuaded to protect British steel jobs, for example, and the disciplines of the internal market would help stop them from doing so easily.

In some respects, the EU is a realisation of Hayek's vision. Indeed, the original ideas articulated at the Messina conference and through the Treaty of Rome were very similar to those Hayek put forward in that paper - they were strongly influenced by the ordo-liberals in Germany and Italy.

At least at a basic level, the free movement of goods, services, capital and labour has to a large extent been delivered, and this has probably contributed to peace and prosperity more than many eurosceptics would

admit. The disciplines of single market legislation have also helped liberalise some countries. State aid rules do prevent narrow nationalist interests, which are prominent in some European polities and give rise to favouritism and protection. Whilst many countries' economies struggle within the EU, the better performance of some nations suggests that domestic policy is still more important in explaining poor outcomes than anything done at an EU level.

Yet in many respects the modern-day EU actually goes way beyond what Hayek would have imagined as the legitimate role of a federation. Clearly, the rationale for the EU has moved far beyond any narrow conception of institutions to stop protectionism. Many of its advocates have significant ambitions for political union and in some instances this has clearly driven economic policies. In other ways too, factors that Hayek did not or could not have foreseen have shaped the Union in a direction antithetical to economic freedom. In particular, though the central EU institutions actually spend very little money relative to national governments, they have both centralised the process of developing regulation and increased the extent of regulation, certainly as compared with the more liberal EU countries. The EU budget, for example, is around £145 billion a year, which is about one-fifth of the level of UK government spending (the UK makes up just over one-sixth of EU GDP).

The purpose of The Paragon Initiative is to examine all major functions of government, analysing the failures of the current arrangements and using economic analysis and empirical evidence to propose alternatives. Thus far, there has been a big focus within the project on constitutional arrangements. In *Federal Britain*, Booth (2015) outlined a federal solution to Britain's current constitutional anomalies, and, drawing on a vast economic literature, put forward the case for a significant decentralisation of policy control within the UK. Minford and Shackleton (2016) examine economic and political aspects of international co-operation, especially focusing on the EU. This shorter paper distils the key lessons from that book and proposes reform to ensure that political institutions promote self-governance, political and economic freedom and serve society rather than the other way round. The proposals are relevant regardless of whether the UK votes to stay in or leave the EU in the forthcoming referendum. Proposals are made for a reform package that would transform the EU and which would benefit the EU with or without the UK. The principles underlying the proposals can also be applied to the development of economic relationships between the UK and other countries.

## Part one: Problems with the EU's political economy

As part of its membership of the European Union, the UK has given up control of a wide range of policy areas and, as a result, regulation has become more complex and more centralised.<sup>1</sup> The most significant areas are addressed in Minford and Shackleton (2016) and are not repeated here. Instead, we examine the most problematic basic features of the current relationship with, and organisation of, the EU. It is these features that are the cause of the problem. The growth and centralisation of regulation are symptoms. Some centralisation may be desirable in any set of international economic relationships. For example, regulation might actually put constraints on the activities of national government where such activities have a protectionist intent. Furthermore, regulation might facilitate the provision of EU-wide 'public goods'.<sup>2</sup> However, in practice, these justifications tend not to be convincing.

### ***Over-centralisation and over-regulation: eschewing diversity and regulatory competition***

One of the main ways in which the EU differs from Hayek's vision is that, far from allowing diversity between nation states in relation to their regulatory frameworks, it has a centralising and harmonising tendency. To a certain extent this is a reflection of a broader trend with modern trade agreements and is not confined to the EU. In an age where tariffs and quotas have

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- 1 The list is very long. It not only includes trade policy, agriculture and fisheries but also (inter alia) large parts of labour market regulation, financial services regulation and energy and environmental regulation.
  - 2 Goods from which the benefits are no excludable and which are non-rivalrous in consumption. A clean environment might be considered one such good.

been reduced and eliminated, non-tariff barriers such as regulatory requirements become the main impediments to trade. The EU, in its role in overseeing free trade, seeks to eliminate these non-tariff barriers to allow a well-functioning internal market.

However, rather than attempting to strike down those regulations that are a clear impediment to trade, the EU has tried to unify – or harmonise – regulation across all member states. This process has also been evident in the US (see Bolick 1994). As soon as a central body is given responsibility for regulating trade, there appears to be a natural tendency for control of economic regulation to become centralised. Bolick argues that this happened in the US as a consequence of the inter-state commerce clause in the US constitution; in the EU, arguably, it happened as a result of the creation of the Single Market.

