Thinking ahead for Europe

SELECTIVE AND FLEXIBLE:

BREXIT LESSONS FROM EU/SWISS MARKET INTEGRATION

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Red lines and constrained options

- Understanding (as far as one can !) the Swiss and UK market integration strategies,
- Requires an appreciation of ‘red lines’ and/or constraints emerging from domestic preferences
- Both countries are and have been pretty divided on EU membership for 5 decades
- Or, UK since 6 decades (opting out after Messina) and wavering, with reversals in 1961 (Macmillan), 1975 (referendum, 2/3 in favour of EU), 2016 (referendum, with misled voters, less than 2 % margin of those voting, a-la Norway in 1994, and only 37 % of those who could have voted)

Red lines and constrained options (2)

- Switzerland was first part of the 'low-tariff club' from which EFTA emerged, led by … the UK
- Only when the Luxembourg process (EU-EFTA countries) began (1984), a Swiss strategy emerged
- was defensive, whilst EU itself was not ready [Single Act only in 1985]
- the 1989 Oslo process invigorated the Swiss
- Banking both on EEA and EU membership options
- Referendum rejecting the EEA was a shock ['92]

Red lines and constrained options (3)

What unfolded was

- (i) a 'second' and 'deeper' Luxembourg process in **2 groups of 'bilaterals', mimicking a quasi-EEA selectively**, taking 10 years (1994 – 2004)
- (ii) with a wish of 'flexibility' common to trade deals and **no overall framework of EU single market principles** [both at odds with the EEA]
- Up to 2006, Swiss policy makers assured the EU that, ultimately, EU membership was their aim and that 'EU-isation' of Swiss legal order would go on
- Hence, the EU could temporarily accommodate the Swiss with this 'sectoral' approach plus 'flexibility'

Red lines and constrained options (4)

- In 2006, if not before, EU felt it had been misled and found itself trapped in bilaterals very dissimilar to the EEA
- EU required ‘appropriate parallelism’ as a principle so that all areas in bilaterals would proceed with equal speed [mitigating risks of a sectoral approach]
- However, in second deal, the services agreement failed (Swiss withdrew), so this principle failed
- EU insisted on ‘guillotine clause’ but it only appeared in Bilateral no. 1, not in no. 2

Red lines and constrained options (5)

- Also institutionally, the 2 Bilaterals were far removed (even) from a quasi-EEA
- EEA: based on 'homogeneity' for single market acquis, not 'flexibility' allowing discretion
- This requires (a) free movement (4x), (b) incorporation of existing AND new EU law [+ case law] in domestic law (static vs. dynamic) ; (c) independent surveillance mechanism on implementation [EFTA S. Auth. is an example, EEA based] ; (d) an effective judicial enforcement mechanism for bilaterals ; (e) a tribunal for disputes about bilaterals

