Trade and Investment Balance of Competence Review

Project Report

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Colophon

Trade and Investment
Balance of Competence Review

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Table of Contents

TABLES

FIGURES

Executive Summary

This report provides a review of Britain's relationship to the EU in the areas of trade and investment policy. It has been prepared in the broader context of the UK government review of the full set of the EU's competences. The report covers three areas:

- The institutional logic underpinning development of the current arrangement, and of alternative arrangements;
- Implications of the EU competence on trade and investment policy for market access to the single market;
- The exercise by the EC of trade and investment policy in the form of offensive actions on behalf of collective interest of EU Member States.

<u>EU competence on trade and investment matters has evolved in response to changing circumstances</u>. While in the early years of the EEC the combination of the GATT-compliance and Internal Market defence rationales helps account for the more limited initial scope of Community competence on commercial policy, this scope grew with demands from trading partners (and EU Members) to include more policies in trade negotiations. This process was reinforced by the gradual reduction of tariffs, which has shifted attention to non-tariff barriers (NTBs) to trade and investment. This does not mean the expansion in remit has been linear or uncontested. However, in order to sustain the European Union as a credible agent in trade negotiations, and to reinforce its role as a bulwark against protectionism in the guise of NTBs, the scope of the Common Commercial Policy has necessarily expanded over time.

<u>The balance of competence has important implications for access to the single market</u>. While joining a customs union with deep structural elements implies transfer of competence for basic aspects of commercial and industrial policy, it also implies reduction in administrative and regulatory trade and investment costs within the single market. Exports to the EU account for 10 percent of UK value added. Relative to alternatives, the customs union obviates the need for rules of origin, and serves to limit NTBs within the single market. The economics literature identifies trade costs from rules of origin, for example, ranging from 4 percent to 15 percent of the value of trade. Non-tariff barriers are also high for non-EU firms when accessing the single market. Limiting these costs provides a basic economic logic for pooling elements of economic sovereignty and constraining Member States to a common external policy.

The pattern of actions taken by the EC aimed at market access in third countries reflects UK export interests relative to overall EU export interests. One area where the EC takes offensive action is through the WTO, including the WTO's Dispute Settlement Body (DSB). Through the DSB, the EC works to ensure market access commitments by other WTO Members. The overall set of EC disputes targets UK export markets more than overall EU export markets. Similarly, in contrast to previous FTAs, the current round of FTA negotiations undertaken by the EC reflects UK export destinations more than overall EU exports. When we look at preliminary and on-going FTA negotiations (including for example Canada, the United States, and Japan), these potential agreements account for 4 percent of UK GDP, measured as value added contained in exports, and 3 percent of value added for the remaining EU Members.

Regarding negotiations with third countries from outside the EU, it is in no way guaranteed that a country choosing to negotiate on its own (for example with the US) can expect to secure a better deal on its own than when part of the block represented by the EU. In the US-Korea FTA, for example, the US insisted on an MFN clause, meaning that if other countries did obtain a better deal in an FTA context, this also extends to the US. The existence of such clauses and their use suggest that a former EU Member State might not be able obtain better market access for its exporters relative to rivals from other EU member states through negotiating FTAs with other countries, such as the fast growing emerging markets.

Chapter 1:

Introduction

This report provides a review of Britain's relationship to the EU in the areas of trade and investment policy. It has been prepared in the context of the UK government review of the EU's competences. This report does not, and is not meant to, provide recommendations for specific policies. Nor is it meant to pre-judge options for policy, including both the current and alternative models. That being said, by necessity an assessment of the current arrangement requires what the arrangement represents, relative to alternatives. As such, while this report is not meant, in any way, to prejudge various institutional arrangements, it is necessary to engage in comparison of this arrangement to alternatives, including earlier historical models seen during the evolution of the present regime, to grasp the meaning of the EU's competences in this area for a proper understanding of the impact on UK interests.

Broadly speaking, the report covers three areas. In Chapter 2, we provide an institutional overview of the current arrangement. This includes the logic underpinning sometimes incremental, and sometimes substantial steps in the evolution of institutional structures in this area. It also includes a comparison of the current setup to alternatives as observed in trade and investment agreements between third countries (such as the US and Australia), and between the EU and third countries (such as between the EU and Switzerland). Chapters 3 and 4 then focus on more quantitative aspects of the current regime. Chapter 3 focuses on potential trade costs linked to market access to the European Union, and the implications that alternative arrangements have for these costs. This includes rules of origin, the common external tariff of the EU, and non-tariff barriers to trade and investment. Chapter 4 focuses on offensive aspects of EU trade policy, including both the pursuit of market access for EU exports through the WTO, and also the set of countries engaged by the EU in negotiations for trade and investment agreements. There is some necessary overlap between Chapters 2 and 4, as Chapter 2 deals primarily with institutional context and logic, while Chapter 4 provides analytical discussion, included quantitative analysis, of many of the same issues. Concluding remarks are provided in Chapter 5.[1]

[1] It should be noted that this report does not place emphasis on issues like trade promotion, but rather on issues related to market access.

Chapter 2:
Rationale for EU Competence and Potential Alternative Arrangements

Membership in a customs union, like the European Union, necessarily implies delegation or assignment of certain competence and authority to the combined members of the customs union that are otherwise reserved for the individual national states that make up the union. Even for areas that remain reserved for individual members, coordination often remains a necessity. Not surprisingly, this assignment of competence to the collective membership of the customs union can also be a source of tension between the core (representing the collection of members and their collective interest, however defined) and the individual members. The purpose of this chapter is to state and critically assess the rationales given for assigning exclusive competence for trade in goods and services and for the commercial aspects of services and investments to the European Union. This allocation of competence will then be contrasted with six alternative arrangements. Overall, the goal is to shed light on the options available for allocating competence and the arguments made for and against each of them, thereby informing deliberations on such matters.

In so far as this chapter addresses the rationale for exclusive competence, the focus will be on the rationale alone. Therefore, this chapter is not an account of the extensive case law on competence, nor is it a potted history of the diplomatic disputes between national governments and the European Union over competence.[2] Still the literatures on these important matters has been consulted in the preparation of this chapter for, in places, they include many of the arguments for and against Member States of the European Union giving up their room for independent action in commercial policy.

This chapter is organised into three sections. The next section briefly states the allocation of competence on commercial policy that exists today within the European Union (EU), as codified by the Treaty on the Functioning of the European Union (TFEU), frequently referred to as the "Lisbon Treaty." The second section states and assesses four elements in the rationale for the current allocation of competence on commercial policy. The third section

[2] For the former see Eeckhout (2011) and Krajewski (2012); for the latter see Meunier (2005) and Woolcock (2012).

discusses six alternative arrangements, drawing in large part upon the modalities concerning commercial policy between the EU and certain non-members. Concluding remarks follow.

2.1 The allocation of exclusive competence to the EU on commercial policy

While earlier treaties concerning the European Economic Community (EEC) and the EU included provisions on commercial policy, the current allocation of exclusive competence can be found in the provisions of the TFEU, of which the United Kingdom is a signatory. Article 2(1) of that treaty defines exclusive competence as follows:

"When the Treaties confer on the Union exclusive competence in a specific area, only the Union may legislate and adopt legally binding acts, the Member States being able to do so only if some empowered by the Union or for the implementation of Union acts."

This provision, therefore, limits the independent action of Member States in the areas of policy concerned. As will become clear, even when a Member State's actions are constrained by exclusive competence, this does not mean that Member States play at the Union level no role in deciding matters relating to the policy in question.

Article 3 of the TFEU states that the customs union between the Member States and the Common Commercial Policy are exclusive competences of the Union. The next step, then, is to ascertain what is meant in the Lisbon Treaty by a customs union and the Common Commercial Policy. In what follows, each is discussed in turn.

Articles 28-32 state what the customs union shall involve, including the adoption of a Common Customs Tariff with trading partners (Article 28), and the procedure to be followed in setting the Common Customs Tariff (Article 31). With respect to the latter, the European Commission has the power of initiative by making a proposal to the European Council. Member States are, therefore, not allowed to introduce or alter tariff rates charged on goods imported from outside the EU, nor are Member States allowed to introduce tariffs or equivalent measures on imports from other Member States. By agreeing to create a customs union, the Member States have given up the right to undertake an independent tariff policy.

With respect to the Common Commercial Policy, its objectives are laid out in Article 206 and include

"...the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers."

A central requirement of the Lisbon Treaty (specifically Article 207(1)) is that the design and implementation of the Common Commercial Policy be uniform, in particular across the Member States. Even the potential, let alone the reality, of independent action by Member States would affect expectations of trading partners and market participants, giving rise to the impression of variation in commercial policy across the Member States. In agreeing to a uniform Common Commercial Policy the signatories of the Lisbon Treaty gave up their rights to independent action in the policy domains covered by the Common Commercial Policy. Uniformity, then, accounts for the transfer of exclusive competence to the Union.

The scope of the Common Commercial Policy is also enumerated in Article 207(1):

"The common commercial policy shall be based on uniform principles, particularly with regard to changes in tariff rates, the conclusion of tariff and trade arrangements relating to trade in goods and services, and the commercial aspects of intellectual property, foreign direct investment, the achievement of uniformity in measures of liberalisation, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies. The common commercial policy shall be conducted in the context of the principles and objectives of the Union's external action."

No mention is made of agricultural products in Article 207(1), a noteworthy omission. According to Article 4(2) competence for agricultural and fisheries matters is shared between the Union and the Member States. The meaning of shared competence is stated in Article 2.

"When the Treaties confer on the Union a competence shared with the Member States in a specific area, the Union and the Member States may legislate and adopt legally binding acts in that area. The Member States shall exercise their competence to the extent that the Union has not exercised its competence. The Member States shall exercise their competence again to the extent that the Union has decided to cease exercising its competence."

Article 207(2) states that the implementation of the Common Commercial Policy shall follow the ordinary legislative procedure (OLP) involving, therefore, approval of measures proposed by the European Commission by both the European Parliament and the European Council. The precise procedures to be followed in the OLP are laid out in Article 294 of the Lisbon treaty.

Article 207(3) and (4) refer to the negotiation of agreements with third parties and international organisations that refer to commercial policy. Once again the European Commission is given the sole power of initiative, in this case by making a proposal to the European Council to launch a negotiation with a third party. The European Commission is assigned the role conducting such negotiations, assisted by the Council. The European Council sets the mandate for such negotiations and decides whether to approve any accord negotiated by the European Commission with a third party, both decisions requiring qualified majorities in almost all matters. With respect to negotiations relating to certain services, including cultural and audio-visual services, unanimous decisions are required. International agreements concerning transportation, including air-related services, fall outside the scope of Article 207 and therefore this Article does not proscribe independent action by Member States for commercial activities in question.

Under the rules laid out in the last paragraph the government of a Member State cannot initiate a negotiation on any element of the Common Commercial Policy with another country or international organisation. Thus, the United Kingdom cannot start the negotiation of a free trade agreement with a third party, for example, the United States. Nor would the United Kingdom be independently represented in any negotiation with a third party or in a negotiation at the World Trade Organization, where the European Commission speaks on behalf of the Member States. As a member of the European Council, the United Kingdom could seek to influence the mandate of any such negotiation and to influence the decision as to whether to accept any accord negotiated with a third party or at an international organisation by the European Commission. Therefore, although the current institutional arrangements have created a single trade negotiator for the European Union, it would be wrong to infer that Member States has no influence on trade negotiations undertaken by the European Commission. We examine this issue, in terms of UK interests as reflected in actions taken by the European Commission, when we assess WTO disputes later in the report. Likewise, with respect to elements of the Common Commercial Policy other than negotiations with third parties, the Member States, as members of the European Council, have a role to play as part of the Ordinary Legislative Procedure.

In sum, the Lisbon Treaty specifies

1. a range of commerce-related policies where independent action by Member States is not permitted,

2. on what basis decisions are to be taken at the Union level, and
3. the respective roles of the European Commission, European Council (made up of representatives of the Member States), and the European Parliament as they relate to the Common Commercial Policy.

Any satisfactory explanation for this allocation of competence must account for all three features mentioned above. In the following section four arguments, each seeking to rationalise elements of the above allocation of competence, are considered.

2.2 Purported Rationales for Exclusive Competence.

Concerning the merits of allocating Exclusive Competence for the Common Commercial Policy to the Union level, the arguments advanced can be assembled into the following four groups:

1. Implementation of a customs union in compliance with the General Agreement on Tariffs and Trade (GATT)
2. Bulwark against Protectionism.
3. Greater clout in international trade negotiations.
4. Promotion and defence of the Internal Market.

Each argument is stated and then assessed.

A GATT-compliant Customs Union.

When the EEC was formed its founding members had the goal of eventually eliminating trade barriers between their economies. Such a goal could only be reconciled with prevailing international trade rules, the GATT, if the founding members created either a customs union or a free trade area. To be GATT-compliant both options required the elimination of tariffs on "substantially all" trade between the founding members. GATT compliance places an additional requirement on custom unions, however. Article XXIV(8b) of the then GATT required that

"...substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union."

The founding members of the EEC went further and, for each good imported from a third party, adopted the same tariff. Tariffs could in principle be altered, however, uniform application would require every EEC member to change their tariffs by exactly the same amount. In creating a customs union, then, the founding members of the EEC gave up their independent rights to alter their tariffs in response to changes in national circumstances, unless stringent conditions were met (namely, the consent of other members was obtained, that those other members so altered their tariffs as well, and if such an alteration was consistent with any other obligations the founding members had under the GATT.) Essentially, the requirement of adopting a common external tariff requires identical and simultaneous tariff changes by member states. This also applies in response to investigations into dumping, subsidy, and import surges and should the members of the customs union decide to introduce lower tariffs for imports from developing countries (as has become common and is frequently referred to as implementing a Generalised System of Preferences.)[3]

Given a free trade area does not require the uniform application of tariffs by its members—and therefore giving up independent state action--what reasons could account for the choice of a customs union? Here it is worth bearing in mind two others objectives of the founding members of the EEC. First, those members sought to eliminate obstacles to trade within the EEC. The creation of a free trade area could have led two or more EEC members having different tariffs on the same good and, in the absence of any other restrictions, this would have resulted in canny importers entering EEC markets first through the lowest tariff jurisdiction and then, if profitable, transhipped into the higher tariff jurisdiction. The higher tariff jurisdiction would find such circumvention of its tariff objectionable, not only its tariff policy rendered ineffective but also no revenues would be collected on the imports transhipped through the free trade area.

As a result, members of free trade agreements typically impose Rules of Origin (ROO). Only those imports from a free trade partner that can show that their "origin" or enough of their origin is generated within that partner can benefit from zero tariffs. Otherwise, the importer has to pay the tariff rate charged on imports from third parties. Demonstrating origin can be onerous and the costs involved have been known to deter importers from seeking zero tariff

[3] It is interesting to note that even within the common external tariff or CET, variation in rates across sectors still reflect the interests of individual Member States. In this regard, the higher the share of an industry in the UK relative the EU average, the greater the tariff. See Francois, Nelson and Pelkmans (2008) and Francois and Nelson (2013) for more on this point. Both papers estimate political weights implied by variation in tariffs and econometrically map these to national production shares.

treatment, a point developed later in this report. Moreover, the suspicion remains that some ROO have been designed deliberately to curtail, even eliminate, the additional competition created by a free trade agreement.[4]

In the light of these considerations, the founding members of the EEC may well have decided that the additional objective of attaining unimpeded internal trade was inconsistent with ROO and, therefore, the creation of a customs union was the only choice that reconciled GATT compliance with their goals. Without ROO internal competition within the EEC would be stronger, resulting in lower prices for buyers, better resource allocation, stronger pressures to curb costs and boost productivity, and more choice. To this list of benefits from custom unions must be added a negative factor, the loss of tariff revenues. More generally, as the eminent economist Jacob Viner demonstrated over 60 years ago, a customs union generates both economic gains and losses and, on net, there is no guarantee that the union's implementation will benefit its members.[5] Such concerns were evidently set to one side, if the founding members of the EEC appreciated them at all. Nevertheless, given that trade within the EEC was more important than trade with countries outside the block, this implied that gains were likely to outweigh losses.

A second consideration in favour of the creation of a customs union that has been mentioned in some accounts is that fostering cooperation between former adversaries was an objective of the signatories of the Treaty of Rome. At a minimum, a customs union requires cooperation in setting the common external tariff initially and when changes to that external tariff are considered. Changes may be considered for a number of reasons, including in response to pressure from domestic interests seeking protection from import competition. Sustaining a common external tariff requires frequent dialogue, cooperation, and coordinated action by members of a customs union. Creation of such a union, therefore, provides former adversaries an opportunity to demonstrate their desire to cooperate outside of foreign and

[4] It should also be noted that the lower are the tariffs charged on an import from third parties, the smaller is the incentive to meet any rules of origin in a FTA. When the Treaty of Rome was signed generally speaking tariffs on manufactured goods were much higher than nowadays.

[5] For slightly different reasons, the creation of a free trade area can worsen its members' total welfare as well. Whether the creation of a free trade area or customs union in goods tends to be welfare enhancing for members of such accords remains one of the most contested matters among scholars of international trade.

military policies, which can be particularly sensitive after times of strife. A free trade area does not require such intensive collaboration between members.

Notice this GATT-compliance argument hinges on the creation and maintenance of a common external tariff as the rationale for exclusive competence in the area of trade in goods (not just tariff policy as the GATT rules cited above refer to "other regulations of commerce").

