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HOW TO LEAVE THE EU: WHAT'S BEST FOR BRITAIN, BEST FOR THE EU?

SHEILA LAWLOR - MARTIN HOWE QC - PATRICK MINFORD - BARNABAS REYNOLDS

New Direction



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INTRODUCTION

HOW TO LEAVE THE EU: WHAT'S BEST FOR BRITAIN, BEST FOR THE EU?

by Sheila Lawlor

THE BREXIT VOTE AND THE EU RESPONSE v REALITY

Britain's decision to leave the EU in the referendum vote of June 2016 was not expected to be welcomed by the EU leadership. At its first meeting after the vote, the tone was struck for a response which combines determination to emphasise the common commitment of the remaining 27 to a united front with a certain degree of sabre rattling – they may put obstacles in the way of an effective, constructive and clean break in the arrangements for the UK's exit.

Donald Tusk, the EU Council's President, announced at the outset that the EU would continue on its pathway without the UK: its leaders were 'determined to remain united and work closely together as 27'. (Donald Tusk, 29 June). That solidarity was underlined again in August on a battleship in the Mediterranean at a summit for the three founder country leaders – Angela Merkel, Francois Hollande and Matteo Renzi – who reiterated their common commitment to defence and security. The theme was again prominent at the next meeting of the 27 in Bratislava in September. Although the Italian and Hungarian leaders distanced themselves from the communiqué, their concerns did not impinge on the German Chancellor Merkel's exhortation that they must all 'get better' and the bloc must improve on '... security, internal and external security, the fight against terrorism, the cooperation in the field of defence', as well as defence and jobs, she added. (Angela Merkel, Bratislava 16 Sept 2016.) Again, in her end of year message, Mrs Merkel stressed that the EU, despite its faults could do 'better than the national state' and for Germany terrorism was the greatest challenge.



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Accompanying this common commitment to continuing a united front has been the less harmonious suggestion that the remaining 27 might obstruct Britain's future trade agreement with the EU. Mr Tusk, for instance seemed to claim that Britain, to access the Single Market must accept 'all four freedoms, including the freedom of movement', and there would 'be no Single Market à la carte'.¹

In fact Mr Tusk's apparent threat is wide of the mark: not only would it be contrary to the economic interests of the thousands of EU citizens whose jobs and livelihoods depend on selling their goods to the UK, now the EU's largest single export market buying 16 per cent of EU goods exports; it fails to reflect the current legal and trade framework in which the EU operates.² The EU has many free trade agreements with non-EU countries, and most of these do not include or allow 'free movement'. That goes for the two biggest exporters to the EU, China, which exports €279.9bn goods, and the US, which exports €196.0bn worth of goods.³

For the EU therefore, it is not only in the interest of the often forgotten EU citizens that free trade with Britain should continue, but given the variety of current trade agreements with non-EU countries, there is every reason for the EU to reach a rapid, clean, bespoke agreement for continued free trade

with Britain, its biggest single export market, and not as its officials threaten, stymie a deal with Britain 'pour encourager les autres'.

NEXT STEPS BEST FOR THE EU, BEST FOR BRITAIN

The UK's position should be simple, straightforward and clear in proposing to the EU continued free trade between Britain and the bloc, an arrangement to mutual benefit. Such a course could be agreed and announced quickly, giving the economies of all the EU countries, as well as the UK, (and their businesses and industries) the stability on which future success can be planned. EU manufacturers and employees would benefit from their goods remaining competitive in the UK market place, probably more than Britain's manufacturers, given that the UK imports more goods from the EU (57 per cent) than it exports to the block (44 per cent). A snapshot of goods bought by Britain from the EU shows, for instance, the UK buys one fifth of Germany's cars each year, buys \$16bn worth of French machinery, aircraft and beverages and buys almost 7 per cent of all Polish exports.⁴

If, however, the EU were to refuse continued free trade, then Britain should prepare to make a trade

agreement with the EU to access the Single Market from outside, just as is done by other non-EU countries, which trade successfully with the EU under WTO rules and without any question of their following the four freedoms. As the authors of this analysis make clear, the UK should prepare for that option rather than get bogged down in protracted arrangements with an unwilling or obstructive EU. In the pages which follow, two of Britain's leading lawyers working in the field of UK and EU law and a leading economist, whose specialisms include trade economics, explain how Britain can best proceed to reap the benefits of Brexit and most effectively leave the EU. The basis for future trade with the wider world stretching from the US to China as well as the EU is set out for trade in goods and services. If followed, not only will Britain and the EU benefit from continued trade in EU goods. But trade in services, from which EU capitals benefit because of the availability of expertise and capital in London, which is one of the world's two leading financial centres, will also flourish. Such arrangements would be clear, straight forward and best for the economies and trade of the EU 27, just as they would be for Britain.

Martin Howe QC explains the legal framework for an effective UK departure from the EU in line with EU and UK law before and after invoking Article 50 of TEU. It proposes the arrangements for future UK trade with non-EU countries and the EU and explains the next steps for the negotiations. Brexit, says Howe, a lawyer specialising in European law, can be carried out rapidly and painlessly either on the basis of continued free trade which Britain should offer, or, if the EU is unwilling to take that course, Britain should waste no further time and go instead for the option of trading on WTO arrangements as other non EU countries already trade with many different bespoke arrangements.

Patrick Minford, Professor of Applied Economics at Cardiff University, explains that the EU damages not only the UK, but all existing members of the EU, and that to become viable as a political entity and command authority once more, the EU needs to change direction and dedicate its powers over commercial policy to free trade. Its regulative powers should be delegated back to national authorities under mutual recognition. Its fourth freedom of free migration should be abandoned as quite unnecessary to trade

integration and dangerous to inter-country unity because of the provocation of large scale transfers.

The Brexit vote, explains Minford, represented a challenge by consumers against producers for whom the Single Market protects their interests through tariffs and regulation, raising costs for consumers significantly higher than world costs would justify. Leaving the Single Market will result in cheaper goods and consumer prices with beneficial consequences for Britain's economy. In fact, the EU consumers across the bloc also pay dearly for goods on account of the Single Market structures and protectionism. The message for EU reform is clear: by removing the regulatory and tariff costs under the Single Market, national economies would stand to gain.

Barnabas Reynolds, an EU UK lawyer who leads the regulatory practice in his City law firm, explains how the UK's financial services and the EU can benefit from Brexit under a deal which follows two principles: (1) respecting the result of the UK's referendum: and (2) respecting the integrity of the EU's legal requirements. He proposes that the UK seek an equivalence-based relationship with the EU in financial services. This would build on current arrangements in which many EU financial services laws allow financial institutions in third countries to access the Single Market if their laws are deemed "equivalent" to the EU's in a relevant area. This happens with respect to Institutions in a range of countries, including companies incorporated in the US, Japan, Singapore, Switzerland, Canada, Mexico and others. Equivalence would provides a workable and mutually beneficial underpinning for a UK-EU agreement after Brexit. Given the UK's close political, geographical and economic ties to the EU, it is likely that an equivalence regime will be even more successful and mutually beneficial than it is in other jurisdictions.

The approach explained by the three authors would respect the referendum result, since the obligations of Single Market membership would be ended, along with the application of the EU's four freedoms, and UK sovereignty would be restored – something which the voters clearly wanted.⁵ It would make for a clean, but amicable break, bring mutual benefit to the economies and livelihoods of UK and EU citizens, and open the way for Britain to take her place as a good friend to her European neighbours and work closely with them for the common good. ●

¹ Donald Tusk, reported 29 June 2017, said: 'Leaders made it crystal clear that access to the Single Market requires acceptance of all four freedoms - including freedom of movement' and 'There will be no Single Market a la carte'. <http://www.express.co.uk/news/politics/684528/Brexit-Donald-Tusk-Britain-free-movement-access-EU-single-market-David-Cameron>

² The U.S is the EU's second largest single export market buying 15 percent of EU goods.

³ http://ec.europa.eu/eurostat/statistics-explained/index.php/International_trade_in_goods (Eurostat 2013 trading figures) China was the origin for more than one fifth (20.3 %) of all imports into the EU-28 in 2015 and was the largest supplier of goods imported into the EU-28. The United States' share of EU-28 imports of goods (14.4 %) was around 6 percentage points lower than that of China, while the share of Russia (7.9 %), which was the third largest supplier of goods to the EU-28, was a further 6 percentage points smaller. Russia exports E206.6. http://ec.europa.eu/eurostat/statistics-explained/images/d/db/Main_trading_partners_for_imports%2C_EU-28%2C_2015_%28%25_share_of_extra_EU-28_imports%29_YB16.png Seven countries accounted for a larger share of the EU-28's imports of goods than their share of EU-28 exports of goods: nearly three fifths (59.8 %) of all imports of goods into the EU-28 came from these seven countries.

⁴ Taking a snap shot of what the UK buys from a sample of three EU countries – Germany, from which it buys \$98.7 billion (7.4 per cent) of Germany's total exports, is Germany's biggest car market buying around one fifth of all the cars Germany produces in a year. From France it buys \$36,2 billion or 7 percent of France's overall exports, especially machinery and aircraft, and from Poland, \$13.4 billion or 6.8 percent of all its exports, of which cars and machinery are at the top of the list

Germany's exports to United Kingdom amounted to \$98.7 billion or 7.4% of its overall exports. <http://www.worldsrichestcountries.com/top-germany-exports.html>

1. Vehicles: \$32.2 billion
2. Machinery: \$13.1 billion
3. Pharmaceuticals: \$8 billion
4. Electronic equipment: \$6.9 billion
5. Plastics: \$3.6 billion

France's exports to the UK amounted to \$36.2 billion or 7% of its overall exports. <http://www.worldsrichestcountries.com/top-france-exports.html>

1. Machinery: \$7.8 billion
2. Aircraft, spacecraft: \$5.3 billion
3. Beverages: \$3.1 billion
4. Pharmaceuticals: \$2.8 billion
5. Electronic equipment: \$2 billion

Poland exports \$13.4 billion or 6.8% of its overall exports to the UK. http://www.worldsrichestcountries.com/top_poland_exports.html

Top five products are:
1. Machinery: \$2 billion
2. Vehicles: \$1.9 billion
3. Electronic equipment: \$1.8 billion
4. Furniture, lighting, signs: \$876.9 million
5. Meat: \$490.4 million

⁵ Ruling the Ruler: Parliament, The People and Britain's Politeia Identity, Politeia 2016. Ruling the Ruler: Parliament, the People and Britain's Political Identity



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PART I.

THE LEGAL AND TRADE FRAMEWORK

by Martin Howe QC

LEAVING THE EU – TRADING FOR THE FUTURE: A STRAIGHTFORWARD AND SIMPLE STRATEGY

This analysis opens by explaining the formal arrangements for leaving the EU and the legal bases (chapters I-II).

Invoking Article 50 TEU is the only legal and practical route for the UK to withdraw from the EU following the Leave referendum result. This is intended to take place by the end of March 2017 pursuant to a Parliamentary Bill following the outcome of the Supreme Court challenge to the government's right to invoke Article 50.

It then considers the arrangements for future UK trade with the world and the EU (III-VII).

It explains how the UK should (i) take over directly the existing free trade relationships with third countries under the existing EU-third country trade agreements, (ii) preserve its free trade relationship with the EFTA countries, (iii) and start negotiating additional and improved free trade agreements in advance of actual exit from the EU to take effect after exit, (iv) how to proceed so as to leave the Single Market with all its

negative consequences and instead maximise the UK's access to the Single Market, and (v) what aims and negotiating tactics should be pursued to seek long term agreement governing trade and other relationships with the remaining EU. In respect of the EU and the Single Market, it proposes that the UK's aim should be a straightforward and simple trade agreement with the EU with three main elements – a free trade agreement, general rules on free movement of goods and services and continued access for goods and services under existing regulations and directives.

For the future, one course for Britain might be to seek readmission to EFTA, the free trading group of states which remains legally independent of the EU and has been more successful than the EU in striking trade deals around the world. EFTA should not be confused with the EEA (European Economic Area, founded in 1992) consisting of the EU and three EFTA states Iceland, Liechtenstein and Norway, all of which are covered by the EU's four freedoms (goods, capital, services and persons) and the rules on competition and state aid.

1.1

ARTICLE 50 OF THE TREATY ON EUROPEAN UNION (TEU)

Under Article 50 (see Appendix) any member state can leave the EU. This right may be exercised unilaterally by the member State and is not dependent upon the agreement or cooperation of the EU institutions or other member states. Nor can the remaining member states prevent the withdrawing State's membership coming to an end at a maximum period of 2 years after notice is given (Article 50(3)).

Article 50 authorises and encourages an agreement between the remaining EU and the withdrawing state on 'the arrangements for its withdrawal' and envisages a 'framework for its future relationship with the Union'. It provides for the withdrawal agreement to be negotiated in accordance with Article 218(3) TFEU (Treaty on the Functioning of the European Union) (which regulates the making of agreements between the Union and third countries), but with the withdrawing state excluded from the Council of Ministers for the purposes of the negotiation. In order to be authorised by the EU, the agreement on withdrawal arrangements needs **(1)** the consent of the European Parliament, and **(2)** approval by the Council of Ministers by QMV (see Article 50(2)).

While Article 50 TEU envisages that there will be a 'framework' for the future relationship between the withdrawing State and the EU, it does not specify

how that framework will be negotiated and agreed. It seems that that would be achieved via the general treaty provisions authorising agreements between the EU and non-member states. The most relevant of these are Article 207 TFEU which authorises commercial (i.e. trade) agreements, and Article 217 TFEU which authorises association agreements.

Article 50 TEU raises a number of issues:

1.1.1 WHAT IF ALL IS SWEETNESS AND LIGHT?

If there is good progress and rapid agreement on terms for withdrawal and the future relationship, then the actual date for withdrawal could be brought forward from the end of the 2-year period, since Art. 50(3) states that the EU treaties shall cease to apply to the State from the (agreed) date of entry into force of the withdrawal agreement (see Article 50(3)).

One oddity of Article 50, is that it does not explicitly authorise the agreement on the future relationship to be made under its machinery prompting some to suggest it is not possible to conclude an agreement in advance of actual withdrawal. This would mean that the



REASONS FOR THE BREXIT DECISION

Two misconceptions about reasons for exit:

- 1 That Britain is against globalisation**
au contraire Britain favours global free trade and EU membership is seen as inhibiting our ability to trade globally
- 2 That the Brexit decision was taken for political reasons even though leaving the EU would be economically damaging:**
au contraire the UK's international trade has developed to a point where continued EU membership is economically damaging

formal steps of agreeing it (as distinct from informally pre-negotiating the intended text) could only take place after the date of actual withdrawal. If such a literalistic argument were upheld, it would be a first in EU law.

Since the withdrawing State will be a 'third state' by the time the future relationship agreement comes into force, there seems no real difficulty in negotiating and approving the agreement under the Treaty provisions dealing with agreements with third states so that the agreement can come seamlessly into force from the date of withdrawal. Denmark was treated as a 'third state' for negotiating agreements between itself and the then EC on matters falling within Denmark's home affairs opt-out Protocol.

1.1.2 WHAT IF NO AGREEMENT CAN BE REACHED?

In practice a UK agreement on the terms of withdrawal would most likely be linked to reaching agreement at least on the key trade-related terms of the future relationship. It would not be satisfactory for either party to conclude the withdrawal arrangements and bring Britain's membership to an end if the future relationship were left up in the air while negotiations of indefinite duration proceeded.

If no withdrawal agreement can be reached, either because the terms of withdrawal themselves are problematic or because a satisfactory framework for the UK's future relationship with the EU cannot be agreed, then under Article 50(3) the UK's membership of the EU would terminate unless both the European Council (acting unanimously) and with UK consent, extended the time.

Some commentators have, strangely in my view, seen this as a negative feature of the Article 50 procedure, for a country withdrawing. Far from that being so, if Article 50 had no time limit, the EU could tie up the withdrawing state in 'years of uncertainty' as those opposed to leaving were prone to allege. Not only is the timing of the initiation of the formal Article 50 procedure under the UK's control (as the withdrawing state), but it allows the UK to set a firm end point beyond which the uncertainty cannot go on.

At the same time, however, it is vital that the UK recognises that it must be willing to exit the EU on that final date without an agreement if that proves necessary and then trade with the remaining EU under WTO terms. Under the WTO Agreements (GATT 1994, Article XXIV) each party would be obliged to levy its standard external tariffs on imports of goods from the other party. It seems that in such circumstances (given the EU's average external tariffs), UK producers would face

⁶ Treaty on European Union, originally the Maastricht Treaty of 1993, as amended by the Lisbon Treaty of 2008

tariffs on their goods exports to the remaining EU that would be substantially less than the UK's current net EU budget contribution. In view of the large trade imbalance in goods, the UK would then levy tariffs on imports from the EU which would be substantially greater, although the amount raised would depend upon the UK's own decisions about what tariffs it would impose after exit on imports under its own uniform tariff policy.

To negotiate a good agreement with the EU, one which serves Britain's and the EU's mutual interests, it is essential that the UK pursues a twin track policy. While seeking to negotiate a trade agreement with the EU and prepare for its implementation, it must simultaneously prepare for and be in a position to execute an external trade policy without an agreement with the EU if necessary. This is not because a successful agreement with the EU is unlikely, but because having no alternative plan in the event of no agreement, is a recipe for disaster. The UK would find itself obliged to agree to whatever terms are offered, just as the Greek Prime Minister Alexis Tsipras was over the 2015 bailout terms dictated to Greece. It should also be pointed out that leaving without an agreement in place at the day of exit does not prevent an agreement being reached in the future- and indeed, this might prove easier once political tensions raised by the UK's exit have subsided.

1.1.3 AN AGREEMENT OR AGREEMENTS WITH THE EU?

The focus of attention of the UK's future relationship with the EU has been on a trade agreement. There are, however, other areas where it would be mutually beneficial to carry forward on the basis of co-operation and agreement, aspects of current UK-EU arrangements such as sharing intelligence and security cooperation and participating in pan-European higher education or research projects and programmes.

There are also strong arguments against attempting to include trade and non-trade UK/EU agreements in a single all-embracing agreement. Why is this?

Trade arrangements should command priority. Concluding an overall agreement would be more time consuming and difficult, given that agreement would need to be reached on a large range of individual issues before the key provisions on trade could be put into effect.

The different aspects of an all-encompassing agreement would entail different ratification procedures. A trade agreement of limited scope falling within the EU's common commercial policy could be agreed by the EU alone (i.e. without the individual member states needing to be parties), in some circumstances and by QMV rather than unanimity in the Council of Ministers, so long as certain provisions are avoided which might trigger a need for unanimity. On the other hand, agreements covering matters not wholly within EU exclusive competence, which are 'mixed competence' or member state competence, would need each member state to be a treaty signatory. In this case each member state would have to ratify in accordance with its own constitutional procedures. (Note that the fact that the EU Canada FTA is a 'mixed competence' agreement enabled Romania to put a spoke in the works by refusing to ratify as a result of a visa dispute between itself and Canada, and that was followed by Wallonia holding up ratification apparently for agricultural protectionist reasons.)

An all-encompassing single agreement (or indeed a series of agreements legally linked together) would create a 'lobster pot' effect which makes it difficult to withdraw from an area of cooperation or to require its terms to be revised without bringing to an end the entire arrangement between the UK and the EU including its trade related aspects. (Switzerland now finds itself inside such a 'lobster pot' since it unwisely agreed that the migration provisions of its bilateral treaties with the EU be linked with its agreements on free movement of goods and services).

1.1.4 NEXT STEPS

Invoking Article 50 TEU is the only legal and practical route for the UK to withdraw from the EU following the Leave referendum result. This is intended to take place by the end of March 2017 pursuant to a Parliamentary Bill following the outcome of the Supreme Court challenge to the government's right to invoke Article 50.

The timing of the formal notice under Article 50(2) should be carefully calibrated first to allow a period of planning and pre-negotiation, and secondly to ensure that by the time of the expiry of the 2-year period in Article 50(3), the UK will have completed all necessary internal and external preparations for withdrawal, and be ready (as a last resort) to exit on that date with viable alternative arrangements ready if there is no agreement with the EU. •

1.2

BEFORE WITHDRAWAL-AMENDING UK DOMESTIC LAW



1.2.1 UK LAW AND EU LAW: THE PRESENT POSITION

After over 40 years of membership, a large number of UK laws are derived from or affected by EU membership, and these fall into a number of categories.

First, there are 'directly applicable' EU laws, such as EU Regulations and parts of the EU treaties, which have become part of the internal law of the UK and of other Member States, without any action on the part of national legislatures or

other authorities. EU 'directly applicable' laws are given legal effect in the UK by Section 2(1) of the European Communities Act 1972. Such laws and treaty provisions would lapse automatically, ceasing to remain part of UK law from the withdrawal date. Rather than leave a vacuum in the law, it would be necessary to have a new domestic law in place to cover the subject matter. For example, it would not be acceptable to have a vacuum in the law on the licensing of medicines if the UK ceases to be covered by Regulation (EC) No 726/2004 on the authorisation and supervision of medicinal products by the European Medicines Agency.

Secondly, many Acts of Parliament implement EU directives or other obligations, and unless something is done about them, these Acts of Parliament would automatically continue in force after the exit date. This might be desirable, but on the other hand it might be preferable either to repeal them or at least to amend them in post-Brexit circumstances. Such decisions would need to be taken on a case-by-case basis – it would not be possible to deal with them all with a single global rule.

Thirdly, numerous UK regulations or other kinds of statutory instruments have been made under Section 2(2) of the European Communities Act 1972 in order to implement directives and other EU obligations.

This large body of UK regulations implementing EU law could not just be allowed to lapse automatically on exit. It would be necessary to go through them and decide to revoke, keep or amend them, case by case.

Deciding the fate of these three categories of existing EU laws and what if anything to put in their place would be a major exercise and would have to be carried out rapidly. Where the EU-derived law is not actively harmful, there would probably be a presumption in favour of keeping the substance of it in force for the time being where practical, and leaving detailed reform or improvement to the future. In the case of EU laws which will automatically disappear on exit, this would involve replicating the substance of the EU law in the form of domestic legislation which comes into force on and from exit.

In order to use the well-tested substance of the legislative machinery the powers of section 2(2) of the European Communities Act 1972 might be written into a new Act dealing with the law after exit. This would allow the 1972 Act to be repealed in its totality from the date of exit.

It is important that the legal position on exit should be clarified. The ECJ or other EU institutions such as the Commission might argue that they continue, post Britain's exit, to have power to take decisions or adjudicate on matters that happened before exit, on for example ECJ cases that are still pending at the date of exit. While some treaties do provide for

the continued exercise of powers after a state has withdrawn⁷ Article 50 of the Treaty on European Union does not provide for any continuing right of the ECJ or other institutions to adjudicate on matters that happened before withdrawal. That would not be acceptable, so the 1972 Act should be amended to ensure that acts of the EU institutions taking place after withdrawal are accorded no legal recognition in the UK.

