Stephen Booth
Director of Policy and Research

Open Europe is a non-partisan and independent policy think tank. Our mission is to conduct rigorous analysis and produce recommendations on which to base the UK’s new relationship with the EU and its trading relationships with the rest of the world. We aim to ensure that Government policy and public debate is rational and well informed.

In the wake of the UK’s vote to leave the EU, our programme of research and consultation will focus particularly on:

- The UK’s new relationship with the EU, including trade, security and political cooperation.
- The most important opportunities for new trading relationships with nations outside the EU.
- Productive international cooperation across areas such as immigration, research and development, cross-border investment and financial services.

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Foreword

The Brexit referendum result was decisive. The country voted to leave by a significant margin and that decision must now be implemented. But how we leave and the nature of our future relationship with the European Union remains unclear. The Government has taken too long to set out its plans, and Europe has been too reluctant to talk about trade and the future.

Some are calling for us to walk away from the negotiating table and trade on the basis of World Trade Organisation rules. Although we should not rule out leaving without a deal in all circumstances, in my view, a good deal would be a better outcome.

Others seem determined to ignore the referendum or to recreate all the elements of the European Union from outside it. They want to tether us into a close orbit following Brussels, without a say over its direction. That won’t work. We are the world’s fifth largest economy. As we leave the EU, we need to have more control over our laws and regulation, not less.

In this important report the leading think tank Open Europe has outlined a path to take Britain out of the European Union and to create a new economic relationship with our European neighbours. This sort of proposal deserves to be considered both in the UK and EU.

The report recognises that our economy is unusually dominated by the services industries. Services account for 8 in every 10 pounds in our economy. Our services sector is too important and too globally-focused to be simply a rule taker from the EU. We have to be able to go our own way and use Brexit as an opportunity for regulatory innovation as Mark Carney himself has suggested.

When it comes to goods, the proportion of our trade with Europe is higher than that of our services. We should recognise that whatever the nature of our future relationship with the EU, many industries will continue to make their products to European standards, particularly if they want to trade with the EU.

But the Single Market in services remains far less integrated and very significant barriers to trade in services across Europe remain. Even in financial services, where rules have been harmonised, only a minority of our exports go to EU members. So it could make sense for the UK to adopt a different approach for goods and services.
There is an argument that Britain could commit to preserving the existing body of EU rules and regulations on goods. Business has already adjusted their systems to make products to meet these requirements. When it comes to future rules on goods, the British Parliament - as an independent country after Brexit - must have the ultimate right to refuse to implement new regulations. But that does not mean that in most cases, if business supports it, it would not make sense to apply new rules from Brussels.

Equally it makes little sense for the UK to seek to form a new Customs Union with the EU after Brexit. To do so would give the EU the ability to sell access to our markets, without our control. It would mean that we were unable to alter our tariff regime to suit our domestic economy, and would entail outsourcing our trade policy to Brussels. Even those countries close to the EU, like Switzerland and Norway are not in a Customs Union with the EU.

Open Europe rightly recognise that the UK must avoid making significant commitments to maintaining a so-called level playing field with the EU after Brexit. Of course Britain will always remain a country with high standards, strong environmental laws, and decent labour protections. But that’s not the same as conceding that those laws which would affect our overall economy could be set by others on our behalf.

Britain and the EU need to find a sustainable new relationship. The media debate here in the UK is dominated by the choice between a free trade deal like Canada’s or membership of the European Economic Area like Norway. Neither option works for the UK. This proposal from Open Europe deserves consideration.

Rt Hon Lord Lamont of Lerwick
Former Chancellor of the Exchequer
Executive Summary

In this paper, Open Europe sets out a proposed model for the UK and EU’s future economic relationship, which we believe offers a pragmatic way through the Brexit deadlock. Open Europe’s model lies between the so-called Canada and Norway arrangements framing the UK political debate.

Our proposal is that the UK should seek to remain close to the EU in terms of goods regulations. After all, as a member the UK was a key supporter of the Single Market, which replaced the European Common Market, in the late 1980s. In return for the UK keeping broad alignment with the EU’s rules, it would be reasonable for goods to continue to be freely traded with Europe. The UK should commit to maintaining the existing ‘acquis’ of rules over goods regulation, and will need a process to determine how to apply future regulation, which must not be simply automatic. Switzerland’s experience of alignment with EU goods rules illustrates that this does not necessarily mean full harmonisation with detailed EU rules in all goods sectors, only those that are already highly regulated. There is scope for flexibility for many products and, as a “third country”, the UK would be open to decide not to apply a new EU regulation, but this could prompt retaliation from the EU and might have an effect on market access.

When it comes to services, given this is where the UK’s comparative advantage lies, we do not believe the UK can be a long-term rule taker from the EU. Although, it should be possible to seek a more secure relationship than the existing equivalence regime for financial services, overall it will be for both sides to manage mutual divergence in services regulation.

Seeking a deeper deal would likely mean accepting wide-ranging level playing field rules. We believe that the UK must be able to regulate its wider economy, and that so-called level playing field requirements must be minimised as they would limit the Government’s ability to regulate areas including employment, taxation and the environment. It would not be sustainable for the EU to have control over such policy areas after Brexit.

Giving up some control - or sovereignty - over goods regulation, is a price worth paying for strong market access. Manufacturers in highly regulated industries often follow EU rules anyway, in some cases even in the United States. But seeking to replicate the patchy Single Market in services would require the UK to give away too much control over its economy, for too little gain.

As we leave the EU, we also believe that the UK must be able to control its own trade policy and be able to agree bespoke new trade agreements of its own. This necessitates leaving the EU’s Customs Union. A new customs union, between the UK and EU, would cede control over trade to a Union, over which Britain would no longer have direct influence. It would allow the EU to sell access to UK markets without our control. However, regulatory alignment on goods would significantly contribute to removing friction at UK-EU borders, including on the island of Ireland.

This broad approach should be acceptable to the EU, which already allows countries like Switzerland and the Ukraine very high levels of access to the Single Market in goods, in return for their broadly following the EU rules. Our view is that, if a solution like the one we suggest is not acceptable, the future model should be based around a Canada-style free trade agreement with additional aspects bolted on, rather than approached from Norway-style Single Market membership with elements removed. Simply, the UK cannot become a rule-taker for services and level-playing field issues after Brexit.


**Background**

After March 2019, the UK will give up its political representation in the EU. It will have no British Commissioner, no MEPs, and will lose voting rights in the Council of the European Union. The UK will no longer have a direct ability to shift the direction of new rules and regulation, and to limit the excesses of legislation. Nonetheless, the EU will continue to introduce new legislation over key areas of the economy – including key growth sectors for the UK such as the digital economy and financial services. After leaving the EU, the question of whether the UK will be able to determine its own regulation over key sectors of its economy has become seen as emblematic of the type of Brexit deal.

The debate within Parliament and the media about Britain’s future relationship with the EU has become framed as a choice on a spectrum from Norway to Canada. The “Norway Minus” option would entail the UK having the closest possible relationship with the EU, although it would be formally outside of the European Economic Area. “Canada Plus” would mean the UK basing its relationship on a Free Trade Agreement, but with additional elements bolted on. A key litmus test of these two options is the extent of regulatory independence possible after Brexit.

The non-EU EEA states, Norway, Liechtenstein, and Iceland, are rule-takers: broadly obliged to implement all new EU Single Market regulations and directives. This would not be an appropriate overall position for the UK, post-Brexit. It would mean high access to the Single Market, but very little control over regulation affecting both trade and the domestic economy. While that might be acceptable in certain areas, it would be an unsuitable long-term scenario for key sectors of the British economy, for example financial services. Remaining in the EEA would also limit the UK’s ability to end Free Movement, an objective of both the Government and Opposition.

At the other end of the spectrum, the Canada-EU free trade agreement eliminates almost all tariffs on goods, and includes some elements of customs cooperation. The CETA deal does extend to services, but it only offers limited integration in financial services. Joint committees on regulatory cooperation are established through the agreement, but there is a recognition that Canada and the EU operate distinct regulatory regimes. However, the CETA deal would entail significantly greater barriers to trade in goods and services than the UK currently enjoys.

In fact, Brussels has struck a range of different agreements with its near neighbours and more distant trading partners. Open Europe analysed the EU’s existing relationships with international partners, and drew on precedents established in agreements with Canada, Switzerland, Japan, South Korea, Ukraine and various pre-accession countries, for example the Czech Republic. There is no single model for a relationship between the EU and third countries. Even EU members have opt-outs from certain elements of the European acquis. Every model for so-called third countries involves what could be described as cherry-picking. Each arrangement is inherently bespoke. Nevertheless, the more the UK asks for as part of the Brexit deal, the harder it will be to negotiate it successfully.
**Open Europe’s proposed bespoke UK-EU model**

Open Europe’s broad proposal is that the UK seeks a Single Market-like relationship for its goods trade and a less integrated relationship for services. Under this relationship:

- The UK and EU should agree an extensive Free Trade Agreement which takes as its starting point zero-tariff and zero-quota trade across all goods lines, with maximal customs cooperation (Open Europe’s suggested model in ‘Nothing to Declare’ is roughly equivalent to the Government’s Maximum Facilitation option; as an alternative the Government is considering creating a Customs Partnership with the EU).

- The UK-EU agreement should be part of an overall partnership or association agreement – which creates a framework for managing UK-EU relations with chapters covering fields from trade to security. The UK and EU should not pursue a complex network of separate bilateral agreements of the sort which Switzerland and the EU have formed. However, the relationship will need to be flexible and will inevitably need to be able to evolve over time.

- The UK should not seek to remain part of the European Economic Area (EEA) Agreement, which would provide ongoing membership of the Single Market. Nor should the UK seek to form a new customs union with the EU.

- The UK and EU should agree to “managed alignment” over goods standards and regulations in return for the UK’s Swiss-style participation in the Single Market for goods. A broad-spectrum enhanced mutual recognition agreement would mean most goods manufactured by one party would be considered pre-authorised for sale across others. In highly-regulated sectors the UK may need to agree to continue to follow EU regulations. This process would not be automatic and it would be open to the UK Parliament to diverge from the EU’s regulatory framework, but if this divergence could not be resolved via negotiation or legal means, market access to the EU could be affected.

- As the EU itself has said, customs checks represent only a fraction of procedures that take place at a border – the majority of these are regulatory controls on goods. Under our model, where the UK agrees to accept and apply EU rules on goods in domestic law, there is high potential for mutual recognition of regulations to avoid the need for border checks. This, together with a comprehensive customs facilitation agreement that moves customs procedures away from the border, provides a strong basis for maintaining an open border on the island of Ireland.

- Our analysis has primarily concentrated on manufactured goods rather than the agriculture and food sector. The choices that the UK makes on its alignment with EU rules on agriculture will have significant implications for finding a solution to the Irish border and how much flexibility the UK has in trade negotiations with non-EU countries. Open Europe will address these issues in future work.

- On services the UK and EU should agree to “managed cooperation”, recognising that the UK could not be a rule taker in these areas. The ambition should be a high level of regulatory cooperation, including a combination of mutual recognition and enhanced equivalence. Both sides need the freedom to choose separate rules over services and this will inevitably lead to the loss of Single Market-style rights in some sectors.

- Although a wide-ranging mutual recognition agreement for financial services would be ideal, an expanded equivalence regime would seem more achievable politically at this stage. This
would necessitate a framework for regulatory cooperation, and lengthy lead times for disputes to be addressed before equivalence or market access could be withdrawn by either party. Higher levels of access would necessitate the UK accepting wider EU level-playing field demands which is undesirable.

- The UK is not likely to deviate significantly from its existing socioeconomic norms, will probably retain the majority of the EU acquis as a non-member, and is likely to remain within the spectrum of European-style economies. However, the UK should not commit to following future EU rules as part of a level playing field agreement. Such a commitment could mean the UK Government giving up control of the regulation of significant areas of its economy, including over employment and labour regulations, environmental standards, and corporate and other taxation policies. It is likely that any dispute resolution mechanism included in the agreement will be available to either party if they feel the other side is seeking an unfair competitive advantage through lowering standards.

- As a non-member the UK should be able to achieve a good level of access to the EU’s markets, and vice versa, through the relationship detailed above. Obtaining fuller access, especially on services, would entail a much greater loss of control, encompassing not just trade but also the wider UK domestic economy. There are diminishing returns available to a more integrated relationship than the model Open Europe proposes.

- On data the UK should seek an adequacy agreement with the EU but should not commit to follow in lockstep with EU data rules. Again, this cross-cutting sector is too important for our future economy for the UK to be a simple rule-taker.

- Unlike the EU’s relationship with Switzerland, there will need to be a joint mechanism for dispute resolution and investor protection. This cannot simply be via the European Court of Justice. For some sectors – particularly where the UK agrees to continue to follow or approximate EU law, such as goods – it may make sense for certain disputes to be handled by the UK docking into the EFTA Court (a separate court with which the EU already works) and appointing a judge to that body, or by a new institution with similar characteristics. In other areas, where UK-EU cooperation more resembles a traditional FTA and is not based on EU law, the remit of the EFTA Court would not necessarily apply and dispute resolution with joint committees or via ad hoc arbitration would be more appropriate.

- In areas where the UK voluntarily commits to follow EU regulations, or to participate in EU agencies on an associate membership basis, the UK will need to accept an indirect role for the ECJ. However, a direct role should remain a UK red line.

- We have not explicitly examined the trade-off between preferential access to the Single Market and any requirement to accept the free movement of people. This would be a matter for negotiation and compromises might include preferential, reciprocal schemes for UK and EU nationals. There is no inherent reason why close UK-EU integration for trade in goods requires the complete free movement of labour.

**The ideological positions of extreme Leavers and Remainers are barriers to a pragmatic deal**

At present the British political discussion has polarised between hardline Leavers who are not prepared to sacrifice any sovereignty or make any concessions to the EU’s own internal rules, and extreme Remainers who seek to replicate exactly EU membership from outside its institutions and are willing to allow Brussels to dictate rules for our domestic economy. This
loud and angry debate is limiting the ability of the Prime Minister to negotiate effectively and secure the best deal for the UK.

Our analysis shows that there is a sweet spot for the future UK-EU relationship. Move too far away and the economic costs could be significant, particularly for manufactured goods with highly-integrated supply chains. Stay too close and we would limit our ability to seize any of the advantages of Brexit, and would be bound by too many rules which we would have no real mechanism to shape. Both polarised positions come with significant costs, and there are diminishing returns in pursuing either option.

Open Europe’s view is that our model ought to be acceptable to both Leavers and Remainers, although it will entail compromise on both sides. Overall, the UK Government needs to consider the trade-offs that the Brexit negotiations inevitably entail. The more the UK asks for in terms of access, the greater the EU will demand in return.

Brexiters should accept that they do not need to give up much sovereignty to ensure high-level access to the EU’s Single Market for goods. The UK would broadly need to follow EU regulations on goods, but these are typically specific to sectors which are already highly-regulated. And there is a relatively limited benefit from regulatory divergence in many of these areas – companies in non-EU states often choose to follow these rules anyway. Equally, on services – the most significant sector of the UK’s economy – the UK would be able to determine its own regulations. As a non-EU member, Parliament would always retain the ability to deviate from EU rules, but this could lead to a diminution in market access.

Remainers should accept that it will not be possible to recreate the full benefits of EU membership from outside the Single Market and that in some senses less is more. The UK will not achieve something akin to full membership of the Single Market if it’s a non-member, and demanding ever greater access would entail an unacceptable relinquishing of control, including on “level-playing field” issues. It would not be sustainable in the medium to long-term for the UK to mirror all EU rules on the financial services sector nor to follow future EU regulations over the domestic economy including on taxation, employment and labour rules, and so on.

This model ought to be achievable. Some will hope for more. But uncertainty has a cost – particularly for business which has to prepare for all realistic scenarios. The danger is that ambitions set even higher would ultimately be frustrated, and that uncertainty which is damaging to the economy is perpetuated.

**Why should pragmatists in the UK and the EU welcome this proposal?**

The UK and EU need a future relationship which is sustainable in the medium to long-term, but also flexible. It should recognise the high degree of trade and economic cooperation, between both sides, as well as their geographic proximity. A relationship which unfairly disadvantages one side or the other would likely not prove stable or sustainable.

The EU’s Single Market is highly developed in goods and UK goods trade is orientated to the EU. In 2016, despite the UK’s comparative advantage in services, 62% of our exports to the EU were goods. 48% of our goods exports go to the EU – this increases to over half of UK exports when also taking into account trade with neighbouring European countries that are closely integrated with the EU’s Single Market. The UK also consumes a large amount of EU exports.
Tariff-free trade does not equal free trade. Regulatory barriers to trade are often more important than tariffs. The EU has agreed largely tariff-free trade with both Switzerland and Canada for goods, but it is easier for Swiss firms to trade with the EU than Canadian firms. This is because Switzerland aligns many of its rules and standards with those of the EU, unlike Canada. The UK should aim for a broad “enhanced” mutual recognition agreement, which would allow one side’s technical regulation automatically to be considered equivalent to the others’ regulations. Examples include the Switzerland-EU Mutual Recognition Agreement and, in a discrete sector, the EU-Israel agreement on Good Laboratory Practices for pharmaceutical products.

There is no ready geographic alternative to the EU for complex supply chains. Key sectors for UK exports include motor vehicles and component parts, chemicals and pharmaceuticals and computing, electronic and electrical products. These sectors alone make up almost half of UK goods trade with the EU and over 40% of goods exports to the EU. In recent years the UK has become more integrated in European supply streams, helping to account for the majority of the recent growth in exports of UK manufactures to the EU. The UK’s participation in complex European-wide manufacturing supply chains is based on its geographic proximity with Europe and on the extent to which the Single Market has removed regulatory barriers within the EU. Given the geographic distances involved, it is hard to imagine how UK businesses could integrate into, say, the NAFTA car manufacturing processes, as an alternative to the EU.

There is no point in divergence for divergence’s sake. The UK has already adopted the EU’s rules for manufactured goods. Our businesses have already invested in meeting these regulatory requirements. UK businesses that sell highly-regulated goods (motor vehicles, chemicals and pharmaceuticals, machinery etc.) into the EU after Brexit, will still need to comply with EU standards and regulations. In some cases there may be advantages in operating a dual regime - of goods for the UK market and for EU markets – but in many areas this likely would not be profitable.

In certain sectors many countries already follow EU rules for goods. Given the ‘Brussels effect’ whereby international businesses and foreign governments adjust their practices to suit the EU’s regulatory model, it seems likely that UK companies in highly regulated sectors would choose to match EU rules and regulations even if the UK Government adopted different domestic legislation. For example, the major American company, Dow Chemical, ensures all of its production is compliant with the EU REACH regulations on chemical production, whether or not it is intended for the EU market.

EU member states do not apply the exact same rules and regulations in all good sectors. Some goods sectors are “harmonised”, so all EU countries are required to apply the same legislation – in some highly-regulated sectors (for example automotive and chemicals), all technical specifications and standards must be harmonised; in others, this is only required for health and safety precautions. Outside of these sectors, the EU has no common rules and standards and allows for mutual recognition: any good that can be sold in one member state can be sold in another (unless they impact public safety, health or the environment).

Agreeing to follow EU regulations for goods after Brexit does not mean new EU rules will automatically apply in the UK. Switzerland agrees to apply EU rules and regulations on goods in its own domestic law as part of its bilateral agreements with the EU. When the EU introduces new rules in these areas, these agreements are not automatically updated and Switzerland has to choose whether to comply with them. For instance, the EU’s REACH chemical regulation, which was brought into force in 2007, did not automatically apply to Switzerland. Switzerland partially revised its domestic chemical legislation in 2009 to move...
closer to REACH, and other revisions have been made since. In 2010, the Swiss Federal Council began the process of negotiations for a Swiss-EU chemical safety agreement, but this was suspended in 2015. Currently Switzerland agrees that chemicals exported to the EU will fully comply with the EU regulations, but REACH does not apply in Switzerland.

Switzerland is able to apply different technical legislation in certain sectors, such as electrical equipment, but these goods are nonetheless considered “equivalent.” Other sectors are deemed “non-equivalent” but in that case Swiss manufacturers can make products bound for the EU in compliance with EU rules, and Swiss conformity assessment bodies can test these products on the EU’s behalf, and assure them as compliant. This is a very helpful precedent.

On services, the UK is a strong and globally-diversified exporter. We are a strongly-services based economy, with services accounting for nearly 80% of our GDP. Services trade accounts for 45% of UK’s total exports and the UK is the world’s second largest exporter of services after the USA. Only 42% of UK services trade is done with the EU, and just 37% of our services exports are to the EU. Service exports for the UK are growing faster in non-EU markets, and a recent Open Europe report urged the UK to seek to expand its services trade with certain markets where it currently under-performs including Canada, India, China and Israel.

The EU’s Single Market for services is far from complete. Despite the theoretical liberalisation of all modes of services supply across the EU, there remain significant barriers to trade in services, with national barriers to trade in many areas remaining. Outside of sectors such as financial and some limited professional services, the Single Market has not been able to remove barriers to services trade across the Union. The prospects for future services liberalisation within the EU are also slim. Across the EU there are many different languages, taxation systems, and laws which block the free flow of services. Domestic laws in member states also limit the flow of services. For example, under German law, architects are required to prove good standing with their national regulator in order to operate in Germany. Yet given some member states, such as Sweden, have no such national regulator, the ability of their architects to practice in Germany is significantly restricted.

The EU Single Market isn’t crucial to Britain’s competitive advantage in services. Just over a third (37%) of our services exports are to the EU. In areas where the Single Market in services is more integrated – such as financial services – the EU still accounts for less than 40% of our exports.

Rule taking is not feasible for the UK’s services sector but the level of integration between UK and EU financial markets requires a novel approach. Given the disproportionate importance of the industry to the UK economy, the risk underwritten by UK taxpayers, and the UK’s dominance of this sector, it is widely accepted that the UK could not be a passive rule taker after Brexit, without the ability to have a say on future rules. The governor of the Bank of England, Mark Carney, has suggested areas of UK financial regulation that could be altered post-Brexit.

The four freedoms of the Single Market (for the free flow of goods, services, people and capital) aren’t indivisible. The EU has already agreed various agreements which divide the so-called four freedoms. For example, Switzerland essentially participates in the Single Market for goods, but not services. According to the European External Access Service, the Ukraine Association Agreement removes “almost all tariffs and barriers in the area of trade in goods, the provision of services, and the flow of investments”, but it does not apply the free movement of people. In any event, goods and people flow far more freely across the EU, than services and capital.
The Canada-EU CETA agreement is not the deepest trade deal the EU could do. CETA offers an example of what the EU can agree under so-called “second-generation” FTAs, but during negotiations the EU was prepared to offer a deeper relationship on services, specifically financial services. It should not therefore be seen as the ceiling of the EU’s ambition. Leaked drafts of the TTIP text also suggest a willingness for the EU to go beyond CETA including through provisions for a binding horizontal chapter on regulatory coherence.

The UK is likely to maintain a European-style economic model but cannot accept wide-ranging level-playing field requirements. The EU is concerned that as a geographically close, and highly integrated economy, the UK could adopt radically different regulations on employment law, corporate tax rates, and environmental standards. Canada agreed to a good governance clause and transparency agreements on taxation, and non-regression clauses on social and environmental law, but they are not required to follow EU rules on tax regulations, environment or labour laws. The EU is explicitly clear that it is seeking a different arrangement with the UK and argues traditional international frameworks would be insufficient because of Britain’s proximity and market size.

The EU does not impose an exact level playing field across the Single Market. The EU’s level playing field regulations do not mean all member states apply the exact same rules and legislation on taxation or social and environmental policy. Instead, the EU traditionally establishes a “floor” of rights, but countries can apply different technical specifications in accordance with this. For instance, member states apply different corporate tax rates - Hungary’s corporation tax rate is 9%, while France currently applies a rate of 33%. Similarly, member states apply different VAT rates – Hungary’s standard VAT rate is 27% while Malta’s is 18%. EU countries also apply different national statutory minimum wages – Luxembourg offers a minimum wage of €1999 per month, while Bulgaria offers €261 per month. Other member states, such as Italy, have no national minimum wage.

There will need to be a dispute resolution mechanism and this can draw on existing models. The EU is clearly dissatisfied with the governance of its relationship with Switzerland, which lacks formal dispute resolution mechanisms. However, the EU already employs various dispute resolution mechanisms in its agreements with other states. This includes the EFTA Court and ad hoc arbitration in its FTAs with Canada, Korea and the proposed FTA with Japan. It has also suggested a new Multilateral Investment Court. These provide precedents for the UK and EU to adopt and the solution could be to incorporate elements of the various approaches to deal with different areas of the future relationship.
Trade-offs in EU-third country trade relationships

- South Korea/Canada
- Switzerland/Ukraine
- Norway

- Equivalence for data, professional qualifications & financial services
- Maximal reduction in non-tariff barriers to goods
- Some reduction in non-tariff barriers to goods
- Tariff-free access for goods
- Recognise some EU regulators
- Apply EU rules on goods domestically
- Regulatory cooperation/coherence with EU & EU oversight in specific sectors

Source: Open Europe analysis
<table>
<thead>
<tr>
<th>Level of economic integration with the EU</th>
<th>What market access does this provide?</th>
<th>Conditions to achieving this level of access</th>
</tr>
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</table>
| **Traditional FTA** (i.e. South Korea/ Japan/ Canada/ TTIP) | Tariff-free access in goods, with some limitations for agriculture products  
Mutual recognition of regulators to reduce costs of authorising goods for sale in the other market  
Minimal access for services | Tariff-free access to domestic market, with some reservations  
Do not agree to follow same rules and regulations  
Some commitments on state aid, taxation and social/environmental policy, based on broad international agreements  
Dispute resolution through joint committees and arbitration panels |
| **Deep and Comprehensive FTA** (i.e. Switzerland/ Ukraine/ TTIP) | Goods  
Mutual recognition of regulation to allow goods to be sold directly in each other’s market | Apply EU rules on goods in domestic law. Constrained in 3rd country FTA negotiations  
New EU laws on goods not automatically applied in domestic law, but failure to accept them could affect access to EU market  
Indirect role for the ECJ as the only body that interprets EU law, but it does not govern the agreement  
Agreements on state aid & taxation that are more binding than international deals, but not necessarily based on EU regulations. Some non-regression commitments on social/environmental policy |
| | Services  
Mutual recognition of professional qualifications to support services provision  
Data adequacy decision to support cross-border trade and security partnerships  
Equivalence decision and regulatory cooperation for certain financial services | Some agreement on labour mobility/accept free movement of people  
Limited ability to diverge significantly from EU direction on data rules. Reliant on the EU to grant and maintain adequacy decision  
Would require regulatory cooperation with the EU and some limitations of UK regulatory independence to remain broadly equivalent with EU regulatory/supervisory system. Some oversight by EU regulatory bodies |
| **European Economic Area (EEA)** (i.e. Norway) | Essentially no tariff or non-tariff barriers to goods  
Developed single market in financial, transport and telecommunication services  
Limited liberalisation of other services, such as professional and business services  
Mutual recognition of professional qualification, allowing direct recognition for certain professionals | Accept full EU acquis through EEA Agreement, including regulations on wider domestic economy (i.e. social and employment law), not just traded goods/services. Constrained in 3rd country FTA negotiations.  
Some ability not to introduce new EEA-relevant EU laws domestically, but would lead to suspension of related access. EEA countries have so far accepted EU rules  
Accept free movement of people  
Allow EFTA Court to interpret and enforce agreement with the EU. No direct effect or supremacy of EFTA Court judgments. Separate to ECJ but coordinates with ECJ case law |
1. Introduction

The UK government has stated that its objective is to secure an ambitious trade agreement with the EU as part of a wider “Special Partnership” post-Brexit. The Prime Minister has said that this long-term relationship will see Britain formally outside of the EU’s Customs Union and the Single Market. However, there are various degrees of possible trade and regulatory integration with both the Customs Union and/or the Single Market. The level of integration will determine the UK’s long-term economic and political relationship with the EU but also affect the UK’s broader economic policy.

A “standstill” transition from March 2019 to December 2020 looks likely

In the short-term, immediately upon the UK’s formal withdrawal in March 2019, both parties have signalled their intention to negotiate a “standstill” transition. This is expected effectively to recreate the benefits and obligations of Single Market and Customs Union membership for UK and EU businesses but the UK will be outside the political structures of EU membership. This transitional phase would be distinct from EU membership since it is expected to deprive the UK government of its voting rights in the Council of Ministers and the UK will no longer have Members of the European Parliament to vote on legislation or be represented in the European Council.

