Chapter 1

Trade

The summary

- Successive UK Governments have had to weigh up the costs and benefits to the UK of membership of the EU. Costs are typically seen as contribution to the EU budget (largely to fund the Common Agricultural Policy and Structural Funds), the cost to business of regulation, and the loss of sovereignty over a range of policy areas. The benefits are typically described as free access to the EU market for trade, free movement of people, and increased geopolitical influence. Successive governments have failed to explain whether the benefits outweigh the costs.
- The EU remains the world's largest customs union and the most important market for UK business. Roughly half of the UK's total exports of goods and services go to the EU, and just over half of total stock of Foreign Direct Investment in the UK is from EU businesses. However, estimates put the 'Rotterdam-Antwerp effect'—where UK goods bound for non-EU markets are transhipped through Rotterdam or Antwerp, and hence recorded as exports to the EU—as high as 10% of UK goods exports.
- Current trends indicate that growth in the EU is slowing, exacerbated by the continuing eurozone crisis. Long-standing structural weaknesses in European economies are being brutally exposed by the financial crisis. Many new business opportunities will no longer be within the EU, but rather will be found in the major emerging economies which are increasingly driving global economic growth. There is a risk that UK businesses are hampered in competing in these markets by overregulation at the EU level.
- Significant opportunities for growth in trade with the EU remain, particularly in the services sector. Services account for 71% of EU GDP, but only 3.2% of this is from intra-EU trade. The UK government continues to push for the completion of the Single Market, especially in services; however, substantial obstacles remain.
- Financial Services is a critical industry for the UK. It accounted for an estimated 11.2% share of tax receipts in 2009-10, and provided a trade surplus of £31.5 billion in 2010. Pre-financial crisis, EU regulation had a largely liberalising effect across Europe, but post-crisis, the trend had been in the other direction. The EU is considering or developing 49 new regulatory proposals that could affect the industry a great many of which are aimed at constricting rather than enabling the industry. That is why the Prime Minister used the veto in December.
- The EU continues to push for further liberalisation with trading partners around the world. External trade policy is an exclusive competence of the EU under the umbrella of its Common Commercial Policy (CCP). As such all external trade negotiations are undertaken on behalf of the UK and all other Member States by the European Commission.
- Currently, the EU is pursuing a number of bilateral FTAs with countries and regions across the world, including, among others, Canada, Singapore, India, and Mercosur and has recently concluded deals with South Korea, Columbia and Peru as well as the Central American Region.
- The UK must balance the potential benefits of increased 'clout' in negotiating as part of the EU against the cost of having deals that are not specifically tailored to UK interests.
- At some time, a tipping point may be reached when the UK judges that the costs of EU membership outweigh the benefits. If this were the case, the UK could withdraw from the EU by invoking Article 50 of the Treaty on European Union. The UK would then negotiate a withdrawal agreement and framework agreement for the UK's future relationship with the EU. If this were not concluded within two years, or an extension agreed, the EU treaties would cease to apply, and the UK would trade with the EU on most favoured nation (MFN) terms of the World Trade Organisation (WTO).
- Analysis indicates that under MFN terms, around half of manufactured exports to the EU would face an average tariff of over 5%, with some sectors particularly hard hit. UK car exports to the EU would face tariffs of 10%. This would have a significant effect on UK business, and make the

UK a less attractive location for FDI. The UK would also lose its influence on framing EU regulation, and it is unlikely to be an option that any UK government would seek.

- A number of alternative models have been considered:
    - The EEA or "Norwegian Option" —The UK would be outside the customs union, and hence subject to complex and costly rules of origin. The UK would still be subject to most EU regulation, but with little ability to shape them. Access to the single market for goods and services would be maintained, and the UK would not be subject to CAP, CFP, or regional policy, and is likely to have a significantly reduced budget contribution.
    - A Free Trade Agreement or "Swiss Option"—Outside the customs union and subject to rules of origin, but not formally subject to EU social or product regulation. In practice, all product regulation is likely to be replicated in order to export to the EU. Not subject to CAP, CFP, or regional policy, and likely to have a significantly reduced budget contribution. Free trade subject to negotiated agreement.
    - Part of the Customs Union or "Turkish Option"—Member of the customs union, so with free access to trade for goods— services and agricultural products are not covered. Required to negotiate free trade agreements with any country that the EU opens trade negotiations with. Outside the EU Treaties and Institutions, so not subject to CAP, CFP, or regional policy, and not likely to make a significant budget contribution. Not subject to social regulation, but subject to all product regulation.
- All of these options appear to come with major drawbacks, and they are not likely to be acceptable, either to the UK or to the rest of the EU.

The options for change

➔ Work within the current system to minimise the costs of membership and maximise the benefits. Ideas on how to improve the CAP, CFP, Regional Policy and Social Policy have been covered in other chapters of this Green Paper.

➔ Continue to press the EU to negotiate free-trade agreements between the EU and the rest of the world.

➔ Continue to develop bilateral relationships to help UK businesses prosper in non-EU markets.

➔ Negotiate the completion of the single market, particularly in services to increase opportunities for trade for UK businesses.

➔ The UK government could seek a unilateral brake on EU financial services regulation through a legally binding protocol attached to the Treaties. This would assert the special circumstances that are the UK's stake in financial services, requiring the Commission to reconsider proposals that impact disproportionately on the UK, and would give the UK a right of appeal for any proposal before it had been agreed by the Council and European Parliament. This would give the UK a veto, because unanimity applies at the European Council level.