Take financial services regulation. Except in relation to consumer-facing business, such as the regulation of mortgages, regulation is now totally determined at the EU level. There are three responsible EU bodies.<sup>3</sup> An indication of how the centralisation of regulation has become a primary objective is given by the mission of the European Banking Authority, which states:

‘The main task of the EBA is to contribute, through the adoption of binding Technical Standards (BTS) and Guidelines, to the creation of the European Single Rulebook in banking. The Single Rulebook aims at providing a single set of harmonised prudential rules for financial institutions throughout the EU, helping create a level playing field and providing high protection to depositors, investors and consumers.’<sup>4</sup>

The European Securities and Markets authority, for example, has unified rules for the issue of prospectuses for all companies above a de minimis limit in terms of market capitalisation within the EU. Such matters were not even regulated by the government at all until recently in the UK, but were left to market institutions (see Arthur and Booth 2010).

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3 The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

4 <http://www.eba.europa.eu/about-us/missions-and-tasks>

UK financial regulators, to a large extent, now operate as 'branches' implementing EU regulation as determined by the Council, Commission and the regulatory bodies that have been established.

*The problems caused by centralised regulation*

In theory, the development of the Single Market could have taken a different route. The EU could have promoted the mutual recognition by countries of each other's standards and regulations with the EU institutions merely prohibiting those regulations that were used in a protectionist way.

The assumption underpinning the alternative approach of harmonising regulation is the belief that a 'level playing field' allows the emergence of real competition and free trade without non-tariff distortions. This approach of promoting the harmonisation of regulation creates many problems.

Firstly, it eliminates diversity between regulatory systems. An approach to regulation suited to, for example, a common law country, might not be suited to a country with a codified system of law. Employment regulation suited to a country with a vibrant labour market, including for part-time work, might not be suited to a labour market where there is greater trade union involvement and uniformity of employment practices. In the case of financial regulation, EU countries have different structures and traditions in financial markets and different degrees and types of involvement by banks in providing finance. Regulation that is appropriate for one country may not be appropriate for another. Regulation, by necessity, has to be more complex if it is to cope with widely varying situations.

The recently proposed Ports Services Regulation is a further example. This risks imposing a regulatory environment on Britain (where ports are largely privatised) which might have been appropriate for the heavily nationalised port sectors in other EU countries.

Secondly, in areas where global regulation may be developed or appropriate, the EU is often simply a needless middleman – implementing regulation developed and recommended by international bodies. This is not merely a theoretical point. As Roland Smith (2016) outlined for the Adam Smith Institute:

'The automotive industry's standards are defined by the World Forum for the Harmonisation of Vehicle Regulations (known as WP.29) under 'UNECE' - a United Nations body. Food standards are defined by the 'Codex Alimentarius' established by the UN and the World Health Organisation. Modern labour regulations are defined by the ILO – the International Labour Organisation. Maritime regulations are defined by the International Maritime Organisation. Many energy-related regulations can be traced back to the global Kyoto accord on climate change and other international agreements.'

We therefore have the paradoxical situation that regional integration through the EU is both unhelpful in restricting Britain's independent voice on many international bodies, but also leads to too much centralisation in areas where regulatory activity should be left to a very local level.

In fact, those in favour of centralisation at an EU level seem to draw the wrong conclusions from globalisation and the break-down of trade barriers – believing that the growth of economic activity across borders necessitates large regional blocs to 'manage' the process. In fact, the opposite is true. The expansion of markets through lower tariffs and technological changes means it is now possible for people to be part of the same economic system without having to be part of the same political entity.

Finally, even if it is believed that wide-ranging regulation is desirable, regulators will make mistakes in designing regulation. Allowing countries to have different regulatory systems allows them to learn from each other's mistakes. If regulatory systems are harmonised, mistakes will be repeated across the whole of the EU. Indeed, mistakes may go unnoticed as there are no benchmarks for comparison.

