



## COMPETITION REGULATION & TRADE BRIEFING



### FUTURE UK TRADE RELATIONS WITH THE EU AND WITH THIRD COUNTRIES

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As an EU member state the UK is currently part of the EU internal market, which is one of the most advanced trade areas in the world and has been developed and extended since 1951. Originally referred to as the 'common market' it consists of a customs union with no tariffs on goods traded between member states and a common tariff for goods entering the EU from outside. In addition to the basic trade rules, it includes a network of more advanced trade related rights and obligations which are enforced by the European Courts.

Central to the internal market are the 'four freedoms' (free movement of goods, persons, services and capital) which are enshrined in the EU Treaties. The Treaty provisions establish these free movement principles which are further refined by a raft of internal market legislation designed to complete the creation of the internal market by abolishing any remaining trade barriers and creating regulatory harmonisation.

Access to the internal market is therefore about much more than removing tariffs on goods. So what does it mean, and is it possible for a member state to leave the EU but retain full access to this internal market? There are a number of existing alternatives to EU membership, each of which provide to a greater or lesser extent participation in the internal market and some of the EU's wider policies and related obligations.

Furthermore, the EU has also agreed various levels of market access for goods and access in individual trade agreements with third countries.

A brief summary of these different models and their various implications are set out below. It is now up to the UK to agree on what kind of relationship with Europe should replace its EU membership and to negotiate with the EU what will hopefully be a mutually beneficial deal. Any new trade arrangement will be between the UK and the EU as a whole, and cannot be

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negotiated with the individual member states, as trade policy is an exclusive power of the EU. The EU Commission negotiates on behalf of the whole EU, in close cooperation with the Council and the European Parliament, who will need to approve the agreement. Where the agreement contains provisions that fall within the member states' jurisdiction, individual member states will also need to ratify the agreement under their national ratification procedures.

## 1. European Economic Area (EEA) agreement

This is The EEA is an international agreement between three of the four EFTA countries (Iceland, Liechtenstein and Norway) and the EU, in order to create a homogeneous European economic area. It includes the free movement of goods, persons, services, capital and establishment and those horizontal areas related to these freedoms (including consumer protection, company law, social policy, environment etc.). The competition and state aid rules also apply to all EEA countries but the agreement does not include the common trade policy, agriculture and fisheries policy, justice and home affairs, foreign affairs and security or harmonised taxation. The fourth EFTA country, Switzerland, has not joined the EEA because its people rejected this in a referendum.

The EEA agreement contains a strict obligation to incorporate and implement EEA relevant EU 'acquis' (EU legislation that has been adopted under the EEA agreement) and those implemented EEA rules must have supremacy over national rules. New EU legislation can only become part of the EEA agreement by unanimous agreement of the three EEA EFTA states.

Although the EEA EFTA states can participate in shaping legislation at the preparatory stages through participation in expert groups and committees, they do not have formal access to the decision making process within the EU institutions.

It would potentially be possible for the UK to join the EEA but on leaving the EU it would first have to become an EFTA member. This would need to be unanimously approved by the other EFTA countries which, in Switzerland, would require authorisation by referendum. The UK's application and its subsequent application to join the EEA agreement would require approval by all EU member states. This option would provide the UK with continued access to the internal market which of course also includes the free movement of persons. Given that one of the key issues in the referendum campaign to leave the EU was the restriction of immigration to the UK from the EU this issue may prevent the use of this option.

There may be a solution in Articles 112 to 114 of the EEA agreement which provide for an 'emergency break' mechanism allowing EEA EFTA countries to take safeguard measures to temporarily suspend parts of the EEA agreement, including the free movement of persons. But any such measures must be temporary and if the safeguard measures create an imbalance between the rights and obligations under the agreement, the EU can take such proportionate rebalancing measures as are strictly necessary to remedy the imbalance. Liechtenstein has used this provision in order to impose specific restrictions on the free movement of people, but use of these measures for this purpose by a large country such as the UK would not be straightforward.