➔ The UK could negotiate changes to the treaties to allow member-states to pursue their own bilateral deals on investment.

➔ If the EU bureaucracy and regulation prevents the UK from developing global reach and makes the intra-EU trade no longer attractive, each of the alternative models described above would constitute withdrawing from our existing EU treaty obligations.

The introduction

Successive UK governments have had to weigh up the costs and benefits to the UK of membership of the EU. Costs are typically seen as contribution to the EU budget (largely to fund the Common Agricultural Policy and Structural Funds), the cost to business of regulation, and the loss of sovereignty over a range of policy areas. The benefits are typically described as free access to the EU market for trade, free movement of people, and increased geopolitical influence. Successive governments have failed to explain whether or not the benefits outweigh the costs.

The detail

External trade policy is an exclusive competence of the European Union (EU) under the umbrella of its Common Commercial Policy (CCP). Article 207 of the Lisbon Treaty (TFEU) stipulates that it includes trade in services and goods, intellectual property and foreign direct investment (FDI). Under the CCP, all EU Member States must apply the same external tariff with trading partners. The European Commission's Directorate General for Trade (DG Trade) is responsible for negotiating trade agreements on behalf of all Member States.

As a result of the ratification of the Lisbon Treaty, the European Parliament must now give its consent to all trade deals negotiated by the Commission - in this respect it enjoys what are known as powers of "co-decision" with the European Council, the body made up of EU Member State representatives. However, the Parliament is not responsible for giving the Commission pre-authorisation to begin negotiations with partners; rather this is the responsibility of the Council of Ministers acting on a mandate proposed by the Commission. Nevertheless, this arrangement effectively gives the European Parliament a veto over any trade package negotiated by the Commission and as a result, it is important that it take the Parliament's concerns into consideration during the negotiating process.

Therefore, the UK has to conduct its trade policy almost entirely through the mechanisms of the EU, leaving very little room for manoeuvre on its own. However, as will be mentioned later, the UK can use its considerable bilateral ties and resources to promote UK companies abroad and to facilitate imports as well as inward investment towards the UK. The EU is the world's largest economy and trading bloc. It accounts for almost 29% of global output, 15% of global trade in goods and 24% of overall global trade. Consequently, the EU is a major player in world trade talks, and partner countries are generally speaking keen to gain access to one of the most attractive markets in the world. In this regard, the Commission, on behalf of the Member States, seeks to leverage said access to the EU market in return for concessions from trading partners. Its size and importance gives it considerable clout when negotiating deals on behalf of Member States.

Trends

Europe remains the world's largest customs union and in addition, is the most important market for UK business. With Europe making up roughly half of the UK's total exports of goods and services and seven of the UK's ten main export markets, as well accounting for just over half of total stock of FDI, Europe's importance will remain crucial for the foreseeable future.

The single market has been an important driver of growth and UK businesses have benefitted from wider and deeper relations with other EU Member States. In fact, the UK has been one of the drivers of the single market, realising that it will benefit from increased liberalisation.

About 25% of the UK's trade is with other developed countries world-wide, with the US, Canada, Australia, Japan, EFTA and New Zealand. Although these markets are relatively low growth areas, they will remain important, indeed it is estimated that over the last ten years the UK's trade with the latter has increased by around 50%.

However, current trends indicate that growth in the EU is slowing, exacerbated by the continuing Eurozone crisis. Long-standing structural weaknesses in European economies are being brutally exposed by the financial crisis. Many new opportunities will no longer be within the EU, but rather will be found in the major emerging economies which are increasingly driving global economic growth.

If the UK is to make the most of its trading relations, two key objectives must therefore be achieved. Firstly, the UK must work towards further liberalising the Single Market and the reform of the wider European economy to increase competiveness and growth. Secondly, the UK must work to ensure that the EU negotiates deals that give UK firms access to global emerging markets. Should meeting these two objectives become problematic through the current EU trading framework, other options must be considered.

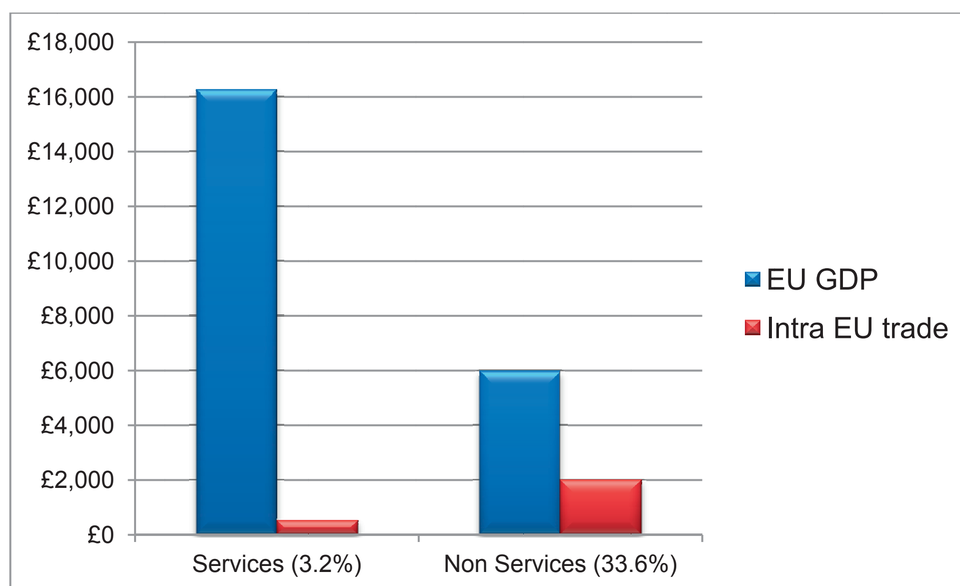
Liberalisation within the Single Market

The EU single market has long been championed by the UK, which it sees as central to ensuring the continued success of UK business. Having come into force in 1992 via the Single European Act (1986), it was designed to eliminate the remaining barriers to trade under the umbrella of the Customs Union.

