

What next after Brexit?

Considerations regarding the future relationship between the EU and the UK

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Summary

In order to be able to assess the future institutional relationship between the UK and the EU, this study organises the relevant facts systematically. This is done by using a framework in which two aspects are compared with each other: On the one hand, the extent of the Single Market access for the EU's current partners (incl. Norway, Switzerland and Canada), and on the other, the concessions agreed by these partners with the EU with regard to free movement of people, relinquishment of regulatory sovereignty (legal harmonisation with the EU) and payments to the EU. Here a clear reciprocity between give and take can be seen, which it is assumed will also be valid for the pending negotiations, particularly as the EU needs to prevent bandwagon effects in terms of other EU countries following the UK example to exit the EU. On this basis we discuss which concessions the UK might give and what extent of Single Market access the EU might grant in return, if it is to be guided by the existing integration models, and in addition takes into account the British trade deficit with the EU and the substantial political and military role played by the British.

Although the UK would like to retain as broad access to the Single Market as possible, the political restrictions might mean that the UK can only offer medium level concessions overall: small regarding free movement of people, small to medium regarding payments to the EU, and medium to high regarding legal harmonisation with the EU. In this respect, there are clear parallels with the Swiss integration model, since Switzerland also gives the EU medium level concessions on average, and in return receives medium level access to the Single Market. However, in the case of the UK there would be a single overall agreement (rather than many individual agreements as in the case of Switzerland) and concessions would be distributed differently amongst the various categories.

For a more precise idea of how British access to the Single Market might be configured in the future, a virtual mercantilistic balancing exercise of reciprocal concessions is carried out which is based on plausible assumptions:

- The UK will leave the Customs Union because only under these circumstances can the British government make their own free trade agreements with third party countries. This will incur higher trade costs because of rules of origin and customs procedures. These costs can be reduced somewhat by trade facilitation measures agreed with the EU, similar to that granted to Switzerland.
- In exchange for avoiding tariffs on imported goods in bilateral trade – which is fundamentally in the mutual interest of both parties – the UK must put significant concessions on the table. After all, in other free trade agreements the EU usually receives considerable market access concessions in other areas in exchange for tariff-free access to the EU goods market – for example, in public procurement in Canada in CETA. This is due to the fact, that the EU has a considerably larger market to offer and with regard to exports the UK is much more dependent on the EU than vice versa. It appears plausible to bring the British deficit in goods trade with the EU into play here. However, it seems doubtful as to whether this would suffice to balance the disproportionate size of the EU market; potentially the UK would have to bring in some of the above-mentioned concessions to the EU.

- In any case the (remaining) limited British concessions would not be sufficient for unfettered British access to the free movement of goods and of services in the EU at the same time.
- Access to the free movement of many industrial goods – that is the admittance of goods to the EU market, which in Switzerland are approved according to Swiss law (harmonised with the EU) – is the greatest concession in access to the Internal Market that Switzerland receives in comparison to other EU free-trade partners. In exchange, Switzerland's greatest concession is the granting of extensive freedom of movement for EU citizens. It therefore makes sense to link these concessions in an attempt to assess the balance of reciprocal concessions. Thus, it is assumed that to gain far reaching industrial goods market access, Switzerland has to attribute a large proportion of its free movement concessions. In addition, the bulk of Swiss concessions regarding legal harmonisation (of product standards) with the EU is brought in here, as this is a precondition set by the EU.
- If the UK were also to opt for the free access for industrial goods, which British industry would likely push for, it would have to put something of similar weight on the table. Since the UK would want to strongly limit free movement of people, other concessions of similar weight would be needed, if the Swiss model is used as a benchmark. It is assumed that the British government would presumably have to concede the majority of (small to medium) British payments to the EU here. The same goes for the (medium to high) legal harmonisation of product standards that is required by the EU anyway to allow access for UK goods. Given the huge significance of free movement of people for the EU, these concessions would probably not suffice by far. Thus, it seems plausible that a large part of the UK's significant political and military role will need to be brought in as a trade off at this stage in this virtual balancing act.
- The parallels between Switzerland and the UK can be continued further. Hence, the very limited remaining concessions that Switzerland can offer are only sufficient for limited access to free movement of services in the EU (only slightly exceeding that under CETA). Despite a strong Swiss banking sector, the EU does not grant the Swiss any passporting arrangements in the financial sector. If the UK were to opt for access to the free movement of industrial goods, access to the services market of the EU would probably remain restricted to a similar extent.
- Ultimately, this leads to conflicting objectives for the British government: It can try to exploit its assumed limited concessions either for free access to trade in industrial goods, or for extensive access to trade in services in the EU. Here, the main issue is passporting rules in the financial sector, and therefore cross-border provision of financial services from London to the EU. However, the EU has been very restrictive with this access concession in its existing integration models – ultimately, in order to promote value added and employment in the EU.
- The EU should orientate its strategy towards the framework proposed here. By thus relying on objective benchmarks, the EU could signal fairness on the one hand, and prevent bandwagon effects on the other. In addition, two different approaches are proposed which would enable the EU to provide incentives for the UK to use British concessions for access to the free trade in industrial goods in the EU.