The UK would still be bound by EU rules and the decisions of the EU institutions. This standstill transition period is expected to end in December 2020, at which point a new long-term trade relationship will need to be ready to come into force. However, the exact length of the transition period could still be up for negotiation.

The government should seek a customs cooperation agreement that supports an independent UK trade policy

In her March 2018 “Road to Brexit” speech,¹ the Prime Minister ruled out a new customs union with the EU but repeated two proposals for customs cooperation first set out by the UK government in a paper in August 2017.² Under the first option, a new “customs partnership”, the UK would mirror the EU Customs Union’s tariffs and rules for products entering the UK and destined for the EU, so as to avoid the need for UK-EU border checks. However, there would be a mechanism by which the UK could apply its own tariffs and trade policy for products solely destined for the UK market.

Under the second option, “a highly streamlined customs arrangement”, the UK and the EU would adopt technological and regulatory solutions to “minimise frictions to trade, together with specific provisions for Northern Ireland.” In a previous report³, Open Europe concluded that the UK should develop this second approach as part of a new bilateral zero tariff free trade agreement (FTA) with the EU. The report argued that the “customs partnership” option would be hard to negotiate, is overly bureaucratic for both business and government, and

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would constrain UK governments’ ability meaningfully to diverge from the EU’s Customs Union in practice.

Leaving the EU’s Customs Union and instituting a customs border, even if it is as frictionless as possible, will entail some costs on UK-EU trade. UK-EU customs and regulatory cooperation will need to be particularly intensive on the island of Ireland in order to achieve the shared UK and EU objective of avoiding a hard border between Northern Ireland and the Republic. However, costs and disruption can be minimised through UK-EU agreements. It is essential that the UK regains the power to set its own tariffs and a meaningfully independent trade policy if the UK is to chart its own economic and political course post-Brexit over the long-term.

This paper seeks to assess how a new UK-EU FTA should shape the UK’s regulatory relationship with the EU’s Single Market.

1.1 The different models for trade with the EU’s Single Market: Norway, Canada, something in between or something else?

Historically, in a world of high tariffs, when the overwhelming majority of global trade was accounted for by manufactured goods and agricultural products, the central aim of free trade agreements was to eliminate restrictions to the movement of goods across borders via tariff reductions. However, in recent decades, average tariffs have fallen globally and there is far greater trade in services. As a result, “second generation” trade deals aim to cover a much wider range of areas – investment, public procurement, intellectual property and so forth.

The growing focus on non-tariff barriers has, among other things, sought to address trade friction and costs caused by differences in regulatory and technical standards, which can apply to both goods and services. Non-tariff barriers can emerge in numerous ways, intentionally or unintentionally. Where regulations differ or diverge – for example when a government creates a new safety standard or demands providers of services fulfil certain criteria – they can pose barriers to trade.

The Single Market is the world’s most advanced attempt to create a single regulatory zone. This integration has been pursued in various ways but, broadly, member states either apply a harmonised (i.e. the same) standard or are obliged to treat each other’s different rules as equivalent to their own. However, integration within the Single Market is far from complete. There remain substantial differences between the regulations of EU member states, particularly for services, and these continue to present regulatory barriers to trade between EU states. The lack of a single language, legal system and differences between the various systems of taxation, and currencies, also pose barriers to seamless trade within the EU.

The various models posited for a new preferential trading relationship with the Single Market sit on a spectrum between two poles. At one end, are the agreements that the EU has reached with its near neighbours. The EU uses these models to export its regulatory framework and socio-economic/normative model to non-EU countries within or on the fringes of Europe. The “Norway model” represents the closest possible integration with the EU – via membership of the European Economic Area (EEA). Norway is outside the Customs Union but the EEA provides tariff-free trade in goods between Norway and the EU and extends the benefits and obligations of the Single Market’s “four freedoms” (the free movement of goods, services, capital and people) to Norway.
However, this model grants minimal national independence over much regulation and EU immigration. Whereas free trade agreements seek to regulate trade (removing tariffs and setting standards) between countries, Norway must also implement Single Market regulations on commerce within its own domestic economy (for example, EU Single Market labour market regulation applies to traded and non-traded sectors). In addition, Norway’s trade deals with third parties must be negotiated within the confines of its regulatory alignment with the Single Market. The Norway/EEA model takes the adoption of the EU’s legal framework, the acquis communautaire, as its basis.

At the other end of the spectrum, the EU has negotiated a series of trade agreements with more distant partners – Canada, Singapore, South Korea, and Japan – which are advanced, albeit traditional FTAs. These agreements, such as the EU-Canada Comprehensive and Economic Trade Agreement (CETA), provide for largely tariff-free trade between Canada and the EU for manufactured goods. However, they provide more limited preferential market access for services.

They tend to refer to international technical standards as the basis for regulatory cooperation and therefore grant far greater freedom to regulate independently of the EU. More limited regulatory integration with the Single Market can pose greater non-tariff barriers to trade in both goods and services than the Norway model.

The European Commission’s lead Brexit negotiator Michel Barnier initially stated that the UK would need to choose between a deal modelled on CETA or the Norway/Single Market model. Meanwhile, various EU figures have cautioned the UK against seeking to “cherry-pick” elements of the Single Market, and Barnier has stated that the Single Market’s “four freedoms are indivisible”.

However, the Swiss-EU relationship offers a variation of integration with the Single Market that falls between that of Norway’s and Canada’s. The Swiss–EU relationship is governed by a web of dozens of complex bilateral agreements. Broadly, it is characterised by partial Swiss participation in the Single Market for manufactured goods, with somewhat limited preferential treatment for services. Switzerland’s partial participation in the Single Market for goods is possible on the basis that Swiss law in these areas is aligned with that of the EU’s Single Market acquis. Like Norway, Switzerland is a member of the border-free Schengen zone and measures to facilitate the free movement of people.

The EU-Ukraine Association Agreement provides another variant of EU deal, which grants Ukraine preferential access to the Single Market for goods and services based on its adherence to the EU acquis and wider acceptance of EU norms. In the case of Ukraine – as well as other countries that have acceded to the EU – the EU has taken a differential approach to extending single market access to highly-integrated European, but non-EU countries.

The EU-Ukraine deal notably does not offer freedom of movement to Ukraine citizens, which illustrates that the four freedoms are divisible if it suits the EU to be flexible. The EU has also allowed existing members to restrict free movement, for a time limited period, for new member states - for example the A8. Other agreements for example between the then European Community and the Czech Republic in 1993, committed to gradually “establish a

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free trade area” in a section entitled “free movement of goods”. The same agreement did not commit to establishing free movement.5

Meanwhile, if the UK and the EU fail to agree a new preferential trade deal, UK-EU trade will be governed by the most favoured nation rules of the World Trade Organisation, which would see EU tariffs placed on UK exports and limited formal, bilateral cooperation on regulatory barriers to trade. Open Europe will explore the implications of this scenario in a future paper.

## EEA Agreement / Norway

### Included under EEA agreement / Norwegian access to EU markets

**Goods:** Tariff-free movement of manufactures and some agriculture and fisheries products; Energy; Competition and state aid; Trade facilitation and technical cooperation.

**Services:** Financial services; Transport; Postal services; Electronic communication, audio-visual services and information society services.

**Capital:** Largely free movement of capital.

**Persons:** Free movement of persons; Social security; Recognition of professional qualifications.

**‘Flanking and horizontal’ policies:** Consumer protection; Cultural Affairs; Education, training and youth; Research and innovation; Public health; Enterprise policy; Civil protection; Health and safety at work and labour law; Environment; Employment and social policy; Company law; Budgetary matters; Gender equality, anti-discrimination and family policy.

**Regulations:** Non-EU members of the EEA have to adopt EU legislation. Once EU law is passed, the EEA Joint Committee works to extend it to them. EEA states have the right to introduce slight amendments (the EU Commission has the final say), contest whether the legislation is ‘EEA relevant’, or refuse implementation, which would mean that the relevant annex would cease to apply. Alignment with EU regulation results in fewer checks at the border – although some checks, for instance related to tariffs, remain – as well as reduced non-tariff barriers for access to the EU market.

### Voluntary add-ons

**Justice and home affairs:** Associate member of Schengen border-free area; Participates in 'Dublin system' for asylum claims; Participates in Europol and Eurojust.

**Foreign policy:** Norway is actively seeking association with the EU's foreign & security and security & defence policies and participates in EU joint missions.

### Not included in EEA / Norwegian independence

Agricultural policy; Fisheries policy; Regional policy; External trade policy; Foreign policy.
## Swiss FTA and bilaterals

### Included in agreement / Swiss access to EU markets

**Goods:** No import/export duties or quotas for industrial products and some agricultural products (processed food); Trade facilitation and technical cooperation.

**Services:** Limited cross-border provision of services for a maximum of 90 days per year under the terms of the free movement of persons agreement (excluding employment agencies and financial services).

**Capital:** Non-life insurers have the freedom to establish operations in one another’s territory.

**Persons:** Free movement of persons; Social security; Recognition of professional qualifications.

### Other areas:
- Public procurement; Research; Overland transport; Air transport; Member of Schengen border-free area; Participates in ‘Dublin system’ for asylum claims; Taxation of savings; Fight against fraud; MEDIA programme.
- ’Cooperation agreements’: Membership of European Environment Agency and EUROSTAT; Education, vocational training and youth; Cooperation with Eurojust and Europol; Cooperation between competition authorities; European Asylum Support Office.

### Regulations:
In the sectors covered, Switzerland voluntarily aligns itself with the EU acquis, which is not automatically transposed into Swiss law. In that sense, Switzerland retains some control over its legislation. This process is overseen by a system of joint committees.

### Not included in agreement / Swiss independence

Cross-border financial services; Social and employment policy; Energy and climate policy; Consumer rights; Agricultural policy; Fisheries policy; External trade policy; Foreign policy.

Regional policy: Switzerland makes an independent contribution to reducing economic and social disparities within the EU, which is made available for projects in the 12 ‘new’ member states that joined the EU in 2004 and 2007.
**EU-Canada Comprehensive Economic and Trade Agreement (CETA)**

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<tr>
<th><strong>Included in CETA / Canadian access to EU markets</strong></th>
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<tr>
<td><strong>Goods:</strong> Tariffs for 98.6% of all Canadian tariff lines and 98.7% of all EU tariff lines will ultimately be fully eliminated – some agricultural products are excluded from full liberalisation.</td>
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<tr>
<td><strong>Services:</strong> Significant liberalisation is limited to mining, postal services, and maritime transport. The EU has granted Canada equivalence in some areas of financial services.</td>
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<tr>
<td><strong>Capital:</strong> CETA adds clarity and transparency to WTO provisions on investment. It reduces the contracting parties’ ability to set pre-establishment and post-establishment restrictions – although subject to some reservations. It also envisions the application of UNCITRAL rules on transparency to investment, and the introduction of a new investment court system (ICS) – although the latter is provisionally not implemented pending full ratification.</td>
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<tr>
<td><strong>Persons:</strong> Temporary movement of company personnel. Canada and the EU have committed to allowing the posting of intra-corporate transferees in any sector for up to 3 years. In addition, professionals can be accompanied by their spouses and families on their temporary posting abroad. CETA also includes a framework for the mutual recognition of professional qualifications, although any such agreement remains voluntary in nature.</td>
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<td><strong>Other areas:</strong> Public procurement (significant liberalisation on the Canadian side); Canada has been granted a separate (partial) adequacy decision by the EU on data protection; Some provisions on intellectual property arrangements, such as protection for some EU products from competition of lower-quality imitations.</td>
</tr>
<tr>
<td><strong>Regulations:</strong> Canada retains control of its regulation and it is not bound by EU regulations. The EU and Canada are encouraged under CETA to identify areas for possible regulatory cooperation, but only on a voluntary basis.</td>
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<th><strong>Not included in CETA / Canadian independence</strong></th>
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<tr>
<td><strong>Policy areas not included:</strong> Social and employment policy (although parties have taken commitments); Energy and climate policy (although parties have taken commitments); Agricultural policy; Fisheries policy; External trade policy; Foreign policy.</td>
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<td><strong>Some sectors are excluded from liberalisation in services:</strong> Audio-visual; Some areas of transport; Public services. In financial services, the provisions do not in practice go beyond the third-country equivalence regime that any third country could potentially apply to.</td>
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<tr>
<td>World Trade Organisation (WTO)</td>
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<tr>
<td><strong>Included / Access to EU markets</strong></td>
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<tr>
<td><strong>Goods:</strong> MFN treatment; Technical barriers to trade – the WTO works to remove “unnecessary obstacles to trade”.</td>
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<tr>
<td><strong>Services:</strong> Under the GATS (General Agreement on Trade in Services) UK companies selling services through subsidiaries should not be discriminated against. The TISA (Trade in Services Agreement) is a potential plurilateral trade agreement aimed at opening up services trade covering 23 states and 70% of world GDP.</td>
</tr>
<tr>
<td><strong>Capital:</strong> The TRIMs (Trade Related Investment Measures) is designed to avoid trade distorting effects of investments in the goods trade. The OECD’s ‘Code of Liberalisation of Capital Movements’ includes legally binding rules on non-discrimination on capital flows.</td>
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<tr>
<td><strong>Persons:</strong> The Uruguay trade round added liberalising measures on intra-company transferees regarded as “essential personnel” and business visitors.</td>
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<td><strong>Other:</strong> Agreement on Government Procurement – a plurilateral deal on opening up of government procurement market.</td>
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<tr>
<td><strong>Regulations:</strong> The WTO Technical Barriers to Trade (TBT) Agreement states its aim “to ensure that technical regulations, standards, and conformity assessment procedures are non-discriminatory and do not create unnecessary obstacles to trade. At the same time, it recognises WTO members’ right to implement measures to achieve legitimate policy objectives, such as the protection of human health and safety, or protection of the environment. The TBT Agreement strongly encourages members to base their measures on international standards as a means to facilitate trade.”</td>
</tr>
<tr>
<td><strong>Not included / Independence</strong></td>
</tr>
<tr>
<td>Free movement of people; Cross-border financial services; Social and employment policy; Energy and climate policy; Consumer rights; Agricultural policy; Fisheries policy; Regional policy; External trade policy; Foreign policy.</td>
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1.2 The new long-term UK-EU relationship is likely to be bespoke

The EU’s position on the binary Norway or Canada choice set out by Barnier has already started to shift, with various national leaders stating that the new UK-EU relationship is likely to be bespoke. French President Emmanuel Macron suggested Britain’s deal would be “special.” He qualified any support for a bespoke deal by adding that “This special way should be consistent with the preservation of the single market”, but noted that, “As soon as you decide not to meet those preconditions, it’s not full access. So, it’s something perhaps between this full access and a trade agreement.”

Similarly, the then Italian Prime Minister Paolo Gentiloni called for a “tailor-made” agreement with the UK, emphasising, “There can be models of reference based on deals the EU has with third countries but these were all done...building off a white sheet, tabula rasa...Here we are doing the opposite – removing things from a 40 year-old structure of extraordinary relationships – and this operation is objectively unprecedented and complicated.” Irish Taoiseach Leo Varadkar said the deal reached with the UK “will be a specific agreement”, pointing out that “It’s difficult to compare it to Norway, which is a relatively small country...or a country like Canada, which is on a different continent.”

More recently, internal documents prepared by the European Commission have noted the necessity to develop “a tailored approach for relations with the UK” and to take “into account the UK’s unique ‘proximity/market size’ mix.”

From a trade perspective, Brexit is unique. It will inevitably lead to an increase in trade friction. However, rather than trying to integrate or manage the relationship between two separate regulatory frameworks, the UK and the EU systems will be fully aligned immediately upon the UK’s withdrawal. During its four and a half decades of EU membership, the UK has adopted the entire EU regulatory framework for goods, services, capital, people and broader issues such as intellectual property, state aid, consumer rights and employment law, other that in certain areas where it enjoys an opt-out.

In the near term, the UK government is legislating in order that the UK remains fully aligned with the EU at the point of departure. The European Union (Withdrawal) Bill will seek to incorporate almost all EU law into UK law at the point of withdrawal in 2019. The UK parliament will subsequently be able to decide which individual measures to retain, amend or repeal. However, immediately following withdrawal, this means the UK will:

- Mirror the EU’s product standards on industrial and agricultural goods.
- Continue to apply EU regulations in cross-cutting policy areas, such as social, employment and environmental law. In some areas, the government has pledged to (continue to) gold-plate EU requirements – for instance on workers’ rights and environmental protections.

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6 Financial Times, ‘Macron boosts May’s hopes of bespoke EU trade deal’, 20 January 2018: https://www.ft.com/content/78564d98-fdbe-11e7-9650-9c0ad2d7c5b5
7 Financial Times, ‘Italy’s Paolo Gentiloni calls for ’tailor-made’ UK-EU trade deal’, 13 December 2017: https://www.ft.com/content/145032f8-df66-11e7-8f9f-de1c2175f5ce
● Keep existing European Court of Justice (ECJ) case law as part of UK law - it will hold a similar status to UK Supreme Court judgements. UK regulators and courts will also be allowed to interpret EU rules and regulations existing on the date of withdrawal in line with future ECJ and EU case law.

The degree of future regulatory alignment with the EU is a key dividing line within the UK government. However, the extent of this division can be overemphasised. Leave ministers are clear that the UK should secure the freedom to diverge from EU rules when it wishes to. But they have accepted the principle in the Withdrawal Bill, that the UK will mirror EU rules at the point of exit, and are not advocating a major repeal of existing EU laws. Environment Secretary Michael Gove has said that the Cabinet will not compromise on “high animal welfare and environmental standards” in order to, for example, secure a free trade deal with the US. Likewise, Trade Secretary Liam Fox has said that the UK does not foresee “any diminution of standards, either in foods safety, environmental standards, or workers’ rights” as part of its strategy to secure free trade agreements post-Brexit.

Remain-backing ministers, such as Chancellor Philip Hammond, support much closer regulatory alignment with the EU. However, Hammond has also stressed that Brexit presents an opportunity for “regulatory innovation”, which would require divergence from EU rules in the future. On the specific issue of financial services, Bank of England Governor Mark Carney has suggested areas of existing regulation that could be altered post-Brexit. It has also been reported that the Bank of England has taken the firm view that the UK cannot become a rule-taker of financial regulation from the EU post-Brexit. This has led to tensions with Treasury officials who are more relaxed about granting Brussels continued influence over UK financial regulation in return for preferential market access.

Ultimately, the post-Brexit UK-EU relationship will be dynamic. Both parties will evolve over time and this will likely lead to divergence in some areas in future. Equally, the UK has no immediate intention to change existing EU rules. The challenges for the new post-Brexit trade relationship is to establish the degree of preferential access the UK and EU will have to each other’s markets at the outset, what regulatory framework will underpin this market access, and how to manage regulatory compliance and/or divergence as the rules in both jurisdictions evolve over time. The answers to these questions are likely to differ from issue to issue.

As a third country, the UK will always have the ultimate right to disregard EU regulations in the future, even in the areas where it chooses to be aligned at the outset. The question is what happens to the overall relationship when the UK or the EU opts to diverge from the status quo. It is very likely that future UK governments and European Councils will need to periodically revisit the terms of any deal. Nevertheless, the UK needs to set out a workable proposition that is politically sustainable, domestically and with the EU, for the medium term.

12 See the Chancellor’s appearance on ITV’s Peston on Sunday, 19 November 2017
13 Financial Times, ‘Carney suggests some financial rules could be rolled back after Brexit’, 29 November 2017: https://www.ft.com/content/fc97d944-d148-36c4-a914-c18a909c3ba2
14 Financial Times, ‘Treasury and BoE clash over City of London regulation after Brexit’, 28 May 2018: https://www.ft.com/content/db4ce5ea-625b-11e8-a39d-4df188287ffe
Given the outline negotiating positions adopted by the UK and the EU, it is difficult to imagine how the UK could adopt the Norway model or how this could be adapted to suit the UK (a model sometimes referred to as “EEA-minus”). First, the UK government has made it clear that it wishes to secure greater control over immigration and end the complete free movement of people. The EU’s “no cherry picking” position is clear that limiting the free movement of people – one of the Four Pillars of the Single Market – is incompatible with Norway-style access to the Single Market.

Second, as noted above, the Norway model would place major restrictions on the UK’s sovereignty. Norway’s status as a “rule taker” of EU regulation is unlikely to be politically sustainable for the UK. Neither is it in the EU’s interest to invest time and political capital in a Brexit settlement that risks unravelling in the short- to medium-term.

Nevertheless, given that the UK and EU do start from the unique position of full integration and that the UK and EU are more significant trading partners, it is fully possible to conceive of a more ambitious trade deal than CETA, a model which has been dubbed “CETA-plus”.

The Prime Minister’s three major Brexit speeches have all set out the UK government’s intention to negotiate a deal that would fall somewhere between the Norway or Canada models. The Florence Speech presented a conceptual framework to underpin a new UK-EU trade deal, based on “three buckets” of cooperation or varying degrees of regulatory alignment:

1) Areas of high UK alignment with EU regulation, where the UK and the EU want to achieve the same goals in the same way;
2) Areas where the UK and the EU may have different goals; or where they share the same goals but want to achieve them through different regulatory means;
3) Areas of policy and regulation which are outside the scope of UK-EU trade and economic relations and where both parties are able to act independently.

May acknowledged that “because rights and obligations must be held in balance”, the decisions taken about the degree of regulatory divergence, particularly in categories 1) and 2) will have “consequences for the UK’s access to European markets and vice versa.”

In her “Road to Brexit” speech, May stressed that the UK accepted the EU's concerns about “cherry picking” but that this principle had to work both ways:

“How could the EU’s structure of rights and obligations be sustained, if the UK – or any country – were allowed to enjoy all the benefits without all of the obligations? So we need to strike a new balance. But we will not accept the rights of Canada and the obligations of Norway.”

The following sections of this paper will assess the inherent trade-offs in the CETA and Norway models and how they might be recalibrated under a new UK-EU trade arrangement covering goods, services and the wider economic relationship.
2. Trade in goods

2.1 UK goods trade is disproportionately geared to EU markets and European supply chains

Despite the UK economy’s comparative advantage in services, the relative ease of trading goods means that these products continue to account for the majority of UK trade. In 2016, services industries accounted for around 80% of UK GDP, but goods accounted for over half of UK total exports.

The share of UK goods exports going to the EU has declined in recent decades as the UK has increasingly diversified into non-EU markets – in 2000, the EU accounted for around 60% of UK goods exports. This fell to 48% in 2016. But it is still by far the UK’s most important export destination – the US accounts for only 15% of UK goods exports, and China only 4% (see figure 2). Of the EU27 countries, Germany, France, the Netherlands and Ireland stand out as the biggest importers of goods from the UK, together accounting for 61.2% of UK goods exports to the EU.

It is widely noted that the EU’s Single Market is more developed in goods than in services. Equally trade in goods is not subject to the same barriers that make it harder to trade services within the EU – for instance, differing legal systems and languages. Reflecting this, UK trade with the EU is disproportionately dominated by goods: in 2016, goods accounted for 62% of total UK exports to the EU, while services accounted for only 38%.

Source: ONS Pink Book, 2017
The UK is also a major consumer of EU goods, importing more from the EU than it exports to it – in 2016, the UK’s trade in goods deficit with the EU stood at £96 billion.\textsuperscript{15}

A sector-by-sector analysis shows that high-tech manufacturing industries feature prominently in UK-EU trade in goods, both in terms of imports into the UK and exports to the EU. Motor vehicles and parts, chemicals and pharmaceuticals, and computing, electronic and electrical products together make up around half of total trade in goods with the EU (46%).

\textsuperscript{15} House of Commons Library, ‘Statistics on UK-EU trade’, 19 December 2017: http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7851#fullreport
Some manufacturing industries are part of complex European supply chains, leading to high import and export of component parts between the UK and EU countries. In 2011, 60% of UK manufacturing exports to the EU were in intermediate products (component parts, rather than finished goods), as were 54.5% of manufacturing imports from the EU.\(^{16}\) UK manufacturing industries have become more integrated in European supply streams over time. Between 2000 and 2011, two thirds of the total growth in UK manufactures exports to the EU came from intermediate products, with finished products only accounting for one third.\(^{17}\)

UK automotive, chemicals and machinery industries are particularly highly integrated in European supply chains. For instance, almost a quarter of the value added in UK motor vehicle exports in 2011 came from EU27 countries (24%) – i.e. from the use of EU components, or further processing in the EU (see figure 4). This is over twice as much as the EU27 share of value added in UK agricultural exports (10.5%) and around five times as much as in UK services exports (5%). Similarly, around 15% of the value added in chemical and machinery exports in 2011 came from the EU27, around four times the EU27 share of value added in mining and quarrying exports.

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\(^{17}\) Ibid.
For UK cars, chemical and pharmaceutical sectors, trade with the EU accounts for around 65% of the international supply chain. Data from the World Input Output Database shows that over 20% of the UK supply chain in cars, chemicals, electricals and machinery products is dependent on imports from the EU, and around 20% of their exports in intermediate products go to the EU.

The UK’s participation in complex European manufacturing supply chains is based on two key factors:

1. **Geographic proximity, which a priori reduces transport and time costs to trade in goods.** These regional supply chains cannot easily be replicated elsewhere. Post-Brexit, UK businesses are unlikely to compete effectively in geographically distant supply streams. The high costs to UK automotive manufacturers of shipping car parts back and forth across the Atlantic makes it hard to imagine UK businesses effectively integrating into NAFTA car manufacturing processes (where supply chains run across the US, Canada and Mexico), for example.

2. **The EU’s single market in goods is highly developed, and has removed tariff and regulatory barriers to importing and exporting component parts and finished products in the EU.** The single market’s regulatory framework, which is built on both harmonisation and mutual recognition, minimises technical barriers to trade between EU member states. This helps to facilitate the growth of complex cross-border manufacturing supply chains.

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2.2 Trade in goods with the EU outside the single market?

**Tariffs and rules of origin**

Outside the single market, UK trade with the EU will be governed either by World Trade Organisation (WTO) rules, or the negotiated terms of a new free trade agreement. Both arrangements would entail new barriers to trade in goods in comparison to the status quo, but an FTA should seek to minimise them as far as possible.

If the UK trades with the EU under WTO rules, it risks facing significant tariffs in key sectors. While the EU’s average tariff for goods is low, at only 1.6%, this masks significantly high tariffs in certain sectors. The EU applies a 10% import duty on finished cars, and 3.8% import duty on components. Agriculture products attract particularly high tariffs – the EU levies an average tariff of 54% on dairy products, 31% on sugars and 22% on cereals. As previous Open Europe research has shown, just over 35% of the UK’s goods exports to the EU are in high-tariff sectors, such as cars, chemicals, clothing and food, beverages and tobacco. If a bilateral FTA is agreed, a substantial majority of these tariff barriers could be removed or reduced.

If the UK secures a trade deal with the EU, trade in goods would be subject to new Rules of Origin (RoO) requirements. Traders could also lose the benefits of current cumulation arrangements (see box), unless the FTA includes provisions for this.

**Rules of Origin and cumulation**

Rules of Origin are technical requirements included in free trade deals that assess whether a good being traded contains a sufficient level of “local content” – domestic components – in order to access the preferential FTA tariff rates. They aim to prevent trade deflection – in a UK-EU FTA, EU RoO would ensure that non-EU goods cannot enter the UK at lower or zero tariff rates “through the backdoor” to the EU, and vice versa. As a member of the EU Customs Union and Single Market, the UK is currently exempt from RoO requirements in trade with the EU. Proving the origin of a product is an administrative burden for businesses. In some cases, the cost of paying tariffs is lower than complying with RoO requirements and firms will elect to pay the tariff rather than use FTA provisions.

Some free trade agreements also include provisions for cumulation of origin. Cumulation allows for components sourced from a trading partner to be considered as “local” for rules of origin purposes. These arrangements are most useful for countries that are integrated in cross-border supply chains. Long supply chains mean a finished good could have undergone processing in a number of different countries, and the share of components from any one country could be quite small. The ability to “cumulate” origin makes it easier to prove that a finished product has a sufficient level of “local content” in order to benefit from the tariff advantages in trade deals. There are varying levels of cumulation: bilateral, diagonal and full cumulation. As a member of the Single Market, UK-EU trade currently benefits from the most advanced form of cumulation – full cumulation across the EU.