The European Commission's 2002 ten year review of the Single Market estimated that EU GDP would have been 1.8% lower a decade after the treaty's signing than without the implementation of the single market. In addition, a 2007 report argued that the Single Market's development had led to a 2.2% increase in EU GDP in 2006 and the creation of 2.75m additional jobs. Furthermore, the single market acts to boost trade between Member States and in the case of the UK, the Department for Business, Innovation and Skills (BIS) has estimated that increased trade in Europe since the early 1980s could be responsible for a 6% increase in British per capita income.

Despite this, and with substantial obstacles still remaining, trade in goods in the current Single Market has made much more progress than trade in services, a sector of enormous importance to the UK. Should the UK be able to make a significant push towards liberalisation of the single market, the benefits could be considerable. BIS has estimated that it could result in raising EU GDP by 14% over ten years.

Unrealised potential: intra-EU trade as a share of services and non-services EU GDP (€ bn)



Source: *Eurostat*[26]

Nevertheless, considerable obstacles remain. While EU Member States have removed many of the major obstacles that affect commerce, they have been far less forthcoming when it comes to removing non-tariff barriers (NTBs) and technical barriers to trade (TBTs), frequently in the form of domestic regulation, in addition to linguistic and political obstacles. For example, the 2006 Services Directive, a piece of legislation designed to liberalise cross-border service provision in the EU, represented a significant watering-down of the Commission's original proposals, including the removal of guidelines designed to allow service providers to work in other Member States according to the rules of their country of origin, as well as rules allowing governments to impose restrictions broadly justified in the name of consumer protection, the environment and public health. In addition, the difficulties faced by the EU in liberalising services sectors constrains the EU's ability to take a lead on global services liberalisation, a competitive and fast growing sector.

The UK also finds itself in a challenging position concerning financial services. The UK currently accounts for 36% of the EU's wholesale finance industry and 61% of EU exports in financial services. While London has traditionally been seen as a gateway to the EU Single Market, new waves of legislation following the financial crisis have seen the UK losing influence, a fact compounded by the voting system in the European institutions which fails to adequately take into account the relative size of the industry in the UK, and results in Britain's financial services sector being under-represented.

Other major trade-related arguments in favour of EU membership concern investment and enlargement. Regarding investment, the Single Market has contributed to growth of inward FDI (the car industry being well known example) to the UK and outward FDI by the UK to other EU countries, mainly as a result of increasing returns on investments. The deepening of the Single Market would increase this trend by further improving these trade flows in relation to services.

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[26] *Eurostat*, trade integration, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Trade_integration,_EU-27_(1)_(%25_of_GDP).PNG&filetimestamp=20090430100045 http://epp.eurostat.ec.europa.eu/tgm/web/table/description.jsp.

One EU policy area where the UK has led from the front and been very successful is on enlargement. In face of opposition from countries more hostile to expansion, the UK has succeeded in convincing other Member States of the need to welcome Eastern European countries to the "club". This has had the added advantage of increasing the size of the market open to firms, however, previous decisions concerning immigration have caused problems in some Member States, particularly the UK. This should not prevent the UK from continuing to support enlargement as it will allow for increased market access to new Member States, however, with widespread "enlargement fatigue" across the EU this may prove difficult in the short-term.

Liberalisation with major trading powers and emerging economies

Firstly, it should be recognised that the size of the EU market makes it an extremely powerful player globally concerning trade not only at a multilateral level at the WTO, but also in bilateral relations with other countries. Third countries want access to its market and in return the EU can demand considerable concessions. The EU can therefore act as a proxy to ensure that the UK gains access to markets around the world with a degree of success and penetration far exceeding what smaller, less powerful players would be able to.

In this regard, a trade off between benefitting from the EU's clout despite its constraints and having a policy tailored specifically to suit the UK is the delicate balancing act that drives the actions of the UK Government in Brussels. This point is especially important given that the other major global players, both current and future, such as the USA, China and India are considerably larger than the UK and it remains an open question whether large trading partners would be interested in negotiations with the UK and willing to make worthwhile concessions in the framework of a trade deal.

Currently, the EU is pursuing a number of bilateral FTAs with countries and regions across the world, including, among others, Canada, Singapore, India, and Mercosur and has recently concluded deals with South Korea, Columbia and Peru as well as the Central American Region. This strategy must be encouraged as much as possible by the UK with a view to ensuring that an agenda of ongoing liberalisation is maintained.