Unlike the EU the EEA is not a customs union with a common external tariff. Whereas goods that enter the EU can travel freely throughout the EU once the relevant tariff has been paid, this is not the case for goods entering the EU via the EEA. In order to benefit from the EEA's free trade area and travel freely within the EEA, goods must have originated in the EEA. The EU rules of origin determine where the goods originated in order to decide the relevant tariff. Broadly speaking there are two main categories under these rules: goods wholly obtained or produced in a single country and goods which are sufficiently worked or processed to qualify as originating from the exporting country. There is a list containing details of operations that must be carried out on given imported goods in order to confer originating status, and "sufficiently worked" means sufficiently worked according to the specifications of the list rules. The cost and administrative burden of dealing with this process would be an extra burden on UK business involved in export to the EU. A similar regime would also apply in the context of a specific free trade agreement negotiated between the UK and the EU (see below).

Being outside the EU's common customs union, the EEA EFTA member states are able to negotiate their own free trade agreements with non-EU countries and have jointly negotiated some 27 agreements. Each country decides individually whether to join one of these agreements and they would require considerable renegotiation to accommodate the UK, with its much larger economy, as a party.

## 2. Swiss model

Switzerland is an EFTA country but is not part of the EEA. Instead it has concluded more than 120 bilateral sector specific agreements with the EU which incorporate provisions similar to those adopted by the other EEA countries relating to free movement of goods, services, persons and capital. These agreements have created a complex network of obligations. In addition, these are 'static' agreements without an inbuilt mechanism to adapt them to evolving legislation and they do not contain any surveillance or dispute settlement mechanisms.

In 2012 the EU Council decided that this system of bilateral agreements had reached its limits and concluded there was an urgent need to create a new institutional framework. Negotiations for the introduction of a framework institutional agreement governing the EU/Swiss bilateral relations were launched in May 2014. The EU Council has decided not to grant Switzerland further access to the internal market in respect of new sectors unless this framework agreement is put in place. The negotiations are currently stalled due to a dispute between Switzerland and the EU over immigration control and will only resume once this issue has been resolved.

Following a referendum in 2014 entitled "Against mass immigration", the Swiss voted to impose quota on immigration including from the EU. The Swiss Government now has until February 2017 to negotiate a deal with the EU on immigration. The EU has so far refused to enter into negotiations and has made it clear that the free movement of people is part of the internal market package to which Switzerland has partial access under one of its bilateral agreements with the EU signed in 1999. The Swiss Federal Council has submitted draft legislation to Parliament which proposes the introduction of a unilateral safeguard clause to control immigration from EU and EFTA countries. Under the bilateral Treaties with Switzerland the EU can invoke a 'guillotine clause' which allows it to suspend all economic agreements if Switzerland does not comply with one of its agreements. As Switzerland is already starting to feel the impact of its vote on immigration (participation in some EU programmes such as Horizon 2020 science research and Erasmus student mobility was partially suspended following the vote) there is talk that a second referendum may be held by the end of 2016 or early 2017.

The Swiss model is often cited as a possible alternative for the UK to its EU membership and the UK will closely be following the outcome of this free movement dispute. If Switzerland is successful in curbing immigration in some shape or form it may set an important precedent for the UK.

## 3. Customs Union

The leading example under this model is the EU-Turkey customs union agreement which came into force in December 1995. The agreement with Turkey covers trade in all industrial goods and processed agricultural products. Services and public procurement are currently not included and negotiations to expand the agreement in order to include these were suspended in 2002. Under the customs union Turkey has adopted the EU's common external tariff and the parties eliminated customs duties and quantitative restrictions on their bilateral trade. Turkey also agrees to align its rules with EU legislation in several essential internal market areas, in particular regarding industrial standards.

The UK is a net importer of goods and net exporter of services, and as it currently stands this model would not work to the advantage of the UK economy.

Turkey can agree trade agreements with countries outside the EU, but as part of the customs union its external tariffs must be aligned with EU tariffs, thereby limiting the trade deals Turkey can agree with third countries. When the EU signs a trade agreement with a third country Turkey must give that country access to its own market on the same terms, but this obligation is not reciprocal. The third country is not required to open its market on the same terms to Turkish exports. Instead, Turkey has to negotiate separate trade deals with these countries.

## 4. WTO

Although currently a WTO member, the UK is not an independent member but participates as an EU member state. Its relationship with the EU will have to be untangled and may result in a renegotiation of at least some of the terms of its membership which would need to be approved by all WTO members.

