Brexit & Trade - Policy Recommendation to Government

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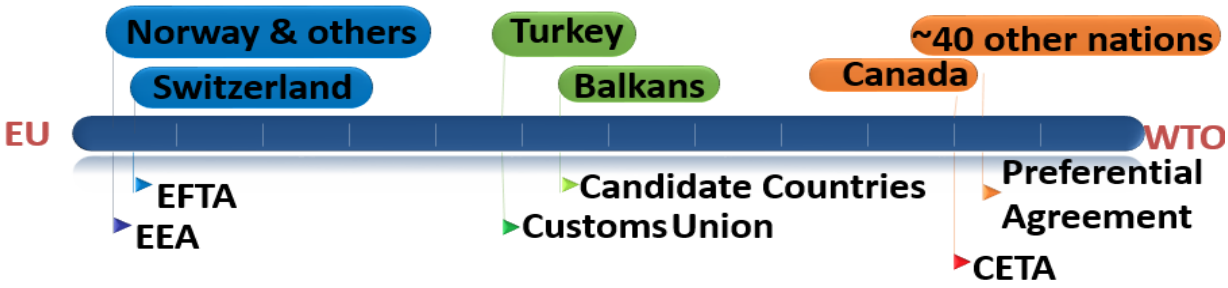
Introduction

After triggering Article 50, the UK was left with a two-year time frame to negotiate with EU officials concerning the future relationship between the UK and EU. If no agreement is reached

by the end of that period and no extension is agreed, the UK will automatically leave the EU and all linked agreements. This would mean that the UK would leave with “no deal” and no transitional phase from EU legislations, falling back on World Trade Organisation (WTO) rules. The ongoing negotiations will determine the severity of the Brexit that UK officials will opt for. Considering most free trade agreements take 5 to 10 years to negotiate and the UK only has 2, it is reasonable for Britain to choose to adopt a model similar to an existing EU trade agreement and 50 such models exist. Countries such as Norway, Switzerland, Turkey and Canada have agreements with varying degrees of integration with the EU, which can be seen as templates for the UK’s future agreement. This report will explore some of the different options in detail and attempt to determine the most suitable existing model which the UK could adopt.



European Free Trade Association (EFTA)

European Economic Area (EEA) + EFTA (Norway)

Norway is a member of the EFTA, which was established in 1960 in part as a counterbalance to the “politically driven” European Economic Community (EEC). The UK was a founding member of the Association, but left in 1973 to join the European Community (EC). Today, EFTA is made up of Norway, Iceland, Liechtenstein and Switzerland. The EEA was signed into existence in 1992 and unites some EFTA members with EU members. The EEA is comprised of 31 states and provides for the free movement of goods, services, people and capital, which are the founding principles of the single market. Importantly, the EEA does not cover common agriculture and fisheries policies; customs union; common trade policy; common foreign and security policy; justice and home affairs; direct and indirect taxation; or economic and monetary union (EFTA, 2017).

EFTA, outside of the customs union, currently has 27 free trade agreements (FTA) covering 38 countries across the world, from Albania to Chile. The Association is responsible for its Convention, which forms the legal basis governing trade between its members, the FTAs it has around the world and the EEA agreement with 3 of its 4 members (EFTA, 2017).
Norway only adopts around 8% of EU originated law once internationally determined standards are stripped away, most of which are directly copied and pasted into EU law from organisations such as the WTO, International Maritime Organisation and Codex Alimentarius. Moreover, Norwegian civil servants are consulted before drafts are put to the European

Parliament which affect the country, to avoid the country having to use its “Right of Reservation” to cancel any new laws coming in which they do not approve of, although the use of this option is not without punishment (Dunt, 2016).

Norway pays in significantly less to the EU budget than a full member, but retains access to the single market, including passporting rights for financial services, which is particularly relevant to the UK, where the financial sector have a trade surplus and significant GDP and tax revenue contribution. In addition, there is currently no precedent for passporting rights without EU or EEA membership. Current passporting rights allow some 5,500 City firms to operate in the EU, comprised of over 330,000 passports (Dunt, 2016). The alternative is ‘equivalence’, which would happen outside of the single market and would need to be assessed by the European Commission and done on a case-by-case basis in terms of services, and is not comprehensive. The duration of an equivalence agreement is not guaranteed and can be withdrawn at any time (European Commission, 2017).