Not only is the process by which regulators can learn from best practice blunted, similarities of regulatory structures may increase the probability of catastrophic risk by encouraging herding behaviour. This is especially true in financial markets, but could also happen in other areas such as agriculture. If an external shock occurs, instead of the system being made up of institutions that see things differently, do different things, try different approaches to managing risk, and so on, uniformity of regulation will encourage institutions to behave in similar ways, such that the system could fail catastrophically when it does fail. As has been widely noted, the Solvency II approach to regulating insurance companies, which the EU

introduced at the beginning of 2016, encourages insurance companies to invest in risky sovereign bonds. This may turn out to be a major error. If it is an error, the consequences of it may be experienced simultaneously across insurance markets throughout the EU.

### ***Regulatory dynamics***

Perhaps most pertinently for Hayek's vision, the centralisation of regulation creates pressure in several ways for higher levels of regulation overall.

The institutions of the EU all have an incentive to promote centralisation as this increases their power. Gradually, the hurdles to the centralisation of regulation at EU level have been reduced so that, currently, 80 per cent of regulation can be passed by a 'qualified majority' which, in practice, means just 16 out of 28 countries as long as they represent 65 per cent of the EU's population. Reversing regulation is very difficult and, as Vaubel (2016) notes, the Parliament, the Commission and the European Court of Justice tend to favour centralisation. There is little democratic scrutiny of regulation, while less competition between jurisdictions may exacerbate the tendency to over-regulate because of 'public choice pressures' from interest groups (including the EU's own structures).

This centralised power to regulate, underpinned by a social democratic view of the nature of competition, has also led to more frequent calls for process regulation to prevent some states from 'undercutting' others in areas such as workers' rights. Far from just ensuring freedom of trade, the EU has broadened its scope, not least through Court decisions, to try to 'level the regulatory playing field'. It is possible for groups of countries to use the EU structures to 'raise rivals' costs' (for example, through harmonised employment regulation such as equal pay, TUPE<sup>5</sup>, collective redundancies, working time directives, and so on). Worryingly, the recent Five Presidents' Report<sup>6</sup> argued for deeper integration of labour markets and social security systems, as well as more harmonisation of company law and property rights. Again, it is difficult to see how countries such as Britain could benefit from such harmonisation.

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5 *Transfer of Undertakings (Protection of Employment)* regulation. See, for example: <https://www.gov.uk/transfers-takeovers/overview>

6 See: [https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union\\_en](https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en)



The degree of centralisation in Brussels, and the dislocation from politicians directly accountable to voters, means that the policy process is likely to be more easily captured by vested interests too. The economic logic of the original vision of the EU – at least amongst many - was liberal in the sense that it would constrain governments acting in their narrow nationalistic interest to the detriment of general economic welfare. It is true that the EU still helps to guarantee this in many ways through policies such as state aid rules and certain aspects of procurement contract legislation, which prevent governments from giving domestic companies special treatment.

A good example of some of the trade-offs from this type of centralisation can be seen in the debate about saving the British steel industry, however. Many eurosceptics have used the steel crisis, and the likely closure of major British steel plants, to highlight how the EU ties the hands of domestic governments. Even if some major economies wanted domestic protection, the co-ordination problem of getting 28 member states to agree to the imposition of so-called ‘anti-dumping duties’ on China has definitely helped to prevent high tariffs being imposed, unlike in the US.

However, the dynamics can work the other way. The centralisation of power in Brussels can give lobbyists and certain industries opportunities to obtain protection from non-EU competitors (not least in the form of non-tariff barriers). This is certainly true in areas such as agriculture where the subsidies provided under the Common Agricultural Policy represent substantial non-tariff barriers to trade. In some product areas, such as motor vehicles, there are both substantial tariff and non-tariff barriers.

Going forward, the potential dominance of euro zone sectional interests within the institutions of the EU is the most worrying possibility for the UK. The euro zone forms a cohesive voting bloc which could act to impose protectionist measures on the UK unless such measures are explicitly prohibited by the treaties. As part of his renegotiation, the Prime Minister David Cameron effectively gave up the power to use a veto against further integration of the euro zone. In return, he wanted Britain to have the power to veto laws which disadvantaged non-euro-zone states. As it happens, non-euro-zone countries will now be able to force a debate among EU leaders about ‘problem’ euro zone laws – a delaying rather than vetoing measure.