Budgetary powers would need to be addressed. As there may be disagreement over the UK's final years' membership subscription (the budget contribution and 'own resources' payments by the UK), it would be sensible to repeal with immediate effect Section 2(3) of the 1972 Act, which provides for the payment of these sums by officials without the authority of parliament. Any final payment into the EU would then have to be approved by parliament.

Areas of competence returned by the EU on exit would need to be reviewed in order to decide whether these should be exercised by Westminster or by the devolved legislatures. For example agriculture outside England is within the devolved powers of the Scottish, Welsh and Northern Ireland legislatures but their scope of action is limited because all are required to implement the EU's Common Agricultural Policy, acting not unlike 'branch offices' of Brussels.

The EU's Common Agricultural Policy (CAP) will cease to have effect on exit, but a common UK framework establishing the core principles of agricultural and farm support policy across the UK will be needed. It would not, for example, be acceptable for the Scottish Parliament to give significant subsidies to sheep farmers in Scotland which are not available to sheep farmers in England or Wales so allowing Scottish sheep prices unfairly to undercut other sheep farmers across the whole UK market.

For these reasons a core UK policy is needed to replace the existing EU CAP. Such a policy would not reduce the scope of the powers of the devolved legislatures but would simply replace existing EU powers (although ritual declarations that devolved parliaments' prerogatives were being usurped might be expected). However, the content of the core UK agricultural policy would no doubt be the subject of

negotiation between Westminster and the devolved legislatures and governments. As a net food-importing nation, the UK would have a strong interest in replacing protectionist barriers which drive up food costs for consumers above world market price with other forms of farm support.

Similarly, the disappearance of the EU's Common Fisheries Policy on exit would lead to the UK regaining control of its fisheries up to the boundaries recognised by international law. A sensible conservation-based national fisheries policy would be needed to replace the existing EU policy.

A number of matters are currently governed by international arrangements between the EU and global or regional multilateral treaties. On these matters now the subject of such global or regional treaties Britain could seek to accede to such arrangements directly, in place of via the EU.

The task of amending UK domestic law in preparation for exit is substantial but achievable, given the two-year period for the necessary work to be carried out. It should also be viewed positively in terms of what can be achieved.

In the process of review of UK law, priority should be given to reforming or sweeping away EU-based laws

that interfere with the competitiveness and efficiency of the UK economy.

For example, outside the Single Market and freed from prescriptive harmonising directives, significant reforms could be made to intellectual property laws to extend exemptions, to restrict scope and terms of protection that confer no economic benefits, and to simplify areas of the law that are unnecessarily complex thanks to EU interventions. The EU's insistence that rights owners should be allowed to prevent 'parallel imports' of their own goods from outside the EU could be ended with enormous economic benefits, at one stroke expanding our global trade and reducing prices to UK consumers.

The UK would regain control of migration from other EU states. EU citizens who are settled and productively working here should not be put in fear of being sent home, nor would we wish to damage our economy by excluding highly paid or highly skilled workers, such as highly paid bankers in the City or skilled health workers. But the inflow of low-skilled workers could be restricted in the same way as it is from non-Member States. The UK would certainly want to take more robust measures than are now permitted by EU law to exclude or remove persons suspected of being a danger to the public or engaged in criminal activities. •

⁷ For example, Article 58(2) of the European Convention on Human Rights provides that the Convention and the jurisdiction of the Strasbourg Human Rights Court continues to apply to withdrawing states in relation to acts taking place before withdrawal.

1.3

BRITAIN, THE EU AND TRADE TREATIES

PRESENT POSITION, FUTURE AIMS

1.3.1 THE POSITION UNDER THE EU

One consequence of the UK's EU membership has been that many aspects of the UK's external relations have been conducted partly or wholly through the EU. And, because the UK is a member of the EU customs union and common commercial policy, it may not negotiate its own trade agreements with non-member countries, but can only do so as part of the EU. As we have seen repeatedly, the EU has had difficulty in negotiating trade agreements because of the large number of vociferous protectionist special interests within its borders. Nor can the UK decide on the level of tariffs it levies on imports because these are set at a uniform level for the EU under the EU's customs union.

By leaving the EU, the UK can re-assume direct control of its external relations, including trade relations. It will also be able to decide the level of tariffs imposed on imports, provided that tariffs are no higher than under the EU customs union.

It is free to negotiate international trade agreements with other countries including the EFTA states. It will be free to make new trade agreements with non-member countries. The process of negotiating new trade deals can be started during the 2-year notice period with a view to bringing them rapidly into force on exit. Contrary to claims made by Commission President Juncker, this is not contrary to the UK's obligations to respect the exclusive external competence of the EU in trade matters. The EU has no competence in respect of the UK's external trade

relations after exit, and hence it is no violation of the EU's exclusive competences for the UK to negotiate and conclude before exit trade treaties which come into force from the day of exit.

1.3.2 EXISTING EU-THIRD COUNTRY AGREEMENTS

At present both the EU and Member States, including the UK, are parties to the EU's existing free trade agreements. The UK could continue to apply the substantive terms of these agreements on a reciprocal basis after exit unless the counterparty State were actively to object. This will not involve complex renegotiation of existing arrangements.

The first aim therefore should be for the UK to take over directly the existing free trade relationships with third countries under existing EU- third country trade agreements. In the case of such third countries, as the UK is already a party to the EU's external free trade agreements, there would be no need to negotiate new terms with these. Rather it should be proposed that such states agree to the UK representing itself rather than being represented by the EU Commission, and to continue the existing free trade terms. These states would have every incentive to continue rather than see tariffs re-imposed on their exports of their goods into the UK market.

At the same time Britain should preserve its free trade relationship with the EFTA countries. (see below pp 43-46).



INTERNATIONAL AGREEMENT

Different categories of international agreements:

- Agreements where UK status unaffected by EU exit - e.g. UN membership
- 'Mixed competence' agreements where UK is party and its competence will expand when EU competence disappears - e.g. WTO Agreements - UK national Schedule of Concessions with max bindings matching current EU Schedule
- Where EU is party, or where MS are also parties but in their capacity as such - e.g. FTAs - continue to apply substantive terms after exit unless counterparties object
- CFSP agreements

1.3.3 THE SINGLE MARKET AND THE EU

The UK should leave the Single Market with all its negative attributes. These are discussed in the next chapter. Instead, the UK's aim should be to maximise the UK's access to the Single Market. In particular, any deal which requires the continuation of the Single Market's harmful 'Fortress Europe' restrictions on our trade with non-EU countries should be avoided.

The UK will also wish to negotiate a trade relationship with the EU which aims to preserve existing trade patterns. As the EU's best customer, one which buys far more from the EU than it sells to the bloc, continuing on the basis of a free trade deal is in the interests of both parties, but even more in the EU's interests than the UK's.⁸ Given the strong incentive for the remaining EU to reach an agreement which avoids the imposition of tariffs on the export of goods to

its largest single export market, the UK, it should not be difficult to agree acceptable terms on a mutually beneficial trade deal within the 2-year timetable, whatever the political stance adopted publicly by some EU politicians.

In the event of no trade arrangement being reached, the default position or baseline for a UK trade relationship with the remaining EU states would be governed by WTO rules. These provide for non-discrimination in tariffs, and outlaw discriminatory non-tariff measures. From this baseline, and as the remaining EU's largest single export market, the UK would be in a strong position to negotiate a mutually beneficial deal.

This then would constitute the position from which Britain would begin negotiating additional and improved free trade agreements with other countries in advance of actual exit from the EU to take effect after exit. ●

⁸ According to the latest figures (2015, ONS 'Pink Book') the UK exported £134.3bn worth of goods to the r-EU but imported £223.0bn. This indicates that the imposition of tariffs on bilateral trade between the UK and the r-EU after Brexit would be very substantially more painful for r-EU exporters than for UK exporters, were it allowed to occur.

1.4

THE SINGLE MARKET

The EU's Single Market is often perceived as a positive feature of the European Union even by many people who are in other respects critical of the EU. However, this perception is often based on an insufficient understanding of what the 'Single Market' actually is. There are a number of different strands or elements, the rules of which determine what the Single Market is. Some of these are beneficial, some are of no particular benefit to the UK and some are downright harmful.

1.4.1 THE ELEMENTS WHICH MAKE UP THE 'SINGLE MARKET':

The single or 'internal' market⁹ is defined as comprising 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties'.¹⁰

1.4.2 THE CUSTOMS UNION AND COMMON COMMERCIAL POLICY. BENEFITS AND COSTS.

The EU is a customs union which benefits free trade because goods are not subject to tariffs when they cross Member State borders in the EU.¹¹ Belonging to a customs union imposes obligations on Member States, including the UK, to apply the EU common rate of customs tariffs to all goods entering from outside the EU. No individual Member States may raise or lower the rates and this therefore can conflict with a country's own priorities for its trade or production. Nor may Member States conclude trade agreements with non-member countries: such agreements are covered by the EU's 'common

commercial policy' which is one of the EU's 'exclusive competences'. Only the EU as a whole can do trade deals with non-EU countries. As a result the different priorities of Member States including the protectionist interests of some of the more powerful Member States, the EU has not been particularly successful in concluding trade agreements with external powers outside its own sphere of client states in Eastern Europe, North Africa and the former colonies of some of its Member States. Moreover belonging to a customs union means that the UK is obliged to impose high tariffs on some goods where the UK has no significant domestic industry to protect - for example, textiles and footwear. As a result, UK consumers must pay higher prices for such goods than would be normal on the world market, with the benefit of the higher prices going to the protected industries in other EU states. Belonging to this customs union is not therefore an unmixed benefit of EU membership. While tariff-free movement of goods does benefit UK consumers and exporters who buy from or sell to other EU Member States, there are also disadvantages. These include (1) having to comply with the EU common customs tariffs which can drive up prices of goods from non-EU states, and (2) being unable to negotiate trade agreements separately from the EU.

1.4.3 OTHER ROUTES TO TARIFF-FREE ACCESS TO THE EU'S SINGLE MARKET.

There is another way to secure tariff-free access to the EU Single Market besides being inside a customs union. The best alternative is to have a free trade area (FTA) agreement with it. An FTA does not



UK- EU TRADE PATTERN

Latest figures:

(UK Office of National Statistics, 2015)

- UK exports of goods and services to rest of EU were £134.3bn
- UK imports from rest of EU were £223.0bn.
- Civitas study on impact of tariffs if no agreement and UK applies same tariffs as EU (http://www.civitas.org.uk/reports_articles/potential-post-brex-it-tariff-costs-for-eu-uk-trade)
- Tariffs on UK exports to EU would be £5.2bn, tariffs on EU exports to UK would be £12.9bn. (Bilateral figures e.g. with Germany are £0.9bn and £3.4bn; France £0.7bn and £1.4bn)
- UK NET budget contribution to EU is £8.5bn (2015)
- Strong mutual interest in continued tariff-free trade in both directions

oblige the signatories to adopt uniform external tariffs in trade with third countries nor to give up their independent ability to do trade deals with them. This is because an FTA only applies to goods which *originate within* the members of the FTA, so the problem of third country exporters avoiding higher tariffs by routing imported goods through one member of the FTA with lower external tariffs does not apply. On the other hand, the customs authorities between the FTA members need to check that goods do originate within the other FTA member (according to 'rules of origin') in order to be entitled to tariff-free access. This is a standard procedure.

A number of European and non-European states enjoy tariff-free access to the EU Single Market via free trade agreements, including the EFTA states (Switzerland, Norway, Iceland and Liechtenstein). In fact, all European countries outside the EU have tariff-free access to the EU Single Market under FTAs except Russia and Belarus [also known as Byleorussia]. Currently, the only major non-EU country within the EU customs union is Turkey.

1.4.4 GENERAL RULES AGAINST BARRIERS TO FREE MOVEMENT OF GOODS AND SERVICES

A second important aspect of the EU Single Market is that under the general rules of the Treaty on the Functioning of the European Union (TFEU), Member States may not apply laws or regulations which unjustifiably prevent or discriminate against goods or services imported from other Member States. The ECJ has developed a large body of case law in this field. It should be noted that these general rules apply to governmental regulatory actions and certain actions by private companies.¹²

These general rules on free movement benefit both exporters of goods and services and consumers, since they tend to lower prices and widen choice. There is however no need to be inside the EU Single Market in order to enjoy market access based on these general rules - most of the EU's trade agreements with non-EU members contain some or all of these general rules.

⁹ It is called the 'internal market' in the EU Treaties

¹⁰ Article 26(3) of the Treaty on the Functioning of the European Union (TFEU).

¹¹ Article 28(1) TFEU states that: 1. The Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries.)

¹² For example they would apply to an attempt to enforce intellectual property rights in one Member State in order to keep out goods which the company which owns the rights has placed on the market in another Member State - normally with the aim of keeping prices higher in the Member State of importation).

1.4.5 HARMONISATION OF LAWS AND REGULATIONS

The third and more controversial aspect of the Single Market is the harmonisation of laws and regulations. There is little disagreement about the uncontroversial point that differences between laws and regulations which apply to goods and services can act as a barrier to trade. Therefore, having a system where rules and regulations are the same across all Member States can reduce those barriers. However the approach has its problems.

In the first place, under the EU system the pressure to regulate upwards is constant: the most stringent level of regulation among the various Member States tends to be adopted into the common EU regulation and replicated across all Member States. With very limited exceptions, harmonisation measures can be imposed on dissenting Member States by Qualified Majority Vote (QMV). This can have particularly adverse consequences for the UK in certain sectors, notably in financial services where the UK's interests tend to diverge markedly from those of the Eurozone countries who have the power to pass measures under QMV against the UK's opposition.

While it remains true that an exporter who wishes to export goods or services into a market must meet the regulatory standards imposed for that market, the disadvantage for Britain is that only 15 per cent of the UK economy is involved in exports into the EU but 100 per cent of the economy consisting of *sales to the domestic market* and *non-EU export sales* are subject to the Single Market regulatory burden. So, the regulatory burdens and costs associated with membership of the Single Market spread out more widely to impose costs on economic activities outside those which gain any benefit from freer trade into the Single Market. This problem is particularly acute in the case of the UK, because we have the lowest share of exports to other EU states of any major Member State (see p. 40).

1.4.6 FREE MOVEMENT OF PERSONS

One of the most controversial building blocks of the EU's Single Market is the right to 'free movement' by EU 'workers'.¹³ At the time when the UK joined the EEC in 1973 free movement was not controversial because

there was comparatively little divergence between standards of living in this country and in other Member States. The fall of the Soviet Union in 1991 and the subsequent accession of former communist Eastern European states with their lower standards of living led to high migration flows into the UK.

While free movement of persons under the EU treaties *is a component of membership of the Single Market, it is not an intrinsic or necessary condition of access to the Single Market* for goods and services. The EU's external trade agreements do not in general contain provisions allowing the free movement of workers. The exceptions are in its agreements with the four EFTA states, which were concluded at a time before the mass migration problem from Eastern Europe arose.¹⁴ Membership of EFTA does not as such give rise to free movement of persons between the EFTA states and the EU. That obligation arises solely as a result of the EEA Agreement which three of the EFTA states belong to, and as a result of the bilateral agreements between Switzerland and the EU. If the United Kingdom were to rejoin EFTA, that step would NOT of itself give rise any obligation regarding free movement of persons between the UK and the EU.

1.4.7 SOCIAL POLICY AND EMPLOYMENT RIGHTS

Workers' rights and social policy are another aspect of the EU Single Market, including health and safety measures, which can be imposed under QMV. If the UK had a free hand in this area of law, it would not lead to a bonfire of workers' rights or the ending of much of the protection on which it had led the way over more than a century. Nonetheless the costs to business can probably be reduced without harming the essential interests of employees by escaping from the detailed and restrictive straitjacket of Single Market rules and their detailed interpretation by the ECJ in decisions which sometimes seem divorced from the real world in which businesses need to compete and earn money in order to pay their workers.

In this area the EU can overrule the UK. The Working Time Directive was imposed against the opposition of the UK when the European Commission re-badged this

social measure (against which the UK would have had a veto under the Treaty) as a 'health and safety' measure. Meanwhile there are numerous EU measures in this field, which the ECJ tends to interpret in a very expansive manner. The ECJ has recently held that under the working time directive, a worker who falls sick while on holiday is entitled to more holiday time in lieu to compensate.

UK businesses must compete in global markets with companies from countries which do not have these EU-style social rights. Having such rights is not a necessary condition for market access.

1.4.8 RESTRICTIONS ON TRADE WITH NON-EU STATES

Another important but little understood feature of the EU Single Market is the restrictions which Single Market rules impose upon Member States against trade with non-EU states. An example is the ECJ case about licensing of agrochemicals (Case C-100/96 R v. MAFF ex p British Agrochemicals Association [1999] ECR I-1499), where the ECJ ruled that it was contrary to Community law for the UK Ministry of Agriculture to grant licences to products from non-EU countries which were identical to, and from the same source as, agrochemicals licensed here. The UK was as a result compelled to ban the import of these products from a non-EU country because they had not gone through the EU-mandated regulatory system even though there was actually no objective reason at all for excluding them.

The same 'Fortress Europe' mentality also applies in the field of intellectual property, where the ECJ has ruled that trade mark rights can be used by trade mark owners to exclude their own genuine goods from the EU market.¹⁵ In such cases the ECJ interpreted EU law to compel the UK to impose restrictions against imports of goods from non-EU states in circumstances where such restrictions would be contrary to the Single Market rules and principles if it had been a case of trade inside the Single Market. The effect on the market and on consumers is damaging: it allows multinational companies to milk UK consumers for higher prices than they charge in their own home markets. The ECJ's reasons for imposing these restrictions are hard to discern, but

FURTHER ISSUES - UK/EU

- Financial services "passporting": UK Financial Conduct Authority figures September 2016: 5,476 from UK to other EEA states; 8,008 inbound from EEA states to UK
- Again, strong mutual interest against disruption of trade
- Free movement of persons
- Political desire to "punish" UK for exercising treaty right to self-determination

seem to stem from a doctrinaire desire to isolate the EU Single Market from world markets.

This is an undoubtedly damaging aspect of the Single Market suffered by countries within the Single Market who are subject its regulatory obligations and to the ECJ's interpretation of those regulatory obligations. Outside the EU, the UK would be free to adopt a much more permissive and pro-free trade approach in its relations with non-EU states, to the benefit of consumers and of industry based here.

1.4.9 CONCLUSION

Although the 'Single Market' is often portrayed positively in economic terms, in reality it consists of a number of different elements some of which are positive, some of which are more equivocal, and others of which are downright negatives. In this category are the fact that it requires the UK to impose sometimes inappropriate tariffs and prevents the UK from negotiating its own trade agreements, and the 'Fortress Europe' regulatory and intellectual property restrictions against imports from non-EU countries which damage consumers and drive up costs needlessly.

Access to the Single Market would be quite different from *membership of the Single Market* with all the negative aspects which that involves. The examples from countries which access the Single Market but do not belong to it are considered below. ●

¹⁵ One example here concerned Tesco, which bought Levi jeans in North America more cheaply than in the UK, imported them to the UK but was then subject to an ECJ ruling which prevented their sale under intellectual property rules. The ECJ ruled that Levi Strauss could use its trade mark rights to prevent the importation and sale of its genuine jeans, because it had not consented to the placing of these particular consignments of jeans on the UK market (Case C-415/99 Levi Strauss & Co v Tesco Stores).

¹³ Under Article 45 of TFEU, the free movement of 'workers'.

¹⁴ For example, the EU/Swiss agreement on free movement was concluded in 2002: Official Journal L 114, 30/04/2002 P. 0006 - 0072.

1.5

WHAT ARE WE LEAVING? WHAT IS OURS TO TAKE WHEN WE GO?

1.5.1 THE EU AND THE COMMON COMMERCIAL POLICY

The EU is a customs union, not simply a free trade area. In a customs union the members operate a single unified system of customs tariffs and any particular category of goods will be charged the same tariff whether it enters the EU through, e.g. Rotterdam or Felixstowe. Because the external tariff wall is identical for all, the members of a customs union need to operate as a bloc when they enter into trade agreements involving tariffs with other countries. An agreement to reduce or get rid of tariffs on imports from another country involves the customs union as a whole. Under the common external trade policy in the Treaty of Rome, the European Commission has responsibility for negotiating trade agreements, under the supervision of the Member States. Such agreements may be concluded by the EEC (now the EU) in its own name, which has so-called 'exclusive competence' to conclude agreements with non-member countries falling within the field of the common commercial policy.

1.5.2 THE WTO AGREEMENTS AND 'MIXED COMPETENCE'

Because in practice trade agreements tend to cover broader subject matter than tariffs alone or related matters within the scope of the EEC/EU common

commercial policy, individual Member States must also be party to any external agreement that goes beyond the common commercial policy of the EU. This is called a 'mixed' or 'shared' competence agreement: where part of the competence to conclude the agreement belongs to the EU, but part of it remains with the Member States.

One particularly important series of agreements which involved mixed competence were the World Trade Organisation (WTO) Agreements which were concluded in 1993 as a result of the Uruguay Round

1.5.3 MULTILATERAL TRADE NEGOTIATIONS. THIS LINKED SERIES OF AGREEMENTS FORMS THE BEDROCK OF GLOBAL TRADE.

Both the individual member states including the UK, and the EU itself, are parties to the WTO Agreements. The respective legal powers of the EC (as it then was) and the Member States were ruled upon by the European Court of Justice in Op 1/94 Re the Uruguay Round Agreements [1994] ECR I-5267. The Court rejected a contention by the European Commission that the EC had across-the-board competence to conclude the WTO Agreements in its own name. Although the core provisions of the WTO Agreements relating to trade in goods fell within the EC's exclusive



competence under the common commercial policy, the Court ruled that other areas covered by the WTO Agreements relating to services (parts of the General Agreement on Trade in Services - GATS) and the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS) were outside the EC's competence or were areas where the EC's competence was shared with the Member States.

The upshot of this 'mixed competence' arrangement is that the EC/EU is responsible for compliance with, and entitled to the benefit of, certain aspects of the WTO Agreements; while the Member States individually remain responsible for, and entitled to the benefit of, the remaining aspects. The boundary between EC/EU and Member State competences is not stationary and under the Lisbon Treaty the trade-related aspects of intellectual property became part of the EU's commercial policy. Further, the current Singapore Free

Trade Agreement case in which the Court's judgment is currently awaited may affect this boundary line by leading to an expansion of EU competence at the expense of the Member States. While this fluctuating boundary line may be confusing for other WTO members, it is in general accepted by them.¹⁶ However, the consequences after the UK's vote to leave the EU are straightforward. The EU will cease to have any competence in respect of the UK's trade or other external relations. The UK will automatically assume rights and responsibilities in respect of 100 per cent of its relationship with other members under the WTO Agreements. In addition, trade relations between the UK and the remaining EU ('the r- EU') will cease to be governed by the EU treaties, and will automatically be governed by the framework of the WTO Agreements - unless a replacement trade agreement is negotiated between the UK and the r-EU which comes into force on exit.

