

The LSE Continental breakfasts are one element of a wider academic programme that aims to understand and inform the process of agreeing Britain's future relationship with the rest of Europe. The breakfasts are private, off-the-record meetings for a select group of distinguished individuals from around the world. They bring together LSE's most renowned academic experts with a diverse group of insightful and influential people to explore key issues shaping the European political landscape.

Meetings are held under Chatham House rules, so that opinions expressed may be reported but not attributed. These seminar-style events typically open with short presentations from two or more experts, followed by open discussion among the group.

In these write-ups, issues raised in the discussions are collected into an essay including references to relevant research and exploring some questions in more depth. The authors are encouraged to elaborate and reflect, so they should not be read as an unvarnished record of the discussion.



BUSINESSEUROPE - LONDON SCHOOL OF ECONOMICS JOINT SEMINAR ON BREXIT

Brussels, June 25, 2018

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Business Europe hosted a panel of LSE experts for an interactive session with business representatives in Brussels on June 25 2018 to discuss the current state of BREXIT negotiations and their potential outcomes. This is a summary and exploration of the points raised, conformed into an essay. The panel was divided into two parts, a discussion of the political situation in the UK with Professors [Kevin Featherstone](#) and [Tony Travers](#), and then on the possible forms of a new trade relationship with Professor [Paola Conconi](#) and [Jan Kleinheisterkamp](#).

Two years have passed since the referendum, but it seems that a lot of questions are still pending. While the status quo outcome "Remain" was a fairly easy position to define, decyphering what "Leave" meant has proved challenging. There are an infinite number of possibilities, and the pro-leave coalition did not have a coherent forward view on what route to take as it brought together a wide spectrum ranging from liberal globalists to national protectionists.

The government has stressed that post-Brexit they want Britain to be able to make independent policy with a high degree of autonomy, and specifically no jurisdiction for the European Court of Justice. This statement is however subject to interpretation and is general enough to encompass a lot of different options. But time is running out: both Brussels and businesses are putting pressure on the British government to clarify its positions and take decisions. Are we at a dead-lock in the negotiations? Will the UK government settle on a definite path? Where are we heading? To tackle these important questions it is crucial to understand the state of the political environment in the United Kingdom and what the options for a post-Brexit UK are.

A fragile political environment

To handle the exit of the UK, the government had to rethink its organization, by creating new entities and increasing the scale of existing ones. The Department for International Trade was set up in July 2016 to assist the government in establishing UK trade policy, and negotiating bilateral partnerships with non-European trade partners. It currently employs an additional 800 officials. The number of civil service staff also increased significantly in other departments. The HM Revenue and Customs has employed between 3000 and 5000 additional staff since the referendum, presumably to handle customs procedures. The nerve centre of the action of the government on the exit was concentrated in the Brexit Cabinet committee, run by David Davis. The Cabinet Office however soon recognized that only a tiny number of people would have to take decisions on behalf of the UK government and took the lead in the negotiations, leaving less room for the Brexit Cabinet committee.

From day one after the referendum, the Prime Minister had to balance between the two camps: leave and remain. That balance is also present in the Cabinet, especially since the last general elections as Theresa May has to sustain a coalition without a parliamentary majority. It was therefore unsurprising that making decisions in the Cabinet turned out to be difficult. Sufficient ambiguity has to be maintained to keep leave and remain ministers and MPs both on side. The broad outline of UK government's objectives in the following February 2017 White Paper is quite illustrative of the tone adopted by the government: *"The Government will prioritise securing the freest and most frictionless trade possible in goods and services between the UK and the EU. We will not be seeking membership of the Single Market, but will pursue instead a new strategic partnership with the EU, including an ambitious and comprehensive Free Trade Agreement and a new customs agreement"*. It crucially lacks details such that everybody can interpret it as they would. It seems that there is no position that keeps the coalition together while it is needed to get legislative empowerment for any decision that is made. This is a real problem for deciding which path to take.