This means that Britain still risks being outvoted by a powerful euro zone

block which might make proposals that especially affect free trade in financial services. One particular (though slightly different) example of how the dynamics of the euro zone can work arose in 2011 when the ECB tried to block clearing of euro trades outside the euro zone – in effect a strongly protectionist measure. The UK took this to the European Court of Justice and won the case in 2015. Though the UK won, it received no support from the Commission or any other EU country except Sweden. Furthermore, the ruling related to the ECB over-stepping its powers rather than the integrity of the Single Market and the discrimination against banks in a given member country. As such, the ECB could ask that its powers be extended and this could be done under qualified majority voting.<sup>7</sup>

The one countervailing tendency to this process of centralisation ought to be the application of the ‘principle of subsidiarity’ within the EU Treaties. This principle was inspired by Catholic social teaching. The original intended meaning of the principle was spelled out in a Catholic Church encyclical in 1931: ‘it is an injustice and at the same time a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organizations can do.’<sup>8</sup> In other words, there should be a strong burden of proof before action is taken at the EU level.

In practice, the principle works quite differently within the EU. Indeed, in one of the explanations of the principle in EU documents it is stated that action should only be taken at local level ‘where it proves to be necessary’.<sup>9</sup> This is a complete inversion of the principle and cannot be expected to protect against centralisation. We will return to this issue below.

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7 There is an excellent discussion of all aspects of this ruling at: <http://openeurope.org.uk/today/blog/uk-secures-important-victory-ecj-preserve-single-market/>

8 *Quadragesimo anno*, 74: [http://w2.vatican.va/content/pius-xi/en/encyclicals/documents/hf\\_p-xi\\_enc\\_19310515\\_quadragesimo-anno.html](http://w2.vatican.va/content/pius-xi/en/encyclicals/documents/hf_p-xi_enc_19310515_quadragesimo-anno.html)

9 See: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:ai0017>

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### ***The EU and the provision of public goods***

Classical liberals understand that there can be a role for governments in the provision of public goods or in dealing with serious problems of 'externalities' – that is where economic activity has social costs and benefits not confined to the parties involved in the transactions.<sup>10</sup> Sometimes goods or services have characteristics that would make it sensible to manage their provision at a higher level than the nation-state (Ricketts 2016). However, it is difficult to think of many areas where the optimum unit of government to deal with spillover effects and the provision of public goods is the European Union level.

The most obvious 'public good' is the provision of defence, and yet there is no real demand (except among some within the European Commission) for a thorough common European defence policy. One does exist – the EU boasts a Common Foreign and Security Policy. But, as Vaubel (2016) explains, there are external benefits of defence which benefit other nations outside the EU with shared interests. This makes NATO (which has, until recently at least, been a broader and fairly reliable inter-governmental institution for maintaining peace and security) a more appropriate level of cooperation. In fact, continuing to develop an EU security policy could undermine NATO.

The European Union has focused particularly strongly on action to address climate change and the environment. And yet these types of externalities issues tend to be either global in nature (for example, carbon emissions) or local (for example, policies which deal with flooding), making it unclear why the EU exerts control in these areas. In climate change policy in particular, the mandates imposed from an EU level seem to assume that the EU can help mitigate overall global carbon emissions simply by 'leading by example'.

While the solutions to some environmental problems could be regarded as 'transnational public goods', it is difficult to identify any that are EU-wide by nature. And governments have strong incentives to co-operate to resolve such issues. This happens in relation to, for example, the River

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10 It should be noted that, just because there are forms of 'externality' it does not follow that government action will lead to more efficient outcomes. Secondly, goods that can be provided privately are often misnamed 'public goods' (for example, clean water which is a private good and broadcasting which is a club good as it is possible to exclude non-payers from broadcast signals. See above for a definition of public goods.

Rhine which flows through several countries and is protected by the Convention on the Protection of the Rhine. Though signed by the EU, it is really a matter for the five Rhine-bordering countries which are also signatories.

Fish stocks have also been controlled at the EU level, and they have continued to decline since the implementation of the Common Fisheries Policy. Certainly, if the objective of policy is to manage an 'EU-wide commons' in relation to fish, that objective has not been achieved. Stocks of many species are in danger and few are in a healthy state.<sup>11</sup> Indeed, the Common Fisheries Policy illustrates well the problem of trying to resolve problems through higher levels of government when much of the knowledge required is localised and cannot be centralised within government. Nobel Prize winner, Elinor Ostrom (2012: 85) made precisely this point in relation to European fisheries policy: 'Well, it is rather tragic because the European fisheries rules go all the way from the Mediterranean to the Baltic. And it's one set of rules for all that. The Baltic is an entirely different ecological system and it just doesn't make sense.'