In principle, the GATT-compliance argument need not require the creation of a supranational authority to administer that tariff, as is the case in most other customs unions created in the post-war era. Moreover, while coordination between members of a customs union is certainly needed to preserve the common external tariff during subsequent negotiations with third parties, again the creation of a supranational body is not required. That is not to say that there aren't any advantages to delegating the power to negotiate to a supranational agent, however such delegation is not required to be GATT-compliant and, therefore, other arguments must be employed to account for the observed delegation of negotiating authority to the European Commission. For example, it might be argued on grounds of administrative efficiency that since a customs union requires frequent coordination between its members that a separate, trusted institution at arms-length from the member states be set up.

Bulwark against Protectionism.

With the lessons of the 1930s in mind, when an outbreak of protectionism is said to have contributed to the depth (if not the outbreak) of the Great Depression, and given the belief of many diplomats in the immediate post-war era that trade liberalisation fostered peace (and that protectionism stoked inter-state rivalry), there was considerable interest in designing trade policy-related institutions in a way that insulated officials—elected or otherwise—from pressures to discriminate against foreign commercial interests and to engage, more generally, in beggar-thy-neighbour activity.[6]

On the assumption that the harm done by protectionism tends to be spread thinly across many buyers and that the beneficiaries from import restrictions and the like gain much, elected officials and civil servants are said to come under direct pressure to limit commerce and frequently find few opponents to counter that pressure. The support offered by vested

[6] The Dutch, for example, were early supporters of limits of protectionism among the original EC Members. (Crozier 2009). Also see Meunier (2005) as discussed below.

interests seeking protectionism tilts the calculus towards elected officials voting to implement trade restrictions if such matters are put before it. This argument is said to apply with more force in legislatures where elected officials represent geographically more compact electorates. Smaller jurisdictions are likely, so the argument goes, to be dependent on a limited number of commercial interests for jobs, wages, investment etc. and elected representatives are thought to be particularly responsive to those interests and their representatives. Under these circumstances, an elected representative inclined to support free trade may be unable to deflect protectionist pressures from their constituents.

Such pressure can be reduced, it is argued, if the legislature authorises a third party—typically, a ministry or other government office—to propose trade policy measures or to negotiate commercial accords with trading partners so long as the third party seeks to advance the wider societal interests, bearing in mind that some of the many national interests implicated will gain and some will lose. The legislature could then, formally, confine itself to setting the parameters of policy and, if constitutionally required, approving trade accords or proposals for new trade-related laws. In this manner, members of the legislature can publicly represent their constituent's interests in the knowledge that the delegated agent will take the general interest into account. Delegation creates a bulwark against protectionism and allows packages of trade liberalisation to be assembled that overcome opposition from those vested interests that fear greater foreign competition.

Again, bitter experience is said to have informed the decision to create a single, supranational agency with the sole power of initiative on commercial policy. In her well-regarded account of the rationales for Europe speaking on trade matters with "one voice," Meunier (2005) argues:

"Coming in the post-war era, with the memory of the international consequences of American protectionism still fresh in their minds, the decision of the founding member states of the European Community to delegate trade negotiating authority to the supranational level can be similarly explained by this willingness to insulate international trade agreements from protectionist pressures. The newly designed Council of Ministers, where the national interests of the European member states are represented could be prone, like the US Congress, to protectionist tendencies. European policymakers even have to face an additional level of lobbying, as special interests can be of a national, regional, or sectoral nature. Letting international trade negotiations be conducted by supranational agents and

trade policy decisions be taken by a majority of member states was expected to prevent the disproportionate capture of trade policy by protectionist interests" (page 9).

Given that protectionist pressures have not gone away, that elected representatives and governments can still be induced to support protectionism by fear of electoral backlash or tempted by offers of support at election time and, in the absence of constitutional provisions that prevent the imposition of protectionist measures, the essential pre-conditions remain in place for the argument outlined above.

This argument can also account for Member States relinquishing the option of acting independently in commercial policy, especially for those policies that tilt the playing field towards domestic interests. After all, the point of delegating authority to a supranational body is to shift protectionist pressure away from a national government—and that pressure won't move if the vested interests involved know that the government can engage in beggar-thy-neighbour acts independently of the supranational body. Such delegation can account for exclusive competence at the Union level in commercial policy.

The "delegation argument" can also account for the European Commission being given the sole right of initiative, thereby making it the focus on pressure from vested interests. So long as the European Commission is charged with taking a Union-wide perspective on the matters before it, then another building block falls into place. That the Council of Ministers confines itself to voting on proposals from the European Commission and not in the day-to-day administration of commercial policy is consistent with this rationalisation of existing EU arrangements.

Over time, the areas of policy covered by the Common Commercial Policy has expanded and this may reflect both what trading partners have been keen to negotiate and the policies that the European Commission feels it must put on the bargaining table so as to build a large enough Union-wide constituency in favour of a trade agreement. On this view, then, the set of exclusive competences may have to change if the delegated agent is going to be able to assemble enough support to win backing for any accord it negotiates. Given that previous trade negotiations have led to tariffs on industrial goods being negotiated to very low levels manufacturers, traditionally a strong supporter of trade liberalisation within Europe, need to see reforms in other policy areas if they are to continue to support trade deals. In this manner, pressures for expanded exclusive competence can be rationalised.

Unfortunately, while many features of current EU commercial policy practice appear to be accounted for by this explanation, there are two weaknesses. First, if the European Commission is supposed to be the delegated bulwark against protectionism, then why on a number of occasions has it sought to weaken the rules concerning the introduction of duties for dumping and subsidies? Moreover, if this explanation was correct, the practice of the European Commission seeking to build a majority of Member States in favour of imposing dumping or subsidisation should not be observed (Evenett and Vermulst 2005). Perhaps a compelling counterargument is that the purpose of delegation is to limit protectionism, not to stop it entirely. In this regard, it is useful to keep in mind the concept of antidumping and countervailing duties as safety valves against protectionist pressure.

Second, if a necessary condition for the European Commission to be a bulwark is that Member States must be willing to give up their rights to independent action in an area of policy, then the vested interests that seek protectionism—or think they will want it in the future—will oppose the expansion of exclusive competence in the first place, or seek to limit its application. The delegation argument provides an account of what to expect once competence has been determined. The same argument, however, also implies that there will be opposition to expanding the powers, and therefore the effectiveness, of the bulwark. As such, the logic developed here accounts for imperfect or incomplete delegation, which limits the degree to which it can be claimed that the existing institutional arrangements curtail state attempts to tilt the playing field. As noted in the previous section, certain service sectors—most notably transportation—have managed to carve themselves out of the Common Commercial Policy or raise the bar in decision-making at the Council of Ministers.

What are the implications of this line of reasoning should a nation consider departing from the European Union? With respect to the extent of trade restrictions, if the assumptions underlying the delegation approach are correct then elected officials in the departing Member State should expect to come under greater pressure to tilt the playing field after exit. However, care is needed. The extent of trade restrictions pre-departure will reflect pressures from vested interests inside and outside the departing Member State. To the extent that departure allows for the elimination of protectionism in sectors where there is little pressure in the departing Member State, then stepping out of the single market may result in less beggar-thy-neighbour activity. Working in the opposite direction is that the pressures within the departing Member State for protection from foreign competition will increase. The number of times that the Member State in question has dispatched vested interests to the European Commission to make their case for special treatment might provide a useful indicator of the degree to which exit from the European Union would result in increased pressures to tilt the playing field in the departing Member State.

Greater clout in international trade negotiations.

In reality, customs unions do not just maintain their Common External Tariffs and administer trade defence regulations. They also decide whether and how to negotiate sectoral accords, multilateral trade rounds, and regional trade agreements with third parties. Such negotiations could, in principle, advance the commercial interests of the customs union or seek to frustrate outright or modify terms proposed by third parties that are inimical to those interests. This begs the question as to whether there are advantages in charging one body—in this case, the European Commission—with the responsibility of conducting negotiations involving cross-border commerce.

Before getting into the heart of the argument it is worth mentioning one consideration: benefits may flow from pooling technical expertise and pertinent information. For a Member State with either a small population or other limits in expertise or with limited overseas investments and diplomatic missions, then perhaps the pooling of expertise into a single negotiator is beneficial. For a Member State with a strong bench of trade policy expertise as well as an extensive range of overseas contacts, this argument may not be so compelling and is not pursued further here.

A far more commonly advanced argument is that the "clout," "bargaining power," or "negotiating leverage" of a group of nations acting through a single negotiator is greater than if the nations acted individually. Meunier (2005) summarises, without necessarily endorsing, this position argument as follows:

"In spite of its complexities, the pooling of external representation in the EU is generally expected to strengthen the European entity in international trade negotiations. The common expectation is indeed that a united Europe is greater than the sum of its parts. Whether one believes that the distributional outcomes of negotiations are determined by power, preferences, or other ad hoc variables, the common assumption is that the more integrated the EU is, the stronger bargaining leverage it can exert" (page 40.)

In a reciprocity-based negotiation on economic matters between states it is often argued that the quantum of economic transactions that a negotiator can commit to an accord strengths the demands that the negotiator can make of third parties because that negotiator is said to have more to offer in return. Woolcock (2012) explains the relevance of this argument to the European Union's clout in commercial policy negotiations:

"The EU's role and possibly effectiveness in international economic negotiations will be greater the larger the EU's relative economic or market power. Equally important is the ability or willingness on the part of the EU to offer or deny its market. In the exercise of such market power it is the EU as whole that counts and therefore the ability of the EU rather than the member states to determine access" (page 18.)

On this view, then, it would appear that the EU's negotiating clout increases whenever there are enlargements to the European Union and with the growth of the economy of the European Union, although the precise relationship between combined market size and bargaining leverage is not specified. The latter matter is relevant given the relatively small size of the economies that have recently acceded to the European Union.

Bargaining leverage is relevant not just for obtaining a "better deal" for policies where trade negotiations are an established practice, but also in putting matters on the negotiating table in the first place. Various EC Trade Commissioners have argued that having a "single voice" in trade negotiations allows the Union to encourage the spread of European approaches to regulating national economies—and even European societal values—in trading partners. Although much depends on the regulation in question, in certain circumstances the spread of EU-style regulations may reduce the compliance costs faced by European firms in foreign markets. The adoption of certain minimum standards for treating European business in regulatory matters abroad (such as the adoption of requirements concerning regulatory transparency, due process, and rights of appeal) are said to be of greater importance in an era when tariffs on many goods are low or zero.

Analysts of the delegation in trade negotiations to a single voice have also argued that difficulties in amending a negotiating mandate once initially agreed can actually strengthen the hand of European trade negotiators as it limits their capacity to make concessions and signals, in effect, that if a third party wants to reach an accord it will have to be on terms closer to the European Union position. This is an example of Schelling's Conjecture[7] and it implies that to the extent that internal discord among Member States makes it harder to agree to changes in the negotiating mandate for the European Commission, then the Commission may be able to negotiate more accords on terms convivial to the European Union. On this view, and it may seem perverse, the public spats between Member States on sensitive matters such as subsidisation of European farmers may result in greater leverage for its negotiator over trading partners.

Acting collectively through a single delegated negotiator, litigator, and administrator of trade law could also deter trading partners from harming the commercial interests of members of the European Union. Whether legally sanctioned or not, should the European Union retaliate against the actions of a trading partner, the volume of trade that EU measures can disrupt will be larger than if a Member State acted on its own. Trading partners know this and may be less likely to harm EU commercial interests in the first place.[8] This argument loses much force if the trading partner discounts—for whatever reason, including dissent between EU Member States—the likelihood and severity of any EU retaliatory response. For this deterrent to be effective, there may be instances where a Member State may have to join an EU action that relates to harm done abroad to another Member State's commercial interests and where the retaliation, if only temporarily, disrupt trade and impose economic losses on the former Member State. Like pooling negotiating strength, pooling retaliatory capacity may be effective and a commitment to pooling inevitably requires taking a longer term, broader view of the net benefits involved.

To what extent can arguments in favour of pooling negotiating authority account for the existing allocation of competences on commercial policy in the European Union? For a single negotiator not to be circumvented by third parties directly negotiating with the Member States, thereby undermining the value of having a single negotiator in the first place, the Member States must forgo the right undertake concurrent negotiations with third parties. Here efficiency considerations require a commitment by Member States not to act ("to tie

[7] See Schelling (1960). Schelling won his Nobel Prize in Economics for his analysis of strategic behaviour, of which bargaining situations and international negotiations are examples.

[8] Another way of stating this conclusion is that the collective clout of the EU members acts as a bulwark against protectionism by trading partners. The difference, between, this argument and the ones in section 2.2. is that the latter refers to the EU acting as a bulwark against pressures at home for protectionism.

their hands.") This does not mean the Member States play no role in the external commercial relations of the European Union, as the European Council determines the mandate for any negotiation, oversees any negotiation, and must approve (along with the European Parliament) any accord proposed by the European Commission.

The fact that both the European Council and European Parliament must approve any commercial policy accords may, on the face of it, seem an additional hurdle created by delegation to a single negotiator. In fact, one concern that third parties have with negotiating with a representative of many sovereigns is that the latter may repudiate any agreement concluded by single negotiator. Requirements that the European Council and European Parliament give their explicit consent to any accord negotiated by the European Commission requires the latter to frequently consult with the former, reduces the probability of an accord ultimately being rejected, and encourages the perception of the European Union as a credible and viable negotiating partner. Efficiency considerations again can be said to account for certain elements of EU practice.

That trading partners seek to negotiate with the European Union, in regional trade agreements and in the context of the World Trade Organization, on a wide range of public policies that are also of value to the European Union implies that the Common Commercial Policy cannot be unduly confined to a limited number of policy areas, such as tariffs and quotas. Moreover, if the European Commission is to effectively respond to proposals from trading partners to include new items on negotiating agendas, then there must be enough flexibility in EU practice to allow for an expansion in the set of state measures that fall within the Common Commercial Policy. It would seem there are practical reasons why the scope of the Common Commercial Policy and associated exclusive competence has grown over time, now to include the commercial aspects of investment, intellectual property rights protection, and services, including financial services.

Certain aspects of this rationale for commercial policy competence can be challenged, however. The first objection is that many factors determine the outcome of a trade negotiation, not just the distribution of economic size of the parties to the negotiation. Woolcock (2012) makes the following observation:

"It is not just market size that counts however, but also the ability to use it in negotiations. In some policy areas the ability of the EU to offer concessions or deny market access has been significantly reduced through internal EU policies or successive rounds of liberalisation and

in some cases the fact that EU policies such as market liberalisation are bounded under rule based international regimes, such as the WTO" (page 19.)

In fact, Woolcock (2012) identified eight factors that determine the extent to which European Commission negotiators can affect the outcome of bargaining with third parties. Meunier (2005) identifies four factors that affect the "determinants of trade bargaining leverage" (page 41), of which economic size is one. Moreover, even if combining forces does add to the clout of European trade negotiators, third parties may not be willing to conclude an accord, a point made by some European Commission spokesman when they blame certain trading partners for the stalemate in the Doha Round of multilateral trade negotiations. At best, it can be said that having a single voice for the European Union in commercial policy is a necessary condition for negotiating impact.

The quotation from Woolcock (2012) makes another point, however, that further qualifies the principle argument made here. Reciprocity in trade negotiations requires the exchange of "concessions," or promises to reform. With the Single Market programme, many internal and external barriers to commerce have been removed. Likewise, with successive reforms to the Common Agricultural Policy, barriers to such trade and subsidies to European Union farmers have been pared back. The effect of pursuing such reforms, which have been strongly supported by certain Member States, is ultimately to weaken the negotiating clout of EU trade negotiators. On the one hand, the more seamless the integration of the EU economy, the more attractive a place it is to do business for firms based in trading partners. On the other hand, as barriers have been lowered through reforms, the benefits flow to trading partners without having to give anything in return. Such trading partners will rebuff any suggestion made in a subsequent trade negotiation that they "pay" for prior EU unilateral reforms unless those trading partners fear these reforms will be reversed. Alternatively put, arguably European Commission trade negotiators would have more negotiating chips if the EU had not pursued the Single Market Programme and subsequent unilateral reforms.

What the foregoing argument imply for a reform-minded Member State? First, that the objective of pursuing internal reforms comes at a price in terms of diminished negotiating clout in external trade negotiations. The force of observation is blunted somewhat if the set of policies that the European Commission can negotiate with third parties is expanded, implying that expanded exclusive competences in commercial policy complement further internal reform.

Second, that a reform-minded Member State that left the European Union would find that any additional unilateral reforms that it subsequently undertook, which may have been precluded by the constraints of EU membership, will undermine the negotiating clout of its trade negotiators. The tension between unilateral reforms and reciprocity-based trade negotiations applies to trade negotiators irrespective of whether that nation is a member of the European Union.

The next objection is that the mandate for negotiations with third parties is itself the product of a negotiation between the Member States, mediated in part by the European Commission. There are no guarantees, therefore, that a Member State supportive of an ambitious negotiating mandate can carry the day. The possibility cannot be discounted that the lowest common denominator (lowest willingness to liberalise policies in the context of a trade agreement) unduly influences the negotiating mandate set for the Union. Once trading partners realise the EU is prepared to make limited concessions they may well reciprocate resulting in, at best, an agreement with low ambition. Speaking with one voice, then, in trade negotiations may confer certain benefits to a Member State but much depends on the ends to which that voice is used.

When the logic of Schelling's conjecture is examined further, matters are potentially worse for a Member State with an ambitious trade negotiating agenda. The same internal discord that makes it difficult for European Commission trade negotiators to make concessions may result in no accord being reached at all, an outcome that Schelling conceded was possible in his original analysis. For this reason, a Member State with a high level of negotiating ambition may be disappointed with the outcomes from a single, delegated trade negotiator.

