THE FUTURE UK-EU RELATIONSHIP

RE-EXAMINING THE EEA AND OTHER OPTIONS

The uncertain outcome of the UK election on 8 June has reopened the question of what the UK's future relationship with the EU should be.

Whilst few doubt that the UK will actually leave the EU, many are asking whether a 'soft' Brexit is now more likely, and whether the UK may remain, in the short or longer term, a member of the European Economic Area which links Norway, Iceland and Liechtenstein to the EU's single market, but not its Customs Union.

This briefing re-examines the UK's options for its relationship with the EU following the UK's withdrawal, including the EEA Agreement, bilateral agreements on the Swiss model, a Customs Union agreement, a Free Trade Agreement and a "no-deal" scenario of trading on WTO terms.

EXECUTIVE SUMMARY

This Briefing examines the rights and obligations arising from each of the possible options for the UK's future relationship with the EU. Whilst the UK's relationship will by definition be unique to the UK, its legal foundation will have much in common with existing models.

Certain structures, like the European Economic Area / European Free Trade Association, are comparatively rigid in their content; a country is either a member on their terms or it is not.

Other models like a Free Trade Agreement can be more or less comprehensive, in terms of market access for goods and services, depending on how they are calibrated.

The available models are set out on the next page.

Key issues

The UK has invoked Article 50 and will cease to be a member of the EU by 29 March 2019, unless the timeline of 2 years is extended.

The following options are available to the UK for its future trading relationship with the EU:

- Secure European Economic Area and European Free Trade Association membership
- Conclude Bilateral Agreements and become part of the European Free Trade Association
- Establish a Customs Union agreement with the EU
- Negotiate and conclude a new international trade deal: UK-EU Free Trade Agreement
- If a trade deal cannot be concluded, rely on WTO rules

Yes | No | Partial

	Access to the EU Internal Market	Freedom to set own external trade policy	Membership of European Council Commission Parliament	Court of Justice of the European Union jurisdiction	Application of EU Social and employment policy	Application of EU Common Agricultural Policy	Obligation to contribute to the EU budget	Participation in Justice and Home affairs measures	Membership of the Schengen area	Application of EU Charter of Fundamental Rights	Freedom to regulate own Financial Sector	Membership of the euro
1 (Norway) EEA/EFTA	Yes	Yes	No	No	No	No	Yes	No	No	No	Partial	No
2 (Swiss) Bilateral agreements + EFTA	Partial	Yes	No	No	No	No	No	No	No	No	Yes	No
3 (Turkey) Customs Union agreement	Partial	Partial	No	No	No	No	No	No	No	No	Yes	No
4 Single / multiple FTA or IAs	Partial: Dependent on details of agreement	Yes	No	No	No	No	No	No	No	No	Yes	No
5 WTO	No	Yes	No	No	No	No	No	No	No	No	Yes	No

1. European Economic Area (EEA) / European Free Trade Association (EFTA)

EEA and EFTA membership would mean pursuing a relationship similar to that enjoyed by Norway (as well as Iceland and Liechtenstein) as a member of the EEA and the EFTA.

While the UK would maintain access to the EU's Internal Market, it would lose all formal legal influence over legislation while having to implement the bulk of it. It would not be a party to the EU's Customs Union and would therefore have to apply Rules of Origin regulations.

As an interim solution, EEA membership would be challenging. The UK would have to negotiate with EFTA first because it is not possible to be a member of the EEA without being a member of either the EU or EFTA. All of the four current members of EFTA would have to agree to the UK becoming a member. This could be straightforward if the existing EFTA membership were amenable to maintaining existing opt-outs from particular pieces of EU law which the EFTA members have adopted, such as Schengen, but could be more complicated if the existing member states did not agree with the UK's current position.

Also, given the need for ratification of new treaties, it is questionable whether this could happen by 29 March 2019. It is also questionable whether the EU would be able to treat the UK as if it were a member of the EEA under the Withdrawal Agreement without the consent of the other EEA members.