It is worth pointing out that this is only the first step in the process. Only once the UK has settled on a position, can the second order negotiations with the EU really start. These second order negotiations will be challenging in themselves. In the preliminary stage of the negotiations with the EU, the UK government was confronted with a number of surprises. The government expected to be able to divide and rule, but faced a high degree of unity in the EU. They were surprised by the lack of flexibility of the EU when it came to defining the rules of a new partnership and their will to stick to existing rules and models, they criticized their 'lack of imagination'. They also did not expect the EU Commission to signal that the UK would be excluded from a number of individual sectors where there is an obvious mutual interest for the UK to continue (Galileo, Europol etc...).

Evaluating the options

Several options for a future UK-EU relationship exist, each with different rights and obligations. The UK government has emphasized the wish for an independent trade policy, a high degree of regulatory autonomy, no financial contribution to the EU, no free movement of persons, and no jurisdiction of the European Court of Justice (ECJ).

The non-recognition of the ECJ has important consequences and somehow binds together all the other requirements of the government. The degree of access to the EU market will depend on the compatibility of future UK market regulations with EU regulations, and the ECJ is currently the single guarantor for interpretation and compliance to these rules. While this does not set a clear path for its future relationship with the European Union, it rules out staying in the single market, the 'Norway' or 'Swiss' options. Adopting an agreement such as the one Norway has with the EU would provide high level of market access but it would imply free movement of people and the UK adoption of all the regulatory measures agreed in the EU, while not having any say in the decisions. Although the UK could have been tempted by the Swiss model which relies on a number of sectorial agreements, the EU clearly stated that it was not a choice on the table outside the jurisdiction of the ECJ. There are thus three potential options: a customs union, a free-trade agreement, or 'no deal' scenario. Among other things, EU membership guarantees regulatory alignment with the rest of Europe and duty-free treatment. These three options imply that UK-EU regulations are no longer automatically aligned, which is crucial for market access. To be sold in the EU, UK goods will have to comply with the whole set of Single Market rules, in particular technical regulations, environmental regulations, intellectual property rules, personal data protection, labour regulations etc...

The customs union option is the closest of these three options to the current situation. There will be no tariff barriers for trade between the UK and the EU, all goods will still be able to move freely between the UK and the EU. However, it does not seem to be fully in line with the objectives of the UK government. In a customs union, the UK cannot implement its own independent external tariff policy as it has to comply with the EU external tariff policy. And as long as the UK government does not want to recognise the jurisdiction of the European Court of Justice, it is hard to envisage any agreement on regulatory alignment.

A free trade agreement with the European Union would allow the UK to pursue an independent trade policy. The UK would be able to set its own external tariffs and sign bilateral treaties with its non-EU trade partners. Free trade agreements differ greatly in their depth, scope, and effects on trade (Hofmann, Osnago and Ruta 2017ⁱ). It seems that the UK wishes to achieve a deep trade agreement close to the trade agreement between the European Union and Canada (CETA), sometimes referred to as 'Canada plus'. If the UK government opts for a trade agreement with the EU, then the CETA is the best existing model and one of the most comprehensive agreements on regulatory alignment. To ensure coordination on sensitive issues such as technical barriers to trade, sanitary and phytosanitary measures, trade in services, trade and labour, there is a 'regulatory cooperation forum' (cf. Chapter 21 in CETA for more detailsⁱⁱ). Ultimately this helps companies to know that whatever practice is acceptable in one jurisdiction is also acceptable in the other.