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21 Open Europe, ‘What if...? The consequences, challenges and opportunities facing Britain outside the EU’, March 2015, p27-28: https://openeurope.org.uk/intelligence/britain-and-the-eu/what-if-there-were-a-brexit/
RoO and cumulation can be negotiated bilaterally, between two countries, or multilaterally, between a regional bloc. Multilateral RoO and cumulation commitments are an important means of facilitating trade within international supply chains – they can significantly reduce the costs and administrative burden of high cross-border trade in component parts. However, a multilateral agreement does come with costs to wider trade – it imposes restrictions on what RoO or cumulation liberalisations one country can negotiate in future deals with third countries. This is likely to be a price worth paying if it strengthens domestic industries’ competitiveness within regional supply streams, where frictionless trade is most important.

If restrictive RoO and cumulation requirements are placed on UK-EU trade post-Brexit, this could damage the UK’s competitiveness in European manufacturing supply chains, and limit the usefulness of non-EU FTAs:

- Proof of origin would have to be supplied and verified in trade of component parts, increasing out-of-pocket and time costs for businesses operating in regional supply streams
- If the administrative costs of certifying proof of origin are too high, businesses might choose to forego the tariff advantages in the FTA. The 2016 Global Trade Management survey by KPMG and Thomson Reuters found that only 23% of respondents use all applicable FTA advantages, with almost a quarter (23%) of these highlighting the complexity of RoO requirements as their biggest challenge.
- If the UK could no longer count EU components towards the “local content” of manufactured goods, some finished products would risk not being able to access tariff-free provisions in non-EU trade deals. For instance, UK components currently account for 41% of the average UK manufactured car, significantly below the EU’s standard 60% “local content” threshold.

Open Europe has argued that the UK could consider negotiating to extend transitional customs union arrangements after the end of the standstill transition period in 2020. This would give government and businesses time to adapt to new arrangements. However, this could only be a short-term measure to ease the transition out of the EU Customs Union for both UK and EU businesses. It would be politically difficult for the UK to agree to apply the EU’s common external tariff and trade policy indefinitely: for instance, faced with the prospect of signing an FTA with a major non-EU trading partner (particularly the US, China or India), the UK would likely want the right independently to negotiate tariff liberalisation.

Regulatory cooperation

What does “mutual recognition” mean?

The term “mutual recognition” has been widely suggested as a way for the UK to ensure minimum disruption to trade after Brexit. However, its use in the Brexit debate has led to
confusion. Mutual recognition is both a conceptual and technical term. While the UK government has referred to less binding concepts of “outcome equivalence”, the EU has multiple formal technical and legal mechanisms that provide for mutual recognition.

**Mutual recognition is understood in contrast to harmonisation**

It is important to point out at the start that all understandings of mutual recognition are in contrast to the concept of regulatory harmonisation. Regulatory harmonisation refers to the decision by country A and B to adopt the same rules and standards in order to ensure barrier-free access to each other’s markets. Within the EU, there are two broad categories of harmonised goods. In highly-regulated harmonised sectors, such as automotive and chemicals, goods are produced to the same technical specifications in all member states. In other harmonised sectors, such as electrical equipment and machinery, common EU regulations are limited to key health and safety protections, and member states adopt their own national provisions on other technical requirements.

In contrast, mutual recognition broadly refers to the decision of country A to recognise country B’s goods and services as legally equivalent to their own (and vice versa), even if they do not comply with the same technical rules or standards. It allows country B’s products and services to be sold in country A’s markets under no more burdensome conditions than domestic providers, without demanding convergence of regulations. Mutual recognition is therefore seen as a means of ensuring a degree of regulatory autonomy, while still avoiding significant barriers to trade with another actor.

**EU case law definition of “mutual recognition”**

EU law provides for a principle of mutual recognition, based on the 1979 ECJ ruling on the Cassis de Dijon case. This allows for free movement of goods within the EU in non-harmonised sectors – i.e. in sectors where the EU sets no common rules and standards, and goods are produced to national regulatory standards. The principle of mutual recognition allows for any good that can be sold in one EU country lawfully to be sold in another – unless they impact on the protection of public safety, health or the environment. According a 2017 European Commission impact assessment, trade in non- or partially harmonised goods accounted for 18.3% of intra-EU trade in 2015.

However, according to the same impact assessment, mutual recognition “is not functioning well” within the EU. It found that 87% of businesses did not use the principle of mutual recognition when selling non-harmonised goods, and instead produced goods to the relevant national legislation in order to sell into other member states.

This principle only applies to EU and EEA members – it is highly unlikely the EU would consider extending this to the UK unless it agreed to adopt and comply with the EU’s full legal framework post-Brexit (As a non-EEA state, the Cassis de Dijon principle does not apply to Switzerland – instead, it has a bilateral agreement on mutual recognition covering a number of goods sectors). “Mutual recognition” between the EU and non-EU countries is instead based on “mutual recognition of conformity assessment” agreements.

**EU Mutual Recognition of Conformity Assessment agreements**

The EU has concluded Mutual Recognition of Conformity Assessment agreements (MRAs) with third countries. In most cases, these do not allow for the direct mutual recognition of standards, as under EU case law. Instead, they allow third-country conformity assessment
bodies to confirm products bound for the EU market meet EU regulations and standards. They therefore help overcome duplication of testing and approval procedures for goods to facilitate access to each other’s markets. However, the EU has also agreed “enhanced” MRAs with Switzerland (and, in a discrete sector, with Israel) which do allow for direct mutual recognition of regulations. MRAs will be discussed in greater detail later on.

The UK government has referred to “outcome equivalence”

By contrast, the UK intends to pursue a less formal arrangement that focuses on equivalence of objectives and outcomes. Giving evidence to the House of Commons Brexit select committee, Brexit Secretary David Davis referred to the UK’s objective to “seek outcome equivalence in many areas, but not harmonisation.” Similarly, the government’s proposal for “regulatory equivalence” in key sectors to obviate the need for infrastructure on the Irish border suggested that “the UK and the EU agree to achieve the same outcome and high standards, with scope for flexibility in relation to the method for achieving this.” This relates more closely to the EU’s concept of equivalence, where it recognises the regulations of a third country as achieving the same objectives as the EU, while not replicating EU law word-for-word. The EU grants “third country equivalence” rights on specific aspects of individual regulations, and these can be unilaterally withdrawn by the EU.

Absent an agreement on mutual recognition of regulations between the UK and the EU, UK goods would need to be tested against EU product standards and regulations, by EU conformity assessment bodies, before they can be sold in the EU. This could significantly increase costs to trade, particularly for supply chain industries that are highly reliant on import and export of component parts with the EU.

The EU is widely considered a regulatory superpower. Due to its large market size and robust regulatory institutions, foreign companies who want access to the EU market often elect to adjust their production to EU rules and standards. The EU’s ability to export its regulatory regime even without the use of FTAs is what is known as the “Brussels Effect.”

The “Brussels Effect” can incentivise both international businesses and foreign governments to adjust their practices to the EU’s regulatory model. For instance, in sectors where it is cost-effective or otherwise necessary for businesses to produce goods to a single set of product standards and regulations, foreign companies often choose to comply with EU rules – this is particularly the case in highly-regulated sectors, where the EU’s rules and regulations are the most stringent internationally. For example, despite significant differences between US chemical regulation and its EU counterpart – the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) – the American multinational chemical corporation, The Dow Chemical, ensures all its production is REACH consistent, whether or not it is intended for the EU market.25

In addition, export-orientated foreign firms who alter their business models to EU regulations may then also be incentivised to lobby their domestic governments to legislate for the same standards in order to ensure a level playing field with other domestic competitors. EU REACH has had a significant international impact, with countries such as Korea, China and Turkey adopting REACH-like regulation.

25 Financial Times, ‘Why the whole world feels the Brussels effect’, 16 November 2017: https://www.ft.com/content/7059dbf8-a82a-11e7-ab66-21cc87a2edde
2.3 Swiss-EU arrangements provide a model for managed alignment with EU regulations in certain goods sectors

Switzerland has the closest arrangement with the EU of any third-country for trade in goods.\textsuperscript{26} While Switzerland is a non-EU member state outside both the Single Market and the Customs Union, Swiss manufacturers obtain essentially equivalent market access as their EU competitors in all goods sectors covered by the bilateral relationship.\textsuperscript{27}

Through a complex network of bilateral sectoral deals, Swiss-EU trade in industrial goods is largely tariff-free. However, significant tariffs remain on certain agricultural products, including meat and some processed agricultural produce.\textsuperscript{28}

Switzerland is party to a European convention on preferential RoO and advanced cumulation – the pan-Euro-Mediterranean preferential rules of origin (PEM Convention).\textsuperscript{29} There are 23 signatories to the agreement, including, among others, the EU member states, EFTA states, the Balkans and members of the Mediterranean Union, including Algeria, Israel and Turkey. The PEM Convention creates harmonised RoO between all members and allows for a system of advanced cumulation – this means that any group of countries, all with bilateral FTAs with each other, can count each other’s components towards the “local content” of a manufactured good for the purposes of RoO. In this sense, the agreement aims to support supply-chain trade in the European Economic Area and the surrounding European neighbourhood.

Switzerland also benefits from an “enhanced” mutual recognition agreement with the EU, which allows for both parties’ regulatory provisions to be considered equally valid in most product sectors.\textsuperscript{30} For example, a car that conforms to Swiss regulation, has fulfilled Swiss testing procedures, and holds Swiss test certificates or conformity marks, is deemed legally authorised for sale in the EU without the need for any further regulatory checks. The Swiss-EU MRA also recognises “the manufacturer’s declarations of conformity” in order to certify a product meets the requirements of the other party’s market, without the need for further checks by either side.\textsuperscript{31}

The EU holds mutual recognition agreements with some third-countries

The EU has agreed Mutual Recognition Agreements (MRAs) with third countries, both as part of free trade deals and as standalone agreements. There are two broad types of MRAs: traditional mutual recognition of conformity assessments, and “enhanced” MRAs.

\textsuperscript{26} Norway enjoys closer integration with the EU in goods, but this is by virtue of the EU single market being extended to it through the European Economic Area Agreement.


\textsuperscript{30} See Swiss State Secretariat for Economic Affairs, ‘MRA Switzerland-EU’: https://www.seco.admin.ch/seco/en/home/Aussenwirtschaftspolitik_Wirtschaftliche_Zusammenarbeit/Wirtschaftsbeziehungen/Technische_Handelshemmnisse/Mutual_Recognition_Agreement_MRA0/MRA_Schweiz_EU.html

Mutual recognition agreements of conformity assessment are more modest. These allow certain designated regulatory bodies in one country to certify whether a good produced in that country complies with the product standards and regulation of its trade partner’s market. This negates the need for conformity bodies in the partner country to reassess a product for entry to its market. Duplicating assessment procedures can present a significant barrier to trade: according to a 2016 business survey by the European Commission and the International Trade Centre, EU businesses consider conformity assessments procedures the most burdensome non-tariff barrier to trade in goods with key partners – it accounted for 31% of non-tariff issues reported by EU exporters. The EU has concluded such MRAs in specific sectors with countries including Canada, Australia, the United States and Japan.

“Enhanced” mutual recognition agreements are more ambitious. These allow for one country’s technical regulation automatically to be considered equivalent to its trade partner’s regulations. This means that any good covered by the agreement can be sold in one country if they have been lawfully authorised for sale in the partner country, and vice versa (unless they impact public safety, health or the environment). In order to allow for this level of mutual recognition, the trade partners agree to adopt the same or substantially similar legislation on regulatory standards in the sectors concerned. Because of the constraints this places on governments’ regulatory autonomy, these agreements are rarely concluded. The Switzerland-EU MRA and the Trans-Tasman Mutual Recognition Arrangement between New Zealand and Australia are the only examples of a broad “enhanced” MRA. There are some limited examples of “enhanced” MRAs in discrete industry sectors, such as the EU-Israel MRA of OECD principles on Good Laboratory Practices (GLP) for pharmaceutical products.

The EU-Switzerland MRA covers twenty “harmonised” product sectors. In highly-regulated harmonised sectors – such as motor vehicles – Switzerland can produce and assess goods to its own domestic standards to be sold in the EU. But in order to do so, it agrees to apply the relevant EU technical specifications and standards in domestic law.

In other “harmonised” sectors, EU common standards and technical specifications are voluntary, and therefore there is greater scope for differences between EU member states and Swiss legislation – this applies to a number of product sectors covered under the Swiss-EU MRA, including radio/telecommunication equipment and electrical equipment. In most of these sectors, the MRA assumes equivalence of EU and Swiss legislation, but recognises the possibility of “shortcomings” in legal equivalence.

However, some sectors are considered non-equivalent – such as pressure vessels and construction plant and equipment, and non-automatic measuring instruments. In the majority of these sectors, Switzerland agrees to produce EU-bound goods according to EU directives. Swiss conformity assessment bodies can then test these products for the EU market, in order to remove duplication of checks.

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32 Ibid., Annex 1
33 Ibid.
34 Ibid.
36 Ibid.
37 Swiss State Secretariat for Economic Affairs, ‘MRA Switzerland-EU’: https://www.seco.admin.ch/seco/en/home/Aussenwirtschaftspolitik_Wirtschaftliche_Zusammenarbeit/Wirtschaftsbeziehungen/Technische_Handelshemmnisse/Mutual_Recognition_Agreement_MRA0/MRA_Schweiz_EU.html
In cases where the EU considers Swiss products have failed to meet comparable standards to the EU, “appropriate restrictive measures” can be taken, “such as withdrawal of an appliance or fitting” from the market. Swiss and EU market surveillance and consumer protection authorities cooperate and share information to ensure manufacturers comply with relevant legislation. Non-compliance with the terms of this agreement are subject to a “guillotine clause” and could lead to the suspension of a broader range of Swiss agreements with the EU (this is discussed in more detail in section five).

In order to maintain its market access to the Single Market, Switzerland is required to update its domestic legislation in line with new EU rules and regulations in the sectors covered by the bilateral relationship. However, this is not an automatic process. When the EU in 2007 introduced REACH, its regulation on the Registration, Evaluation, Authorisation and Restriction on Chemicals, the Swiss Federal Office for the Environment commissioned an independent assessment on whether or not to introduce this new regulation in its domestic...
law. The report found that the effects of REACH on the Swiss economy would be “considerable” even if Switzerland did not apply the EU’s regulations domestically, given 63% of Swiss chemical output went to the EU and 85% of Swiss chemical imports came from the EU. In 2009, Switzerland partially revised its domestic legislation, the Swiss Chemicals Ordinance (ChemO), to reflect some of the provisions of REACH and the EU’s Classification, labelling and Packaging (CLP) regulation, such as testing requirements and restrictions for certain substances. Switzerland has since undertaken other revisions to ChemO in line with EU regulations. In 2010, the Swiss Federal Council began the process of negotiations for a Swiss-EU chemical safety agreement, but this was suspended in 2015. However, although Swiss chemicals legislation is closely aligned with EU REACH regulation, REACH does not apply domestically in Switzerland: new chemical substances must be notified, registered and declared separately in Switzerland before they are placed on the market, even if they are already EU-registered. Swiss chemical exports to the EU are also required to comply with REACH regulations.

Switzerland participates in many of the EU’s regulatory agencies in order to reduce duplication and increase efficiency in the monitoring and authorising the sale of goods with the EU (see Annex I). Switzerland’s arrangement also allows an indirect role for the ECJ. Although the ECJ does not directly enforce Swiss-EU agreements, Swiss legislation that is derived from EU law is required to adapt over time in line with any new and relevant ECJ judgments.

In all, Switzerland’s ability to adapt to developments in the EU acquis on a case-by-case basis reflects a higher degree of legislative flexibility to the rule-taking procedure foreseen in the EEA agreement. Switzerland continues to retain control over its legislation and can decide to reject new EU law outside its sectoral agreements with the EU. But, Switzerland faces the risk of creating new barriers to trade with the EU if it fails sufficiently to comply with new EU regulations and ECJ rulings (see section five).

However, the EU has in recent years raised concerns over Switzerland’s arrangement. The “static” nature of the bilateral arrangement means that Switzerland and the EU face political disagreements over each new amendment and revision to the treaties. By contrast, modifications to EU legislation take place automatically within the Single Market. The EU has also consistently argued for new institutional arrangements to more effectively enforce the agreements.

39 Swiss Federal Office for the Environment, ‘Impact of REACH on Switzerland’, 2007, p7:

40 The Swiss Confederation, ‘National Reporting to CSD 18/19 by Switzerland: Chemicals’, p3:

41 Swiss Notification Authority for Chemicals, ‘Chemical Safety / REACH’:

42 Swiss Federal Office of Public Health, ‘Guidelines for notification, registration and declaration of new substances in accordance with the Swiss Chemicals Ordinance (ChemO SR 813.11)’, 1 March 2018, p3:

43 Swiss Notification Authority for Chemicals, ‘Chemical Safety / REACH’:
2.4 CETA-style deals largely eliminate tariffs but provide more limited basis for addressing regulatory barriers to trade

The FTAs that the EU has negotiated with other third-countries have substantially lowered tariff barriers to trade in goods. The 2016 CETA deal between the EU and Canada eliminates duties on around 98% of goods, including all industrial and fisheries products.\(^4^4\) The vast majority of these tariff liberalisation commitments were front-loaded, with around 98% of the tariff elimination on both sides occurring at entry into force of the agreement.\(^4^5\) Similarly, the EU-Korea free trade agreement has removed 98.7% of duties in trade value, covering both industrial and agricultural goods.\(^4^6\) Failure to achieve 100% tariff elimination in EU FTAs is primarily due to exemptions for sensitive agriculture goods. Agriculture is traditionally a sector with high defensive interests, meaning it has often proved difficult to liberalise in trade negotiations.

EU FTAs have been less successful in significantly reducing non-tariff barriers to trade such as Rules of Origin requirements. A CETA-style FTA would only offer marginal liberalisation of RoO thresholds and cumulation allowances. The EU-Canada agreement is based largely on the EU’s standard RoO requirements, with only limited derogations in sectors including cars, textiles, fish and some agricultural produce.\(^4^7\) While CETA signposts the possibility for triangulating cumulation allowances with the US for trade in automotive and agriculture goods, this can only be enacted once an EU-US trade deal is concluded.\(^4^8\)

Similarly, the EU-South Korea FTA also offers marginal liberalisation of RoO for automotive products, increasing the share of foreign content allowed in the production of Korean cars to 45%, 5% above its average threshold.\(^4^9\) Equally, the EU-Singapore FTA allows for components originating in an ASEAN country to be counted towards “local content” only if they undergo further processing in the EU or Singapore.\(^5^0\) The agreement does foresee expanding cumulation allowances to include other ASEAN countries in the future, once the EU concludes a trade agreement with another ASEAN nation.\(^5^1\)

These limited bilateral measures on RoO and cumulation are more appropriate for distant trade partners, which mostly trade in finished goods, and reflect that Canadian and Korean manufacturers are already members of their own respective North American and Asian regional supply chains. A future UK-EU deal could be more ambitious in these areas to reflect the specific nature of UK-EU supply chains, which affect both bilateral trade and UK/EU trade with the rest of the world.

EU FTAs also provide limited means of reducing regulatory barriers to trade. In some cases, EU FTAs have allowed goods that meet international standards to be sold into the EU. But these provisions usually apply to a limited list of goods in key sectors where the EU directly applies

\(^4^5\) Ibid.
\(^4^8\) Ibid.
\(^5^1\) Ibid., p22
the international standard itself. As an example, EU vehicle safety is regulated by international standards and in part by regulations devised by the United Nations Economic Commission for Europe (UN ECE).\textsuperscript{52} Therefore, in the EU’s FTAs with Japan and South Korea, certain motor vehicles and parts that are certified as meeting the standards set by the UN ECE are considered compliant with EU regulations and can be sold in the EU, without the need for further testing, certification or labelling.\textsuperscript{53} This is a limited form of mutual recognition: the EU does not agree to recognise Japanese and South Korean vehicle safety standards as equivalent, but it reduces barriers to trade for goods that apply the same standards as the EU.

In other FTAs, the EU has agreed mutual recognition of conformity assessment in key sectors. Unlike “enhanced” MRAs such as the Swiss-EU agreement, this “does not require the recognition or acceptance by a Party that the other Party’s technical regulations are equivalent to its own.”\textsuperscript{54} For instance, CETA includes a protocol on the mutual acceptance of the results of conformity assessments covering eleven product sectors.\textsuperscript{55} While this imposes no restriction on Canada’s right to determine its own domestic regulations, this means that Canadian goods still require additional technical checks and certification in order to be sold in the EU. However, the CETA protocol allows the EU to recognise and accept certification and documentation produced by Canadian conformity assessment bodies demonstrating compliance with EU regulations – and vice versa. This helps to reduce duplication and shorten time to market. The CETA protocol specifies that conformity procedures must be performed by a registered conformity assessment body, and unlike the Swiss-EU MRA, self-declarations of conformity by manufacturers are not considered valid.

CETA does also include a protocol on the mutual recognition of compliance and enforcement of good manufacturing practices for pharmaceutical products.\textsuperscript{56} This recognises relevant Canadian and European regulatory authorities for medical and pharmaceutical products as equivalent. The scope of both mutual recognition protocols has been viewed as a means of supporting trade in automotive and pharmaceutical sectors in particular.

The EU’s plans for regulatory cooperation with the US in draft proposals for the Transatlantic Trade and Investment Partnership set forward the most ambitious arrangements on mutual recognition of regulations between two FTA partners. Although work on the agreement has stalled, the regulatory chapters of TTIP provide a creative blueprint for increasing the compatibility of divergent regulatory regimes. Privately, some EU member states have suggested that the TTIP model could be a more suitable model for future UK-EU relations.

According to a 2013 US-EU high level working group report, TTIP provisions aimed both to address current regulatory differences and to ensure greater regulatory convergence in the future.\textsuperscript{57} The US and EU aimed to reduce the costs of existing regulatory divergence through mutual recognition, as the EU has already achieved with other FTA partners. However, to


\textsuperscript{55} Ibid., p567

\textsuperscript{56} Ibid., p581

ensure dynamic regulatory alignment, TTIP included an unprecedented horizontal chapter on regulatory coherence and cooperation. On one hand, this sought to embed the use of good regulatory practices internally in the EU and the US when developing new regulation and standards – for instance, through the rigorous use of impact assessments, stakeholder consultations, and early exchange of both parties’ planned regulatory actions. They hoped this would create the conditions for more coherent regulatory planning internationally between both partners. TTIP also aimed to establish structures for formal bilateral regulatory cooperation. For instance, a 2015 EU proposal suggested regular meetings and exchanges of a standing US-EU Regulatory Cooperation Body, which could establish areas for future cooperation as well as monitor the implementation of TTIP’s regulatory chapters.  

2.5 The case for regulatory divergence on goods post-Brexit

After Brexit, UK manufacturers selling highly-regulated goods into the EU will need to comply with EU product standards and regulations. This is also true of goods where the EU applies safety or labelling requirements. The UK cannot force the EU to change its regulations as a non-member. Given the EU represents its biggest goods export destination, a significant proportion of UK goods will therefore already be required to align with EU technical regulations.

UK manufacturers may consider producing goods which are destined for domestic consumption or non-EU markets to different regulatory standards. However, it is not clear that this would be a cost-effective option for businesses. Manufacturers with multiple export destinations, including the EU, would have to assess the cost of operating under a dual regulation business model – there is limited evidence of appetite for this, particularly in highly regulated sectors. For instance, in a letter to International Trade Secretary Liam Fox, the British Chambers of Commerce, the EEF (the manufacturers’ organisation), and the British Standards Institution, warned: “This causes fragmentation of the domestic market as multiple standards encourage local ‘rules’ to proliferate and increase cost and complexity for industry, consumers and regulators.”

There is some suggestion that businesses in highly regulated sectors may benefit from deregulation post-Brexit to reduce costs of production. However, this would risk creating obstacles to trade with the EU in sectors deeply integrated in regional supply chains. There appears no strong business case for immediate significant divergence from the EU’s regulatory regime. For instance, in a recent letter, the Chemical Industries Association argued that leaving the EU’s regulatory regime “would seriously bring into question ten years of investment, as registrations and authorisations that permit access to the EU single market would suddenly become non-existent on exit day.”

It is not clear that adopting the EU’s high regulatory standards has restricted growth in non-EU markets. Member states such as Germany have been very successful at exporting goods

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60 Financial Times, ‘Chemical and pharma groups urge Gove to stick to EU regime’, 11 December 2017: https://www.ft.com/content/8a9d05ce-dd9c-11e7-a8a4-0a1e63a52f9c
around the world. Germany is the world’s third largest exporter of goods, behind the China and the US. In 2016, Germany exported €77 billion in goods to China – its largest trading partner that year – almost four times more than the UK (£13.5 billion).\(^{61}\)

Equally, certain UK goods exports have performed well in non-EU markets under EU membership. For instance, while UK car exports to EU countries grew by 7.5% in 2016, demand for UK vehicles in the US increased by almost half (47.2%).\(^{62}\) The UK is unlikely to try to compete on lower standards – like other EU member states, the UK primarily produces high-quality manufactured goods.

However, it is not only the UK that could diverge from the current EU regulatory framework. In the future, the EU may decide to introduce a new body of regulation in goods sectors – for instance, it has traditionally proven particularly active in regulating pharmaceutical and chemical products. This would be a concern for highly-regulated UK goods industries post-Brexit – businesses do not want to do away with existing rules because this imposes costs to adapt, but they would be concerned about the introduction of new rules.

If the EU re-regulates key sectors, the UK will have to assess at the time whether to comply with updated EU legislation, and what the consequences to market access will be if it chooses not to. Similarly, there is a strong case for less formal alignment with the EU when it comes to industries of the future, such as autonomous vehicles, virtual reality devices, biotech and some medical technology, and artificial intelligence. There is also a greater cross-over between goods and services. The UK has a strong competitive advantage in these digital and new technology sectors – it would not be in Britain’s interest to become “rule takers” from the EU in these areas, particularly as these are growth industries over which the EU, or indeed others, have yet to establish a full regulatory framework.

### Agriculture

While the UK government has pledged to remain close to EU regulations in manufactured goods sectors, it has suggested it will seek freedom to diverge from the EU on agriculture, food and drink regulation. In her “Road to Brexit” speech, Prime Minister Theresa May said, “It will be particularly important to secure flexibility here to ensure we can make the most of the opportunities presented by our withdrawal from the EU for our farmers and exporters” – although she offered little detail on what changes the government envisaged in this area. There are two broad reasons why the UK might want flexibility on agrifood regulations and standards post-Brexit:

1) In order to negotiate and conclude trade deals with non-EU countries such as the US, for whom relaxing the EU’s food safety regulations would be a key demand. It is worth noting, however, that UK Environment Secretary Michael Gove has ruled out lowering food safety and environmental standards.

2) In order to move away from the EU’s “precautionary principle” on regulations, which requires a producer to demonstrate their product is proven to be safe in order to be

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marketed. Instead, the UK may choose to adopt a risk-based approach, where a product must be demonstrated to be harmful in order to be banned.

Regulatory divergences between the UK and the EU on agriculture, food and drink post-Brexit will likely result in increased checks at the borders. For instance, if the UK were to adopt alternative sanitary, phytosanitary and veterinary regulatory measures to the EU, under EU requirements, agricultural products and livestock from the UK would be subject to checks at the point of entry to the EU. Given the high level of agrifood trade across the Irish border, this would pose significant problems for the operation of an open border on the island of Ireland, unless a bespoke negotiated solution is arrived at.

Open Europe will discuss post-Brexit agriculture policy in greater detail in later work.

2.6 Conclusions

The EU’s agreements with Canada and Switzerland provide two broad models for the future UK-EU framework for trade in goods.

Canada’s deal allows for tariff-free trade in almost all goods, with some exemptions for sensitive agricultural products. But it provides only limited means of addressing regulatory barriers to trade. It includes mutual recognition of conformity assessments in key sectors, which helps to reduce costs to businesses from duplicating testing and approval procedures and time-to-market delays. However, CETA does not provide liberal RoO cumulation allowances or direct mutual recognition of standards, both of which would be particularly important to support the UK’s participation in complex European manufacturing supply chains.

Switzerland’s bilateral deals with the EU provide tariff-free trade in all goods covered by the agreements, and go further in minimising regulatory barriers to trade in goods. Switzerland participates in the EU’s pan-Euro-Mediterranean Convention on preferential rules of origin (PEM Convention), which facilitates supply-chain trade in the EEA and the European neighbourhood by allowing broad RoO cumulation. Switzerland also benefits from mutual recognition of regulatory standards in twenty product sectors. This allows Swiss manufacturers to obtain essentially equivalent market access as EU businesses in all sectors covered by the agreement.

However, Switzerland’s high level of barrier-free access for trade in goods comes with corresponding obligations. Participation in the PEM Convention means it has to comply with RoO thresholds set by the EU, with limited means of influencing these requirements and limited flexibility to negotiate lower standards in its own trade agreements with non-EU countries. Similarly, in order to achieve its "enhanced" MRA with the EU, Switzerland agrees to apply the EU’s legal and regulatory framework in its domestic law in the relevant sectors.