Indeed, whilst there may be some sense in groups of countries co-operating to manage fish stocks, it is impossible to see a case for this being undertaken at an EU level.<sup>12</sup>

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<sup>11</sup> See Bate (2016).

<sup>12</sup> In fact, five EU countries are landlocked.

### ***External protectionism and coordination problems***

Though the single market allows free trade between member countries, the European Union as a customs union raises product prices to UK consumers through protective measures such as tariffs, non-tariff barriers and the Common Agricultural Policy. Tariffs include 32 per cent on wine, 13 per cent on wheat, 12 per cent on goods vehicles and 10 per cent on cars (see Thompson and Harari 2013). Minford (2016) has estimated that abolishing these would enhance economic welfare in the UK by around 4 per cent.

On the positive side, the EU has preferential trade agreements with over 50 countries around the world. Yet there is some evidence that a common external trade policy actually hinders smaller nations from obtaining beneficial free trade deals, particularly with large and fast-growing countries. Several smaller countries have negotiated free trade deals with large economies, such as (in the case of Switzerland) China and Japan, and (in the case of New Zealand) China and Australia (Mansfield 2014).

This suggests that, whilst it is often said that being part of a large EU block helps with 'bargaining power' in signing trade deals, the flexibility brought about by being able to sign deals unconcerned by objections from more protectionist EU member states and only having to iron out disagreements on a smaller number of industries facilitates a more stream-lined process. It will be increasingly important for countries such as Britain to have free trade with some of the rapidly growing developing and middle-income countries as the EU falls in relative economic importance.

***Reform is extremely difficult***

All of this might matter less if there were a prospect of meaningful EU reform. Yet the evidence from David Cameron's 'renegotiation' suggests otherwise. Even with the prospect of one of its most prominent member states threatening to leave, the European Union showed little appetite for reform and the changes to Britain's EU relationship ultimately obtained do not alter any of the fundamentals outlined above.

In part this reflected the government's own negotiating agenda. The restriction of benefits to migrants formed its centrepiece. This was, to a large extent, a 'red-herring', as the UK government could easily have taken action to deal with any perceived problem domestically. Certainly no vision of fundamental reform was articulated by the UK government.

In those areas where the government wanted significant protections, such as in relation to a veto for non-euro-zone countries on issues to do with financial regulation, the reform package merely offered up the potential for 'discussion' at the level of the European Council.

The difficulty of achieving meaningful change can, in some instances, be a useful constraint on blocks of countries implementing damaging and protectionist policies. However, the trade-off is that those status quo policies which are damaging are difficult to overturn. This can lock in sub-optimal policy.

## Part two: Paths to liberal internationalism

The referendum on 23 June will determine whether Britain remains in the EU. This section outlines the international economic arrangements the UK might seek in the two scenarios of remaining in and leaving the EU. In the case of leaving, a proposal is made for the promotion of free trade internationally. The discussion surrounding the remain scenario focuses on a radical reform plan for the EU.

Leaving will certainly not automatically lead to greater economic liberalism in all areas. In labour market and lifestyle regulation, for example, the UK government has shown itself to be much more illiberal than is required by EU law (Shackleton 2016; Snowdon 2016). If the UK were to leave the EU but then become more protectionist both on trade or immigration, then that would come with economic costs. Brexit increases the range of political possibilities, for better and for worse. Here we outline what 'best', or at least 'better', could look like.

### ***Britain outside the EU***

As analysis by others has shown, provided that the UK acts broadly in a liberal fashion upon leaving the EU there is no need for damaging economic consequences (Mansfield 2014; Oxford Economics 2016). In this section we outline the broad steps that should be taken in areas over which the EU currently has competence and assess where those powers should lie and the broad institutional approach that should be taken.

One possibility would be for the UK to join the European Economic Area (EEA). In effect, this would keep the UK within the Single Market. This would maintain all the current trading and regulatory arrangements, including on migration, but would return control of external trade policy. It would also allow Britain to exit the Common Agricultural Policy and the Common Fisheries Policy. This is often described as the ‘Norway option’ and could be the starting point for the development of a new ‘British’ relationship over time. Overall, when examining laws currently in force, the EEA only applies 21 per cent of total EU laws (North 2015a). This is likely to be pushed for by the political, civil service and business establishment in the event of a Brexit vote – because it will be the least disruptive in the short-term.