1. Introduction

The uncertainty surrounding the exit of the United Kingdom (UK) from the European Union (EU) remains high. Following an exploratory phase, the British government has now given the first indications concerning the broad goals they are seeking in the negotiations concerning the future integration model for the UK and the EU. However, at the present time we are still being left more or less in the dark concerning the shape of any specific arrangements. Therefore, we are placing the issues under negotiation in order, and on this basis are making a first cautious evaluation as to which reciprocal concessions could lead to which outcomes in the negotiations. In this way, key elements of a future agreement between the UK and the EU are outlined and expanded upon. Since it is improbable that negotiations will be completed within the two-year timeframe after the start of the exit negotiations, it is likely that there will be temporary transitional arrangements. In the following discussion, we concentrate on the negotiations on the agreement concerning the arrangements for the future relationship between the UK and the EU.

This study is a shortened version of a German IW-Report (see Matthes/Busch, 2016, also for additional references). In Chapter 2 a framework will be developed for the ensuing examination by referring to existing integration models between the EU and other partner countries (Norway, Switzerland, Turkey and Canada). In Chapter 3 the strength of the respective negotiation positions will be examined. Based on this we will then discuss in Chapter 4, which concessions the UK is likely to be prepared to bring to the table with regard to free movement of people, relinquishing regulatory sovereignty and payments to the EU. Chapter 5 assesses the extent of Single Market access the EU might be ready to grant in exchange, if it follows the existing integration models. Strategic considerations follow in Chapter 6 and policy recommendations are provided in Chapter 7.

2. Proposed Framework

The following discussion is based on the assumption that the negotiations will be carried out using a mercantilist yardstick, as is normally the case with free trade agreements. As such it is underpinned by the principle of reciprocity, that is, the fundamental equivalence of give and take. In the mercantilist view, dismantling trade barriers is regarded as a concession, because this improves access to one's own market for one's negotiating partner's exports. The negotiation outcome can be seen as equalising the reciprocal concessions, allowing for the respective relative negotiating power of the parties concerned.

A key argument for using a mercantilist approach for the negotiations is based on the fact that announcements from the European institutions to date have made it clear that after Brexit, the UK should not be granted unconditional access to the Single Market, so to speak “à la carte”. Instead, it appears plausible that the UK model, at least in principle, should follow the same pattern as the existing integration models the EU has with third countries (Malhotra, 2016), which are underpinned by the principle of reciprocity.

The following concessions of a partner country to the EU are considered to mainly influence the extent of access to the Single Market the EU will provide to the respective country:

- The extent to which the partner country grants freedom of movement to EU citizens.
- The extent to which regulatory sovereignty is relinquished in the sense that EU-regulations are adopted (in some cases without having a say in the making of new regulations).
- The extent of (net) payments to the EU.

In Table 1, the different integration models (Norway, Switzerland, Canada, Turkey) are qualitatively evaluated and compared with reference to what the respective EU partners give to the EU as concessions and the extent of access to the Single Market the EU grants them in return (for more detailed information and references about these integration models see Busch/Matthes, 2016; Matthes/Busch, 2016).

Table 1: Extent of concessions and access to the Single Market
Qualitative evaluation of the authors

| | Turkey | CETA | Switzerland | Norway/EEA |
|--|---------------------|--------------|-----------------|--------------|
| Free movement of people for EU citizens | No | Small | Extensive | Large |
| Relinquishment of regulatory autonomy | Small | Small | Small to medium | Large |
| Net payments to the EU | No | No | Small | Large |
| Overall concessions | (Very) small | Small | Medium | Large |
| Extent of access to the Internal Market | Small | Small | Medium | Large |

Turkey and Switzerland: in these cases the EU displayed generosity (not least with regard to exemption from customs duty), because at the time of the negotiations both countries were seeking entry to the EU).

Source: Institut der deutschen Wirtschaft Köln

Table 1 clearly shows that there is a rather clear, almost proportional relationship between the extent of concessions from the countries in question and access granted to the Single Market. This relationship is demonstrated in Figure 1, where the two further options of WTO-state and EU-member are included. In this illustration, the

models under discussion are located on the diagonal, which shows the progressive proportionality of the relationship.

Figure1: Illustration of the proportionality between the extent of concessions of EU partner countries and the extent of Single Market access granted by the EU

| | | | | | | |
|---------------------------------------|------------|---|-----------------|-------------------------|--------|-----------|
| Extent of Access to the Single Market | Full | | | UK with | | EU-Member |
| | Large | | | Continental Partnership | Norway | |
| | | | | | | |
| | Medium | | | Switzerland | | |
| | Small | | Canada (Turkey) | | | |
| No / Hardly | WTO-Member | | | | | |
| | | No / Hardly | Small | Medium | Large | Full |
| | | Extent of Concessions in terms of Freedom of Movement for EU citizens Regulatory Sovereignty and Payments to the EU | | | | |

Full access to the Internal Market also includes full decision-making rights with regard to new EU regulations and agricultural trade freedom. The EU grants these rights only partially to Norway and Switzerland.

Turkey and Switzerland: in these cases, the EU displayed generosity (not least with regard to exemption from tariffs), because at the time of the negotiations both countries were seeking entry to the EU.

Source: Institut der deutschen Wirtschaft Köln, based on Table 1

Figure 1 provides the framework for the ensuing analysis. It places in order the integration models that could serve as a guide for negotiating the future institutional relationship between the UK and the EU. Below EU membership, Norway (as a country of the European Economic Area or EEA) is the most comprehensive model. Next comes the integration model of Switzerland (based on a multitude of bilateral agreements). The customs union with Turkey and the CETA agreement with Canada are located below Switzerland.