Despite the challenges of adopting the EEA model as an interim solution, it would provide the most comprehensive market access as a bridge to longer terms arrangements between the EU and the UK.

2. Bilateral agreements, or the "Swiss" model

Opting for an arrangement that is a combination of bilateral agreements while joining EFTA, similar to Switzerland would be difficult.

This option would mean that the UK would not have to automatically implement EU Internal Market legislation – the UK could instead conclude agreements on a case-by-case basis. The enforcement of the agreements within UK would also solely be in UK's hands, as there would likely be no agreed enforcement mechanism.

The EU has however indicated that it does not believe this piecemeal approach is acceptable in its relationship with Switzerland. It is unlikely that it would accept it with a larger partner such as the UK.

3. A Customs Union agreement with the EU, or the "Turkish" model

The UK could pursue a similar relationship to the one enjoyed by Turkey by entering into a Customs Union agreement with the EU.

The Conservative government is however currently committed to withdrawing from the EU's Customs Union. This option was initially mooted by many as an amicable solution, but the Chancellor of the Exchequer, Philip Hammond, said in his Mansion house speech on 21 June that the UK should be "outside the Customs Union itself, but with current customs border arrangements remaining in place, until new long-term arrangements are up and running."

This suggests that access to the EU Customs Union would form part of an interim agreement. This is controversial in itself as it would delay the entry into force of any new UK FTAs with third countries.

4. Free Trade Agreement (FTA)

The UK could seek to conclude a comprehensive FTA with the EU. At the time of writing, this is the UK's preferred option. However, the EU has made it clear that negotiations for the conclusion of a FTA can commence only after the terms of UK's withdrawal from the European Union have been finalised.

5. WTO

The UK has in its own right been a member of the General Agreement on Tariffs and Trade (GATT) since 1947 and of the WTO since its creation in 1995. WTO membership is composed of countries, territories and customs territories such as the EU. The WTO most favoured nation principle underpins today’s multilateral trading system. Customs unions are exceptions; their members can remove tariffs among themselves and impose a single tariff for third countries. In the event a Free Trade Agreement cannot be concluded within the time available, the trading relationship between the UK and the EU may need to be conducted on the basis of the WTO.

EEA & EFTA MEMBERSHIP

The UK could pursue a similar relationship to the one enjoyed by Norway, Iceland and Liechtenstein as a member of the European Economic Area (EEA) and the European Free Trade Association (EFTA).

The EU would have to amend its own treaties to reflect the UK's departure and the UK would have to negotiate with EEA and EFTA members in order to join those organisations.

These negotiations would pose a number of complex questions. For example, the UK would no longer be subject to the jurisdiction of the Court of Justice of the European Union (CJEU), but it would still have to apply Internal Market rules, which in turn would need to be enforced. EFTA members that are also members of the EEA (all but Switzerland) have recourse to the EFTA court, which has a separate body of jurisprudence which the UK may have to incorporate.

The UK would have to negotiate with EFTA first because it is not possible to be a member of the EEA without being a member of either the EU or EFTA.

All of the four current members of EFTA would have to agree to the UK becoming a member. This could be straightforward if the existing EFTA membership were amenable to maintaining the UK's existing opt-outs from particular pieces of EU law which the EFTA members have adopted, such as Schengen, but could be more complicated if the existing member states did not agree with the UK’s current position.

Furthermore, the existing EEA members (which include all of the EU member states) would need to agree that the UK could become a party to the EEA Agreement as an EFTA member. This may be difficult since the EEA Agreement was conceived as a vehicle for existing non-EU countries to integrate more closely with the EU with a view towards potential membership and not for an existing member to divorce itself of aspects of the EU, or as an interim measure between EU membership and a different non-EEA model such as an FTA.

As such, the arrangements for such a move from EU member to EEA/EFTA membership could potentially be very complex.