¹⁶ Under the ECJ's Lugano doctrine, the EU acquires external competence in areas where internal EU harmonisation occurs and a shift in competence took place

There is no question of the UK having to leave the WTO or to re-apply for membership. The UK is one of the original founding members of the WTO, as laid down by Article XI(1) of the WTO Agreement.¹⁷

1.5.4 RIGHTS AND OBLIGATIONS UNDER THE WTO AGREEMENTS

The WTO Agreements provide today's framework for global trade. They contain a number of important principles and rules and a mechanism for judging disputes under the World Trade Organisation. At present however, the UK is precluded from resorting to the WTO disputes mechanism in any disagreement with the EU or other Member States by Article 344 of the Treaty on the Functioning of the European Union (TFEU), which states that:

“Member States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein.”

One of the key principles of the WTO Agreements is non-discrimination in trade relations. WTO members may not, for example, charge different tariffs on goods imported from different countries except in clearly defined, limited circumstances. So on leaving the EU, if no trade agreement were reached between the UK and the r-EU, the r-EU would apply its standard external tariff rates to imports from the UK.¹⁸ It could not discriminate by charging higher rates to the UK than to other non-EU countries. Similarly, the UK would apply its standard external tariffs to imports from the r-EU.

The UK would not be obliged to charge the same rate of tariffs on its imports as when it was a member of the EU customs union, and would legally have the right to reduce them. The EU has made a number of commitments in multilateral trade talks not to increase its tariffs above certain levels (so-called 'bound tariffs'), and Liam Fox the International Trade Secretary has announced that the UK will file Schedules of Commitments on its own behalf at the WTO which adopt the same "bound" upper limits at the current EU schedules. These are simply upper limits: the UK is free to charge lower tariffs or zero tariffs if it chooses to do so after exit.

The UK, when no longer under an obligation to maintain its tariffs at the same level as now obliged by the EU customs union, will be able to lower the cost of living for consumers and to lower costs of imported goods for its industries. At the moment tariffs are often set at a high level to protect industries in other parts of the EU even though the UK no domestic industry to protect, e.g. textiles and clothing, shoes and many kinds of heavily protected agricultural produce. The UK receives no benefit to its own indigenous industry, but pays twice over for the privilege of protecting foreign industries from lower cost competition in the world market. Our consumers pay higher prices than they need for the products concerned, and moreover the tariffs collected at our ports must be paid to the EU as part of its so-called 'own resources'.

The clear and unequivocal benefit of leaving the EU will be the right to set tariffs at levels which suit the UK's circumstances and probably, as a nation with a bias to free trade, reducing them in many cases. •

¹⁷ Article XI: Original Membership: The contracting parties to GATT 1947 as of the date of entry into force of this Agreement, and the European Communities, which accept this Agreement and the Multilateral Trade Agreements and for which Schedules of Concessions and Commitments are annexed to GATT 1994 and for which Schedules of Specific Commitments are annexed to GATS shall become original Members of the WTO.

¹⁸ Under Article XXIV paragraph 5 of GATT 1994, members of the WTO are entitled to form customs unions or free trade areas and to abolish tariffs between themselves without this being regarded as discriminatory against other countries. The EU is a customs union. After Brexit, the UK could therefore maintain a zero tariff regime in both directions between itself and the r-EU either by continuing to belong to the EU customs union or by entering into a free trade agreement.)

1.6

TRADING WITH THE WORLD TAKING ON THE 'THIRD COUNTRY' FTAs



UK TRADE AGREEMENTS

Priorities after Brexit:

- FTA with EFTA countries possibly longer term UK will re apply for membership of EFTA -now Vaduz Convention (NB not EEA membership)
- Thereby enhance and build on EFTA's network of free trade agreements with third countries, which is wider than EU's
(<http://www.efta.int/free-trade/free-trade-agreements>)
- Take advantage of historic UK trade and political links to open negotiations with e.g. Commonwealth countries

1.6.1 TRADE WITH NON EU STATES. WHAT WOULD CHANGE?

The EU has a number of free trade agreements with non-member states. These provide for the elimination of tariffs on trade in most goods, and seek to eliminate or at least reduce non-tariff barriers. A number provide for free trade in services as well as goods. EU Member States (including the UK) are normally parties to these free trade agreements as well as the EU itself under the 'mixed competence' rules.

For those countries outside the EU, at present both the EU and Member States, including the UK, are parties to existing free trade agreements. The UK could continue to apply the substantive terms of these agreements on a reciprocal basis after exit unless the counterparty State were actively to object. This will *not* involve complex renegotiation of existing arrangements.

One example is the 2011 Free Trade agreement with the Republic of Korea. (<http://www.lawyersforbritain>.)

org/files/eu-korea-free-trade-agreement-2011.pdf). The EU and the Member States are parties to the treaty.¹⁹

The substantive obligations in the agreement apply between the Parties. In the case of the obligation to eliminate customs duties (Article 2.5) each party is obliged to eliminate its customs duties in originating goods of the other party.²⁰ There would be no difficulty for either the UK or Korea to continue to comply with the substantive obligations of this FTA to each other or for Korea to continue to apply these to the r-EU. Such a course would not need any renegotiation of the substantive provisions of the FTA, but just a statement by the UK that on formally leaving the EU it intended to continue to operate the terms of the FTA between itself and Korea, and one by Korea that it would likewise continue to do so. In respect of procedural provisions involving bilateral joint committees or procedures for settling bilateral disputes, the UK would not continue to be represented by the European Commission or other EU organs in its relations with Korea, so these would need to be operated on a bilateral UK/Korea basis in respect of the UK's obligations under the FTA.

Korea could in theory object to the rolling over of the FTA in this way, but it is impossible to see what reason it would have to do so or what the gain would be if Korea brought to an end the existing free trade relationship between itself and the UK as an EU Member State, prompting the renewed imposition of tariffs on Korea's substantial goods exports to the UK, including cars and electronic goods.

To conclude on the general point, in order to provide for the smooth and continued flow of trade in

both directions no new FTA or renegotiation of the substantive terms of the EU-third country FTA would be necessary, rather a simple acknowledgement would be given by the UK and the third country that each would continue to operate its substantive terms on a mutual basis until further notice, and to set up bilateral UK/third country machinery to mirror the bilateral EU/third country machinery of the FTA. Indeed the UK would most likely wish to go further and strengthen and deepen existing FTAs and negotiate new FTAs with other parties. This longer term process would in no way prevent the rolling over of the terms of the existing EU FTAs into UK FTAs.

This kind of 'rolling over' of treaty obligations is a familiar process in international law. It happens in cases of 'State succession' where an existing State splits and the component parts wish to continue existing treaty relationships with other States.²¹ The exit of the UK from the EU is not legally a case of State succession. The UK will reassume the full powers of its existing Statehood by re-assuming rights and responsibilities for its own international relations in areas at present where its interests are represented via the EU. However, the practical issues involved are very similar and there is a similar mutual interest in preserving the continuity of existing treaty arrangements, particularly those which affect day-to-day existing trade, unless there is some good and concrete reason for changing those arrangements. It follows that the international counterparties to the existing EU FTAs will almost certainly follow general State practice in State succession cases and accept the rolling over of FTA arrangements so that they continue to apply to the UK after Brexit. •

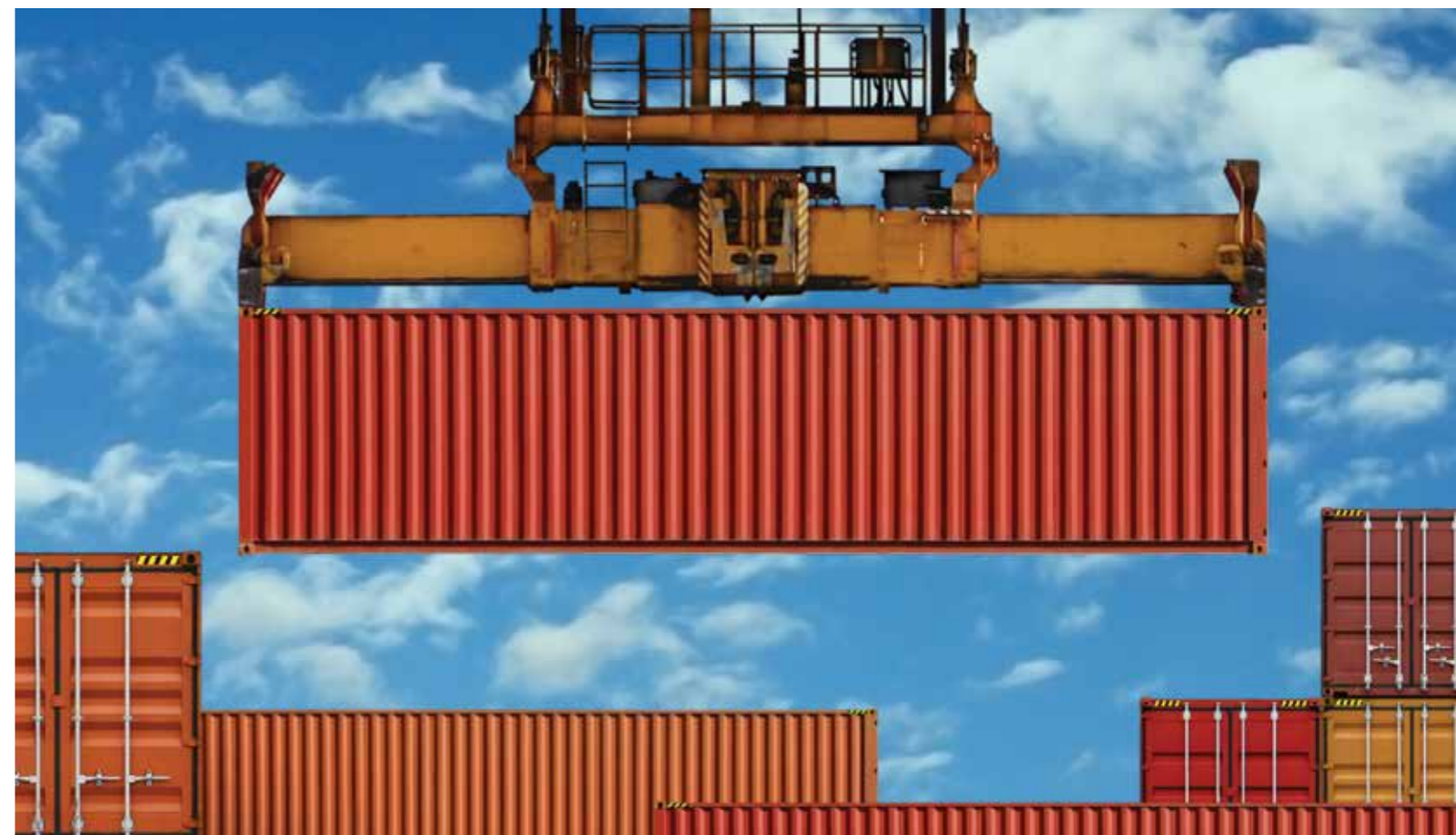
¹⁹ The definition of the Parties in Article 1.2 refers to the 'mixed competence' explained above: the 'EU Party' is defined as 'the European Union or its Member States or the European Union and its Member States within their respective areas of competence as derived from' the EU Treaties.

²⁰ Article 2.5 'each Party shall eliminate its customs duties on originating goods of the other Party in accordance with its Schedule included in Annex 2-A.' The FTA also contains mutual obligations regarding freedom to provide services, intellectual property and other matters.

²¹ For example, when Czechoslovakia split into the separate states of the Czech Republic and Slovakia on 31 December 1992, both new States agreed to assume and continue to honour the treaty obligations of the former State of Czechoslovakia, and other States and international bodies accepted the succession as being effective, where necessary agreeing new machinery for the separate representation of the two new States.

1.7

THE NEW DEAL BRITAIN, THE EU AND WORLD TRADE



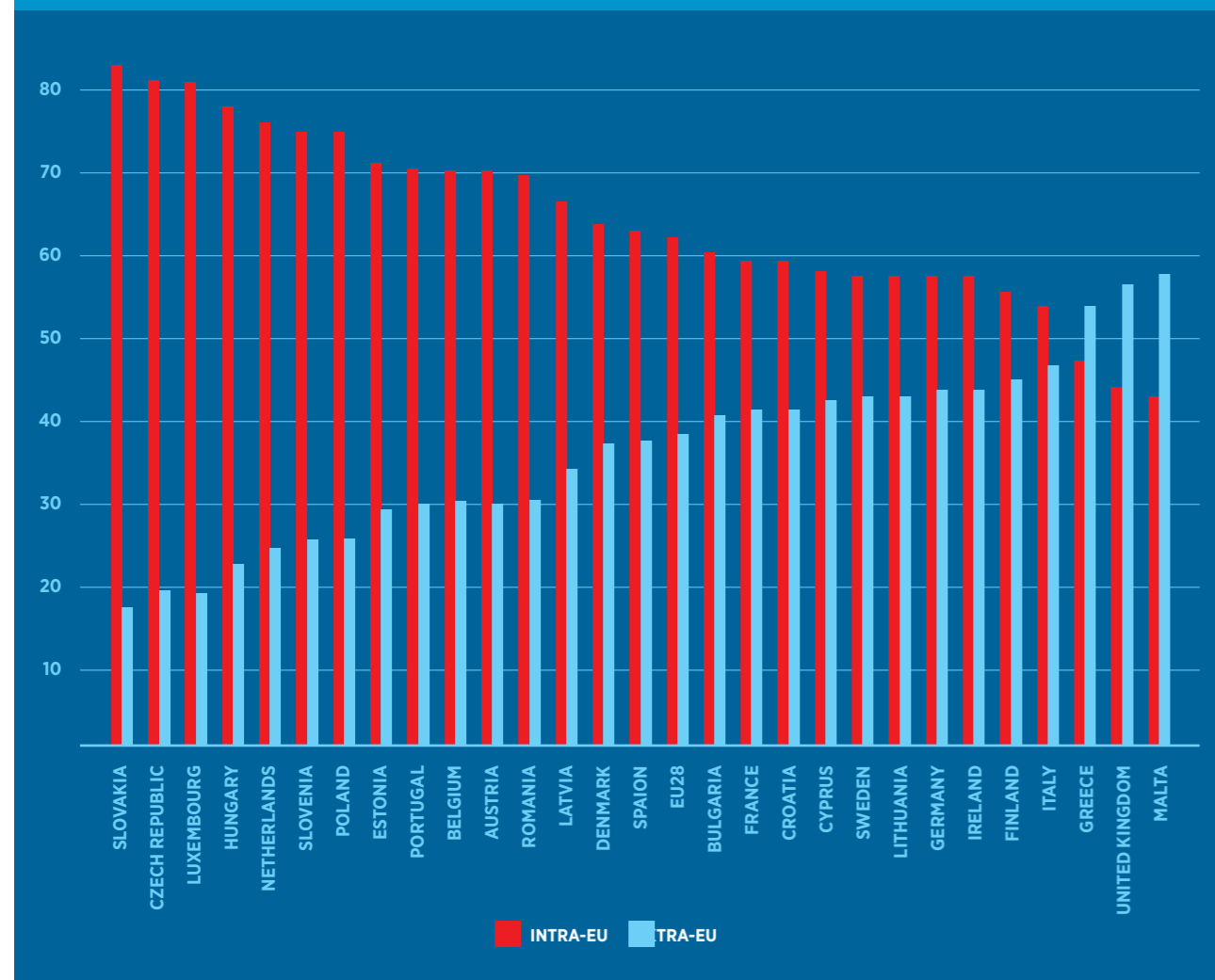
1.7.1 ON THE RISE – BRITAIN'S GLOBAL TRADE

Over the past 10 to 15 years, the proportion of the UK's trade with the EU has declined dramatically, displaced by the surge in UK trade with the wider world. By 2015 Britain's exports in goods and services to the EU from Britain had fallen to just 44 per cent from 1999 figure of 55 per cent, a trend likely to continue. This points to the fact that Britain's trading future is with the wider world, not the EU – a trend confirmed by the evidence on exports over the past fifteen years. This is no passing phase but a long term and persistent trend likely to continue into the future.

Britain therefore, having voted to leave the EU, must now shape her priorities for trade deals to what is best for global trading interests. Therefore, any deal regarding trade with the EU *must not* interfere with or compromise our global trading interests.

This point is dramatically demonstrated by a comparison of the UK's pattern of trade with that of other EU Member States. According to the comparative study by the official EU statistics body (Eurostat) of the destination of EU exports, to within or outside, the evidence in trade trends is clear: Intra-EU trade in goods - recent trends. By 2013, the percentage of UK exports to other EU states had dropped

INTRA EU EXPORTS COMPARED WITH EXTRA EU EXPORTS BY MEMBER STATE, 2013 (% SHARE OF TOTAL EXPORTS)



to 43.6 per cent, lower than any Member State except tiny Malta, indicating a trade pattern significantly out of line with the rest of the EU. It is almost 20 per cent (18.4 per cent) below the EU average of just over sixty per cent (62 per cent). It represents a major change from the position in 2002 when the UK share of exports to the EU was itself over sixty per cent (61 per cent), and when the UK was far closer to the EU average and more typical of the pattern of other Member States.

Such evidence shows why UK interests differ dramatically from those of other EU Member States. *Global trade is much more important* to us than it is to other EU Member States, while our exports to the rest of the EU are *much less important* to us than any other major EU state - the next major state closest to us in its trading pattern is Italy, which, nonetheless sends over half of its exports, 53.7 per cent to other EU states.

1.7.2 THE EU'S BEST CUSTOMER

The other aspect of our trading relationship with the EU is the UK's balance of trade. The UK imports significantly more from the EU than it exports to them, the persistent trend over recent years, one which appears to be strengthening.

According to the latest figures (2015, ONS 'Pink Book') the UK exported £134.3bn worth of goods to the r-EU but imported £223.0bn, a trade gap of -£88.7bn. This means that Britain imports 66 per cent more goods from the EU than it exports to us. This trade gap matters, but not because it is of itself a bad thing: within a country's overall trading pattern there will normally be surpluses with some trading partners and deficits with others, and there is no special reason to aim for a trade balance with each partner. Rather, the trade gap has major implications for negotiating the new trade deal with the remaining EU. Any attempt by the remaining countries to penalise - and

thereby inhibit (e.g. by tariffs) - trade between the UK and the r-EU after exit would disproportionately affect EU exporters compared with UK exporters.

Some EU politicians since the referendum have been trying to deter their own or other Member States' voters from seeking a referendum on EU membership. They have suggested that access to the r-EU Single Market will not be simple. However their own exporters' interests will in reality dominate their approach to striking a new trade deal, German car workers and manufacturers and French farmers will want guarantees that their government maintains the preferential arrangements to trade with the UK dependent upon reaching a harmonious and mutually beneficial trade deal with the UK.

1.7.3 KEY ELEMENTS OF THE TRADE DEAL WITH THE EU

A lot of confused thinking exists about what should be the nature of the UK's new trade deal with the EU. It has for instance been mistakenly implied, that a current EU trade agreement should provide the blueprint- the Norwegian, Swiss,²² Canadian or even Albanian 'model'?

While the EU's existing trade agreements show what has been agreed to in the past, examination of the EU's external trade deals demonstrates that there is no fixed template and no limited 'a la carte' menu for the form of relationship from which other states must choose. The wide variety of the agreements reached simply demonstrates that the EU is willing to negotiate on a case by case basis a deal which suits the mutual interests of itself and the party it is negotiating with. Therefore it is not surprising if agreements negotiated to suit the circumstances and interests of other states with economies that differ from the UK should not be best fits for the UK's interests.

What the UK should press for in terms of a trade related agreement is in fact fairly straightforward and simple, and consists of three main elements:

- **A free trade agreement:** A free trade agreement allowing for tariff-free entry of goods (in both directions). This is permissible under Article XXIV of GATT as a permissible

exception to the rule that WTO members must charge the same tariff rate to all comers. Unlike a customs union, members of a free trade area can decide on the level of standard tariffs charged to non-members of the free trade area. Such a course would allow the UK to charge lower or nil tariffs on goods where there is no substantial UK industry to protect, to the benefit of our consumers and industry. The r-EU would have a strong incentive to agree to an FTA deal, given the substantial trade imbalance (above p.). It should be pointed out that all non-EU territories in Europe have free trade agreements with the EU apart from Belorussia.

- **General rules on free movement of goods and services:** The general rules of the EU treaties on free movement of goods and services have generally worked well and in the interests of the UK. There would be no difficulty in replicating these general rules in a new EU-UK trade agreement. Already many of the EU's external trade agreements do so. Since these rules benefit consumers in the state of importation, there is a strong case for replicating them and applying them also to goods and services imported from non-EU states.

- **Continued access for goods and services under existing regulations and directives:** The EU currently has a large number of regulations and directives which determine the rules with which goods and service providers must comply as the basis for selling those goods or services in other Member States without further restrictions. Unlike a new candidate applying for an EU trade relationship, the UK is currently compliant with this mass of regulations and directives. This simplifies the basis for a trade deal. Provided neither party changes the relevant rules, mutual access to markets would continue after exit in the same way as before. Such a provision would give both parties (us and the EU) the right to change the rules in a relevant area -though a rule change might affect the continued access rights of businesses exporting from the UK to the r- EU or vice versa. •

²² It is of course interesting to note that the Western European countries who are outside the EU all seem to be doing very well economically and do not want to convert their existing arrangements into EU membership.

1.8

RE-JOINING EFTA

THE EUROPEAN FREE TRADE ASSOCIATION

The UK was a founder member of the European Free Trade Association (EFTA) in 1960 which operated as a free trade area in Europe alongside the EEC. Its members were the UK, Norway, Sweden, Denmark, Switzerland, Austria, and Portugal. In 1973, the UK and Denmark joined the EEC and as a result withdrew from EFTA. The problem then arose of how Denmark and Britain could continue their free trade relationship with the other EFTA countries given that once in the EEC, a customs union, individual Member States may not belong to a free trade area with external countries (only the customs union as a bloc can do so). The solution found was for the EEC to enter into free trade agreements with the remaining EFTA states, preserving the free-trade relationship between the UK and Denmark and the other EFTA states and expanding it so the EFTA members could enter free trade relations with the other EEC members (the original Six).