Moreover, Figure 1 captures the reciprocity principle. The green-shaded areas indicate that from an EU perspective represent an advantage in terms of reciprocity, and the orange/red ones a disadvantage for the EU. The political benefit of our

approach lies in the fact that it allows to objectify the upcoming negotiations. The EU will very likely be faced with reproaches in the British public debate that it treats the UK unfairly. In this respect, our framework can serve as a reference point to define the category of fairness which would imply not to force a solution on the UK in the green areas. In addition, our approach can identify solutions that are overly generous for the UK (red areas) which could induce bandwagon effects.

Figure 1 can also make clear that the continental partnership for the UK proposed by some international experts (Pisani-Ferry et al., 2016) would clearly breach the requirement for reciprocity and proportionality. According to this model, the UK would retain very extensive access to the Single Market and even have more decision-making rights with regard to new EU regulations than Norway currently has. As a concession for this, sustained and extensive legal harmonisation with the EU would be necessary. However, the UK would be able to restrict the free movement of people to a considerable degree; in fact, this would only be a “small” concession, according to the classification used here. Payments to the EU would also be made; however, the authors are not precise about the amount. A classification in the medium category does not seem implausible. Taking all three categories together (with an unweighted average), the overall concessions would only fall into the medium category, while the access to the Single Market would be relatively large. Such a breach with proportionality entails the risk of creating bandwagon effects with regard to other EU countries. In a reaction to such generous treatment of the UK, also Switzerland and the EFTA partners would probably want a better deal. In our view, for these reasons the creation of a continental partnership is not advisable.

3. Considering the strengths of the negotiating positions of the UK and the EU

In order to be able to evaluate in Chapter 4 which negotiation outcome can be deemed likely, once the British wishes and concessions have been weighed up, the strengths of the respective negotiating positions must first be considered.

The UK's negotiating position

Supporters of an EU exit represented the negotiating position of the UK as relatively good. Important arguments included the fact that the UK has a considerable trade deficit in relation to the EU (and particularly in relation to Germany), and plays an important (geo) political and military role in Europe. Hence – so the argument goes – Germany and other important EU states would be willing to strike a generous compromise with the UK. However, these arguments need to be qualified:

- A counterbalance to the British trade deficit is the fact that the EU is a much larger market than the UK. In 2015 about 44.4 per cent of British exports went to the EU, but only 6.5 per cent of EU exports went to the UK. This implies that the UK is clearly much more dependent on reaching a trade agreement than the EU.
- It is undeniable that the UK plays an important political and military role in Europe, which could well gain in significance if the USA were to engage less in Europe in the future. However, it does not seem plausible that a political-military de-coupling would represent a successful strategy for the UK, as it relies at least as much on the EU as vice versa (Malhotra, 2016). Offering cooperation in this area would therefore work for the UK as a bargaining chip in negotiations only to a limited extent.

In addition, it could be argued that the UK could improve its negotiating position by threatening a beggar-my-neighbour policy on business taxation and regulation. There are certain indications that such a strategy has been mooted (FAZ, 2016). However up until now, reactions on the part of the EU have indicated that such provocative strategies could further harden the negotiating position of the EU and the (remaining) EU member states. Moreover, it is not clear how potential tax losses could be offset financially in view of a likely rise in the UK's fiscal deficit in the course of the Brexit.

The British negotiating position might be also somewhat weakened by the fact that the government has to take account of the concerns of parliament as well those of Scotland and Northern Ireland.

- Before the referendum the majority in the British parliament appears to have been against Brexit. Nevertheless, the House of Commons will not oppose the result of the referendum – but it has demanded a political price for its cooperation, which could restrict the government's ability to act. Parliamentarians demand (ongoing) transparency about the negotiating strategy of the government which could imply leaks to the public.
- The Scottish government has stated clearly that it wants to remain in the Single Market, and the Northern Irish government is worried about the introduction of a customs border with the Irish Republic if the UK were to leave the Customs Union. These restrictions limit the scope of the British government to threaten to erect trade barriers against the EU.

Ultimately, the question arises whether the UK would threaten to raise high and protectionist barriers to trade with EU partners on a broad scale, in case the negotiations with the EU failed. While the UK has to adopt a WTO tariff schedule that could be based on EU tariffs at the outset, a protectionist strategy does not appear very credible due to the liberal British economic tradition. Moreover, the EU exit was justified by prominent Brexit supporters on the grounds that leaving the EU would

enable the removal of EU foreign trade protectionism to the advantage of the British economy (Minford, 2015).

The EU's negotiating position

The EU's strongest asset is undoubtedly the aforementioned size of the European market, and the fact that the UK is therefore more heavily dependent on a constructive agreement than is the EU. This may well work to the EU's advantage with regard to the timescale for the negotiations, as the UK will probably push for the quickest possible conclusion and as a result is likely to end up in a defensive position.

In addition, the negotiating position of the EU is strengthened above all by the fact that it can credibly point to the fact that its scope for negotiation is limited. After all, agreeing an overly generous arrangement with the UK, one that could be interpreted as cherry picking, would be very problematic for the EU for two reasons. Firstly, such a solution could lead to other critical EU member states also opting for an exit from the EU. This would threaten the very foundations of the EU and therefore it is an imperative to avoid such an outcome from the EU perspective (Busch et al., 2016). Secondly, if the UK were to receive a clearly more favourable integration package, the EEA states and Switzerland could also use this case as a precedent and ask for improvements of their own status in relation to the EU.