Ultimately, such a decision would be at the discretion of the existing EFTA members and remaining EEA members, not the UK.

The UK would still need to re-establish its independent tariff and trade regime, setting its own external tariff in relation to third countries, most likely on the basis of the EU's existing schedules of commitments. If this led to other WTO members suffering losses from any tariff changes, this could involve negotiations with the UK and / or the EU for compensation.

Tariffs would not apply between the UK and the EU – the EEA Agreement abolishes tariffs on trade between the parties to the agreement, but not customs controls.

The UK would have to continue to implement all rules that related to the Internal Market including rules related to employment, consumer and investor protection, environmental policy and competition law rules.

The UK would no longer be a part of the Council of the EU, losing the right of veto over legislation requiring unanimity, it would no longer be represented in the European Parliament and Commission and it would not participate in meetings of the European Council.

In principle, financial services are covered by the EEA Agreement, but developments since the global economic crisis of 2007 have meant that, in practice, the development of the Internal Market for financial services between the EU and the EEA/EFTA has been slow and problematic. This has been mainly due to the advent of the European system of financial supervision and the European Supervisory Authorities (ESAs), which were put in place in 2010 to help oversee the financial services market and set universal standards on supervision. The EEA legal acts incorporating the EU regulations establishing the ESAs came into force in October 2016 with the exception of Short Selling and Credit Default Swaps, which entered into force on 1 February 2017 and the European Market Infrastructure Regulation on derivatives, central counterparties and trade repositories, with an in force date of 1 July 2017.

The UK would have to comply with EU Rules of Origin requirements that are more complex than the current Internal Market arrangements, which do not distinguish between products from different member states within the EU.

The UK would contribute less to the EU budget, but it is likely that it would continue to pay a substantial amount (for instance, because Norway pays towards a number of EU social programmes, the Norwegian per capita contribution is about €100 per year, compared to the current UK per capita contribution of €180 per year). It is these advantages and disadvantages that must be weighed against each other in assessing the merits of the Norwegian model against the UK's current membership.

Rights

- UK nationals, as citizens of an EEA member state, would benefit from the provision on free movement of persons and institutions.
- The EEA Agreement provides for access to the EU's Internal Market.
- Freedom to set own external trade policy. The UK would not be a party to the EU's Customs Union and Common Commercial Policy and so would not have to apply the EU Common External Tariff – although the UK would be subject to the EU's Common External Tariff rules, in particular in relation to Rules of Origin requirements.
- The EEA Agreement gives EFTA experts the ability to participate in consultations on the preparatory work of the Commission.
- Freedom to set own agricultural policy by virtue of not participating in the EU Common Agricultural Policy.
- Freedom to set own fisheries policy by virtue of not participating in the EU Common Fisheries Policy.
- Freedom to establish own VAT regime.
- Other areas are excluded from the EEA Agreement, such as participation in the Schengen free-movement zone, Justice and Home Affairs cooperation and Defence (although EEA/EFTA states have negotiated participation in such arrangements individually).

Obligations

- To abide by EU law in relation to the EU Internal Market.
- To permit the free movement of persons from other EEA member states.

- To contribute to the EU budget.
- To abide by EU Rules of Origin. This is the corollary of not being a member of the EU's Customs Union and therefore not having to apply the common external tariff. In order for products to benefit from preferential treatment under the EEA Agreement, economic operators have to prove that they have originated from the EEA. Operators within the Customs Union do not have to do this as they are inside the customs area already, where Norway is not.

EFTA AND BILATERAL AGREEMENTS

The UK could apply to re-join the EFTA and then seek to conclude a range of bilateral agreements with the EU in the same way that Switzerland has. The UK was a founding member of EFTA in 1960 but left when it joined the European Community in 1973.

In 1972 Switzerland signed a Free Trade Agreement with the then European Community, followed by two large tranches of bilateral agreements in 1999 and 2004 respectively, referred to as 'Bilaterals I' and 'Bilaterals II', along with other agreements in areas such as insurance.