The UK government recently laid out its proposals to ensure as frictionless as possible trade in goods through “a comprehensive system of mutual recognition.” Prime Minister Theresa May said in her “Road to Brexit” speech:

“The UK will need to make a strong commitment that its regulatory standards will remain as high as the EU’s. That commitment, in practice, will mean that UK and EU regulatory
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standards will remain substantially similar in the future...Our default is that UK law may not necessarily be identical to EU law, but it should achieve the same outcomes.\textsuperscript{63}

She also emphasised that any decision by a UK parliament “not to achieve the same outcomes as EU law...would be in the knowledge that there may be consequences for our market access.”\textsuperscript{64} She added that the UK would seek participation in the European Medical Agency, the European Aviation Safety Authority and the European Chemicals agency, and would accept “abiding by the rules of those agencies and making an appropriate financial contribution,” and “respect the remit of the ECJ in that regard.”\textsuperscript{65}

The government is right to aim for mutual recognition of regulatory standards, particularly in sectors that operate in complex European manufacturing supply chains, such as automotive, aerospace, chemicals and pharmaceuticals. However, in order to achieve this, the UK will need to agree to replicate relevant EU rules and regulations in UK domestic law, as per Switzerland’s arrangement with the EU. There is no precedent for the EU offering a third country broad mutual recognition based on “achieving the same outcomes”, and it is unclear whether it would be willing to compromise on this for the UK. The government will have to provide more clarity on whether its commitment to maintain “substantially similar” rules will mean agreeing to apply EU legislation in key sectors. It is worth noting that it may be considering this path, given the Prime Minister’s willingness to “abide by” EU rules in important supply-chain sectors (pharmaceutical, chemicals and aerospace sectors) in order to participate in EU agencies.

Agreeing to apply the EU’s regulatory model in key goods sectors post-Brexit will impose some restrictions on UK trade policy in future FTA with third countries. However, the UK will still reserve the right to diverge in the future – just as the EU will have the right to recognise the UK as no longer fully aligned. The question will be what proportionate or retaliatory measures will be enacted in this scenario. The dispute settlement framework of the future UK-EU agreement will therefore be a very important aspect to consider. This will be discussed in greater detail in section five.


\textsuperscript{64} Ibid.

\textsuperscript{65} Ibid.
3. Trade in services

3.1 The UK is a strong and globally diversified exporter of services

International trade has traditionally been dominated by goods because it has proven harder to remove barriers to services trade. Contrary to the comparatively simple nature of cross-border trade in goods, services can be delivered in various ways – defined by the WTO’s General Agreement on Trade in Services (GATS) as the four “modes of supply.” In practice, services are often provided through a combination of these four modes and can be linked to trade in goods (for example, the provision of a maintenance service sold with factory equipment).66

This makes services trade difficult to measure in official statistics and illustrates how the provision of services can run into more potential trade barriers than the exchange of goods. For example, the cross-border supply of services can be restricted by local licensing requirements which prevent foreign firms from marketing their products. Professionals seeking to provide a service in another jurisdiction often have to contend with visa requirements. And, firms seeking to establish an office in a foreign country can face discriminatory rules which favour local firms. The ease with which services can be traded can also depend on a broader framework such as how easy it is to share data or travel across borders.

### How services are traded: the four modes of supply

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<tbody>
<tr>
<td>Services supplied from one country to another (e.g. international telephone calls), officially known as “cross-border supply”</td>
<td>Consumers or firms making use of a service in another country (e.g. tourism), officially “consumption abroad”</td>
<td>A foreign company setting up subsidiaries or branches to provide services in another country (e.g. foreign banks setting up operations in a country), officially “commercial presence”</td>
<td>Individuals travelling from their own country to supply services in another (e.g. fashion models or consultants), officially “presence of natural persons”</td>
</tr>
</tbody>
</table>

Source: WTO General Agreement on Trade in Services

However, services have become increasingly tradeable over time. The end of traditional national monopolies in some sectors (e.g. transport, telecommunications), new technologies (electronic banking, greater digital interconnectivity) and cheaper air travel have gradually expanded the scope for trade. World services trade has increased by 8% per annum over the past decade, around double the rate of growth of goods trade, and it is projected that services’ importance to global trade will continue to grow due to further advances in technology and liberalisation.67

Services currently account for around a fifth of total global trade. However, they are far more important to the UK’s export mix, where they represent around 45% of the country’s total

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66 Jansen and Piermartini, ‘The Impact of Mode 4 on Trade in Goods and Services’, November 2004
exports. This makes the UK the second largest global exporter of services, behind only the US.\(^{68}\) The UK’s exports are largely dominated by financial services and professional business services, with a handful of other sectors also featuring strongly.\(^{69}\)

While UK services exports are concentrated in some sectors, it is a globally diversified exporter, far less reliant on intra-EU trade than the EU28 average. Only 42% of UK’s trade in services is with the EU, one of the lowest scores within the bloc – only Malta and Ireland trade less with their European partners as a share of total services trade. The UK’s reliance on the EU market is much less marked in services than in goods. The UK exports only 37% of its services to the EU, compared to 48% of its goods.\(^{70}\)

Additionally, since 2000, services exports have grown much faster in non-EU markets and the centrality of the EU to UK exports is likely to decrease further in the future. Unlike goods, trade in services is facilitated by factors such as a common language and legal system – this no doubt helps to explain why the US is currently the primary destination for UK services exports despite its distance and the lack of a bilateral trade agreement. A recent report by Open Europe also suggests that the UK could benefit from focusing on non-EU markets where it currently underperforms in services trade, in particular Canada, India, China and Israel.\(^{71}\)

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\(^{68}\) World Trade Organisation, ‘World Trade Statistical Review 2017’, p104: [https://www.wto.org/english/res_e/statistics_e/wts2017_e/wts2017_e.pdf](https://www.wto.org/english/res_e/statistics_e/wts2017_e/wts2017_e.pdf) The figures are relative to commercial services, which include all service categories except government services – which comprised about 1% of the UK’s global service exports in 2016, according to the ONS Pink Book

\(^{69}\) Our “Professional business services” category corresponds to the category “other business” in the 2017 ONS Pink Book

\(^{70}\) ONS, ‘The Pink Book’, 2017

Technical barriers undoubtedly remain which make it difficult fully to exploit the potential of these markets, but in several cases the historical and cultural links with these countries could represent an advantage for trade in services.\textsuperscript{72}

\textbf{Intra-EU trade in services as a share of total trade in services, 2016 (%)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Intra-EU trade in services as a share of total trade in services, 2016 (%).}
\end{figure}

Source: Eurostat; ONS Pink Book, 2017

\textsuperscript{72} Ibid.
The UK’s services exports to the EU are furthermore concentrated among a small group of commercial partners. The top five UK export destinations in the EU (Germany, France, the Netherlands, Ireland, and Italy) account jointly for almost £60 billion – two thirds of its total exports to the bloc. When the UK’s global trading partners in services are ranked, the UK’s top 15 partners include eight single market members – and once again, the importance of Germany (2nd), France (3rd), Netherlands (5th) and Ireland (7th) is apparent, although for instance the UK exports more to the US (1st) than to Germany or France, and more to Switzerland (4th) than to the Netherlands or Ireland. But the picture for other EU27 states is somewhat different. The UK exports more services to the Isle of Man (28th) than to Portugal (45th); more to the Marshall Islands (47th) than to Romania (49th); and more to Papua New Guinea (77th) than to Slovenia (79th).

3.2 UK services exports to the EU concentrated in the financial and business services

UK exports to the EU are concentrated in four to five sectors, in a pattern fairly similar to that for the country’s global exports. Financial services and business services again account by far for the largest share (Fig.4). The UK has a particularly strong comparative advantage in financial services, which generates a substantial trade surplus with the EU (Fig.5).

The UK’s specialisation in financial services is particularly marked when compared to other EU member states’ exports to the rest of the Single Market (Fig.6). The UK’s exports to the

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73 ONS, ‘The Pink Book’ (Chapter 9), 2017
74 While we are here considering broad sectors, it is important to stress that occasionally great variation exists between the different subsectors making up for each of the categories considered. For instance, despite a large trade deficit with the EU in travel services, the UK boasts a substantial surplus in higher education, which is part of the broader travel category
75 Intra-EU data are the product of own calculations based on Eurostat data
Single Market are dominated by financial services. Whereas professional business services accounts for roughly the same share of UK exports to the EU as it does for other EU members, and travel and transport are far less significant in terms of UK exports to the EU compared with the average member state.

Source: ONS Pink Book, 2017
However, it is crucial to note that, even for those sectors where the UK is most integrated in the Single Market – financial and professional business services – the EU market accounts for less than 40% of UK exports.
3.3 UK dislocation from the Single Market likely to have less impact for services than for goods

The development of a common market for services has been an objective of the European project from the outset. As early as the Treaty of Rome in 1957 – which established the European Economic Community (EEC) – there was a stipulation that an internal European market should be created. This included liberalising the movement of goods, workers, services and capital between the member states. However, it has proven far more difficult to liberalise trade in services than it has trade in goods or the movement of people.

Theoretically, the EU has liberalised all modes of supply. In practice, this is more developed in some areas than others and it is widely acknowledged that the Single Market in services has not lived up to expectations. For example, the EU allows almost complete free movement of people, essentially offering very comprehensive liberalisation via Mode 4 (temporary presence of natural persons). The EU also has strong rules enforcing non-discrimination for firms or individuals establishing a presence in another member state (Mode 3), although here some national barriers remain. On the other hand, the internal market’s achievements are more modest in relation to cross-border supply (modes 1 and 2), where liberalisation is compromised by many national exceptions, which create barriers to intra-EU trade.\footnote{The 2005 Professional Qualifications Directive ensured the automatic recognition of a range of professional qualifications across the Single Market, and loosened rules on the temporary or occasional provision of services across borders. The Services in the Internal Market Directive clarified the broader framework for cross-border service provisions, and obliged member states to simplify bureaucratic procedures for businesses. The EU has furthermore developed rules on issues such as data sharing. The new EU General Data Protection Regulation (GDPR) that will be enforceable from May 2018, for instance, is designed to harmonise data privacy laws across Europe. See Redondo, ‘The modernised Professional Qualifications Directive – The end of crisis-induced unemployment in the EU?’, 9 December 2013: \url{https://blogs.kcl.ac.uk/kslreuropeanlawblog/?p=591#WirEaoZI8dV}; European Parliament, ‘The Consequences of Brexit on Services and Establishment: Different Scenarios for Exit and Future Cooperation’, June 2017, p22: \url{http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602035/IPOL_IDA%282017%29602035_EN.pdf}; Independent, ‘Thousands protest ahead of ‘Polish plumber’ vote’, 15 February 2006: \url{http://www.independent.co.uk/news/world/europe/thousands-protest-ahead-of-polish-plumber-vote-5547273.html}}

EU attempts to further services liberalisation comprise a patchwork of horizontal measures, designed to prevent discrimination and facilitate administrative cooperation, and sector specific legislation. The 2006 Services in the Internal Market Directive aimed to cut legal and administrative barriers by addressing the differences that exist between the national legislation of the member states, but this effort became highly politicised. In France, the notion of the “Polish plumber” undercutting domestic workers was blamed for the defeat of the EU constitution in a 2005 referendum.\footnote{The 2005 Professional Qualifications Directive ensured the automatic recognition of a range of professional qualifications across the Single Market, and loosened rules on the temporary or occasional provision of services across borders. The Services in the Internal Market Directive clarified the broader framework for cross-border service provisions, and obliged member states to simplify bureaucratic procedures for businesses. The EU has furthermore developed rules on issues such as data sharing. The new EU General Data Protection Regulation (GDPR) that will be enforceable from May 2018, for instance, is designed to harmonise data privacy laws across Europe. See Redondo, ‘The modernised Professional Qualifications Directive – The end of crisis-induced unemployment in the EU?’, 9 December 2013: \url{https://blogs.kcl.ac.uk/kslreuropeanlawblog/?p=591#WirEaoZI8dV}; European Parliament, ‘The Consequences of Brexit on Services and Establishment: Different Scenarios for Exit and Future Cooperation’, June 2017, p22: \url{http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602035/IPOL_IDA%282017%29602035_EN.pdf}; Independent, ‘Thousands protest ahead of ‘Polish plumber’ vote’, 15 February 2006: \url{http://www.independent.co.uk/news/world/europe/thousands-protest-ahead-of-polish-plumber-vote-5547273.html}} As a consequence, key liberalising proposals – such as the ‘country of origin principle’, which would have allowed companies to provide cross-border services under the regulations of their home country rather than the country where the service is delivered – were removed from the legislation when it was eventually adopted.

There are obvious practical hurdles to creating a genuine single market for services within the EU: the lack of a common language, differing systems of taxation and very different national systems for certain professions. For example, Germany operates a system of guilds for many professions and trades, which require years of training and formal qualifications, whereas the UK and others operate more open systems that do not require formal qualifications. As an example Swedish construction firms find it difficult to operate in Germany. German law requires foreign architects to prove that they have good standing with their national regulator. However, there is no such regulator in Sweden. Similarly, Germany requires electricians and
plumbers to submit a certificate of vocational qualification, but Sweden does not issue such a certificate.\(^78\) This has understandably led German tradesmen to resist attempts to enable counterparts across the EU to compete in their domestic market.

The most progress in services market integration has therefore been confined to areas where sector-specific legislation provides an EU-level legal framework that overrides national legislation: financial services, transport, and telecommunications. In financial services, EU legislation provides companies with passporting rights\(^79\), with Directive 2013/36/EU establishing the right for financial services providers authorised in an EEA state to provide services cross-border and to set up branches in another EEA state. Transport is another sector where a great degree of liberalisation is secured by a number of regulations and directives. For instance, in air transport services, EU law introduces the notion of community carrier, which replaces different notions of national carriers and guarantees that a carrier licensed by one of the Member States can operate anywhere in the EU.\(^80\) In telecommunications, the EU has abolished roaming charges and a series of regulatory provisions have ended traditional national monopolies to open up national markets to greater competition.\(^81\)

In other sectors liberalisation lags behind. For example, many national barriers to trade in professional and business services remain. Examples range from residency requirements for patent agents in Malta and Sweden to the necessity for accountants, tax advisers and patent attorneys in Austria to obtain insurance from an operator authorised to exercise in the country.\(^82\) Within the sphere of professional services, legal services are the exception. Specific directives have opened up intra-EU markets that have traditionally been closed to non-EU legal service providers.

EU rules governing the Single Market in services are enforced under the EU treaties and secondary legislation and upheld by the European Commission and EU’s Court of Justice. The rules governing the Single Market in services have been extended to the EEA/EFTA states via the EEA agreement and are enforced by the EFTA institutions.

Outside of the Single Market, the UK will either have to export its services to the EU under WTO rules or under any preferential terms negotiated under a new UK-EU FTA. It is likely that this will lead to greater restrictions on UK services exports, particularly those that are traded cross-border and where Single Market integration has provided for meaningful liberalisation.

However, it is difficult to assess exactly how Brexit will affect UK services exports to the EU for several reasons. First, unlike for goods, the impact of reverting to the WTO default scenario is much harder to gauge. As Borchert (2016) notes, the commitments to market access and non-discrimination that countries have made to fellow WTO members under the GATS and Most Favoured Nation Rule are generally not very ambitious. However, MFN access

\(^78\) Aslund and Djankov, ‘Europe’s Growth Challenge’, 2017, p80
\(^80\) Open Europe, ‘Open Skies: A plan for post-Brexit cooperation in civil aviation’, forthcoming
to services markets is often more open in practice than is foreseen under a country’s formal commitments lodged with the WTO.

Second, tariffs are not imposed on services, so there is no common EU external tariff. The issue is the extent to which services exports will face new non-tariff and regulatory barriers. But due to the incomplete and uneven nature of the EU’s single market in services, there is often no uniform set of EU rules for third countries accessing individual member state’s markets, even under an FTA. Some member states have more restrictive policies for non-EU members while others do not. Therefore it will be easier for UK exporters to access some European services markets than others from outside the EU. For example, in the legal sector, while several member states do not impose restrictions on establishing a commercial presence, Austria only allows licensed lawyers from EEA countries to establish a branch.

Third, a large proportion of services trade isn’t provided across borders but via the establishment of a commercial presence in the given market. Official ONS statistics on trade in services do not necessarily present the full picture as they fail fully to capture the level of trade conducted through the establishment of subsidiaries and branches. It has been suggested that services provided via a commercial presence are at least as significant in value as the cross-border trade more easily measured by the statistics. The negative effect of Brexit on UK firms’ ability to establish a commercial presence through outward foreign direct investment (FDI) is likely to be small. Existing levels of outward FDI are unlikely to be easily reversible by legal means and would require the EU and the UK to actively encourage disinvestment in their economies.

3.4 EU FTAs increasingly address trade in services but ambition is more limited than for goods

CETA provides an example of what the EU has been prepared to agree with partners under “second generation” FTAs. These are agreements that the EU has reached with developed economies and go beyond simply reducing tariffs, touching on a wider range of issues, including services, investment and public procurement among others. Critics of the CETA deal as a basis for UK-EU trade note that the services provisions are unambitious. Clearly, the CETA model is not a perfect blueprint for the UK and all FTAs reflect the interests of the parties. Canada’s trade in services with the EU was worth only €30.3 billion in 2016 against £175 billion for the UK.

However, CETA and other recent agreements such as the EU deals reached with South Korea and Japan provide useful precedents upon which the UK and the EU can build. CETA contains specific chapters on cross-border services and investment, as well as sector-specific chapters on financial services, international maritime transport services, telecommunications and e-commerce. The commitments mainly consist of reducing discriminatory measures and removing quantitative restrictions across all sectors.

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85 ONS, ‘The Pink Book’, 2017
CETA is the first trade agreement where the EU has agreed to open up its services markets using the “negative list” approach. This means that all services markets are liberalised except those explicitly excluded. The European Commission estimates that approximately 50% of the gains on the EU side from CETA were to come from the removal of barriers to trade in services.\textsuperscript{87}

The major conceptual difference between CETA and the Single Market is that, in theory, the Single Market provides a common regulatory framework for member states. CETA removes many outright restrictions on Canadians or Canadian firms from operating or establishing themselves within the Single Market (such as numerical restrictions or nationality restrictions) but there is still a requirement to comply with the regulations of the EU or the importing EU member state and vice versa.

CETA does not provide a comprehensive framework for regulatory cooperation beyond some provisions to encourage cooperation on a voluntary basis. However, the EU has previously demonstrated its willingness to go beyond CETA in this respect: negotiations for a US-EU trade deal included provisions for a more binding horizontal chapter on regulatory coherence, intended to ensure both sides considered in advance the impact any new regulations would have on bilateral trade.\textsuperscript{88}

In addition, some sectors are excluded entirely (audio-visual services, services supplied in the exercise of government authority and some forms of transport) from CETA and the liberalising commitments are subject to long lists of “reservations” that are contained in the Annexes of the agreement. These measures allow either the EU or individual member states to reserve the right to maintain existing restrictions or implement new measures that could restrict access to Canadian firms in the future.

Annex I of the CETA deal, which sets out the list of existing market access restrictions the EU and member states reserve the right to maintain, lists 292 reservations. Over a third of these reservations apply to the field of business and professional services and, of these, a majority are either related to legal services or to accounting, auditing and bookkeeping. Other sectors where high numbers of limitations apply are public services (health, social, and education) (35 reservations), transport and transport-related services (29), commercial marine activity and fishing (28), distribution (25), and financial services (18).\textsuperscript{89}

These individual reservations can vary widely in terms of potential impact. For example, nationality restrictions applied by Finland and Sweden over the right to engage in the activity of reindeer husbandry are not likely to have a significant economic impact. Whereas, for instance, limits on the right of third country companies to establish branches in the EU have a bigger impact. Nevertheless, the concentration of reservations in certain sectors gives an illustration of where accessing EU markets is hardest and most complex.\textsuperscript{90}

\textsuperscript{89} The categories are based on own analysis of CETA Annex I
\textsuperscript{90} In their study of services liberalisation achieved in CETA, while employing a different method and extending the analysis beyond our limited focus on Annex I, Magntorn and Winters (2018) come to similar conclusions as far as restrictiveness in different sectors is concerned. Although their analysis shows that CETA liberalisation for business services might be greater than our analysis of Annex I would suggest. See: Magntorn and Winters, ‘Can CETA-plus solve the UK’s services problem?’, March 2018, p4-6: http://blogs.sussex.ac.uk/uktpo/files/2018/03/BP18-10.209199781912044559.pdf
However, due to the shortcomings of the Single Market in several sectors, the difference between being a member of the EU’s Single Market and trading under CETA’s rules is not entirely black or white in practice. A significant proportion of the barriers listed among CETA’s reservations apply not only to Canada but also to other members of the EU. There are several examples within the professional and business services sectors. For instance, a KPMG study for the Dutch government concluded that cross-border accountancy services “will be impacted by Brexit only to a limited extent” because “the internal market has been standardised to a much greater extent for goods than for services.” As an example, although there is free movement of services and workers between the UK and other member states at present, and the EU’s Professional Qualifications Directive guarantees the recognition of professional qualifications throughout the EU, “in nearly all cases, accountants must obtain an additional professional qualification in the EU member state where they want to work.”

3.5 Sector specific considerations for the new UK-EU relationship

In this section we address the considerations that apply to the UK’s most significant services export industries: financial services and professional business services, and to a limited number of sectors where single market integration is particularly advanced. We also note how cross-cutting issues, such as the movement of professionals and the cross-border transfer of data, are important to the continued integration of UK-EU services trade post-Brexit.

Financial services

In the report *How the UK’s financial services sector can continue thriving after Brexit*, Open Europe concluded that the notion that the City of London’s success is based on full and complete access to the EU single market in financial services is not borne out by analysis. It has benefitted from the liberalisation of EU markets, but its strengths are both global and domestic.

Nevertheless, it is clear that the loss of passporting rights, which allows financial firms to provide services from a UK headquarters to the rest of the EU under a single regulatory framework without the need to establish a new subsidiary, will cause disruption and extra costs. This will be more significant for some financial services than others.

For example, passporting works best for banking, and around a fifth of the sector’s annual revenue is estimated to be tied to the passport. However, passporting works less well for asset managers, given that a number of technical barriers remain to marketing funds across the EU (e.g. supervisory and legal fees). It is also a global business. As stressed by Sir Jon Cunliffe, Deputy Governor of the Bank of England, “Well over 50% of the roughly $8.5tn assets under management in the UK are pensions, insurance and investments of UK citizens. Another 20% comes from the rest of the world beyond the EU. Less than 20% of assets managed in the UK, are domiciled in the rest of the EU.” The insurance industry already largely operates on the basis of subsidiaries, which are not reliant on a passport, rather than branches.

91 KPMG, ‘Impact of non-tariff barriers as a result of Brexit’, January 2018, p74
Rule taking is not a feasible option for the UK

Given that UK financial services are already globally diversified and the disproportionate importance of the industry to the UK economy, regulators and industry players have made it clear that the UK cannot simply become a passive rule-taker of EU regulation as the price of access to the Single Market. The UK alone accounts for a third of financial services exports across the EU.

In addition, financial services is a dynamic and liquid industry and UK-EU divergence is likely to arise for a number of reasons. While the regulatory framework is developed internationally – for example, through the G20’s Financial Stability Board and by the Basel Committee – there are strong reasons for the UK and EU to apply and tailor rules to their specific circumstances.

The UK will need to strike a balance between maintaining access to EU markets and the flexibility to ensure the industry is globally competitive. This was stressed by Barclays CEO Jes Staley, who stated that, “I think the UK should negotiate a regulatory regime which is roughly equivalent to Europe to keep us having access to that single market.” However, he added, “Now that the United States has basically said we’re going to take a different regulatory tact, maintaining the regulatory flexibility in the UK to keep London competitive with New York is another dimension to this debate.”

The UK is likely to be at the forefront of new areas of regulation (such as those relating to FinTech, for example) and Bank of England Governor Mark Carney has already stated that there are rules the UK would look to revise, depending on the outcome of the negotiations. These include the rules on bankers’ bonuses and capital risk weighting for the insurance industry under the Solvency II regime. The UK government also has to ensure it can adequately supervise and regulate an industry where crises have potentially huge implications for the taxpayer, as the financial crisis of 2008 demonstrated.

Meanwhile, the EU is still in the process of constructing a Banking Union centred on the Eurozone states and the political centre of gravity among the EU27 and EU institutions is one that could lead to a more restrictive regulatory environment for financial services. This was already evident before the UK voted for Brexit and in the wake of the financial crisis. The UK was concerned not only with the content of new EU financial rules but also by the growing centralisation of supervisory powers in both the European Central Bank and the EU’s three supervisory authorities, and the potential for Eurozone caucusing to undermine the interests of non-Eurozone members of the Single Market.

Level of UK-EU financial market integration demands a novel approach

CETA is the most comprehensive EU FTA to date with regard to financial services. In principle, the agreement liberalises financial services trade in all the four different modes of supply, and includes specific commitments on regulatory transparency and the cross-border transfer and processing of information by financial institutions. CETA offers a codified and liberal regime for firms to establish a presence in the EU.

95 See former Chancellor George Osborne’s speech to an Open Europe conference, 15 January 2014: https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe
However, CETA allows each party to impose terms and conditions on the provision of cross-border financial services and to restrict the ability of firms from one party to do or solicit business in the other party’s jurisdiction (Article 7.6 of the Chapter on financial services). It also includes a “prudential carve-out” that allows either party to limit access by adopting measures designed to protect investors, depositors, and the wider stability of the financial system.

As a result, although in principle both the EU and Canada have committed to liberalise, in practice the agreement provides Canadian entities with limited cross-border access to the EU market, with exceptions only in a limited number of sub-sectors – this falls well short of the “passporting” rights offered by membership of the Single Market. Therefore, Canadian firms wishing to trade cross-border into the EU must largely rely on the EU’s third country equivalence regime, to which any third country can apply.

Third country equivalence offers Single Market-like rights when a country is judged by the EU to have a broadly equivalent regulatory and supervisory regime. However, it is only a partial solution. While some EU regulations offer passport-like rights for third countries (e.g. MiFIR) others offer no equivalence at all (e.g. CRD IV). Granting equivalence is also a political decision, requiring a judgment from the European Commission, which can unilaterally be revoked.

CETA provides for a Financial Services Committee, comprised of representatives of the authorities in charge of financial services policy in the EU and Canada, to coordinate and maintain dialogue on regulation, which is likely to help manage Canadian bids for equivalence with EU rules. The EU has recognised equivalence with Canada in 16 out of 34 different areas of financial services where equivalence is available.\(^\text{96}\) For instance, the EU has deemed Canada’s regulatory and supervisory framework equivalent for credit rating agencies and for credit institutions and investment firms, which means EU banks can apply preferential risk weights to relevant exposures to entities located in Canada.\(^\text{97}\) However, unlike Canada, the UK starts from the basis of having the exact same regulations as the EU – something which should make equivalence easier to achieve.

The EU explored the possibility of going further than CETA in its TTIP negotiations with the US, where it stressed the need to ensure a certain degree of “regulatory coherence” that would have allowed greater mutual market access. The US resisted including regulatory cooperation in financial services as part of the deal and no agreement on the actual meaning of “regulatory coherence” had been reached at the time the negotiations stagnated.\(^\text{98}\) However, the EU’s proposals for cooperation in financial services with the US still fall short of passporting rights.

In a March 2018 speech, Chancellor Philip Hammond, dismissed the standard third country equivalence model as “wholly inadequate for the scale and complexity of UK-EU financial services trade”, arguing instead that:

“The principle of mutual recognition and reciprocal regulatory equivalence, provided it is objectively assessed, with proper governance structures, dispute resolution mechanisms, and

\(^{97}\) See equivalence/adequacy decisions taken by the European Commission as of 09/01/2018: https://ec.europa.eu/info/sites/info/files/overview-table-equivalence-decisions_en.pdf
sensible notice periods to market participants clearly could provide an effective basis for such a EU-UK post-Brexit partnership. 99

The high degree of UK-EU regulatory integration up to the point of Brexit provides a practical basis to strike an ambitious new FTA for financial services beyond that of CETA.100 The practical difficulty arises from creating a supervisory framework to manage any divergence in the future in order to coordinate new policy and minimise any disruption to market access this could cause.