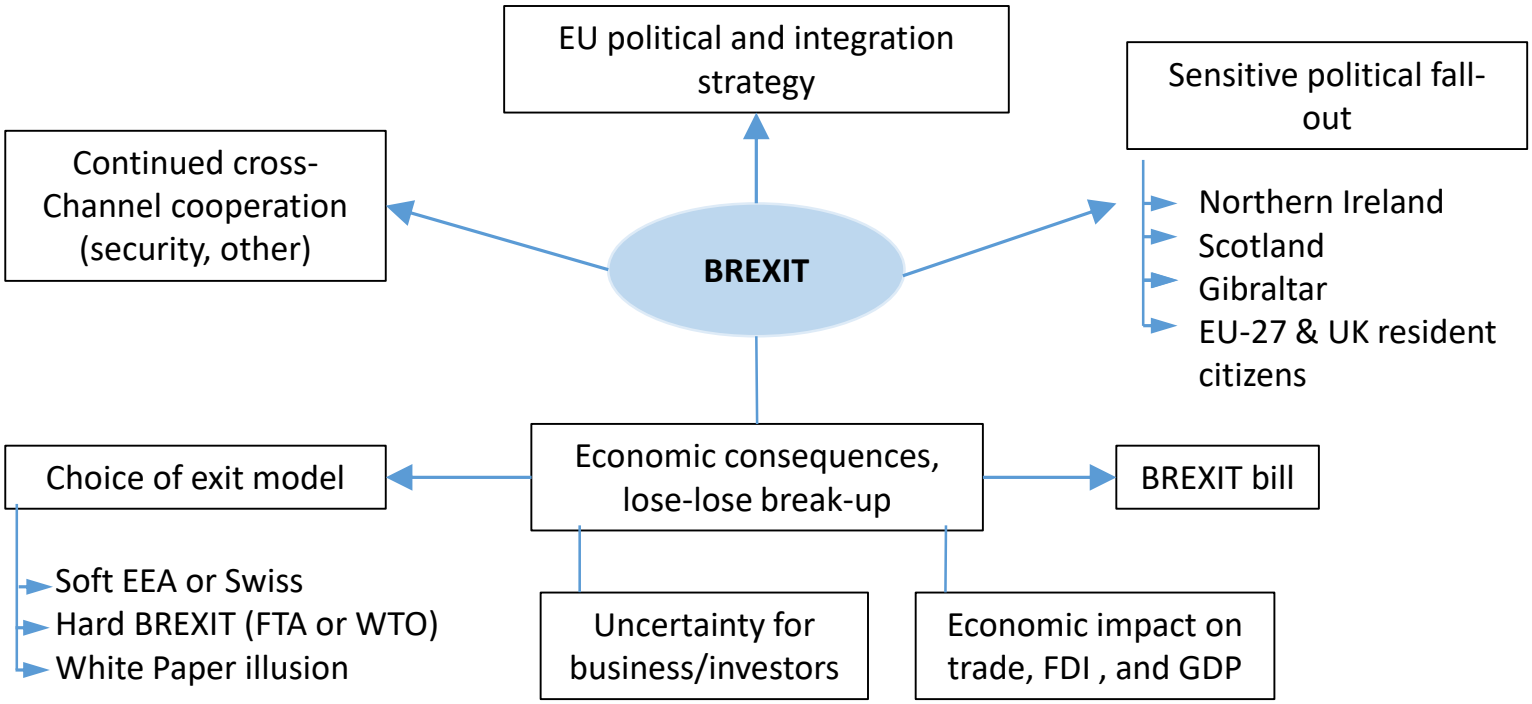
Red lines and constrained options (6)

- None of these 5 conditions are fulfilled
- However, EU accepts (a) (temporarily) ; (b) Switzerland does this 'autonomously', striving for 'equivalence' and 'EU-compatible' Swiss regulation; (c) surveillance is now lacking [note that the EU and EFTA/EEA find numerous problems with implementation for decades] and little is known about 'equivalence' in some cases ; (d) enforcement today happens in usually cordial bilateral diplomacy, on complaints – nothing judicial; (e) there is no tribunal as final arbitrator [legal debate on CJEU ; EFTA Court ; new Court]
- In 2010, Council insisted that (b) to (e) **be addressed urgently** by Switzerland; is stuck !

EU-Swiss bright predicament today

- EU/Swiss trade and investment are blossoming
- Switzerland 3rd trading partner for EU; EU is no.1 trading partner for the Swiss [note : Switz 1/8 th of UK]
- EU exports more services to Switzerland [€ 116 bn] than (the 27) to the UK [€ 80]; EU-27 imports of services from the UK are higher [€ 101] than all-EU from Switzerland but not that much [€ 72 bn] (2015)
- Inward all-EU FDI stock from the Swiss is € 627 bn, EU-27 inward stock from UK is € 684 [hardly more]; all-EU outward FDI stock in Switzerland is € 829 bn, as against € 986 bn in UK for EU-27
- Yes, there are frictions, do they matter given this predicament, a **bilateral economic success story ?**