In spite of this, there are difficulties that the UK experiences as a result of the Commission negotiating on behalf of all 27 EU Member States. Whether or not the UK is able to overcome these difficulties will be crucial in deciding whether or not continued EU membership is in its national interest. For example, the EU, like many others, grants high levels of protection for its agricultural sector and while a serious reform of the measures distorting trade has been undertaken, much remains to be done. The average Most Favoured Nation (MFN) tariff is 15% and in some areas such as dairy and fruit/vegetables, tariffs can be as high as 156% (such as is the case with dairy products). One example of where agriculture has been a stumbling block preventing market access in areas such as services is with Mercosur. At the Doha Round, the EU made a considerable concession in significantly reducing agricultural tariffs, however, other trading blocs and countries were more reluctant to match these allowances.

One interesting point that should also be considered is that if the business of one specific Member State is targeted by a trading partner, that is considered to be an attack on all Member States. For example, should Argentina decide that it would, in contravention of WTO rules, put in place barriers to the trade of UK companies, the EU considers this (through its exclusive competence) as an attack on all EU countries. Furthermore, the future of trade will be increasingly focussed on Non-Tariff Barriers to Trade including Technical Barriers to Trade. The EU, as a large player will be more able to have a strong influence on world standards that will be adopted in the future, allowing for a competitive advantage for EU firms.

Given that the trade policy is an exclusive competence of the EU, it would appear at first examination that the UK Government's bilateral room for manoeuvre is limited. Admittedly, access to markets will be governed by a framework of EU relations, however, the UK can do much unilaterally to ensure that its firms receive favourable treatment and are allowed to penetrate markets successfully. This is particularly relevant where the EU does not have preferential access to a third country's market.

Although the multilateral trading system is likely to remain the fundamental basis of world trade, bilateral relations between sovereign countries will continue to be of importance. It is fundamental to the future success of the UK that we cultivate long-standing relations and cultivate new ones in parallel to the EU's efforts. In this regard, the UK is especially well placed, with historical ties to a number of current players as well as potential partners whose significance will increase in the years to come.

The UK Government can be of assistance to UK firms in a number of ways.
Firstly, the UK must ensure that the country remains an attractive place for trade and investment, as well as doing all it can to assist UK firms operating in markets abroad. UK Trade and Investment should continue to work at offering advice and guidance to businesses of all types on trading internationally, as well as investing in foreign markets.
In addition, British commercial diplomacy could be improved and exporters should receive enhanced guidance and advice, capitalising on close bilateral ties to help them gain access to growth markets. In particular, this advice should be aimed at SMEs and should be aimed both where market presence is already strong, and in fast growing emerging markets that will provide the best future opportunities. In addition large diaspora populations living in the UK and their links with their countries of origin could be used to harness trading relations with partners around the world.

The case study: access to public procurement markets

Proposal for a Regulation of the European Parliament and the European Council on the access of third country goods and services to the Union's internal market in public procurement and procedures supporting negotiations on access of Union goods and services to the public procurement markets of third countries.

What it is?

On the 23rd of March 2012, the European Commission adopted a proposal for a Regulation in the EU's international procurement policy area. The stated aim of the proposal was to "improve conditions under which EU businesses can compete for public contracts in third countries." The Commission's justification for the proposal was that EU suppliers currently face restrictive procurement practices in many of the EU's main trading partner countries. In addition, the proposal aimed to confirm "the legal status of bidders, goods and services from countries that have an international agreement with the EU in the area of public procurement" while clarifying "the rules applicable to bidders, goods and services not covered by those agreements."

Commission's Justification

Certainly, the EU maintains a very open policy compared to other trading partners, but with China only opening a fraction of its potentially enormous market to foreign bidders. Moreover, the financial crisis has led to many countries enacting protectionist measures to favour domestic businesses. In total, the Commission has estimated that over half of the

world's market is closed, a share that is currently growing. Going by the logic that, given the rising importance of emerging economies and the absence of a level playing field, the Commission argues that the EU must act now to gain leverage in international negotiations with trading partners in order to redress the imbalance and gain substantial market access commitments for the benefit of EU business.

The battle in Council

The battle developing over the proposal encapsulates the current tensions within the EU over trade policy. The principle of reciprocity has long been championed by France, with Nicolas Sarkozy making it a central tenet of his unsuccessful re-election campaign. Tension exists between countries which wish to see mercantile reciprocity (led by, but not exclusively comprising the “club med”) and those, led by the UK and Germany, who see this as a damaging policy long-term.

Some policy makers have observed that smaller EU member states lack the administrative capacity to properly analyse the Commission's proposals and their potential effects, and will be more easily swayed by the immediate appeal of protectionist logic.

With its trade deficit at record levels in 2011, and without significant improvement in sight, France's fall back on protectionist policies is likely to be a continuing trend, further exacerbated by the election of Francois Hollande, the Socialist candidate. The UK must seek to work with other like minded countries to head off a creeping threat from a regulation that would not be in its interests should it come into force. Current developments are encouraging, however, future events cannot be foreseen with any certainty.

The battle in the European Parliament

Under the Lisbon Treaty the European Parliament enjoys powers of co-decision over trade policy. The European Parliament has been vocal in its calls for "reciprocity" in public procurement policy with emerging economies. On the 23rd of May 2012 it adopted in a resolution on trade relations with China containing a paragraph calling for reciprocity with all emerging economies. Furthermore, MEPs have consistently been urging the Commission to come forward with this instrument. This is clearly not in the UK's interests as to a large extent, as a more global trading nation than most, it relies on third country market access. This could be put into question should the EU's partners retaliate against what they see as a protectionist ploy from a supposed champion of open global markets. However, these arguments are unlikely to resonate with the majority of MEPs, whose sentiments tend to be more protectionist than liberal.