Assuming the UK's WTO status is resolved, in the absence of any special relations with the EU, the UK's right to trade with the EU in both goods and services would be governed by the WTO rules. WTO members must apply most favoured nation tariffs (MFNs) to all other WTO member countries, unless they have a trade deal or customs

union in place with those countries (the rules for free trade agreements are set out in the WTO and all free trade agreements must be notified to the WTO). UK exporters would pay tariffs on their exports into the EU and the UK would have to add its standard import tariffs to imports from the EU (since the UK could not grant better tariff treatment to the EU than to other WTO members). That standard UK import tariff could be zero, provided the UK applies this zero tariff to imports of all origins. Any products exported to the EU would also need to comply with all EU product standards, so advantages of losing any so-called red tape imposed by the EU through various standards and technical requirements would strictly be limited to products traded within the UK only.

Trade in services is governed by the General Agreement on Trade in Services (GATS) which also operates on the principle of non-discrimination. Unless preferential agreements are in place, restrictions on market access must be applied uniformly to all WTO countries. But barriers to entry for services do not usually take the form of tariffs imposed at the border but arise from the national regulatory regime of the importing country. EU internal market rules provide for free movement of services and freedom of establishment and require that a service provider in one member state should be free to provide its services in other member states usually subject to regulations of its home country. No equivalent regime exists under the WTO and this option cannot be compared, therefore, to the UK's current position as an EU member state.

A subgroup of 23 WTO members (The Real Good Friends of Services, or RGF) which includes the EU is engaged in negotiations for a 'plurilateral' agreement to liberalise trade in services, in order to overcome the stalemate in the broader WTO negotiations. Although initially only binding on the participants, the aim is to structure any agreement as compatible with the GATS rules in order to facilitate extension to other WTO members in future. So far, 18 negotiation rounds have taken place but there is no formal deadline for ending the negotiations.

## 5. UK tailored FTA

There is no reason why the UK's new relationship with the EU should be based on one of the existing models and why it could not agree its own free trade agreement with the EU. Trade deals between the EU and third countries are all different, reflecting the requirements and nature of the economy of the participating countries. The Canadian Comprehensive Economic and Trade Agreement (CETA) is a helpful example here but the UK will of course decide on its own priorities and red lines and is likely to want to negotiate free trade of services, which is only very partially addressed by CETA.

Trade agreements with third countries are negotiated and concluded in accordance with the process set out in Article 218 TFEU. The Council authorises the Commission to conduct the negotiations and once completed the Commission presents the deal to the Council and the European Parliament. The Council votes by qualified majority (at least 55% of the members of the Council representing the participating member states, comprising at least 65% of the population of these states). The European Parliament also has to give its consent by simple majority. Also, where a trade treaty extends beyond the EU's areas of exclusive competence to areas of shared competence (environment, consumer protection, energy, transport) or to areas of exclusive competence for the member states (rights in property and most taxes), the treaty has to be signed and ratified by all EU member states. This will be the case for most trade treaties and can add considerable delays to these treaties coming into force. The recent EU/Canada CETA, which has taken more than seven years to negotiate, has still not been ratified two years after signature.

With a new free trade agreement in place the EU and UK would be able to apply zero duty to each other and there would be no requirement to extend duty free treatment to other WTO countries.

Negotiating such an agreement will take time, and it will be important to have adequate transitional arrangements in place in the interim, which should hopefully be included in the UK's withdrawal agreement.

## 6. Other options

There are of course many other possible outcomes and the UK and the EU may end up negotiating one or several unique arrangements. One possibility (which could complement some of the above) may be a model aimed specifically at addressing areas of desired integration, for example financial services, through separate agreements. The Energy Community Treaty, which is an international organisation bringing together the EU and its neighbouring countries in order to create an integrated pan-European energy market may be a precedent for this. Its key objective is to extend the EU internal energy market rules and principles to countries in South East Europe and the Black Sea region on the basis of a legally binding framework.

