

## Can the UK Negotiate a New Kind of Free Trade Arrangement?

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### Introduction

In the UK referendum on Brexit, a small majority in the whole UK voted to leave the EU, but those who advocated leaving had never made considered suggestions about what should be done. There was no serious discussion, and certainly no consensus, even among the Leavers. No such an immensely important national decision has ever been undertaken with so little consideration.

A year later, there is still no clear agreed description of what Leavers want. This is in spite of the economic harm caused by continuing uncertainty, the increasing exasperation of the other EU Member States, the loss of respect which the UK is now suffering, and the general agreement of almost all well-informed people that Brexit, whatever its results may be exactly, is from an economic standpoint an extremely serious mistake.

In the light of this uncertainty, it seems useful to consider what objectives the UK might try to achieve, and to see if there is a realistic chance that they might be obtained. There has been very little public discussion on these lines, and still less analysis of the possible objectives, although both discussion and analysis are particularly necessary because the UK government, insofar as it has discernible ideas, is envisaging an EU-UK agreement that would not fit into any recognised category.

The UK prime minister has said that she does not want to reveal her negotiating position. It is normal in negotiation not to disclose the minimum that one would ultimately accept. But it makes no sense, and is clearly contrary to universal practice in international negotiations, not to give general indications of what is intended, so as to find out how far, and subject to what conditions, it (or something like it) might ultimately be agreed. Useful dialogue is not possible on any other basis.

So far the UK government has used only meaningless phrases. This lack of professionalism can be explained as the result of several factors. The politicians concerned are inexperienced in international negotiations. They do not know what they want. They have failed to listen to their experienced advisers. They suffer from ignorance and confusion about the basic principles of the EU customs union and single market, and of the constraints resulting from World Trade Organisation rules. The complications of negotiating free trade in services are less clearly understood than trade in goods, although services are now more important, in particular to the UK. (For example, for services the UK would need to accept constraints both on

undue laxity in the regulation of UK companies and on excessive obstacles for EU companies providing services in the UK).

The politicians also suffer from ignorance of the basic principles of the EU, due to the long-standing dislike of the EU in the UK. The English (the Scots are different) were always reluctant participants in the EU, and did not understand or share the wish to cooperate to ensure peace, prosperity, and human rights in Europe. Lastly, the UK is facing the impossible task of trying to deal with non-economic prejudices by devising economic solutions.

There is a further complication for the EU-UK negotiations, when they get going. The EU negotiators will be well aware that UK companies, even if there is no EU-UK agreement, will be free to set up subsidiaries in the EU. When they do so, and providing that the subsidiaries comply with EU law, they will be able to get all the advantages of the single market. On the other hand, if there is no EU-UK agreement, the EU companies will be guaranteed almost no corresponding rights in the UK. (For example, subsidiaries in the EU will be protected from unfair State aids by EU State aid rules, but EU companies would be protected from UK State aids, if at all, only by WTO rules). It will be one of the aims of EU negotiators to counterbalance this lack of symmetry.

In spite of all these complications, and at the risk of speculating unduly, this paper considers the possible aims of the UK, and analyses the likelihood of achieving them. Readers may be surprised to find that some conclusions can be suggested. In brief, the main conclusion is that it would be difficult or impossible to negotiate a special new agreement, but that all the UK's legitimate objectives would be achieved if the UK would join the European Economic Area. The EEA offers the best, and perhaps the only, solution, both for the UK as a whole and for Scotland and both parts of Ireland, because it would enable them to sell freely in both the EU and the UK, substantially as at present.

### The customs union

The customs union is essentially a border around the EU. Goods entering the EU pay any applicable EU tariffs when they cross the border. Goods produced in the EU are inside the border, and it is not relevant for them. EU Member States all must apply the same tariffs and customs procedures. They are not free to make bilateral trade arrangements with non-EU States. Once inside the border, goods may circulate freely.

The UK wishes to be able to make bilateral trade agreements with non-EU States, and so must leave the customs union. It is not possible to be partly in the customs union, or in it for some products and not for others.

The UK wants to be able to make trade agreements with non-EU States because that would enable it to import cheap food from outside the EU, and to seek trade concessions in return for doing so. Since this policy would benefit UK consumers at the expense of UK farmers, it is never mentioned officially.

## The single market

Unlike the EU customs union, the single market is not the result of a single EU measure. The phrase describes the result of all the EU rules that have been adopted to produce conditions of competition that are similar or equal throughout the EU, as far as legislative and other State measures are concerned. These rules deal, among other things, with State aid, harmonisation of legislation on services and technical barriers to trade, mutual recognition of approvals and certification, harmonised rules on solvency of banks, and reciprocal enforcement of court judgments. In short, the single market is intended to be a level playing field for freedom of movement of goods, services, capital, establishment and individuals.