Given the size of the UK financial services industry and existing levels of capital market integration, there are limits to how much the EU can restrict UK financial services activity with EU entities post-Brexit. Despite the likelihood of some client facing roles and operation being moved from the UK to an EU jurisdiction, the high degree of existing capital market integration is likely to mean that substantial amounts of existing EU business will continue in London. Banks may employ practices such as “back-to-back” trading101 and “reverse solicitation”102, whereby the services are provided at request of the client, to limit the size of the presence they establish in the EU.

EU regulators such as the European Banking Authority (EBA), have recognised that “in practice the degree of economic and financial integration between the UK and the Member States remaining after Brexit will be significantly greater than with any other third country.” In a recent opinion, the EBA added that the EU’s “existing third country framework was not designed with such an integrated third country in mind.”103 The EBA opinion illustrates an acknowledgment within the EU that the post-Brexit framework for financial services needs to be adapted for continued EU exposure to the UK, albeit this would still fall short of Single Market-like access. Similarly, Robert Ophèle, chairman of the Autorité des Marchés Financiers (AMF), the French markets watchdog, stated that “a new third country emerging on the EU border, the UK, which also happens to be a dominant financial center... immediately triggers a brand new set of issues regarding equivalence; level playing field issues, which are completely different when the third country is in a distant time zone or when it is your next door neighbour; [and] sovereignty and financial stability issues when the vast majority of financial services provided to EU clients could be delivered from an equivalent third country.”104

No hub in the EU will be able to replicate the broad range of services on offer in London upon which many EU businesses currently rely. As suggested by Jeremy Browne, the City’s representative to the EU, “London’s role will not be easily replicated, and the alternative to

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100 IRSG, ‘A new basis for access to UK/EU financial services post-Brexit’, 2017: https://www.irsg.co.uk/assets/ExecENGNewBasisForAccessweb.pdf
101 Back-to-back trading allows an entity in one jurisdiction to carry out a duplicate transaction in a larger location, so a deal done on the ground for a client in Lisbon can actually be booked in London. See Financial Times, ‘City firms need to take more responsibility for life after Brexit’, 21 May 2017: https://www.ft.com/content/873e7278-3e14-11e7-9d56-25f963e998b2
London not being Europe’s global financial centre is that the EU does not have a global financial centre. This has been recognised by financial institutions in EU countries too. Bundesbank Executive Board member Joachim Wuermeling, for instance, said that for the EU “from the point of view of financial-market efficiency, financial-market integration, financial stability, but also real economic development,” Brexit “is clearly harmful.” Therefore, many on the EU side, including the then Italian Prime Minister Paolo Gentiloni, have argued that it is unthinkable not to include some form of agreement on financial services as part of any UK-EU deal.

The UK government is seeking a model similar to that advocated by the International Regulatory Strategy Group (IRSG), a UK financial services trade body. The IRSG argues a new UK-EU agreement should provide maximum mutual access to each other’s markets on the basis of perfect UK-EU regulatory alignment at the point of Brexit. This would include the establishment of a framework for regulatory and supervisory cooperation to oversee the management of future alignment or divergence. Reciprocal access would be guaranteed, not by virtue of compliance with the EU’s equivalence regime, but by mutual recognition that each other’s rules achieve common goals, which would provide greater flexibility for UK and EU regulators. The model would also include a mechanism to settle disputes that might emerge between the parties.

While having the merit of recognising the exceptional nature of the UK-EU relationship, such a model is unlikely to be accepted by the EU, at least in the form suggested. Firstly, the EU is unlikely to grant the UK similar market access to that it currently has, even at Brexit point, if it leaves the Single Market. Furthermore, the EU will not commit to any arrangement that could threaten its regulatory autonomy, so ultimately any decision by the EU to limit UK market access will be unilateral, just as it is under the current equivalence regime.

Therefore, it might be more realistic for the UK government to aim for an expanded equivalence regime. The aim would be to broaden the scope of where equivalence is available to a wider number of financial services activities. It should also seek to provide greater legal certainty over the process for determining equivalence. This would require a framework for UK and EU regulators to consult each other on the shape of future regulation in UK and EU jurisdictions and the implications for reciprocal market access. It would also require longer lead times, and an opportunity to resolve disputes, before equivalence and market access were to be withdrawn by either party.

There is an appetite in the EU to review its system of third country equivalence, which was not designed with so large a third country at its doorstep in mind. Ultimately, the fact that equivalence arrangements take different forms in different areas of financial services shows that a certain degree of flexibility is inherently built into the mechanism of equivalence. However, the biggest obstacle to achieving an ambitious agreement in financial services is political. It is likely that the EU will seek to restrict some cross-border activities, partly to

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105 Financial Times, ‘UK’s City envoy defends London as a ‘European asset’, 18 July 2017: https://www.ft.com/content/18d77d4d-49d1-3e32-bd51-65321ea5abf8


encourage the relocation within the EU of UK-based operations and as a demonstration that leaving the Single Market comes with consequences for market access. In addition, the EU is likely to want to establish a level playing field in order to avoid the possibility of having a deregulated large competitor at its doorstep or attach other conditions such as accepting the free movement of people. The UK will need to weigh how much it wishes to accept EU demands in these other areas as part of an overall package.

### Are the “MFN clauses” in CETA a barrier to ambitious UK-EU cooperation?

The WTO Most Favoured Nation (MFN) principle compels each WTO member to extend to other members “treatment no less favourable than that accorded to like services and services suppliers of any other country.” The application of this principle does not apply to preferential trade agreements.

However, separate MFN clauses can also be included within FTAs or within specific chapters. MFN clauses act as a “ratchet” to lock in future liberalisation by ensuring that signatories of the FTA benefit from any future liberalisation agreed with a third party in a subsequent FTA. The EU has included MFN clauses in some of its most advanced agreements, including the ones with Canada and South Korea. As a result, in principle the EU will have to extend to these countries any preferential access it agrees in future FTAs in the sectors covered by the MFN clauses, without the need necessarily for those countries to offer reciprocal access.

Exceptions do however apply to the application of the MFN principle. Annex II of CETA states that:

> “The EU reserves the right to adopt or maintain any measure which accords differential treatment to a country pursuant to any existing or future bilateral or multilateral agreement which: (a) creates an internal market in services and investment; (b) grants the right of establishment; or (c) requires the approximation of legislation in one or more economic sectors.”

In the case of the EU-Korea agreement, the MFN clause:

> “Shall not be so construed as to prevent any Party from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zone of services that are both locally produced and consumed.”

The “approximation of legislation” could be interpreted as something achievable in the context of the EU-UK negotiations. The point seems to revolve in general around the issue of regulatory cooperation. That is, as long as the UK and the EU are able to agree on a certain approximation of their legislation and on regulatory cooperation, the MFN clause will not necessarily be a problem.

That said, the matter is fundamentally a political one. Countries like Canada and South Korea could always challenge the interpretation of the exemptions. The EU could also use this argument to justify the impossibility of opening its market.

### Professional business services

Non-financial business services comprise a wide range of highly regulated and unregulated services. Therefore, the issues raised by withdrawal from the Single Market will vary. However, the ease with which these services can operate in EU markets is largely driven by
three issues: the right of establishment or to provide services in another state, the mutual recognition of professional qualifications, and the ease of movement for professionals.

The CETA model provides a precedent for liberalisation in all of these areas but there are some important differences in comparison to Single Market membership.

**Right of establishment and to provide services**

Most professional services are not delivered cross-border throughout the EU in the same way as financial services firms “passport” from a UK base. Professional business firms such as Deloitte or KPMG typically expand their business into new markets within the EU by establishing a local presence and moving staff between different offices.109

The CETA model provides for the removal of many restrictions on right of establishment, by committing the EU not to limit the ability of Canadian companies to establish a presence in the EU market through quantitative and nationality restrictions, or by forcing Canadian companies to take a particular legal form.110 Reservations limit the scope of liberalisation, by allowing EU states to impose some restrictions in specific sectors, such as legal services. Nevertheless, UK professional and business services would still largely be able to establish a presence in EU markets post-Brexit under this model.

The single market also facilitates cross-border supply of professional services in a limited number of areas. In the legal sector, for instance, the Lawyers’ Services Directive allows lawyers to provide services in another member state on a temporary basis without prior registration with the bar of the hosting state. This might be problematic to replicate in a UK-EU FTA. In other areas, such as mutual recognition of accountancy and auditing standards, replicating the current arrangements might be easier. For accounting and auditing the EU already accepts some third countries’ standards as equivalent to make it easier for foreign companies listed on EU markets to fill in their financial statements.111

**Mutual recognition of professional qualifications and cross-border movement of professionals**

On mutual recognition of professional qualifications, CETA does not go much beyond commitments taken at the GATS/WTO level.112 While it establishes a framework for cooperation – something the EU has confirmed in its guidelines it wishes to include in the future EU-UK FTA113 – this remains largely voluntary and it is left to the respective regulators to come up with proposals for mutual recognition of different professions.

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111 The UK will apply IFRS (international financial reporting standards) post-Brexit, which are the same standards applied by the EU. See European Commission: https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/financial-reporting_en


The UK can aim for something more ambitious than this. In her “Road to Brexit” speech the Prime Minister said that “given that UK qualifications are already recognised across the EU and vice versa...it would make sense to continue to recognise each other’s qualifications in the future.” There are precedents for a degree of mutual recognition of professional qualifications between the EU and third countries, on which the UK could build. The EU has, for instance, extended the application of the Professional Qualifications Directive to Switzerland.

Reaching mutual recognition will be more important for some professions than for others. EU rules provide for a more or less effective framework depending on the profession. For instance, they provide for the direct recognition of qualifications for nurses, midwives, doctors, pharmacists, architects and veterinary surgeons. However, lawyers, auditors, insurance intermediaries, commercial agents and other professions have to go through an additional process for mutual recognition. In some cases, even within the Single Market some substantial barriers remain. For example, to be a member of the German accountancy body sitting an exam in German is required. This makes it very difficult, even under present conditions, for a UK accountant to practice in Germany.

CETA is more ambitious on the temporary entry and stay of natural persons. In this respect, it includes the most ambitious provisions that the EU has negotiated so far, which represent a substantial improvement on previous commitments. Canada and the EU have committed to allowing the posting of intra-corporate transferees in any sector for up to three years, as well as allowing contractual service suppliers or independent professionals to stay in the other party for up to one year. In addition, professionals can be accompanied by their spouses and families on their temporary posting abroad.

Even this, however, would be very different from the full right to post intra-corporate transfers in all sectors the UK and EU currently enjoy. The UK and the EU can ensure greater mobility of people, provided that there is political will. To date, any restriction on labour mobility has been driven by the UK’s demand to end the free movement of people. In its guidelines on a possible future EU-UK FTA, the EU has stated it will seek to include “ambitious provisions on movement of natural persons, based on full reciprocity and non-discrimination among Member States” The UK has yet to set out its proposals for continued labour mobility post-Brexit.

Cross-border exchange of data

The UK has been a key contributor in shaping the current EU data protection regime. However, it has been pointed out that after Brexit an increasingly different Anglo-Saxon and European approach to data protection could emerge. The UK might want to consider diverging from new regulations that the EU could introduce in the future and that might complicate trade with the EU and other countries. At present, however, it is disputed whether there would be advantages which the UK could derive from diverging from the EU data.

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protection rules: the General Data Protection Regulation (GDPR). In the words of TechUK chief executive Julian David, the idea that “adherence to the EU data protection regime is incompatible with securing high-quality trade agreements” is based on a “misunderstanding”, and, “there would be no tangible benefit to any US trade deal, for example, by diverging on data protection given the EU and US have a model for sharing data based on the EU’s data protection requirements.” However, the US Commerce Secretary, Wilbur Ross, recently said that the introduction of the EU’s strict GDPR rules “could significantly interrupt transatlantic co-operation and create unnecessary barriers to trade” and recent reports suggest some US tech start-ups have chosen to withdraw from the EU rather than invest resources in complying with the EU’s strict GDPR rules.

Ensuring free data flows is an issue not confined to a single sector. Several sectors, from digital to financial services, heavily rely on and benefit from free flow of data in the conduct of their activities. The UK is one of the countries that are most heavily involved in cross-border data flows. According to Frontier Economics, it accounted for 11.5% of total global exchanges in 2015, of which 75% were conducted with EU countries. It will thus be vital to maintain a close relationship with the EU in this field.

Data protection is an area where the EU is particularly active. Non-EU businesses and authorities have to demonstrate compliance with EU rules, when providing a service to an EEA-based individual. The EU has granted so-called “adequacy decisions” to some third countries, including Canada, whose law on data protection is deemed to meet European standards. An adequacy decision enables the flow of EU citizens’ data outside the EU. Without an adequacy decision, these flows, and in turn the trade of many services, would become more difficult and costly (particularly in areas quickly expanding such as digital services) – although not impossible.

Canada’s adequacy decision was granted prior and separately to the negotiation of CETA. In the area of data protection, CETA provisions are limited. The question is briefly covered in the e-commerce chapter and merely consists of an agreement on maintaining dialogue on different issues related to data protection, from electronic certificates to storage of information. CETA also includes a commitment by both parties to take in “due consideration” international standards set by international organisations of which they are members. A couple more articles are dedicated to it in the financial services chapter and in relation to telecommunications. Yet, CETA does not really break any new ground in this area.

The UK will be compliant with all EU rules at Brexit point, which should make an adequacy decision easier. Yet, like equivalence rights for financial services, this is essentially a political

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119 Financial Times, ‘EU data privacy laws are likely to create barriers to trade’, 30 May 2018: https://www.ft.com/content/9d261f44-6255-11e8-bdd1-cc0534df682c
120 Financial Times, ‘US small businesses drop EU customers over new data rule’, 24 May 2018: https://www.ft.com/content/3f079b6c-5ec8-11e8-9334-2218e7146b04
122 Article 3 of GDPR
124 However, it has been suggested, some recent developments in UK legislation might threaten to undermine the chances of such a decision. The Investigatory Powers Act of 2016 (the so-called “snoopers’ charter”) is seen as a particularly problematic barrier, and could be ruled unlawful by the ECJ. Furthermore, in the past the EU has shown
A decision on the part of the EU, which cannot be taken as guaranteed. The EU's chief Brexit negotiator Michel Barnier recently said, "This is an autonomous EU decision. There can be no system of 'mutual recognition' of standards when it comes to the exchange and protection of such data."\textsuperscript{125}

Adequacy decisions come with an inherent degree of uncertainty attached to them. The 2000 Safe Harbour decision, via which the EU determined that the US met EU data protection standards for commercial purposes, is a case in point. The decision was in 2015 declared invalid by the Court of Justice of the EU and was then replaced by the EU-US Privacy Shield, which imposes greater obligations on US companies and the US government.\textsuperscript{126}

The UK government has proposed a model for cooperation on data protection that goes beyond simple adequacy, by adding greater certainty through the establishment of a regulatory dialogue. As part of this regulatory dialogue, the British government has suggested that the UK's Information Commissioner's Office could have an ongoing role in EU regulatory fora. Prime Minister Theresa May confirmed this in her recent "Road to Brexit" speech, saying:

"We will be seeking more than just an adequacy arrangement and want to see an appropriate ongoing role for the UK's Information Commissioner's Office. This will ensure UK businesses are effectively represented under the EU's new 'one stop shop' mechanism for resolving data protection disputes."\textsuperscript{127}

This may be difficult to achieve politically: only EU member states' national data protection authorities can obtain formal representation on the European Data Protection Board (EDPB). The UK Information Commissioner's Office has itself noted that its relationship with the EDPB will "necessarily change" post-Brexit, although it has recommended that the UK aim to achieve "observer status or something similar."\textsuperscript{128}

However, it is interesting to note that the European Council's negotiating guidelines on future UK-EU relations stress, "In the light of the importance of data flows in several components of the future relationship, it [the future agreement] should include rules on data."\textsuperscript{129} The guidelines go on to emphasise, "As regards personal data, protection should be governed by Union rules on adequacy with a view to ensuring a level of protection essentially equivalent to that of the Union."\textsuperscript{130} However, that the EU is suggesting the inclusion of rules on data in the future FTA signals that it might be willing to offer something more comprehensive than current adequacy arrangements, for which inclusion in the FTA would not be necessary.\textsuperscript{131}


\textsuperscript{128} \textit{House of Lords European Union Committee}, 'Brexit: the EU data protection package', 18 July 2017, p45


\textsuperscript{130} Ibid.

The flow of data will also be an issue in future UK-EU security cooperation. The ECJ’s decision on Safe Harbour, which deemed it invalid because it allowed violation of data protection measures in exceptional circumstance when national security was at stake, illustrates that the two issues cannot be entirely separated. The UK and the EU’s interdependence not only at the commercial level but also at that of security and intelligence makes the UK case an exceptional one and the two parties will have greater incentives in coming up with specific arrangements that can ensure free flows of data among them remain as open as possible.

**Broadcasting**

The UK is a global leader in broadcasting. According to European Audiovisual Observatory data, 1523 out of a total 5141 channels operating in the EU in 2015 were licensed in the UK.\(^\text{132}\) While part of the UK’s success is due to factors (e.g. the English language) which will remain unaffected by Brexit, the latter could still have a substantial impact in this sector, which is significantly integrated at the EU level.

UK-based firms are heavily reliant on European markets. A government report revealed that in 2014 57% of the UK’s exports in film, TV, video, radio and photography services were destined to Europe.\(^\text{133}\) A substantial share of broadcasting services is furthermore provided cross-border. This makes broadcasting particularly exposed to the potential negative effects of Brexit.

Through its Audiovisual Media Services Directive, the EU has liberalised rules in the sector by establishing a ‘country of origin’ principle which allows broadcasters to provide content throughout the EU without additional barriers, provided they comply with the rules of their host member state.\(^\text{134}\) Furthermore, EU rules also oblige member states to incentivise the distribution of European content, by setting minimum requirements for the amount of ‘European’ content to be broadcasted (Article 17).\(^\text{135}\)

Outside the single market, unless alternative arrangements are found, UK-produced content will no longer classify as European and the UK will no longer be able to benefit from the ‘country of origin’ principle. The Audiovisual Media Services Directive allows member states to develop stricter rules than those set at the EU level. While additional rules cannot be applied to providers from other EU states, as a third country UK firms will need to be compliant with them.\(^\text{136}\)

In her “Road to Brexit” speech, the Prime Minister recognised that, in broadcasting, “We cannot have exactly the same arrangements with the EU as we do now.”\(^\text{137}\) However, she called


for "creative options with an open mind, including mutual recognition which would allow for continued trans-frontier broadcasting."

Such an ambition clearly indicates that the UK government intends to go beyond a standard FTA in this sector. Current EU FTAs do not provide for much liberalisation in broadcasting. Audio-visual services are for instance excluded altogether from the CETA agreement. This is not unusual in EU FTAs, and it is referred to as the 'cultural exception'.

In the absence of an agreement on audio-visual services as part of a comprehensive FTA, the UK could consider the option of membership of the Transfrontier Television Convention. The convention allows content produced in one of the signatory countries to be classified as European for the purposes of the Audiovisual Media Services Directive. It also establishes its own 'country of origin' principle. Yet, the Convention has significant limits: some important European markets (e.g. Ireland, the Netherlands) are not signatories to the convention; it does not apply to on-demand services – a key future growth industry; and the enforcement mechanisms would not provide the certainty for businesses which single market structures do.

Individual firms in the sector that might be particularly affected by Brexit will need to consider setting up subsidiaries in an EU country. EU rules require indeed that “a significant part of the workforce involved in the pursuit of the audio-visual media service activity” operates in a member state in order to be deemed under the jurisdiction of said member state.

Civil aviation

Aviation services agreements are a discrete policy area, usually negotiated separately from free trade agreements. For example, the EU has concluded air services agreements with Canada and the US discretely from trade talks with these countries. However, the EU’s aviation agreements with the European Economic Area (EEA) countries and Switzerland are tied together with the EU’s wider economic relations with these countries.

The UK and the EU will need to negotiate new arrangements that apply for civil aviation post-Brexit. The UK will cease to be a member of the European Common Aviation Area (ECAA) and there is no equivalent to the rules of the World Trade Organisation that provide a broad fallback option post-Brexit in the event of no deal. This poses a theoretical risk that flights could be grounded.

In economic terms, it is clearly in the interest of both sides to reach a comprehensive new agreement on this issue. The UK is the largest aviation market in Europe and the third largest globally, after the US and China. The EU is the UK’s biggest destination market, making up 49% of passengers and 54% of scheduled commercial flights from the UK. The UK and EU tourism industries are highly interdependent with 45.7m (76%) of trips by UK residents to

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139 See Council of Europe, ‘European Convention on Transfrontier Television’: https://rm.coe.int/168007b0d8


other EU destinations and 23m (67%) of visitors to the UK coming from other EU destinations. In addition to revenue generated from air transport alone, local economies are boosted by tourist spending, with the ONS estimating that UK citizens spend £615 per visit abroad compared to the £594 of foreign visitors to the UK.  

Previous EU agreements, with countries in the European neighbourhood and further afield, demonstrate that there is a sliding scale of integration in the EU’s aviation market: those states with most rights to fly within the ECAA, accept the EU’s acquis on aviation and, in some cases, a role for the European Court of Justice (ECJ). Membership of the EU currently guarantees the rights of UK-based airlines to fly to/from the EU but also the right to fly between and within other EU states.

At the other end of the scale are more traditional bilateral air services agreements with the US and Canada that provide for flights to and from the EU, but not within or between EU states. These agreements are based on mutual recognition of regulation and do not require states to sign up to EU law or the purview of the EU’s institutions.

The UK government’s stated intention to leave the single market is likely to have consequences for the type of aviation agreement that is negotiable with the EU. The immediate and top priority for the UK government should be to establish legal certainty over the right to fly to/from the UK to the EU and non-EU markets. However, the UK is likely to forego certain market access rights post-Brexit (the freedoms most likely to be curtailed are the rights of UK-based airlines to fly point to point within EU member states and between EU member states). The small number of UK airlines affected by this change are already operating under the assumption that that current freedoms will be curtailed and are taking the necessary steps to adjust.

The UK government has stated its intention to seek to retain membership of the European Aviation Safety Agency (EASA) and the Single European Sky (SES) initiatives. The EU has suggested the possibility of “an air transport agreement, combined with aviation safety and security agreements.” EASA plays an important role in setting out safety standards for the industry and the SES is taking important steps to make the management of air traffic more efficient. The UK and EU aviation markets will continue to be heavily integrated post-Brexit and it would be beneficial to both parties for the UK to continue participating in these initiatives.

This would require applying the EU legislation relevant to EASA and SES, and mirroring this as it develops in the future. It is not easy to assess how divisible continued UK membership of EASA would be from the adoption of the broader EU acquis on aviation. This would be a matter for UK-EU negotiation. However, the EU has previously adopted agreements that provide for selective adoption of ECAA rules and the UK currently plays a significant role, primarily alongside France, in EASA’s activities – a role that would likely be missed by other EASA members. Inevitably, the ECJ will have an indirect role in the future as it interprets EU law in

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these areas, as it does under the EU-Switzerland agreement on aviation. However, the UK and the EU could be individually responsible for enforcing the agreement in their territory – i.e. there would be no direct effect to ECJ rulings. The UK has already accepted this form of ECJ role in the withdrawal negotiations over citizens’ rights. Disputes over implementation could be resolved in a Joint Committee or, ultimately, by termination of the agreement.

3.6 Conclusions

Up to this point, the UK has essentially been presented with a binary choice between the Norway and Canada model for services access. When it comes to the post-Brexit services arrangement, the two models have distinct implications.

The UK should not look to pursue membership of the Single Market outside the EU for trade in services. Such a model would clearly be problematic for the UK, which would find itself relegated to a rule-taker in sectors vital to its economy, without the ability to have a say on future rules that will govern these sectors.

The consequences of leaving the Single Market are less marked for services than they are for goods. This is a result of the fact that (1) the UK is already a globally oriented exporter of services and less dependent on the EU market than it is for goods, with the importance of EU markets likely to further decrease in the future; and (2) the single market in services is less developed than for goods.

However, at least in the few areas where the single market has achieved substantial liberalisation, losing access to the internal market will not come without notable costs. In order to limit the potential negative effects, the UK should prioritise agreement with the EU on some key issues. This includes financial services, data protection and mutual recognition of qualifications, but also other integrated areas such as transport and telecommunications. These crucial areas have been recognised by the government too.

A new UK-EU FTA will need to address two questions. First, how much access the UK will secure at Brexit point in light of its full harmonisation with EU rules. Second, how continued compliance with EU regulations can be assessed and how disagreement can be managed in the future in areas where the UK is granted access at Brexit point but where it might want to gradually diverge.

The CETA model gives Canada the freedom to set its own regulations, with a view to greater regulatory cooperation. The process of regulatory cooperation is voluntary and non-binding in nature. The downside to this model is that market access is more restrictive. These restrictions vary in importance from sector to sector and are particularly relevant for those sectors (e.g. financial services) and cross-sectoral issues (e.g. data protection) where the EU sets common standards.

The Canada model partly addresses some of the concerns outlined. In financial services, equivalence provides Canadian companies with a (partial) alternative to passporting rights. Data flows are enabled by an adequacy decision granted to Canada by the European Commission. And the EU-Canada CETA agreement also provides some substantial right of establishment. However, most of liberalisation through CETA happens in the form of the removal of nationality and quantitative restrictions, while provisions on regulatory cooperation remain significantly limited. Hence, for instance, there are no substantial achievements in mutual recognition of qualifications between Canada and the EU beyond the establishment of a voluntary framework for cooperation.
The UK could seek a more ambitious agreement, which should promote two-way regulatory cooperation post-Brexit. Establishing this type of cooperation on a lot of the issues mentioned is more a political than a practical problem. This poses the challenge of establishing a system for regulatory cooperation politically acceptable to both sides.

There is also likely to be a difficult political trade-off. The more the UK asks for from the EU in services – and trying to replicate existing market access for financial services is certainly regarded as a ‘red line’ in many European capitals – the more the EU will ask in return. In its recent guidelines, the European Council has confirmed “its readiness to initiate work towards a balanced, ambitious and wide-ranging free trade agreement (FTA),” which appears to envisage a more comprehensive agreement than CETA, but only “insofar as there are sufficient guarantees for a level playing field.”¹⁴⁶ The EU will likely ask the UK to follow future rules in many other areas, such as the free movement of people, taxation, employment law and the environment. This is unlikely to be politically acceptable for the UK.

4. Meeting the EU’s concerns over a “level playing field”

4.1. A degree of level playing field obligations are included in all recent EU FTAs

One of the core principles underpinning the EU’s Brexit negotiating guidelines is that “any future deal will need to be based on a balance of rights and obligations and ensure a level playing field (LPF).”¹⁴⁷ Last May, European Council President Donald Tusk laid out the scope of regulatory obligations in greater detail, saying, “The UK must be aware that any free trade agreement will have to ensure a level playing field, and encompass safeguards against unfair competitive advantages through, inter alia, tax, social, environmental and regulatory measures and practices.”¹⁴⁸

These cross-cutting issues do not necessarily directly address the terms of trade or market access – they seek to prevent unfair competition between countries by establishing ground rules about the wider economy, including employment law, environmental protections and climate policy.

Importantly, LPF mechanisms that currently exist within the EU’s Single Market do not require all member states to play by exactly the same rules: instead they generally establish a “floor” to guarantee a minimum level of labour rights, employment law and state intervention across the EU. Member states currently apply, for example, varying corporate tax rates, levels of maternity leave and minimum wage structures.

All recent EU FTAs include a degree of cooperation in LPF areas. For instance, the EU’s Trade Commissioner Cecilia Malmström recently said that a binding reference to the International Paris Climate Agreement was “needed in all EU trade agreements” from now on.¹⁴⁹ A spokesperson for the European Commission has also recently said:

“All agreements negotiated by the EU include a very substantial chapter on trade and sustainable development with social and environmental standards shaping the agreements...This point is a priority for the EU and it would be difficult to imagine concluding an important trade deal without an ambitious chapter on trade and sustainable development attached to it.”¹⁵⁰

The depth and scope of these commitments vary depending on the geographic proximity of the trade partner, and their economic/political integration with the EU. The EU is particularly concerned by the potential development of a regulatory competitor on its doorstep with strong economic ties to its market. More distant and less integrated trading partners tend to conclude more limited arrangements on LPF regulations.

¹⁵⁰ Ibid.
Free movement

While the free movement of people is not directly related to EU level playing field measures, it could form an additional requirement if the UK seeks a close trading arrangement. It is unclear whether the EU would call for continued freedom of movement if the UK is not pursuing formal single market membership. And while the EU does appear to recognise the limited flexibility the UK has on this issue politically, it is reasonable to assume that the more the UK attempts to replicate free movement of goods and services, the more the EU will underline the indivisibility of its four freedoms. For instance, a recent report has suggested the EU may seek a preferential agreement on immigration in exchange for access to the EU market for key UK services sectors.