## 7. Transitional arrangements

In light of the complexities and time it is likely to take to negotiate some of these a new trade arrangements with the EU, it will be desirable to put in place transitional arrangements which will apply until a permanent alternative to the UK's EU membership has been agreed and takes effect. Article 50(2) TEU which deals with the withdrawal process of a member state provides for an agreement to be negotiated which sets out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union.

Although Article 50 is untested there must be good arguments for the case that this is exactly the type of arrangement it is intended to cover. The Commission insists that Article 50 only deals with the terms of leaving, ie the disentanglement of a member state and that a separate agreement dealing with the new trading relationships will be made in accordance with the Treaty provisions dealing with trade agreements with third countries. But transitional arrangements would by their very nature be temporary and would not constitute the final new EU/UK trading relationship. Also, it will be beneficial not just for the UK, but also for the EU and its member states to ensure that robust transitional provisions are in place in order to reduce any unnecessary uncertainty.

## 8. Trade relations with non-EU countries

### Negotiating new trade agreements

Under Article 3 TFEU the EU has exclusive jurisdiction over trade policy, which is referred to as the EU's Common Commercial Policy. Trade agreements with non EU countries can only be concluded by the EU and member states are not able to negotiate their own trade deals with third countries, although they can still sign international agreements in other areas. For example the UK recently signed the Cape Town Convention dealing with security interests over aircraft, as rights in property are an area of exclusive member state competence. The UK and four other member states have ratified the Uncitral Model Law on Cross-Border Insolvency. Insolvency is an area of shared competency and relations between EU member states are regulated by the EU Insolvency Regulation, now recast in Regulation (EU) 2015/848 which comes into effect in June 2017.

As long as the UK is a member state it will be subject to the EU's common commercial policy. Triggering Article 50 TEU will start the withdrawal process but the UK will remain subject to the EU Treaties until the withdrawal agreement takes effect or until two years after the notification under Article 50, whichever is earlier (unless all member states agree to extend the two year period). Whether or not the UK can start negotiating its own FTAs with third countries before the withdrawal process is finalised and sign them once it is no longer a member state is not clear, but this is again the type of issue that should be agreed as soon as possible under the withdrawal process.

Following Brexit, the UK's ability to negotiate its own trade deals with third countries will depend on the model replacing its EU membership. If the UK joins the EEA agreement it will technically be free to enter into its own trade agreements, as the EEA is not a customs union. By contrast, if the UK were to join a customs union such as the Turkish model, it would be bound by the EU's common commercial policy and would be limited as to the terms it can agree with third countries.

### The UK's position under existing EU trade agreements

The UK's post Brexit position in respect of existing EU trade agreements is not clear. There are currently around 50 preferential trade agreements in place between the EU and third countries. The UK is party to these agreements by virtue of its EU membership. Some of these agreements, which only cover provisions which fall within the EU's exclusive competence, are concluded between the EU and the third countries only. Following Brexit these agreements may cease to apply to the UK and the UK may need to make an assessment as to which of these agreements remain relevant and should be renegotiated.

But many of the EU preferential trade agreements are 'mixed agreements' which means they contain provisions which relate to areas which are within the EU's exclusive powers as well as provisions which relate to areas reserved for the member states or shared with the EU. Mixed agreements are concluded between third countries and the EU as well as the EU member states, and it has been argued that it may therefore be possible for the UK to agree with the third countries on a 'rolling-over' of these agreements.

This could potentially be an attractive transitional solution both for the UK and the EU. It would buy the UK time to negotiate its own preferential trade agreements, and for the EU it would avoid a situation where the third country could claim that without the UK's membership the original agreement was no longer what was agreed. For some third countries the EU may become less attractive without the UK as a member state. The issue as to whether the EU would have to negotiate compensation with its partners for the rights and benefits these third countries would lose as a result of the 'shrinking' Community was considered in the context of Greenland leaving the EU.

For both types of agreements (ie 'mixed agreements' as well as agreements concluded by the EU without the member states) the third country concerned may object to the UK's withdrawal. Withdrawal from the EU under Article 50 would remove the legal obligations between the UK and the EU member states, but a third country may not necessarily accept that the UK can walk away from its obligations under a procedure in which it is not involved. The UK, the EU and the third country may therefore need to take positive steps to terminate the UK's participation and to ensure that it is no longer bound to offer market access under the terms of that agreement.

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