BREXIT UNFOLDING

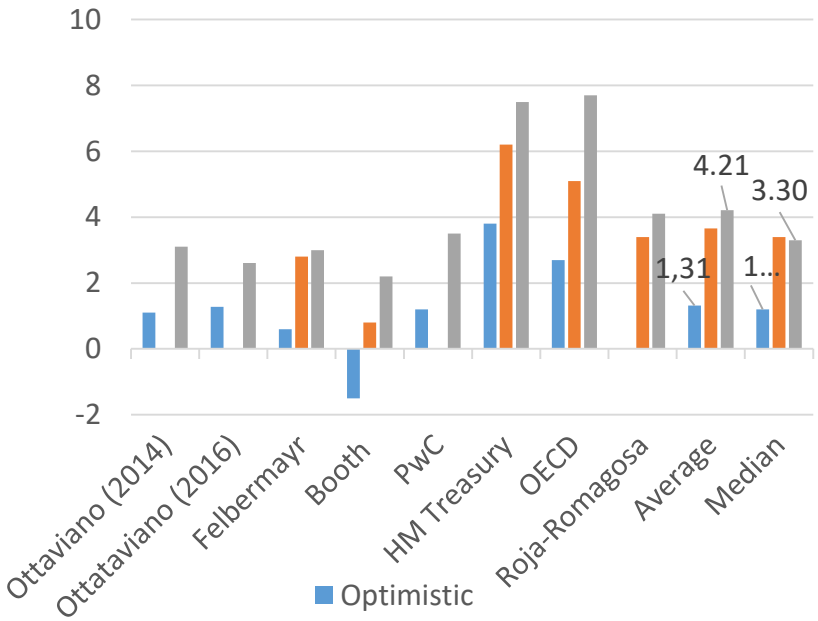


BREXIT unfolding (2)

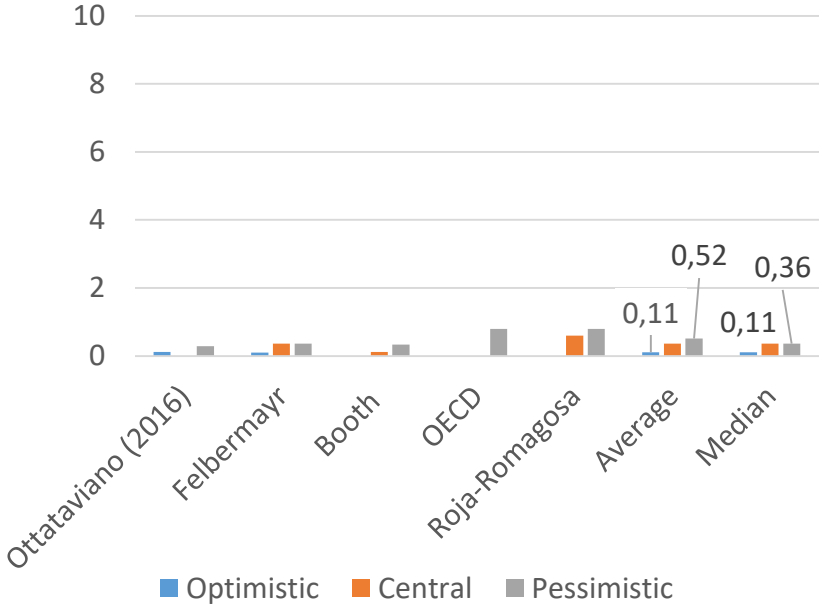
EXIT model :

- 1. EEA or Swiss/EU >> **single-market-minus + CJEU** (or equiv.) [assumes that Swiss solve frictions]
- 2. such a soft BREXIT **inconsistent with 3 UK red lines** >> no CJEU, no customs union, no free movement of EU-27 workers
- 3. semi-soft BREXIT in Febr. White Paper : yes, a FTA but beginning with EU acquis in the UK : **illusion** >> bound to harden over time (with 'frontier', see 2.)
- 4. if talks fail, due to special wishes, shock waves

Loss in UK's GDP (2030) by type of exit scenario (%)