Both the UK government and the Opposition have expressed their intention to end free movement following the UK’s withdrawal from the EU. However, the UK may choose to offer preferential immigration arrangements to EU citizens post-Brexit in order to secure a close trading relationship. The UK could also seek to liberalise rules of Mode 4 services as part of the UK-EU agreement, for instance by agreeing not to impose limits on visas. Open Europe will address what a future UK immigration system could look like in a future paper.

Non-EU EEA countries

Barrier-free access to the EU internal market for non-EU EEA countries is conditional on full application of and compliance with EU LPF regulations. For instance, Norway agrees to apply the full EU acquis including flanking policies on competition, taxation, social policy, consumer protection and environmental standards. Compliance with EU regulations is enforced by the EFTA surveillance authority and the EFTA Court.

2011 Norway exit taxation case

Prior to 2011, Norwegian tax rules allowed for the collection of an immediate exit tax from companies, and the shareholders of companies, that transferred their seat to another EEA state. In 2010, the EFTA Surveillance Authority (ESA) issued a letter of formal notice that argued the imposition of an immediate exit tax was in breach of the EEA agreement and EU corporate law. Norway’s Ministry of Finance disputed ESA’s conclusion and, in 2011, ESA enacted the second stage of the infringement procedure, issuing a reasoned opinion on breach of EEA regulations. In November 2011, the European Court of Justice ruled in a separate case that the immediate recovery of tax on a company that transfers its place of management was not compatible with EU law. Following the ECJ ruling, Norway agreed to amend national tax laws to allow exit tax liability to be deferred until capital gains are realised. The deferral of exit tax payments would only be available for exits to countries within the European Economic Area.

Switzerland

Switzerland does not directly apply EU level playing field regulations, and achieved an integrated relationship with the EU for many years without concluding LPF agreements, for instance on taxation. However, it has since reached separate bilateral agreements with the EU for voluntary cooperation in key areas. For instance, in 2015, the EU and Switzerland signed a
bilateral tax transparency agreement, which replaced the 2005 Taxation of Savings agreement.\textsuperscript{151} Switzerland does not automatically adopt new EU LPF initiatives – for instance, while EU member states intend to implement a new EU Anti-Tax Avoidance Directive alongside new OECD requirements on tax transparency, Switzerland agrees only to implement international minimum standards agreed by all OECD countries in order to achieve a level playing field.\textsuperscript{152} Compliance and enforcement of tax transparency with the EU is also ensured by relevant Swiss and EU authorities, rather than a supranational dispute settlement mechanism.

On state aid, Switzerland and the EU have agreed limited measures to prevent distortive practices. An early 1972 Swiss-EC bilateral agreement prohibits “public aid which distorts or threatens to distort competition”, but academics have argued that this provision has limited direct application as a matter of Swiss law.\textsuperscript{153} Switzerland agrees to apply EU state aid rules in the civil aviation sector, through the 1999 Swiss-EU Air Transport Agreement (ATA). The ATA does not provide a specific enforcement mechanism, but both sides agree continuously to review compliance with these rules.\textsuperscript{154}

The European Commission directorate-general for competition notes that, in all other sectors, the EU cooperates with the Swiss competition authority, the Competition Commission, on the basis of the 1995 OECD recommendation for cooperation on anti-competitive practices relating to trade.\textsuperscript{155} In 2015, Switzerland and the EU concluded an agreement for cooperation on the application of competition laws, which allows both sides to coordinate enforcement activities and changes to competition policy.\textsuperscript{156} The below example demonstrates how the EU can use stronger bilateral cooperation on competition and taxation to address its concerns over state aid.

\begin{quote}
\textbf{2007 Swiss Canton corporate tax rate case}

In 2007, the European Commission called on Switzerland to reform its tax rules, which allowed Swiss Cantons to fully or partially exempt profits generated abroad from cantonal and municipal company tax. The Commission argued that certain company tax regimes in Swiss Cantons offered unfair tax advantages that amounted to state aid, which undermined the proper functioning of the 1972 Free Trade Agreement between the EU and Switzerland. It stressed that the decision was "not about tax competition but about State aid undermining the level playing field necessary for our partnership and the trade relations between Switzerland and the EU."

While the EU was allowed under the agreement to take retaliatory measures, it declared it would seek a negotiated settlement. In 2014, Switzerland and the EU reached a mutual understanding, which saw Switzerland agree to amend parts of its tax regime and base new
\end{quote}

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{152} Ibid.
\item\textsuperscript{153} Global Competition Review, ‘State Aid 2017: Switzerland’, 2017: \url{https://globalcompetitionreview.com/jurisdiction/1004484/switzerland}
\item\textsuperscript{155} See European Commission, ‘Bilateral relations : Switzerland’: \url{http://ec.europa.eu/competition/international/bilateral/switzerland.html}
\item\textsuperscript{156} EUR-Lex, ‘Agreement between the European Union and the Swiss Confederation concerning cooperation on the application of their completion laws’, 3 December 2014: \url{http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:22014A1203(01)&from=EN}
\end{itemize}
\end{footnotesize}
Striking a balance: A blueprint for the future UK-EU economic partnership

taxation rules on OECD international standards. EU member states in turn committed to lift any countermeasures they had imposed once the Swiss reforms were implemented. In a 2017 referendum, the Swiss public rejected the corporate tax reforms proposed by the Swiss Federal Council that would have repealed the Canton tax regime. The Federal Council has this year finalised new proposals for reforming its tax regime.

Switzerland cooperates closely with the EU on environmental matters. While it has not agreed to adopt the EU’s substantive rules for environmental policy, Swiss environmental legislation has harmonised with EU legislation in certain specific areas. For instance, Switzerland has aligned with EU provisions on aircraft noise emissions under the 1999 ATA. Similarly, in 2016, Switzerland and the EU concluded an agreement to link their emissions trading schemes. As a result, emissions allowance prices are harmonised across both markets, and Switzerland agrees to adopt similar competitive conditions to the EU.

EU labour standards do not apply to Switzerland. As part of the “accompanying measures” of the Swiss-EU 2002 agreement on the free movement of people, Switzerland agreed to introduce a new domestic law on minimum wages, working conditions and collective labour agreements. However, this is different to adopting and remaining in step with EU social and labour laws. Indeed, the Swiss Foreign Minister recently reiterated Switzerland’s priority to preserve its own rules on minimum wages and working conditions, which help to limit the impact of EU free movement on the domestic labour market.

Traditional FTA partners

Third country trading partners that are further away and less integrated, such as Japan and Canada, have agreed limited LPF commitments with the EU. Substantive provisions are often based on international standards or agreements; enforcement mechanisms focus on information sharing and transparency; and dispute resolution mechanisms are usually non-binding. For instance, CETA provisions for controlling state subsidies build on the WTO Agreement on Subsidies and Countervailing Measures, requiring both parties to share information every two years on the form, legal basis and amount of state aid granted affecting trade in goods. In situations where one party is concerned that use of state aid has harmed their interests, a non-binding consultation can be requested to “eliminate or minimise any adverse effects” of the subsidy or government support on the complaining party.

Canada and the EU have also agreed a good governance clause on taxation, ensuring transparency, swift information exchange and cooperation on proposed future tax measures. However, the agreement outlines an extensive list of exemptions – for instance,

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158 Ibid.
160 Financial Times, ‘Swiss soften line on foreign judges in bid to bolster EU ties’, 5 March 2018: https://www.ft.com/content/17d840b6-209b-11e8-a895-1ba1f72c2c11
162 Ibid.
163 Ibid., Chapter 27.
domestic tax conventions must take precedence in the event of a conflict with the agreement.\textsuperscript{164}

CETA also includes a non-regression clause on social and environmental standards as part of a chapter on trade and sustainable development. This commits both parties to “upholding their environmental and labour protection objectives in a context of trade relations that are free, open and transparent.”\textsuperscript{165} The recent Japan-EU agreement includes a stronger non-regression clause, prohibiting both parties from “lowering the level of protection provided by their respective domestic environmental or labour laws and regulations” to encourage trade and investment.\textsuperscript{166}

Both the UK and the EU have emphasised that LPF mechanisms should take account of the likely bespoke nature of a future UK-EU agreement. Prime Minister Theresa May has urged that “rights and obligations must be held in balance” in a new UK-EU trading relationship, and the European Commission have called for LPF provisions to “cater for the specificities of the EU-UK relationship.”

4.2 The UK government has pledged to gold-plate current EU standards and protections

The EU has expressed concerns that, post-Brexit, the UK will move toward deregulation, lower social protection, and reduced corporate taxes as a means to gain competitiveness over the EU.\textsuperscript{167} The UK government has issued a number of statements to allay these fears. In particular, the government has highlighted its intention to commit to current EU regulations on state aid and competition, and to enhance social and environmental protection after its withdrawal.

Most recently, Prime Minister Theresa May said in her “Road to Brexit” speech:

“If we want good access to each other’s markets, it has to be on fair terms. As with any trade agreement, we must accept the need for binding commitments – for example, we may choose to commit some areas of our regulations like state aid and competition to remaining in step with the EU’s. The UK drove much of the policy in this area, and we have much to gain from maintaining proper disciplines on the use of subsidies and anti-competitive practices.”\textsuperscript{168}

She also pledged that the UK would not roll-back key social and environmental protections post-Brexit, although these were not covered by the same “binding commitment”:

“And in other areas like workers’ rights or the environment, the EU should be confident that we will not engage in a race to the bottom in the standards and protections we set.”\textsuperscript{169}

Earlier this year, Brexit Secretary David Davis also stressed that the UK has no intention “to undermine Europe, or to act against the interests of our nearest neighbours.” He said:

\textsuperscript{164} Ibid., Article 28.7
\textsuperscript{165} Ibid., Chapter 22
\textsuperscript{167} Ibid.
\textsuperscript{169} Ibid.
"We will continue our track record of meeting high standards, after we leave the European Union. I know that for one reason or another there are some people who have sought to question that these are really our intentions. They fear that Brexit could lead to an Anglo-Saxon race to the bottom... These fears about a race to the bottom are based on nothing, not our history, not our intentions, nor our national interest."

Davis said the UK would instead "lead a global race to the top," which "is essential to tackle our shared challenges."

In January 2018, Chancellor Philip Hammond told a German newspaper that the recent general election in the UK "made it very clear that the British people have no appetite for changing our economic model." He added, "Whatever people say, in practice they have a strong attachment to a European-style market economy, with strong social welfare, strong labour protection and strong environmental rules."

Similarly, in May 2017, Hammond said in an interview with French media:

"It is often said that London would consider [adopting a system of] unfair competition in terms of fiscal regulation. That is not our plan, nor our vision of the future... Even when we have left the European Union, the United Kingdom will maintain a social, economic and cultural model that will be identifiably European."

This was a notable shift in messaging from earlier in the year, when the Chancellor told German press that while the UK is currently "objectively a European-style economy... with a social model that is recognisably the European social model," failure to reach a trade agreement with the EU would mean "we could be forced to change our economic model and we will have to change our model to regain competitiveness."

The Prime Minister and other senior ministers have also pledged to maintain and improve workers’ rights and social and environmental protection after Brexit, beyond enshrining these in UK law via the EU (Withdrawal) Bill.

In her January 2017 Lancaster House speech, Prime Minister Theresa May said:

"A fairer Britain is a country that protects and enhances the rights people have at work. That is why, as we translate the body of European law into our domestic regulations, we will ensure that workers’ rights are fully protected and maintained. Indeed, under my leadership, not only will the government protect the rights of workers set out in European legislation, we will build on them."

Environment Secretary Michael Gove has committed to improving environmental standards and protections post-Brexit, and has called for the introduction of a new UK enforcement body:

“We must not only maintain but enhance environmental standards as we leave the EU...We are transferring all existing European law, including environmental protections, into UK law through the EU (Withdrawal) Bill...[And] we will consult on using the new freedoms we have [post-Brexit] to establish a new, world-leading body to give the environment a voice and hold the powerful to account. It will be independent of government, able to speak its mind freely.”

Separately, Gove told the 2018 Oxford Farming Conference that the UK would continue to apply high environment and animal welfare standards in future trade deals:

“We have among the highest environmental and animal welfare standards of any nation on earth. So people know when they’re buying British they’re buying food which is guaranteed to be high quality and more sustainable. That’s why it would be foolish for us to lower animal welfare or environmental standards in trade deals, and in so doing undercut our own reputation for quality. We will succeed in the global market place because we are competing at the top of the value chain not trying to win a race to the bottom.”

He has also pledged to maintain the current level of UK farming subsidies for at least three years after the UK’s withdrawal, and has suggested this could be extended until 2024 subject to consultations.

4.3 The UK could choose to adjust regulations better to suit national circumstances

Previous Open Europe research has estimated that the 100 most expensive EU-derived regulations cost the UK economy £33.3bn a year, according to the government’s own Impact Assessments (2014 prices). Targeted deregulation post-Brexit could deliver some gains to the UK economy. For instance, our estimates show that if the government were to pursue a politically feasible strategy of deregulation, this could deliver a saving of 0.7% of GDP. The UK’s flexibility to deliver gains from post-Brexit deregulation will depend on the depth and scope of LF provision included in its agreement with the EU. It is worth noting that non-EU EEA members, such as Norway, adopt 93 of the 100 most costly regulations, equating to 94% of the total costs. These include the most burdensome regulations, relating to financial services, social and employment law, and energy and climate change policies.

In pledging to gold-plate current EU standards and regulations, the government is choosing to forego this saving in order to ensure a smoother path to agreeing a comprehensive trade deal with the EU. However, if the UK fails to achieve a deep partnership with the EU, it would likely be forced to reconsider a strategy of deregulation in order to boost its competitiveness.

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178 Ibid.
179 Ibid.
There are certain policy areas in particular where the government could look to modify the domestic regulatory environment to better suit the needs of the UK economy. Depending on the terms of the future UK-EU agreement, some of these amendments could also be feasible as part of a close bilateral partnership.

For instance, concerns have been raised that the EU’s Habitats Directives – EU environmental legislation that aims to ensure the conservation of threatened animal and plant species – has imposed undue costs on the development of important infrastructure in the UK. In 2011, then Environment Secretary Caroline Spelman suggested that, in some instances, the Habitats Directives’ requirements have raised “particularly complex issues which give rise to unnecessary costs and delays” in construction. Former Transport Minister Patrick McLoughlin has previously suggested the directive had delayed the building of transport infrastructure in the East Midlands. Similarly, the government’s 2017 housing White Paper notes that the obligation, under the directive, to safeguard great crested newts – a European Protected Species – has slowed down the construction of new houses in particular parts of the UK – despite the newts remaining common in England. Given the importance placed on increasing the supply of affordable housing in the UK to address the current housing crisis, the government may look to amend this legislation to reduce unnecessary time delays and costs for new developments. It is important to note that the UK would still remain bound by international treaty obligations for habitats protection, such as The Convention on Biological Diversity and The Bern Convention.

Meanwhile, NHS employers and medical associations have previously indicated that obligations under the EU Working Time Directive (WTD) impose a one-size-fits-all approach to EU economies and industries that fails to account for the operating environment of the UK’s National Health Service. In 2014, the Royal College of Surgeons noted that the WTD had had adverse consequences for particular specialties, arguing it had led to a deterioration of training and increased exhaustion among surgical staff, and created serious concerns about the impact on patient care. Other stakeholders have also suggested the WTD has reduced training for doctors, and a review of the rules would be necessary to allow for delivery of a 24h operational health service. Post-Brexit, there may be scope for the UK to modify regulations in line with the needs of different medical specialties, in consultation with medical associations and staff.

4.4 LPF mechanisms in a future UK-EU FTA

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181 See Financial Times, ‘Developers set for Brexit triumph over great crested newt’, 10 February 2017: https://www.ft.com/content/83cf8ff0-eeef-11e6-ba01-119a44939bb6


In January, the EU laid out its proposals for a level playing field as part of a future UK-EU trading relationship. It called for the “non-lowering” of existing standards between the UK and the EU via dynamic state aid provisions, “good governance” and binding cooperation on tax policy, and “non-regression” clauses for environmental and labour standards. Similarly, in a recent “Road to Brexit” speech, UK Brexit Secretary David Davis emphasised the importance of “the principle of fairness and fair competition” in a future UK-EU agreement, highlighting the need to prevent distortive state aid practices and anti-competitive behaviour.

Regulatory obligations included in a UK-EU agreement should remain proportionate to the level of market access obtained. The UK government should be aware that the greater market access it seeks, the greater the LPF obligations the EU will demand. This is particularly true for services sectors – the UK government’s commitment to maintain key social and environmental protections should theoretically provide a sufficient level playing field for trade in goods. However, if the UK seeks an ambitious agreement for financial services access, the EU is likely to call for more binding cooperation in areas such as taxation.

In the same vein, it would be unreasonable for the EU to demand the UK remain bound to EU LPF regulations if it is only prepared to offer the UK a simpler CETA-style FTA. This would be politically unsustainable for any British government – the burden imposed by LPF regulation would not only limit deregulation, which might be favoured by some Conservatives, it would also create obstacles for a Labour party that proposed the imposition of national monopolies in key services and utilities, or the abolition of VAT duty on items such as household fuel. However, the EU’s negotiating guidelines on the future bilateral partnership calls for “robust guarantees” to ensure a level playing field and prevent “undercutting of protection with respect to, inter alia, competition and state aid, tax, social, environment and regulatory measures and practices,” despite offering the framework for a traditional free trade deal that falls short of the current benefits of single market access.

In the following sections we suggest joint LPF arrangements the UK and EU could consider to suit a comprehensive free trade agreement with high access for goods trade and lower access for services. In the medium term, the UK should agree voluntarily to continue complying with EU standards in sensitive areas such as workers’ rights and environmental standards – the government has already pledged to protect and enhance domestic rules and regulations in these areas post-Brexit. In the long term, LPF provisions should build on international baselines and other forms of bilateral cooperation to ensure both parties attain similar regulatory outcomes while respecting each other’s regulatory autonomy.

**Labour and environmental standards**

On social and environmental standards, the EU recommends agreeing “non-regression” clauses anchored in EU and international law. This should be an acceptable arrangement for the UK, given the government has already publicly pledged not to rollback social rights and environmental standards. However, negotiations will need to define “non-regression” – does this require the UK voluntarily to apply EU regulations in these areas in domestic law, or can

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the UK and EU agree to ensure “non-regression” of specific policy outcomes even if by different means? The latter is likely to be preferable for the UK government.

As a concrete demonstration of its engagement to protect social and environmental rights, the UK should consider making a political commitment not to amend existing regulations in the near term. However, this should be time-limited – it would be politically unsustainable for the details of UK legislation on employment standards, fair wages and social security rights to be governed in the long term by the post-Brexit agreement with the EU. This is also a key businesses concern – the Confederation of British Industry has outlined the importance of retaining control over employment law in negotiations on the future UK-EU relationship.188 Importantly, a good precedent for a time-limited arrangement has already been set: the draft report for the Withdrawal Agreement includes an eight-year sunset clause on the role of the ECJ in enforcing EU citizens’ rights in the UK post-Brexit.

In the longer term, UK-EU cooperation on social and environmental law should build on international conventions, such as the International Labour Organisation (ILO) conventions and the Paris Climate Agreement. As these are more limited in scope and enforceability, the UK and EU should also agree to additional mechanisms to ensure similar outcomes from domestic social and environmental policy. For instance, regular meetings of a joint committee would be useful to ensure advance information sharing of relevant legislative plans. The joint committee could also act as a preliminary forum to discuss instances where one party considers its interests have been harmed. The dispute settlement mechanism in this area should be linked to the wider dispute settlement and remedy procedure governing the full agreement (see section five).

**Taxation**

On taxation, the EU recommends negotiating a “good governance” clause as part of a UK-EU FTA, along the lines of what it has concluded with Canada and Singapore. The EU also wants to agree binding requirements on information exchange and anti-tax avoidance measures, and a joint Code of Conduct on business taxation that mirrors the EU code. Establishing a binding agreement on information exchange and anti-tax avoidance should be acceptable to the UK. Given the UK’s ‘Global Britain’ ambition, there is an inherent benefit in protecting its image as tax transparent. Promoting transparency and exchange of information among jurisdictions for tax purposes is also already a global aim – the OECD last year launched its Automatic Exchange of Tax Information portal. However, rather than referring to EU tax Directives, future UK-EU cooperation on tax transparency and anti-tax avoidance measures should build on OECD and international Base Erosion and Profit Shifting (BEPS) systems – this would be similar to Switzerland’s arrangement.

The UK will also have to decide whether or not it wishes to remain in the EU VAT area. If the UK were to leave, it would no longer be bound by the EU VAT directive and could diverge from EU standard VAT rates. Currently, the EU sets a minimum VAT rate of 15%. For goods that are eligible for reduced VAT, the EU minimum threshold is 5%, and the UK, like other EU countries, has derogations allowing it to zero-rate certain products. Leaving the VAT area would give the government the flexibility to introduce new VAT bands, or zero-rate VAT on household essentials such as domestic fuel, children’s car seats or tampons.

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However, it would also impose an additional burden on traders. Currently, no VAT is levied on intra-EU trade, with VAT only charged when a good is sold to the final buyer. If the UK were to leave the EU VAT regime with no other agreement in place, importers would be required to pay VAT upfront on goods from the EU before they can be released. This would create additional cash flow and time burdens, which would be particularly costly for small businesses.

The upfront collection of VAT at borders could also mean increased operations along the Irish border. In addition, leaving the EU VAT area without a replacement agreement would increase operational costs for companies that trade in services. This is because businesses would need to become VAT-registered in each member state where they operate – at present they need only be registered in one member state.

The current draft of the government’s Taxation and Cross Border Bill indicates that VAT will be charged on all goods imported from outside the UK after Brexit. It is therefore likely that the government intends to leave the EU VAT regime. However, the UK and the EU could strike a VAT cooperation agreement along the lines of the recent Norway-EU deal. Under this arrangement, Norway agrees to operate a similar VAT system to the EU, and Norway and the EU apply the same structure of cooperation against VAT fraud as the EU’s own regime.

Alternatively, the UK and EU could implement unilateral measures to mitigate costs to business from leaving the EU VAT area, for instance by establishing a duty deferment scheme, which allows for import VAT not to be paid at the point of entry (i.e. at the border). Other unilateral measures include increasing the capacity of bonded warehouses to allow businesses to suspend duty on stored goods; or introducing a self-accounting scheme for import VAT, similar to the EU’s Intrastat system. If technological systems cannot be implemented in time, the UK could consider remaining part of a VAT area for a time-limited period after the transition period to ease the burden on businesses.

**State aid**

The EU’s recommendations for cooperation on state aid are wide-ranging, including substantive rules as well as measures for enforcement and dispute settlement. It aims to negotiate provisions equivalent to EU state aid rules as part of a future bilateral agreement. It also seeks to establish a dynamic mechanism to ensure UK-EU provisions on state aid remain in line with EU rules if these are updated or amended. In addition, it calls for the UK to establish an independent national authority to supervise compliance and communicate with the European Commission. In cases of non-compliance, the EU wants the agreement to include effective and swift means to enforce remedies.

This proposal is much closer to the Norway-EU agreement, given Norway agrees to comply with EU state aid rules and update these in accordance with new CJEU judgments over time. By contrast, CETA provisions on state aid are based primarily on the WTO Subsidies and Countervailing Measures agreement. The EU position paper recognises that robust UK-EU state aid provisions would impose more obligations on the UK than the EU has agreed with other FTA partners, but it argues that existing international rules fail to take sufficient account of the UK’s deep integration in European value chains and its geographical proximity. Prime Minister Theresa May also noted in her recent “Road to Brexit” speech that “the level of integration between the UK and EU markets and our geographical proximity” increase the importance of reciprocal commitments on state aid and competition policy to ensure frictionless trade.189

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May’s speech indicated that the UK is prepared to make “binding commitments” to remain in step with the EU on state aid and competition policy, emphasising that this would be in the UK’s own economic interests.\(^{190}\) The UK has traditionally granted relatively little state aid compared to the EU average – according to the 2017 EU State Aid Scoreboard, UK state aid expenditure amounted to 0.36% of GDP, around half the EU average of 0.69% of GDP.\(^{191}\) The UK also has a good record of compliance, with stakeholders viewing the EU’s state aid regime as a useful instrument for “tackling more industrially active Member States.”\(^{192}\)

Basic WTO requirements would only provide limited means for the effective cooperation on state aid both the UK and EU are seeking. However, EU recommendations for a dynamic mechanism to move in lockstep with EU state aid rules would require the UK to bind itself in advance to future EU rules and regulations with no influence. Both sides should instead establish a new binding agreement based on the non-regression of current state rules that is subject to periodic mutual review by both sides – Theresa May called for “reciprocal binding commitments to ensure fair and open competition” in her proposals for the future economic partnership.\(^{193}\)

The UK will also have to establish a new independent notifying authority, as state aid requests are currently notified to and approved by the European Commission – this could be the existing Competition and Markets authority. The UK body would be required to operate very closely with the Commission and jointly ensure compliance with state aid rules.

The key aspect of the long-term agreement on state aid will be the enforcement mechanism. UK and EU must include a more robust dispute settlement mechanism than the non-binding consultation procedure under WTO rules – it should include a formal procedure for arbitration and remedies. This should follow in line with the broad dispute settlement mechanism covering the bilateral free trade agreement (see section five).

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\(^{190}\) Ibid.
5. Managing the new UK-EU relationship and dispute resolution

The UK and the EU will not only have to find agreement on the scope and depth of future cooperation; there will also need to be new mechanisms to manage the operation of the relationship and solve potential disputes that may arise. If both parties’ rules are found to be equivalent or mutually recognised at the time of withdrawal, what happens when future regulatory divergence on one side leads the other to question the degree of divergence? What would constitute a proportionate response to divergences by either side, and who will be the final arbiter? To whom do companies turn if they are discriminated against by an authority of the other party, what remedies are there, and how are they enforced?

Following the UK’s withdrawal from the EU, it will automatically fall out of EU jurisdiction. The fact that the UK will no longer enjoy representation in any EU institutions would render the continued direct supervision via EU authorities politically unacceptable to the UK. It would be hard to see how EU institutions could remain neutral arbiters in adjudicating a dispute between “themselves” and a third country.

However, this does not necessarily mean that ECJ decisions will be fully excluded from the operation of a future UK-EU relationship. As the ultimate authority on the interpretation of European law, the ECJ will continue to have an indirect role in any future UK-EU agreement that bases itself at least partly on alignment with EU regulations and standards. The ECJ’s interpretation of these laws can alter their effect in the same way that an amendment by the Council of Ministers or European Parliament can. Continued alignment with certain EU rules could mean adapting to amendments to EU law in those areas, whether they result from decisions of the EU’s Parliament and Council, or from those of the ECJ. It would be open to the UK, as a third country, to decide to go in a different direction but this could affect market access with the EU.

Outside the EU, the principle of "direct effect: must end in the UK. On the basis of the 1972 European Communities Act, this principle ensures that certain types of EU legislation have direct effect in the UK without the need for an implementing act in national legislation. With the repeal of the European Communities Act as part of the EU (Withdrawal) Bill, EU law would lose its direct effect in the UK legal system. Any future dispute mechanism negotiated via treaty would only be binding on the UK as a matter of international law.

Both the British government and the EU have stated the need for a dispute resolution mechanism (DRM) as part of the future relationship. However, the UK is clear that ECJ rulings will no longer have direct effect in the UK and that the ECJ cannot be the ultimate arbiter of any future disputes between the UK and the EU. Nevertheless, in her speech at the Munich Security Conference and in her “Road to Brexit” intervention, Theresa May indicated that the UK would “respect the remit” of the ECJ when cooperating with or participating in EU agencies. The EU on the other hand places utmost importance on preserving its legal autonomy, ensuring that the ECJ remains the ultimate arbiter on all matters of EU law. However, there are also shared objectives: a mechanism that provides a high level of legal certainty, that is cost-efficient and effective.

This chapter does not attempt to provide a full or final blueprint for UK-EU dispute resolution post-Brexit. There are many important questions, such as on the exact scope of remedies, staffing or whether there should be a standing authority or ad hoc arbitration panels. Instead, the focus lies on sketching out a politically viable model for the governing of disputes in the future economic relationship between the EU and the UK.
The UK has important strengths which should affect the nature of the dispute resolution mechanism. Our courts and judiciary are respected the world over for the fairness and impartiality. The UK remains the foremost destination of choice for dispute resolution, as foreign companies, investors and individuals trust our judges, lawyers and legal system to come to fair judgements. This will continue to be the case in the future.