The negotiating position of the EU is also likely to be strengthened by the fact that each individual member state will probably have to vote on an agreement on the future relationships between the EU and the UK. There is good reason to suppose that this agreement will be a so-called mixed agreement where each member state would de facto have right of veto (Malhotra, 2016). The more the member states are involved, the more restricted the EU's room for compromise will become. For example, the central and eastern European countries place particular value on the free movement of people and on further payments from the UK into the EU structural funds, from which they in particular benefit.

Overall, the EU clearly appears to have a stronger negotiating position. This has to be born in mind in the following discussion.

4. Evaluation of British concessions

It is still not clear which concessions the UK is prepared to give. However, a rough evaluation has to be made in order to assess the probable outcome of the negotiations.

The speech of the British Prime Minister at the Tory party conference on the 2nd October 2016 is of particular importance here (May, 2016). Central to the Brexit perspective is the key aim of regaining regulatory sovereignty, particularly in relation to migration control but also in relation to a disengagement from the supranational organs of the EU. Since then there has been much talk of the UK moving towards a “hard” Brexit.

However, several arguments can qualify this view. Firstly, it is possible that the Prime Minister’s speech was mainly intended as a “trial balloon”, in order to observe the reactions of the EU partners, British domestic politics, and above all the business associations in the UK and the EU, to a hard Brexit. Secondly, this hard positioning could also be viewed as an attempt to strengthen the British negotiating position vis-à-vis the EU. Thirdly, as a relevant side condition to the key objective of regaining sovereignty, access to the Single Market is to be maximised. In this trade-off market access appears to have gained relevance for the British government recently. Fourthly, a number of statements by government representatives (referred to below) suggest that despite the hard rhetoric of the Prime Minister, the UK might be prepared to make the relevant concessions, particularly in relation to regulatory harmonisation and payments to the EU.

Free movement of people

In relation to free movement of people concessions are only likely to be reached in the **small category**. The politicisation of the topic in the UK, and the clear position of the British government’s desire to control immigration, leave very little room for larger concessions. We consider the following arrangements to be likely:

- The UK and the EU will agree to a mutual grandfathering arrangement for those citizens who have already entered the partner country (by a certain date).
- The UK will impose a marked reduction on future immigration, even if certain preferences for EU citizens are retained, particularly focused on high skilled immigration.

The EU is likely to consider the British restrictions on the future immigration of EU citizens very critically. The official position of the EU is that access to the Single Market is linked to the recognition of the four freedoms (Tusk, 2016). The significance of free movement of people is also evident in the fact that even

Switzerland, although it only has medium access to the Single Market, makes very considerable concessions to EU citizens in this respect. For Switzerland and Norway there are admittedly some vaguely formulated protection clauses, but these can only be invoked if there is a very steep rise in immigration. In addition, if the other party to the contract tries to restrict the free movement of EU citizens, the EU for its part has the right to suspend other concessionary arrangements as part of the reciprocal agreement. The fact that the EU operates very restrictively in this regard can be seen in its reaction to Switzerland's attempt to restrict immigration, following a referendum in 2014 (Matthes / Busch, 2016; Vogel, 2016).

Restriction of regulatory sovereignty

In the case of the relinquishment of regulatory sovereignty, a concession in the **category medium to large** might be possible. As a benchmark, we can draw on the fact that Switzerland has aligned about a third of its legislative initiatives to EU requirements, and Norway has implemented about three quarters of EU legislation compared with EU members (Busch/Matthes, 2016).

It is true that criticism of a supposed overregulation by the EU played an important role in the Brexit debate, and the British Prime Minister underlined the desire to regain regulatory sovereignty (May, 2016). However, the EU only grants access to the Single Market if the trade partner undertakes extensive legal harmonisation with EU regulations in the respective areas. In this case, one also needs to bear in mind that countries like Norway and Switzerland only have no relevant say in the regulations they take on. In view of the conflicting aims that are emerging here it is difficult to assess what a future scenario might look like.

However, there are a number of arguments suggesting that a considerable level of harmonisation with the EU law could well remain in the future:

- The regulations between the EU and the UK are currently (still) extensively harmonised. When the UK withdraws from the EU a comprehensive bill (Great Repeal Bill) will transfer all EU legislation into British law. In fact it has been reported that according to Brexit minister Davies, the bulk of the existing market regulation will be retained (Emerson, 2016, 8).
- The UK will not fundamentally dismantle consumer, health, employee or environmental protection, but presumably maintain a comparable level of protection in many of these areas (Open Europe, 2013).
- In relation to technical *product* standards, a progressive regulatory alignment is more likely than in relation to *production* standards, for example in relation to regulations concerning working or environmental conditions, which have been criticised as relatively costly (Open Europe, 2013). Continued legal alignment for *product* standards appears plausible, because these rules are less controversial

in the political arena and because UK membership in pan-European standard-setting organisations (CEN and CENELEC) will very likely continue.