There are currently over 120 bilateral agreements in force between Switzerland and the EU.

Unlike Iceland, Liechtenstein and Norway, Switzerland has refused to bind itself to EU Internal Market legislation. It has decided to conclude agreements on a case-by-case basis. The enforcement of the agreements within Switzerland is also solely in Swiss hands as there is no agreed enforcement mechanism.

This piecemeal approach to these arrangements causes considerable tension between the EU and Switzerland. It is not an "off-the-peg" solution, but one that is specific to Switzerland. It has developed by accretion, as extra layers of treaties have been added over a period of over 40 years. The EU has said that it does not consider the Swiss arrangement to be viable in the long run and wishes to move to a more comprehensive model.

Based on this, it is unlikely that the Swiss option would be open to the UK; and if it were, it is not a comprehensive solution and may take many years, if not decades, to achieve the same level of market access as Switzerland currently has.

Rights

- The UK would be free to conclude trade agreements with third countries either independently or jointly with the other four members of EFTA.
- The UK would not be bound to transpose EU Internal Market legislation automatically into UK law.
- The UK would not be bound by the provisions of, or be required to, contribute to the CAP, CFP and structural funds.
- The UK would only be bound by EU social legislation in so far as it chose to be under bilateral agreements.

Obligations

- UK exports to the EU would be subject to EU Rules of Origin.

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- UK goods exports to the EU would have to comply with all relevant EU standards.
- Whilst not an obligation, Switzerland contributes to reduce the economic and social disparities in an enlarged EU.

CUSTOMS UNION AGREEMENT

The UK could pursue a similar relationship to the one enjoyed by Turkey by seeking to establish a Customs Union agreement with the EU.

Essentially, this option is limited to trade in goods. The immediate weakness of this model is that does nothing in the field of services, which account for about 80% of the UK's economy.

It would allow continued tariff-free access to the EU for UK manufactured goods, but the UK would have no right to participate in standards setting in relation to the regulation of that trade.

The UK would have to abide by the EU's common commercial policy and common external tariff regime. The implementation of the Customs Union with Turkey has required Turkey to apply the common customs tariff, common EU rules for imports, the EU procedure for administering quantitative quotas, EU protective measures against dumped and subsidised imports, common rules for exports, common rules for export credits, and common rules on textile imports and exports.

The UK would also have to abide by EU state aid and competition rules.

In the EU market, the UK would lose its current right to provide services, including financial services, on equal terms with EU members. Apart from its obvious disadvantages, this could have serious and unexpected consequences, given the extent to which trade in goods– whether within or outside the EU – is now intertwined with services in modern supply chains. If the UK wished to gain preferential access in relation to services (including financial and professional services) and public procurement it would have to conclude additional agreements with the EU. Such agreements would take time to negotiate, and would probably not provide the same levels of access as currently enjoyed.

This could severely damage the relevant sectors. In terms of services, the UK would rely on its rights under the General Agreement on Trade in Services (GATS), which is discussed further in the scenario on the WTO.

The UK would make savings by virtue of not having to contribute to programmes such as the CAP or structural funds, and would regain exclusive control of regulation of financial services and services. However, this could be at the expense of free access to the EU's Internal Market in financial services.

Given the asymmetry of trading volumes between the UK and the EU, membership of the EU Customs Union could be sensible as a step towards EU membership, not as a permanent model for engagement.

It is true that the UK would be able to negotiate agreements with non-EU third countries on trade in services where it currently negotiated as part of the EU. For goods, however, the UK would have to follow the EU's overall trade policy as a member of its Customs Union, resulting (as in the case of Turkey) in loss of independence and influence in this area. The EU would retain the ability to conclude trade agreements (whether multilateral, plurilateral or bilateral) with third countries without any input from the UK. That would give those countries access to the UK goods market, on the terms the EU had negotiated to suit itself, not the UK.