Significance

The instrument draws upon the classic EU split when it comes to trade. The southern, more protectionist countries are lined up against the more liberal nations of the north. To a large degree, the result could prove indicative of future developments in EU trade policy. Should the more protectionist bloc triumph, it might augur poorly for the liberal Member States, however, should the liberal states of the north succeed in rejecting, watering down or freezing the proposal, it might indicate that the balance within the EU is more positive for the UK. Watch this space.

Other Models of Association with the EU

At some time, a tipping point may be reached when the UK judges that the costs of EU membership outweigh the benefits. If this were the case, the UK could withdraw from the EU by invoking Article 50 of the Treaty on European Union, and negotiate a new arrangement. Article 50(1) TEU states: "Any Member State may decide to withdraw from the Union [that is, the European Union] in accordance with its own constitutional requirements."

If a Member State does decide to withdraw, Article 50 TEU obliges that country to inform the European Council of its decision. The European Council, acting by consensus though without the withdrawing state's representative, agrees guidelines for a withdrawal agreement between the withdrawing country and the EU.

Article 50 TEU says that this withdrawal agreement shall set out "the arrangements for its [the withdrawing country's] withdrawal, taking account of the framework for its future relationship with the Union."

On a recommendation from the European Commission, the Council will select an EU negotiator to negotiate with the withdrawing country. When the negotiations between the EU and the withdrawing nation have come to a settlement, the Council of the EU can conclude the withdrawal agreement on behalf of the EU by QMV, after obtaining the consent of the European Parliament. The withdrawing country concludes the withdrawal agreement in accordance with its own legal procedures.

All the while, the withdrawing state is excluded from the Council's decision-making.
It is possible that the withdrawal agreement could provide for the withdrawing country to continue participating in certain EU policies. Article 50 TEU clearly requires the "framework" for the withdrawing country's future relationship with the EU to be decided at the same time as the withdrawal agreement, as this agreement must take that framework into account. In practice, the broad framework of this future relationship would probably have to be agreed by all, or the great majority of, EU Member States.

Article 50 TEU provides that the EU treaties as they stand cease to apply to the withdrawing country when the withdrawal agreement enters force. If an agreement hasn't been concluded, the EU treaties cease to apply two years after the withdrawing nation told the European Council it was leaving the EU (though the European Council, acting unanimously and in agreement with the withdrawing country, can extend this period, for instance if negotiations remain ongoing).

If no agreement is reached, the withdrawing country would default to trading on Most Favoured Nation terms with the EU under the framework of the WTO.

As this is likely to be highly disruptive to the UK, and hence not acceptable to UK business, it is likely that the UK would need to have an agreement, at least in principle, outlined with the EU for the future relationship before invoking Article 50.

A number of options have been proposed as an alternative to the UK's full membership of the EU. The principle ones are outlined below.

<u>The EEA or "Norwegian Option."</u>

What is it?

Norway is currently a member of the European Free Trade Area (EFTA) and, through a Free Trade Agreement (FTA) with the EU, the European Economic Area (EEA). However, it is not a member of the EU and therefore not a member of the customs union. The EEA is an accord between three EFTA members and the EU (the Swiss opting to stay out). This path would allow for the UK to enjoy tariff free access to the European market while simultaneously allowing for the UK to largely decide upon its external trade policy with other global partners independently.

Furthermore, the EEA allows for an extension of four fundamental pillars of the EU single market, the movement of people, capital, goods and services, however, these would remain subject to many regulations being decided by the EU, covering, among others, social security for migrants, in addition to related legislation covering employment. For example, EEA states are obliged to adopt provisions such as the controversial EU Working Time Directive.

While there can be consultation over certain measures, this option would therefore require the UK to continue to follow measures over which it would by and large have no voting influence in the decision making procedure. Currently, input from Norway and other EEA members takes the shape of limited participation by appointed experts in Commission and European Council committees, however, rather like the current consultation procedure within the European institutions, there is no real legally binding mechanism that allows for their interests to be taken into account.

Moreover, these formal arrangements do not provide a role for EEA members to deal with the growing influence of the European Parliament, an institution which has seen its role and authority grow in recent years, and whose powers may well increase in years to come both as a result of formal transfers and, more crucially, as a result of its institutional ability to exercise those competences with increased effectiveness.

In theory, the CAP and CFP, criminal justice and asylum policy, Schengen, foreign policy and defence and external trade are all excluded from the EEA Agreement. However, this has not precluded EEA countries from striking certain sectoral deals with the EU.

By way of example, Norway cooperates with the EU beyond the EEA framework in the following ways:

Schengen

Norway is a signatory of the Schengen Agreement and as a result, has adopted many of the rules and laws regarding police cooperation.

Justice and Home Affairs

Norway has agreed to a series of provisions, including joining a number of EU agencies.

Defence

Norway is a member of the European Defence Agency, an agency which oversees cooperation both in defence procurement and EU military operations, such as the currently ongoing one in relation to Somali Piracy.

Norway therefore enjoys close relations with the EU across a number of fields.

Benefits

Access to the single market would be maintained, however exports would be subject to Rules of Origin. Rules of origin apply to specify the conditions under which a good becomes eligible for zero tariffs within the free trade area and that there is no backdoor. ROO can be relatively simple for products wholly produced and assembled in one country. However, when a product involves complex supply chains, determining origin can be a very complex, sometimes subjective, and time-consuming process.