EFTA (Switzerland)

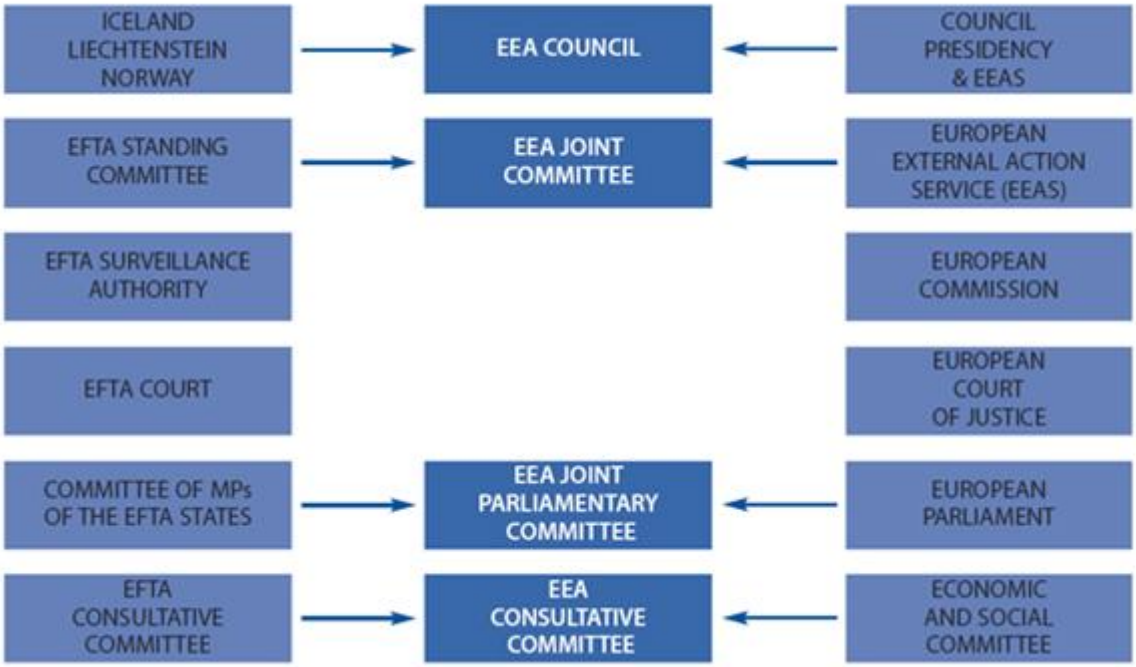
It could be argued that Switzerland in theory is the most logical choice. In practice, however, it has very little chance of getting ahead. The names of Switzerland and Norway are sometimes associated, but their relationship to the EU is very different. Both countries contribute to the EU budget (Switzerland less), belong to the Schengen area and apply parts of the EU rule book , but in different ways.

Switzerland, a member of EFTA but not the EEA, has a unique relationship with the EU that is the result of a significant body of more than 120 bilateral agreements negotiated over the last decades. The bilateral treaty approach allows Switzerland the flexibility to choose the EU initiatives in which it wishes to participate. It also has a free trade agreement with the EU and a number of agreements, which give it access to the single market for most of its industries. However, it does not have full access to the single market for its banking sector and other parts of the services sector, which together make up almost 80% of the UK economy. Swiss financial institutions often serve the EU market through subsidiaries based in London. Furthermore, its agreement also requires the free movement of people.

The main difference with Norway is the treaties and the community legislation continue to be applied as it is being developed in Brussels. Even though they do not have a vote (although they have a voice) in the development of the regulation, it applies to everything that has to do with matters that are within the EEA agreement, with their common regulations and standards. In Switzerland, the implementation of community legislation is not automatic.

Overall, it is likely that the Swiss model would result in less economic integration between the UK and the EU than EEA membership, leading to higher economic costs of Brexit. The Swiss model would also entail giving up some sovereignty, since the UK would no longer have a say in EU decision-making, but would have to adopt EU legislation to participate in the Single Market. (Dhingra, S. and Sampson T., 2016)

<u>The Two-Pillar EEA Structure</u>



This diagram shows the management of the EEA Agreement, the left side showing EFTA states and their institutions and the right showing the EU side. Joint EEA bodies are in the middle. Noteworthy is the the lack European Court of Justice involvement.