- If the UK deviated from EU *production* standards in the future, this would compromise the level playing field from the EU perspective. However, the EU has not insisted that Switzerland adopts relevant production related EU regulations such as the working time directive. Moreover, within the Single Market there are also considerable differences in relation to the other cost-relevant working and product market regulations tolerated. Therefore, the common level-playing-field argument does hold only to a limited extent.
- With regard to financial services, the CRD IV banking regulations may well be assessed as the third most costly EU regulation (Open Europe, 2015). However, the scope for choosing significantly weaker regulations is limited here, because the UK is very unlikely to withdraw from the G20 process and the regulations of the Basel Committee on Banking Supervision. The aim of safeguarding financial stability will continue to be important in the UK as well.
- In the critical British public debate, regulations, because of their complexity and lack of transparency, tend to be seen as less politically sensitive than payments to the EU, where criticism can become focussed around a single figure. Therefore, politically it seems plausible that the British government will change some EU regulations which have been the focus of particular criticism, and use these changes in the public debate as a strongly recognised signal that sovereignty has been regained. This could then open up political scope for other less prominent regulations to be continuously harmonised with EU law in the future more or less on the quiet.
- With regard to competition and the rules on state aid, we consider it likely that except from some possible high profile industrial policy action (for example against steel imports from China at dumping prices) there will be no fundamental departure from the traditional liberal British economic model. The EU might tolerate limited competition infringements and state aid actions by the UK – for several reasons. Firstly, the EU competition and subsidy law only has very limited validity also for Switzerland (Oxera, 2016). Secondly, the EU can rely on a strong competition authority which can take effective action also against non-EU states for relevant competition infringements.
- Finally, there is certainly a question mark over how, in case UK law was harmonised to EU law, it could be monitored, and potential disputes settled, and what role the European Court of Justice (ECJ) would play here. Admittedly the British Prime Minister has spoken out against being subjected to the jurisdiction of the EJC (May, 2016). However, there is also room for interpretation here. We consider the following regulation after a Brexit to be conceivable and plausible: in the case of a dispute the jurisdiction of the EJC would only apply to the interpretation of the terms of the agreement and the EU law adopted by the UK,

as is foreseen in the new rules planned between the EU and Switzerland. Since the UK could relinquish the legal harmonisation (and thereby the direct relationship to the EJC) by not agreeing to a settlement, British legislative autonomy would continue to be extensively upheld. In such a case, the EU would very probably reserve the right to restrict access to the Single Market for the UK in the relevant area for the reasons of reciprocity.

Payments to the EU

The UK is likely to reduce its net payments to the EU considerably, but not completely stop them. Thus, a concession of the category **low to medium** appears plausible. On the one hand, there is certainly great sensitivity in the British debate around this issue, and an eye-catching figure can easily attract public criticism. On the other hand, the British government appears to realise that in part they also have to “buy” access to the Single Market (or the Horizon 2020 research cooperation program). In fact, a number of government representatives, have already made relevant statements in this direction (e.g. The Telegraph, 2016a), and thus have begun to temper the expectations of the general public about this matter.

The EU will view the reduction in payments critically above all because if the EU were to basically lose the UK as a net payer, this would leave a significant gap in the EU budget. Between the years 2010 and 2015 Britain’s net contribution, which varies from year to year, amounted on average to 9.4 billion euro. If there are no reductions in the EU budget, Germany will be particularly hard hit by this (Spiegel Online, 2016), but so will other net contributors.

Overall Concessions of the UK to the EU

In summary the following concessions seem likely:

- **Free movement of people:** **small**
- **Restriction of regulatory sovereignty:** **medium to large**
- **Payments to the EU:** **small to medium**

Overall British concessions are likely to be classified in the **medium category**.

In addition the British trade deficit with the EU along with the political and military significance of the UK needs to be taken into account (see Chapter 3 for qualifications of these allegedly highly valuable bargaining chips).

5. Evaluation of Single Market access for the UK

Single market access on average

If the EU operates in a mercantilist way and hence takes account of reciprocity and proportionality, medium concessions of the UK would only allow for a medium degree of access to the Single Market granted by the EU. This would be approximately and on average comparable with the **Swiss integration model** (see framework in Figure 1) – even if the individual components of concessions and Single Market access were to be configured differently.

It is true that the British Prime Minister has spoken against adopting the Swiss model (May, 2016). However, this statement could refer primarily to the structure of the EU-Swiss integration model with regard to the considerable number of individual bilateral agreements which are difficult to manage. By contrast an EU-UK agreement will very likely be a single agreement – possibly based on the structure of association agreements, in order to include foreign and security policy (Duff, 2016; Emerson, 2016). In addition such an agreement would, to a limited extent, be tailored to British interests in individual areas.

Access to the Single Market in detail

Against this background we can ask what specific form an agreement between the UK and the EU might take, and how the British concessions might be matched against the EU concessions regarding access to the Single Market. In the following discussion we will attempt such an evaluation, with some reference to the Swiss integration model, in order to evaluate the relevance of important EU concessions regarding access to the Single Market. It is also important here to take account of the strength of the respective negotiating positions. Here the relative size of the two markets plays a key role. With regard to any individual reciprocal market access concessions the UK, with its significantly smaller market, is clearly at a disadvantage in relation to the EU, and will thus have to produce other concessions in order to redress the balance in each area. How the reciprocal concessions offset each other, depends on the chosen sequence of events. It is assumed here that for the UK the tariff matters related to the free movement of goods are particularly relevant, and would therefore be right at the top of the agenda. The conclusions of the following evaluation are speculative and intended to serve as a starting point for a debate.