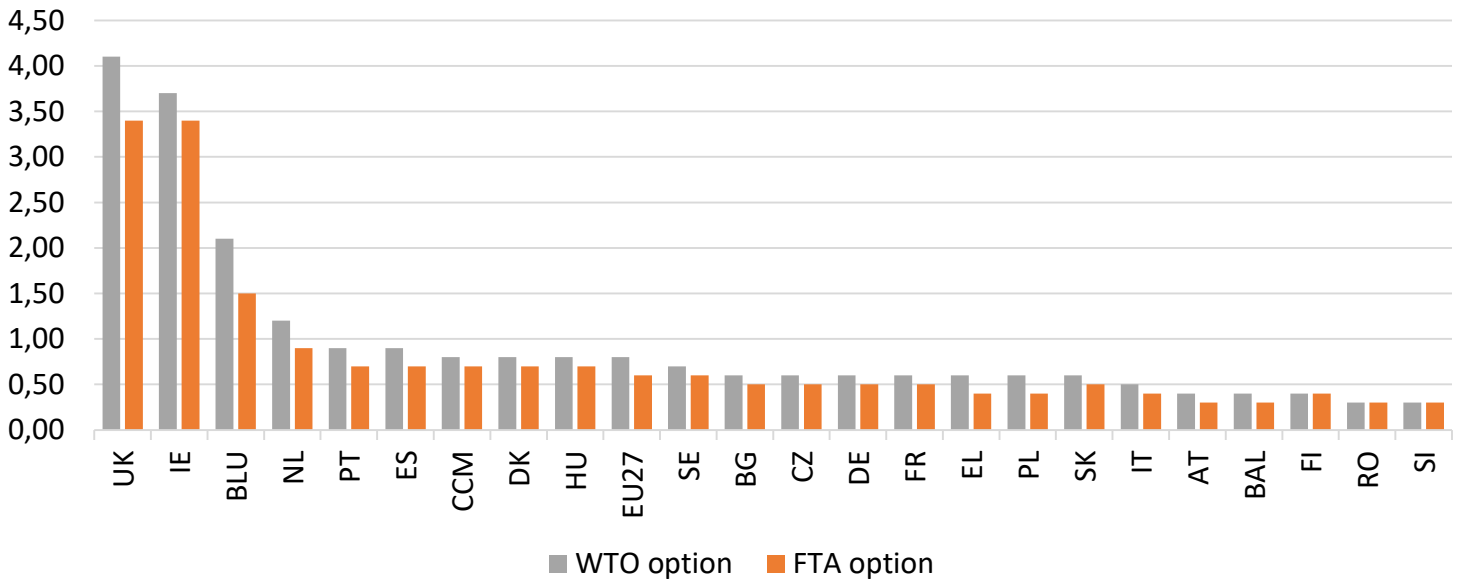


Loss in EU27's GDP (2030) by type of exit scenario (%)



Source : Emerson, Pelkmans et al, 2017 (for EP).

Losses in GDP (2030) by Member States and type of Brexit scenario (%)



Source: Roja-Romagosa (2016).
Note: FTA kicks in after 10years.
BLU (Belgium and Luxembourg); CCM (Croatia, Cyprus and Malta); BAL (Baltic countries).

Source : Emerson, Pelkmans et al, 2017 (for EP)

BREXIT effects on EU27 exports:

to the UK, two studies to illustrate

- Treasury (2016) first gives the effect on **ALL** UK trade [EEA - 9 %, **bilateral FTA - 14 % to - 19 %,** WTO – 17 % to – 24 %], which are anything but comfortable
- But for ***bilateral*** trade across the Channel, Treasury utilises the '**benefits of EU membership**' literature, and finds a range of effects of EU membership on trade with other EU between **51 % - 104 %,** with its own (gravity) approach coming to a range of 68 % - 85 % compared to WTO
- A hard BREXIT (to WTO) would see trade **shrink this much**; a half-hard BREXIT (FTA) would shrink trade somewhat less, namely, with 2/3 of that reduction; both are huge

From soft exit to 'hard' BREXIT ?