This would risk having an adverse impact on UK interests given that, in the case of bilateral FTAs, the EU's negotiating strategy is generally to offer access to its market for goods in return for the third country offering access to its market for services. The UK would then have to negotiate, after the fact and from a position of weakness, separate FTAs with the same third countries to gain reciprocal access for UK goods and, more importantly, services.

Rights

- Access to the EU Internal Market for goods without the need to comply with EU Rules of Origin for non-EU countries.
- The UK would not be obliged to contribute to the EU budget, or participate in common policies such as CAP, CFP and regional funding.
- The UK would not be obliged to implement EU social and employment law.
- The UK would be free to regulate its own financial services sector.

Obligations

- To impose the EU common external tariff on imports from outside the UK/EU Customs Union.
- The UK would have to abide by EU regulations in relation to goods, i.e. product standards.
- The UK would have to abide by significant portions of the EU's common commercial policy.

UK-EU FREE TRADE AGREEMENT

The UK could conclude a deep and comprehensive Free Trade Agreement (FTA) with the EU. That is the UK government's current objective.

The UK would be free to set its own external tariffs on goods from the rest of the world, conclude its own free trade agreements with third countries, set its own agricultural and fisheries policy, and internal market and employment rules.

In order to maintain a substantial amount of the access that the UK and rest of the EU currently have to each other's markets, any FTA would have to be much more comprehensive than any existing FTA. Modern FTAs such as the EU-Korea FTA include market access (trade in goods, services and government procurement), regulatory cooperation (to eliminate technical barriers to trade) and agreement on trade rules (including on customs and trade facilitation, investment, intellectual property, competition, sustainable development and dispute settlement).

It would be free to regulate its own financial services sector.

See our paper: *The future of trade agreement for the UK – A guide for businesses*, published in partnership with the Confederation of British Industry in January 2017 for a comprehensive analysis of the UK and its future trading relationships.

Rights

- Right to set own commercial policy, i.e. customs tariffs.
- The UK would not be obliged to contribute to the EU budget, or participate in common policies such as CAP, CFP and regional funding.
- The UK would not be obliged to implement EU social and employment law.
- The UK would be free to regulate its own financial services sector.
- The UK would be free to conclude FT As with third countries.
- The UK would not be bound by any automatic transposition of EU Internal Market legislation into UK law.
- The UK would have freedom to establish its own VAT regime.

Obligations

- UK exports to the EU would be subject to EU Rules of Origin.
- UK goods exported to the EU would have to comply with all relevant EU standards.

WTO

The UK has in its own right been a member of the General Agreement on Tariffs and Trade (GATT) since 1947 and of the WTO since its creation in 1995.

WTO members are countries, territories and customs territories such as the EU.

The WTO 'Most Favoured Nation' principle underpins today's multilateral trading system, i.e. WTO members must offer the most favourable tariff they would offer a particular country to every other WTO member. In effect, this means that WTO members cannot discriminate outside against individual members. Customs unions are exceptions; their members can remove tariffs among themselves and impose a single tariff for third countries.

This is what would happen in a 'no deal' scenario, where there would be no bilateral formal connections or independently negotiated agreements with the UK's former European partners. The EU treaties would cease to apply with immediate effect on the UK's departure.

The UK would be free to conduct all its own trade negotiations. As regards financial services, the "prudential carve-out" under the GATS Annex on Financial Services would allow EU regulators to take whatever prudential measures they deemed necessary to intervene in trade in financial services between the UK and the EU so as "to protect investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system".

The UK is likely to have to negotiate with third countries to ensure that it can continue to benefit from the trade deals it currently has as a member of the EU. There are a number of ways to do this and indeed, Canada's Finance Minister has said that he expects to work with the UK to ensure that it will continue to be part of the CETA. Legally, it is unlikely that existing EU FTAs will automatically continue to apply to the UK after it leaves the EU, even where the UK has also signed them as a mixed agreement. This is due to the contractual provisions in the agreements, particularly the provisions on "parties" and "territorial application".