To summarise, compared to pooling negotiating authority inside the European Union, a Member State who chose instead to operate outside the single market is likely to have less clout but more control over the mandate given to its negotiators, possibly a greater likelihood of concluding bilateral and regional negotiations (although on whether on better terms is unclear), and probably a diminished ability to deter malfeasance by trading partners. That the contrast between these two arrangements is far from clear-cut reflects the many factors that determine the outcome of negotiations. Worse, the absence of accepted empirical counterparts to terms such as "negotiating clout" etc. hampers a sharper assessment of the pros and cons of different institutional arrangements and practices.

Promotion and Defence of the Internal Market.

While arguments have been advanced that the exclusive competence of the Union in the field of commercial policy be fashioned so as to make the European Union a more effective negotiator with third parties, the objectives that the Member States have signed up to concerning internal commerce have been used to make the case for certain policies being included in the exclusive competence of the Union. In this regard it is worth recalling the commitments undertaken to the "Four Freedoms" (of movement of capital, goods, persons, and services) in the Treaty of Rome, the objective of freeing internal trade adopted in the same treaty, and later the Single Market Programme and related steps. Moreover, in what follows, it is worth recalling that the objective of establishing a level playing field within the EU implies not only the removal of barriers to cross-border commerce and movements of capital and labour, but also the removal and prevention of distortions to internal market outcomes.

The case for uniform export-related policies was made on such grounds relatively early on in the life of EEC.[9] The argument was advanced that should Member States implement independently and different export incentives (such as export credits), the result would be to distort competition and market outcomes within the EEC, even though the ultimate customers were outside the customs union. Eeckhout (2011) summarises as follows the logic employed by the European Court of Justice that linked the matter of exclusive competence for certain trade-related policies to the non-trade objectives of the European Union. The quotation is long but revealing of the degree to which membership of the European Union should be seen as a package of interlinked objectives and obligations, with specific implications for the desirable degree of independent action on the part of Member States:

"The common commercial policy was conceived in the context of the operation of the common market, for the defence of the common interests of the Community, within which the particular interests of the Member States had to endeavour to adapt to each other. This conception was clearly incompatible with the freedom to which the Member States could lay claim by invoking a concurrent power, so as to ensure that their own interests were separately satisfied, at the risk of compromising the effective defence of the common

[9] See Eeckhout's discussion of Opinion 1/75 of the European Court of Justice concerning a draft "Understanding of a Local Cost Standard "that had been negotiated at the OECD and where the European Commission contended that the Community (as it was called then, Union now) had the right to conclude the Understanding (see Eeckhout 2011, pages 14-18.)

interests. Any unilateral action on the part of the Member States would lead to disparities in the conditions for the grant of export credits, calculated to distort competition between undertakings of the various Member States in external markets. Such distortion could be eliminated only by means of a strict uniformity. Concurrent powers therefore could not be accepted, and the Treaty provisions on concluding agreements of commercial policy clearly showed that the exercise of concurrent powers was impossible. To accept to the contrary would amount to recognizing that, in relations with third parties, Member States could adopt positions which differed from those which the Community intended to adopt, and would thereby distort the institutional framework, call into question the mutual trust within the Community, and prevent the latter from fulfilling its task in the defence of the common interest" (Eeckhout 2011, page 15).

The logic outlined above can be applied to policies other than export credits, as Eeckhout has rightly argued:

"…the argument is of much broader scope, and connects the common commercial policy as a whole, as regards both imports and exports, with the internal market. Indeed the EU internal market, characterized as it is by strong integration and generalized freedom of movement of products, persons, capital, and companies, could hardly function effectively in the absence of common external trade policy, which uniformly lays down the external terms of trade" (page 16).

Lest there be any confusion the logic developed so far calls for uniform principles to be applied to export policies, not that those export policies be banned. Therefore, in the example considered above, Member States would not abandon offering export credits, rather they would implement schemes to issue such credits that did not introduce competitive distortions into the internal market.

A related, but distinct, class of policies are those that regulate commerce within a Member State as well as cross-border commerce from other Member States and from non-members and where the goal of the policy is, at least, in principle not trade-related. Safety-motivated technical requirements for products and sanitary and phytosanitary standards for fish and agricultural products are examples of such policies. The concern arises that the implementation of these policies might in fact discriminate against suppliers from both inside and outside the European Union, thereby distorting outcomes within the Internal Market.

Even when the discrimination is against a supplier outside the European Union, the purchaser inside the Union may be adversely affected and, when that purchaser also supplies customers downstream, then competition in the downstream market within the Union is distorted. In an era of ever-finer supply chains involving both manufacturing and services, the risk that discrimination against suppliers outside the Union distorts the operation of downstream markets within the Union is greater.

These matters have been taken up in numerous trade disputes and negotiations, not least at the multilateral and regional levels, and a strong case can be made for exclusive competence being given to the Union in so far as the goal is to prevent the implementation of these policies from introducing undue discrimination between suppliers. Notice, the case for exclusive competence concerns the manner in which a policy is implemented, not whether Member States can employ such a policy at all. Similar arguments can be made for exclusive competence in other regulatory policies where the implementation could illegitimately discriminate against classes of suppliers. The regulation of entry and performance of financial sectors firms is case in point, where so-called prudential regulations and regulations relating to financial stability are used to discriminate against certain, disfavoured suppliers.

Given that firms can choose the means by which they supply a foreign market then, as has been well established in academic economic research, when faced with a barrier to importing into a nation, a firm may decide to establish a factory or other subsidiary in that nation. This is known as tariff-jumping foreign direct investment and it implies that the degree to which foreign suppliers can contest a nation's market depends on both the policy stance towards importation and towards foreigners establishing facilities. That firms can choose how to supply a market implies that a uniform tariff policy should be matched by uniform policies towards foreign direct investment.[10]

Without the latter, differences across the European Union in policies towards establishment would, in the presence of tariff-jumping, distort both flows of investment into the European Union and trade flows within the Union in so far as the new facilities were used to supply customers in Member States where conditions on establishment by foreigners were more restrictive. Once again, the goal of promoting a level playing field within the European Union

[10] It is not unreasonable to expect that for some foreign suppliers the decision to establish a subsidiary abroad is also affected by expectations about the treatment of the subsidiary once it has been established, as that treatment may affect the profitability of the investment. Consequently, there is a case for

has implications for the desirable degree of independent action by Member States and, therefore, for the designation of a policy as an exclusive competence of the Union. Similar arguments can be developed for competition in the various types of service sector markets.

One concern with these defences of competence is that they rely on the notion of a distortion to the Internal Market. Notice the term “distortion” was not defined and one is entitled to as “distortion from what?” The competitive market benchmark, so often used in economics, may not be appropriate in every market. Moreover, how significant a distortion is necessary (in the case of policies already implemented) or expected (in the case of planned policy initiatives) before a Union-wide dimension is introduced into competence? This rationale for competence, therefore, may be easier to state in principle than to implement in practice.

In sum, the promotion and defence of the Internal Market provides a rationale for a broad range of policies being included in the exclusive competence for the Union. Implicitly, two factors rationalise the expansion of competence in the past. Neither factor is going away and this may justify further expansions in the policies covered by exclusive competence in the future. The first factor is that, with the decline of tariff barriers over recent decades, more firms are finding domestic regulations impeding their ability to compete in foreign markets and the possibility cannot be discounted that the implementation of such regulations, whose purpose may have nothing to do with trade policy, is in fact being influenced by protectionist intent.

The second factor is that corporate organisation has changed markedly, to take advantage of cheaper foreign sourcing and the technologies to manage commercial activities over greater distances. As corporate organisation changes, the impact of government policies on market outcomes can change. The sustained defence of the level playing field in the Internal Market, then, will require paying attention to the effects of changes in domestic regulation and their enforcement and of corporate organisation, which in turn may alter the calculus underlying which matters should be subject to exclusive competence at the Union level.

Assessment.

EU competence over trade and investment matters has several facets. The purpose of the previous sections has been to state and assess four purported rationales for the current EU competence on commercial policy. To help draw together the arguments made, Table 1 identifies different elements of current competence arrangements and indicates whether an uncritical reading of each of the four rationales provides an explicit or implicit justification for each element. Even with an uncritical reading it should be evident from reviewing Table 1 that no rationale can account for every element of EU competence. A critical reading would no doubt leave even more gaps in this table. That each rationale has deficiencies in logic or explanatory power should now be clear.

Still, it is not evident why any single rationale must account for every element of competence. What is the objection to combinations of the four rationales accounting for every element provided those rationales are coherent? Indeed, given the number of policies explicitly mentioned in the definition of the Common Commercial Policies has grown over time, it may be that in the early years of the EEC the combination of the GATT-compliance and Internal Market defence rationales accounted for the then Community competence on commercial policy, at least as it appeared on paper.

As demands from trading partners to include more policies in trade negotiations grew and followed by similar demands made by European negotiators of trading partners, plus the gradual reduction of tariffs shifted attention to other impediments to trade and with the changes in corporate organisation, pressure to widen the remit of the Common Commercial Policy grew. This is not to imply that the expansion in remit has been linear or uncontested. Rather that, in order to sustain the European Union as a credible interlocutor in trade negotiations, and to reinforce the bulwark against protectionism as new means arose to favour domestic interests that are less transparent than tariffs, then the scope of the Common Commercial Policy necessarily expanded over time.

Seen this way the EU competence on trade and investment matters has evolved in response to changing circumstances. Any Member State or analyst considering alternatives to the current competence arrangements may want to consider how effectively an alternative addresses the same circumstances and likely future circumstances. For example, in the case of resisting protectionism, one might ask what reasons there are to believe that an alternative to the present arrangements would result in fewer national resources being misallocated due to pressures for relief from foreign competition? This question could be asked for both the period of transition to any new arrangement and after those arrangements have been established. This approach would, then, ground a comparison of alternatives in terms of the real-world challenges facing trade and investment policymakers as well as national commercial interests. That approach is taken up in the next section, where a certain number of alternatives to EU membership are identified and systematically compared.

Table 1: Assessment of the Purported Rationales for Competence in Commercial Policy.

*Note in table below: E=Case for competence made explicitly in text; I=Case for competence can be inferred from the logic outlined in the text, even if EU competence has not in fact been established in that area.*Not mentioned in Articles 206 and 207 of the TFEU but included per the Terms of Reference.*

Element of competence	**Rationale**			
	GATT-compliant customs union.	Bulwark against Protectionism.	Greater clout in international trade negotiations.	Promotion and defence of the Internal Market.
Tariffs	E	E	E	E
Other policies relating to trade in goods	E	I	E	E
Trade in services		E (cross border trade), I (rest)	I	E (cross border trade and establishment), I (rest)
Commercial aspects of intellectual property			I	
Foreign direct investment		I	I	E
Policies towards exports			I	E
Portfolio investment*			I	
Dumping and subsidies	E	E	I	
Financial services*		I	I	E
Transport services*		I	I	I
Basis upon which decisions are to be taken at the Union level		E	E	
Respective roles of the European Commission, European Council, and the European Parliament		E	E	

2.3 Alternatives to Membership of the European Union.

Such is the diversity of contemporary trade agreements, in principle there are many alternatives to membership of the European Union. In this section the purpose is to explore the similarities and differences across six specific alternatives to EU membership. In what follows those alternatives are stated and then, employing criteria developed in the last section, which relate to the objectives facing contemporary commercial policymakers in the real world, a comparison is made between these six alternatives to EU membership and EU membership itself.

Specifying six alternatives to membership of the European Union.

For the purpose of this discussion assume a nation, which leaves the European Union, remains a member of the WTO and, upon leaving the EU, retains the same external tariffs as the EU but now also applies those tariffs to imports from the EU. Although further details about each alternative will be spelt out later, at this stage it might be useful to list the six alternatives considered for they span a wide range of alternatives to the status quo. The six alternative arrangements considered in this section are:

1. No trade agreement with the EU of any kind or “going it alone”.
2. To conclude a free trade agreement (FTA) with the EU confined to trade in goods.
3. To conclude a “modern” FTA with the EU with coverage similar to the FTA between the EU and Korea.
4. To conclude a customs union (CU) with the EU.
5. To accede to the European Economic Area (EEA), obtaining treatment similar to that of Norway.
6. To negotiate a FTA with the EU plus the suite of bilateral accords similar to those Switzerland has negotiated with the EU.

No position is taken here on the likelihood and willingness of the remaining EU Member States to negotiate any of the above accords with a former Member State. Although the probability of starting and successfully concluding each type of accord is a pertinent consideration for policymaking, there is no objective way to ascertain those probabilities.

To allow for a more concrete discussion, each of the six alternatives is spelt out in some detail below.

Going It Alone.

One option for a Member State contemplating an alternative arrangement to Membership in the European Union would be to operate outside the single market and rely on its WTO membership to protect its commercial interests. As a member of the WTO, some of the EU's trade and domestic policies are constrained by their WTO obligations. All of the tariff lines (product categories) employed by the EU to regulate imports are bound in WTO obligations. The simple average of the maximum tariff that the EU is allowed to charge on non-agricultural goods is 4 per cent and on agricultural goods is 13.9 per cent, although those averages can mask considerable variation. Moreover, EU tariffs on 37.1 per cent of non-agricultural goods and 10.2 per cent of agricultural goods are bound at zero in WTO accords.[11] This is not the place to describe all of the EU's WTO obligations. Nevertheless, it is important to acknowledge that those obligations extend well beyond tariffs. In particular, the principle of Most Favoured Nation (MFN) treatment, where it applies, requires the EU to treat any ex-member as well as any other non-EU member of the WTO. Thus, the EU could not impose higher tariffs on imports of a good from a former Member State than on the same good imported from another WTO member with whom the EU does not have a free trade agreement or customs union.

With respect to the Internal Market, exit from the European Union would imply that the former Member State would not have to implement regulations agreed at the Union level. The costs and benefits of not implementing such regulations will always vary on a case-by-case basis, making generalisation unwise. Of course, should the EU pass a regulation that the exiting country found beneficial to implement as well, nothing would stop the exiting country from doing so. Separately, to the extent that future EU regulations affect access to EU markets, then exit may result in subtle forms of discrimination by governments remaining in the EU against the commercial interests of the exiting nation. Having said this, any EU reforms that are implemented in a manner that do not discriminate against commercial interests inside and outside of the EU would benefit the exiting nation.

With respect to trade relations with third countries, a country that exits the EU would be able to initiate its own trade negotiations with those countries. Those negotiations could relate to

[11] This data comes from the WTO's Tariff Profiles. Information on the EU's tariff profile can be found at http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=E27

many different matters including the conclusion of free trade agreements, agreements covering particular sectors of interest to the parties concerned, as well as to disagreements between parties.

As a member of the WTO, a former Member State of the European Union would be able to bring the policies of other WTO members before that body's Dispute Settlement Understanding. To the extent that the commercial interests involved and the potential for effective retaliation change with the exit of a Member State leaves the European Union the pros and cons of bringing cases to the DSU will likely vary for the exiting Member State and, importantly, for other WTO members. The latter may be more willing to bring cases against a former Member State now that trade relations with the European Union are not affected by doing so.

Finally, as a member of the WTO, the former Member State could seek to advance a different set of interests in multilateral trade negotiations than was the case as a EU member. Here it is worth recalling that the WTO employs the consensus principle, which has two implications. First, that the exiting member state could block proposals that are counter to its interests that the EU might not have blocked. And, second that the EU could block any proposal that the former Member State chose to advance at the WTO.

A FTA with the EU confined to trade in non-agricultural goods.

One alternative is for a Member State to combine exit from the EU with the conclusion of a free trade agreement with the European Union. Compared to Going It Alone, this would result in no change in the tariff treatment of manufactures and industrial products, thus avoiding the tariff increases associated with the former. There would, however, be a change in tariff treatment for agricultural products. There is also the question of consistency with GATT Article 24. Moreover, to qualify for zero tariff treatment exporters from the exiting country would have to demonstrate that those goods originated in the exiting nation. The associated paperwork, known as Rules of Origin, is widely thought to discourage exporting. It would also be the case that exporters from the European Union would have to demonstrate origin to the satisfaction of the customs officials of the exiting nation. The additional costs and time delays associated with Rules of Origin would reduce the benefits of the free trade agreement and might disrupt time-sensitive supply chains, in particular.

Like the previous alternative, signing such a FTA would give the exiting country control over its tariff policy with third countries (non-EU nations). Hence, the exiting country would be free to negotiate accords with those third parties. However, even as part of a FTA that is confined to trade in goods, the EU may insist on provisions in the FTA such that any benefits the exiting country gives to a third party that go beyond the provisions in the FTA with the EU be extended to the EU. The willingness of an exiting country to liberalise trade with a third party may well be affected by any requirement to share any benefits with the EU as well. If such "third party MFN provisions" were included in a FTA between the EU and the exiting country, they would also apply to the EU. Therefore, the exiting country could piggyback on any deals the EU subsequently struck with third parties.

All of the comments made in the discussion of the Going It Alone alternative that relate to treatment of individuals and firms seeking to supply the EU's markets through means other than exporting, to future regulations imposed by the European Union, to negotiating free trade agreements with third parties, and to WTO Dispute Settlement, apply to this alternative as well.

A "modern" FTA with EU.

These days FTA agreements have far greater scope than they used to, especially when industrialised countries are signatories. No longer confined to eliminating tariffs on industrial products, modern FTAs typically include provisions on a wide range of government policies that can affect the major forms of cross-border commerce, including foreign investments and mobility of staff. Indeed, the term "free trade agreement" is a misnomer and some governments prefer the terms "partnership agreements" and the like to describe the wide-ranging accords that have been negotiated in recent years. The recognition that modern firms seek to supply foreign markets through a wide range of means and that many government interventions can diminish the profitability of supplying a foreign market has led business to argue for free trade agreements to have a greater scope than before.