Free movement of goods

It is very likely that the UK will **leave the customs union** so as to restore its flexibility over its own customs arrangements, because only then will the British government be sufficiently free to make its own free trade agreements with third countries. The

issue of a customs border between Northern Ireland and the Republic of Ireland will be unavoidable in this case.

It might be true that being in or out of the customs union is not a binary issue. However, even if the UK opted for a certain number of products to remain in the customs union, costly customs procedures will have to be set up to check whether products are in or out of the customs union. Moreover, for products outside the customs union, costly rules of origin will have to apply.

However, a **certain relaxation of customs procedures and of rules of origin** is likely to be in the mutual interest of both parties. This could be shaped similarly to the trade facilitation arrangements with Switzerland.

It is assumed that the **absence of industrial goods tariffs** will continue. An assessment about possible future tariffs on agricultural goods is provided here. On the one hand, the continued absence of industrial goods tariffs is basically in the mutual interest of both parties, particularly given cross border supply chains. On the other hand, and more importantly, obtaining tariff-free access to the EU's industrial goods market is by no means a foregone conclusion for the UK. On the contrary, given the enormous relative size of the market of the EU this would be a considerable concession by the EU. In its free trade agreements with smaller states the EU usually obtains considerable concessions from the respective partner in other spheres (for example with regard to public procurement in Canada) in exchange for granting far reaching tariff-free access for the partner's industrial goods exports. Hence according to mercantilist logic, the UK has to offer considerable concessions in return.¹ At this point, because of the link with industrial goods trade, it makes sense to bring the British goods trade deficit with the EU into play; all the more so, since the UK has hardly any concessions to offer in any other areas (unlike Canada), because the British market is already very open to the EU and because the UK is not very likely to erect new trade barriers in the case no agreement is reached with the EU (Chapter 3). However, from our perspective it is doubtful as to whether the trade deficit would be a sufficient counterbalance to outweigh the tariff-free access to the EU's large market. This is even more the case given that the aforementioned trade facilitation arrangements also have to be considered as disproportional EU concession, due to the relative size of the EU market. It is therefore possible that a certain amount of the British concessions mentioned in Chapter 4 will be required here.

¹ In the case of Switzerland the EU was probably more generous than in other free trade agreements because at the time of the negotiations, Switzerland was seeking entry into the EU (Breidlid/Najy, 2016). The UK cannot avail itself of this advantage.

Whether there will be extensive mutual recognition of products in industrial goods trade and thus **access to the free movement of industrial goods in the Single Market**, is more difficult to evaluate. This concession by the EU would imply that British products only need to be approved once in the UK (on the basis of sufficiently harmonised product standards with the EU). Thus, it would not be necessary for UK firms to manufacture separate product version for the domestic and the EU market respectively – which would incur considerable extra costs. Certainly for trade in industrial goods, this kind of free access to each other's markets would be in the mutual interest of both parties, not least because of the bilateral industrial value chains. Moreover, industry representatives from both sides are likely to press for it. Nevertheless, again the considerable size of the EU market has to be taken into account which the UK would need to balance with equivalent concessions.

How valuable is the concession of extensive mutual recognition for industrial goods from the perspective of EU? Taking the Swiss model as a point of reference, the EU appears to value this concession very highly. Ultimately mutual recognition for a large number of industrial product groups is the greatest concession regarding access to the Single Market that Switzerland receives compared to other EU free trade partners. By contrast, Switzerland's greatest concession is granting freedom of movement to all EU citizens. It therefore makes sense to place these two concessions in relationship to each other based on their great relevance. In an attempt to establish equivalence in reciprocity, it thus seems plausible to attribute a major part of the Swiss concession on freedom of movement here. In addition, Switzerland implicitly also brings to bear the majority of Swiss legal harmonisation with the EU, which the EU demands as a basic pre-requisite for access to the Single Market in this important area.

This raises the question of which concessions the UK could throw onto the scales to receive extensive mutual recognition and thus access to free movement of industrial goods in the Single Market from the EU. A relevant British concession needs to be (as in the case of Switzerland) the sustained legal harmonisation of product standards that the EU demands in any case. This would mean that a significant part of this British concession (assumed to be medium to large in Chapter 4) would be brought to bear here. However, as pointed out in Chapter 4, the UK is assumed to only offer a small concession in relation to free movement of people – which is much less than Switzerland offers. That means that further considerable concessions from the UK would be necessary, if the Swiss model were to be used as a reference point. Therefore, the UK would presumably have to provide a considerable part of the low to medium sized British payments to the EU (thought to be realistic in Chapter 4). It seems very doubtful, however, that this would be sufficient to offset the lack of free movement of people that the EU values very highly. Due to the lack of additional UK

concessions, this would mean that a considerable part of the great political and military significance of the UK would also need to be brought to bear in this important area of free movement for industrial goods.

Free movement of services and capital

A further key issue for the UK is the **access to the service markets of the EU** and above all for financial services and business services providers, because the British economy has particular strengths here and can demonstrate a clear trade surplus with the EU. Alongside this is Great Britain's important role as the bridgehead for financial service providers from third countries (such as the USA) for access to the EU Single Market, which plays an important role for the City of London (Matthes/Busch, 2016; Schoenmaker, 2016).