It may, however, be possible to agree an amendment to the FTAs, for example, to agree that the provision on territorial application should also include a sentence that the Agreement shall apply to the EU customs territory "and the United Kingdom". However, this would require agreement not only from the third country, but also from the EU-27. It may also require a certain relationship between the UK and EU to be able to continue.

Alternatively, it may be possible for the UK and the third country to agree that the terms of the EU FTA will continue as between the UK and the third country. This means that the UK would not have to negotiate with the EU-27, and so it is likely that an agreement of this sort could be achieved more quickly. However, this would not be simple as there are a number of provisions that could not be easily transcribed, for example in relation to quotas, technical standards, and joint committees set up by the FTA. Negotiations on these points may lead to attempts to renegotiate the agreement more generally, particularly if the economics of separate agreements with the EU and the UK are less attractive for the third country.

Ultimately, whether the UK can continue trading with its current trade partners on the same terms will have to be negotiated, and the eventual outcome will depend upon what can be agreed.

The WTO is only concerned to a limited degree with regulatory issues (to the extent that they affect market access and national treatment): WTO membership would not, by itself, provide a means of approaching regulatory disputes in the way that is offered in, for instance, a number of the EU's FTAs.

Trading with the EU as a member of the WTO would involve the UK and EU imposing MFN tariffs on each other's goods. A House of Commons Library study has estimated that about 90 per cent of UK goods would be covered.[1] The risk is that this would have detrimental consequences on UK consumers and trade; for example, the current average MFN EU tariff for motor vehicles is around 10 per cent, which would increase the costs of UK automotive imports into the EU.

A further risk is that UK producers will put pressure on the government to raise tariffs on its competitors in order to protect their own interests, not just in Europe but globally, by increasing certain MFN tariffs. This would increase costs for consumers, and ultimately reduce the volume of trade.

Free movement of capital would not, technically, be affected by UK departure from the EU. The Maastricht Treaty removed all restrictions on capital movements between EU members and also between the EU and third countries from 1994. However, the status of the UK as Europe's leading financial centre may be endangered by departure from the EU.

More importantly for the financial services industry, the WTO regime, and GATS in particular, does not deal with non-tariff barriers in any great detail. Instead, the focus on non-tariff barriers tends to be concerned with whether they are discriminatory in nature and whether they can be objectively justified.

[1] House of Commons Library, 'Leaving the EU', Research Paper 13/42, 1 July 2013.

The existence of non-tariff, behind the-border barriers is perhaps the most significant obstacle to market access and national treatment faced by the financial services industry globally.

The right of commercial establishment that comes with EU membership would also be lost on departure from the EU except to the extent that it is replicated under the EU's GATS commitments to third countries or through other instruments such as EU members' participation in the Organisation for Economic Cooperation and Development Investment Guidelines. Dispute resolution and the enforcement of competition law outside the EU is weaker.

There are elements of this scenario which are uncertain. Would there be a transition period and, if so, would the UK be bound by rulings of the CJEU during that period? What would happen to EU citizens and businesses based in the UK, and vice versa? The latter question relates to what are variously known as vested, executed or acquired rights, and the degree to which they are "grandfathered" (i.e. accepted as pre-existing and not to be disturbed).

Rights

- Control over trade policy.
- Control over own borders – no obligation of freedom of movement. Freedom to regulate and legislate independently, within existing WTO framework, although the GATS includes provisions on "Temporary Presence" covering the provision of economic services by natural persons.
- The UK would no longer contribute to the EU budget, nor would it be likely to receive direct or indirect EU funding.

Obligations

- UK businesses exporting goods and services into the EU would have to follow its product standards, as they would for any other jurisdiction they sought to export to.
- The UK would be subject to the EU's Common External Tariff when trading with EU member states.
- The UK would continue to be bound by WTO and related agreements at the global level, e.g. the G20 level on, for example, derivatives reform or capital requirements.

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