The single market is therefore the package resulting from the progressively evolving body of EU measures designed to eliminate or minimise obstacles to free movement throughout the EU.

Companies that comply with the requirements of the single market benefit by being able to offer their goods and services throughout the EU. The UK apparently would like UK companies to be able to do this ("to have access to the single market") without having to comply with the EU requirements. The intention would be to allow UK companies to have all the benefits of the single market while simultaneously having all the competitive advantages of being unregulated or less strictly regulated in the UK. It should be obvious that this would be unacceptable to the EU. The single market is the result of many years of negotiations designed to lead to compromises providing broadly balanced results for all Member States; There could be no question of allowing a non-EU State, such as the UK after Brexit, to get all the benefits of the single market without undertaking any of the corresponding obligations.

Some UK politicians believe that it would be possible to negotiate arrangements under which the UK would get some of the benefits of the single market in return for accepting some of the obligations. This is discussed below.

If the UK were not in the single market, it could remain in the customs union, if it were willing to do without the power to make trade agreements with non-EU States. This would mean that there would be no tariffs on trade between e.g. the UK and the Republic of Ireland. But goods and services originating in the UK would still have to comply with all the EU single market requirements when they were imported into the Republic

The UK has apparently decided not to remain in the single market, for two reasons. To remain, the UK would have to accept greater freedom of movement of persons than the UK apparently wants. The UK would also have to accept the jurisdiction of the European Court of Justice. Surprisingly, these two features are thought to outweigh the economic benefits of the single market.

## The European Economic Area (EEA)

Free trade areas may be set up under World Trade Organisation rules. In a free trade area, each member can trade with the other members without tariffs or quotas, and is free to make bilateral or multilateral trade agreements with other countries : there is no common external tariff.

The European Economic Area is a free trade area, of which Iceland, Norway, Liechtenstein and the EU are members. The EEA is however more than a free trade area, because it has been designed to allow the three non-EU States to be in the single market. For this purpose they are expected to adopt and to continue to copy all EU single market measures, so as to provide "homogeneity", that is, economic regimes essentially the same as those in the EU. The EEA has its own small equivalent to the Commission (the EFTA Surveillance Authority) and its own court, the EFTA Court. Unlike the European Commission, the EFTA Surveillance Authority has no policy-development role; it is concerned only with the application of EEA rules. The EFTA Court usually follows the case law of the European Court of Justice, but deals very efficiently where necessary when new issues arise. EEA arrangements do not apply to agricultural products, but they provide for free movement of goods, services, establishment, capital and individuals. The EEA has no common policies for agriculture, fisheries, taxation, security or energy. These are dealt with, insofar as international arrangements are concerned, by separate agreements.

The effect of "homogeneity" is that the three non-EU States are in the single market, but not in the EU customs union. If the UK were willing to join the EEA, it would essentially remain in the single market also. (Rules of origin would be needed to deal with goods originating in other countries so a customs frontier will be needed for this purpose). However, it seems that the UK is not willing to do this, for three possible reasons. The EEA would oblige the UK to accept greater freedom of movement of persons from the EU than the UK is apparently willing to accept. Being in the EEA would mean that the UK would have to copy all EU single market measures without being able to influence them. The EEA would also mean that the UK would be subject to the jurisdiction of the EFTA Court, and it is not clear that the UK would consider this very much better than the European Court of Justice.

From a purely economic point of view, the EEA would give the UK both the freedom to make bilateral agreements with non-EU States and the benefits of being in the single market. The same thing would apply to Northern Ireland if it were enabled to join the EEA separately, as proposed in a paper circulated by professors in Queen's University Belfast.

The EEA solution would not deal with agriculture, fisheries, energy or security. They would have to be dealt with by specific agreements. However, adapting the EEA solution would not make it any more difficult to deal with these issues.

## The World Trade Organisation (WTO) rules

At present the EU makes trade agreements exclusively on behalf of EU Member States, as a single member of the WTO. When the UK leaves the EU, it will no longer have the benefits of any of the agreements that have been made by the EU. Because of the EU's size and bargaining strength, these benefits are very great, and the loss of them will be very serious for the UK.

If no new trade agreement is made between the EU and the UK, they will each be bound by the rules of the WTO. There are several rules that are relevant. One is that the EU will be obliged to treat the UK as any other non-EU State, and impose the existing EU external tariff on imports from the UK into the EU. A second rule would oblige the UK to continue to apply the tariffs that it now applies (that is, the EU external tariff) until the UK reduces them, on a non-discriminatory basis, in accordance with WTO principles. The UK will presumably do this, to obtain low cost agricultural imports, and to get some trade concessions from the low cost countries in return for doing so. The UK will need to negotiate new trade agreements with every country in the world with which it wishes to trade, and until it has done so it will only have the same rights as any other WTO member to sell to those countries. The UK would have lost all the trading advantages to which it is now entitled as an EU State.