- The February White Paper - though still open-ended in many respects – is based on the idea that the 2019 starting position of the UK is little else than a "domestic form of EU"
- The single market acquis, if not yet in UK law, will be integrally 'imported into it' via the Repeal Act
- presented as if BREXIT is no more, and no less, than a "clear break" (immigration and the CJEU) but otherwise there would be no "trading costs" given the EU acquis in the UK
- If taken for granted, FTA and WTO simulations would be far too sombre; for trade (and FDI?), **BREXIT would mean little**

From soft exit to 'hard' BREXIT? (2)

- This suggestive presentation has to be **dismissed**
- First, the EEA (= single market acquis-minus) is rejected and so is the customs union ; **so, the UK wants much LESS**
- Second, there is no proposal to introduce joint EU/UK disciplines to ensure the EU acquis is maintained over time
- Third, tariff-free mutual access is more or less assumed – makes sense - but that **presupposes a rich/deep FTA** ; the DCFTA (e.g. EU/Ukraine) is a good candidate to 'mimic', esp. because the UK already fully 'owns' the EU acquis and migration is not 'in'. But the DCFTA is clearly based on '**entrenching the single market acquis**', hence, **not** 'taking back control', except for migration
- So **BREXIT will harden over time**, unless the UK deeply commits to a DCFTA-type acquis ; is **not** in White Paper

Costs of leaving the customs union

- out-of-the-C.U. is a costly option for the UK, and to some extent for the EU; **'free circulation' is an asset**
- The trade facilitation literature shows that efficient customs generates low costs (e.g. 0.3 % - 0.4 % of the invoice price) but this can be much higher when customs [or rules] are inefficient ; OECD work (2015) shows that the transaction costs of getting goods across the border might be increased by customs procedures by **routinely 3 % - 5 %,** but also by as much as 24 % (in extreme cases), so **far from trivial**
- for origin rules, range of costs is far wider [some 4 % to 15 % higher trade costs] and product-specific >>> matters a great deal for EU-27 – UK **value chains** in automotive products and electronic goods ; these sectors may well reduce the cross- Channel interaction; AIRBUS has said so
- BREXIT customs agreement proposals (August) are a fiction and chaos looms in several harbours

Free goods movement across the Channel, all-or-nothing-or-most?

- Free movement [here, for goods] combines two essential ingredients : it is a 'right' for [EU] consumers and companies, **but subject to** overcoming/removing derogations, i.e. assuring SHEIC regulatory objectives
- The White paper suggests that, in 2019, the UK and EU acquis will be the same (except CU + migration), so….?
- In this thinking, the EU27 and the UK could 'agree' to allow 'free goods movement' in a treaty, under conditions
- So, **BREXIT would amount to possible deviations from** or erosion of 'free goods movement', if (a) new EU laws are not incorporated in the UK, (b) the UK opts for amendments or new UK laws affecting derogations, (c) the UK does not accept relevant CJEU rulings ; all this could be big or small (?)
- **Core issue** : can 'taking back control' be so light and limited?

Compare with EU/Switzerland

- EU/Switzerland has no free movement, and there is no overall framework (or a specific clause) for it
- On 30 March 2019, also UK will no longer enjoy free (goods) movement, **unless** the homogeneity conditions (slides 6 and 7) would be guaranteed
- **If so, why have BREXIT** because 2 red lines are then violated : free circulation [CU] is the basis for free movement ; CJEU will again be critical ; and EU will insist on other conditions of slide 6
- Sticking to these red lines will be costly with UK customs (and the logistics behind it) and a separate dispute settlement will be needed ; access worsens, homogeneity lost - unacceptable to EU

Free services movement across the Channel ?