For our purposes, it may be valuable to consider the following alternative: a country may exit the EU but in the process of doing so negotiate a wide-ranging "modern" FTA with the EU. For sure, one might wonder if the remaining members of the EU have much appetite to negotiate a FTA with a former member state. On the face of it this criticism might apply with similar force to some of the other alternatives considered in this section. Still, the strength of commercial ties between the exiting nation and what remains of the EU may provide a sufficient pragmatic rationale for negotiating a modern FTA.

To help fix ideas, it might be useful to consider a FTA that the EU has negotiated recently with an industrialised country as a template. The FTA the EU negotiated with Korea, which was signed in 2010 and came into force on 1 July 2011, was the last the EU concluded with an OECD member. One indication of the broad commercial objectives of this FTA is given in the following statement in the Preamble of this agreement. Specifically, one goal of the accord was to

"…create an expanded and secure market for goods and services and a stable and predictable environment for investment, thus enhancing the competitiveness of their firms in global markets."

Another indication of the range of policies covered by the EU-Korea FTA is given by the titles of the chapters of this accord, which are reproduced in Box 1.

Box 1: Many government policies are in principle implicated by the EU-Korea FTA.

Titles of the chapters of the EU-Korea FTA:

1. Objectives and general definitions.
2. National treatment and market access for goods.
3. Trade remedies.
4. Technical barriers to trade.
5. Sanitary and phytosanitary measures.
6. Customs and trade facilitation.
7. Trade in services, establishment, and electronic commerce.
8. Payments and capital movements.
9. Government procurement.
10. Intellectual property.
11. Competition.
12. Transparency.
13. Trade and sustainable development.
14. Dispute settlement.
15. Institutional general and final provisions.

One objective of signing such an accord would be to "lock in" as far as is possible the treatment by the remaining EU members of the exiting country's commercial interests. If successful, this might limit the change in treatment of the latter and therefore the potential disruption to exports, foreign investments, and nationals of the exiting country that live abroad in the EU. However, inevitably national and EU regulations change over time, and the degree of protection effectively afforded by such a FTA may diminish over time, calling perhaps for further negotiations to supplement the original FTA.

The points raised in the previous alternative about Third Party MFN clauses apply with even greater force here as any accord between the EU and the exiting country could include such provisions not just on tariffs but on other policies as well. Therefore, if the exiting country were to negotiate subsequently a FTA with, for example, an emerging market in which very generous provisions on foreign investments were included that generous treatment might have to be extended to the remaining EU members as well. That emerging market might not be pleased that it has used precious negotiating capital to include a provision that other countries (in this case the remaining EU member states) will benefit from. The key point here is that a FTA signed by a country exiting the EU and the remaining EU Member States can cast a shadow over the negotiations between the former and third parties. Exiting the EU does not necessarily eliminate all influence of the EU on a country's negotiations with third parties.

The wide range of provisions contained in such a modern FTA requires a comparably broad assessment of the economic costs and benefits of this alternative. Any such evaluation would require specifying a path for future EU regulations and inevitably any such assumptions would be contested. The inclusion of third party MFN clauses would complicate an assessment even further as it would require assumptions on the likelihood and content of the FTAs the exiting country might sign with third parties.

A Customs Union with the EU.

Another alternative is to combine exit with an arrangement with the EU to preserve customs union on trade in goods. In what follows the discussion focuses on the implications for tariffs and negotiations with third parties. In principle, as is the case in some customs unions, a customs union accord could include a wide range of provisions on government policies other than tariffs, in which case many of the comments made in the last subsection remain pertinent.

One advantage of signing such a customs union over the free trade agreements considered earlier is that exporters from the exiting country would not have to demonstrate they have met any rules of origin in order to retain zero tariff treatment in the EU. This would still be a potential problem, however, if the EU signs trade agreements with a set of countries and the exiting country does not do the same. In such a case, rules of origin may still come into play when selling intermediate goods that feed into production destined for those markets.

A defining characteristic of a properly functioning customs union is that its parties implement the same tariff regimes on goods imported from third parties. Changes, therefore, in those tariffs require the assent of each party. In the present case, this would amount to the former EU member state having to come to agreement on tariff changes with the remaining EU member states. Such agreement may not be forthcoming (and indeed might be quite unlikely), especially if the exiting member state views the pros and cons of certain tariff changes differently from the remaining EU member states. The end result might then be a Turkey-type situation, where the exiting country is simply forced to accept EU decisions on tariffs, and to pursue trade agreements with whomever the EU signs agreements with.

The remarks in the following paragraph are particularly relevant once one considers the implications for an exiting country's ability to negotiate free trade agreements with third parties, such as the United States and the fast growing and large emerging markets. To the extent that those third parties demand as part of a FTA zero tariff access to the exiting country's markets, then the exiting country would have to convince its former EU partners to alter the common, uniform external tariff. Those EU partners may not oblige. If they don't oblige, then the exiting country would have to negotiate with third parties accords that do not cover trade in goods. At a minimum, those third parties would find such accords less attractive than a FTA.

In short, in this alternative the price for avoiding the costs of rules of origin are limitations in the types of accord that the exiting country can likely negotiate with third parties. Like all of the alternatives considered until now, unless it is agreed to the contrary, the exiting country could act independently at the WTO and would not have to implement regulations agreed by the EU.

Membership of the European Economic Area (EEA).

One alternative that seeks to combine the benefits of independent action in trade negotiations with third parties and the potential to take independent action at the WTO with considerable legal certainty in accessing the EU's large markets would be for a country exiting the EU to join the European Economic Area (EEA). The EEA was signed over 20 years ago in 1992. The non-EU members of the EEA include Norway, Iceland, and Liechtenstein. These three countries are members of the European Free Trade Association (EFTA), along with Switzerland. That the EFTA countries can act independently in their trade policy with third parties is evidenced by the numerous FTAs that they have signed.

The spirit of the commercially relevant aspects of the EEA is conveyed in the following two statements found in the Preamble to that agreement:

"Considering the objective of establishing a dynamic and homogenous European Economic Area, based on rules and equal conditions of competition and providing for the adequate means of enforcement including at the judicial level, and achieved on the basis of equality

and reciprocity and of an overall balance of benefits, rights and obligations for the Contracting Parties.

"Determined to provide for the fullest possible realization of the free movement of goods, persons, services, and capital within the whole European Economic Area, as well as for strengthened and broadened cooperation in flanking and horizontal measures."

In terms of sectoral coverage the EEA is narrower than the obligations of EU membership as the former does not cover agriculture and fisheries, giving in principle the non-EU members of the EEA the right to operate independent commercial policies in those sectors, subject of course to any obligations arising from WTO accords. The EEA retains a key commitment of the EU of commercial significance, namely, to the so-called Four Freedoms (to unrestricted commerce in goods and services, unrestricted investment flows of all types, and to the free movement of persons.) As will become clear, this commitment is accomplished without Norway, Iceland, and Liechtenstein being members of the European Union.

What are significant are the EEA provisions that give legal certainty to the horizontal or uniform treatment of commerce that underpins the commitment to the Four Freedoms and, therefore, the Single Market. Not only did the non-EU members of the EEA accept the *acquis communautaire* as it stood when the EEA was signed in 1992, they also agreed to implement regulations agreed subsequently by the EU that apply to the commerce covered by the EEA accord. Presumably the benefits from predictable access to the EU's Single Market are the reward for giving up independent policymaking in a wide range of commercially relevant regulatory matters.

While provision is made to consult the non-EU members of the EEA before the EU decides, ultimately the decision rests with the EU. Put differently, only those signatories of the EEA that also choose to become members of the European Union participate in making the decisions that affect commerce in the EEA. Therefore, an EU member state that chose to exit the European Union and was able to join the EEA would no longer take part in the collective decision making process that determines the wide range of regulations that affect commerce in the EEA.

Nothing prevents the EEA signatories from negotiating other agreements, even bilateral agreements, between them on matters not covered by the EEA. In fact, since the EEA was signed in 1992, Norway has negotiated other accords with the EU on, amongst others, police cooperation, immigration, foreign and defence policy, regional policies, agriculture and fisheries.

Views have been expressed as to the effectiveness of the EEA. In its latest Conclusions on relations with the EFTA states, on 12 December 2012 the European Council make the following statement about the operation of the EEA[12]:

"The Council notes that overall, the EEA Agreement has continued to function in a satisfactory manner. The Council welcomes the substantial efforts made by the three EEA EFTA countries (Iceland, Liechtenstein, and Norway) in the course of the past year to reduce the number of outstanding legal acts still to be incorporated into the EEA Agreement. The Council draws the attention to the importance of addressing, as a matter of priority, the remaining large number of legal acts, for which the compliance date in the EU has passed, but which have not entered into force in the EEA EFTA countries as their incorporation into the EEA Agreement has been delayed. In this regard, the Council underlines the principles of homogeneity and legal certainty guarantee the efficiency, sustainability, and ultimately the credibility of the single market and must therefore continue to guide the action of all parties in relation to the functioning of the EEA Agreement."

This statement makes clear the monitoring of compliance by the EU to the regulations passed, the EU's expectations of non-EU EEA members in this regard, and the direct link between adoption of EU regulations and the preservation and extension of the Single Market. As will become clear in the next subsection, the above remark is considerably friendlier in tone that the assessment of the present arrangements between Switzerland and the EU.

Perhaps the most extensive assessment in recent years of the EEA from the non-EU perspective was submitted to the Norwegian Ministry of Foreign Affairs on 17 January 2012 by an expert review committee established by that nation's government on 7 January 2010. That report, aptly titled "Outside and Inside: Norway's agreements with the European Union," includes the following observations[13]:

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[12] The associated EU document can be found at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/trans/134523.pdf .(Hyperlink to European Council statement on the EEA).

[13] The first chapter of that report can be found at http://www.regjeringen.no/pages/36798821/PDFS/NOU201220120002000EN_PDFS.pdf .(Hyperlink to Norwegian Report assessing the impact of the EEA on Norway). Chapter 5 of that report summarises the main elements of the EEA, while chapter 6 describes the accords Norway has

"Norway's relationship with the EU is based on association without membership. In an international context this is an unusual form of cooperation, one that Norway shares with only two other small countries – Iceland and Liechenstein. The four other EFTA states, which also took part in negotiating the EEA Agreement in 1990-92, soon chose a different path, and no other states have since followed Norway's example, although some have, on occasions, considered it. At the same time, Norway has not been particularly keen to open the door to other countries. In practice, Norway's form of association with the EU has not been a model for others" (pages 6 and 7).

On the decision-making features of the EEA, the Review states:

"The most problematic aspect of Norway's form of association with the EU is the fact that Norway is in practice bound to adopt EU policies and rules on a broad range of issues without being a member and without voting rights. This raises democratic problems. Norway is not represented in decision-making processes that have direct consequences for Norway, and neither to we have any significant influence on them. Moreover, our form of association with the EU dampens political engagement and debate in Norway and makes it difficult to monitor the Government and hold it accountable in its European policy.

"This is not surprising: the democratic deficit is a well-known aspect of the EEA Agreement that has been there from the start. It is the price that Norway pays for enjoying the benefits of European integration without being a member of the organisation that is driving these developments. Although the democratic problems are as great today as they were 20 years ago—and have in fact increased—this is a situation that the broad political majority has been willing to accept and that many have become accustomed to" (pages 7 and 8).

A suite of Swiss-style bilateral accords.

Swiss-EU commercial relations suggest another potential alternative to membership of the European Union. Unlike Norway, Switzerland declined to join the EEA following its rejection in a referendum of the Swiss people. The reality of strong commercial ties between Switzerland and the EU called for an alternative approach to be developed that gave Switzerland a greater degree of autonomy than was implied by EEA membership.

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concluded with the EU since the EEA was signed in 1992. Chapter 7 reviews the translation of the EEA and subsequent EU regulations into Norwegian law.

Well before the negotiation of the EEA in 1972 Switzerland had concluded a FTA with the then European Economic Community. That FTA principally covered trade in manufactured goods. An agreement granting equal rights of establishment for insurance companies was signed in 1989 and came into force in 1993. A subsequent accord, negotiated in 1999, covered trade relations in agricultural products. Such steps introduced greater reciprocity into Swiss-EU trade relations and were justified in terms of the economic benefits arising from enhanced market access.

Two sets of bilateral accords were negotiated in 1999 and 2004. As a first approximation, each policy area appears to have been covered by a separate accord. In this manner, the Four Freedoms have largely been introduced into Swiss-EU commercial relations, with the associated economic benefits that follow from doing so. The argument has been made by the Swiss authorities that this bilateral approach is pragmatic, allows for tailor-made solutions, provide for considerable market access to all concerned, yet retains Switzerland's independence in decision-making. The bilateral agreements, therefore, involve no transfer of decision-making authority to a supranational entity and each party takes sole responsibility for implementation of the bilateral accords in their sovereign territory.

Rather than be obligated to adopt the *acquis communautaire*, Switzerland commits to adopt *equivalent* legislation. Thus, in principle, the EU and Switzerland could have different legislation to implement the same shared commercial objective, which might have implications for degree of legal certainty that commercial entities enjoy. Uniformity in legal regime need not be assured in the future, even it is has been accomplished to date. It has been argued that this approach does not preclude adoption of existing legislation and the adoption of new legislation following the identification of new matters of common interest to both the EU and Switzerland.

Under this arrangement Switzerland is free to negotiate commercial accords with countries outside of the EU and has done so individually and in collaboration with EFTA partners. Moreover, the current suite of bilateral accords with the European Union, in no way restricts Switzerland's rights of action in the World Trade Organization.

Both the European Union and the Federal Council of Switzerland have expressed some dissatisfaction with the outcomes of the current suite of EU-Swiss accords. In its December 2012 conclusions, the European Council stated that difficulties had been reached in concluding new accords and that this had adverse implications for the operation of the Internal Market. The Council reasoned as follows:

"The Council notes that in the last years, negotiations as regards Switzerland's further participation in parts of the Internal Market have been marked by a stalemate, partly due to unresolved institutional issues…

"Recalling its conclusions of 2010, the Council reaffirms that the approach taken by Switzerland to participate in EU policies and programmes through sectoral agreements in more and more areas in the absence of any horizontal institutional framework, has reached its limits and needs to be reconsidered. Any further development of the complex system of agreements would put at stake the homogeneity of the Internal Market and increase legal insecurity as well as make it more difficult to manage such an extensive and heterogeneous system of agreements. In the light of the high level of integration of Switzerland with the EU, any further extension of this system would in addition bear the risk of undermining the EU's relations with the EEA EFTA partners" (pages 5 and 6).

The Council went to advocate the adoption of an EEA-style framework to cover Swiss economic relations with the EU, arguing as follows:

"…the Council considers that further steps are necessary in order to ensure the homogeneous interpretation and application of the Internal Market rules. In particular, the Council deems it necessary to establish a suitable framework application to all existing and future agreements. This framework should, inter alia, provide for a legally binding mechanism as regards the adaption of the agreements to the evolving EU acquis. Furthermore, it should include international mechanisms for surveillance and judicial control. In this context, the Council notes that by participating in parts of the EU internal market and policies, Switzerland is not only engaging in a bilateral relation but becomes a participant in a multilateral project. All in all, this institutional framework should present a level of legal certainty and independence equivalent to the mechanisms created under the EEA Agreement." (page 6).

On the Swiss side, in a report on relations with the EU in 2010, the Federal Council provided its assessment of the status quo as follows (Swiss Confederation 2010). The Federal Council noted that:

"With respect to its relations with the EU, Switzerland's foreign policy objectives require it to take action to safeguard its room for manoeuvre in the decision-making process, to secure adequate access to the EU market for its economic actors, and to function as a dependable and solidary partner in Europe by adhering to and promoting common values.

"Until now, these goals have been largely achieved thanks to the conclusion of bilateral agreements, even if this solution has certain weak points, for example the lack of options for influencing standards that directly concern Switzerland, restrictions on sovereignty in those areas where Switzerland is required to adapt its legislation to that of the EU in order to avoid competitive disadvantages, the lack of full access to the EU single market, and latent legal uncertainty." (page 14).

Moreover, the Federal Council acknowledged the pressures to adapt the current arrangements, noting as follows:

"The existing degree of market access to the EU could erode, for example as the result of regulatory developments in the EU, and as a consequence of this, adhering to the contractual status quo could potentially give rise to deterioration in the economic framework conditions. While Switzerland's economic and monetary policy autonomy would remain intact, in practice the pressure to adapt would not be lessened." (page 8)

Despite the reservations expressed above the Federal Council ultimately recommended that Switzerland retain its current bilateral approach to managing relations with the European Union.

Qualitative assessment of the alternatives to EU membership.

Key differences in the provisions of these potential arrangements are identified and their implications for the independent action of a former member of the European Union are summarised in Table 2. In shedding light on these provisions, the goal is to support a more informed discussion of the differences between these options. Particular attention is given to the differences in provisions as they relate to commercial relations with the European Union and the implications, if any, for relations with non-EU third parties. It turns out that some of the alternative arrangements that a nation could negotiate with the EU have knock-on effects for any subsequent negotiation they might have with third parties.

In comparing the options available in Table 2 the major impression is that each alternative to EU membership affords more leeway in managing commercial relations with non-EU members. However, if the country in question negotiates a FTA or CU with the EU that includes so-called third party MFN clauses then, depending on the legal content of the clause, the nation will have to share any concessions that it makes to a third party with the EU. Such clauses alter the negotiating calculus as a former EU Member State may be less willing to make concessions to the third country in any FTA or CU negotiation that the former is obligated to implement for the EU.