Candidate countries

Customs Union (Turkey)

Turkey has been a candidate to the European Economic Community, the predecessor to the EU, since 1987, though negotiations stalled since 2016 as relationships worsened. In the meantime, Turkey established a customs union with the EU that took effect in December 1995. This means that goods can travel freely between the EU and Turkey without any customs restrictions and the two have common external tariffs. However, this does not cover agriculture, services or public procurement (the process of finding, agreeing terms and acquiring goods/services from an external source). Turkey does not pay fees and there is no freedom of movement. Joining a customs union with the EU, while leaving the single market, is an option for the UK post-Brexit. This would allow tariff free access to the EU market, which would minimise disruption to exporters. However, this does not seem to be a suitable option for the UK. Firstly, there is no service deal – services makeup nearly 80% of the UK's GDP. A customs union would also involve continuing to follow EU standards and regulations, but without having a say in what such policy. This is incompatible with May's desire for a "fully independent, sovereign country". Moreover, the common external tariffs that a customs union involves are undesirable: Turkey currently has to adopt the same tariffs towards countries that the EU has free trade agreements with, even if Turkey is not party to these agreements. In

addition, common external tariffs also mean that the UK would not have the freedom of negotiating its own free trade agreements – a key argument for leaving the EU. Overall, joining a customs union with the EU seems a bad option for the UK – indeed, it was intended as a step for Turkey towards joining the EU, rather than as a solution in moving away from the EU.

Preferential Agreement

Roughly 40 other nations have preferential trade agreements of some kind with the EU. Some of these are more integrated than others, considering the nature of the British economy and its links to the EU it would make sense to adopt the most inclusive of which is the Comprehensive Economic & Trade Agreement (CETA).

CETA (Canada)

CETA is an agreement between Canada and the EU that was signed in February 2017 but has not yet been ratified. If the UK is to leave fully all existing European political architecture and secure a trade agreement of its own it makes sense to adopt CETA as a framework as it is the most recent and also far reaching trade deal with the EU. CETA removes almost all tariffs and also goes a considerable way to removing non tariff barriers. It also opens most of the service sector which is important considering the UK's relative strengths in this area. It doesn't however include banking passporting rights. There is also a mutual recognition of qualifications and standards which saves firms time and money by removing duplicate checks. Downsides of CETA are that financial services are not included and agricultural regulations are also not harmonised. The reasons that agricultural rules are not harmonised are that EU geographical indicators are protected and also the EU has different rules regarding GM and hormones which it wanted to protect. One key issue for the UK leaving the EU is immigration. The CETA framework allows firms to relocate staff internally bypassing normal immigration visas. Seeing as all these people have guaranteed jobs they are not going to put too much pressure on social security. Other immigration is subject to normal controls as decided by each side. This position would work well for the UK as it would be able to regain control of its borders.

CETA plus

If the UK government chooses to use CETA as a template we would recommend using the 2 year negotiation window to work on these areas for the so called "CETA plus" i.e CETA with harmonised agricultural regulation, which should be easy considering they are already currently harmonised, and also including financial services especially the passporting rights that are a key issue for the City of London.

WTO

The World Trade Organisation aims to increase trade worldwide by having a large majority of countries follow guidelines 180 countries that are not in the EU currently follow these. These guidelines mean that all goods and countries are treated equally without discrimination. This is because a country must give the same tariff to all other nations or trading areas according to the WTO rules. Over time, the WTO are reducing all tariff and non-tariff barriers to trade. If the UK fails to make a deal or transitional deal with the EU it will be left on these terms. Trade is highly likely to fall and is predicted to reduce income by 3% in the short run (LSE 2016). In the long run, there will be loss in drive for innovation and productivity from lack of specialisation, shared capital and skilled knowledgeable workers. Predictions show that income will be 9.5% lower than it otherwise would have been in the long run (LSE, 2016). Intra-EU trade will force firms to become more efficient driving costs down between 20% and 40% faster than the costs for the other developed countries around the world (LSE 2016). Furthermore, the entanglement of red tape will mean that very tedious and specific paperwork must be filled just to export to the EU. This is because the WTO struggle to progressively reduce non-tariff barriers. If even only 10% of the £229 billion worth of exports to the EU is rejected due to the tedious paperwork filled incorrectly this will be catastrophic for the UK economy. In the situation of being just on the WTO rules, it has been put forward that the best strategy would be to have unilateral free trade. Since only 85-90 per cent of the UK's economy is in non-protected sectors (Bourne, 2016) only some firms will be damaged but the economy as a whole should prosper. This would allow for lower prices and therefore give consumers a higher standard of living. By adopting unilateral free trade damage to the economy can be minimised, but this is still making the best out of a very bad situation. Income will still fall by 2.3% (LSE 2016) in this situation and could start to recover as new deals are made.

EEA over CETA

Each potential option for the UK has drawbacks, but the most preferable options seem to be either a CETA or follow the Norway model. These allow high access to the EU without restricting free trade agreements with other countries. While both have disadvantages – for example, the strict rules of origin that create non-tariff barriers through extensive paperwork – these options are the two that are most likely to maximise UK growth.