- In services, 'free movement' in the EU goes far (and the link with unrestricted FDI ought to be taken into account) but it is not fully accomplished [see CETA MS reservations]; is often stuck on weak M.R., restrictive national laws, etc.
- One observes an *incremental deepening* of the single services market; UK used to be in the frontline (e.g. Services dir.); **why turning their back on all this** ?
- Additional EU progress includes infrastructure (in some Netw Industries), supervision, EU Agencies, national reforms in professional services (lowering barriers)

Free services movement (2) ?

- For the UK, services are of great economic importance, hence, considerable BREXIT risks
- UK strong in professional services (in a range of subfields such as accountancy/auditing, law firms, financial services, management advice, some ICT) and audio-video-services
- UK is dependent on several modes of transport (esp. air, road haulage, maritime shipping)
- White Paper mostly descriptive, no positioning, so what will the UK want ?
- Switzerland has no free movement of services, no services agreement ; only rail, road and air deals ; with air, EEA-type arrangement ; also on non-life insurance and some audio-visual services ; in Bilateral-1 also mode 4 [temp. cross-border services], so, **limited, splintered and complicated – bad for UK**, coming 'out of' EU acquis

Nothing like before for finance in UK

- **End of free passporting** from UK to EU, will affect front office in
  - Corporate finance
  - Derivatives
  - Brokerage
  - Asset management, etc…
- **Equivalence is not a solution**
  - Not one single form of equivalence, different degrees
  - Is unilateral decision by EU Commission
- **EU-27 wants withdrawal first** before new deal => uncertain transition period, very damaging for finance
- **Revanchist attitudes might dominate** in rest of EU: grab City business
- **Asymmetry** in relations will affect EU-UK cooperation
- Requires large financial groups to **fragment** business again, leads to less efficient single market

FDI : BREXIT impact & barriers

- FDI problem in BREXIT is **not** about 'new' barriers as FDI is practically free for 3rd countries
- The economic issue is that FDI is partly dependent on '**market size**' ; BREXIT reduces UK access to the large EU27 market ; recent estimates show an (inwards to the UK) FDI reduction of 22 % under the WTO option
- However, the lower attractiveness of the UK for FDI has knock-on effects given the nexus between trade and FDI (in value-chains and otherwise) ; it might also affect UK productivity levels negatively (range of 3 % - 7 %)
- Hence, BREXIT is likely to induce **some FDI diversion** towards EU27, and the more so the harder BREXIT is

FDI and Switzerland vs. BREXIT

- Again, barriers are not the problem
- market size logic is reversed in the Swiss case
- A lot of the Swiss wealth is earned **in the EU**, not only in Switzerland [not, as some Brexiteers say, Switzerland is 'better off' outside the EU, just look at how well-off they are]
- FDI by Swiss firms in the EU is <u>the</u> way Switzerland benefits from EU market integration (goods & serv)
- NOTE : EU FDI to Switzerland is even higher, but the determinants may partly be distinct from market integration [tax, re-routing, other]

Some conclusions

- The EU/Swiss 'model' is rather deficient compared to what the UK has today - would be costly for UK
- Apart from serious gaps/omissions in bilateral treaties, the sectoral approach is also incredibly complicated to manage with numerous committees and without an overall framework - cherrypicking
- When John Springford calls 'Brexiting Swiss-style' the best UK-EU trade deal [CER, April 17], he willingly sacrifices options such as EU membership or an EEA-bis (which he favours himself) due to 'red lines'
- The EU is not willing to negotiate another 'sectoral & flexible' (non-homogeneous) deal with special access to the single market

Some conclusions (2)

- And certainly not without the four conditions required for the 'institutional agreement' with Switzerland [see again EU Council conclusions of 28 Febr 2017]
- Stronger, the EU has used its leverage (blocking student programmes ; not negotiating the Swiss joining the EU single market in electricity, despite its win-win character) to press Switzerland to 'ensure homogeneity and legal certainty for citizens and businesses' [but negotiations are slow]
- Once progress is seen, the 'full potential' comes in sight (e.g. financial or overall services ?; agro-food)
- On free movement of persons, EU prevailed !!
- So, 2 UK 'red lines' are lost; 'no CU' is last red line

Thank you!

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