This discussion of third party MFN clauses is not a theoretical possibility and is of potential policy significance to a country thinking of leaving the European Union. When the United States negotiated its FTA with Korea, a number of third party MFN clauses were included that meant that, should Korea ever give more advantageous terms to another trading partner in a FTA then those terms must also be extended to the United States. The fact that the US could not discount the possibility that Korea would later conclude a FTA with the EU may have been relevant. Much depends here on whether third party MFN clauses are included and the policies covered by those clauses. Still, the existence of such clauses and their use suggest that a former EU Member State may not be able obtain as much commercial advantage for its exporters over rivals from EU member states through negotiating FTAs with other countries, such as the fast growing emerging markets.

In comparing the options in terms of the nation's commercial relations with the EU, the options differ markedly in terms of their stringency. There is a trade-off between on the one hand greater access to the EU's various markets (going well beyond trade in industrial products) and the degree of legal certainty in the treatment of own farmers, manufacturers, and service providers by other EU member states and, on the other hand, the ability to preserve independent action, in particular the leeway to alter the treatment of commercial interests located in EU members. In trade deals a nation does not get something for nothing; reciprocity is and will remain a fact of life. Having said that, the options available do provide a range of benefits and obligations and some may weigh regard some obligations as more burdensome than others.

Seen in terms of the potential objectives of commercial policymaking, the choices between the alternatives to EU membership and EU membership are stark, as shown in Table 3. The principal advantage of non-membership relates to greater freedom in the conduct of commercial policy with non-EU countries. Whether much of commercial and diplomatic advantage can be made of such freedom depends on a number of factors, potentially qualifying this advantage. One important factor to assess is the willingness of non-EU trading partners to substantially improve access to their markets and to reform their regulations in the context of a legally binding trade agreement and whether, quite frankly, the nation contemplating leaving the European Union is prepared to do so as well. If there is little appetite for doing so on either side, then greater freedom to negotiate may deliver less than some might think or hope.

In contrast to the conditional benefits of greater negotiating freedom, all of the alternatives to EU membership are likely to result in weaker resistance to protectionism at home, protectionism in the EU, and protectionism in other trading nations. Non-membership options confer little, if no, leverage over internal regulatory decision-making in the EU, thereby reducing the likelihood of further internal reform in the EU and increasing the likelihood that opponents to reforms will rollback previous reforms. Under all but one alternative, some of the benefits of the EU's customs union are lost.

Table 2: Comparison of alternative arrangements in terms of options available vis-à-vis EU and Third Parties

Changes from status quo	**WTO membership only**	**Negotiate FTA in industrial goods with EU**	**Negotiate "Modern" FTA with EU**	**Negotiate Custom Union with EU**	**Join EEA**	**Replicate Swiss arrangements**
Commercial policy relations with the EU						
Change tariff rate paid by EU suppliers on non-agricultural trade	Yes. Only up to binding levels specified in WTO accords	Only if a "snapback" provision negotiated	Only if a "snapback" provision negotiated)	No change from current situation	No change from current situation	No change from current situation
Free trade in non-agricultural goods	No. Tariffs allowed per WTO obligations	No change from current situation	No change from current situation	No change from current situation	No change from current situation	No change from current situation
Exercise own agricultural trade policy and subsidies	Yes. Only up to binding levels specified in WTO accords	Depends on terms of FTA	Depends on terms of FTA	Depends on terms negotiated	Depends on terms negotiated	Depends on terms negotiated
Rules of origin	No change from current situation	Would be introduced	Would be introduced	No change from current situation	Would be introduced	Would be introduced
Freedom of movement of capital	As per EU's WTO obligations only	As per EU's WTO obligations only	Could be negotiated	Could be negotiated	No change from current situation	No change from current situation
Freedom of movement of people	Only as prescribed in EU's WTO obligations on Mode 3	Would have to be negotiated	Would have to be negotiated	Would have to be negotiated	No or little change from current situation	No or little change from current situation
Freedom of movement of services	As per EU's WTO obligations only	As per EU's WTO obligations only	Would have to be negotiated	Would have to be negotiated	No or little change from current situation	No or little change from current situation
Mutual recognition of	No	Would have to be	Would have to be	Would have to be	No or little change from current	No or little change from current

Changes from status quo	WTO membership only	Negotiate FTA in industrial goods with EU	Negotiate "Modern" FTA with EU	Negotiate Custom Union with EU	Join EEA	Replicate Swiss arrangements
regulations		negotiated	negotiated	negotiated	situation	situation
Must implement EU regulations	No	Not unless negotiated in FTA	Not unless negotiated in FTA	Not unless negotiated in CU	No change from current situation	No
Financial contribution to the EU	No	Not unless negotiated in FTA	Not unless negotiated in FTA	Not unless negotiated in CU	No change from current situation	No
Possible target of EU trade defence measures	Yes	Yes but could be negotiated	Yes but could be negotiated	Yes but could be negotiated	Yes	Yes
Benefit from any unilateral EU reforms	Yes	Yes	Yes	Yes	Yes	Yes
Possible joint action with EU on third party protectionism	Yes	Yes	Yes	Yes	Yes	Yes
Potential to negotiate further agreements with the EU	Yes	Yes	Yes	Yes	Yes	Yes
Commercial policy relations with other third parties						
Change MFN applied tariff rates	Yes up to limits set down in WTO obligations	Yes up to limits set down in WTO obligations	Yes up to limits set down in WTO obligations	No	Yes up to limits set down in WTO obligations	Yes up to limits set down in WTO obligations
Initiate own trade defence investigation against third party	Yes	Yes	Yes	No	Yes	Yes
Initiate own FTA/CU negotiations with	Yes	Yes	Yes	No	Yes	Yes

Changes from status quo	**WTO membership only**	**Negotiate FTA in industrial goods with EU**	**Negotiate "Modern" FTA with EU**	**Negotiate Custom Union with EU**	**Join EEA**	**Replicate Swiss arrangements**
third party						
Define own, unimpeded negotiating mandate for FTA/CU	Yes	Yes	Yes	No (common external tariff agreed with EU)	Yes	Yes
Conduct own negotiations for FTA/CU	Yes	Yes	Yes	No	Yes	Yes
Conclude negotiations of a FTA/CU	Yes	Yes	Yes	No	Yes	Yes
Share with EU certain benefits of FTA/CA with third parties	No	Yes if Third Party MFN clause in accords negotiated with the EU	Yes if Third Party MFN clause in accords negotiated with the EU	Yes if Third Party MFN clause in accords negotiated with the EU	No	No

Table 3: Comparison of Alterative Arrangements and EU Membership in Terms of Selected Criteria

Key to following table: +=Arrangement better than status quo, -=Arrangements worse than status quo, 0=No change; ? qualifier (indicates doubt about + or – judgement), D=Depends (for reason specified).

Criteria	**WTO membership only**	**FTA in goods with EU**	**Modern FTA with EU**	**Custom Union with EU**	**EEA**	**Swiss arrangements**
GATT-compliant EU customs union						
Benefit from EU customs union	- (face tariffs)	- (due to Rules of Origin)	- (due to Rules of Origin)	0	- (due to Rules of Origin)	- (due to Rules of Origin)
Bulwark against protectionism						
At home	-	0 (tariffs vis-à-vis EU) – (policies not covered by FTA)	0 (tariffs vis-à-vis EU) – (policies not covered by FTA)	0 (tariffs vis-à-vis EU) – (policies not covered by CU)	0 (tariffs vis-à-vis EU) – (policies not covered by EEA)	0 (tariffs vis-à-vis EU) – (policies not covered by accords)
In EU	-	0 (tariffs vis-à-vis EU) – (policies not covered by FTA)	0 (tariffs vis-à-vis EU) – (policies not covered by FTA)	0 (tariffs vis-à-vis EU) – (policies not covered by CU)	0 (tariffs vis-à-vis EU) – (policies not covered by EEA)	0 (tariffs vis-à-vis EU) – (policies not covered by accords)
In third parties that are not EU members	- (reduced threat of retaliation)	- (reduced threat of retaliation)	- (reduced threat of retaliation)	- (reduced threat of retaliation)	- (reduced threat of retaliation)	- (reduced threat of retaliation)
Negotiations with third parties that are not EU members						
Freedom to negotiate with third parties (initiation,	+	+	+	+ (some limit on tariffs)	+	+

Criteria	**WTO membership only**	**FTA in goods with EU**	**Modern FTA with EU**	**Custom Union with EU**	**EEA**	**Swiss arrangements**
mandate, conclusion)						
Likely negotiating clout with third parties	-	-	-	-	-	-
Internal Market of EU						
Benefit from principle of assimilation	0	0	0	0	0	0
Benefit from future EU unilateral reform	0	0	0	0	0	0
Ability to promote further EU internal reforms	-	-	-	-	- (at best consulted)	- (at best consulted)
Ability to stop or limit rollback of EU internal reforms	-	-	-	-	-	-

Chapter 3:
Quantitative Aspects of Access to the Single Market

In this chapter, we focus on quantitative aspects of market access within the single market under alternative arrangements. We focus on trade cost savings associated with alternative institutional arrangements for market access within the single market, following on the institutional discussion in the previous chapter. The assessment here includes, but is not limited to the current arrangement, involving a customs union. We compare this to both the implications of a free trade agreement, and to a baseline of no agreement.

3.1 MFN Tariffs of the EU

One immediate consequence of "Going It Alone"—in leaving the EU and not negotiating a Free Trade Agreement or Customs Union with the EU—is that the former Member State would face a change in tariff treatment by the European Union. Instead of being able to export goods tariff free to the EU, exporters from the former Member State—which include farmers as well as manufacturers—would face the common external tariffs erected by the EU. This is where the statistics mentioned in the last chapter are relevant and as well as the information reported in Table 4 below. While the EU's average tariff on non-agricultural goods is quite low, tariffs on some "sensitive" products are quite high and therefore the impact of higher tariffs on the exiting country should be determined on a product-by-product basis. It is also worth noting that, given that the EU is locked in to zero tariff treatment for so many non-agricultural products, many manufacturers in a country that exited the EU could face no change in tariff treatment in their exports to the European Union.

Table 4: Maximum Tariffs Charged in Certain Product Categories by the EU

Product category	Maximum tariff currently applied to certain products within specified category, %	Simple average tariff currently applied to all products within specified category, %
Textiles	12.2	6.6
Clothing	12.0	11.5
Leather, footwear	17.0	4.2
Non-electrical machinery	10.0	1.9
Electrical equipment	14.0	2.8
Transport equipment	22.0	4.3
Other manufacturing	14.0	2.7

Source: http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=E27

Exit from the European Union would also imply that the EU's commitments at the WTO on trade in services and investment would govern its treatment of the exiting country's service sector firms, temporary movement of staff abroad, and investments within the European Union. To the extent that the protections for these types of commercial interests are stricter in the EU than in the relevant WTO accords, then exit from the European Union may result in worse treatment of individuals and firms trying to supply the EU market other than through exporting.

3.2 Rules of Origin under an FTA

While customs unions have a common set of external trade policies, this is not the case with free trade and preferential trade agreements. An advantage of such arrangements is the ability to set one's own tariffs and non-tariff barriers, even while agreeing to free trade with the relevant partner. However, as noted in Chapter 1, this also raises the possibility that third countries will try to access free trade areas through the most open border. This undercuts the ability of partner countries to set their own tariffs. To preclude this, free and preferential trade agreements contain a set of rules aiming to ensure that the products imported from the partner country are indeed originating from that country. Without these rules, since in FTAs the member countries have different external tariffs and regulatory barriers, products would be shipped through the countries with lower tariffs. Rules of origin specify under which conditions the products are deemed to be originating from the partner country. Technically, the main justification for rules of origin is to prevent trade deflection – imports from non-beneficiaries that are routed through a participating country to avoid customs duties (Brenton and Manchin, 2003). However, in reality, they can also be used as effective barriers within free trade areas.

When goods are produced in a single stage, the origin of the products is relatively easy to establish. For all other cases the rules of origin define agreed methods by which it can be determined that the product has been sufficiently processed in the free trade partner to qualify for preferential access. The specification of rules of origin has become especially important in recent years as technological progress and globalization have led to the increasing fragmentation of the production process into different stages or tasks which are undertaken in different locations, often outside of a given FTA. These costs range from adaption to administration and verification costs.

Obtaining preferential access in an FTA can be costly because of administration costs, inclusive of the need to document origin, as well as costs linked to compliance to regulations linked to the same rules. Furthermore, because higher value added production involves multiple stages of production, with the potential for products to move back and forth across borders multiple times, the administrative burden of proof is increasing in the complexity of production. By this, we mean the costs of paperwork and documentation linked to rules of origin. Several studies have evaluated the costs implied by different preference schemes. In an early paper, Herin (1986) argued that the costs of documentation and the administration of origin rules applied by the EEC imposed costs on exporters located in EFTA countries equivalent to some 3 percent of the value of the goods traded. More recent estimates provide a range of estimates clustered between 4 percent and 8 percent (combined compliance and administration costs). Work on NAFTA by Carrère and de Melo (2004) finds that average total compliance costs were 6.2 percent in 2001. Using double-censored Tobit estimation techniques, they obtain a compliance cost estimate of 3.9 percent for products where the utilization rate is below 100%. This is because, when costs are high enough, firms simply give up on preferential rates and pay the MFN tariff despite the availability of preferential rates. While most estimates focus on combined costs linked to rules of origin, Cadot et al. (2006) provide a distinction between compliance costs needed to conform methods of production to meet rules of origin requirements, and subsequent administrative costs, for both North America and Europe. They estimate the trade-weighted compliance (administrative) costs to be 6.8 percent (1.9 percent) respectively for NAFTA, and for the Pan-European preference scheme to be around 8 percent (6.8 percent). This means that for the Pan-European preference scheme, combined compliance and administrative costs may be close to 15 percent. Looking at NAFTA, Anson et al. (2005) estimate that in the case of NAFTA average compliance costs are around 6 percent, offsetting the preferential tariff differential of about 4 percent. Administrative costs chewed up about half of the value of preferential access for Mexican firms. For developing countries, these costs can be even higher, due to information disadvantages and institutional weaknesses. Manchin (2006) looks at African, Caribbean and Pacific (ACP) countries preferential trade with the EU. Using Heckman sample selection and endogenous threshold estimation techniques the paper finds the total (administration and compliance) costs of taking up preferences to be between 4 percent and 4.5 percent. Most recently, Keck and Lendle (2012) emphasize the importance of fixed costs associated with utilizing preferences.

With the UK as a customs union member within the European Union, British firms are saved the compliance and administrative costs linked to proving the origin of products shipped in the European market. With the UK instead taking direct control over its external trade policies, and so operating outside the customs union, rules of origin would become necessary under free trade with the customs union. This means British firms would be exposed to a combination of administrative and compliance costs linked to rules or origin, ranging (based on existing estimates) from 4 percent to perhaps 15 percent of the cost of goods sold. For low tariff products, it is therefore likely that firms would instead simply opt to pay the common external tariff of the EU, and so avoid costs linked to rules of origin. This means that, for low tariff products, there would be very little difference between no trade agreement, and one involving free trade combined with rules of origin.

3.3 Non-Tariff Barriers on Goods and Services

Another aspect of alternative trade arrangements for market access within the single market relates to non-tariff barriers or NTBs. NTBs and regulatory divergence are complex issues. Even the measurement of the importance of these barriers for trade and investment is a difficult exercise. In this section we draw on the Ecorys (2009) and CEPR (2013) Transatlantic Trade and Investment Partnership (TTIP) studies of transatlantic NTBs, as these provide as assessment of EU barriers to firms based both inside and outside the single market. The methodology incorporated in both studies used a multi-pronged approach that combined literature reviews, business surveys, econometric analyses (gravity modelling together with CGE modelling), as well as consultations with regulators and businesses and inputs by sector experts aiming to obtain a qualitative and quantitative estimates of transatlantic NTBs. This included both trade and FDI-related NTBs.

NTBs and regulatory differences for traded goods can have two main effects. NTBs can either increase the cost of doing business for firms, or they can restrict market access. Traditional NTBs, like import quotas, are an example where NTBs directly limit market access. In contrast, regulations that require expensive reconfiguration of products (like changing voltage or reconfiguration of an exhaust system) for export are an example of cost raising NTBs. Both can have different impacts by changing market concentration and economic power (and thus profits) of companies. In order to be able to make a distinction between those two types of NTBs, the concepts of 'cost' and 'rent' are useful. From Ecorys (2009), about 60 per cent of the price impact of NTBs can be classified as following from actual cost increases on average, while the creation of market power (economic rent) is responsible for the other 40 per cent of price increases.