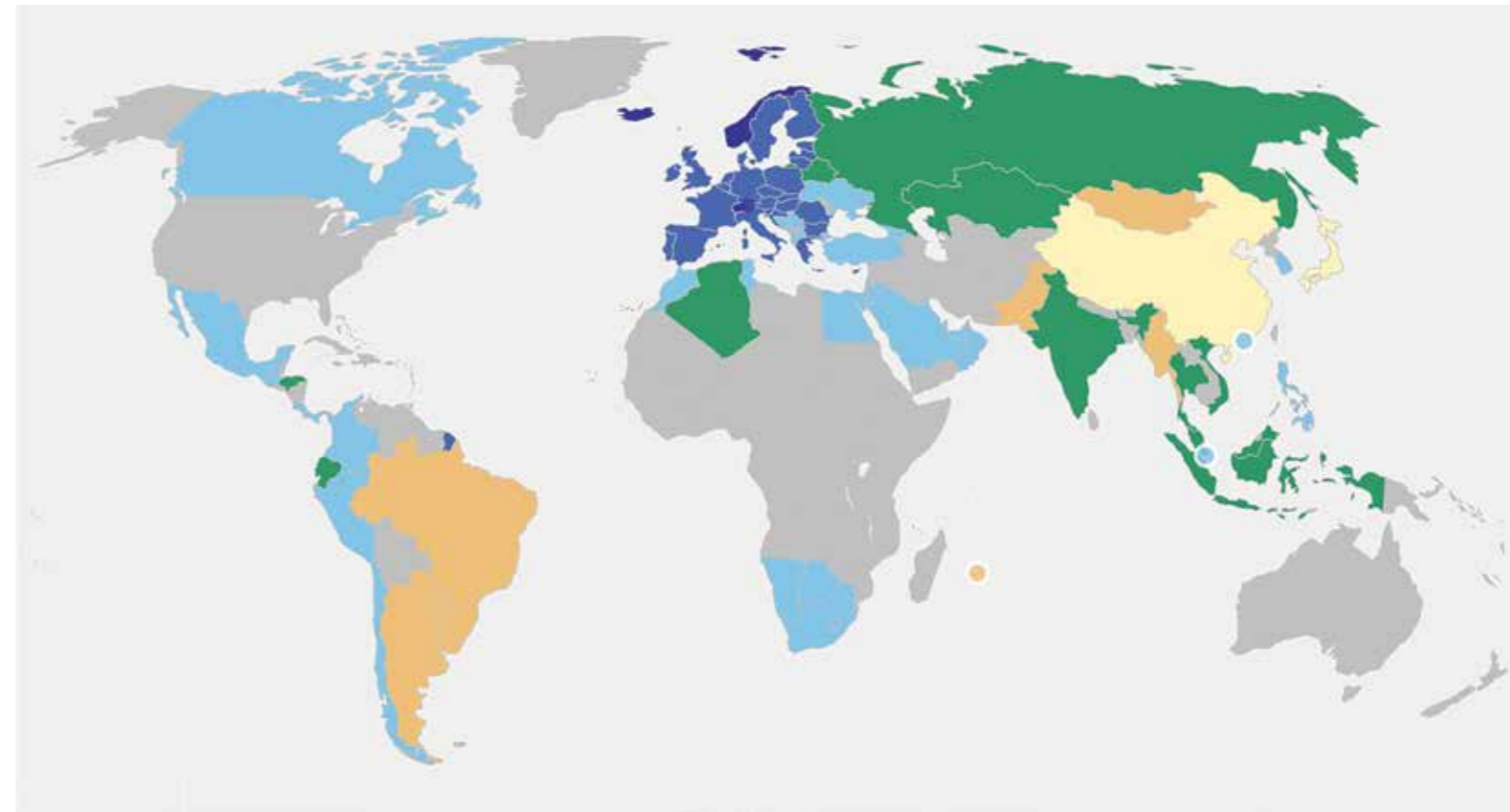
When Sweden, Austria and Portugal joined the EEC and as a result withdrew from EFTA, they therefore preserved their free trade relationships with the EFTA states. EFTA now consists of Norway, Iceland, Switzerland and Liechtenstein. It should be stressed that EFTA itself is a separate organisation which regulates itself and negotiates trade deals with other blocs or countries –as it has done with the EU.

However confusion has arisen because three of the remaining EFTA states belong to another organisation,

the EEA (European Economic Area, founded in 1992)- the EU plus Iceland, Liechtenstein and Norway. The EEA agreement enables these three EFTA states to participate fully in the Single Market and covers the four freedoms (goods, capital, services and persons) and the rules on competition and state aid. The aim was a homogenous European Economic Area and for this the EU's Single Market legislation applies under the EEA agreement in the whole of the EEA. However, Switzerland declined to join the EEA and as a result the trade relations between itself and the other EFTA States are still governed by the EFTA agreement (now revised and known as the Vaduz Convention). Switzerland went down a different route in reaching other bilateral arrangements with the EU though these may be set for review following its recent referendum.

EFTA, which remains legally independent of the EU, has been notably more successful than the EU in striking free trade deals around the world. Whereas the EU's more important free trade negotiations continue to be held up by individual Member States' objections, e.g. on account of protectionist inclinations towards their own industries, with for example the Mercosur Latin American bloc,²³ and the USA meeting many and prolonged obstacles. Only recently after protracted discussions did it reach a free trade agreement with Canada. And it should be noted that the EU only concluded its agreement with Korea in 2011. Meanwhile the long awaited Canada-EU trade agreement has been further delayed by the refusal

²³ It was reported in April that a group of Member States led by France pressed the EU Commission to delay the restart of the already heavily delayed free trade talks between the EU and Mercosur, the Latin American bloc which includes Brazil and Argentina, on account of the potentially harmful effects of free trade on some sectors of EU agricultural producers who would be exposed to competition from South American producers. El Pais, 26 April 2016



■ EUROPEAN FREE TRADE ASSOCIATION
 ■ EU (EUROPEAN ECONOMIC AREA)
 ■ FREE TRADE AGREEMENTS
■ JOINT DECLARATION OF COOPERATION
 ■ ONGOING FTA NEGOTIATIONS
 ■ FTA RELATIONS OF INDIVIDUAL EFTA STATES

of Romania to ratify the agreement because of a visa dispute with Canada, and then by Wallonia's further delay to ratification. And in the case of the flagship long drawn out EU-USA attempts to negotiate a Trans Atlantic Trade and Investment Partnership (TTIP), these have been held up by the French position that its film industry should be shielded from competition with Hollywood, one of the USA's most important export industries. As a result of this and other protectionist demands, there have been delays and problems and it is not clear that an EU USA free trade agreement will ever be concluded.

The lack of success by the EU in negotiating free trade agreements with major export markets may have led the EU to focus on reaching trade agreements with less developed countries in Eastern Europe and elsewhere, and a large number of micro-states (Map of EU FTAs). While worthwhile for reasons other than trading self interest to promote the development and political stabilisation of these countries, something which the UK may well wish to continue, these are not major export markets.

EFTA has been more successful than the EU in reaching agreements with large and growing export markets around the world (EFTA Free Trade Map). It has ongoing negotiations with major and growing export markets such as India, Malaysia and Indonesia. Such success by comparison with the EU suggests that these smaller blocs tend to be better than the larger EU in forging trade agreements with other countries.

The revised EFTA convention (the Vaduz Convention) extends beyond free trade in goods, and includes provisions on free trade in services and the free movement of capital and of persons. None of these should be problematical to the UK given that the Vaduz Convention only applies between its members and so would not act as a gateway for the free movement of persons from the EU or elsewhere. All four EFTA states have standards of living comparable to or even higher than the UK with high educational standards and high skill economies.

The logical course for the UK would be to apply for readmission to EFTA with a view to its membership taking effect immediately upon EU exit. There seems no reason why the four current EFTA states should not welcome such an application. The EU and its Member States are not parties to the EFTA convention. They would therefore have no say over such an application for membership. Such a course would in the first instance preserve free trade arrangements between the UK and the EFTA states and avoid the risk of, e.g. Swiss exports into the UK being subjected to tariffs (and vice versa). Notably, in 2013, the UK was Switzerland's fifth most important export market in the world (Swiss official website), while the UK

was Norway's single most important trading partner receiving 25 per cent of Norway's total exports in that year (Norway official website).

Re-joining EFTA would benefit more than just direct trade relations between the UK and the EFTA states. As well as facilitating and deepening free trade between its own members, by re-joining EFTA, the UK would be able to seek the extension of existing EFTA FTAs to itself, and also to give a large positive impetus in collaboration with its EFTA partners to forging new agreements and extending existing free trade agreements particularly in the area of trade in services. •

APPENDIX

ARTICLE 50 OF THE TREATY ON EUROPEAN UNION

Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.

A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.



PART II.

THE ECONOMIC FRAMEWORK MOVING THE ECONOMY TO A BETTER FUTURE

by Patrick Minford

This analysis is not simply about the damage the EU does to the UK. It applies mutatis mutandis to all existing members of the EU, on which similar damage is inflicted by the EU's malfunctioning institutions.

The EU now faces a major crisis of rejection by public opinion in country after country, not dissimilar to its rejection by UK public opinion. To become viable again as a political entity, and so to command authority once more, the EU needs to

change direction radically away from the model of 'always more Europe, progressing towards a super-state'. Its powers over commercial policy must be dedicated by Treaty to being directed to free trade. Its regulative powers should be delegated back to national authorities under mutual recognition. Its fourth freedom of free migration should be abandoned as quite unnecessary to trade integration and dangerous to inter-country unity because of its provocation of large scale transfers.

2.1

INTRODUCTION

THE BREXIT BATTLE, THE SINGLE MARKET AND PRODUCERS v CONSUMERS

THE BATTLE FOR FREE TRADE



- People voted in the Brexit referendum for control of their borders and our laws.
- The only way to achieve that is to leave the EU cleanly.
- The optimal economic way is to go for unilateral free trade with all countries including the EU.

“ ... The only action that guarantees we meet what consumers voted for in the Brexit referendum, which was control of our borders and our laws, is that we leave the EU cleanly; and the optimal way for us to do that economically is to go to unilateral free trade with all countries including the EU. We do this by invoking Article 50 and using the European Communities Act 1972 to amend existing EU law as needed, in the manner explained by Martin Howe in Part 1 (pp...). No need for any trade agreements; no effects of any protectionist actions taken against us by any parties, including the EU. We simply ‘walk away’ into a trading world governed by WTO rules, with a UK governed by our own democratic laws....

The Brexit referendum can be understood as a battle between UK producers and UK consumers (that is, all UK households). This is because the main effect of the EU is to raise prices through protection and regulation to benefit groups of producers. Their consumers pay these higher prices. Moreover producers also benefit at the expense of consumers by the taxes

levied to subsidise unskilled immigration as well as by the taxes levied to pay directly into the EU budget. On the one side the producers were the farmers and the manufacturers who gained directly from the protection as well as particular groups such as universities, regional assemblies and some City firms such as big banks with large EU business who had a direct interest in EU funding. On the other side were the general householders who did not belong to any of these groups who paid the higher prices or the extra taxation.

The producers cast their argument as ‘needing to be in the Single Market’ which sounds grand and deserving. But the Single Market is simply the geographic area within which EU regulation creates ease of doing business and around which the EU creates a protective trade barrier as well as mandating free migration. Thus to be ‘in’ it requires that one submits to the regulation, the protection and the free migration.

Or one can by contrast leave the Single Market and sell into it from the outside as other non-EU countries do; then you have your own regulation, you choose

your own trade barriers and you control migration from the EU as from everywhere else. In both cases you benefit from the fact that the Single Market exists as an area within which barriers to trade are largely eliminated; but there is a difference in the terms on which you deal with the EU’s consumers and businesses.

The calculations in this article show that being in the Single Market is damaging to us compared with the best policy we can follow which is to be outside with no trade barriers against the rest of the world (‘unilateral free trade’), our own regulation and our own migration controls. This is because of the costs of EU protection, EU regulation and of the unskilled migration permitted by the EU. The gains from this best policy take the form of much lower prices and taxation paid by consumers which in the long term give rise to higher output and living standards. Essentially what happened in the Brexit referendum was that for once those consumers were able to examine the whole EU package. This showed that they were being exploited by the producers who dominate politics in normal times through the power of their ‘lobbying’ activities which amount to a form of

political bribery, one permitted them in the interests of paying more cheaply for our politics.

Since the referendum, the producers have continued to fight back, now that the vote is over and normal politics has resumed. The line they are arguing is that somehow we can do a ‘deal’ with the EU that allows Britain to be ‘in’ the Single market while also ‘leaving’ the EU. What could such a deal possibly be? It turns out that such ‘deals’ are exemplified by the ‘Norway’ or European Economic Area treaties; but these on inspection are hardly different from our current EU membership except that we lose any say over the EU regulations imposed on us. There is still free migration, virtually all the EU regulation and all the same EU protection; rightly the Remain side denounced these options during the campaign as amounting to little more than ‘the EU via fax’ and said we would be better off simply remaining.

It is argued that the Canada-EU deal is close to this: but this has not been ratified by the EU and has now to be agreed by all regional and national Parliaments of the EU countries. The difference too between the UK and Canada is that Eastern European countries

and others such as Ireland do not have free migratory access to Canada as they do to the UK and which they are determined not to lose; they could veto any such agreement even if some countries such as Germany with close UK trade ties might want it. Any such 'deal' has essentially to be agreed by a large majority of EU countries if not unanimously and it is hard to see how that agreement could be achieved. We saw how difficult it was for David Cameron to get any change at all agreed in his pre-referendum negotiations. The fundamental difficulty is that whereas the EU Commission and other EU institutions such as the Court have huge powers to implement detailed policies that lie within the scope of the EU Treaties, they have virtually no power to compel EU countries to agree to arrangements with outsiders that are additional to the Treaties. You may say: 'Well, why not try to get such a deal anyway?' But the problem with this is that we may waste much time trying and get nowhere, at great cost to the economy in policy drift.

But there is a further clinching argument for not wasting time on any such 'deal': it will not make us better off than simply leaving for unilateral free trade (with all including the EU), our own regulations and migration controls, with no deal at all - call it a 'full Brexit'. The reason is that the effect of lower tariffs on us by the EU will simply divert more of our output to the EU at the expense of other suppliers of these products; but there will be no effect on the *total* world demand for these products and so none on their world prices. But it is these world prices that determine how much in total we produce. So we produce the same output in total and sell less elsewhere at the same prices. Irrelevant to us!

The same argument applies to any trade agreements we sign around the world; no effect once we have abolished *our* tariffs and other trade barriers. This also applies to all those City financial products for which the EU might give or deny us preferential access: we argue here that such preferences such as passporting are in practice of small importance and that any EU protection of financial services unlikely. But the point is that they are irrelevant to the UK's national interests and total output; they only affect the size of our EU market relative to our non-EU market. As much as particular firms such as banks with large EU markets may want to keep those markets unchanged in size, this has only to do with *their* narrow interests and not with the *national* interest. What the City should also remember in its lobbying tactics is that it, like other service industries in the UK, will gain massively from the lower cost base created by a full Brexit through lower prices and taxation; getting a 'deal' for the Single Market at the expense of a full Brexit with no deal would cost them dearly.

So, in sum, the only action that guarantees we meet what consumers voted for in the Brexit referendum, which was control of our borders and our laws, is that we leave the EU cleanly; and the optimal way for us to do that economically is to go to unilateral free trade with all countries including the EU. We do this by invoking Article 50 and using the European Communities Act 1972 to amend existing EU law as needed, in the manner explained by Martin Howe in Part 1 (pp...). No need for any trade agreements; no effects of any protectionist actions taken against us by any parties, including the EU. We simply 'walk away' into a trading world governed by WTO rules, with a UK governed by our own democratic laws. •

2.2

BREXIT'S ECONOMIC MESSAGE

CHALLENGING PRODUCER POWER, CHALLENGING THE EU STATUS QUO



“...the Brexit vote can be clearly seen as a vote by consumers in favour of higher living standards against producers wishing to hang onto their existing markets...”

2.2.1 CHALLENGING PRODUCER POWER, CHALLENGING THE EU STATUS QUO – THE UK VOTE.

The EU referendum had a vital economic aspect. It challenged producer power, the power of many big businesses and vested interest lobbies to maintain their own interests at the expense of the consumer. Although producers lost the referendum, they have launched a fight back, trying to push the British government into keeping the status quo in the form of an EEA settlement with the EU.

What is that *status quo*, how has it evolved and what powers does the EU have which these interest groups want to retain?

The main powers exercised by the EU are (i) the control of trade barriers for goods - food and manufactures - via its customs union and (ii) the control of regulations within the area of the customs union, known as the Single Market. But a start has also been made in regulating trade in *services* within the EU, known as the 'Single Market in services'. This, however, is largely ineffective since the vast bulk of service regulation is done by national governments and EU actions have barely changed this so far. It is difficult to know exactly how the regulation of services will develop. As a result there are sharp divisions of opinion within the City of London about the merits of staying in the EU. The main developments, so far, have been first the imposition of a variety of new regulations on the City, such as bonus caps, the proposed Financial Transactions Tax, and general regulation of finance under the Markets in Financial Instruments Directive (Directive 2004/39/EC) (MIFID), the effects of which on the economy will be dealt with in the discussion of regulation (p. 31). Second, the introduction of 'passporting' for

financial services within the Single Market has been introduced. Inside the EU, firms can get a derogation from national interventions on the sale of financial services across internal EU borders; whereas, outside the EU the same firms cannot access this derogation and are forced to sell at prices raised by full national interventions. So this is in effect a Customs Union in EU financial services, which may in time spread to other services. However this protectionism in financial services is substantially mitigated by the conceding of passporting to financial firms operating in wholesale markets (basically banks and large investment funds) from other countries with 'equivalent' regulative regimes; this is due to the emphasis in the Maastricht Treaty on freedom of capital both inside the EU and with the outside world. Given also that other retail financial firms (i.e. those selling to the general public like stockbrokers) usually have local offices and do not rely on passporting, it is probably fair to say that so far there is no real protectionism or Customs Union in financial services. Instead the EU has tried to reduce effective national barriers to service trade and make this reduction widely accessible around the world. Furthermore in the case of the UK, with low or non-existent national barriers to service trade, the EU has barely altered prevailing prices, except via its regulative actions- considered separately here. These are the assumptions on which the analysis which follows will be developed. The picture by contrast of the Customs Union and the Single Market in goods, ie agriculture and manufacture, is of a protectionist organisation with respect to the outside world. This protectionism raises prices within the Single Market area by around 20 per cent on food according to OECD estimates and by about the same on manufactures according to estimates based on price comparisons.

2.2.2 THE EU CUSTOMS UNION - PROTECTING THE FEW AT A COST TO THE MANY

It is pretty obvious from the passions aroused by the idea of leaving the EU that the scale of protectionism is substantial, and that in manufactures it mainly comes from non-tariff barriers, which are elusive ways of making it difficult for outside competitors from cheap-labour sources to sell their output - mainly probably through the difficulty of satisfying regulations inside the EU. After all, suppose that in manufacturing it was merely tariffs at stake, which

average around 2 - 4 per cent depending on how they are weighted, it would be surprising to see much of a fuss. What alarms UK manufacturing producers about leaving the Single Market is that they will lose protection that keeps prices up substantially; if the estimates above are correct UK firms will face prices 20 per cent lower in their home UK market.

UK farmers are relatively small in number and many of them highly efficient and rich, so that they are making little noise. Small scale farmers can and will be helped directly as they were before the UK joined the CAP. Even if we do have an EEA agreement it seems likely that we will not stay in the CAP. So the farmer lobby is fairly quiet.

UK financial service firms, notably banks, are making a fuss. But as we have seen there is not much basis for this with protectionism kept at bay by the needs of capital mobility and the euro.

The biggest producer fuss is in manufacturing. That is baffling to some extent, with manufacturers having managed to make their cause something akin to the Holy Grail. Among the political classes on all sides of the Houses of Parliament it is routine to pay obeisance to 'rebalancing', 'protecting our manufacturing base' and such phrases that are code for maintaining manufacturing; I was pilloried by the last Prime Minister in PMQs for saying that the elimination of protection would in turn eliminate low-value manufacturing (i.e. metal-bashing done much more cheaply in the Far East). Just as the big inefficient aristocratic farms were largely destroyed over the decades succeeding the abolition of the Corn Laws (1846) which allowed imports of cheap American cereals, so today what remains of manufacturing of the low-value variety will not survive competition from China, Vietnam and other such producers in the decades to come. During the referendum campaign ordinary citizens were unfazed by the idea that manufacturing would have to contract and would only survive by going 'up the value chain' and so raising productivity.

Today only 8 per cent of employment is in manufacturing and around 10 per cent of total output. This contrasts with the 1970 figures of an employment share of 35 per cent and an output share of 32 per cent. So competition has, over nearly 50 years, driven much of our manufacturing out of existence and ensured that the manufacturing that



- The EU Single Market protects producers through its regulation and tariffs. Consumers pay the costs & voted against producers in the Brexit referendum.
- Leaving the Single Market & EU Customs Union in manufacturing, will mean voters gain from a price fall.
- UK consumer prices should fall by around 8%. The overall GDP gain is 4% measured by a WTO model.
- Productivity and competition will bring further gains used to calculate the effects indicates that

is left is massively more productive. The renaissance of UK productivity growth that occurred in the 1980s was unleashed by the Thatcher government reforms and the competition they created. Many of the older voters in the referendum who themselves had been once employed in manufacturing (or came from parents who were), may well have felt that the competition they and their parents experienced, which led to the UK economy's enrichment, could reasonably be extended to today's manufacturing firms and workers.

By leaving the EU Customs Union and Single Market in manufacturing voters stood to gain a substantial fall in prices, while this would also provide the spur of additional competition to manufacturing producers with further indirect gains coming via productivity. Those voters among the 8 per cent employed in manufacturing who might lose their jobs could be reassured by a fully employed economy in which they would find jobs elsewhere. According to the World Trade model I set up to calculate the effects of Brexit, UK consumer prices fall by around 8 per cent and the overall GDP gain is 4 per cent.

So the Brexit vote can be clearly seen as a vote by consumers in favour of higher living standards against producers wishing to hang onto their existing markets. Matters, however, did not end there. The Single Market had two further ramifications. It created regulation in all aspects of UK industrial life and it mandated free movement of labour around the EU. Both of these levy substantial costs on UK consumers as we will explain in detail below.

2.2.3 LESSONS FOR THE EU

This analysis is not simply about the damage the EU does to the UK. It applies mutatis mutandis to all existing members of the EU, on which similar damage is inflicted by the EU's malfunctioning institutions. EU protectionism causes similar damage to EU consumers and resource allocation that it does to the UK's. On our world trade model, the damage to the EU itself was around 3 per cent of GDP- only slightly less than to the UK, because the UK is such a large net importer from the EU that this adds around 0.8 per cent of GDP to the efficiency losses due to

protectionism pure and simple. For the EU per contra there is a gain from being a net exporter to the UK of about 0.15 per cent of GDP. These transfers come about because a customs union raises the prices importers across the whole union pay for the exports from the rest.

So EU consumers too would benefit from abandoning this protection for their own producer lobbies - in Germany manufacturing, in France farming. Of course these lobbies are very powerful and Brussels is structured to ignore consumers and bend to lobbying. One deep irony is that the EU's defencelessness against lobbying is partly due to its having no sources of revenue of its own; the only way it can satisfy a powerful national lobby is to use (distortional) protection, whereas a national government can often deal with it by some sort of compensation. Nations however are deeply reluctant to let the EU raise its own taxes.

The resolution of this dilemma is to reduce the EU's powers to levy protection so that it is not worth lobbying it.

Then we turn to regulation, where for the UK we find there have been substantial cost-raising effects, reducing UK competitiveness: my estimate is that so far about 6 per cent of GDP has been cut from UK growth as a result of this EU regulation. I have not specifically estimated the analogous costs for the rest of the EU but they are likely to be of a similar order of magnitude as they concern the broad operation of all the same markets. The solution to the EU's problem of over-enthusiastic regulation is to revert to the original plan for Single Market regulation: national competing regulative systems based on mutual recognition.