Another WTO rule that may prove to be important prohibits subsidies for exports. This would mean that the UK would not be free to compensate UK companies for loss of the ability to export tariff-free into the EU. The UK apparently promised to do this, illegally, if the situation arose. If the UK gave export subsidies, the importing countries or the EU could impose countervailing duties.

Another WTO rule that may prove to be even more important is the rule that States must give one another most-favoured-nation (non-discriminatory) treatment. Any EU-UK agreement that is not for a free trade area or a customs union, insofar as it concerned goods, would need to comply with this principle. This would mean that any concession given by the EU to the UK would automatically have to be extended to all WTO members, which would make any such concession impossibly expensive for the EU. This means that many of the ideas discussed below would be excluded for this reason, even if they were otherwise acceptable.

### Free movement of persons

Free movement of individuals, whether as employees, self-employed persons, or as investors or owners of businesses, is an essential component of the "four freedoms" (goods, services, persons and capital) that are the basis of the single market.

The UK wishes to control, limit and regulate immigration. It says it cannot control immigration from the EU States while it is in the EU, because controls would be inconsistent with the EU rules on free movement. However, the UK has never strictly or comprehensively controlled immigration from non-EU States, although it has

always been legally free to do so. It is therefore not clear how or how far it wishes to control immigration from EU States. It is not even clear whether the UK envisages controls at the UK frontier (harbours, airports) or by some other method of controlling individuals before they have entered the UK.

Until the UK has decided what it wants to do, and how and how far to do it, nobody can say whether its proposed future policy could be reconciled with EU principles. In other words, it is not even clear that the UK needs to leave the EU for this reason. However, one has to assume that it does. If the UK were willing to accept some limits on its freedom to restrict immigration from the EU, it should be possible to find a reasonable solution involving "managed free movement". If the UK's proposed policies, when they have been decided upon, are known, and if they are considered to be incompatible with EU rules, that would mean that the UK cannot be in the single market, either in the EEA or in some newly negotiated free trade agreement

The UK government has said that it wants to negotiate a new "ambitious and comprehensive" kind of free trade agreement. Although the UK has not said so, several things are clear. It would need to be comprehensive, as required by WTO rules. It would need to deal with services, in particular financial services, because they are so important to the UK economy. It would need to deal with non-tariff barriers, because they are more important than tariffs in modern trade. It would have to limit the extent to which the UK could subsidise its industry. It would have to include a legally binding mechanism for dispute resolution.

No clear indication has been given to say precisely what, if anything, the UK has in mind. There is no obvious precedent, theme or concept for such an agreement. The descriptions might mean anything. Philip Hammond and David Davis have expressed different views, but neither of them is precise or clear. The impression given by UK civil servants is that they are not confident that there is any clear idea (they are not merely saying that they are not free to reveal it).

The EU negotiating guidelines (para 20) make it clear that any free trade agreement cannot amount to participation in the single market, "or in parts of the single market".

In theory, the UK might be thinking of several possibilities

1. An agreement applying to some sectors of business only. But that would not be "comprehensive" as Hammond suggests and WTO rules require. The EU would not agree to free trade only in sectors in which the UK thought British industry is most competitive. No UK government could defend an agreement that gave some sectors (e.g. financial services) the benefits of free trade and gave other sectors nothing. An agreement only on services and not on goods would not be "wide ranging" as the EU guidelines require, and would benefit London and not the rest of Britain, increasing the economic divisions within the UK. It would be technically difficult to define the sectors to be liberalised, and this would lead to disputes over the scope of the

agreement, which would lead to litigation. It would benefit the EU States with the sectors being liberalised, and do nothing for the other EU States. The EU is not now satisfied to allow Switzerland to continue to have a large number of separate arrangements on specific sectors or issues, so it would not agree to the UK obtaining a similar set of arrangements, even under a single umbrella agreement.

2. In theory, an agreement that was not confined to specific sectors might be limited to specific obligations and benefits. Obligations might be narrower in scope, or expressed loosely or vaguely, or with ineffective enforcement procedures.

For example, the agreement might, in theory, be written in such a way that the UK undertook no obligations in respect of public supply or service contracts, or undertook no obligations to limit State aid or subsidies by tax or otherwise. Public enterprises might be excluded from the UK's obligations, or "services of general economic interest". The UK might try to obtain "passporting" or mutual recognition rights without accepting an obligation to maintain harmonised legislation.

No such exclusion or omission would be acceptable to the EU. It would be an "unfair competitive advantage", ruled out by the EU guidelines (para 20). It would inevitably create a serious imbalance, which no competent EU negotiator could accept. It would mean that the UK would get the benefits of the single market without the corresponding obligations. This would be so in particular because any of these omissions could be used to create a competitive advantage for almost any sector in the UK at any time in the future. It is relevant that before the UK joined the EU in 1973 there was evidence that the UK was not complying with its obligations in respect of public contracts for aeroplanes and computers. All this would be particularly important if the UK government seeks to promote economic change through State measures.