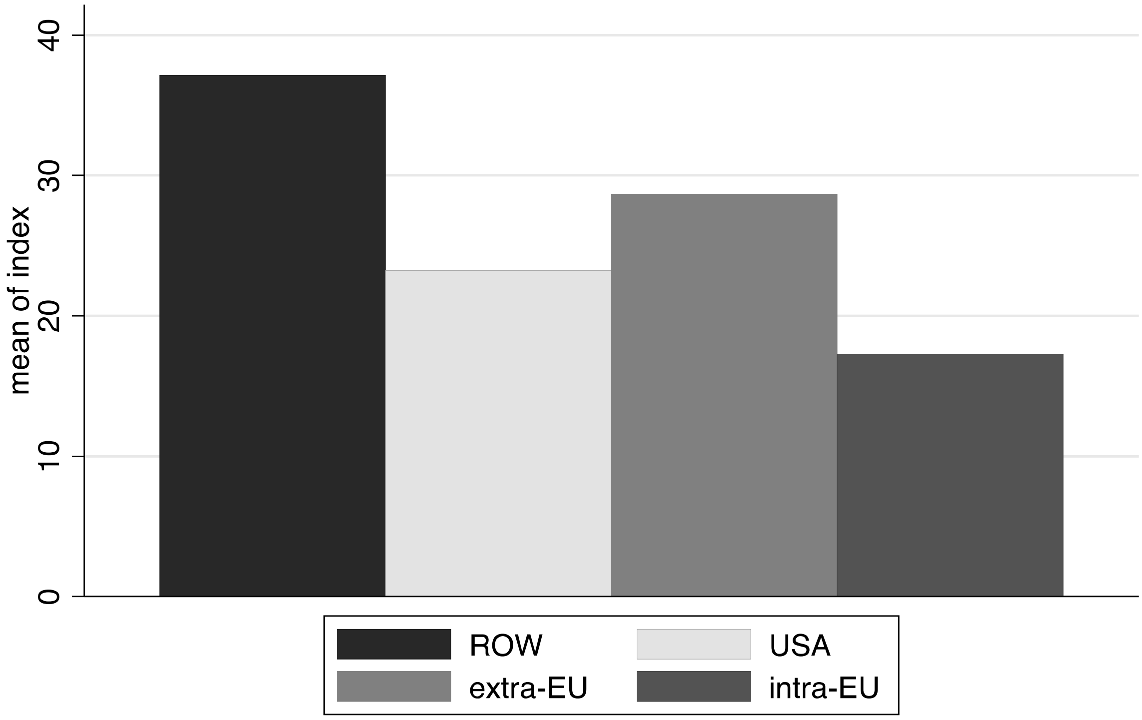
The relevance of NTBs depends on the type of arrangement, and the sector involved. According to the estimates from Ecorys and CEPR studies, non-tariff barriers for access to the single market are the highest for food and beverage products, with imports from North America, for example, facing a 56.8 per cent tariff equivalent. This can be viewed as representative of trade costs for full outsiders to the single market. In this sense, it is an upper bound on the costs that might evolve over time under alternative arrangements for market access to the single market in the case of the UK. Among services, financial services are one of the sectors with the highest estimated NTBs. In this sector, EU barriers against third countries amount to 11.3 per cent.

It should be stressed that in contrast to limiting tariffs through an explicit free trade agreement, limiting the impact of NTBs through a negotiated agreement is not as straightforward. Indeed the evolution of the EU has reflected a long and difficult process aimed at reducing such barriers. There is evidence that this process has been successful. For example, based on the survey results from the TTIP studies, regulatory barriers are lower within the single market (between for example British and German firms) than they are with respect to third countries (like Canadian firms in Germany). However, barriers still remain even within the single market. One can view the long run process of consolidation of competition policy and product and market regulation within the EU as an effort to limit these costs. Overall, these costs are relatively high. Operating outside the mechanisms that have evolved to limit these NTBs within the single market, if the UK were to depart the customs union, may imply exposure to these higher trade costs.

In addition to trade, there is also the question of NTBs and market access linked to MNEs. The original ECORYS (2009) study reported overall rankings of market access for operations of MNEs, in addition to rankings of market access for direct trade in goods and services. For an overview of the pattern of openness indicated by the survey responses in the TTIP studies, Figure 1 below summarizes the average levels of the NTB indexes in the survey data from those studies. Here 0=fully open and 100=fully closed. In the figure, the average index levels are reported for NTBs facing firms operating in the EU, the US, and in third countries (labelled as "rest of world"). We have further split the average index values into indexes for NTBs facing EU firms operating in the EU (the "intra-EU" index), and non-European firms operating in the EU (extra-EU).

The figure illustrates a number of useful points. First, intra-EU NTBs (the ranking of market access restrictions facing European firms operating affiliates in other EU Member States) are shown to be substantially lower than NTBs reported by non-EU firms when operating in those same EU markets. This fact reflects the success of the European Union in reducing internal barriers to cross-border operation of European firms within Europe. Hence, while the EU NTB index for FDI averages approximately 28 for firms from outside the EU, while it averages roughly 18 for firms inside the EU. The difference is an effective preference margin (lower NTBs) for intra-EU FDI.

Figure 1: Average Value of NTM Indexes for FDI

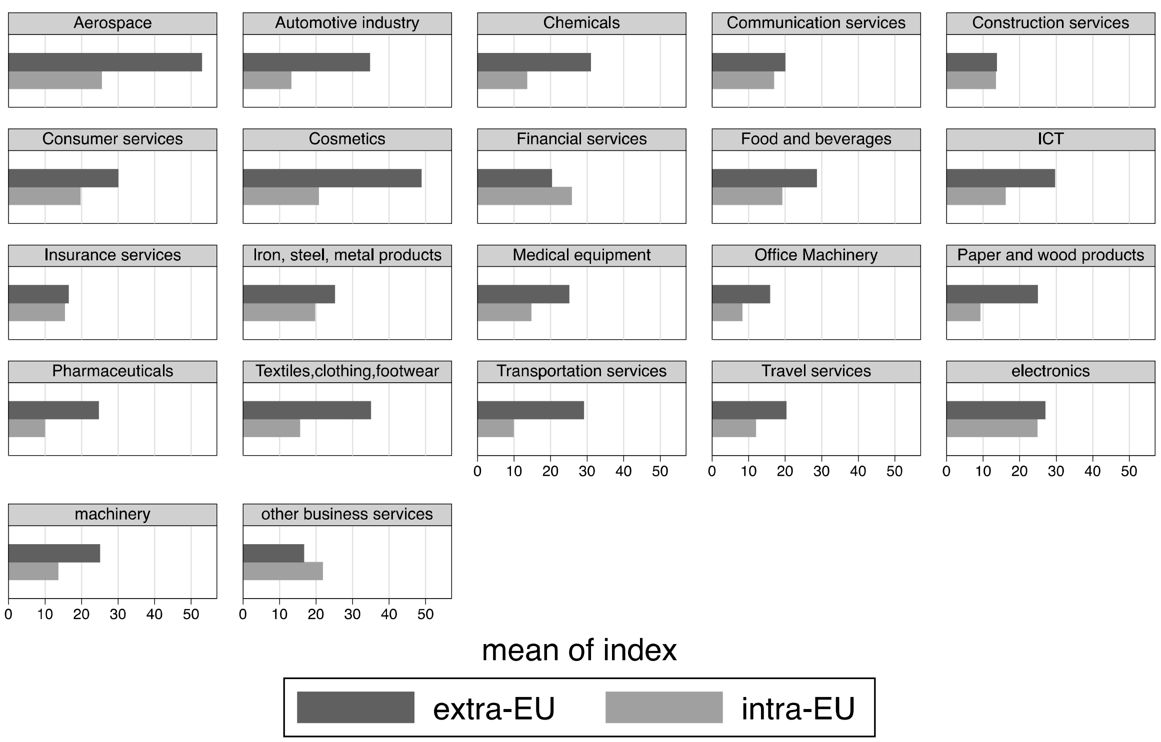


source:See text. Extra-EU(Intra-EU) refers to NTMs faced by non-EU(EU) firms operating in EU.

Figure 2 provides further breakdown by sector. In Figure 2, we again see the intra- and extra-EU NTB index variations for non-European and European firms operating affiliates within the EU. In terms of NTB rankings, the greatest differences for goods are apparent in aerospace, chemicals (including drugs and cosmetics), and motor vehicles. For services, the greatest differences are in transport, travel, and ICT services. As can be seen from the figure, however, the financial services indexes are shown to be more or less the same for intra-EU and extra-EU investment. This implies that there are similar levels of openness for European and extra-EU banks engaged in FDI in Europe. The same message holds for insurance, construction, and business services.

Like trade in goods, different arrangements for market access to the single market are likely to involve substantial differences in market access through MNES.

Figure 2: Average NTM index values for FDI located in the EU



source:See text. Extra-EU(Intra-EU) refers to NTMs faced by non-EU(EU) firms when operating in the EU.

3.4 Quantifying Implications for Trade Costs with the EU

In this section, we draw on the previous discussion of trade costs, including NTBs and rules of origin costs. We map these to the structure of UK production and trade, to provide a national-accounts based estimate of the overall level of trade costs implied by different arrangements for market access to the single market. This is not meant as a measure of what is "best" or " preferred." Neither is it a substitute for a full model-based assessment. Rather, it is strictly an accounting exercise, designed to identify some of the market access implications of alternative arrangements, in contrast with placing trade and investment policy under the umbrella of the EC. While Chapter 1 provides discussion of 6 alternative arrangements, here we focus more narrowly on two alternatives: (1) basic MFN market access through WTO commitments, and so being outside the single market completely, and (2) an FTA similar in scope to the market access conditions envisioned for the US under a possible trade and investment partnership. For both, we include both estimated rules of origin costs (assuming 6 percent costs as a share of value of goods sold) and estimated NTBs (from the Ecorys and CEPR TTIP studies). Under MFN market access, we assume NTB costs similar to those estimated to currently face the US when accessing the single market, as well as MFN levels for the common external tariff. For an FTA, we assume NTB levels similar to those envisioned for the US under the proposed TTIP, combined with rules of origin costs. In cases where rules of origin costs (taken at 6%) exceed MFN tariffs, we assume that the MFN tariff applies instead. We take 6% as a conservative estimate for administration and compliance in a European context.

Table 5 below presents the trade cost implications of applying the mix of tariffs, rules of origin costs, and NTBs to UK exports to the single market. The numbers in the table follow from applying estimated trade costs, as discussed above, to the actual value of UK exports to the single market. Scaled by GDP, these range from 1.24 to 1.77 percent of UK GDP, or between £18 billion and £25.8 billion annually. In other words, based on evidence from other FTAs, and based on NTB estimates from firm surveys regarding access to the single market, the two alternative arrangements for market access to the single market imply higher costs for British firms when accessing the single market. These follow from (non) avoidance of the need for rules of origin under different arrangements, combined with protection against NTBs for EU Member States against other EU Member States.

Table 5: Trade Costs, Million Pounds and Share of UK GDP

	Outside	FTA
value, million pounds		
rules of origin		2,796
tariffs	3,811	
NTBs	21,956	15,233
total	25,767	18,029
value, share of GDP		
rules of origin		0.19
tariffs	0.26	
NTBs	1.51	1.05
total	1.77	1.24

Note: Base Data are from GTAP8 (benchmark year 2007).

Chapter 4.
Extra-EU Trade Policy

In this chapter, we focus on both offensive and defensive aspects of EC trade and investment policy with respect to third countries. We place emphasis on two activities of the European Commission: (1) as both a complainant and respondent in WTO disputes, through what is known as the dispute settlement body or DSB, and (2) through selection of partners for FTA negotiations. In both cases, we measure offensive and defensive interests on a mercantile basis, meaning as the share of extra-EU exports.

4.1 WTO disputes

Under the DSB, WTO Members have access to a quasi-legal mechanism that exists to enforce market access obligations agreed between WTO Members. The EC has filed complaints through the WTO 88 times from its inception in 1995 through mid-2013. These filings are one aspect of offensive European Commission policy, in the sense that the European Commission has used the DSB to ensure both systemic and sector-based commitments made by trading partners. We focus here on two issues. The first is cases filed against the UK, through the EU. By this we mean cases where the UK has clearly been a respondent, with its interests represented by the EC. The second is the pattern of WTO disputes filed by the EC, and the extent to which the pattern of these cases reflects UK export interests.

Individual Defensive Cases involving the UK

Because it was a founding Member of the original GATT in 1947, the United Kingdom is a Member of the WTO in its own right. However its schedules of commitments are those for the EU as a whole. Similarly, the WTO trade policy reviews for the UK are covered under the review of the EU. The United Kingdom has not initiated disputes on its own as a WTO Member. Rather this is done by the EC, on behalf of all Members (including the UK). However, it has been the explicit target of three disputes, all filed by the United States. These are as follows:

- DS67 United Kingdom — Customs Classification of Certain Computer Equipment

(Complainant: United States) 14 February 1997

- DS316 European Communities and Certain Member States — Measures Affecting Trade in Large Civil Aircraft (Complainant: United States) 6 October 2004
- DS347 European Communities and Certain Member States — Measures Affecting Trade in Large Civil Aircraft (Second Complaint) (Complainant: United States) 31 January 2006

The first of these disputes involved classification by UK customs authorities of electronics goods, in particular PCs with multimedia capability. The EC appealed an initial decision in favour of the US, and in the appeal the EC won the dispute. The second and third disputes relate to the long running battle between Europe and the US over commercial airline production. The UK, together with Germany and France, has been targeted by the US for providing actionable subsidies for the development, production, and export of commercial aircraft, most recently the A380. These disputes have taken an unusually long time to reach completion, and have been appealed as well. The EC has defended Member policies (meaning the UK, along with France and Germany) throughout this process. It has also taken offensive action at the same time to support these same industries. This covers two cases.

- DS317 United States — Measures Affecting Trade in Large Civil Aircraft (Complainant: European Communities) 6 October 2004
- DS353 United States — Measures Affecting Trade in Large Civil Aircraft — Second Complaint (Complainant: European Communities) 27 June 2005

The EC has also consistently reserved its rights as a third party in the set of Aircraft disputes involving Brazil and Canada. These disputes are for smaller, commuter-sized aircraft produced in both countries. They cover the following:

- DS46 Brazil — Export Financing Programme for Aircraft (Complainant: Canada) 19 June 1996
- DS70 Canada — Measures Affecting the Export of Civilian Aircraft (Complainant: Brazil) 10 March 1997

- DS222 Canada — Export Credits and Loan Guarantees for Regional Aircraft (Complainant: Brazil) 22 January 2001

The Overall Pattern of Disputes

In order to assess the pattern of utilization of the DSB, it is necessary to count the number of disputes. This in turn requires a definition of the *unit of account* of a dispute. The approach followed here is to count each pair of countries involved in a *Request for Consultation* as a separate dispute. On this basis, there were 491 disputes through July 2013.[14] This is the approach taken in most of the more legally oriented literature that has sought to quantify participation in the DS system.

The geographic pattern of these dispute filings by the EC is summarized in the figure below. The figure shows the number of disputes by partner.

Figure 3: EC filings of WTO disputes through mid-2013

source: World Trade Organization 2013.

The set of disputes at the WTO cover a broad range of issues. In the case of EC filings, the

[14] Based on the WTO's own system, there have been 463 disputes. This is because while the WTO itself assigns each such request a unique DS number, it has not been consistent. In some years, when countries filed a common dispute, it was assigned one dispute case number. In more recent years, each country pair involved in a dispute as complainant and respondent receives a separate number. See Francois, Horn, and Kaunitz (2009) for further discussion.

basic breakdown is summarized in the table below.

Table 6: EC dispute filings by topic

	count	share
All disputes	88	1.00
by issue		
AD/CVD and Safeguards	40	0.45
National Treatment	38	0.43
MFN clause	22	0.25
by sector		
Metals	9	0.10
Motor Vehicles	6	0.07

Source: own calculations from WTO filings.

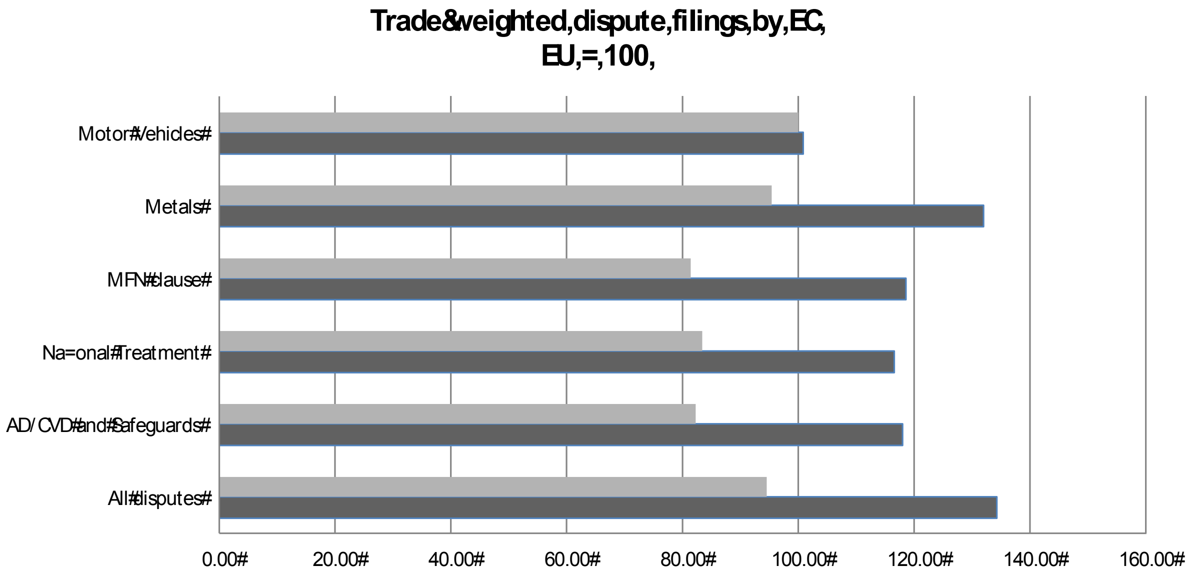
Almost half of the filings by the European Commission (45 percent) were related to WTO implementation of dumping, countervailing duty, and safeguard measures. Of these, 52.5 percent were disputes with the US or Canada. These reflect an aggressive position taken by the EC in ensuring that the US implemented changes to antidumping rules under the Uruguay Round Agreements establishing the WTO. They also reflect a successful set of challenges to the US against safeguard duties imposed on steel imports by the US.