Finally there is unskilled immigration: in this case the rest of the EU is a mix of transferring and recipient countries so that the net taxpayer losses for rich countries are balanced by the net gains of the countries despatching immigrants. The 'fourth

freedom' of unfettered migration is a source of huge potential friction within the EU and it has always been unclear what its economic benefits can be, when trade is free within the EU.

The question of the euro is not relevant to the UK, unless one assumes that in the long term our opt-out might not be sustainable. In other work (Minford et al, 2015) I have pointed out that this may well be the case and the potential costs to the UK of joining in the euro need to be considered in a full review of costs and benefits. For euro-zone members in the rest of the EU it is extremely relevant; the euro's malfunctioning has been a source of huge economic losses in the South of Europe and also in the North because of the spillovers from these. The root of the malfunction lies in the absence of fiscal union: but plainly also fiscal union cannot be achieved in the face of huge opposition from public opinion in Germany and other rich Northern countries of the EU. The conclusion has to be that the eurozone should be cut back to a group of countries between whom fiscal transfers need to be minimal- essentially those Northern countries only.

The EU now faces a major crisis of rejection by public opinion in country after country, not dissimilar to its rejection by UK public opinion. To become viable again as a political entity, and so to command authority once more, the EU needs to change direction radically away from the model of 'always more Europe, progressing towards a super-state'. Its powers over commercial policy must be dedicated by Treaty to being directed to free trade. Its regulative powers should be delegated back to national authorities under mutual recognition. Its fourth freedom of free migration should be abandoned as quite unnecessary to trade integration and dangerous to inter-country unity because of its provocation of largescale transfers. Finally the eurozone should be cut back to a group of Northern countries for whom fiscal union is unnecessary, as always intended in the Maastricht Treaty. Its negotiations with the UK over Brexit could become the template for this new EU, so welcome to us all. •

2.3

WHAT CONSUMERS WANT

HOW TO IMPLEMENT BREXIT



The UK can clearly therefore export to the EU in the same way that these countries do; in so doing it benefits as an external user from the SM but is not regulated by it. Of course this is precisely why the EU in the first place set up the SM: it benefits their citizens by enabling them more easily to access not just the fruits of their own production but also that of the rest of the world.

In summary the SM is a benefit to the internal trade of the EU; and this benefit extends to foreign countries selling within the EU just as it does to EU countries selling within the EU. But to enjoy this benefit these foreign countries do not need to 'join the SM' and be regulated by it. They also have good reasons to want to have their own regulative systems.

2.3.1 A UK-EU DEAL? THE REALISTIC OPTIONS

How can Brexit be best achieved to honour what consumers voted for in the referendum? How would this contrast with the effects of the EEA-type agreement that the government, spurred by producer power and EU pressure, may mistakenly be tempted to pursue?

Before proceeding, it should be noted that governments when not pushed directly by voter power, will inevitably succumb to producer power. That is because producers lobby them and promise them indirectly all sorts of rewards. They pay for their political campaigns, they provide jobs after political retirement or ejection, they can facilitate private activities like expensive holidays or travel, and so forth. This is not banned as corrupt activity; rather we accept that our politics must somehow be paid for and this method is allowable subject to rules of 'interest declaration' and such like. We should not therefore be surprised or shocked that now 'normal politics' has resumed post referendum, the producer lobbies are back in business and that policy is reflecting this. The Remain camp is still in full voice, its latest effort being to paint the post-Brexit economy as dominated by a terrible 'Brexit shock'; as has now been revealed by the economy's strong growth since the referendum, the best estimate of the Brexit shock is in fact slightly positive!

Nevertheless to resist the effects of these producer lobbies, political and policy debate play a central role. Through argument, debate and a free press, politicians may be encouraged (or shamed) into doing what they should, in spite of producer lobbying.

Such lobbying can be reinforced by the interests of many national governments in pursuing matters of trade, regulation, protection, migration and the Single Market. These are of enormous sensitivity within the EU, as David Cameron found when he tried to negotiate some changes to the UK's EU relationship before the referendum. A good example of this sensitivity is the TTIP with the USA and the CETA with Canada. TTIP is opposed widely in the EU by groups who dislike the idea of the new 'corporate courts' where governments can be sued; it has now been pronounced dead by Germany's SPD. CETA, after taking seven years to negotiate, also includes these corporate courts and is strongly opposed by Germany's left wing; it has now run into controversy

across the EU and has been declared a 'mixed' agreement that requires ratification in all member countries, including regional parliaments. Its prospects look as bleak as for the TTIP. One must conclude from this that any agreement between the UK and the rest of the EU is vulnerable to holdup from many sides.

For example any attempt to block unskilled migration into the UK within the Single Market is unlikely to be permitted by countries like Poland, Bulgaria or Romania. Yet under Article 50 any agreement between the UK and the EU would need unanimity on the EU side unless it were very simple and limited; even then it would require agreement by Qualified Majority Vote and it is extremely likely that the many countries concerned to maintain free migration could assemble a blocking minority (a dozen countries). A complex EEA-style deal, like the EEA Agreement itself, would need to be agreed and ratified by each individual Member State as well as by the EU itself. If no agreement can be concluded within two years, then the UK leaves anyway without agreement. Frankly, if one looks at the many diverse interests of the 27 countries making up the rest of the EU, almost any agreement on anything other than the basic matters of rights for existing citizens, visa requirements and other routine inter-state matters look quite intractable. This, to repeat, is what David Cameron found: the only 'negotiation' to be had was effectively to stick to the existing treaties.

Until the EU next tries to revise these Treaties comprehensively and throw all the cards in the air for general horse-trading, there seems to be no chance of change. It is an extraordinary irony that the EU has great powers to make directives via its existing institutions and virtually none to negotiate inter-country relationships. This was illustrated by the euro-crisis when getting joint action to help the embattled countries of the South relied totally on Germany's willingness to make transfers and to allow the ECB to lend almost unlimited amounts for which it might in the end be liable; Germany only agreed to this to save the euro. It would hardly do anything similar to save a deal with the UK. Just like its Cameron predecessor, the May government could be doomed to discover these facts all over again. It is not that countries like Germany would refuse to do some 'deals' with the UK over trade; they would love to do so. The problem would be to take every country along with this, if the accompanying request is to weaken free migration. There is simply no likelihood that the major countries

probably wanting a deal could persuade or would bribe the others to go along.

For this reason the only safe assumption for any UK proposal for Brexit on these matters must be that it requires NO agreement by the rest of the EU. In the rest of this section such a proposition is considered. How would no agreement compare with the EEA-type proposals currently circulating under which effectively the UK would 'negotiate' the status quo.

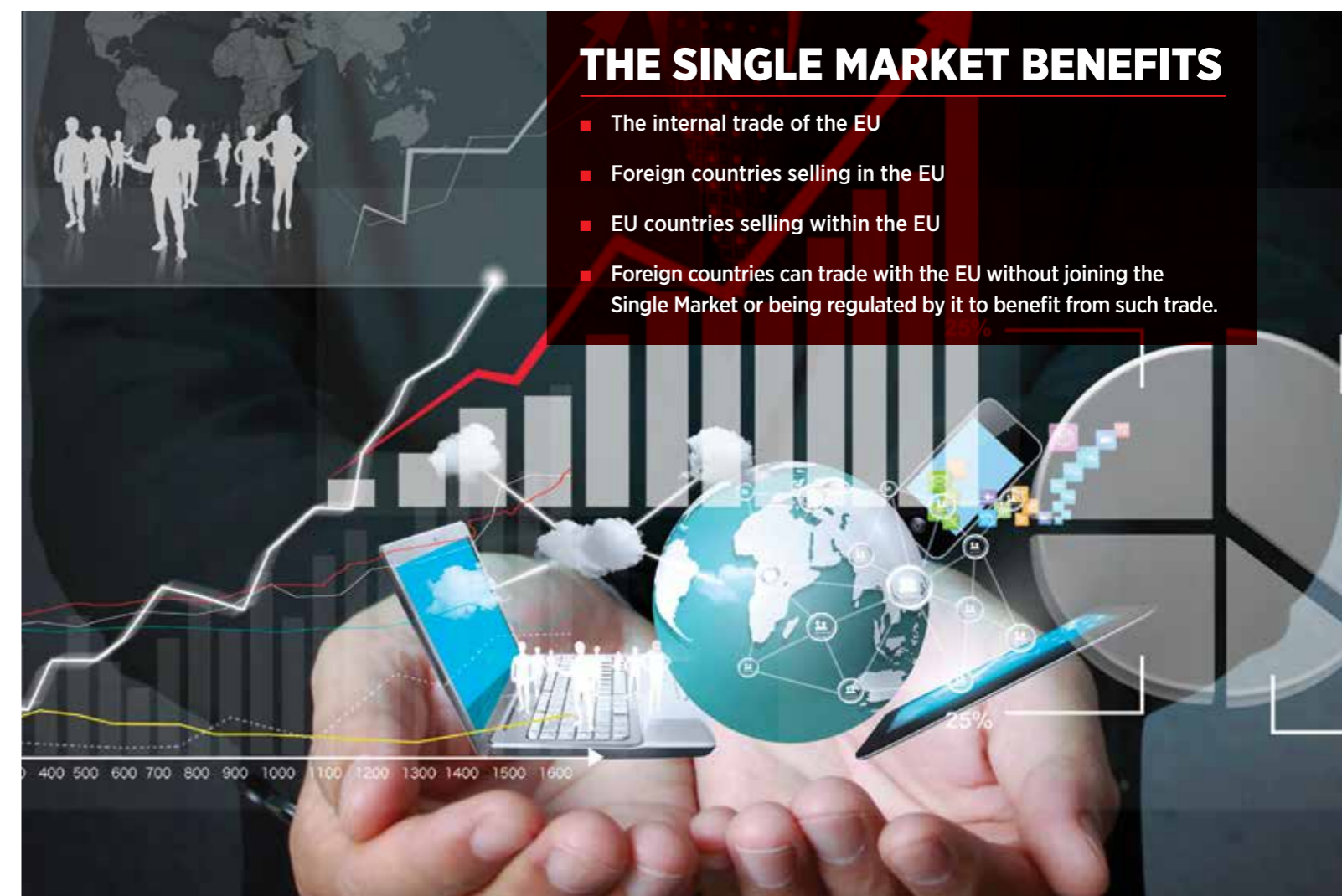
It so happens that the UK's very best economic interests lie in total exit from all EU institutions and in relations with the EU at arm's length from the outside. This seems to be such a heresy in today's UK consensus that it needs careful examining and explaining.

The key reason it is a heresy is that the consensus holds being in the Single Market to be a vital UK interest. So to tackle this question properly we need to examine what the Single Market is and how it affects us.

2.3.2 OUTSIDE THE EU - HOW TO TRADE WITH THE SINGLE MARKET

To understand the SM consider the UK's equivalent. In the UK anyone can set up a business and sell anywhere in the country, letting premises, hiring people, issuing invoices, knowing that the law protects them against any interference from local authorities, or from the local hygiene inspectors, or anyone else. All it must do is conform to the usual commercial, tax and other law of the country.

Now compare what it was like to do business in some part of Italy if you were a French firm. The problem would be getting a licence to set up the business from the Italian authorities; these are at several levels of government, national, regional and local. Then you would have to satisfy rules for corporate behaviour laid down at these various levels; such rules could vary unexpectedly because of politics at these levels. These all amount to substantial costs of doing business and could be regarded as forms of protectionism by local,



regional and national authorities. Because European countries were formed mostly out of local communities, and only became 'states' in the relatively recent past, these sorts of barriers to internal European trade were widespread before the Single Market was introduced in the late 1980s. Even if countries had broken down their own internal barriers there were still barriers between countries. These barriers were nothing to do with tariffs but were 'non-tariff' barriers to doing business.

Originally, as proposed by the UK and the Commission under M. Delors in the 1980s the SM was to consist of 'mutual recognition' of national regulative systems. Thus each country was supposed to have a clear set of rules for doing business (like that of the UK for example) but these could differ across the SM space. The idea was that states could then compete on their systems and this would ensure that there was not excessive regulation. This idea was however abandoned soon by M. Delors and the SM regulative system was made uniform across the EU. In addition a 'Social Agenda' was introduced, whereby the SM regulations would also implement social objectives, especially in the labour market. The SM now regulates economic activity widely and is extended routinely by judgements of the European Court of Justice as well as directives, which are initially drafted and proposed by the Commission and then amended by the Council of Ministers and the European Parliament.

The main advantage to a business of the SM is that it can do business under these common rules anywhere in the EU. However notice that for a UK firm the alternative outside the EU is UK regulation of its home market, which was already well advanced and effective before the advent of the SM. There was no equivalent of the regional, local or national non-tariff barriers to trade either for UK firms or for foreign firms set up in the UK or importing into the UK. Under UK common law there was a clear set of business regulations. It was rather different from that since adopted by the EU for its SM, as is rather obvious from the Brexit debate. The difference arises from the extent of the intrusiveness of SM regulation compared with UK regulation. This may well arise from the difference in legal systems: the UK common law is based partly on statute, partly on precedent and practice. Continental law is entirely based on statute and is therefore highly prescriptive.

It is clear that the SM creates great advantages for businesses operating in the EU: without it we would be back to the multi-layered national protectionisms.

But it does not follow that the UK should be 'inside' the SM like other EU members.

There is an analogy here with the euro. Many EU economists claim that being in the euro reduces business costs of currency uncertainty; this may well be true for EU member countries which trade overwhelmingly with each other. It is also helpful to foreign countries trading with European countries to deal only in one European currency. However when a foreign country does only a limited amount of trade with the EU it does not at all follow that it should join the euro! Plainly the US would not wish to join the euro! Nor would or do other smaller economies worldwide. As it happens the UK also did not wish to join the euro for rather similar reasons - that its trade is mainly with non-EU countries.

In the case of the euro it is useful for the UK that the EU countries closely linked by trade all use the euro, but it makes no sense for the UK to join the euro. Analogously it is useful for EU countries to have the SM and for the UK outside trading with the EU it is useful that its products can be sold anywhere under the SM. But it does not follow that the UK should be inside the SM, any more than it should join the euro.

Thus it is plain that the regulative system in the UK is comparable with, and satisfies, the same general standards of conduct as other regulative systems in developed countries, such as the US, Canada and Australia. Under WTO rules there is no basis for trade in goods to be treated in a discriminative way as compared with these countries, all of which export into the EU and sell their goods within it under the SM system. The UK can clearly therefore export to the EU in the same way that these countries do; in so doing it benefits as an external user from the SM but is not regulated by it. Of course this is precisely why the EU in the first place set up the SM: it benefits their citizens by enabling them more easily to access not just the fruits of their own production but also that of the rest of the world.

In summary the SM is a benefit to the internal trade of the EU; and this benefit extends to foreign countries selling within the EU just as it does to EU countries selling within the EU. But to enjoy this benefit these foreign countries do not need to 'join the SM' and be regulated by it. They also have good reasons to want to have their own regulative systems. So indeed does the UK - as evidenced by the Brexit referendum which highlighted the majority demand for domestic control of laws and borders. •

2.4

EU MEMBERSHIP COSTS AND CALCULATIONS

It turns out that the costs to EU citizens of the EU tariff on agriculture and manufacturing are roughly the same as those for the UK. Thus when the 10 per cent tariff is levied EU-wide including in the UK, the UK effects shown below are more or less replicated in the rest of the EU. The only difference for the rest of the EU is that there is a small net revenue gain due to the net revenue transfer from UK to Rest of EU (RoEU) consumers; but as a per centage of the much larger RoEU GDP total it is only 0.15 per cent of their GDP. Thus the total welfare cost to RoEU is just under 3 per cent of GDP. What we see here is that the dominant ideology of the EU is corporatist and mercantilist, aiming to benefit producers of manufactures and food at the expense of consumers.



2.4.1 ASSUMPTIONS AND MODELS

The main point of economic activity is the welfare of our citizens and we measure this by their consumption or 'living standard'. An economy has finite resources and the aim of economic policy is to maximise their consumption potential from these resources. Sometimes you hear commentators talking about investment as an aim of policy but this is nonsense! Investment is a cost; it is consumption deferred whose only justification is a return in higher future consumption. We take account of the need to invest when we measure consumption benefits; because these are only included after deducting the costs of necessary investment and maintenance.

Trade contributes to this consumer welfare aim by increasing the value of what can be consumed from what is produced by exchanging it in trade with other countries. In much of the discussion of Brexit from the Remain side the emphasis was on the problems of producers, notably how important to them was the Single Market. Remarkably none was focussed on the problems of consumers in accessing best value from the rest of the world.

Yet the key fact about the EU is its promotion of protectionism via its customs union barriers against the non-EU world. It is odd that the EU should be protectionist externally when it aims to increase competition and free trade internally. The reasons

for this take us too far back into the origins of the EU in the thought of economists like Jean Monnet: essentially something akin to mercantilism, the theory popular in the 18th century that an economy's strength depends on how large its exports are, seems to have prevailed in this thinking, that the EU's best interests were promoted by protecting its own industries and fostering its exports, while using imports as a source of scarce revenue for the infant state and to help pay for measures like the Single Market.

The most well-known, indeed egregious, example of the EU's protectionism is in food, where the Common Agricultural Policy creates a system of fixed tariffs and also variable tariffs or subsidies designed to keep the internal price of food at target levels. The latest estimate of the producer subsidy equivalent for food from the OECD is around 20 per cent. Almost all of this due to the protective system.

Less well-known is the protection of manufactures, mainly via non-tariff barriers. The average of the tariffs on manufactures, depending on how you weight them, is between 2 and 4 per cent. But comparisons of EU prices with lowest world prices suggest that non-tariff barriers make up another 16-18 per cent; it could be much more if we use crude estimates of Chinese prices. However these are not well researched and if we base our estimates solely on OECD prices which have been gathered with great thoroughness we obtain a price discrepancy at the border or factory level of around 20 per cent. The big fuss made by UK producers over being inside the Single Market largely reflects the fear of losing such protection and having to sell into the EU from outside the Customs Union; if the Customs Union protection around the SM was negligible it would be of little consequence. Those who criticise our estimates as too high have still come up with big estimates of the effects on our exports of being excluded from the SM! To calculate the effects of EU membership on goods trade we assume that the UK leaves the EU Customs Union and its associated single Market entirely, and substitutes unilateral free trade, thus sweeping away the EU protectionist arrangements in favour of free entry for foreign products under standard UK regulations for product standards in the UK market. We review this using a standard world trade model in which trade is determined by comparative advantage under full competition. In this model all markets for goods and services 'clear', in the sense that prices move to equate demand and supply; this

final situation or 'general equilibrium' is discovered by computer methods and hence the model is known as a Computable General Equilibrium (CGE) model. We chose this model for two reasons.

First, it corresponds to the realities of the long run behaviour in which we are interested for the analysis of a long run change in trade regime like leaving the EU. Those who trade in world markets are well informed about the qualities of the products they buy for onward sale to distribution chains in each country. Little 'imperfection' can survive this knowledge. Different types of laptop or luxury car or refrigerator are ruthlessly evaluated by their characteristics and each characteristic is priced. Besides good information there is ample competition, with traders from many countries selling into many countries with no entry barriers to this world market. Under these conditions the products a country will sell depend on the resources that it has within its borders. We can assume that capital flows freely between countries because in the modern world there are few controls left on how savers invest around the world. But a country's supplies of unskilled and skilled labour depend on how its training and education system has developed over time, while its supply of natural resources is essentially God-given. It is these last three resource supplies that govern what it will produce according to 'comparative advantage'.

Second, this model does well in analysing trends in world markets over time. The biggest trend in recent decades has been the emergence of globalisation, with manufacturing production shifting in large quantities to the 'emerging market' economies. At the same time we have seen big changes in wages and employment in developed countries, with rising inequality and unemployment. Another factor in the mix was the progress of computerisation of manufacturing production. In a major piece of work (Minford, Nowell and Riley, 1997) we used this world trade model to examine these changes and whether they could be accounted for. We found that an equally-weighted combination of globalisation and computerisation could give a good empirical account of all these changes.

These two factors, theoretical and empirical, gave us reasonable confidence in using this model for the major trade regime change for the UK of leaving the EU, with its implications for our trade not just with the EU, with which just over 40 per cent of our trade takes place, but with the rest of the world for the other 60 per cent.

CALCULATING THE BREXIT EFFECT

THE COST OF GOODS: WORLD PRICES, TARIFFS AND A COUNTRY'S PRICES

Effects of UK tariff of 10 per cent on Agriculture and Manufacturing - per cent changes from Base

PERCENT CHANGES	UK	EU	NAFTA	ROW
y	-3.99	0.04	0.04	0.03
y_A	0.00	0.00	0.00	0.00
y_M	113.01	-2.17	-2.97	-1.97
y_S	-32.07	1.19	1.13	1.33
y_D	-3.90	0.04	0.04	0.03
E_A	-12.04	0.05	0.09	0.15
E_M	-0.61	0.01	0.01	0.04
E_S	-5.37	0.05	0.05	0.01
w	14.37	-0.19	-0.19	-0.19
h	-11.05	0.66	0.66	0.66
l	47.18	0.11	0.11	0.11
N	1.35	-0.02	-0.02	-0.02
H	-2.48	0.08	0.08	0.08
L	-28.14	0.00	0.01	-0.01
K	6.79	0.07	0.08	0.06
CPI	7.51	0.13	0.13	0.12
P_A	10.07	0.07	0.07	0.07
P_M	10.00	0.00	0.00	0.00
P_S	0.31	0.31	0.31	0.31
Pw_A	0.07	0.07	0.07	0.07
Pw_S	0.31	0.31	0.31	0.31
Welfare	-3.3	-0.00	0.01	-0.01

- A CGE model of trade gives measures of the cost to the UK and the EU of this protectionist policy.
- A CGE model of international trade, is intended to contain the relevant relationships that will hold in economic theory across economies and will determine the pattern of trade and the prices at which it takes place.
- These relationships are numerical so that we can extract meaningful estimates of the quantitative effects of changing trade policies in the long run.
- The aim is estimates that a) are consistent with good uncontroversial economic theory b) give a reasonable idea of potential orders of magnitude for the long run.
- Experience shows that large-scale changes in trade arrangements have quite radical effects on the shape of economies; therefore we need a model that can work out what these effects might be. The Table shows the CGE model estimates of being in the EU, in terms of the percentage effects on a wide range of economic variables.
- In this CGE model there is full competition in all products with free entry.
- There are world markets for the three traded goods, agriculture, manufactures and services; world supply and demand fix the relative prices of these goods, hence two relative prices - of agriculture/manufactures and services/manufactures.
- Tariffs (or equivalent measures) raise home prices in the country, raising them above their world price. For an individual country therefore, prices of traded goods are set in world markets plus the effect of its own tariffs. In each country there is also a non-traded good, produced under full competition at its long-run average cost.