In contrast to a customs union, rules of origin have to be defined in any free trade agreement. These are a set of the rules that prescribe which goods get the preferential tariff treatment. It often takes the form of a percentage threshold on the domestic content of a product. For instance, when exporting a car from the UK to the EU, a car manufacturer operating in the UK would have to prove that a sufficient share of the

value of the car has been produced in the UK to qualify for preferential treatment. As of now, UK companies do not have to worry about complying with rules of origin. Small producers don't rely on supply chains so much, but to the extent they do, they will be likely to decide not even to try to comply with the rules given the administrative costs it entails, and instead to bare the cost of the tariff. Big firms, which do have a lot of suppliers outside and inside the European Union, would be greatly affected by such rules. Most Japanese car manufacturing companies currently use the UK as their base to serve the European market. Almost 80% of cars manufactured by Nissan at its plant in Sunderland are currently sold to consumers in the rest of Europe. Given they use a lot of imported intermediate inputs, their cars are unlikely to comply with the established rules of origin. If this is the case, they may have to stop importing key parts and components from abroad, or face a tariff when exporting their car to the single market.

A recent paperⁱⁱⁱ by Paola Conconi et al. shows that rules of origin matter. The existence of such rules led to a sizable reduction in Mexican imports of intermediate goods from third countries relative to NAFTA partners when the agreement was put in place. In the absence of rules of origin, trade between these countries would have been 45 percent higher. This is especially important for goods for which there was a big gap between the preferential tariff rate within the agreement, and the basic WTO 'most-favoured nation' rate (MFN). The implication of this, is that if the UK's relationship with the EU is changed from a customs union to a free trade area, then it might have the perverse effect of reducing UK trade with non-EU countries, since at present, once non-EU goods or materials have entered the UK, they do not incur any additional cost when they are re-exported to the EU. Once the UK is outside the customs union, firms that export to the EU will need to keep their non-European inputs below the threshold. The devil seems to be in the details: what threshold of minimum domestic content is agreed on cars may, for example, determine whether companies like Nissan remain in the UK or move to France or Germany. The government should make sure that the rules of origin it negotiates with the EU as part of the new trade deal are as flexible as possible to minimize the distortion of global supply chains and the risk of relocation of multinationals.

Finally, the 'cliff-edge' scenario cannot be excluded given time is running out. If no agreement is reached, the UK and the EU would trade under the most-favored nation terms available to all World Trade Organization members. Goods traded would be subject to MFN tariffs and both border and behind-the-border non-tariff barriers would increase. This outcome would result in the largest increase in trade barriers between the United Kingdom and the EU. According to the UK government, in the case of a no-deal scenario, the UK will need 5,000 new customs officials with a comparable increase in demand for customs authorities of the EU27 Member States. The impact on businesses is expected to be very significant in terms of time and resources as well. A report^{iv} by the Institute for Government estimates that 180,000 British companies will need to make customs declarations for the first time after a 'cliff-edge' Brexit. The additional administration required to cope with this task is expected to cost UK traders around £4 billion a year.

Where does the public stand?

British citizens still seem evenly split on whether it was right to vote to leave the EU. In March 2018, about 42 percent of the people surveyed on [YouGov](#) think it was right, while 45 percent think it was wrong. These proportions are remarkably stable since August 2016. There are however some signs of change when focusing on expectations on the way ahead. Survation conducted an [online poll](#) of about a thousand UK adults aged 18 and above on their attitudes toward Brexit. To the question “Should there be a second referendum once the deal becomes clearer?” 48 percent of respondents answered “Yes” in the latest poll, significantly more than in March 2018 (36%). This could be due to the recent controversies on the EU withdrawal bill in Parliament and the sense that a new referendum would somehow provide clarity. People seem to want to have a say on the type of deal that would be agreed. When given two options, 43 percent of respondents think it should be a ‘soft’ Brexit, while 37 percent of them think it should be a ‘hard’ Brexit. It is important to keep in mind that the definition of ‘soft’ and ‘hard’ has been itself highly ambiguous and evolving over time. Interestingly, the proportion of respondents that view a ‘hard’ Brexit as damaging has increased significantly. In the most recent [polls](#), 47 percent of respondents accept the interpretation that no deal would be bad for the UK.

Where are we heading?