For financial services, there are so-called passporting rules for various financial services based on a complex set of EU rules (Lannoo, 2016; Scarpetta/Booth, 2016; SVR, 2016; Wyman, 2016). These passporting rules enable financial institutions that are established in the UK to supply their services cross-border (or via cost effective branches that are supervised by the UK) to all other EU countries. Thus, it is possible to provide a service without having to set up costly subsidiaries in the relevant EU countries, which need its own licence, have to be separately capitalised, and are supervised by the country where they are located. Moreover, there is a requirement that a substantial part of the business activity is transacted in the respective EU country and not by the parent company in the UK in a cross-border fashion.

The passporting rules are important above all for banks and for the trading of securities and derivatives; they also pertain to a slightly lesser extent to investment funds and only to a limited degree for insurance companies (Lannoo, 2016; Scarpetta/Booth, 2016). In this way London is able to fully exploit its strengths – above all its agglomeration advantages and its English language skills. Without the passporting arrangements London would not have been able to specialise so intensively in financial services. If this particular Single Market access condition was to be lost, this would presumably lead to a significant relocation of financial service providers from London to financial centres in the EU such as Frankfurt, Paris or Dublin (Demary/Voigtländer, 2016).

To prevent this from happening the British government could try to ensure that the EU granted the UK an equivalence status for financial services which is principally available for non-EU countries. If the regulations abroad are recognised as equivalent by the EU, financial service providers from third countries will be able to offer cross border services on this basis, even from their own country. However, relevant restrictions exist here. Equivalence status is only available for a few financial

service activities (Scarpetta/Booth, 2016). A further disadvantage lies in the fact that ultimately equivalence status is granted as a political decision by the EU and can be withdrawn at any time. This would certainly be too uncertain a business basis for London as a financial centre. For this reason, the British government will presumably be anxious to reach a tailor-made agreement with the EU based specifically on the UK's interest in the financial sector. However, this might only be partially successful, as the following discussion shows.

It is true that the EU has a comparatively liberal regime with regard to free movement of capital, as compared with trade in services. According to Article 63 of the TFEU, not only are all restrictions between the EU member states forbidden but in principle also between the member states and third countries. This means that third countries with WTO status enjoy relatively extensive free movement of capital in the EU (Scharf, 2008).

In contrast, the EU is much more restrictive in relation to trade in services. With the exception of a few service areas (like for example public procurement) the EU maintains considerable restrictions on third countries. This is the case particularly for cross-border service provision, but also for example in the deployment of employees and the recognition of professional qualifications. Even Canada's access (within the CETA framework) is way behind the service access level provided by the Single Market (Erixon, 2016; Scarpetta, 2016). This is also the case for Switzerland, to whom the EU concedes only a little more than to Canada – and that includes hardly any financial passporting arrangements (except for certain non-life insurance branches), although the banking sector plays an important role in Switzerland and banking regulation is relatively strict there.

Behind the differentiated openness for movement of capital and trade in services there is ultimately a mercantilist motivation, which is likely to significantly affect the EU's negotiating position in relation to the UK. In the case of cross-border service provision from abroad, value added and jobs which are linked to these services remain predominantly abroad. From this perspective it is not surprising that the EU is more generous with granting establishment rights in the EU via a subsidiary. In this case the EU country concerned tends to profit from higher value added and more jobs (if there is not a complete substitution of local providers). In addition, the establishment of a subsidiary and the licensing associated with it ensure that foreign providers are bound by EU regulations and thus ensure that a level playing field exists.

The EU is likely to maintain this logic in relation to the UK. The following arguments can be made to support the notion that the EU will not grant financial passporting rights for the UK:

- Up until now the EU has not offered cross-border service provision in the financial sector to any partner country in other free trade agreements. (Lang/Conyers, 2014).
- The negotiation arithmetic speaks against greater concessions by the EU for access to their services market, because here the EU shows a deficit in bilateral trade with the UK. In contrast to trade in goods, the British government cannot provide any direct trade-off with the large market of the EU here.
- Individual EU member states might hope that if the passporting rights are not granted they can strengthen their financial centres at London's expense.
- High-ranking representatives of the EU commission have called for a direct link between passporting arrangements for financial services and the free movement of people.
- If the British government were to deploy most of their concessions, as discussed above, for access to extensive free movement of industrial goods, the UK would only have very narrow concessions remaining for access to the EU's (financial) services market, according to the arguments made here. These consist of the remaining legal harmonisation (obligatory from the EU perspective), the remains of the already only low to medium payments to the EU and the remaining political/military weight.

In this respect, too, parallels can be drawn between Switzerland and the UK. If one follows the argument discussed above, the Swiss deployed the majority of their concessions for the extensive free movement of industrial goods in the EU. That means that only a small share of their concessions remain in relation to legal harmonisation and to free movement of people, as well as with regard to very low payments to the EU. This has obviously not been sufficient for the EU to also grant access to free movement of services in the EU. Instead, Switzerland receives access to the Single Market only in very few service sub-sectors such as road and air transport and for non-life insurance, but not the banking pass. In addition, the EU grants Switzerland somewhat better conditions than to Canada for the temporary deployment of workers and the recognition of professional qualifications.