GLOSSARY

y= output; **E**=expenditure; **w**= wages of unskilled; **h**=wages of skilled; **l**= rent on land; **N**=unskilled labour; **H**= skilled labour; **L**= land; **K**= capital; **CPI**=consumer prices; **P**=price of commodity; suffixes: **A**=agriculture; **M**=manufacturing; **S**=services; **W**=world

2.4.2 THE COST OF PROTECTION - WORLD PRICES, TARIFFS AND NATIONAL PRICES -

We now turn to our CGE model of trade to obtain measures of the cost to the UK and the EU of this protectionist policy. The model's workings suggest that in the case of manufacturing, a tariff on manufactures for example acts to raise a country's price of manufactures. Then because manufactures use a lot of unskilled labour its expansion drives up

unskilled wages. In order to force other industries to economise on the unskilled labour manufacturing needs for its expansion, the other traded sectors contract. The non-traded sector's size moves close to proportionally with the whole economy as demand for non-traded goods is related proportionally to total income, apart from any effect of its changing relative costs brought about by the tariff. The rise in tariff raises consumer prices so that consumers are less well off than they would have been buying the manufactures more cheaply from abroad.

In reaching our estimates for the long run effects of Brexit under the WTO free trade assumption we assume that over the next decade or so (our 'long run') the existing 20 per cent protection gradually gets whittled down to 10 per cent by general international pressure - much as can be observed in previous decades. We therefore apply a tariff -equivalent rate of 10 per cent to the CGE model.

It might seem on the face of it that 10 per cent protection in agriculture and manufacturing is not a very large or significant amount. It raises prices in these two sectors by 10 per cent over the world price, while leaving service prices at world levels. For those used to macro models of short to medium run behaviour relative price movements of different sectors of this order occur regularly; for example world raw material prices can double or triple and greatly affect retail prices of sectors using those materials. Yet we do not observe huge sectoral output swings in the economy.

The difference here is that we are computing the long run effect of permanent relative price changes of these sectors. The sectors with higher prices pay higher wages, both skilled and unskilled, for the workers they need; they pay more for land and they use more capital whose price is fixed in world markets. What our CGE model shows in the Table is that resources are heavily attracted out of the service sector into agriculture and manufacturing. In fact we assume that output in agriculture is capped (effectively by control on the land that can be used in this sector) in our model by government policy; so that the attraction into this sector is frustrated by rising land prices. However for manufacturing no such limit is placed and the result is a substantial boost to manufacturing at the expense of services.

The effect of raising prices for these two sectors by 10 per cent is first a substantial, 7.5 per cent, rise in the cost of living. Wages of unskilled workers go up more than this, 14 per cent, because they are disproportionately used in manufacturing. But skilled workers' wages fall by 11 per cent, being disproportionately used in service industries. Landowners do well, with land prices soaring 47 per cent. We see in these figures how the politics of vested interests works; unions representing unskilled workers, farmers and other landowners, as well as manufacturing businesses, will clearly support being inside the EU.

Yet the effect of shifting output into sectors where their productivity is less than the price paid by consumers is an overall loss of welfare for UK citizens; these citizens would value more the output lost in services whose production contracts 32 per cent. The loss of welfare, measured by the loss of potential consumption by UK households, is 3.3 per cent. This potential consumption change is measured as the change in the value of all output deflated by its consumer price cost (i.e. the change in [nominal GDP/CPI]), minus the change in the value of resources used to generate it). In other words the welfare effect is the per centage change in the resources available for consumption to UK households.

This cost is computed as if the protective measure is a tariff. However the customs union acts as a tariff in its effect on outputs and consumption; but the equivalent of the 'tariff revenue' (i.e. the extra cost of imports due to the protection) is disposed of differently. There is revenue on imports from outside the EU; this revenue (paid by UK consumers) accrues to the EU itself but it is already counted in the UK's net contribution (after rebate and EU spending on UK projects). There is also 'revenue' accruing to EU businesses that sell protected goods to the UK because they can charge higher prices: this revenue is not counted elsewhere and is a cost to UK consumers. Our businesses also gain more from other EU consumers on their exports; so the 'net revenue' paid by UK consumers to EU consumers is the tariff times the net imports by the UK. For manufacturing where we have large net imports (about 8 per cent of GDP) this net revenue transfer amounts to 0.8 per cent of GDP on the 10 per cent tariff-equivalent we have assumed. For agriculture the workings of the CAP on transfers between countries for agriculture are complex and are already counted in the net UK contribution. So in sum the total cost to the UK of the protection of agriculture and manufacturing is 4.1 per cent of GDP.

Some politicians attach totemic significance to manufacturing; we have heard quite a few arguments since the 2010 election that the economy should be 'rebalanced' towards manufacturing. One can see why the vested interests listed above would want this; it is no doubt to appeal to these interests that politicians

make these arguments. But there is no economic case for encouraging output in sectors which market forces would contract. For such a case there would have to be some disparity between social and market values; yet there is no such disparity. Similar arguments were made two centuries ago for preserving agriculture with a similar lack of basis.

Leaving the EU and eliminating this protection would, according to these figures, raise service output and greatly reduce manufacturing as narrowly defined here in the long run. The reason for this is fairly simple: as the UK has developed in the decades since the economy began to be liberalised in 1979, there has been a big rise in the share of skilled labour in the workforce. By now approximately 50 per cent of university-age people go to some form of higher education or equivalent. This has favoured the expansion of skill-intensive industries of which the service industries are the principal examples. We can also include in these industries the design or hi-tech element of manufacturing, which is a service industry; 'manufacturing' in the national accounts includes this, inside the manufacturing firms it comprises. So the hi-tech service activity currently included in manufacturing (on some measures it may be as high as one third) would not be reduced but just reclassified. These workers are engaged in jobs that require the use of their brainpower and associated skills. The actual making of things, manufacturing in the original sense of 'metal-bashing', has contracted hugely in the UK. What the CGE model tells us is that in the absence of EU protection this type of manufacturing would largely disappear, leaving only the hi-tech manufacturing that uses skilled labour intensively.

This result should not be regarded as very shocking. The strongly declining share of manufacturing in GDP has been an unremitting trend feature of the UK since the 1980s; it would be intensified by leaving the EU, and eventually we would be left only with those parts of manufacturing that involve design and hi-tech skills, as one would expect in a relatively small country heavily endowed with skilled and educated labour.

We can note that there is a good demand for unskilled workers in the non-traded service sector

(distribution, construction, utilities and so on) which cannot be substituted for by bringing in cheaper substitutes from abroad. As this non-traded sector is around half of the economy, one can see that if roughly half the labour force is unskilled it will be fully employed in the non-traded sector and there will be little of it left over for the manufacturing sector. Plainly EU protection, as we have seen, raises the wages of unskilled workers; but if there was a case for redistribution to these workers because they were poor, then this would already be done by public redistribution policy. This policy area is extremely active in the UK, as evidenced by the high progressivity of the tax-benefit system. There is no case for using protection to help carry out this policy since it is clumsily directed at the issue and so, as we have seen, creates a big cost for the economy as a whole.

It turns out that the costs to EU citizens of the EU tariff on agriculture and manufacturing are roughly the same as those for the UK. Thus when the 10 per cent tariff is levied EU-wide including in the UK, the UK effects shown below are more or less replicated in the rest of the EU. The only difference for the rest of the EU is that there is a small net revenue gain due to the net revenue transfer from UK to Rest of EU (RoEU) consumers; but as a per centage of the much larger RoEU GDP total it is only 0.15 per cent of their GDP. Thus the total welfare cost to RoEU is just under 3 per cent of GDP. What we see here is that the dominant ideology of the EU is corporatist and mercantilist, aiming to benefit producers of manufactures and food at the expense of consumers.

If we take this analysis and apply it to Brexit under the WTO free trade option we can see that these costs are eliminated as compared with the status quo and therefore with the EEA-status quo option now being touted by Remainers and the old establishment consensus. In summary the gains from trade given by our full Brexit comes to 4 per cent of GDP.

On top of that come the gains from substituting UK for EU regulation and from introducing a Green Card immigration system that would stop any unskilled immigration that did not pay for itself via taxes. •

2.5

REGULATION AND 'FREE' LABOUR MOVEMENT

FURTHER COSTS

“...Regulation can be thought of as being like a business tax that raises UK costs so that there is more import penetration and less export sales. This worsening of the long-run balance of payments constraint on the UK economy must be resolved by a combination of a falling GDP and falling real wages (which also shows up as a fall in the 'real exchange rate', the relative price of UK goods versus foreign prices when measured in the same currency);

“...Unskilled workers on low wages pay little tax ... each adult unskilled immigrant on average costs about £3500 a year, with the total cost running currently at around £3.5 billion (0.2 per cent of GDP) and rising rapidly. In a further twist the taxpayers involved are mainly the local community because there is no mechanism to compensate the community for the extra demands on health and education services. ... there is evidence that local unskilled wages are depressed by the rise in unskilled immigration (Ashton, MacKinnon and Minford, 2016); while this is not a general net social cost to the economy it contributes to the net social cost for the poor communities hosting migrant unskilled labour.

“...There is no problem with skilled labour migration because these migrants pay enough taxes to offset any welfare costs they levy. Hence a Green Card system would solve the migration problem while admitting any number of skilled migrants whose presence is economically justified and in no way politically controversial.

2.5.1 REGULATION AND ITS COSTS

Measuring the effects of this EU regulation is not easy. However, it is interesting to note that many on the left, in the unions and in some industry groups strongly supported EU membership on the grounds that it brought in more stringent labour market regulation than the UK democratic process itself would bring in. Note also that the Confederation of British Industry (CBI) supports EU regulation; one aspect of this regulation is that large businesses, which dominate the CBI, are effective in lobbying Brussels in its regulative decisions. In my recent book's second edition (Minford et al, 2015) I used the Liverpool Model to calculate the macroeconomic costs of regulative measures; these are quite different from the usual estimates of the cost of implementation. Macroeconomic effects are those on employment and GDP from loss of competitiveness in world markets because of raised costs; regulation can be thought of as being like a business tax that raises UK costs so that there is more import penetration and less export sales. This worsening of the long-run balance of payments constraint on the UK economy must be resolved by a combination of a falling GDP and falling real wages (which also shows up as a fall in the 'real exchange rate', the relative price of UK goods versus foreign prices when measured in the same currency); the overall effect on UK living standards can be measured from these.

Minford et al (2015) came to the conclusion that EU regulative intervention – which has ranged widely, to include not merely the direct setting of industrial standards but also labour market intervention, the imposition of controls on 'Anglo-Saxon' finance such as bonus caps and the proposed financial transactions tax, and heavy-handed energy and climate change



directives – had reduced UK GDP by some 6 per cent so far but that it had the potential in future to lower it much more if the social objectives prevalent in the majority of European countries went unchecked. Large employers, that already have departments devoted to 'compliance', are happy to let such regulations prevail because it acts as an entry barrier for small firms who cannot afford to implement them. Again, as with protection, ultimately the consumer pays through lower living standards.

2.5.2 FREE LABOUR MOVEMENT – THE COST

But a more explosive aspect of EU intervention comes through free migration. Producers love this because it allows them to import unskilled labour from poor areas of the EU into rich areas where labour is expensive. The EU takes a high moral tone about this 'fourth freedom' that the EU has given to the world. However it acts as a powerful producer privilege at the expense of the consumers in the labour-importing country. The reason is that unskilled workers on low wages pay little tax and in the UK receive tax credits if they have accompanying dependents; in addition these workers and their families receive free education and health services and get their housing costs paid. This implies that there is a net cost for existing UK residents; the wages paid by the employer are matched by the productivity of the worker so the employing firm is not out of pocket. But the net welfare costs have to be met by UK taxpayers; each adult unskilled immigrant on average costs about £3500 a year, with the total cost running currently at around £3.5 billion (0.2 per cent of GDP) and rising rapidly. In a further twist the taxpayers involved are mainly the local community because there is no mechanism to compensate the community for

THE COST OF 'FREE' MOVEMENT OF LABOUR

- Unskilled workers on low wages pay little tax In the UK receive tax credits if they have accompanying dependents
- These workers and their families receive free education and health services.
- They get their housing costs paid.
- This implies that there is a net cost for existing UK residents. Net welfare costs have to be met by UK taxpayers

SKILLED LABOUR – A GREEN CARD SYSTEM

Skilled labour migrants pay enough taxes to offset any welfare costs no problem exists. A For skilled migrants whose presence is economically justified and not politically controversial a Green Card system would solve the migration problem.

the extra demands on health and education services. In a final insult to these communities there is evidence that local unskilled wages are depressed by the rise in unskilled immigration (Ashton, MacKinnon and Minford, 2016); while this is not a general net social cost to the economy it contributes to the net social cost for the poor communities hosting migrant unskilled labour.

Notice that there is no problem with skilled labour migration because these migrants pay enough taxes to offset any welfare costs they levy. Hence a Green Card system would solve the migration problem while admitting any number of skilled migrants whose presence is economically justified and in no way politically controversial. Again, we see that it is the economic costs levied by producers on consumers via the welfare costs of unskilled migrants that create the problem. With breath-taking insouciance Remain campaigners quoted average net costs across *all* migrants to support the case for *unskilled* immigration! •

2.6

THE ECONOMIC FALLACIES

WHAT BRITAIN REALLY NEEDS



It might be thought that the estimates given in preceding chapters are all very well but that if we left the EU there would be a quite separate problem of being 'outside' the EU 'market' as well as 'excluded' from other markets with which the EU has signed free trade agreements (FTAs). The IEA-prize-winning paper on Brexit (Mansfield 2014) recommended that the first activity to be undertaken after Brexit should be a general negotiation of FTAs with Uncle Tom Cobleigh and All. What are we to make of such arguments? Is it true that there are gains in trade terms from leaving the EU and yet that we are vulnerable to problems of 'access' to all such markets?

2.6.1 TRADE AGREEMENTS? HOW RELEVANT?

What we need to understand is that if some other countries set up barriers against our trade, it would have no implications for the world prices of the types of products we produce. Those prices are set in all the markets of the world. If our producers faced some extra tariffs in some markets this would have no effect on the world price of the goods we produce. The UK produces a small fraction of world exports in virtually all product markets. These UK exports will be more expensive in the markets with extra tariffs but the impact on the overall demand for these products will be zero or negligible.

When a country sets up a tariff on a UK product, total demand for the product does not change; all that happens is that demand shifts from the UK product to the rival foreign products. Because there is no change in total demand for the product its world price also does not alter.

We can pursue the matter in more detail. What will happen to the UK supplies that are not demanded in

this market? Other countries will now be supplying more to this market. But as world prices are unaltered all countries including the UK are producing the same total output as before. It is plain that there will be a general diversion of trade between markets: the UK sells less in the protecting market, and sells more elsewhere, while the other countries sell more in the protecting market and less elsewhere.

This apparently paradoxical result comes from the workings of 'general equilibrium', that is the final situation after all effects have been worked out. Often commentators focus on the immediate effects of a policy; this is known as 'partial equilibrium'.

It might seem difficult to assume that each country's total output of this commodity will remain the same. Could not the UK be forced to produce less given that this one market has demanded less of this product? But this would violate the industry's responses! If world prices are the same and it has willing workers and capital supplying this original amount of output, a fall in demand triggers a search for new markets to sell the profitable unsold output. This search is rewarded by finding the extra unsatisfied demand in the other markets where other suppliers no longer can supply so much.

Some might argue that particular firms have invested in the now-protected market and will find it difficult to switch to new markets. This might be so; the interests of firms are always to keep their existing markets because for them and their contacts they can make more money there than in new markets. If the industry supplies new markets the benefits might well accrue to other firms. However from the UK's national viewpoint this is not our concern. This reveals that trade policy as seen by firms with their own interests and markets is not the same thing as trade policy seen from the nation's viewpoint. This is important

to realise because of the stridency with which these firms may enter the policy debate to protect their own vested interests.

The effects of trade policy must not be confused with the effects of general issues for the economy. We generally keep these effects separate and assume the economy is in equilibrium with respect to other issues when trade policy changes occur. For example if the UK is suffering from high unemployment, then it needs a set of policies that focus on raising aggregate demand and on removing any supply-side impediments to employment. It would be stupid to use trade policy to do this, since this has in general little if any effect on either aspect. So the way to compute the best available policies is to assume the economy is in a reasonable equilibrium with respect to these general aspects and then see what trade policy can do to improve that through its own idiosyncratic effects.

These are not easy ideas to grasp for those not used to international trade theory. Most people think in terms of 'market access' and the bilateral bargaining between producers and the country to which they are selling. But this is not how world trade works - except in the very short run which is soon over and so not relevant to a long-term shift like leaving the EU.

This illustrates what is known in international trade theory as the 'importance of being unimportant'; a small supplier in world markets such as the UK, faced with a tariff from country X, would simply divert supply to another market and so keep its price unchanged, passing the tariff on to the consumers in country X. The UK is too small to affect the world price of most goods/products it sells - hence it is 'unimportant' at the world level—and by implication no protectionist actions by other countries affect the prices of UK products because these are world prices which such protectionism does not affect.

This powerful argument implies that the calculation of the UK's net trade gains is immune to what third countries decide to do with their trade barriers on UK products, and is explicitly based on the assumption that the EU indeed raises its usual Most Favoured Nation (mfn) barriers on UK products so that UK export prices in the EU market revert to world prices.

This point applies by obvious extension to the whole range of potential trade agreements.

Thus the trade agreements the EU has concluded with a wide range of (mostly small) third countries can continue if the countries involved are willing. If they are not they can lapse. In either case these countries will sell to the UK barrier-free.

Or consider trade agreements with the US and China. By the same argument above, although these countries are large any tariff they reduce on UK products would simply divert demand to other suppliers and not affect the world price of these products. There would be no effect on UK output or exports, simply trade diversion.

2.6.2 EU PROTECTIONISM V THE UK - NO LONG TERM EFFECT

Consider EU protectionism against the UK post-departure. Under WTO rules the EU must levy the same barriers against the UK as against other non-EU countries such as Japan and the US. The WTO outlaws discrimination. In our calculations above we assume precisely this situation under which UK producers no longer receive the 'preference' over world suppliers generally: as a result the UK producers receive the world price like these others. We showed above that though these producers lose profits, consumers gain far more in lower prices.

But suppose that after Brexit, the EU creates some new trade barrier specifically targeted at the UK. Plainly this is illegal under WTO rules, as being discriminatory. There is no evidence that the EU would act illegally in this way. It would be extremely bad for UK-EU relations for the UK to have to take the EU to court in the WTO justice system; plainly the UK would win and the EU would have to conform to WTO rules. Such a scenario is plainly unlikely and perhaps ridiculous.

However, notice that the long run damage of such an action, as long as it is undertaken, is only to the EU itself, because it raises prices of UK goods or services to EU citizens, diverting demand to other country sources. Yet from the UK's viewpoint this diversion, as we have seen above, is not damaging in the long run. World prices of these products remain the same and we sell more elsewhere, just as others sell more in the EU. One can think of this as an additional reason to illegality why the EU would not do anything so silly.

It is true that such stupid actions do cause some short run costs of transition, both for us and for EU firms, because of the unnecessary redeployment of sales forces etc. But again this added cost to both sides simply reinforces the case that such discriminatory action will not be taken by the EU.

An extreme example of total protection against the UK has been suggested by North (2016) and similar arguments have been advanced by Tyrie (2016). North argues that the WTO option is dangerous because the EU could deny the UK the piece of paper certifying that UK products satisfy EU product rules (Mutual Recognition Agreements), even though it does supply this to other countries like Japan, the US and China. This would amount to an absolute denial of market access by the EU to UK products! Clearly outside the EU the UK would reach an agreement on mutual recognition of standards just like these other countries. Any refusal by the EU to reach such an agreement while doing so with all these other countries would be, as above, discriminatory under WTO rules and therefore justiciable in the WTO courts like any other discriminatory actions. The UK would of course take the EU to court at once if there were any such denial; and the courts would decide rapidly against the EU since plainly it is a huge and outrageous discrimination.

Again this would be an act of gross self-harm by the EU since it would absolutely deny their consumers access to UK goods and services at any price! Again too in the long run it would not harm the UK because of the same trade diversion argument. But plainly both sides would suffer large short run costs of disruption to existing sales channels etc. Even to consider such behaviour by the EU seems wrong, suggesting absurdly that the EU could behave quite irrationally at huge cost to itself, putting itself beyond the pale in international relations.

2.6.3 THE CITY, FINANCIAL SERVICE, EU PROTECTIONISM

A number of City firms are concerned about what the EU might do in the way of financial protectionism, which is not so actively policed by the WTO. Euro-bond clearing has been mentioned as something that might be denied to the City. Then we have 'passporting' and 'equivalence', where it is argued that the EU might deny UK retail firms the financial passport and argue that there was not UK 'equivalence' of regulations so that wholesale firms too could not sell into EU financial centres.

All these actions are discriminative policies with respect to financial trade which operates no differently in theory from any other sort of trade! Discrimination is in principle also justiciable under the WTO GATS. Only if it can be shown that EU actions were required for prudential reasons would such action not be against the GATS; it is hard to see how protectionism could be justified as prudentially necessary, though clearly this cannot be ruled out. In the end if an authority is bent on protectionism, it may be difficult to prevent.

But all the arguments about EU protection as self-harm with no long run effect on UK output of these financial services apply here too just as above to goods trade. Again there would be some short run transition costs all round to UK and EU firms which add to the discouragement to the EU to undertake such actions. But the long run (and hence the key and dominant) costs are for the EU and nil for the UK.

There is however more to the matter in this case from the EU's viewpoint which should discourage it from going down this route. The EU generally prizes capital mobility into and out of the EU: as an objective it is enshrined in the Maastricht Treaty. The reason lies in the management of monetary union. The gains from monetary union come from the reduction in currency and financial barriers to trade and investment. Plainly capital mobility makes these as low as possible. This is an additional reason we are unlikely to see such financial protectionism.

We see from this that all the vigorous City pushing of these issues as reasons for staying with the

EEA-status quo option is simply the prosecution of vested interests; it has nothing to do with the UK's national interest. We may also note in passing that the City, like other service industries in the UK, will gain massively from the lower cost base created by a full Brexit through lower prices and taxation; getting a 'deal' for the Single Market at the expense of a full Brexit with no deal would cost them dearly.

Yet a further reason is that such behaviour against the conduct expected of members of the Basel club of central bankers, the Bank for International Settlements, which is the issuer of international regulations that central banks are supposed to follow uniformly. Each central bank and associated financial regulator is supposed to adhere to a 'level playing field' across the main world markets. The reason for this is that if financial crisis hits, central banks have to cooperate over banks' cross-border assets and liabilities. Protectionism of one country's banks interferes with this cooperation. Therefore the ideal of free capital mobility and common non-discriminatory regulations is striven for. In effect the BIS acts as an adjunct of the WTO for financial affairs- and indeed the Governor of the Bank of England, Mark Carney is chair of the Financial Stability Board, the arm of the BIS charged with overseeing actions by the world's central banks to promote financial stability.

However, suppose that after all some EU protection against the City did occur and that had the effects in diverting financial product demand away from City firms to their competitors in the EU, would they affect UK financial product output? No! By the same arguments as above for goods, there would simply be a redistribution of UK exports from the EU to the rest of the world where they would replace EU exports.