The UK's net contribution to the EU budget would be reduced as it would no longer be obliged to fund the CAP, the CFP as well as the EU's regional policy. However, it should be noted that EEA states still provide support to the EU's less affluent member states through the EEA fund, and the UK would most likely be required to contribute sums commensurate with the size of its economy. However, the specific amounts are difficult to estimate.

The UK would enjoy control over non-EU trade policy. EFTA states have developed a large network of bilateral deals, 24 FTAs with 33 countries and are in the process of negotiations with others. Certainly, the UK would be keen to seek FTAs with other countries around the globe.

Procedurally, it could be foreseen, owing to the small size of EFTA, that deals could be concluded more quickly than they might be within the EU. This would allow for advantageous situations where UK firms could enjoy new market access ahead of European competitors (EFTA's deal with South Korea came into force on 1 September 2006, whereas the EU's only did so on the 1st July 2011), provided of course that they were to secure similar levels of access as they would otherwise have been able to negotiate as part of the EU bloc.

A brief examination of the EFTA partnership reveals highly divergent interests. Switzerland and Norway, the two main members, frequently clash over key tenets of trade policy with third countries, both as a result of their geographic peculiarities, individual political and economic interests. For example, Norway wishes to see the inclusion of binding human rights clauses into trade agreements whereas Switzerland remains less concerned. Switzerland's key interests in services and pharmaceuticals are not shared with Norway. One might counter this argument by pointing to an ability to tailor deals more specifically to EFTA countries, which enjoy less competing interests than the EU counts among its member states.

Costs

In light of the UK's large trade volumes with other EU Member States, it is vital that the UK retain influence of the rules by which the game is played, as well as the body responsible for refereeing those rules. Both these exigencies would become problematic if the UK were to join the EEA.

Norway, as an EEA member, is required to abide by EU regulations relating to the Single Market, regulations covering product standards, in addition to EU social and employment laws. However, the UK would retain no voting rights in the EU decision-making process. This lack of influence would be felt in all three institutions as the UK would no longer send a Commissioner to serve in the European Commission, would no longer send ministers to the European Council and no longer send MEPs to the European Parliament as there is no directly elected representation for non-EU countries.

As a consequence, a scenario could be foreseen in which the UK loses its ability to shape laws covering financial as well as employment and social regulation to its advantage. These laws are of less importance to Norway owing to its small financial services industry and high social costs, which are greater than those imposed by the EU.

Moreover, the UK would of course be obliged to adapt to a new set of technical rules (which owing to the unique composition of Norwegian exports do not apply to the same extent as would be the case for the UK) under the EEA agreement that would be tedious, costly and disruptive to trade.

The prospect of loss of unfettered free movement of goods would probably be unacceptable to a number of important and largely foreign-owned UK manufacturing sectors such as vehicles, chemicals and processed foods. And it would certainly be unpopular with most continental exporters to the UK.

Conclusions

Firstly, it is not clear whether or not the EEA states would accept a new member as large as the UK. The UK's accession would fundamentally alter the composition of the association and the legal requirements necessitated by such a change would be complex and require difficult negotiation.

The Norwegian Government has itself drawn up a report which states, "In the United Kingdom the EEA Agreement has also attracted a certain degree of attention at times... However, the EEA has not been subjected to a systematic analysis, and it is unclear whether it is seen as a realistic alternative.”

An in-depth analysis on what such a move would mean for the UK has yet to be modelled.

A Free Trade Agreement or "Swiss Option"

What is it?

The UK would seek to conclude a new bilateral treaty with the EU in the form of a Free Trade Agreement (FTA). It would not be a member of the EEA, indeed this option would be a step further away from the "Norwegian option", similar to Switzerland's current relationship with the EU.

It is worth noting from the outset that the Switzerland-EU FTA is a particularly idiosyncratic model, driven by the particularities of the Swiss economy and Switzerland's relationship with EU Member States. Therefore, when considering this option it is not clear what shape or form a potential UK-EU FTA would take, as the Swiss model is so unique, and consequently, it is instructive mainly in form, rather than in content.

Current EU-Switzerland relations consist of three elements: the original 1972 Free Trade Agreement, and pacts subsequently updated in 1999 and 2004 known as "Bilaterals I" and "Bilaterals II". The package allows Swiss companies’ tariff and duty free access to the EU's Single Market in the areas covered.

The deals cover a variety of areas, including the free movement of persons, access to the EU procurement market, certain technical barriers to trade including NTBs, customs facilitation, as well as mutual certification which allows for the testing and admission of Swiss products to the EU under the supervision of a single regulatory authority.

In addition, some Swiss agricultural products enjoy tariff reductions and Swiss researchers are granted access to some EU research programmes. Switzerland also partakes in the Schengen agreement and cooperates across a range of justice and home affairs issues, including immigration and policing. Crucially, negotiations covering services liberalisation were suspended following nine months of negotiations.

Benefits

One reason frequently adduced in favour of the Swiss model concerns its democratic legitimacy and accountability. Swiss politics is defined by its direct link with Swiss citizens, with frequent referenda across a number of issues, with EU trade being no exception. The "Bilaterals I" and "Bilaterals II" packages were both put to voters, albeit in different forms, with the former achieving the approval of 67.2% of Swiss voters while the Schengen component of the latter attained 54.6%.