In particular, following the Norway model is the best-case scenario for the UK outside of the EU. This is largely due to the passporting rights that the EEA includes. Passporting rights are crucial to the UK because financial services contribute 8% of the UK's output, and employ 3.5% of the labour force (Carney, 2015). The financial sector is also vital to the government's budget, contributing over £60 billion in 2014. The City of London is a financial hub (the City placed first in the competitiveness ranking of global financial centres in 2017 (Yeandle, 2017, p. 6) and would face huge losses if tariffs were imposed on financial services. While it is unlikely that London will lose its status as a Europe's leading financial centre, it is more than possible that some firms move to other cities within the EU, such as Dublin or Frankfurt, to gain trade barrier free access to the EU.

There is also the issue of time that makes a CETA deal an inferior solution. The CETA between Canada and the EU has taken extensive negotiations over seven years, and still isn't in force – though it is difficult to compare the forging of a new relationship with the "mother of all divorces". In any case, a Norway model would be easier and quicker to negotiate, potentially even within the two-year time frame as EU countries would retain their valuable access to the UK with minimum disruption. This is highly beneficial to them, and so they would be more willing to conclude negotiations quickly.

A potential problem with the Norway model compared to a CETA is that it entails the freedom of movement of people, which both main party political leaders have stated they will avoid. However, on the whole, this seems a misguided policy. Firstly, the EU has consistently linked free trade in services, clearly important to the UK, to the freedom of movement of people. Weidmann, head of the German central bank, said "passporting rights are tied to the single market and would automatically cease to apply if Great Britain is no longer at least part of the European Economic Area." Secondly, evidence suggests that limiting migration to the 'tens of thousands', as the Conservative party stated, will have harmful effects on the UK economy. The government's fiscal watch dog claimed that "by the mid-2060s, with net migration of around 100,000 public debt would be about 30 percentage points higher as a proportion of GDP than if that number were 200,000." (The Economist, 2017). This is largely due to the dependency ratio of the UK: the government is facing an increasing number of pensioners, and a smaller work force as the population ages. Migrants tend to be of working age (Bruzelius, Ehata and Seeleib-Kaiser, 2017) and therefore contribute to the government budget through income tax. Migrants are especially important in certain sectors, such as food manufacturing, where 40% of workers are foreign (Stones, 2014). Evidently it will be difficult for the prime minister to convince the public that the UK should retain free movement of people, but studies suggest that the effect of migration on GDP per head is negligible (Migration Watch UK, 2016), and it seems necessary to ensure passporting rights. Therefore, the UK should emulate Norway's deal to maximise prosperity outside the EU.

Conclusion

There are many options available to the UK once it leaves the EU in 2019, but the report has focussed on templates that already exist, due to the time pressure involved with the negotiations. It is difficult to say which trajectory the negotiations will take, but the political narrative is constantly changing, and different issues are taking precedence, most notably immigration cuts. Both main parties have ruled out freedom of movement in their manifestos, which suggests that remaining in the Single Market of the EU, or the Internal Market of the EEA, may be impossible. Put into context, the UK may receive some concessions due to its size and economic significance, especially its status as a top world financial centre and major Euro based clearing location, but this is not guaranteed. In a talk to Exeter students, Chris Huhne, former Lib-Dem cabinet minister, was very pessimistic in his predictions for the UK's prospects outside the EU. He cited the gravity trade model and showed that trade with the Republic of Ireland is more than that with India and Shanghai, which debunks the rhetoric of Brexiters positing an open post-Brexit UK, trading with all corners of the world. The currency market's negative reactions to signs of a hard Brexit were also significant to him, as well as rules of origin on complex manufactured products such as electric cars.

Conversely, Eamonn Butler of the Adam Smith Institute told students he was pro-Brexit, because he believes it has become less of a free trading organisation and more of a protectionist one. The preferences of all states in the Union must be considered, which is why trade deals take so long and he thinks the age of multilateral trade deals is over. He was against regulations and increasing corporation tax, regarding the paternalistic regulation approach from the EU as stifling entrepreneurship.
This report recommends the Norway template because it offers the opportunity to negotiate FTAs through EFTA, and as a member of the EEA (but not the EU) the UK could retain access to the single market and sovereignty on the key areas of agriculture and fisheries, foreign and security policy, justice and home affairs and direct taxation, but not immigration.

Limitations

While this report recommends the EEA/Norway option, there are a few limitations that are worth considering. The first problem is that the UK does not feature the same economic conditions as Norway. For example, Norway has a considerable oil supply that enables significant economic growth. Norway was further integrating into the European Union, while the UK is in the process of leaving it. Furthermore, the EU position on Brexit is unclear. The most viable assumption is that they would try to punish the UK and set an example to dissuade other countries from following the same path. In this situation, the EU wouldn't allow a positive (non-zero) sum situation in which case both parties in the negotiations would benefit from the British exit.

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