Clearly there have been many expressions of concern within the City about this perceived threat of EU protectionism in financial services. Visions of financial firms being lured to Frankfurt, Paris and Amsterdam have been floated in front of some credulous politicians' eyes by City lobbyists. Yet the truth is quite mundane: the City stands to gain greatly from Brexit through two main channels. The first is the shift of UK resources into traded services such as the City because these are the UK's sectors of comparative advantage. Our estimate is that this could boost the City

by around 10 per cent in size. The second is the reclaiming of regulation away from the EU's to the UK's jurisdiction: as explained carefully by Reynolds (2016) the UK's common law regulative environment is cost-reducing compared with the civil law approach from the EU. Thus the Financial Centre model he talks about would thrive outside the EU.

What then would be the effects of EU protectionism (which we can think of as some partial qualification of equivalence)? Our estimates suggest that EU business dependent on passporting forms less than 10 per cent of the City's total business (written evidence of Economists for Brexit to House of Commons Committee on International Trade, December 2016). Some of this business would be diverted to other EU providers; we are not talking about massive amounts of the City's business therefore. As explained above, this diversion of demand would not affect world prices of the financial products traded in the City, whether they are wholesale to firms located here or abroad or retail to customers located around the world; the reason is that it is just a diversion, not an effect on the total demanded by the EU. With world prices the same the profits of City activities remain the same; the output would be the same therefore and it would be diverted to other non-EU markets. There is a nice symmetry here: the EU sells more in the EU, we sell less- they sell less elsewhere, we sell more. There is simply a relocation of existing output: known as 'trade diversion'.

Of course in the short term some City firms specialising in EU business will lose out and may find such business diversion difficult. However, we must also bear in mind the general long-run gains the City as a whole will make for the two reasons above, and note that these will be widely shared, including by these firms who may lose EU business. This makes any case for compensation for such short term losses quite tenuous.

One could go on with more examples of the follies of protectionism and why we in the UK if we abandon protectionism have nothing to fear from it. The essential point is that in countries doing it protectionism is self-harm arising either from intellectual confusion (associated with 'mercantilist' ideas) or from the lobbying of vested interests. •

2.7

HOW TO IMPLEMENT BREXIT, WTO AND UNILATERAL FREE TRADE

NEXT STEPS

Let us now assume that our current government accepts the need to move as rapidly as possible to the full Brexit WTO option of unilateral free trade (henceforth just plain 'Brexit'), so reaping the massive gain we have talked about. How does it go about it in practice? As everyone knows it is one thing setting out an economically advantageous policy and it can be quite another getting it implemented in practice given all the constraints and hazards of the political process. We learnt this from Mrs. Thatcher's governments which devoted much ingenuity and energy to bringing people, including all the major vested interests, along with the policy process.

The first thing to notice is that the EU itself now becomes the least part of the problem. There is no need for agreement on trade or regulation or immigration, as we will have left. The mechanics of how we leave has been masterfully explained by Martin Howe (2016) in this series: we use the 1972 European Communities Act to sort out the immediate regulative framework after Brexit, then abolish it, meanwhile having triggered Article 50. Under Article 50 we need to reach agreement with our EU ex-partners, all of them on any remaining issues (i.e. other than trade, regulation and immigration on which no agreement is necessary). These are uncontroversial: they include the rights of existing foreign residents (which must be respected under all civilised norms), inter-country cooperation on terrorism and foreign policy, no-visa agreements and a miscellany of other matters. Agreement on these should be swift.

The main political action to be taken is internal: the reasonable compensation of producers who lose out from Brexit.

- Producer interests damaged by the Brexit consumer revolution
 - Farmers: A new regime is needed for farmers, which recognises that many largescale farmers can manage perfectly well but that there will need to be direct help for smaller and more vulnerable farmers, given our environmental aims as a country.
 - Manufacturers: Our manufacturers are losing their protection and will need to adjust to more competition from the rest of the world in their home market: this is a reasonable requirement to which they must respond with higher productivity as the majority who sell on world markets already do. After all they have been rather lucky to be protected by the EU for so long, quite against the intentions of the Thatcher supply-side reforms of the 1980s. They are vociferous about the costs they will now face of selling into the SM from outside and new pro-business policies could more than offset this cost. As it happens it is not very large, around £3.5 billion being the tariff costs they will face. There will be no way the EU can deny they meet product regulations by refusing pieces of authorisation or other tricks, unless it wants to be defenestrated rapidly in the WTO courts.

These two sets of actions deal with the major producer interests damaged by the Brexit consumer revolution.

- Other Groups: There are numerous other groups that benefited from the channelling of UK money into the EU and back: various regions of the UK received special EU grants and universities benefited from EU funds for research. Universities also band together with EU and other counterparts to collaborate in research: this activity will not cease on Brexit as this collaboration can continue.

- A Committee of Compensation for loss of EU funds should be set up to deal with the many demands arising from losing these EU funds.

The basic principle can be 'complete but efficient compensation'. Our contribution to the EU is usually measured by netting out these 'receipts' so by compensating these recipients there is no loss of net EU receipts. An element of saving can be achieved by allowing for the inefficiency usually involved in these grants: there are complex rules surrounding how they are spent which can reduce their practical value to recipients substantially. •



THE SINGLE MARKET - ACCESS NOT MEMBERSHIP

THE BENEFITS FOR BRITISH CONSUMERS

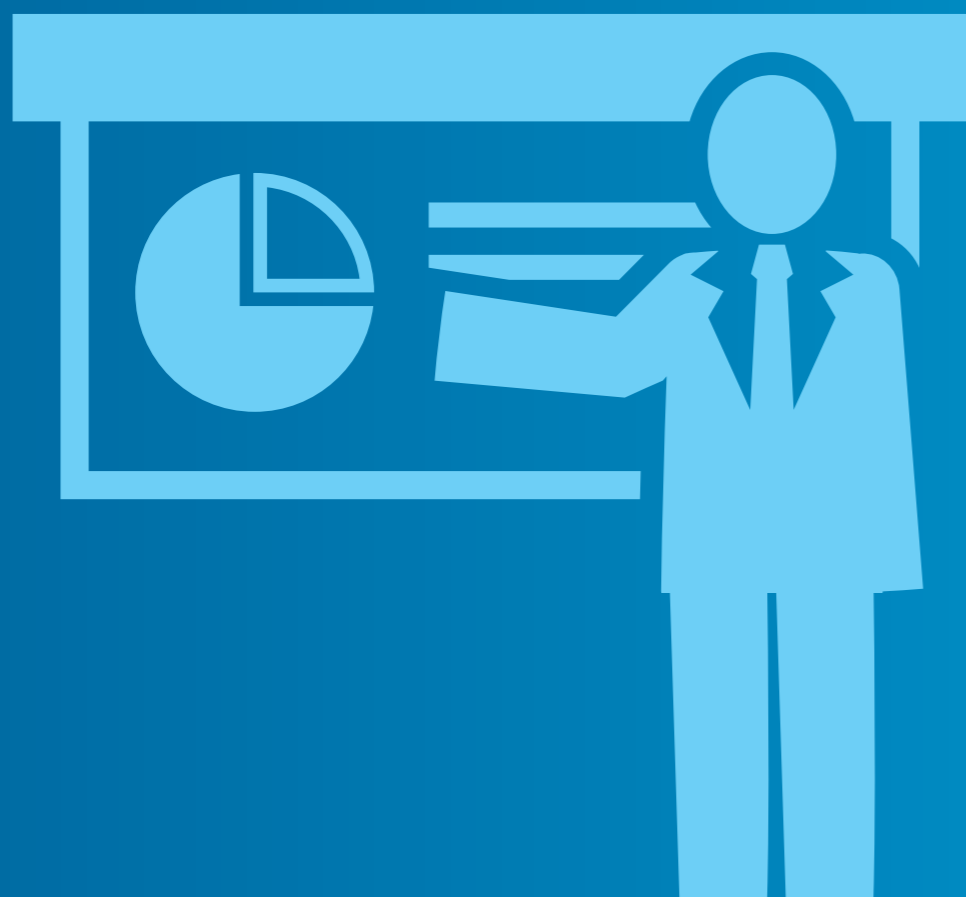


In this section I have argued that the only way to achieve the objectives that were voted for in the Brexit referendum is for the UK to go for a clean break with the EU and trade with the EU outside the Single Market under WTO rules and unilateral free trade. This break can be achieved rapidly by using the 1972 European Communities Act to tidy up the post-Brexit regulative order, then abolishing it; at the same time invoking Article 50 swiftly and settling uncontroversial non-trade issues quickly.

Producer interests, powerful again now that normal politics has been resumed, are pushing for the status quo in the form of an EEA agreement. Siren voices have suggested that some form of agreement can be negotiated that allows the UK to stay in the Single Market and yet control its laws and borders; however any such agreement could be vetoed by any of our 27 EU ex-partners, and there

is no likelihood that countries such as Romania, Bulgaria and Poland could ever compromise on free migration, or that countries like France or Germany could compromise on our obeying the Single Market regulations as now. Hence any agreement on trade would involve traducing the key elements of the Brexit referendum vote; the only alternative to such an EEA-status quo agreement is clean departure under the WTO option.

Such a clean departure would also be optimal economically. UK voters would enjoy the consumer gains that come from a great increase in free trade. The resulting rise in competition, the improvement in regulation and the introduction of a Green Card immigration system would usher in a second UK supply-side revolution, comparable in effects to the first one led by Mrs Thatcher's governments in the 1980s. •



PART III.

THE UK, GLOBAL FINANCIAL SERVICES AND THE EU

NEXT STEPS FOR COMMON BREXIT BENEFITS

by Barnabas Reynolds

Designing the post-Brexit framework must start from the following two principles: respecting the result of the UK's referendum and respecting the integrity of the EU's legal requirements.

The most feasible course of action is for the UK to seek an equivalence-based relationship with the EU in financial services. Many EU financial services laws allow financial institutions in third countries to access the Single Market if the third-country's laws are deemed "equivalent" to the EU's in a relevant area. Institutions from a number of other countries enjoy this access under various pieces of existing EU legislation, including companies incorporated in the US, Japan, Singapore, Switzerland, Canada, Mexico and others.

An equivalence-based relationship with the EU would respect the referendum result, as it does not imply any application of the EU's "four freedoms" to the UK or other concessions of UK sovereignty incompatible with the referendum result. It also respects the integrity of the EU. Equivalence therefore provides

a workable and mutually beneficial conceptual underpinning for a UK-EU agreement after Brexit. Given the UK's close political, geographical and economic ties to the EU, it is likely that an equivalence regime will be even more successful and mutually beneficial than it is in other jurisdictions.

As with any negotiation, both sides must prepare for the possibility that agreement on the Enhanced Equivalence model will not be achievable. This could happen because plugging the gaps in existing equivalence regimes is not politically achievable. Or it could occur because equivalence determinations are not forthcoming, or the EU requires such a high degree of conformity with EU laws in order to be deemed equivalent that the UK is in practice unable to make the significant and meaningful changes to its rules that the UK is likely to wish to make.

The Financial Centre Model would allow the UK to develop an attractive, market-friendly regulatory framework, allowing banks and financial institutions to improve returns on equity, free from EU regulation.

3.1

GLOBAL FINANCIAL SERVICES IN THE UK

IMPLEMENTING BREXIT – BEST FOR THE UK, BEST FOR THE EU

3.1.1 INTRODUCTION

Following Brexit, the EU will continue to be an important political, social and economic partner for the UK. So will the UK for the EU. Free trade, friendly relations and close socioeconomic ties between continental Europe and the UK predate the establishment of the EU and the UK's admission to the EU. It is in the interests of everyone, both in Europe and worldwide, that such friendly bonds continue after the UK leaves the EU. It is also important for EU counterparties and customers to have access to capital and financial services at a low cost within the EU timezone; and it is important for UK financial services businesses to be able to continue to service those counterparties and customers on a cost-effective basis.

Article 50 of the TFEU provides the mechanism by which the UK will withdraw from the EU. It provides for an agreement between the EU and the UK, “setting out the arrangements for [the UK's] withdrawal, taking account of the framework for its future relationship with the Union”. In anticipation of this article being triggered, attention on both sides of the Channel must now be placed on making the best deal for the EU, UK and all within their jurisdictions.

Designing the post-Brexit framework must start from the following two principles: (1) respecting the result of the UK's referendum; and (2) respecting the integrity of the EU's legal requirements. The nature

of these two principles and the implications for the future relationship between the UK and the EU are set out in detail in this chapter.

3.1.2 RESPECTING THE RESULT OF THE REFERENDUM: MOVING ON FROM THE STATUS QUO

For several years, the EU's “passport” system within financial services regulation has enabled counterparties and customers located elsewhere within the EU to be dealt with directly and quite easily. This has reduced costs for EU counterparties and consumers and for UK-based financial institutions when dealing with EU counterparties and consumers. It is of course true that maintaining the passport would minimise disruption, but it would fail to respect the result of the referendum.

The Prime Minister, Theresa May, has ruled out arrangements which do not involve controls over EU immigration and a return of sovereignty. In any event, given the vote, the UK will need to be able to regulate its own markets taking into account local conditions and needs, based on its traditionally key values of free and clean markets, systemic risk protection and consumer protection. The UK will face difficulty achieving these important goals if it maintains the passport.

The problems associated with the passport are set out in more detail in “Maintaining the Passport: Politically and Practically Problematic” in Part 2.



3.1.3 RESPECTING THE INTEGRITY OF THE EU: AN INABILITY TO “PICK AND CHOOSE”

A new, major bilateral deal for the UK or some new, associate or quasi-membership of the EU, as some have proposed, seems neither practicable nor desirable, whether for the EU or the UK.

The UK acknowledges that the EU is a complex, sophisticated system of interlocking rights and obligations. As stated by several key decision-makers in the EU, it is not possible to pick and choose from that system, nor is there any appetite to “reward” the UK for leaving the EU by granting it special privileges. The EU is also understandably keen not to set an attractive precedent.

The problems associated with striking an acceptable bilateral deal are set out in more detail in “Minimal Request for Bilateral Deal” in Part 2.

3.1.4 ENHANCED EQUIVALENCE-BASED ACCESS: ATTAINABLE AND MUTUALLY BENEFICIAL

The most feasible course of action is for the UK to seek an *equivalence-based* relationship with the EU in financial services. Many EU financial services laws allow financial institutions in third countries to access the Single Market if the third-country's laws are deemed “equivalent” to the EU's in a relevant area. Institutions from a number of other countries enjoy this status under various pieces of existing EU legislation, including companies incorporated in the US, Japan, Singapore, Switzerland, Canada, Mexico and others.

An equivalence-based relationship with the EU would respect the referendum result, as it does not imply any application of the EU's “four freedoms” to the UK or other concessions of UK sovereignty incompatible with the referendum result. It also respects the integrity of the EU, as it operates

pursuant to provisions specifically inserted in EU financial regulation for access to (as opposed to membership of) the Single Market. Equivalence therefore provides a workable and mutually beneficial conceptual underpinning for a UK-EU agreement after Brexit. Given the UK's close political, geographical and economic ties to the EU, it is likely that an equivalence regime will be even more successful and mutually beneficial than it is in other jurisdictions.

Equivalence-based access would allow for reciprocity and mutual benefit between the UK and the EU. Mutual access between the EU and UK would be premised on the two jurisdictions operating a similar approach in relevant legislative areas, at least when facing each other, which would provide for strong, open relations between the EU and the UK and deliver the advantages of access from the EU to the City, the main financial market in its time-zone, and "least friction" access for City-based businesses to EU customers and counterparties. Gaps would be plugged in the regimes where equivalence does not yet exist, allowing both the EU and UK to benefit from equivalence-based access for all forms of capital, wherever in the world that originates from.

The UK and EU should go further than this to reflect the historical, geographical and cultural importance of the relationship between the two. An additional agreement should be sought between the UK and EU on a procedural framework for establishing, maintaining and withdrawing equivalence for the future. That would give certainty to both parties and to financial markets participants across Europe. The Enhanced Equivalence model is set out below.

3.1.5 THE UK'S ALTERNATIVE: THE FINANCIAL CENTRE MODEL

As with any negotiation, both sides must prepare for the possibility that an agreement on the Enhanced Equivalence model will not be achievable.

This could happen because plugging the gaps in existing equivalence regimes is not politically achievable. Or it could also occur because equivalence determinations are not forthcoming, or the EU requires such a high degree of conformity with EU laws in order to be deemed equivalent that the UK is in practice unable to make the significant and meaningful changes to its rules that the UK is likely to wish to make.²⁴ The UK could similarly require the EU to have equivalent laws which are effectively identical to those in the UK, in order for EU financial businesses to establish branches in the UK. Alternatively, either side could be suspicious of the quality of each other's regulators and refuse to rely on home state supervision by those regulators.

The Financial Centre Model would allow the UK to develop an attractive, market-friendly regulatory framework, allowing banks and financial institutions to improve returns on equity, free from EU regulation.

By building on the UK's reputation as an attractive, market-friendly, well-respected place to do business, the incentive would be for banks to continue to be established in the UK, and have their most significant customers come to the City to transact business.

This model would allow EU customers and counterparties still to access the global financial markets in the UK, but through affiliates and other structures. These would impose a (relatively small) cost on EU customers and counterparties seeking such access in their financial services and provisioning. It would be an avoidable cost were Enhanced Equivalence to be available. However, it could be more than offset by a far more tailored, focused and common-law based regulatory regime in the UK, with regulation brought back close to the market, in the language of the market, with all the advantages and de-risking that brings with it. The Financial Centre model is set out below. •

3.2

THE REGULATORY FRAMEWORK

KEY CONSIDERATIONS



3.2.1 RESPECTING THE RESULT OF THE REFERENDUM

Passporting allows a financial services business in one member state to access customers in another EU member state cross-border, without obtaining additional local regulatory approvals. There is a separate ability under a passport to establish a branch in another member state. Passporting, particularly the cross-border passport, has been seen as a useful tool in recent years. However, there are various shortcomings with any proposal to continue with some form of passporting following Brexit if the UK is to respect the result of the referendum:

- Rule-taking of EU regulations. Passporting is based on a common EU rulebook, commonly applied and commonly interpreted across the EEA. Any continuation of passporting would therefore mean that the UK – without a voice in the legislative process around the EU's financial services rules – would simply be a "rule-taker".

- Supranational bodies. Various EU bodies would continue to have influence and power over the UK in the application of the financial services laws but without any UK input. The UK would have no governance over these bodies following Brexit. The bodies include:

- the Council of the European Union which comprises representatives of the EU Member States, and has legislative authority;
- the European Parliament, which has amendment powers over EU laws;
- the European Commission, which has the sole authority within the EU to propose new legislation;
- the supranational European Supervisory Authorities,²⁵ which are the arbiters of interpretation and application of financial services legislation. They have step-in rights and in some sectors such as trade repositories, supervise institutions directly (including, currently, the UK-based institutions); and
- the Court of Justice of the European Union, which is the supreme arbiter of interpretation of all EU legislation.

²⁴ Such an outcome would effectively mean that the UK would essentially become a "rule-taker" in all but name, and would continue to be bound by (almost) all of what seems likely to become increasingly inflexible and burdensome EU standards.

²⁵ European Banking Authority, European Securities and Market Authority and European Insurance and Occupational Pensions Authority.

- Free movement and financial contributions. The passporting framework within the EU has been associated at an EU level with the EU's "four freedoms". As noted below, the UK must respect the integrity of the EU's legal framework, under which the "package" of rights and obligations includes these four freedoms. It is likely that access to the passport would entail at some level a continuation of free movement of workers or people, which is politically unsupported in the UK.²⁶ In addition, it could well be that the EU would require the UK to continue to contribute – perhaps at a level not dissimilar to current contributions – to the EU budget in exchange for a continuation of the passporting regime.

It would not be possible politically to assert that the UK would be respecting the result of the referendum if it were to sign up to a framework where it has no voice in drafting, formulating, implementing or enforcing **EU legislation, simply for the purposes of maintaining the passport.**

3.2.2 RESPECTING THE INTEGRITY OF THE EU: NO EXTENSIVE BILATERAL DEAL

Contrary to suggestions from some commentators, an extensive bilateral deal would be undesirable for both the UK and the EU.

Any bilateral deal would involve the UK seeking numerous bespoke amendments to the EU legislative framework and access to the Single Market. In such circumstances, the EU is likely to require significant concessions from the UK, including in relation to sovereignty issues, free movement of persons and budget contributions. These are fundamental to the integrity of the EU's legal and regulatory system,

and the UK acknowledges that they cannot be excised simply because they were three of the main issues influencing the referendum outcome.

There is determination by some key decision-makers not to allow the UK a smooth path for leaving the EU and not to permit cherry-picking of the EU package.²⁷ Many politicians in the EU have made clear they are not willing to offer the UK special treatment. There is a fear that such rewards would pave a path to exit for other member states exiting the EU would complicate the EU's own bilateral processes with other third countries, such as the on-going negotiations with Canada, and the EU's relationship with Switzerland.

3.2.3 THE FUTURE OF THE PASSPORT AND THE STATUS OF THE UK

It is difficult to see how a lengthy proposition seeking to amend the passporting regime or somehow to perpetuate the passport under a new name, solely for the benefit of the UK, would be achievable politically. The UK must recognise the EU's position that membership is a package, and that a "sweetheart" deal would be seen as rewarding the UK for leaving, which is unviable politically. Discussions would immediately revert to the four freedoms, EU institutional oversight and the other difficulties already discussed.²⁸

It is useful, therefore, to distinguish between *membership of the Single Market*, and *access to the Single Market*. For the reasons set out above, membership of the Single Market is almost certainly unachievable if the twin principles of respecting the result of the referendum and respecting the integrity of the EU are adhered to. Access to the Single Market, however, remains achievable. Indeed, every single country in the world can have "access to" the Single Market, just as every single country in the world can have "access to" the UK. **All that is to be determined are the terms of such access.** •

²⁶ See further Shearman & Sterling Client Publication, "Brexit: Free Movement of Persons", 5 August 2016.

²⁷ The formation of a compromise as regards some of these problems is a conceivable possibility. For example, the UK might be granted some form of representation on the Council or in the EP. These compromises, however, would come at a cost in terms of negotiations and would simply serve to tie the UK closer to the EU, its objectives and its processes, contrary to the referendum outcome. In any event, compromises would only have the effect of diluting, rather than eliminating, the significant negative effects previously discussed.

²⁸ By way of example, the 1989 EU-Swiss Agreement, although limited to non-life insurance, demonstrates that where EU market access is given to certain non-EEA firms (other than equivalence-based access), the EU has required that such access be subject to some form of free movement of persons, leading to the legal difficulties associated with implementing the 2014 Swiss referendum. The measures around free movement of persons are required, notwithstanding the fact that Swiss access falls short of full passporting as each branch still needs to seek local authorisations in many cases.