However, many of the major gains to Britain of exiting the EU in the longer term can only be achieved by exiting the single regulatory system that forms the Single Market. To realise the true gains from Brexit, the EEA must, in these circumstances, be very much a transitional arrangement. The following long-term approach is suggested in different areas of policy.

#### *Trade policy*

In the long term, the UK should seek to move towards a position of free trade on a global basis, rather than attempting to obtain it through a series of bilateral arrangements with others or operating within the protected EU customs union and Single Market. This is something the UK should push for at a global level through its independent seat and membership of the World Trade Organization. But Britain should anyway lead by example by declaring unilateral free trade – stripping away all domestic tariffs from both EU and non-EU countries. This would deliver reductions in consumer prices, and a recalibration of the economy towards currently unprotected areas, enhancing productivity as Britain trades in areas of significant comparative advantage.



If this proves politically impossible, the UK should prioritise free trade agreements with the fast-growing areas of the world, with particular regard to the liberalisation of trade in services. Given capacity constraints for delivering trade agreements, prioritising large countries where the economic gains would be greatest (USA, China, India and Japan) makes sense.

### *Regulation*

The UK should use the opportunity of exiting the EU to revise its regulatory approach, particularly in a number of key areas – especially financial services, the labour market and energy. Where desirable, the UK could continue to co-operate with the EU in a bilateral agreement. Both at the global level and the EU level, there is no objection in principle to unifying regulation. However, that should come through evolution and agreement rather than by establishment of structures at the EU level which allow it to develop and impose a single regulatory model throughout the EU. Whatever the faults in the detail of the regulation, arrangements such as the Basel Accord have facilitated increased trade in banking by establishing a set of regulatory requirements through a structure that transcends the EU and which any member can leave. As we note above, unifying regulation may reduce the costs of trade but is not a pre-requisite for free trade.

Key EU regulations that should be repealed as the UK transitions out of the EEA should include:

- The Working Time Directive
- The Collective Redundancies Directive
- The Agency Workers Directive for the labour market
- Binding renewables targets
- Restrictions on GM crops and much other environmental regulation
- Various aspects of EU financial services and securities markets regulation including the Alternative Investment Fund Managers Directive.

Other areas where legislation should be reviewed over time include transport, business and commercial law, health and safety law and consumer law.

### *Migration*

The UK should adopt a liberal migration policy outside the EU, the details of which are beyond the scope of this paper. The ideal would be to maintain a bilateral free movement arrangement with the rest of the EU (this would be condition of EEA membership), but then to liberalise domestic migration policy with the rest of the world (and in particular, abolish the current crude quota for non-EU migrants). An alternative approach possible outside the Single Market would be to adopt a non-discriminatory policy which, whilst falling short of the liberal ideal, treated all applicants for migration the same way wherever they came from.

### ***Britain inside the EU***

If the UK remains inside the EU, it should articulate a vision for reform that would recast it along liberal lines. It might be thought that such a vision would be politically unattainable. That may be correct. However, the history of the EU has shown that, when a radical vision has been proposed in what is otherwise a vacuum, substantial change has been possible. Indeed, the Single Market Act was one such vision, even if the outturn was not one for which the originators of the idea had hoped; the creation of the euro was another.

The radical vision should be built on four pillars:

- Enshrining the principle of subsidiarity
- Returning to mutual recognition
- Competitive federalism
- Constitutional reform

### ***The principle of subsidiarity***

The principle of subsidiarity needs to be redefined – or, strictly speaking, properly defined - in the treaties. Merely reinvigorating efforts to enforce the principle as outlined in the treaties is not good enough.

The idea of subsidiarity is that the *higher* level of government (the EU in this case) should only intervene if the lower level is *not capable* of acting. Furthermore, the *higher* level of government should only intervene in such a way that it aids the lower level of government in carrying out its functions and does not dictate to it. Only those functions that must be undertaken at the higher level should be reserved for the EU. If the function can be carried out by civil society or other organisations, the government should not get involved at all.

To give an example of how this might be operationalised, consider the example of labour market regulation. The policy objective might be decent working conditions. If the principle of subsidiarity applied, we would ask whether this objective was already achieved via market and civil society mechanisms (for example, through trade unions, mutual aid societies,

and so on). Insofar as market mechanisms did not suffice, local or national government could intervene. When we look at the problem this way round, it is difficult to see any justification for action at EU level in this particular area.