Our interest here is the extent to which the EC utilization of the DSB reflects the interests of the UK. Many approaches can be taken to address this question. We have chosen here to examine the weighted set of bilateral disputes using both the extra-EU export shares of the UK alone (based on 2007 data from GTAP), and the export shares of the rest of the EU. These are compared to the set of disputes weighted by export shares for the total EU, inclusive of the UK. The result is a trade-weighted index. The total number of disputes weighted by the full EU export shares is set to 100. The result is presented in the figure below. In formal terms the index is calculated as follows:

$$Index = 100 \cdot \frac{\sum_{r=1}^{r} \theta_{uk,r} D_r}{\sum_{s=1}^{s} \theta_{EU,s} D_s}$$

In the equation, the term $\theta_{uk,r}$ is the export share or region *r* in total extra-EU exports of the UK. A similar calculation has been done for non-UK EU Members.

Figure 4: Trade Weighted Disputes Index



	All#disputes#	AD/CVD#and# Safeguards#	Na=onal#Treatment#	MFN#clause#	Metals#	Motor#Vehicles#
rest#of#EU#	94.45#	82.23#	83.43#	81.44#	95.32#	99.93#
UK#	134.16#	117.77#	116.57#	118.56#	131.92#	100.69#

There is an apparent bias toward UK export destinations in the pattern of WTO disputes. From the table, where the disputes based on full EU export shares are benchmarked to 100, we have roughly 34 percent more disputes weighted by UK export shares. In other words, if we take export volumes as a measure of commercial policy interests, then the overall set of EC disputes reflects UK export markets more than overall EU export markets. This also holds when we examine systemic issues covered by the disputes, including not only contingent protection and safeguards, but also the core WTO issues of national treatment and MFN treatment of European firms. On a sector basis, the pattern of disputes involving market access for metals (primarily steel) also shows a bias toward UK export destinations. Where this does not hold is motor vehicles, where the pattern of disputes reflects the broad set of European export interests.

While the indexes show an apparent tilt toward UK interests in the pattern of disputes in the figure, we cannot really say if this is significant without a formal statistical test. In the table below, we summarize Poisson-based regressions (technically these are Poisson quasi-maximum likelihood or PQML estimates) of the set of EC dispute filings. The unit of count, as before, is the number of disputes filed against partners. We report Poisson estimates because this allows for zero counts – i.e. countries where no disputes have been initiated by the EC.[15]

Table 7: PQML analysis of EU disputes

	model 1	model 2	model 3
Total EU export share		-1.836	
UK deviation from EU share		18.092**	16.724**
lnGDP of export market	2.632**	6.779**	7.279**
lnGDP squared	-0.058	-0.214*	-0.234**
constant	-24.227**	-51.5721**	-54.764**
pseudo-R^2	0.716	0.733	0.733
X^2	80.3 Pr>0,0.00	170.76 Pr>0,0.00	181.88 Pr>0,0.00
countries	85	85	85

notes: **=.05 significance, *=0.10 significance.
Trade shares and GDP are based on 2007 values.

The first model reported in column 1 is for estimates of the total count of disputes as a function simply of export market size. Consistent with the empirical literature on all WTO disputes (see Bown 2010), the count of disputes is largely explained simply by the size of destination market. In the second specification, we have also included the export market share of total EU exports (total EU export share), and the deviation of the UK's export share from the total export share. Supplementary analysis suggests that there is a very high correlation between market size and the total EU export share, explaining the poor performance of this variable in the second specification. We have dropped this in the third column. From the goodness of fit statistics, this is the preferred specification. The estimates for model 3 confirm our casual observation based on Figure 2. When we have a 1% increase in the importance of a market for UK exports, relative to the importance for the EU as a whole, we have a 16.7 percent increase in the number of disputes filed. In other words, statistically speaking, we expect more disputes to be filed against countries that are more important for the UK than for the EU as a whole.

[15] While not shown here, in addition to PQML we also applied a zero-inflated Poisson or ZIP estimator. It yields almost identical results.

Economic Power and WTO Disputes

When viewing both the offensive action of the EC, and its role in depending UK interests in the multilateral arena, the specific position of the US sticks out. The EC shows an apparent lean toward UK export markets in disputes largely because the US attracts so many disputes, and the US is the UK's primary extra-EU export market (33% of exports). Put simply the US is big. When focusing on specific products, this is also true. For example, the US represents 21.5 percent of the UK's extra-EU metals exports, but only 15.0 percent for the remaining EU Members. As such, the EC's aggressive (and successful) stance against Bush Administration-era special safeguards for steel were more important for UK steel interests than for the other Members as a whole. One could argue that the EC would have gone after the US regardless of UK interests, and would have been successful anyway. However, a critical point is the relative economic clout of the EU relative to the US, when compared to the UK as discussed in Chapter 2. WTO disputes reflect the calculus of power politics. It is not so clear how successful the UK would be on its own when defending its rights under the multilateral system.

As shown in Figure 5 below, as part of the EU block, the UK (inside the single market) stands at par with the US in terms of economic weight. Levels of GDP (one measure of economic power or weight) are similar. On its own, however, the UK is only 20% the size of the US economy. Indeed, for a range of trade partners beyond the US, the EU has far greater weight than the UK would on its own. This includes Japan and Canada, who are both in the process of negotiating with the EC or have recently completed negotiations. On this basis, the UK would negotiate relatively close to par with both Japan and Canada, were it to embark on its own FTA negotiations, while it would be in a position similar to Canada vis-à-vis the US (and vis-à-vis the EU itself as well).

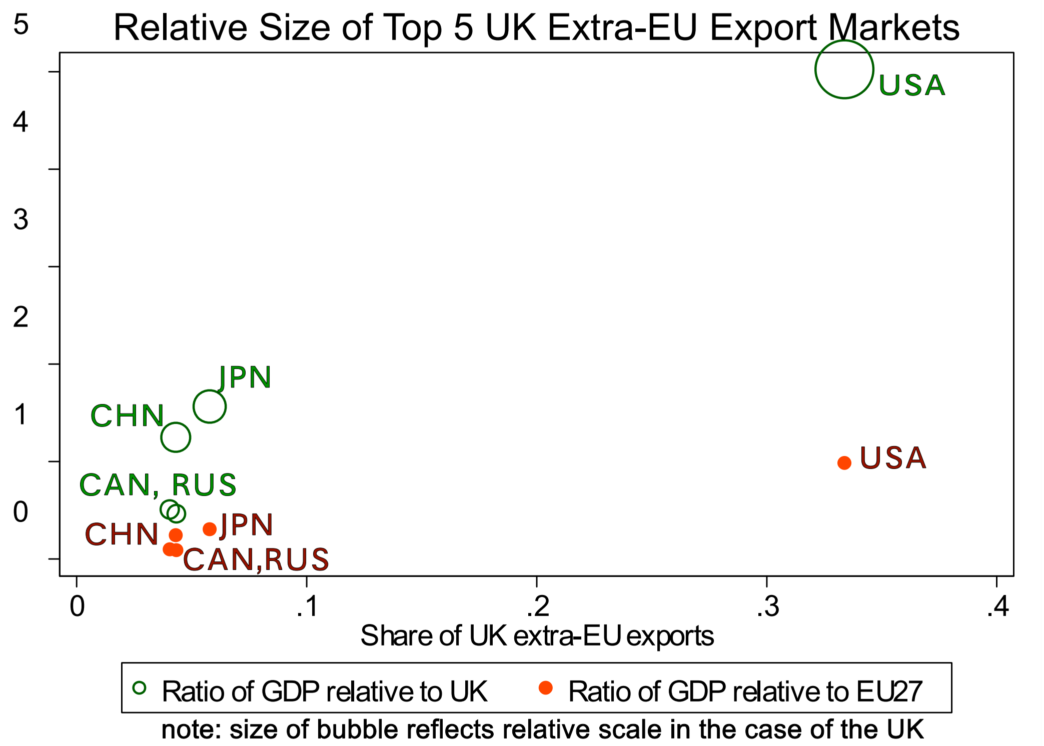


Figure 5: Relative Economic Power:
Size of top 5 UK export destinations relative to UK and EU27

source: Own calculations from GTAP8 database.

4.2 FTA partners

Since the adoption of the "Global Europe" communication in 2006, the European Union has been committed to launching and completing a new round of negotiations for free trade agreements. Longstanding talks with Brazil (in fact, with MERCOSUR) were to be revived, if possible. Negotiation of free trade agreements with India and Canada commenced, as have those for a transatlantic partnership with the United States. Ambitions for trade and investment negotiations with China were more muted. Moreover, conclusion of Russian accession to the WTO was seen then as a priority—rather than a FTA negotiation--and came to pass. As a Member State of the European Union, the United Kingdom was able to influence this strategy in informal consultations with the European Commission and formally through the European Council. Under the Treaty of Lisbon, British members of the European Parliament would also have their say on the approval of any free tree agreements that are negotiated. The full scope of on-going and recently concluded negotiations is summarized in Figure 6.

Figure 6: Current and Ongoing FTA Negotiations

source:http://trade.ec.europa.eu/doclib/html/149622.htm (hyperlink to DG Trade website)

Should the United Kingdom leave the European Union then, as was established in Chapter 2, there are a wide range of circumstances under which the UK could conduct independently negotiations for free trade agreements with non-EU members. The facts outlined above could provide a useful benchmark against which to compare an alternative, namely, a less constrained free trade agreement strategy for the United Kingdom. In principle, the UK could seek to conclude FTAs with jurisdictions that the EU has been unable to finalise negotiations with (such as MERCOSUR and India) or unwilling to negotiate FTAs with (such as Russia and China.) Moreover, the status of the UK's trade with countries that already have FTAs with the European Union would have to be clarified (such as with Korea and, as is likely, with Canada) and this, in principle, might provide an opportunity for the UK to negotiate accords that are more ambitious than the EU deal they replace or accords more tailored to the UK's commercial interests.

The difficulty in comparing the benefits to the UK of the current EU strategy towards FTAs and the benefits of a more independent FTA strategy upon exit is that many factors must be taken into account. As the EU has learned the hard way, just because a FTA negotiation is launched does not mean that it will be concluded (the negotiations with the Gulf Cooperation Council countries started a quarter of a century ago!). Moreover, the conclusion of a negotiation does not imply that the terms of the accord align with initial expectations of either party, or that each party will implement the agreed terms. Finally, other developments in the world economy, in particular unilateral trade reforms (that have been pervasive in many developing countries, such as India) and multilateral trade accords (interest in which may eventually be rekindled), as well as the FTA strategies of other nations, would have to be taken into account in any comprehensive assessment of the costs and benefits of any strategy towards FTA. In fact, given the range of factors involved, many of which have yet to happen and must therefore be the subject of at worst guesses and at best cautious estimation, it is tempting to ask how any analyst could know for sure that an independent FTA policy for the United Kingdom must deliver greater benefits for the UK than current EU strategy? Or, to be balanced, vice versa?

In the context of UK interests as represented by Brussels, one simple indicator is the extent to which exports to prospective FTA partners embody UK exports (i.e. jobs and overall economic activity.) To this end, we focus briefly to the value added contained in trade, that is, the economic activity embodied in exports. In Table 8 below, we report the value added contained in exports to destination, grouped by the FTAs that are in place, and those under negotiation.

Table 8: Value-added in exports, Share of GDP

	UK	Other EU	Total EU
European Union	0.10	0.16	0.15
European FTAs/CU	0.01	0.01	0.01
Other FTAs	0.01	0.01	0.01
On-going FTA negotiations	0.04	0.03	0.04
Other	0.03	0.03	0.03
total	0.18	0.25	0.24

Source: own calculations based on GTAP8 database.
See Francois, Manchin, and Tomberger (2013) for methodology.

From Table 8, existing trade agreements (including the EU itself) account for 12 percent of UK GDP on a value added basis, measured as value added embodied in exports. For the EU as a whole the share is much higher, at 17 percent of value added. When we look at preliminary and on-going FTA negotiations (including for example Canada, the United States, and Japan), these potential agreements account for 4 percent of UK GDP, measured as value added contained in exports, and 3 percent of value added for the remaining EU Members. On this basis, the recent choice of partners for FTA negotiations does appear consistent with UK interests, measured on this mercantile basis.

It might also be instructive to compare four FTA negotiations with Korea, a leading emerging market. Australia, Canada, the United States, and the European Union have all launched FTA negotiations with the Republic of Korea. Korea is a suitable comparator because its economy is large enough to be of interest to trading partners and to stiffen Seoul's backbone in demanding concessions from negotiating partners. Other large emerging markets share such characteristics with Korea. Can mid-sized nations obtain similar FTA deals with Korea to those of the behemoths of the trading system?

Table 9: A Comparison of Four Negotiations for FTAs with Korea.

Trading partner of Korea	GDP (current $ PPP adjusted), UK=100	Total imports of goods and services (current $, UK=100)	Status of FTA negotiations with Korea	Estimated gains (official claims)
Australia	43.4	38.8	Launched 5 March 2009. Stalled over agriculture and automobiles.	
Canada	63.6	67.9	Launched 15 July 2005. Stalled over agriculture and automobiles.	
USA	672.3	321.3	Announced 2 February 2006. Came into force 15 March 2012.	Total employment increase of 0.04% Total export increase of 0.53%
European Union	732.1	855.0	European Council gave permission to negotiate in April 2007. Came into force on 1 July 2011.	Total export increase of 0.69%
Memo: UK	*100*	*100*	*n.a.*	

Sources: GDP, export, and import data from World Development Indicators; official estimates of impact of FTAs with Korea taken from the websites of DG Trade and the United States Trade Representative.

Australia and Canada are English-speaking nations whose economies are closer in size to the United Kingdom than they are to the United States and the European Union (see columns 2 and 3 of Table 9). Likewise, the size of Australia's and Canada's total import bill, that is, the size of "market access" available to foreign suppliers, is closer to the UK's than the UK's is to the massive US market and the EU market (even if the UK is excluded.) While the concept "negotiating clout" is not one that is amenable to precise empirical measurement defending the proposition that, acting alone, the UK's bargaining leverage is closer to that of Australia and Canada than to the USA and the European Union is not entirely absurd.

The argument is also advanced that a nation acting independently could move more nimbly than a group of nations acting collectively, allowing free trade negotiations to be concluded more quickly even though the former has less negotiating clout than the latter. FTA negotiations with Korea are instructive in this regard as Canada started its negotiations with Seoul before the USA and the EU did, yet the Canadian-Korean FTA negotiations remain stalled (see column 4 of Table 9). Acting alone is no guarantee of success.

Another argument advanced is that the concessions that a nation can extract from a trading partner in a FTA negotiation depend on the nation's bargaining power. If the UK has less bargaining power than the EU and the USA, then the gains obtained by the UK acting independently would be bound from above by the gains the latter two obtained in their FTAs with Korea. Column 5 of Table 9 takes the official (and, therefore, possibly exaggerated) claims made about the gains from the US-Korea FTA and EU-Korea FTA at the time these accords were signed and converts them into percentages of well-known aggregates of national economic performance, in particular total employment and aggregate exports.

With all the negotiating clout that the United States has, it was able to extract from Korea concessions that would expand total employment in the US by just 0.04%. Even with generous assumptions about eliminating or reducing non-tariff barriers in Korea, the European Commission was able to boast a likely gain in exports that would increase total EU exports by less than 0.6%. These findings serve as an important reminder that—although estimates of the gains from FTAs frequently run into billions of euros and dollars—once scaled appropriately, even the behemoths of the world trading system negotiate FTAs with tiny effects. The dirty secret of FTAs is that they are almost always second- or third-order in their nationwide economic effects, a finding that will not change if the UK were to leave the European Union.

4.3 Negotiating free trade agreements with the United States

One purported advantage of departing the European Union is that a country would be free to negotiate free trade agreements with third parties. While much excitement surrounds deeper engagement with the faster growing emerging markets, a trade deal with the world's largest economy, the United States, is also a possibility. The purpose of this section is to identify the broader strategic lessons from the leading accounts of free trade negotiations between the United States and two mid-sized trading economies with Anglo-Saxon heritage, namely, Canada and Australia. This section does not claim to be a blow-by-blow account of these negotiations.

The Canada-United States Free Trade Agreement (CAFTA) was signed in January 1988. In terms of the economic integration of the Canadian economy with its American counterpart, this accord is widely regarded as more significant accord than the subsequent North American Free Trade Agreement (NAFTA) that included Mexico.[16] The free trade agreement between Australia and the United States was negotiated later and was signed in May 2004. The Canadian deal, therefore, represents one of the earlier FTAs that the United States negotiated, whereas the Australian accord was signed as part of the "Competitive Liberalization" strategy pursued by the US Administration of President George W. Bush.[17] Security policy considerations were a prominent feature of the latter policy. Having said this, Canada and the United States share a wide common border, the relevance of which will become apparent.

The leading accounts of these two negotiations differ in authorship, which ought to be borne in mind in assessing what follows. The Canadian account[18] was written by three of the officials involved in the negotiation while they remained in public service. Not surprisingly this text is quite restrained, still it contains a number of useful and occasionally pointed remarks. An independent professor, still a fully paid up member of the small elite circle of Australian trade policy experts, wrote the leading account of the negotiations of the free trade agreement between Australia and the United States[19]. The latter account is, to put it mildly, frank and this may reflect the extraordinary events surrounding the conclusion of that accord. The author in question had access to many of the senior negotiators on the Australian side and has backed up her claims with numerous media reports. According to Google Scholar, the Canadian account has been cited 89 times since it was published in 1994. The Australian study is of more recent vintage, published in 2005, and has been cited 55 times. Even though

[16] Indeed, some observers have argued that some of the binding provisions in the CAFTA were weakened in the NAFTA, at the insistence of the United States.

