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The Cost of Non-Schengen for the Single Market

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A suspension of the Schengen Agreement would damage the European economy, in particular by undermining the European single market. And it would not just damage the movement of people and labour in Europe. Several studies show that the Schengen Agreement also eases the free flow of goods, services, and capital. Suspending Schengen would therefore constrain all four freedoms. Over time, intra-EU trade flows, European value chains and the competitiveness of the European economy would be hurt. At a time of already sluggish productivity and trade growth, this would severely damage the European economy. As European Commission President Jean-Claude Juncker warned, restoring border controls "could kill off the internal market".

Enacted in 1995, the Schengen Agreement abolished internal border controls and enabled passport-free travelling across the Schengen area. In an attempt to better control the recent refugee influx, some member states of the European Union (EU) first introduced temporary border controls for a six-months period (among them Germany, Austria, Sweden, Denmark, France, Belgium). However, if the functioning of Schengen is at risk because of "serious deficiencies" regarding external border controls, the European Commission can recommend a suspension of Schengen of up to two years (Art. 26 of the Schengen Borders Code). Although the European Commission still aims to fully restore the Schengen system by the end of 2016, it has confirmed that it "would act without delay" if the deficiencies in the management of the EU's external border persist beyond May 12th – a date which is approaching very soon.

If Schengen would be suspended for the two-year period or even in full, trade and economic growth in the EU could be severely damaged. The Schengen Agreement is not just a symbol of European integration, it creates real economic value by facilitating cross-border exchange. Obviously, the Schengen Agreement promotes the free movement of people, but that is not all. It also boosts the flow of goods, services and capital across borders. Several studies show that either the Schengen Agreement itself or labour mobility more generally contribute to increased flows in trade and finance, and improve macroeconomic performance. Let us consider recent research in this field.

The Schengen Agreement cuts the time for labour to cross borders for work and has eased working life for all those who commute to another country or regularly travel for work. Scholars at the Kiel Institute for the World Economy (IfW) argue in a paper that the Schengen Agreement connects national labour markets across borders. Naturally, labour markets get more integrated in border regions, and cross-border commuting is, according to the IfW, therefore most common in the border regions of France, Germany, Switzerland and the Benelux countries. However, the long-term trend is an increase in regular cross-border business travelling beyond border regions, mostly destined for the big metropolitan areas in Europe.

According to a report by Deutsche Bank Research, the migration of labour also helps to cushion the effects of macroeconomic adjustment on labour. During the global financial crisis, labour mobility helped to reduce unemployment rates in Ireland and Spain. These would have otherwise been 3.5 (Ireland) and 1.7 (Spain) percentage points higher. Furthermore, cross-border labour mobility increases the long-term competitiveness of European firms, because the available labour resources are used more efficiently. In its assessment of the costs and benefits of labour mobility for sending and receiving countries, the European Central Bank argues that this is the case because cross-border labour mobility enables a better skills-match and an up-skilling of European workforces. Similarly, a European Commission report finds that intra-EU labour mobility seems to be positive for the receiving countries, because migrant workers contribute to the skills mix in the national labour market and can be employed in sectors and occupations with job shortages.

The second type of cross-border movement which would be affected by a suspension of the Schengen Agreement is the free flow of goods. In 2015 intra-EU trade in goods made up for approximately 60% of the EU's overall trade. And Schengen does not only abolish border checks – which is the part most commonly known – but it also requires to remove all obstacles that hinder a "fluid traffic flow" at internal borders (Art. 22 of Regulation (EC) No 562/2006).

The Bertelsmann Stiftung estimated the impact of reintroduced border controls on the EU's gross domestic product (GDP). Border checks which stop and control trucks cause time delays which increase transport costs and lead to higher product prices. According to their results these higher product prices can cause a yearly reduction in GDP growth of 0.04 percentage points compared to intra-EU trade with open borders. Furthermore, the study argues that the time delays at the border would make just-in-time production and decentralized production more difficult for European firms. As a result, production costs for intra-European value chains would increase and the price competitiveness of European producers would decrease. This could affect location and investment decisions by foreign firms.

A recent Ifo study finds that for EU member states the removal of border controls leads to an increase of 3.8% in goods trade or a cost saving equivalent to a tariff reduction of 0.7 percentage points for every internal border which a good needs to cross. As a result, countries which are at the periphery of the Schengen Area benefit more from the Agreement because their costs savings are greater if goods have to cross several borders until they reach their markets.

The Schengen Agreement also impacts intra-European goods trade via another channel, i.e. migration. An article shows that if two countries are members of Schengen, trade between these countries increases by approximately 0.1 percent per year. The authors argue that this is due to three reasons. First, immigrants have a preference for local goods from their home countries – we all know that the bread or cookies from home taste better when we are abroad. Second, immigrants have a better knowledge about competitive low-cost suppliers in their home countries, and, third, their social networks decrease the risk of importing and exporting. This helps to establish trade relations with companies in the sending countries.

The third area that would be affected by a suspension of Schengen is the free flow of intra-European services. First of all, it is worth repeating that it will be more complicated for workers to move to other EU countries for work purposes. Technically speaking, the free movement of natural persons is affected (mode 4 of services trade). Moreover, it would become more difficult to travel and consume foreign services in another EU country, as is usually the case in the tourism sector (mode 1 of services trade). As the study by the Bertelsmann Stiftung argues, if border-controls are reintroduced, this may reduce tourism activities, at least regarding short term trips. People would probably not want to wait at borders for timely passport checks just to go on a museum or a one-day shopping trip to a city.

Finally, a suspension of the Schengen Agreement could reduce financial flows within in the EU. The study by the IfW reports that increased cross-border migration can be associated with more foreign direct investment and increased financial flows between countries. The logic is similar to how labour mobility boosts trade in goods. If migration increases the knowledge about and increases business links with firms in sending countries, financial flows will increase and investors in receiving countries will have a greater interest to invest in the markets of these sending countries.

Considering that the Schengen Agreement facilitates intra-EU trade and the integration of the European single market in many different ways, it is likely that a suspension of the Schengen Agreement over a longer period would damage the competitiveness of European firms and economic growth in the EU. After all, the single market is the backbone of the European economy. While it might be seen as an appealing short term solution for some politicians who do not know how to deal with the increased refugee flows, the longer-term economic effects are negative. If the EU wants to cope successfully with the challenges arising from big refugee flows, it needs more than ever a competitive and growing economy which creates jobs and revenues. And the fact that goods, services, persons and capital can flow and be traded freely within the European market is an important factor of the competitiveness of the European economy. It makes it a sought after trade partner and attractive destination for foreign investment.