5.1 A new dispute resolution mechanism can be based on existing models

There are essentially three types of DRM used to govern international agreements, including those to which the EU is a party:

1) **Political/diplomatic/administrative:** All modern trade agreements include this form of DRM to manage the operation of the agreement. This usually takes the form of “joint committees”, often sector-specific, comprised of officials, diplomats or politicians which meet regularly to discuss the implementation and functioning of the agreement. These forums can avoid disputes arising in the first place and/or provide a means of settling disputes through negotiation before they escalate to a level that might require more formal arbitration.

Joint committees are provided for in traditional EU FTAs, including CETA, within the EEA agreement and for the various Swiss-EU bilateral agreements. The Swiss-EU relationship is unique in that the joint committees are the sole DRM governing the application of the relationship. The other EU agreements are supplemented with a quasi-judicial or judicial DRMs that ultimately settle disputes.

2) **Arbitration:** This type of DRM takes the form of an ad hoc arbitration panel rather than a standing court. However, it is legalistic in that the treaty or trade agreement will set out the rules and procedures for convening an arbitration panel, including who sits on it, and any penalties that might be applicable as a result of the panel’s verdict. Legal arguments will be presented by either side to the panel, often comprised of one representative of both parties and a neutral third party. The proceedings may be public or private.

It is usually used in state-to-state disputes but is also used in investor-state disputes. This form of DRM is used in several EU FTAs, including with Canada, Korea, Japan and Singapore. It is also the first stage of formal dispute settlement at the WTO.

3) **Judicial:** This form of DRM provides for a standing court to rule on disputes relating to the functioning of the agreement or rights derived from it.

The ECJ is a judicial DRM within the EU. The ECJ is responsible for interpreting EU law when requested by national courts and it hears cases brought against member states by the European Commission or other member states. It also hears cases brought by individuals and businesses against EU laws or the EU institutions.

The EFTA court is a judicial DRM for disputes falling under the EEA agreement. It is distinct from the ECJ, and is responsible for enforcing the EEA Agreement for the three EEA/EFTA states – Norway, Iceland and Liechtenstein – while the ECJ enforces this for EU countries. This “two-pillared” approach to governing the EEA Agreement is not viewed as a breach of the EU’s legal autonomy, as the ECJ continues to act as the sole interpreter of EU laws within the bloc.
The authority of the EFTA Court is different to that of the ECJ. National courts of the EEA/EFTA states are not required to refer to the EFTA Court on matters of European law. Also, preliminary rulings by the EFTA Court do not have direct effect or primacy in the three EEA/EFTA states. While the EFTA Court is a separate body to the ECJ, it generally follows relevant ECJ case law to ensure uniform interpretation of EU law, although this is not always the case. For instance, in 2014, the EFTA Court ruled that EEA nationals can invoke residence rights under Article 7 of the Citizens’ Rights Directive against their home state. The ECJ had previously narrowly interpreted Article 7 as imposing obligations on EEA states other than the home state.

As is the case with most DRMs governing international agreements, none of these models have direct effect or supremacy in the countries to which they apply. The ECJ, as a supranational judicial authority, is distinctive in this sense. The future UK-EU agreement should not allow the direct effect or direct applicability of the ECJ to continue in the UK.

5.2 Establishing a DRM for the new UK-EU economic relationship

The depth of the final UK-EU economic and political relationship is likely to determine what form of DRM is established.

The governance of the overall UK-EU agreement is likely to be a combination of multiple DRM models – most of the EU’s FTAs include multiple forums for dispute resolution. For instance, under the CETA deal, disputes between the EU and Canada can be resolved in joint
committees or ad-hoc arbitration panels. The EU’s agreement with Switzerland is the only bilateral relationship governed through joint committees, with no formal dispute settlement mechanism. The EU will likely insist that this will not be sufficient for all aspects of the agreement. It has previously expressed its unwillingness to replicate its arrangement with Switzerland in future agreements – while official-level committees can be useful for resolving technical disputes or minor amendments, they are weak mechanisms for addressing wider infringements and political disputes. It is also in the UK’s interest to establish a clear and predictable legal framework to prevent disputes from developing into political crises.

Where the UK-EU deal is premised on the approximation or adoption of EU law, for instance on goods regulations, the EU is likely to propose the ECJ as DRM. However, any judicial authority governing the agreement must be impartial. It would therefore not be appropriate or credible for the ECJ to be the sole arbiter of any part of the agreement. The EFTA Court provides a precedent for a joint judicial DRM that respects the legal autonomy of the EU.

The UK could choose to “dock” to the EFTA Court for areas that relate to EU law - the outgoing president of the EFTA Court, Carl Baudenbacher, has suggested this could be a feasible solution. Under the “two-pillared” approach that currently applies to EEA/EFTA states, this means the EFTA Court would enforce the relevant sections of the UK-EU agreement for the UK, while the ECJ would carry out the same role for EU member states. Alternatively, the UK and the EU could establish a new joint standing court to oversee areas of the agreement that are based on EU law - it could be comprised of an equal number of UK, EU and third country judges. This judicial body would likely be required to refer to and follow relevant ECJ case law in order to ensure consistent interpretation of EU law.

In other areas of cooperation, where the UK is not seeking to align with the EU’s legal or regulatory regime, the EFTA Court would not necessarily provide the appropriate legal forum for dispute resolution and a more traditional FTA arbitration procedure could be sufficient. Under this arrangement, if a dispute between the UK and the EU cannot be resolved through joint committees and mediation, it will be brought before an arbitration panel appointed by both sides. The panel will receive submissions from both sides before producing a binding decision. As the panel will govern areas of the agreement that fall outside the scope of European law, they would not be required to refer to the ECJ.

The model of DRM used will also depend on which parties are able to initiate disputes – otherwise known as which parties have “standing”. All three models set out above allow states to bring disputes. However, individuals and private businesses would not necessarily have standing before FTA joint committees or arbitration panels. Under these governance arrangements, private parties that believe they face discrimination from the other party to the agreement would have to lobby their government to initiate a dispute.

However, in some areas, this would be insufficient. For instance, businesses – particularly SMEs – would find it hard to resolve questions of unfair taxation or competitive practices this way. Similarly, state-state DRMs would be unable to resolve disputes in areas that confer rights directly on individuals – such as the proposed Withdrawal Agreement does on citizens’ rights. A judicial DRM would seem more appropriate for these issues.

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194 For example, the EU draft protocol on Ireland and Northern Ireland, under which Northern Ireland would remain in a common regulatory area with the EU, calls for continued ECJ jurisdiction. See European Commission, ‘Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community’, 19 March 2018, p113.
Alternatively, in investment-related disputes, the UK and EU may consider establishing an Investor-State Dispute Settlement (ISDS) mechanism, which would give businesses the right to initiate a case. The issue of ISDS has received considerable public and political opposition in previous trade agreements, including CETA and the proposed EU-US Trans-Atlantic Trade and Investment Partnership. There are concerns around the transparency of ISDS mechanisms and it would not be appropriate for fundamental disputes affecting our economy to be decided behind closed doors. Both the UK and EU should share the concern of increasing the transparency of dispute resolution. The UK could instead support existing EU proposals to launch a Multilateral Investment Court, which could provide a more transparent judicial forum.

All of the EU’s international agreements outline retaliatory measures that can be taken if one party fails to comply with the decision or remedy imposed by the DRM, or if a dispute arises as to whether the remedy is appropriate or proportionate.

- **EU FTAs with Canada, Japan and South Korea** allow a party to take proportionate measures to suspend relevant treaty preferences, or impose retaliatory tariff sanctions, in cases of non-compliance with agreed treaty commitments or arbitration panel decisions.
- The EEA Agreement allows the EU to take “countermeasures” if EEA/EFTA states use their right of reservation not to implement new EU legislation, or if there are significant delays in implementation. This includes the suspension of preferential market access in the related areas. Significant regulatory divergence with the EU could lead to exclusion from the single market.
- The “Bilateral I” package of the EU’s agreements with Switzerland is covered by a “guillotine clause”. This allows either party to terminate all the agreements in this package if a dispute in one agreement cannot be resolved. The significant economic and political repercussions of suspending all agreements means it is considered an instrument of last resort. It has so far never been used.

Ultimately, all major trade disputes resort to high-level political negotiations to resolve substantial disagreements. Even despite the existence of a “guillotine clause”, significant disputes in Swiss-EU relations have been resolved through other political countermeasures. For example, the EU did not trigger the guillotine clause after Switzerland refused to extend free movement rights to Croatia following its accession.

### Swiss-EU freedom of movement dispute

In a 2014 referendum on immigration, 50.33% of Swiss citizens voted to introduce quotas on EU immigration. Shortly afterwards, Switzerland refused to sign an agreement extending freedom of movement rights to Croatia, following its access to the EU. Given the Swiss-EU guillotine clause covers the agreement on the free movement of persons, the EU would legally have been able to terminate the agreements. However, the EU first retaliated on other issues. Notably, it stopped negotiations with Switzerland on a cross-border electricity deal, and suspended Swiss participation in the EU’s research and development project, Horizon 2020. After Switzerland extended free movement to Croatia in 2016, and implemented the referendum result without imposing restrictions on EU immigration, Swiss participation in Horizon 2020 was re-established.

The DRM for the UK-EU agreement is likely to draw on a number of existing models. In areas where the UK seeks to remain aligned with the EU, such as on goods, or where private parties
should be able to initiate disputes, a judicial DRM seems most appropriate. However, in sectors where the UK seeks less integration with the EU, notably including services, ad-hoc arbitration panels would likely provide a more appropriate and sufficient forum for dispute resolution.
6. UK-EU broader relationship

This paper has addressed the framework for future economic relations between the UK and the EU, but this is only one piece of the puzzle. The bilateral trading relationship will form part of a broader political and strategic partnership.

UK-EU cooperation currently covers a vast array of policy areas, including defence, security and foreign policy; development and foreign aid; justice and law enforcement; energy and climate change; research and higher education. It will be important for the UK and EU to maintain a multidimensional partnership post-Brexit.

Both parties have demonstrated their intention for wide-ranging economic and strategic bilateral relationship.

In her 2017 Florence Speech, Prime Minister Theresa May made the following offer:

“We are proposing a bold new strategic agreement that provides a comprehensive framework for future security, law enforcement and criminal justice co-operation: a treaty between the UK and the EU.”

In her recent “Road To Brexit” Speech, she added:

“There are many other areas where the UK and EU economies are closely linked – including energy, transport, digital, law, science and innovation, and education and culture…In all these areas, bold and creative thinking can deliver new agreements that are in the very best interests of all our people - both in the UK and across the EU.”

On the EU side, the negotiating guidelines on the future bilateral relationship note:

“Law enforcement and judicial cooperation in criminal matters should constitute an important element of the future EU-UK relationship in the light of the geographic proximity and shared threats faced by the Union and the UK…The future partnership should cover effective exchanges of information, support for operational cooperation between law enforcement authorities and judicial cooperation in criminal matters.”

It is worth noting that the initial draft version of the guidelines also included the following:

“In the fields of security, defence and foreign policy there should be no gap in the EU-UK cooperation as a consequence of the UK withdrawal from the Union.”

This has been revised in the final version to call instead for “strong UK-EU cooperation in the fields of foreign, security and defence policy.”

In January, the EU’s chief Brexit negotiator, Michel Barnier, stressed:

“For our point of view, we think that in addition to trade, our partnership should include security, defence and foreign policy, as well as justice and home affairs and include some sectors such as aviation and fisheries.”199

Following the agreement for a transition, Barnier emphasised:

“I personally think it is possible for us to reach an agreement during [the transition] on the future ambitious partnership on foreign policy and external security in particular.”200

Elsewhere, a recent European parliament resolution on the EU’s negotiating guidelines also suggested a broader UK-EU association agreement, which would provide “a flexible framework allowing for varying degrees of cooperation across a wide variety of policy areas.”201 The parliament suggested a four-pillar approach, based on trade and economic relations; foreign policy, security cooperation and development cooperation; internal security; and other thematic cooperation.

The UK is internationally competitive in many of these areas, in particular defence and security, foreign aid and higher education (see Annex III for further discussion of the potential areas of broader UK-EU cooperation). The UK is one of the European Union’s two nuclear powers and UN Security Council members. It is also one of only five EU member states to meet the NATO spending target on defence, and has the largest military budget within the EU. Elsewhere, the UK is a significant international aid contributor, both independently and through the EU. It is the second largest international aid donor in the world, and its contributions to the European Development Fund are the third largest of the EU member states.202 On higher education, Britain is home to 16 of the top 100 universities (4 of the top 10),203 and ranked first in the world for quality of research in 2016.204

The UK should bring its competitive advantage in such sectors to the negotiating table in order to help to construct the particular “deep and special partnership” the government is seeking. From a strategic bargaining perspective, the UK could leverage an offer of continued collaboration and contribution to the EU in broader policy areas in order to overcome some technical hurdles in trade talks.

None of the EU’s current partnerships with third countries, including with EEA/EFTA countries such as Norway and Switzerland, sufficiently cover the breadth of cooperation that the UK and EU are seeking. Norway-EU collaboration is focused on energy cooperation: Norway is an important energy supplier to the EU and works jointly with the EU on the international stage

203 QS, ‘World University Rankings’, 2018
to address climate change. Elsewhere, as a non-EU NATO member, Norway collaborates with the EU on defence policy and has led EU battle groups in the past, but it does not match the UK’s defence capabilities and contribution. Switzerland and the EU cooperate closely on science, research and innovation, but do little together on defence and external development aid. As with the UK-EU economic agreement, the broader partnership will need to be bespoke to account for the current extensive scope of bilateral cooperation.

The process of negotiations has so far seen more emphasis placed on the future trading relationship than the wider strategic partnership. Few detailed proposals have been put forward on the structure of post-Brexit cooperation in the fields of foreign policy and law enforcement for example. But the two pillars of the future partnership cannot easily be separated from one another – provisions for the transfer of data offers a good example of their interdependence. Establishing a new UK-EU framework for the secure transfer of data will be vital for justice/home affairs and security collaboration, as well as trade. The EU itself has stated “the importance of data flows in several components of the future relationship.”

Although both sides have a joint interest and commitment to continuing close cooperation in these wider policy areas, achieving an ambitious strategic partnership post-Brexit will require political goodwill on both sides. If trade negotiations between the UK and the EU break down acrimoniously, it is not only economic relations that will likely be negatively affected. The resulting damage to mutual trust and goodwill could weaken the potential for joint collaboration post-Brexit in broader political and strategic areas.

Both the UK and the EU have much to gain from placing the future partnership in its wider context. The next few decades are likely to bring significant global economic and geopolitical shifts. Economic power is expected to shift away from established advanced economies, with the EU27 forecast to account for less than 10% of global GDP by 2050. A recent interinstitutional report by the EU also notes the “long-term weakening of the multilateral system”, and raises concerns about the resurgence of Russia, external threats to the security of energy and infrastructure in Europe, and long-term immigration challenges.

The post-Brexit UK-EU partnership must recognise the importance of continued cooperation on political and strategic issues in this changing global environment. There will continue to be a valuable multiplier effect to joint engagement on key international issues from security and sanctions to sustainable development and climate change. As David Davis noted recently, “Close cooperation with our allies is central to standing up for a rules-based international order.” Both have a continued interest in ensuring security and stability across Europe in the future and this should be reflected in the overall bilateral agreement.

Conclusions

The current Brexit negotiation should not deprive future governments of the tools to diverge from the EU in the future. The world, the UK and the EU will all no doubt look very different in the decades to come and future governments should be able to choose how to diverge from the EU’s trade and customs policy, goods and services rules and standards, and its wider regulatory framework in order to pursue new trade deals and develop the UK’s global and domestic competitiveness.

However, the UK needs to present a workable negotiating position that is politically sustainable domestically and with Brussels for the immediate and medium term. The future UK-EU economic relationship will be dynamic, as both parties will evolve over time. It is likely to develop in stages and will be subject to continuous amendment and negotiation.

Our analysis illustrates that the EU has adapted its approach to economic agreements depending on the partner involved. Given the UK and EU’s unique and shared history of integration and the geopolitical importance of continued close cooperation, the future partnership should be bespoke and ambitious. However, the Brexit negotiations are complex, politically fraught and the UK needs to consider the trade-offs that they entail. The more the UK asks for in terms of access, the greater the EU will demand in return.

Open Europe’s view is that our model ought to be acceptable to a large proportion of moderate Leavers and Remainers. We also believe this model is negotiable. Some will hope for a more ambitious economic relationship but the danger is that setting sights too high increases the likelihood of failure and greater Brexit disruption. This adds to the uncertainty facing business. The perfect should not be the enemy of the good.

Brexiteers should accept that they do not need to give up much sovereignty to ensure high-level access to the EU’s Single Market for goods. Under our proposal, the UK would broadly need to follow EU regulations on goods, but these are typically specific to sectors which are already highly-regulated. There is a relatively limited benefit from regulatory divergence in these areas and many non-EU states choose to follow these rules anyway. Equally, on services – the most significant sector of the UK’s economy – the UK would be able to determine its own regulations. As a non-EU member, parliament would retain the ability to deviate from EU rules, but this could lead to a diminution in market access.

There are some Brexiteers who seem unwilling to accept any degree of constraints on the UK’s sovereignty. This is not only incompatible with a deal with the EU but would also make it almost impossible to agree any trade agreement of significance with new partners. All trade agreements require a degree of compromise whether it be on opening domestic markets, agreeing to international regulatory standards or allowing for greater mobility of people.

Remainers should accept that it will not be possible to recreate the full benefits of EU membership from outside the Single Market and that in some senses less is more. This proposal would do much to safeguard UK-EU supply chains for goods, where UK-EU economic integration is most developed, but the UK will not achieve something akin to full membership of the Single Market if it’s a non-member, and demanding ever greater access would entail an unacceptable relinquishing of control, including on level-playing field issues, which affect the UK’s domestic economy. It would not be sustainable in the medium to long-term for the UK to mirror all EU rules on the financial services sector, nor to follow future EU regulations over taxation, employment and labour rules, and so on. Ultimately, as the Brexit vote illustrated, if UK-EU cooperation is not politically sustainable, it will break.
Annex I: Membership of EU agencies

Membership of the single market has also allowed the UK to participate in EU regulatory agencies. These aim to reduce duplication and increase efficiency in monitoring and authorising the sale of goods across the EU. In sectors where EU agencies are partly responsible for enforcing regulatory conformity – such as the European Medicines Agency (EMA) – the UK will have to consider whether to maintain participation in these bodies or to increase the capacity of national regulators.

In her recent “Road to Brexit” speech, Prime Minister Theresa May noted three EU agencies involved in goods regulation which the UK may wish to remain part of in the future – the European Medicines Agency (EMA), the European Chemicals Agency (ECHA), and the European Aviation Safety Agency (EASA):209

**European Medicines Agency:** The EMA evaluates applications by pharmaceutical agencies for EU marketing authorisation; uses regulatory mechanisms to facilitate research and development of medicines; and continuously monitors the safety of medicines authorised in the EU.210

**European Aviation Safety Agency:** EASA is responsible for inspections of aeroplanes and components, certifying all new goods in the EU aviation market and issuing air safety certificates. It also sets a common standard of best practice for inspections, certifying safety inspectors and aircraft repair stations; it conducts research and encourages international cooperation; and it sets environmental standards for the EU aviation area.

**European Chemicals Agency:** The ECHA manages the registration of chemicals under REACH and coordinates authorisation and restriction of goods under EU Classification, Labelling and Packaging (CLP) regulations. It holds centralised EU data on safety of chemicals and enforces REACH regulations at the EU level. 211

All three currently have an important role to play in authorising the sale of goods on the EU market and/or enforcing compliance with EU regulations. May highlighted that continued membership of these bodies would be “the only way to meet our objective of ensuring that these products only need to undergo one series of approvals in one country.”212

National regulatory agencies do exist in all these industries – for instance the UK Medicines and Healthcare Products Regulatory Agency regulates medicines and medical devices in the UK, while the EMA regulates the market at the EU level. However, in some industries, such as aviation, EU regulators are responsible for running safety and maintenance checks on all goods in the European market, as well as for setting crucial common standards. Even in industries where EU agencies are not responsible for the authorisation of all goods, businesses can be

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required to apply directly to the EU regulator under particular circumstances to receive approval to market their products in any member state – for instance, pharmaceutical companies are required to submit a centralised request for authorisation to the EMA in order to market new cancer treatments anywhere in the EU.213

May recognised in her speech that associate membership of these EU bodies “would mean abiding by the rules of those agencies and making an appropriate financial contribution.”214 She also sought to highlight the importance of UK contributions to these agencies, both in terms of its technical expertise and the strategic importance of its market in assessing products for automatic sale in the wider EU market.

In other sectors, where the UK wants to diverge from EU regulations, the government would be unlikely to seek continued participation in EU agencies. Under this scenario, it will need to strengthen the capacity of its domestic regulators to manage responsibilities currently delegated to EU agencies.

Annex II: IRSG model for future cooperation in financial services

The International Regulatory Strategy Group (IRSG), a financial services trade body, has proposed a model for future cooperation in financial services that could provide a useful template for managing divergence in other highly regulated services sectors under a new UK-EU deal. Such a model would address the following issues:

1) Access based on current alignment

Post-Brexit EU-UK mutual access to their respective services markets should be as comprehensive as possible, on the basis that EU and UK regulations will be perfectly aligned at Brexit point and in light of the British Government’s commitment to transpose EU law into national law via the EU (Withdrawal) Bill.

Alongside financial services, the model can apply to many areas of transport services (particularly maritime transport), telecommunications, some legal/accounting standards, and cross-sectoral issues such as data protection. In other areas, the UK will need to accept that national barriers remain as they are outlined in national legislation. As noted in our paper, many of these national barriers are a feature of the current incomplete nature of the single market in services.

2) Assessing divergence – materiality and outcomes

A high degree of mutual access in the areas where this can be achieved will furthermore be dependent on agreeing an effective system for managing divergence.

Despite perfect initial alignment, the regulatory frameworks of the UK and the EU will likely diverge in the future. Under this scenario, the IRSG proposes, divergence should be assessed with respect to agreed goals rather than in legalistic terms. The rationale behind this approach is that a certain degree of divergence, provided that it remains in line with the common goals, should not be deemed sufficient cause to undo the entire agreement and lead to a restriction of mutual market access.

Of course, it will be here a matter of establishing what the shared outcomes are and how consistency with them can be assessed. But notably such an approach is in line with what suggested by the British government. The latter envisaged the possibility that post-Brexit in some areas the UK might want to achieve the same goals as the EU but by different means.

3) Promoting ongoing alignment and regulatory co-operation

Regulatory cooperation with the aim of ensuring that the established common goals are upheld will be needed. For financial services, the IRSG report envisages “the creation of a Forum for Regulatory Alignment.”

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Its task will be to assess and manage regulatory change in the eventuality that any of the two parties introduces a modification potentially threatening the regulatory alignment. The forum will also be tasked with promoting a coordinated regulatory response, for instance when new global standards emerge that have to be implemented in the respective jurisdictions.

Such a model could be extended to other areas where the EU sets common standards, such as data protection, and where regulatory cooperation will be crucial in the future. In other areas, where the EU provides for mutual recognition rather than harmonisation, such as on recognition of professional qualifications, different arrangements might be needed.

4) Supervision

The EU and the UK will also have to agree on a system of supervision with common standards in dealing with single firms, as well as on the respective right of supervision on other party’s firms.

In this context, it is important to stress that UK regulators and supervisory bodies will play a greater role after Brexit and especially so in relation to the implementation of the EU (Withdrawal) Bill. Regulators will in fact have the ability to amend regulation derived from EU law, as they are best placed to do so and charging Parliament with such a task in the different sectors would not be realistically feasible. Importantly, tough, democratic checks on the work of regulators should be left in place and any implementation that could lead to regulatory divergence with the EU should be a matter of public policy.

Although UK regulators will play a greater role, the EU will unlikely concede all regulatory supervision of UK firms providing services in the EU, and vice versa. For instance, the Commission has already signalled its intention to bring euro-denominated clearing under the supervision of the European Securities and Markets Authority (ESMA), even if the clearing houses are based outside the EU. The EU has also made clear that any future UK-EU agreement “should safeguard financial stability in the Union and respect its regulatory and supervisory regime and standards and their application.”

It is therefore particularly important to agree in advance the degree to which the EU and the UK will be able to supervise firms of the other party.

5) Dispute settlement and retaliation

Finally, such a model would need to be coupled by an effective dispute settlement as some disputes and different points of view might be inevitable if the goal is one of managed divergence. Therefore, it will be crucial to develop a system which ensures proportionate retaliation, should the UK and EU systems be found no longer aligned. We discussed this in detail in section five of this report.

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Annex III: Broader relationship

The UK contributions to the future political and strategic partnership with the EU are likely to cover in particular defence and security, foreign aid, police and justice cooperation, research and higher education. Agreements in these sectors could be included as part of a broad partnership or association agreement, or as a series of independently negotiated sectoral treaties. In certain areas, the UK could continue cooperation with EU programmes under already existing third-country rules, or it could seek to negotiate bespoke solutions.

The sections below aim to consider the UK’s competitive advantage in key strategic sectors and what models might be appropriate to ensure future effective UK-EU cooperation post-Brexit.

Defence and security

UK-EU cooperation on defence and security will remain crucial after Brexit; a threat to Europe will remain a threat to the UK, and vice-versa. As Prime Minister Theresa May stressed at the Munich Security Conference 2018:

“Europe’s security is our security. And that is why I have said – and I say again today - that the United Kingdom is unconditionally committed to maintaining it.”

The UK plays a unique role in Europe’s security and defence landscape. It is currently one of only two member states that possess the full-spectrum of military capabilities, including nuclear powers; and one of five to meet the NATO defence spending target of 2% of GDP. Its withdrawal is estimated to reduce the EU’s defence capabilities by up to a quarter. The UK currently provides around half of EU heavy transport aircraft and nuclear-powered attack submarines, and over a third of electronic-intelligence aircraft. Keeping British military capacities integrated with EU projects will be vital for Europe’s security landscape. UK and EU defence industries will also benefit from continued bilateral cooperation on research and defence post-Brexit. Equally, as Prime Minister May suggested in her Munich Security conference speech, both sides should seek to continue close cooperation on the development and implementation of sanctions.

Much of the UK’s contribution to European defence and security takes place outside of EU institutions and structures. The UK has a permanent seat on the UN Security Council and plays a leading role in NATO, committing British military to NATO operations in Eastern Europe; leading NATO’s enhanced forward presence in Estonia; and deploying military assets near the Polish-Lithuanian border. The UK has also established formal bilateral mechanisms for defence cooperation with the EU’s other foremost military power – France. This is founded on the 2010 Lancaster House Treaties, which strengthened operational linkages between UK and French militaries, pooled equipment and materiel, allowed mutual access to defence markets, and increased industrial and technological cooperation. At the UK-France summit earlier

this year, Theresa May stressed the UK’s continued commitment to Franco-British defence and security cooperation after Brexit:

“We are and will remain a steadfast partner to our friends and allies … The [French] President [Emmanuel Macron] and I agree on the importance of the UK-France relationship, not just to our security but to European security … we will continue to play a full role to improve the security of the continent.”

It is also interesting that French President Emmanuel Macron has proposed a new European military intervention force to be created outside existing EU frameworks. Establishing this force outside EU structures would mean that defence and military cooperation between the EU’s two biggest military players could continue more smoothly post-Brexit.

The EU has a strong interest in keeping the UK integrated in defence and security efforts after Brexit, and is willing to treat this sector as a special case in negotiations. For instance, an initial draft of the EU negotiating guidelines on the future UK-EU partnership noted:

“In the fields of security, defence and foreign policy there should be no gap in the EU-UK cooperation as a consequence of the UK withdrawal from the Union.”

Similarly, a recent position paper from the European Commission suggests that new UK-EU mechanisms for security, defence and foreign policy cooperation could become operational during the Brexit transition. The EU had previously suggested the UK would not be able to have a differentiated transition period for different sectors. The exceptionalism shown by the EU towards UK-EU defence and security relations is likely in part motivated by the fact that EU cooperation in this area takes place through intergovernmental rather than supranational frameworks. Therefore, absent a new agreement, the UK could fall out of current EU defence cooperation structures during a transition.