As already acknowledged, the time pressure is increasing and the UK government will have to make a decision in the upcoming weeks. Is there momentum building behind the customs union scenario, a so-called ‘soft’ Brexit? There are several reasons to think so. One of the main differences between a customs union and a free trade agreement lies in border checks. While no border checks are necessary in a customs union, border checks are necessary to ensure conformity with rules of origin in a free trade agreement. If there is a strong commitment to having no border in Northern Ireland, there is simply a binary choice: having a Customs Union between the EU and Northern Ireland or having a Customs Union between the EU and the entire UK. There cannot be another alternative if there is a rejection of the uncertain technological options proposed by the government. Even though the position of the government has been very ambiguous, it seems reasonable to assume that the Prime Minister and her entourage are seeking an arrangement that most people will regard as at the soft end of the spectrum. Moreover, there must be a vote in Parliament in mid-July on a proposal to commit the British government to an outcome involving a customs union. Given the Labour and dissenting Conservative MPs that are in favour of that outcome, such a vote may be won in Parliament. Finally, the UK government is currently taking no steps to set up the kind of regulatory agencies and infrastructures that would be necessary after March 2018 in the context of having no Brexit agreement.

However, nothing is certain. A number of events could throw the outcome off track. The upcoming meeting of the Cabinet at Chequers will be crucial in determining the path for the weeks to come. The Cabinet could decide on a ‘hard’ Brexit outcome. It is a question of how far Theresa May prioritizes the unity of her Cabinet versus what is best for the UK economy. The upcoming vote on the Customs Union in the Parliament may well be lost as there is a high pressure within the Conservative Party to push for a ‘hard’ Brexit. The certainty is that by March 29 2019, the UK will exit the EU, but the amount of change that will occur in the medium run will depend on the outcome of the

negotiations. Then, the UK may enter a transition period in which the free movement as well as the rules of the customs union and the single market will be maintained. The UK will potentially be able to start negotiating new trade deals with non-EU countries. In January 2021, it will in principle be the end of the ‘temporary customs arrangements’ to a destination that it has yet to be defined.

To conclude, lots of questions have been opened but not many answers have been provided. “So far nothing has happened, and we won’t know until we know”. Given the consensus among experts that a no-deal scenario would be damaging for the UK economy, one might wonder whether the MPs would be willing to accept it.

Further readings

Business Europe (2018) “[Brexit: the Customs implications and solutions](#)”

Booth, Stephan, Christopher Howarth, Mats Persson, Raoul Ruparel, and Pawel Swidlicki (2015) “[What if...? The Consequences, Challenges and Opportunities Facing Britain Outside EU](#)”

De Lyon, Josh, Elsa Leromain, and Maria Molina-Domene “[Brexit is still a hot topic on Twitter, but public sentiment remain largely unchanged](#)”

Dhingra, Swati, Hanwei Huang, Gianmarco Ottaviano, Joao Paulo Pessoa, Thomas Sampson, and John Van Reenen (2016) “[The Impact of Brexit on Foreign Investment in the UK](#)”

Dhingra, Swati, and Thomas Sampson (2016) “[Life After Brexit: What are the UK’s Options Outside the European Union?](#)” CEP Brexit Analysis

European Commission (2017) “[White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025](#)”

HM Government 2016 “[Alternatives to Membership: Possible Models for the United Kingdom Outside the European Union](#)”

UK in a Changing Europe, “[Article 50 One Year on](#)”

ⁱ Hofmann, Claudia, Alberto Osnago, and Michele Ruta (2017) “[Horizontal Depth: A New Database on the Content of Preferential Trade Agreements](#)” Policy Research Working Paper 7981, World Bank

ⁱⁱ [The Comprehensive and Economic Trade Agreement](#), or CETA, a trade deal between the EU and Canada.

ⁱⁱⁱ Conconi, Paola, Manuel Garcia Santana, Laura Puccio, and Roberto Venturini (2018) “[From Final Goods to Inputs: The Protectionist Effect of Preferential Rules of Origin](#)” American Economic Review (forthcoming)

^{iv} “[Implementing Brexit: Customs](#)” Joe Owen | Marcus Shephard Alex Stojanovic IFG ANALYSIS