It is crucial that the principle of subsidiarity is properly defined so that action by the European Union can be challenged in the European Court of Justice with a good prospect of success.

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### ***Mutual recognition within the Single Market***

Some have argued that the creation of the Single Market was a great victory for free trade and free markets. Indeed, this was the view of the British government at the time of the passing of the legislation. Furthermore, when commentators discuss the 'completion' of the Single Market (especially in services) they relate this to the benefits that come from free trade within the Single Market.

As has been noted above, the development of the Single Market has gone hand-in-hand with the centralisation of regulation. This arises, it is argued, because, once a central authority is given the power to regulate business that relates to cross border trade, there will be an unstoppable drive towards centralisation because there is no logical end-point in the regulatory responsibilities of the centre because all regulation, ultimately, has some bearing on the relative costs of trade.

The norm should be that nation states within the EU recognise and accept each other's regulatory frameworks with the EU having the power to 'strike down' regulation that inhibits trade disproportionately or which is designed to inhibit trade.<sup>13</sup> However, in an environment in which members states accept each other's regulation under the principle of 'mutual recognition', regulation should not inhibit trade. Arguably, this is the approach that Mrs Thatcher envisaged would arise from the Single European Act. Indeed, as Nikolaidis and Schmidt (2007) put it: 'In his 1986 White Paper on completing the single market, Lord Cockfield hailed mutual recognition as the miracle formula for the much needed liberalization of services markets. Twenty years later, the European Union is passing a services directive where the principle of mutual recognition is conspicuously absent, at a time when effective liberalization seems ever more necessary.'

It is worth adding that there is no reason why groups of countries should not, through inter-governmental agreement, harmonise their regulation in particular areas or work through other international agreements (such as

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13 The reason why a regulation should be struck down if it is designed to inhibit trade is clear. There would, of course, be difficulty in judging which regulations disproportionately inhibit trade. However, that is an appropriate test. There are many barriers to frictionless trade: different legal systems, laws and regulations are part of that set of barriers. We do not expect governments to provide free shipping to reduce the transport costs of trade; neither should they remove all differences in laws and regulations that might raise the cost of trade. As will be noted below, EU countries might agree consensually to unify regulation.

the Basel Agreement, developed through the Bank for international Settlements) to agree common principles of regulation. Britain and Ireland, for example, shared similar laws in many fields until they entered the EU. Harmonisation could evolve organically if it were desired.

### ***Competitive federalism***

The underlying constitutional approach to EU governance should be one of 'competitive federalism'. Though the whole idea of federalism in the EU debate is toxic in the UK context, this proposal would lead to decentralisation and a reduction in the power of the Union. Powers should be granted to the centre by agreement of member states (preferably via unanimity). Though there should be no legal impediments to the free movement of capital, labour, goods and services within the EU, member states themselves should develop their own regulatory structures and those regulatory structures would be the subject of competition. As noted above, this does not mean that countries cannot agree, outside EU structures, to unify regulation; and regulations that impede trade would be prohibited. Many regulations actually relate to national preferences and have nothing to do with inhibiting trade (for example, labour market regulation) – they may raise costs at home, but, presumably, the polity in the country concerned regards the costs as worth the benefits. Many other regulations relate to consumer protection and, though differences in such regulations raise the costs of trade, they do not intrinsically discriminate against companies in different countries. A process of competition between regulatory approaches can help reduce the burden of regulation and also aid the process of discovery of the best forms of regulation.

### ***Constitutional reform***

Finally, constitutional reform is needed to ensure that the EU does not act when it should not do so. Roland Vaubel, a German academic, and the European Constitutional Group of which he is a member, have suggested a number of changes that would tame the power of the EU. These would include a second chamber of the European Parliament with members from national parliaments that could veto centralising regulation. Vaubel also points out that both the Commission and the European Court of Justice have an interest in more centralisation and he proposes that a second court (made up of proper judges with real experience from national courts – which is not the case with the ECJ) should hear cases involving the distribution of powers between the EU and member states with a duty to apply the principles of subsidiarity and proportionality.

These sorts of constitutional changes, together with the reforms proposed above, are necessary in order to create a European Union that serves the people of Europe rather than the EU institutions themselves.

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