Similarly to Norway and other EFTA countries, Switzerland is also exempt from EU policies such as the CAP, CFP (not so important in this case) as well as regional policy. However, Switzerland does contribute to regional development in the newest Member States of the EU on a voluntary basis. Moreover, Switzerland does not, unlike EEA members, have to implement EU internal market legislation relating to social and employment law, including the Working Time Directive and the Agency Workers Directive, however, Switzerland does implement some EU equivalent legislation in the framework of its bilateral deals with the EU. Importantly, and unlike the EEA, Switzerland's accords with the EU do not involve explicit transfers of legal or decision making powers to Brussels or any supranational authority.

Therefore, on paper, the Swiss retain the ability to refuse implementation of provisions which would trigger new negotiations between the two sides.

Costs

Firstly, Switzerland enjoys very little influence and no formal say in the EU decision making process. Unlike EEA members, the Swiss have no observer rights or participation status, they must use various formal and informal outside channels to influence and debate legislation within the EU institutions.

Additionally, many of the extant agreements are based on either equivalent EU legislation or on simple adoption of existing EU law, such as is the case with product standards and access to procurement markets, as well as the rules governing the Schengen Agreement. These are laws which were introduced following EU debate in EU legislative forums, to which the Swiss are not party.

A major bureaucratic challenge is also presented by the administrative arrangements covering bilateral agreements. The mechanisms employed to oversee the accords foresee amendments only in case of mutual agreement and are not subject to a principle of automaticity. In practice this means that, particularly in areas of equivalence such as technical barriers to trade, the standards require constant updates under unanimity for Switzerland to enjoy access to the Single Market. This situation is further complicated by a lack of a court or surveillance authority enforcement and dispute settlement mechanisms.

This absence of dynamic and flexible relations creates additional inconveniences. For example, if the EU adopts new legislation in areas where the two parties do not enjoy a bilateral agreement, Swiss firms can find themselves having to deal with market access issues as a result of new barriers to trade. The REACH Regulation had a significant impact on the Swiss pharmaceutical industry which conducts a large part of its trade with the EU market.

The requirements of REACH, which stipulates that manufacturers register certain information relating to their products with the European Chemicals Agency, has resulted in significant and complex certification issues. Having considered the parallel creation of an agency in Switzerland, the Swiss authorities have concluded that this would lead to extensive duplication. As a result, Switzerland is now exploring the possibility of a new agreement with the EU in this sector.

One area of particular relevance for UK concerns Switzerland's service sectors, especially financial services, and this should be considered at length. Negotiations for a bilateral deal on services floundered in 2003. EU legislation does not apply to Switzerland as it is not part of the EEA and although there is an agreement covering financial services, it is not greatly used as most large Swiss providers have set up subsidiaries in the EU. However, the smaller Swiss firms that are not able to establish subsidiaries are significantly impacted. So the status quo, by which movement on services is covered by the existing agreements, only allows for selective coverage under a range of different instruments for companies based in Switzerland. For example, Switzerland has the right to provide services for a period not exceeding 90 working days per calendar year. This represents a significant missed opportunity for Swiss firms; indeed, some studies indicate that if the Swiss were to implement the EU's Services Directive, the gains achieved would be significant.

Since the financial crisis, the EU has been in the process of significantly reforming the regulatory framework for financial services. This includes provisions to force financial institutions "on shore" resulting in Swiss banks having to weigh up by means of new cost-benefit analyses whether or not the cross-border side of their business is still viable and should be maintained. In this regard, the Swiss authorities noted in 2009 (before most EU legislation had been drafted or is now due to be implemented) that "the existing barriers to market access place Switzerland at an economic disadvantage."

The Swiss Federal Council has also noted that, "Switzerland loses out in terms of jobs, value creation and tax receipts. This also makes it difficult to obtain economies of scale and thus a more cost-effective handing of financial services." The large costs of opening EU-based subsidiaries effectively leads to a situation where many SMEs cannot afford access to the EU market. This situation is not likely to improve in the face of the new drive towards a new regulatory regime in the EU.

Switzerland's authorities are not helpless in the face of this reality, however. The Swiss government is actively exploring a number of options to improve the current situation:

1. Mutual recognition of equivalence and regulation to ensure that Switzerland's regulatory framework meets EU requirements. In this regard, a formal process has already been agreed between the European Commission and Switzerland with the objective of the EU recognising equivalence on Swiss law, which will seek to mirror the Solvency II Directive.
2. Voluntary alignment of Swiss national law to EU law as such has already taken place with the MiFID Directive whereby Swiss banks have adopted its requirements. However, this applies only in so far as the EU is willing to recognise Swiss provisions as equivalent to their EU variant.
3. A new financial services agreement with the EU, building on progress made before talks broke down in 2003. This must be done to take account of barriers existing at an EU level and within EU Member States.

With regard to direct financial contributions to the EU, although Switzerland does not contribute to the EU budget in the manner of Member States, and is exempt from the CAP and regional policy, it contributes financially in other ways. These indirect contributions

result from both Swiss acceptance of a need to ensure good relations with EU Member States and the direct demands of the EU with regards to transport infrastructure.

Switzerland contributes by means of a "Memorandum of Understanding" to support the EU's cohesion policy objective following the last round of enlargement. Currently, Switzerland contributes CHF1.3bn a year to develop new EU Member States and the Swiss authorities spent €15bn on the Alps Transit project or transalpine railway network (NEAT), a project of little direct benefit to Switzerland other than to satisfy EU demands for access through its territory.