The exact modus operandi of future UK-EU defence and security cooperation remains to be defined in greater detail. However, as the EU and member states move towards further defence integration – for instance through the recently established Permanent Structured Cooperation (PESCO) – they will need to bear in mind what future role they envisage for the UK. While Michel Barnier previously said the UK and EU would continue to cooperate closely on foreign and defence challenges, he has since indicated that the UK would not be able to participate in the planning of EU defence and security instruments in the future, nor would it be able to lead EU battlegroups. While it is unlikely that the UK will retain proper decision-making powers in EU defence structures, an agreement will need to be found that allows the UK to make its voice heard.

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Foreign aid

The UK is Europe’s biggest aid donor in absolute terms, and one of just five EU member states to meet the UN’s target of spending 0.7 percent of GDP on foreign aid. Between 2011 and 2015, it contributed around $2bn per year to EU aid budgets, topped only by France and Germany. The UK also participates in the EU’s Joint Programming, which aims at making development funding more efficient through better coordination. Existing models for cooperation with third countries in this area should be examined to ensure effective and efficient UK and EU foreign aid programmes after Brexit.

Law enforcement

The UK and EU cooperate closely in the fields of law enforcement and intelligence sharing through a range of EU programmes and instruments such as Europol, Eurojust and the European Arrest Warrant. This yields significant benefits for both sides. It allows quick and uncomplicated access to shared information, for example through the Schengen Information System or the Passenger Name Record framework, to facilitate the prosecution of cross-border crime.

The UK has a strong interest in maintaining its current level of involvement in EU intelligence and law enforcement programmes. In her 2017 Lancaster House Speech, Prime Minister Theresa May said:

“With the threats to our [UK and EU] common security becoming more serious, our response cannot be to co-operate with one another less, but to work together more. I therefore want our future relationship with the European Union to include practical arrangements on matters of law enforcement and the sharing of intelligence material with our EU allies.”

Similarly, former Home Secretary Amber Rudd said last year:

“The Home Office is working with operational law enforcement partners to examine all the different ways of delivering that result, and to find a practical, co-operative way of supplying certainty as we leave the EU...We value the co-operation that we have at present through the European Criminal Records Information System and the Schengen Information System.”

Keeping the UK closely integrated in its cooperation on law enforcement and intelligence sharing is also of considerable interest to the EU. The UK is a key contributor in the field. It is, for example, among the top four contributors to the Europol Information System, the agency’s main database on crime. It also allows the EU indirect access to information shared between the “Five-Eyes Alliance” encompassing the UK, US, Canada, Australia and New Zealand. Should the UK cease its involvement in EU intelligence and law enforcement programmes, the EU’s efficiency in this area would be reduced.

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Ensuring that cooperation can continue smoothly will be a complex task, both legally and politically. Questions over the role of the ECJ and the alignment of data regulations inevitably will arise. There already exist different models of cooperation with third countries: on Europol, for example, Norway and the US are operational partners while Denmark (which also has an opt-out on Justice and Home Affairs) has a third-country agreement with the agency. It remains to be seen which models ultimately work best for the UK and the EU on Europol and other agencies. There is, however, a strong incentive for both sides to find pragmatic solutions that maintain current operational capabilities and put security first.

**Research and Development, Science and Education**

The UK currently participates in a range of EU-related bodies in the areas of research and development, science and education. The UK government has indicated its intention to seek to retain much of this cooperation. In her Lancaster House Speech, Theresa May stated:

“We will also welcome agreement to continue to collaborate with our European partners on major science, research, and technology initiatives. From space exploration to clean energy to medical technologies, Britain will remain at the forefront of collective endeavours to better understand, and make better, the world in which we live.”

In October 2017, the EU Commissioner for Research, Carlos Moedas, reacted positively to this:

“I welcome the statements by the UK government that the UK would like to continue to take part in those specific policies and programmes which are greatly to the UK and the EU's joint advantage, such as those that promote science, education and culture.”

One very prominent project the UK seeks to remain a part of is the Erasmus programme, which facilitates European exchanges for students and researchers. Between 2007 and 2014, around 91,000 British students went abroad under the Erasmus scheme, while around 167,000 used it to study in the UK. Another 14,300 UK researchers and teachers received EU funding to research and train in the EU during that period. With other non-EU members such as Switzerland and Turkey being full members, continued UK participation should be easy to negotiate. Even more so since other members will seek to retain access to the world-class universities situated in the UK. For British students and researchers, continued participation in the Erasmus programme will provide greater opportunities to study abroad.

But the current cooperation extends also to other science and research programmes, including Horizon 2020, Euratom and the European Space Agency. Finding mutually agreeable solutions that protect current access may be more difficult in some of these areas. In particular, questions in areas such as data transfers and the free movement of people may become stumbling blocks.

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235 Ibid.
Annex IV: Dispute resolution mechanism models

The dispute resolution and governance proposals published by the UK government so far are extremely ambitious, and ask a lot from the EU. While Prime Minister Theresa stressed in her “Road to Brexit” speech that the UK would refrain from substantially diverging immediately after its withdrawal from the bloc, she acknowledged, “If [in the future] the Parliament of the day decided not to achieve the same outcomes as EU law, it would be in the knowledge that there may be consequences for market access.” It will be challenging to negotiate an unprecedentedly deep trade relationship built on the government’s stated principle of ‘managed divergence’. However, it will be an even bigger task to establish a suitably robust dispute resolution mechanism (DRM), capable of governing such a dynamic regulatory environment.

Such a dispute resolution mechanism will need to be able to handle future divergence from either side effectively, and without bringing down the whole agreement. To achieve this, the EU and the UK will need to answer difficult questions. What will be the proportionate response to divergences by either side, and who will be the final judge of it? Will different agreements be tied together by a guillotine clause as in the case of Switzerland?

Depending on the agreement made and dispute settlement mechanism selected, penalties put upon parties in breach of their obligations may take different forms. It will have to be settled, for example, whether cross-retaliation will be allowed, and what role case law will play in determining a penalty. Importantly, it will also need to be decided how far penalties will be pre-determined by the agreement - or whether they will be entirely up to the arbitration court. While it is common to refer to a specific dispute resolution mechanism that can be called upon for mediation, some trade agreements directly set out penalties for either side defaulting on provisions.

Existing models can provide a useful basis to start addressing some of these questions.

A new dispute resolution mechanism can be based on existing models

Many different models are being used already, including by the EU. Not all of them are directly applicable or desirable for the UK, but some provide useful starting points or offer building blocks for a new, bespoke dispute resolution mechanism setup.

The EEA/EFTA model

The EU employs a special system of dispute resolution with member states of the EEA, using the EFTA Court and the EFTA Surveillance Authority (ESA). Even if the UK should choose not to follow the EEA option, it could still ‘dock’ to the EFTA Court and ESA, and use these two institutions for dispute resolution in a future UK-EU trade agreement. Under this scenario, the EFTA institutions would interpret and apply a new body of law (UK-EU agreement) rather than the EEA agreement.

The proposal to dock the UK to the EFTA court has repeatedly been floated by the court’s outgoing president, Carl Baudenbacher, who argued that the EFTA court was more “market-
oriented” and pragmatic than the ECJ. Questions over the feasibility of ‘docking’ differ. While Baudenbacher argues that such a model should be easily acceptable to the EU, which, he says, proposed the option to Switzerland in 2013, there are also concerns that increasing the EFTA Court’s profile would run counter to the EU’s strategic interest.

The UK could make use of the EEA DRM model either by copying the currently employed two-pillar structure, or, more ambitiously and likely harder to achieve, by trying to adopt a one-pillar structure. Under the two-pillar structure, the EFTA court and ESA could handle breaches of the withdrawal agreement by the UK, while the EU institutions would continue to handle complaints against EU actors. An important upside of such a model would be that, contrary to the ECJ, EFTA Court judgments do not have direct effect. The Institute for Government suggested that under this structure, the UK and the EU could introduce new joint committees and working groups (they are currently used between EEA/EU states) to “bridge the two pillars.” Using the EFTA court would likely entail accepting the constitutional setup of the EEA Agreement, which ultimately grants quasi-direct effect and quasi-supremacy to EU law. It would ensure a certain role for ECJ case law, as set out in the Articles 105 and 111 of the EEA Agreement.

It would also mean that, under Article 102 of the EEA Agreement, disagreement over new legislative acts may lead to the suspension of the respective part of the agreement. In practical terms, should the UK or the EU disagree with a legislative act brought forward by the other side - provided the act falls into an area covered by their agreement(s) - it would be brought to a joint committee which then has six months, or, if this is later, until the entry into force of the legislation, to find a mutually acceptable solution. Should the committee fail to do so, the respective part of the agreement “is regarded as provisionally suspended, subject to a decision to the contrary by the EEA joint committee.” The suspension takes effect six months after the consulting period laid out above ended, but never before the legislative act is actually implemented. Importantly however, “The rights and obligations which individuals and economic operators have already acquired under this Agreement shall remain. The Contracting Parties shall, as appropriate, decide on the adjustments necessary due to the suspension.”

Under the one pillar structure, it would only be the EFTA court that has the final authority on interpretation of the UK-EU treaty for both sides. Complaints against both sides would thus be dealt with by the EFTA institutions, cutting out the ECJ and European Commission. This solution would be unlikely to find favour with the EU. Since the Withdrawal Agreement contains provisions identical to EU law, granting the ultimate authority on its interpretation (for EU actors) on a body other than the ECJ would conflict with the EU’s insistence on legal autonomy. The IfG suggests that these concerns could be mitigated by granting the ECJ the power to overrule the EFTA court in case of legal conflict, yet doubts whether this would be a sufficient measure to make this option politically viable.

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237 Institute for Government, ‘Could the UK sign up to the EFTA Court after Brexit?’, 14 December 2017: https://www.instituteforgovernment.org.uk/blog/could-uk-sign-efta-court-after-brexit-baudenbacher
239 See the ‘Agreement on the European Economic Area’, 1 August 2016, p33: http://www.efta.int/media/documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.pdf
240 Ibid.
Divergence and penalties

The EEA Agreement Article 102 allows the EU to take countermeasures if an EEA member state employs its right of reservation over a piece of EU legislation, or significantly delays their implementation. However, both the EU and EEA countries stress that it has to be used as last resort, only if previous negotiations fail. Crucially, EEA states can only use their right of reservation over a new piece of legislation, not to repeal a law already in place.241 This would create a questionable legal situation, in which parliament’s democratic rights would be seriously constrained.

EEA member states are granted certain flexibility on the adoption of new EU legislation, although this is very limited. The adoption of new EEA-relevant EU legislation occurs through an amendment of the EEA Agreement annexes. According to Article 102 of the EEA Agreement, the decision on this amendment shall be taken “as closely as possible to the adoption by the [European] Community of the corresponding new Community legislation” - indicating that although differences shall be kept to a minimum, they may well exist.242 According to the Norwegian government, such adaptations may concern “delimitation of substantive or geographical scope, institutional adjustments, transitional arrangements or derogations.” However, it also judges that “few transitional arrangements and derogations have been agreed,” partly because “the EU follows a restrictive line as regards transitional arrangements and derogations, because its aim is to achieve the greatest possible degree of homogeneity throughout the EEA.”243

The EEA Joint Committee has to approve of the final form of adoption taken. Concerning case law, EEA member states are forced “to arrive at as uniform an interpretation as possible of the provisions of the Agreement and those provisions of Community legislation which are substantially reproduced in the Agreement,” under Article 105 of the EEA Agreement.244 Should it fail to do so within two months after a difference in case law emerged, the formal dispute resolution mechanism under Article 111 may be applied.

Only once have Iceland and Liechtenstein openly sought to use their right to reservation over a new EU legislative act. In 2004 the EU proposed Directive 2004/38/EC on the right of citizens of the Union and their family members to move and reside freely within the territory of the member states. Both countries complained the directive would overstep the EEA agreement’s legal boundaries, and therefore should not be considered relevant for EEA member states.245 Yet, the third EEA member state, Norway, backed the European Commission and came out in favour of the directive. Iceland and Liechtenstein ultimately accepted the directive. Dr Jóhanna Jónsdóttir of the Icelandic Institute for International Affairs (and formerly senior officer at the EFTA Secretariat), concluded, “Because of this threat of exclusion, Iceland, as well as the other parties to the EEA Agreement, are under very strong

242 See ‘Agreement on the European Economic Area’, 1 August 2016, p33: http://www.efta.int/media/documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.pdf
244 See ‘Agreement on the European Economic Area’, 1 August 2016, p34: http://www.efta.int/media/documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.pdf
245 Jóhanna Jónsdóttir, ‘Can the EU make Iceland comply?’, April 2008: https://ecpr.eu/Filestore/PaperProposal/65b72990-1fa1-4d84-8423-9b4890299e87.pdf
pressure to agree to Joint Committee decisions to incorporate acts into the EEA Agreement and are unlikely to refuse such action no matter how inconvenient it is.\textsuperscript{246}

EEA member states have some leeway regarding the (non-)implementation of EEA-relevant legislative acts coming from Brussels. The European Commission tends to be rather lenient in enforcing timely implementation of its directives and regulations. It prefers prolonging the timeframe of the conciliatory phase to an early triggering of the guillotine clause or other formal sanctions. Considering the high political and economic costs associated with the freezing of a complete (part of an) agreement, this makes sense. Still, so far the EU has essentially always achieved its aim. All three EEA member states have, in almost all cases where they were in open opposition to a new EU legislative act, ultimately backed down and accepted the rules coming from Brussels.

\begin{center}
\textbf{Case Study: Norway’s Third Postal Directive}
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This case is the closest Norway came to exercise its right to refuse to implement legislation in the EEA Agreement. It was also the first time in EEA history that an EFTA state announced the intention to exercise its reservation right. Previously, Norway had avoided the use of the reservation right, given its political symbolism.

On 23 May 2011, Norway’s Labour-led government announced that it would use the right to veto the Third Postal Directive (2008/06/EC), which opened up competition to the delivery of letters of less than 50 grams. It was argued that the directive could threaten the Norwegian postal system, cutting down wages for postal workers and leaving Norwegians living in remote areas without postal service. The use of the reservation right was also encouraged by a rise of general anti-EU sentiment in Norway.

The EU considered implementing sanctions against Norway, threatening to exclude it from parts of the single market. As noted above, the EU could have initiated Article 102 to exclude Norway from the parts of the Annex to the Agreement concerned with postal services.

The European Commission also found that another 427 acts had not been implemented into Norwegian law, when their “compliance date” had expired. The Commission stressed, “In line with the provisions of the EEA Agreement, the EU should continue to urge the EFTA side to address the backlog of outstanding EU acts” and that it should “develop a response strategy” if EFTA members apply EEA legislation selectively.

But despite these threats, ultimately there was no punishment against Norway’s delay, which meant that Oslo managed not to put into force the EU postal directive for over three years, without negative consequences from Brussels.

A new Norwegian government elected in 2013 ultimately reversed the decision and implemented the Directive. However, it also stressed, “It is essential for Norway that the EU understands the need for flexibility and adaptations to legislation that take account of our national needs.”

It is difficult to know what would have happened if the Norwegian government stood by its decision not to implement the directive or did not implement the other acts.

\textsuperscript{246} Ibid.
Another failed attempt

In 2012, Oslo attempted to negotiate an exemption from the guarantee limit of the Deposit Guarantee Schemes Directive, which conflicted with the domestic Norwegian deposit guarantee scheme, via the EEA mechanism. The Norwegian Minister of Finance, Sigbjørn Johnsen, sent a letter to the EU finance ministers to argue that Norway’s exemption from the scheme would not “have any distortive effects on competition.” The EU refused to grant the exemption, and Norway in the end complied.

Mechanisms used in EU FTAs

The EU has included dispute settlement mechanisms based on the WTO model in all its free trade agreements since 2000. Since 2009, investor-to-state dispute settlement mechanisms also feature in all its trade and investment agreements. Moreover, the European Commission has, since 2015, pushed for the establishment of a multilateral investment court as a permanent body.

Dispute settlement mechanisms

Under CETA, disputes that cannot be solved in a voluntary mediation phase are being brought before an arbitration panel. This panel consists of three arbitrators appointed by the parties in a consultation. If parties cannot agree, then the Chair of the CETA Joint Committee will draw by the lot the arbitrators from the list established under Article 29.8. The Panel produces an interim report, on which the parties can comment, before a final report is produced. Both parties must comply within reasonable time, and if they do not then the requesting party may suspend obligations or receive compensation. While cross-retaliation between sectors seems to be allowed, there is an interesting exception made for the financial services sector. According to Article 13.20(5), if the arbitration panel finds a measure taken by either side is inconsistent with the agreement, but the measure does not affect the financial services sector, then the complainant must not suspend benefits in the financial services sector in return.

The Dispute Resolution Mechanism applied in the EU-South Korea FTA is based on the WTO model as well. Again, following a consultation period, any dispute is referred to an arbitration panel composed of three experts, which are either chosen by both parties or selected by lot from a list previously agreed upon. The panel, which may receive submission from the parties involved and whose hearings are public, has 120 days to rule from the day of its establishment. The decision it takes is binding. The party at fault is granted a reasonable (as agreed by parties or decided by an arbitrator) period of time to comply with the judgement. If the transgression is not remedied in time, the case can be referred back to the panel, with whose agreement the complainant may then issue proportionate sanctions. All time limits in

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the procedure can be reduced in cases of urgency. A special accelerated dispute settlement is foreseen for the car sector, with the period foreseen for an arbitration panel ruling reduced from 120 to 75 days.

The agreement also contains a special mediation mechanism to deal with non-tariff measures. This mechanism does not aim at judging the legality of any act, but seeks to find quick and effective solutions to market access problems. While it may involve a mediator, his opinion or recommendation is not binding. Both parties can still seek legal recourse through the arbitration panel afterwards.

Importantly, the DRMs in these trade agreements do not grant ultimate authority to the ECJ. However, neither of the agreements governed by them base themselves, not even partly, on European law. This will likely be different in a future UK-EU relationship. Since at least the Withdrawal Agreement will include provisions identical to EU law, the EU will be insistent on giving ultimate authority on its interpretation to the ECJ. While simple arbitration courts as used in CETA and the EU-South Korea FTA will not be sufficient to govern the entirety of the UK’s future trade relationship with the EU, they may still provide a useful model to be used in those parts of the agreement that fall outside the scope of European law, and where the work of joint committees failed to solve a dispute.

Divergence and penalties

The EU-Japan trade agreement clearly determines appropriate retaliation measures the EU may take if Japan defaults on certain commitments made under the agreement. Under the agreement, Japan committed to align its standards on cars entirely with those of UNECE, which are the ones the EU applies. The Commission judges that this alignment “should lead to the removal of all regulatory barriers for accessing the Japanese car market.” However, the agreement introduces a safeguard clause, which allows the EU “to reintroduce tariffs in case Japan stops applying UNECE Regulations or reinstalls removed NTMs [non-tariff measures] (or develops new ones)” in the sector. This safeguard clause is limited to ten years. It was reportedly introduced after severe pressure by the French and Italian automobile industries, who feared that Japan would not do enough to actually reduce non-tariff barriers for European exports. It may be useful also in a future UK-EU treaty to directly set out the appropriate retaliatory measures that can be taken to punish either side for defaulting on its commitments.

The EU-South Korea free trade agreement also contains safeguard clauses. These do not refer to regulatory cooperation however, but rather to sudden surges in imports experienced by the other side. Both the European Parliament and industries have the right to ask the Commission to launch an investigation where they think that the FTA’s reduced customs duties led to excessive increases in imports from South Korea. Where the investigation finds that the lower duties cause or threaten to cause “serious injuries” to EU producers, it may decide to stop further reductions in duties or increase them to their initial levels. A similar clause is

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252 Ibid. 
contained in the EU’s agreement with Singapore. In both cases, it is further specified that, where one party invokes the safeguard clause and raises duties, it must consult with the other party and offer “appropriate trade-liberalising compensation in the form of concessions having substantially equivalent trade effects or equivalent to the value of additional duties expected to result from the safeguard measure.”

With respect to the future UK-EU relationship, it seems unlikely that a safeguard clause would be introduced to protect either side against a sudden rise in exports from the other side -- both sides already benefit from zero-tariff trade in goods and the aim for most industries is to keep trade as open as possible. What is more realistic, are safeguard clauses on the UK’s adherence to EU regulations -- either in the sense that they may not diverge from regulations they follow already, or that they have to adopt or align themselves in a timely manner with newly introduced EU regulations in areas where it has been previously agreed. Here the key point may be to what degree breaches of such obligations will either be penalised according to pre-agreed clauses, or settled through more complex dispute resolution mechanisms.

Who defines the proportionality of retaliatory/rebalancing measures?

Most trade agreements today allow for retaliatory/rebalancing measures to be taken in case of one side’s non-compliance with treaty obligations. Where the punitive measures are not prescribed in detail in the agreement already, it is generally stipulated that any such measures need to be “proportionate.” But who decides what is proportionate and what is not?

**EEA Agreement**: The EEA foresees rebalancing measures for the case that either side invokes the safeguard measures granted under Art. 112. If disputes arise about either the proportionality of the safeguard measure itself, or about the rebalancing measures taken in response to it, the Joint Committee is granted three months to resolve the dispute. Where no agreement on the proportionality can be reached at the committee stage, either side can bring the case before an arbitration panel. The panel consists of three judges, one of each party and one jointly selected third country national.

**CETA**: Under CETA, the harmed party may suspend part of its own obligations under the agreement as a retaliatory act. The agreement stipulates this suspension must be “equivalent to the nullification or impairment caused by the violation.” Any disagreement over the equivalence of a retaliatory act is referred to an arbitration panel.

**EU-Japan | EU-South Korea**: Similar to CETA, these agreements allow the complainant to suspend “concessions or other obligations” as a rebalancing act. This must be “at a level equivalent to the nullification or impairment.” If the party affected by these retaliatory measures deems them not equivalent in effect, the panel that judged on the non-compliance initially is tasked to judge on the equivalence of the retaliatory measures taken in response.

Switzerland’s relationship with the EU

The EU has also committed itself to other setups for dispute resolution in its trade relationships. Among these different models, the one used by Switzerland is special in so far

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255 See ‘Free Trade Agreement between the European Union and the Republic of Singapore’: [https://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwip5t7g5t7YAhXDhQKHWAACaQEganMAA&url=http%3A%2F%2Ftrade.ec.europa.eu%2Fdoclib%2Fhtml%2F151732.htm&usg=AOvVaw0Cm1Y4nIwozc-mgFv-gYg](https://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwip5t7g5t7YAhXDhQKHWAACaQEganMAA&url=http%3A%2F%2Ftrade.ec.europa.eu%2Fdoclib%2Fhtml%2F151732.htm&usg=AOvVaw0Cm1Y4nIwozc-mgFv-gYg)
that it is strictly limited. There is no formal dispute resolution mechanism with sanctioning powers governing the economic relationship between Switzerland and the EU, except in the area of air transport. Instead, both countries rely on a system of joint committees to govern the majority of their over 120 bilateral agreements. Prior to the committees’ consultation, the ECJ publishes its non-binding decision on the matter. However, there is no arbitration court with binding decision-making powers located above the joint committees.

Moulding a new UK-EU dispute resolution mechanism with the Swiss model as blueprint is unlikely to find favour in Brussels, however. The EU has repeatedly voiced its discontent over its arrangement with Switzerland, which it sees as “complex and unwieldy to manage and [it] has clearly reached its limits.” In January 2018, the European Commission proposed to Switzerland a reform of their joint DRM. Rather than continuing to rely on joint committees only, the EU seeks to establish a two-tier system with an arbitration panel as first step and an enlarged role for the ECJ. While this does not mean a complete rejection of joint committees on the EU side - indeed, they are used in various other agreements as well - it indicates that the EU will be unwilling to replicate the Swiss model in any new deal, and would seek at least a reformed version of it.

Some of the Swiss-EU agreements are connected by a “guillotine clause.” This clause governs the seven sectoral agreements of the ‘Bilateral Agreements I’ on the free movement of persons, technical barriers to trade, public procurement markets, agriculture, research, civil aviation, and overland transport. Where the respective joint committees cannot find agreement on solving a dispute relating to specific regulations in one of the sectors, the complainant can invoke the guillotine clause, rendering all related sectoral arrangements void. Guillotine clauses are also present in the EU’s agreements with EEA member states. Such a rule would put serious pressure on the UK, since the failure to abide by EU regulations in one sector could in theory drastically limit market access for other parts of the economy as well. However, while its drastic nature makes it a strong deterrent, it also restricts its actual employment. Due to the considerable impact that freezing a whole sectoral agreement has economically on both sides as well as politically, the threshold for its use is high. It has never been invoked against Switzerland or the EEA countries.


257 Brunsden and Atkins, ‘EU’s Swiss proposal could serve as Brexit blueprint’, 19 January 2018: https://www.ft.com/content/4164a5f0-fc6f-11e7-a492-2c9be7f3120a

How do EU regulations enter into law in Switzerland?

EU passes new regulation, either a Regulation or a Directive, in sectors covered by Swiss-EU agreements

**Regulations** are both directly applicable and have direct effect in EU member states
- Member states do not need to pass an act of parliament in order for these to pass into law
- National courts can recognise and enforce these laws

**Directives** are not directly applicable in EU member states and have no direct effect
- Member states must implement the requirements of the directive through their domestic legislative process within a deadline
- National courts cannot recognise these until they have been implemented in national law

**Regulations and Directives** are not directly applicable and have no direct effect in Switzerland
- Swiss-EU agreements are not automatically updated – Switzerland must decide whether to comply with new EU regulations

Swiss Federal Council approves decision to transpose EU Regulation/Directive into Swiss domestic law

Switzerland and EU arrive at a negotiated settlement

EU Regulation or Directive passes into Swiss law through domestic legislative process
- Relevant Swiss-EU agreement amended / new treaty agreed to recognise Swiss equivalence with EU legislation

Swiss Federal Council decides not to implement new EU Regulation/Directive. Negotiations take place in relevant Swiss-EU joint committees with the aim to achieve a mutually acceptable compromise

EU and Switzerland do not arrive at negotiated settlement. The EU imposes market restrictions in relevant sectors as Swiss regulation is no longer deemed equivalent. Political negotiations may still continue

On certain issues, EU can choose to enact “guillotine clause”, terminating all bilateral agreements covered

Source: Open Europe
The WTO model

The most basic model of dispute resolution is provided by the WTO. Under the WTO Dispute Resolution Understanding (DSU), all member states can initiate proceedings to establish whether countries are discharging their obligations under the WTO agreement. The system is state-to-state only, and has three stages:

1. **Consultations**: Consultation between the disputing parties, possibly through voluntary use of good offices, conciliation and mediation. Parties must attempt to find a mutually agreed solution for 60 days before they can proceed to the next stage.

2. **Adjudication**: If the parties cannot find a mutually agreed solution by consultation, they must notify the Dispute Settlement Body, a committee comprising ambassadorial representatives from all WTO states. The DSB must then establish a ‘panel’ – a group of three or five lawyers or legal academics. There is a different panel for each dispute. Panellists may not be nationals of the states which are parties to the dispute. The panelists hear the legal arguments, and then issue an interim report of their findings. Parties are invited to make comments. Then the panelists draft a final report, which they circulate to all WTO members. Within 20 days of the report being circulated, the DSB ‘adopts’ the report, unless there is an appeal from one of the parties. If a party does appeal, the Appellate Body hears the appeal and conducts a review within 90 days.

3. **Implementation**: Once the panel of the Appellate Body has delivered a final report and it has been adopted by the DSB, ‘prompt compliance’ is expected. Member states must implement them immediately, or if not possible then within a ‘reasonable period’ (45 days, 90 days or a time established through arbitration). If a party does not comply, it is expected to offer an extra trade concession as ‘compensation’ to the other party. If it does not, then the injured party may suspend a concession (with the authorisation of the DSB).

The WTO system is used to enforce WTO law under WTO agreements. This means there is only limited protection for trade in services, something that may be a key concern for the UK in its future relationship with the EU. It is also sparsely used only, with just 488 cases dealt with over the past two decades, compared to more than 1,700 cases brought before the ECJ in 2016 alone. Importantly, the WTO does not enforce EU law or any other third agreements, which means that it is unlikely to be a useful tool to resolve disputes over the withdrawal agreement.

Should negotiations between EU and UK collapse, however, the UK will be reliant on this system for the resolution of trade-related disputes between itself and the EU. UK trade officials will also need to become re-acquainted with the WTO mechanisms since the UK would need to rely on them for disputes with certain other non-EU countries. Currently, the European Union acts on behalf of the UK in WTO trade disputes.

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259 Armstrong and Bernard, ‘How will we enforce post-Brexit trade deals?’, 25 November 2016; http://ukandeu.ac.uk/how-will-we-enforce-post-brexit-trade-deals/
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