3.3

THE FUTURE FOR FINANCIAL SERVICES



3.3.1 EU ACCESS TO THE UK

The City's openness to, and accessibility by, EU firms should not be compromised by Brexit. Firms that access the City's wholesale markets remotely from the EU, or who deal with or through firms that are authorised in the UK, should be able to continue to do so in a straightforward manner. In addition, it should be ensured that those who have, or who are planning to establish, a physical presence in the UK do not face new barriers in terms of increased operating costs, the need for case-by-case approvals, or both.

The UK has long had an exemption from the requirement for regulatory authorisation for third-

country financial market participants carrying out investment business with institutional clients or counterparties in the UK on a cross-border basis. The "overseas persons exclusion" applies to a broad range of sectors, including exchanges, clearing, settlement, brokerage, derivatives, principal and agency business, and advice. This provision allows all non-UK firms – be they EU or non-EU – to access the wholesale markets located in the UK and UK customers on a cross-border basis without local regulation.

A related issue requiring consideration is the future status of UK branches of EU/EEA banks, which currently operate without subsidiarisation or local regulation, on the basis of aligned regulatory

standards under European regulation and the EU/EEA passport. It is key to optimising the success of the world's financial markets that access remains as friction-free as possible. Enabling EU banks to continue to book and conduct business from their City branches will be an important part of meeting that objective.

The UK Government should avoid creating barriers to cross-border financial services and instead streamline the process for all foreign firms (both EU and non-EU) who access the wholesale markets based in the UK.

The UK could add to the overseas persons exclusion by establishing an "equivalence" regime of its own for branches and cross-border business. This would comprise a list of overseas jurisdictions that meet international regulatory standards and which have regulatory information-sharing and cooperation agreements with the UK authorities, allowing any firm authorised and regulated in one of those jurisdictions to do business in the UK with all types of client. Those who establish a branch would need to comply with local UK branch regulatory and conduct requirements. Under the Enhanced Equivalence model, this would necessarily include the EU, which could be recognised as equivalent, with the on-going relationship governed by a procedural bilateral deal.

3.3.2 UK ACCESS TO THE EU

The EU is the UK's closest neighbour, and access to EU customers and markets is, and will continue to be, of great importance to many UK businesses.

The ability of UK financial institutions to provide services to counterparties and customers in the EU will continue to be one of the UK's policy priorities.

In the absence of the passport or a grand bilateral deal, for the reasons described above, access to the Single Market will be available pursuant to

current (and forthcoming) third-country equivalence regimes. As currently formulated, a significant proportion of the City's financial services in the EU could continue in their current delivery mechanisms without disruption.

Third-country equivalence regimes are a relatively new concept in EU law. There are therefore certain areas in which such a regime has not yet been developed and access based on third-country equivalence is not currently available. Where there are "gaps", two routes are open to the UK:

- under an "Enhanced Equivalence" model, these gaps would simply be filled. This could be done by amending existing legislation and ensuring that future legislation provides for such third-country equivalence access for all third countries. Alternatively, and more ambitiously, this could be achieved by providing a framework for a general right of access to the Single Market on a third-country equivalence basis. This Enhanced Equivalence model is set out in Part [3.4]; or
- under a "Financial Centre" model, the gaps would not be filled and – in those areas where existing third-country equivalence regimes are insufficient – the UK would simply leverage its attractive, tailored regulatory framework and financial clout to operate as an entirely free-market financial centre. This Financial Centre model is set out in Part [3.5].

Both the EU and the UK will also need carefully to examine whether activities are truly "cross-border" or are really domestic. Such analysis has in practice been conducted without real rigour in the past, given the relative ease in terms of cost and process of engaging with the passporting process. Businesses may also structure their cross-border services in line with existing provisions, such as reverse solicitation exemptions. •

3.4

ENHANCED EQUIVALENCE MODEL

Comprehensive access to the Single Market on a third-country basis is possible. In many sectors, the framework for such "equivalence"-based access is already in place.

3.4.1 EQUIVALENCE

Many EU financial services directives and regulations provide for third country institutions to achieve access to the EU market and customers if their country's legal and regulatory regime is deemed "equivalent" to relevant EU laws. The EU concept of equivalence recognises that not all regulatory regimes are the same in every detail but that they seek the same kinds of outcomes. Requiring "equivalent" laws is not the same as requiring "identical" laws. Many third-country institutions deal with EU counterparties and customers on this basis. The UK is well-positioned, in light of time-zones and market structure issues, to leverage an equivalence regime.

3.4.2 KEY FEATURES

Equivalence requirements vary for EU market access across different sectors. However, a number of commonly imposed requirements have emerged for the recognition of third country regulatory regimes.

Equivalence determination. The country in question must be deemed to have a legal system and, sometimes, a supervision regime that is "equivalent" to the EU regime. That determination generally²⁹ involves the relevant ESA providing technical advice to the European Commission on how the third country's laws and regulations compare to the corresponding EU requirements and then a decision by the Commission, which takes into account political elements. An equivalence determination by the European Commission may be conditional rather than

full, meaning that certain EU legislative provisions will only be disapplied for the specific area determined to be equivalent. Furthermore, temporary equivalence decisions are possible where progress is being made towards equivalence.

Co-operation agreements. UK regulators may need to enter into co-operation agreements with either the relevant national regulator of a member state or with the relevant ESA, depending on the sector. Such agreements provide for the exchange of information and methods for co-operation and communication. In recent years, co-operation agreements have become more commonplace worldwide. These agreements are the basis for increased co-operation between regulators in the supervision of financial institutions as well as in enforcement actions against those falling short of the standards. Greater regulatory cooperation was mandated by the post-crisis G20 Pittsburgh Commitments. Given that the UK and EU regulators already work closely together to monitor and prevent systemic risk, it seems inconceivable that these relationships would be unwound.

Reciprocity. Some of the equivalence regimes are premised on the existence of reciprocal arrangements, allowing EU access to UK markets on similar terms to UK access to the EU. This would, of course, benefit both the EU and the UK, and should be welcomed.

3.4.3 EQUIVALENCE IN PRACTICE: INDEPENDENCE AND COOPERATION

The EU's equivalence regimes are premised on the recognition of a third country's regulatory requirements, although differing in details from the EU's, being "equivalent" to the EU's standards. One question is how identical a third country's legal and regulatory regime needs to be to that of the relevant EU regime for equivalence to be forthcoming.

²⁹ The process, legal tests and parties involved vary slightly amongst the various equivalence regimes.

Given that the UK's current regulatory regime is based on EU rules, and given that EU laws will generally be grandfathered upon Brexit, it seems likely that there will be few obstacles to equivalence determinations immediately upon Brexit. Thereafter, it is anticipated that the UK will wish to move away from some of the EU's policy objectives following Brexit. For example, single-market objectives will no longer be of relevance to the UK, and so measures introduced on that basis are likely to be reviewed. When reviewing its regulatory requirements, however, the UK must pay close attention to EU laws and engage in meaningful dialogue with the EU, so as to ensure that mutual recognition of equivalence is not jeopardised.

In engaging with this process, the UK must be cognisant of the EU's requirements for equivalence purposes. The test to be applied for equivalence varies under the different regimes. For example, the European Commission has stated that the equivalence process "involves identifying any differences between our respective legal and supervisory arrangements and assessing whether similar regulatory outcomes are nonetheless achieved; namely the reduction of systemic risk in the financial markets."³⁰ Similarly, the recitals to MiFIR state that an "equivalence assessment should be outcome-based; it should assess to what extent the respective third-country regulatory and supervisory framework achieves similar and adequate regulatory effects and to what extent it meets the same objectives as Union law."³¹

The UK will also be able to take its cue from the laws of jurisdictions which have already been deemed equivalent under the various regimes; where EU requirements are not replicated in those jurisdictions, it is to be anticipated that removal of such requirements in the UK would not affect the UK's equivalence determination either.

Laws that should not be replicated in the UK, and whose absence should not affect an equivalence determination, include:

- rules and regulations which have been found, in equivalence determinations with respect to other jurisdictions, not to be necessary for equivalence purposes. There are various

examples of EU requirements which are not replicated in jurisdictions that have already been deemed equivalent under various equivalence regimes. Such requirements are therefore unnecessary for equivalence purposes and, if undesirable, need not be replicated in the UK.

- rules implemented for the purposes of furthering the EU's "Single Market" ideal, such as the market structure rules in MiFID II/MiFIR, and potentially much of MiFID II/MiFIR more generally. These reflect a priori understandings at an EU level of a cross-border ideal, which will no longer be relevant to the UK post-Brexit. For example, one of the driving factors behind the introduction of MiFID in 2004 was to harmonise conditions governing the operation of markets across the EU to allow the seamless capital flow of euros. MiFID II (including MiFIR) seeks to address shortcomings and unintended consequences in MiFID and its market structure provisions are founded on an intent to further the Single Market. Following Brexit, eliminating barriers to allow the cross-border intra-EU flow of business is no longer an issue for the UK. (It should be noted that some rules introduced ostensibly for "competition" reasons are actually, properly analysed, Single Market rules).
- competition-based rules. These should be a matter for UK domestic sovereignty, and should be subject to a UK-centric approach.
- rules which are duplicative and impose redundant process requirements, such as dual-reporting of derivatives to trade repositories by both sides of a trade and of exchange-traded instruments under EMIR.
- aspects of social policy which are not truly financial regulatory matters, such as the bonus cap.
- laws that create new processes or costs, or which are prohibitive and overly-prescriptive, but which do not promote practical systemic risk-based or other key outcomes, such as cumbersome fund manager rules under the AIFMD, the costly requirements to establish new processes for "indirect clearing" which

are widely acknowledged (including by ESMA) not to deliver any material benefits to end-customers on an insolvency, and commodity market position limits, which are not founded on a proper analysis of the evidence.

It should be noted that obtaining an equivalence determination in any given area necessarily involves a trade-off of some flexibility. Both the UK and the EU should carefully consider, sector-by-sector, the value of such a trade-off and whether equivalence is worth pursuing. This may become particularly relevant in the context of any future measures at the EU or UK level that do not fit within the other's socio-economic framework. It may well be the case that, for some areas of law, it would be better for the UK to allow counterparties and customers to come to the UK to do business through local presences, and not to seek equivalence on those topics at all.

3.4.4 DE-POLITICISATION

Brexit is, by any standards, one of the most significant recent developments in European history. The negotiations and the basis for the future EU-UK relationship will have serious ramifications for all parties. Many competing interests are at stake. For the Enhanced Equivalence model to work, some of the political "heat" must be taken out of the equation, both in the short- and long-term. Such a need arises in three important areas:

- the process of expanding the existing equivalence regimes. This will involve the usual EU legislative process (see "Legislative Process" below);
- the process of assessing the UK's legal framework immediately on Brexit and adopting equivalence determinations with respect to the UK in each of the various sectors;³² and
- the process of ensuring predictability for both the EU and the UK by adopting a robust

procedural agreement as regards the EU-UK relationship going forwards (see "Predictability: Tackling Uncertainty through a Procedural Deal" below).

In what might be expected to be somewhat fraught negotiations, calm heads must prevail for the Enhanced Equivalence model to be viable. Retribution or politicised "interpretations" on either side will undermine what ought to be a technical legal process.

3.4.5 LEGISLATIVE PROCESS

The process for plugging the gaps in the existing equivalence regimes could be achieved either by piecemeal amendment of existing EU legislation, or (more ambitiously) by the introduction of a general right to access based on third-country equivalence across the board. In either case, this would be achieved through the normal EU legislative process.³³

The addition of equivalence to existing financial services directives and regulations should be achievable in short order and could take place outside the context of the Brexit negotiations. Whether achieved by the piecemeal filling in of the various gaps, or a more comprehensive equivalence regime,³⁴ the UK can and should be proactive in proposing the necessary legislation and helping to guide it through the EU legislative track. It is to be hoped and expected that most of the EU states would see the economic benefits to themselves in adopting such an approach, and that the business lobbies in those states would assist the EP members in their understanding of the benefits. Such an approach would not prejudice any equivalence decision for particular parts of the financial sector in the UK (which would be a decision to be made separately by the EU as part of the Brexit negotiations). It would merely ensure that the EU markets have access, in principle, to third-country financial services and products where there is proper regulation in the third country under a similar regime.

³⁰ Letter from Michel Barnier, European Commissioner, to Ashley Alder, Chairman of the IOSCO Asia Pacific Regional Committee, 20 December 2013.

³¹ Recital 41, MiFIR.

³² The equivalence process in each sector generally involves the European Commission accepting the advice of the European Securities Committee. The European Securities Committee is composed of high level representatives from the member states and is chaired by a representative of the European Commission. The assessment by the European Securities Committee is a technical legal exercise. The decision by the European Commission as to whether to adopt an equivalence determination injects a political element.

³³ Article 294, TFEU.

³⁴ On this model, a framework Regulation would provide for third-country access in all sectors of the Single Market. A "menu" of sectors for equivalence would therefore be available. Third countries and their institutions would apply for access on a sector-by-sector basis according to standard criteria for determining equivalence standards.

3.4.6 CREATING TWO-WAY PREDICTABILITY THROUGH A EU-UK PROCEDURAL DEAL

The move from access based on passporting to access based on equivalence will not only present significant issues for financial institutions from a legal structuring perspective, but it will involve a shift in thinking. Some have objected that equivalence brings with it a certain amount of uncertainty since a determination of equivalence can be withdrawn.

The EU-UK relationship is an important one for historical, geographical, political and cultural reasons, and it is perfectly reasonable to take steps to ensure the continuation of good relations between the two jurisdictions. Considerable predictability for both the EU and the UK could be injected into the Enhanced Equivalence model if there were to be a bilateral deal on process and procedure. Such an agreement would be separate from the expanded substantive rules, which would apply to all third countries, and would instead be a direct, bilateral agreement between the EU and the UK. This agreement could be concluded as part of the Article 50 settlement,³⁵ and could cover the following:

- a commitment to include third-country equivalence regimes in all future financial services legislation in the UK and EU;
- a commitment to de-politicise equivalence determinations with respect to the UK and EU, both at the time of Brexit and going forwards;
- modification of dispute resolution requirements in third-country equivalence regimes, such that decisions of UK courts and tribunals are recognised and enforceable in the EU, and *vice versa*;
- the creation of a standing working group between the UK and EU for discussing new legislative measures, reforms, reductions and removals in equivalence matters, with the ability to make referrals to an independent body or trade panel to determine disputes as to whether equivalence requirements have been breached;

- the introduction of significant notice periods whereby the EU gives the UK, and the UK gives the EU, advance notice with respect to any proposals to extend, withdraw, condition or amend recognition of equivalence;
- a commitment not to impose any other barriers on financial services business conducted cross-border between the UK and EU;
- a commitment by the UK to work to ensure that EU financial institution branches in the City can continue to operate; and a corresponding commitment by the EU to similar effect. In the UK context, this would require a modification of the PRA's current "subsidiarisation" policy for systemically-risky third-country branches; and
- an agreement as to how to treat branches of UK institutions in the EU and of EU institutions in the UK under some fast-track process, where the delineation between home and host state regulation is also agreed.

Other matters could be discussed as part of this agreement. Crucially, however, the agreement would only pertain to process and procedural matters, so as to avoid encroaching on the "four freedoms".

3.4.7 MUTUAL DESIRABILITY

The expansion of existing equivalence regimes would open the EU's markets to investment from around the world, promote trade, decrease costs and ultimately make the EU a more attractive place to do business. Filling in the existing gaps in the equivalence framework should therefore be seen as a priority from the EU's perspective. Brexit would simply serve as a catalyst for this logical expansion.

Michel Barnier, the EU's chief negotiator for the Brexit agreement, has recognised the attractiveness of equivalence as the basis for international cooperation and supervision of markets in a global context. For example, he noted when discussing EU-US equivalence that "[w]here the rules of another



country are comparable and consistent ... it is reasonable to expect US authorities to rely on those rules and recognise activities regulated under them as compliant. We in the EU can do exactly the same. That is how we must restore confidence and build transatlantic business. This is reasonable because it accepts legal boundaries and the need for regulators to trust and rely on each other."³⁶

The Enhanced Equivalence model is likely to be a mutually reciprocal arrangement, whereby the UK also provides access to the EU, including for branches in the UK of EU Credit Institutions and EU Investment Firms. This is important from the EU's perspective, as there are five times as many EU banks exercising passport rights to provide services in the UK as there are UK banks providing services in other EU jurisdictions under the CRD passport.³⁷ The cost implications of requiring EU Credit Institutions and EU Investment Firms to operate through UK subsidiaries rather than branches would be significant. An outcome based on mutual recognition should be welcome for the UK.

3.4.8 AN APPROPRIATE COMPROMISE

Under the Enhanced Equivalence model, the UK would adopt (or continue with) measures

equivalent to large portions of the EU's regulatory framework for the purposes of maintaining equivalence. On the day of Brexit, for reasons of time, this would involve maintaining the EU drafting and wordings on many topics.

The Enhanced Equivalence model is premised on a comprehensive use of equivalence-based access in all sectors where such access is deemed necessary. The practical effects of moving to this model (from the current passporting arrangements) should, if properly managed, be nil, and businesses in the UK and EU should feel little impact. In order for this approach to work, however, the EU must determine the UK equivalent in all relevant sectors, and must not withdraw that determination. The UK must also provide access for EU institutions.

The Enhanced Equivalence model is something of a compromise. It will limit the freedom and flexibility of the UK to re-think its rules in a more profound manner. On this model, the EU should work hard with the UK through the above committee-based process in order to move to better regulation and to remove many of the over-zealous regulatory reforms introduced after the credit crunch. It is helpful that the US appears likely to do the same with the onset of the new Republican administration. •

³⁵ Article 50, TFEU authorises the conclusion of "an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union". That agreement would be concluded by QMV, for which purposes the UK would not be included, and 20 out of the remaining 27 member states would need to vote in favour. However, if the nature of the agreement is sufficiently complex, it might constitute an "association agreement" for the purposes of Article 218(8), TFEU, in which case unanimity would be required. In addition, if the agreement covers matters outside the EU's powers, it would have to be in the form of a "mixed agreement" to which the member states are parties in their own right. In such a case, the Member States will need to sign and ratify the agreement according to their own constitutional requirements, such as for the Comprehensive Economic and Trade Agreement with Canada. It should be possible, however, to structure the agreement so as to avoid it constituting either an association agreement or a mixed agreement, and so as to fall within the QMV process.

³⁶ Michel Barnier, The US must not override EU regulators, 21 June 2012, Financial Times.

³⁷ FCA letter to Andrew Tyrie, 17 August 2016.

3.4

FINANCIAL CENTRE MODEL



In the event that a sensible, proportionate, and mutually-beneficial agreement on Enhanced Equivalence cannot be reached, the UK would be forced to take an alternative path, and take such steps as are necessary to protect its financial services industry and ensure that it continues to be a world-leading financial centre.

3.5.1 OVERVIEW

The Financial Centre model is based on the adoption of a far more free market response, where neither passporting nor equivalence are considerations. The Financial Centre model would enable the UK to re-think its regulatory framework entirely. The UK legislators and regulators would have full control. They can operate entirely under common law thinking.

3.5.2 A COMPREHENSIVE RE-THINK

There has been some friction between the UK's common law-based system for the financial markets and the EU's social policy-based approach to rulemaking. The EU approach to rule-making,

implementation and interpretation imposes more of a blanket of regulation on activity than the UK's traditional approach.

If forced down this route by an inability to reach political agreement on the Enhanced Equivalence model, the UK would be forced to re-think the regulatory framework entirely. This would include the following:

- re-drafting all laws and regulations in common-law style;
- regulation focussed on outcomes and identified risks, with intelligent oversight and compliance;
- a careful re-focus on safety, soundness, market conduct and consumer protection, which would result in many laws being pared back and some being bolstered;
- more thorough assessment and, as appropriate, removal of all Single Markets laws and regulations; and
- comprehensive removal of antitrust-based laws and regulations and the removal of antitrust from the remit of the financial services regulators.

This would not, if properly executed, bring with it new risk and is not a proposal for deregulation to deviate from international standards. This model should in fact enable the UK to control the risks of the financial markets and establish an appropriate legal and regulatory framework for the City.

Global standards must, of course, be a touchstone. The UK would reinvigorate its participation in global standard-setting bodies and would allow itself more nimbly to implement laws and regulations that address the true risks and are aligned with regulatory oversight. That oversight and legislative responsiveness would remain close to the financial markets by being based in London.

3.5.3 THE WORLD'S OLDEST "NEW" FINANCIAL CENTRE: COUNTERPARTIES AND CUSTOMERS COME TO THE CITY

Before passporting was introduced in its most basic form in the mid-1990s, counterparties and customers generally chose to come to the UK for business. They dealt through UK subsidiaries, branches, representative offices and by flying into the UK for meetings or on projects. They did so because of the attractiveness of the UK's financial markets, the cleanliness of those markets and the UK's sensible approach to law and regulation. The UK can create a system that frees itself from EU regulation, much of which has dampened the economy or increased costs, with no clear benefit to systemic risk or consumer protection objectives.

EU counterparties and customers in the wholesale markets are generally already established in a manner that would permit them to access the financial markets under the Financial Centre model. EU corporates can access the UK's markets through UK affiliates, and the UK government will be well placed to ensure that all market participants are aware of the steps taken to ensure that their businesses can carry on without significant interruption.

3.5.4 ATTRACTING BUSINESS TO THE UK

The development of a market-friendly, tailored regulatory framework in the UK would represent a significant attraction.

The main beneficiary of the Financial Centre model would, of course, be the City itself and the UK economy, as banks and financial institutions would be drawn from the EU to the UK as an attractive jurisdiction for business. Even more importantly, businesses from around the world, when comparing the UK to the EU (or indeed the UK to other jurisdictions, such as New York), would see a market-friendly regulatory framework, enabling them to flourish, providing for free and clean markets, systemic risk protection and consumer protection.

The incentive, rather than moving business to the EU, would be for banks to continue to be established in the UK, and to have their most significant customers come to the City to transact business. Some calculations suggest that the City, under a Financial Centre model, could even expand by around 10 per cent, compared with the current position.³⁸ The mechanism by which such business would move, and the model under which it would operate most efficiently, is likely to vary from sector to sector.

The UK will be able to facilitate the establishment by EU entities of UK affiliates and the receipt of services through those affiliates, for example, by structuring the UK's tax laws so as to permit a clear pass-through of funds, allowing business that currently is cross-border to be conducted through UK conduits of EU counterparties and customers. Those conduits could receive loans, engage in trading, receive insurance and so on.

If forced down this route by an inability to reach an agreement on the Enhanced Equivalence model, the UK would also have to anticipate an EU response of "closing ranks" in an attempt to shore up its own interests. Such a protectionist response by the EU to the renewed attractiveness of the UK would in fact be counterproductive for the EU, and would simply serve to highlight the appeal of the UK's free-market response approach. EU protectionism would not damage the City once long-term market responses are taken into account. In fact, it would primarily serve to disadvantage the EU's own financial institutions and, ultimately, its own citizens. •

³⁸ See Minford, P, "Flawed Forecast, The Treasury, the EU and Britain's future", Politeia, 8 June 2016.



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