Much more than that is unlikely to be achievable for the UK given that the remaining British concessions are similarly small, if one follows the arguments made up until now. All this points to the fact that the negotiations about the UK's access to trade in services and above all in financial services will be highly controversial.

6. Strategic considerations

Confronted with these contradictory objectives, the UK could be inclined to relinquish the free access to trade in industrial goods, which is important for the UK industry. The British government could instead attempt to use their concessions in the fields of services, thereby endeavouring in particular to retain passporting arrangements for financial services.

Thus, as one of the key results of this study, a significant conflict is revealed between the interests of industry and of the financial sector about the way the scarce British concessions should be allocated.

In this context, the question arises which of the two sectors have more political influence in the UK, and whether the British government would rather support industry or the financial sector in their Brexit plans. Various issues play a role here:

- With reference to the overall economic significance, the weight of the manufacturing industries slightly outweighs that of the financial sector. Industry accounts for around 10 per cent of the gross value added (2015) and for around 8 per cent of the workforce (2014) as against the financial sector's 7 per cent for value added and 4 per cent for the workforce (Rhodes, 2016). In addition, both sectors overall relevance is somewhat higher as both purchase inputs from other sectors, such as business services or the construction industry for example.
- There is no doubt that the City of London wields great influence, but the influence of industry ought not to be underestimated either. Above all, it could be greater in the British parliament, because industry is distributed more evenly across the country than the finance sector and can therefore influence MPs more strongly via their constituencies.
- Moreover, the Brexit referendum has shown that there is broad dissatisfaction particularly in the UK industrial regions that have been affected by structural change. The British government seems to want to respond to this (May, 2016). In this regard, it would therefore be counterproductive if these regions were affected by a loss of access to the free movement of goods in the EU. It is true that there was an overwhelming vote for Brexit in these districts, but with the aim of improving people's lives, not making them worse.
- The image of the financial sector is still tarnished following the global financial crisis and it is therefore not likely to be politically well-received if it is precisely those interests of investment bankers and hedge funds in London which are given such strong consideration at the expense of industry (The Telegraph, 2016b).
- Finally the Labour Party and left leaning commentators could escalate the British government's support of the financial sector at the cost of industry in the public

debate on the conflict between capital and labour. This would also work against the image of the British government as an advocate of workers' interests.

There are therefore a number of arguments against the idea that it would be a successful strategy to favour the interests of the financial sector to the detriment of industry.

7. Summary and policy recommendations

In negotiating an agreement with the UK concerning future institutional arrangements, the EU should operate in a fair and constructive way. This will be a challenge, as the British public debate will most likely feature the EU as being unfairly strict on the UK. At the same time, the EU should not allow any cherry picking because this could result in a bandwagon effect among other EU states as well as countries such as Switzerland and Norway. A precedent must not be created which could ultimately lead to the disintegration of the EU.

Objective guidelines and benchmarks would clearly facilitate steering a course through the negotiations by which the EU Commission is seen as a fair negotiator in the UK but at the same time avoids any bandwagon effects. The framework developed in this study (Diagram 1) is intended to offer these. Hence the EU – in negotiating according to mercantilist principles – should adopt and adhere to these guidelines. By pointing to the existing integration models and by demanding clear reciprocity between the British concessions and the access granted to the Internal Market it will avoid bandwagon effects and be able to demonstrate at the same time that it is offering the British government a fair arrangement.

Finally, recommendations are given that would enable the EU to provide incentives to the UK to use the above-mentioned available British concessions for the extensive free movement of goods:

- Firstly, this could be achieved if the EU adheres to its official position so far, namely that the four basic freedoms of the Internal Market are inseparable. This means that the UK could only retain passporting arrangements for financial services if the British were to make sufficiently large concessions in relation to the free movement of people, which seems unlikely at the present time.
- Secondly, a politically more attractive (and less dogmatic) possibility would be to establish an enhanced version of a free trade agreement (FTA 3.0) which goes beyond the approach taken in the recently established new generation of free trade agreements which aim primarily at reducing non-tariff barriers (NTBs) –

starting with the FTA with South Korea, going further with Canada in CETA and particularly with the US in the envisaged TTIP. In TTIP, NTBs in industrial goods trade are intended to be tackled mainly by way of mutual recognition which would be largely based on establishing the equivalence of regulatory outcomes. This approach, which would involve very strenuous analytical procedures, could be called FTA 2.0. An FTA 3.0 with the UK would involve mutual recognition on the basis of sufficiently harmonised rules and standards, which would be a much more reliable way to do business. If the British government decided to follow this option, the advantage for the UK would lie in relatively extensive access to the free movement of industrial goods in the EU – which would considerably go beyond CETA. The advantage for EU would consist of the fact that the EU could offer a fair deal to the UK that adequately reflects the assumed British concessions in terms of the framework proposed in this study. At the same time, the establishment of an FTA 3.0 would imply that the access to the free movement of service (and to the cross border supply of services) for the UK would remain restricted, as is commonly the case in FTAs that largely pertain only to the industrial goods sector traditionally.

In summary, by adhering strictly to the principle of reciprocity the EU should make it clear to the British public that significantly reduced British concessions will also limit access to the Single Market in important areas. If this conflict of objectives is clearly set out – unlike in the referendum campaign – the British people can decide whether the sovereignty gained by leaving the EU is worth the costs of less economic integration with the EU. Whether this would lead to a re-evaluation of the exit question remains an open question at the present time.

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