The UK might propose to accept only obligations expressed loosely, vaguely or ambiguously. Ambiguous language to cover real disagreement is well known in English history. This would be bad legal drafting, which the EU would not accept. The UK will be reminded that it must agree to a dispute settlement procedure ultimately involving a court, and courts ought not to be required to clarify deliberately defective language.

The UK might propose a comprehensive agreement, but one under which disputes would be subject only to consultations and settled only by mutual agreement, without recourse to a court. This approach has been ruled out by the EU in the case of Switzerland, and it is impossible to imagine that the EU would accept any version of it in the case of the economically much more important UK. Decisions on EU-UK disputes must be legally binding and

enforceable. Any such approach would be regarded as a retrograde step, back to WTO practice, which is widely regarded as insufficient.

3. The UK might propose to accept all or most of the present EU single market measures except those dealing with free movement of persons. This would be unacceptable to the EU, for several reasons. First, the single market measures have always been designed as a balanced package of which free movement of persons is an essential part. Such a UK proposal would deprive workers of one of the principal benefits of the EU. It would deprive the inhabitants of the less developed regions of the EU of the right to move to areas offering better opportunities. Second, the UK could restrict or frustrate freedom of establishment and services, and free movement of capital, if it were free to prevent companies from the EU States from bringing their key employees with them when they wished to establish operations or provide services in the UK.

4. A free trade agreement that said little about services would bring little benefit to either the EU or the UK. But most economically important services are regulated, so there would have to be constraints on the way or the extent to which they could be regulated. Even if the UK were willing to agree to such constraints, it would be extremely difficult if not impossible to define the permissible limits of regulation of a wide range of services for the future.

5. The UK might agree to accept all the existing EU single market measures but undertake no obligations to copy future measures. Such a proposal would fall short of the EEA arrangements, and would not be accepted by the EU. It would mean that the EU-UK arrangement became progressively out of date, and that the UK had accepted no obligation to deal with new problems as they arise.

6. Another suggestion that has apparently been made is for the UK to make a large contribution to the EU budget, and in return for the EU to give UK financial institutions the right to do business in the EU, while being subject to less strict UK regulation. This would be a subsidy by the UK taxpayer for the UK financial institutions, and a subsidy for the UK financial institutions by the EU financial institutions. The mere fact that this suggestion, which is clearly unacceptable, has been made, shows how little thought has been given by the UK to EU-UK relations.

## Conclusion

In short, it seems unlikely that the UK's efforts to negotiate a completely new kind of agreement will be satisfactory or successful. Indeed, it is hardly necessary to spell out the difficulties in as much detail as has been done here.

None of this should be surprising. There are clear and well-known economic and

legal reasons why any "ambitious and comprehensive" trade agreement ends up looking very like either the EU or the EEA. A State that wants fewer obligations than EU Member States cannot expect to obtain greater benefits than EU States. Well-designed trade agreements provide balanced benefits and obligations, and the UK's wish to get the benefits without the obligations was never realistic. In fact, Brexit was always based on a combination of ignorance, prejudice and nostalgia. Leavers knew nothing of the history of the EU or the EEA. Trade negotiations have their own inescapable logic that limits the number of possible solutions.

Inexperienced or ignorant negotiators cannot create new solutions by starting with naive and mutually contradictory aims. Those who advocated Brexit have consistently disregarded all the evidence, all the arguments, and all the weight of opinion of people who know what they are talking about. The impression that the UK has no clear and obtainable vision of what it wants is not misleading: it has not. Obtaining a clear and reasonably satisfactory result depends on the UK negotiators coming, however slowly, to understand this, and to abandoning some or all of their original objectives. Success is not guaranteed. The UK may end up with the World Trade Organisation "for slow learners". That would make Brexit very much more damaging to the UK economy than it will be anyway. Everything depends on how obstinate and unrealistic the Leavers prove to be.

The detailed discussion, above, of hypothetical possibilities shows that the only realistic alternative to EU membership that is satisfactory for the UK from an economic viewpoint is the EEA. Everything therefore depends on whether and how soon the UK can get over what seem to be its objections to the EEA: freedom of movement of persons, a court, and the need to copy EU measures. Once it is understood that any substantial and worthwhile free trade agreement between the UK and the EU will involve an administrative body like the EFTA Surveillance Authority and a court, it will be seen that it would be foolish to duplicate the institutions of the EEA. Even if the UK is slow to abandon these objections for the UK as a whole, it should be willing to abandon them in relation to Northern Ireland, as suggested by the Queen's University professors, to avoid serious damage to the economy there