[17] For an account and analysis of the US strategy of Competitive Liberalization see Evenett and Meier (2005).

[18] Michael Hart, Bill Dymond, and Colin Robertson. *Decision at Midnight: Inside the Canada-US Free-Trade Negotiation.* UBC Press. 1994.

[19] Ann Capling. *All the Way with the USA: Australia, the US and Free Trade*. UNSW Press. 2005.

the commercial interests of Australia and Canada differ, these accounts share some common insights into negotiating with the United States.

The Canadian-US negotiation

On October 1st and 2nd 1985 President Reagan and Prime Minister Mulroney exchanged letters indicating their intention to launch negotiations on a free trade agreement between Canada and the United States. These negotiations proceeded until an impasse was reached in September 1987 and on September 23rd Canada suspended the negotiation because "the United States is not responding to elements fundamental to Canada's position" (Hart *et al*, page 422.) The impasse was broken at the political level between 2-4 October 1997 and the accord subsequently came into force on 1 January 1989.

Hart *et. al*'s account of the causes of the impasse is revealing as it points to differences in objectives, in linkage between FTA and multilateral trade strategy, in perceived willingness to change, and in operational method. Their interpretation is:

"The lack of progress reflected the seemingly irreconcilable differences of approach between the two sides. Canada saw the purpose of the negotiations to be the establishment of a wide-ranging and comprehensive free-trade agreement that, by the end of the century, would provide for open and secure movement of all goods and services as well as better rules for the movement of investments and people between the two countries. The United States saw the negotiations basically as an opportunity to resolve outstanding irritants and make a head start on its multilateral trade negotiating agenda. Rather than envisioning a freestanding and comprehensive trade and investment agreement, US negotiators saw the agreement as an adjunct to the GATT. The vision of a big deal between the world's two largest trading partners seemed beyond the grasp of the US negotiating team. Interagency rivalry coupled with the apparent absence of firm leadership, at both the political and bureaucratic levels, had stymied the negotiations for months.

"While the media focused on dispute settlement as the main stumbling block, the differences were wider and more profound. For example, it was by now clear that the United States was unwilling to consider anything more than minor adjustments on procurement and technical standards and was seeking only a small deal on trade in services. Their demands on issues like intellectual property, investment, and subsidies, especially as they related to culture and regional development, were unreasonable and betrayed a continuing ignorance of Canada. Reluctance to make any significant move on issues that required changes to

existing US legislation demonstrated both a lack of commitment and of clout. On every issue that mattered, the gap was very wide indeed. Even relatively minor matters had not yet been resolved." (pages 297-8)

Digging deeper, it was argued that the priority attached to international commerce as a determinant of national living standards differed greatly between Canada and the United States, the latter's home market was at the time ten times the size of the former's. Hart and colleagues argue that:

"In the United States, the level of political attention in the cabinet and the White House had to correspond to the place which trade held in the national agenda. That place had been steadily rising over many years, but it always competed for space with issues such as arms control negotiations with the Soviets… Despite Canada's appeals, the bilateral trade negotiations had yet to reach the top of the US political agenda." (page 312)

Canadian officials also made the error of assuming that just because the US president assured them that he wanted a comprehensive accord that the rest of the American government wanted that too. That the US Congress retains the constitutional prerogative on trade policy matters was overlooked, as the following observation reveals:

"It was not sufficiently understood on the US side that in Canada when the prime minister decides, the bureaucracy swings into action and delivers. By contrast, in the United States, the president's voice is important, but it is not the only voice. The US team, operating in an entirely different political system, certainly knew that the president and his senior cabinet officers wanted in an agreement, but they also had a lively sense of what would be acceptable to the American business community and Congress. Tough, slow, nerve-wracking negotiations were the result, characterized by mutual doubt" (Hart et al, page 314)

It is telling, then, that when the deadlock was broken both senior US cabinet and congressional officials were involved (Hart *et al*, chapter 15). In particular, Hart and colleagues note:

"Given the role of members of Congress in bringing the two sides back to the table, chances of success in Congress had also been strengthened. The failure of both sides to deal adequately with Congress throughout the course of the negotiations had in many ways been neutralized by the strange course of events at the end of the negotiations. Indeed, critics in Congress over the ensuing few weeks expressed their concerns in muted terms" (page 342).

Hart and colleagues credit US officials with ultimately not wanting the negotiation to fail. Canada made concessions in areas where the US Administration needed to show short-term gains, while reckoning that the basic deal remained intact. On some issues (e.g. trade in services and government procurement) ambition was scaled back and, at best, the foundations laid for future liberalisation. On other issues—such as intellectual property—the United States withdrew its demands, reasoning "that no loaf was better than half a loaf" as Hart *et al* put it (page 341).

Overall, Hart and colleagues assess that the FTA with the United States was a "good agreement" for Canada (chapter 17). Their defence begins, perhaps curiously for trade negotiators, by rejecting the mercantilist calculus of concessions in trade negotiations, noting instead the limited negotiating clout that Canada has in the world and the harm done to Canadian living standards by restrictions on international commerce—including Canadian restrictions. On their view, then, trade accords that remove trade barriers—and that constrain government behaviour—are beneficial. When those barriers are removed by both parties, as they certainly were in the case of tariffs in the CAFTA, the associated accords are mutually beneficial. The "bottom line" assessment of the accord from Hart and his colleagues is that even with the attendant compromises both parties benefited from the accord, that on net Canada benefited more, and that those benefits depended on Canada making investments in upgrading and restructuring their industry to take advantage of tariff-free access to the US market (page 384-5).

The qualified and conditional nature of the claims made by Hart and his colleagues is of interest, especially in the light of subsequent slowing down of trade across the US-Canadian border as a result of more extensive security checks implemented after the 11 September 2001 attacks in Washington DC and New York City.[20] Even the US Chamber of Commerce has recognised the link between such security considerations and the reduced gains from the NAFTA accord.[21]

The Australian-US negotiation

With respect to the negotiation of a free trade agreement between the United States and Australia, it is worth noting that before the government of Prime Minister Howard decided to seek such negotiations in November 2000, previous Australian governments had turned down

[20] This is not to imply that security-related matters are the only factor slowing down the movement of persons and goods across the US-Canadian border.

[21] See http://www.uschamber.com/sites/default/files/reports/1112_INTL_NAFTA_20Years.pdf (Hyperlink to US chamber of commerce report on the US-Canada FTA).

US entreaties to liberalise trade bilaterally in 1985, 1992, and 1997.[22] Although Australia had negotiated free trade agreements with Thailand and Singapore before launching negotiations with the United States, it had long been the stated policy of the Australia to support non-discriminatory trade reforms through the multilateral trading system. Moreover, one Australian prime minister had publicly stated that his country would never discriminate in its trade relations against Japan, a large trading partner (Capling page 41). Thus, many observers regard the Howard government's pursuit of a free trade agreement with the United States as a significant turning point in Australian trade policy.

Hitherto Australian leverage with the United States on bilateral trade matters was limited, as evidenced by two disputes that arose in the years just before the free trade negotiations were launched (Capling page 43). Australia was unable to stop the United States from taking action against imports of allegedly subsidised leather and from imposing restrictions on imported lamb, the latter despite a direct intervention by the sitting Australian prime minister to US President Clinton. Both barriers were eventually removed but only after Australia exercised its rights at the World Trade Organization. Capling draws the following conclusion from these two episodes:

"This brief experiment with aggressive bilateralism should have reinforced the time-honoured lesson about the limits of Australia's bilateral leverage in dealing with major powers on trade issues. The limits are especially evident in Australia's dealings with the United States where, regardless of the merits or morality of its case, the nature of the congressional system means that domestic producer politics trump Australia's interests every time" (page 43).

Australia has a longstanding and close security relationship with the United States as evidenced by, amongst others, the ANZUS treaty.[23] That security relationship is pertinent for two reasons. First, in 1999 Australia mishandled intelligence cooperation with the United States over events relating to East Timor.[24] Second, the Australian government sought to reassert its cooperation on security matters with the United States after the events of September 2001. Indeed, senior United States and Australian officials made reference to the

[22] Capling identifies three reasons—including limited economic benefits—for Canberra's rejection of these overtures.

[23] Formally, The Australia, New Zealand, United States Security Treaty, signed in 1951.

[24] US assessments of the reliability of Australia as security partner then went under a clout, perhaps not unlike the potential US reaction to the recent vote in the UK parliament against military intervention in Syria.

security relationship when the FTA negotiations were formally launched (see pages 53 and 54 of Capling.) This too marked a departure for Australia. Capling notes:

"It had been a cardinal rule of Australian foreign policy that commercial, political, and security interests should not be mixed, for fear that frictions in the trade relationship could not be quarantined from other aspects of Australia's bilateral relationships. This view was held by trade, foreign, and defence policy experts alike" (page 54).

Like the Canadian negotiation, the Australian-US trade negotiation seemed like it would ultimately fail. The liberalisation of the US import regime for agricultural products—notably sugar, dairy, and beef—was a key negotiating priority of Australia. In February 2004 Australian trade negotiators recommended to their ministers to abandon trade talks, not least once the US refused to "budge" on its agricultural offer (Capling page 56), while insisting that all of its agricultural exports enter Australian markets duty-free. The American position on beef, for example, did not change despite a personal intervention by Prime Minister Howard to US President Bush. Even so, the Australian prime minister overruled the objections of his senior negotiators and instructed his trade minister to conclude the negotiation, as the latter did with his US counterpart on 8 February 2004.

Defenders of the Australia-US FTA argue that the emphasis on trade policy is misplaced. In their view, this accord represented an attempt to integrate Australia's economy with the United States, by adopting more common policies and institutions. Even by the standards of such economic analyses, the divergence of estimates of the net benefits to the Australian economy of this accord was substantial—ranging one hundred fold! The Australian Senate commissioned a leading Australian trade economist to estimate these benefits and her best estimate was a gain of 53 million dollars. Even the serving trade minister acknowledged the deal was a "disappointment"[25] and Capling reports that he conceded the benefits were in the millions, rather than billions, of dollars (page 58). Capling distinguishes between the influences of the close Australian-US cooperation on security matters on the willingness of the US to launch FTA negotiations with the terms upon which the US would ultimately settle those negotiations. She argues:

"Some media commentators—and some politicians—seemed to believe that the Bush Administration would 'reward' Australia for its decision to go to war in Iraq. There was a reward, and it had come in the form of President Bush's agreement in November 2002 to

[25] See http://www.theage.com.au/articles/2004/02/09/1076175101703.html (Hyperlink to assessment of the Australia-US FTA).

negotiate the trade agreement with Australia. But it was not within the president's gift to provide Australia with good outcomes in the agreement itself, as the substance of the agreement was always going to be determined by congressional politics. Had Bush supported a generous deal on agriculture as a reward for his valued ally the war on terror, Congress would have sunk the agreement. As it turned out, the deal on agriculture was designed to cause the least offence to the most highly protected sectors of US agriculture" (page 67).

Worse, having started the FTA negotiation, Capling argues that because of the security relationship that Australia could not walk away from these talks without harming its overall relationship with the United States—in contrast to, among others, South Africa which had abandoned FTA negotiations with Washington. At the signing of the FTA, the Australian trade minister said of the trade accord "This is the commercial equivalent of the ANZUS Treaty." Capling concludes:

"But this linking of trade, foreign, and defence policies had its downside as well. The meshing of Australia's economic, political, and security agendas made it impossible extract the trade agreement from the mix" (page 75).

A strong security relationship between Australia and the United States proved, then, to be a double-edged sword for Canberra. The potential for collateral damage to the overall US-Australia relationship should Canberra walk away from a bad trade deal arguably weakened the hand of Australian trade negotiators. In the light of these considerations, part of the American rationale for fusing trade and security considerations in the Bush-era policy of Competitive Liberalization becomes apparent.

Implications for the United Kingdom

The experiences of Canadian and Australian counterparts in their negotiations with the United States should give UK officials pause. Many of the reasons why those negotiations fell short of Ottawa and Canberra's goals would apply to any future US-UK negotiation over a free trade agreement. That US administrations can launch trade negotiations must not be confused with the fact that, in the US Constitution, it is Congress that ultimately decides whether, and upon what terms, a trade agreement is approved. Congress is no rubber stamp and is prepared to act independently, with the implication that the any deal that is enacted into law is almost certainly going to be less advantageous than whatever accord is reached with the trade negotiators of the US Executive Branch.

While the US has in the past instituted so called “fast track” procedures to limit Congressional amendments to bills relating to trade agreements, Congress is still entitled to reject a FTA put to it. Moreover, and this is less well appreciated, Congress still exercises influence over the text submitted to it by the executive branch.[26][27] Therefore, the deal that the UK initials with a US administration need not be exactly the same deal that the US Congress legislates ultimately. Domestic commercial and other interests are free to influence members of the US Congress after any foreign government initials a trade deal with trade negotiators from the US Executive Branch. This creates the appearance, if not the reality, of two sets of negotiations: first with the Executive Branch and, secondly, indirectly with the US Congress.

The second major implication for the UK concerns its strong non-trade-related diplomatic and military relationship with the USA. There should be no illusions about expecting the latter to “deliver” a high quality FTA that is of significant commercial interest to the UK. The parallels to the Australia-US FTA negotiation are evident. A strong security partnership is, as argued earlier, a double-edged sword: it makes not only the launch of a FTA negotiation with the USA more likely but also increases that the odds that the UK will be offered a deal on US terms, indeed a deal that the UK will find it hard to reject for fear of harming its overall relationship with Washington. Moreover, given the greater importance of trade and investment to the UK economy than to the US, as their Canadian counterparts discovered British officials will find themselves disadvantaged during the inevitable haggling by wanting a deal more than their negotiating partner.

In sum, for constitutional, national security, and economic reasons, any assumption that a UK departure from the European Union would pave the way for the signing of an ambitious free trade agreement with the United States—juiced up because of the “special relationship” between London and Washington DC—is at odds with the experience of other Anglo-Saxon countries that have sought far-reaching trade deals with American counterparts.

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[26] See for example this statement by an influential senator concerning the enactment of the US-Singapore and US-Chile Free Trade Agreements, http://www.finance.senate.gov/imo/media/doc/071003mb.pdf (Hyperlink to a statement on the US-Singapore and US-Chile Free trade agreements]

[27] A more recent, telling Congressional intervention during the non-markup process of the US-Korea FTA, amongst others, can be found at http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=250265 (Hyperlink to a Congressional Intervention on the US-Korea FTA).

Chapter 5.
Concluding remarks.

EU competence in commercial policy is complex and has evolved markedly over time. To a non-specialist, it no doubt appears daunting and the costs and benefits of the associated diplomatic and bureaucratic machinery may appear opaque. Worse, there are few available, readable attempts to state and critically assess the purported rationales for EU competence. Experts in the field may take such rationales for granted, others are entitled to ask "why?" This report seeks to fill the gap, drawing upon the insights and arguments in the available legal, economic, and political science analyses of EU commercial policy.

There are four broad rationales for EU competence. No single rationale can justify the current configuration of EU competence in commercial policy, but combinations of these rationales probably can. That is not to say that the rationales are without their weaknesses. Defenders of EU competence in commercial policy would do well if the case for pooling sovereignty in this area of policymaking were revisited and refined.

Some of the rationales advanced for EU competence in commercial policy could provide a coherent and solid defence of the proposition that there are substantial economic and commercial benefits to governments giving up their rights to act independently in many areas of trade-and investment-related policymaking. After all, the economics of commercial restrictions are well accepted. On net, such restrictions harm national economies and almost always there are better means to attain the same goals. One of the benefits of trade agreements is precisely that they tie the hands of governments that might otherwise be tempted to implement resource-misallocating measures often in response to short term gain.

Assessing the purported rationales for EU competence in commercial policy is valuable because it helps identify the challenges that pooling sovereignty sought to overcome. These challenges have been used to form criteria with which to compare six alternatives to EU membership with one another and with EU membership itself. The principal findings in this regard are summarised in Table 3. Alternatives to EU membership hold out the promise that greater freedom of movement in trade relations with non-EU nations, including the faster-growing emerging markets, can deliver tangible commercial benefits. These benefits, conditional as they are, are to be weighed against the losses in terms of reduced resistance to protectionism at home and abroad, forgoing influence over the development of the EU internal market and associated reforms, and greater costs in accessing the EU's markets whether through higher tariffs or more time and money spent filling in the paperwork to meet burdensome Rules of Origin.

While joining a customs union with deep structural elements implies a transfer of competence of basic aspects of commercial and industrial policy, it also implies reduction in administrative burdens and regulatory trade and investment costs. The economics literature has identified trade costs from rules of origin, for example, ranging from 4 percent to 15 percent to the cost of goods sold. Non-tariff barriers are also quite high for non-EU firms trying to access the single market. Limiting these costs provides a basic, economic logic for pooling sovereignty and constraining Member States to a common external policy. Exports to the EU account for 10 percent of UK value added. Any assessment of alternative arrangements vis-à-vis third country policy flexibility therefore needs to include possible exposure to trade costs for accessing the single market itself, when organising the decision calculus. It also needs to include the benefits of wielding the weight of a large block in trade disputes in places like the WTO's dispute settlement body, versus a likely reduction in clout as a smaller trading country on one's own.

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