Conclusions

One important consideration which must be borne in mind is the uncertain future faced by EU-Swiss trade relations. Since 2008, Switzerland-EU bilateral deals have come under increasing pressure from Brussels. Both the Council and the Commission are keen to generate a paradigm, with a more comprehensive arrangement under consideration. The European Council has explicitly called for a more comprehensive approach, including stepping up enforcement and dispute settlement mechanisms to provide for increased compatibility of Swiss and EU law, and importantly, for decisions to be made by the European Court of Justice (ECJ).

The Council concluded that, "while the present system of bilateral agreements has worked well in the past, the challenge of the coming years will be to go beyond this complex system, which is creating legal uncertainty, has become unwieldy to manage and has clearly reached its limits." Furthermore, the Swiss government has itself committed to, "looking at the possibility of dynamically adjusting the agreements to comply with new EU legislation, how to ensure the coherent application and consistent interpretation of future agreement and the development of an effective dispute procedure."

Nevertheless, the Integration Office of Switzerland has declared that, "Any solution must respect the sovereignty of both parties and the efficient operation of their institutions." The future is far from clear, and what shape future EU-Switzerland relations will take remains to be seen, allowing an element of uncertainty and demonstrating the implicit tensions within trading relations. What is clear is that the current system is seen as unsustainable by EU Member States.

The Turkish Option, member of the customs union outside the EU Treaties and Institutions

What is it?

As is the case with the use of the "Swiss example", it is useful to bear in mind that the Turkey-EU customs union, while setting a useful precedent, is the product of a unique set of geo-political circumstances which were and are themselves designed in the context of a supranational transition towards full EU membership. Despite the current difficulties in the relations between Turkey and the EU, the Turkish government remains fully committed to Turkey's entry into the EU .

If the UK were to remain within the customs union, it would continue to enjoy the free circulation of goods

Benefits

As both the "Norwegian option" and the "Swiss option", a relationship with the EU modelled on Turkey's would mean the UK would not contribute to the CAP, CFP or regional policy.

However, it could be foreseen that the UK would be obliged to provide funding in one way or another as we have seen with the EEA states and the Swiss. Furthermore, Turkey does not subsidise the EU budget; in fact, it is a major recipient of EU pre-accession funding.

Moreover, the UK would not be obliged to implement EU labour and social laws, leaving it more room for manoeuvre and flexibility when deciding its domestic legislation. It would also gain the ability to negotiate on behalf of its domestic services sector with third countries independent of the EU, however, the UK's access to the EU's services market would be governed by a new agreement, possibly along the lines of the agreements that Switzerland currently shares with the EU. This would entail the market access problems that have already been outlined in the analysis of the "Swiss option".

This option, of remaining in the customs union, would have the benefit of enjoying the free movement of goods, without hindrance. In addition, the UK could also cooperate with the EU through its own seat at the WTO in Geneva. As already pointed out, this new arrangement would not necessarily preclude the UK from striking deals with other trade partners in the field of services that would go further on services liberalisation than the EU's.

It could be argued that neither GATT Article XXIV nor the GATS Article V contain specific provisions that would prevent the UK from imposing, on average, lower barriers to third market imports, than existed previously on an individual country basis.

Costs

An examination of Turkey's customs union agreement with the EU quickly illustrates one of the main problems that Turkey faces. The agreement foresees that Turkey must adopt the EU Acquis' provisions on technical barriers to trade in addition to product regulations, rules on competition and state aid. In the customs union the EU would have the power to adopt Acts through a decision making process in which the UK would have no formal political power.

This is not such an issue for Turkey, which as a candidate country, is required to adopt the EU Acquis prior to accession; however, the UK would not be negotiating to join the EU, rather it would be going in the opposite direction. This peculiarity would create significant problems for the UK given that the EU's uniform product regulations would apply to goods in the Great Britain's domestic market, regardless of whether or not they were to be exported to the EU.

Coupled with this, the UK would to a large extent be losing its ability to influence future possible internal liberalisation of the single market. The Single Market would not have taken the shape it has today it not been championed by Baroness Thatcher and it is hard to imagine that the EU would become more liberal if the main proponent of free trade both within and without the bloc were to leave.

It could be foreseen that a consequence of the weakening of the free trade lobby within the EU could lead to a situation whereby any deal struck with the EU on services (for such a deal would be necessary) would entail less market access than that currently enjoyed by the UK as part of the EU. Furthermore, the difficulties encountered by Switzerland in negotiating a deal in services demonstrate the potential obstacles faced by the UK.

There would also be limited room for manoeuvre in negotiating external trade agreements on trade in goods. Article 16 of the Turkey-EU custom union agreement requires that Turkey align its own commercial policy with that of the EU so that a common external tariff on goods can be maintained. If the UK were to be a member of the customs union, it would be required to do likewise.

However, in order to align its commercial policy, the UK would be obliged to conclude FTAs with any third country with which the EU has signed one with and on the same terms. This would create critical difficulties, as not only would the UK be left out of negotiations, but the EU could sign FTAs without any real consultation with the UK. This could lead to a situation whereby the UK might in some instances be forced to sign deals with countries from which it might not gain significant concessions.

It remains an open question as to whether third countries would be willing to negotiate deals with the UK, or at least would negotiate at a snail's pace. A preferential deal with the EU means that third countries can export indirectly without tariffs, via the EU, whilst needing only to grant access to EU, and not Turkish goods. The EU now includes a "Turkish Clause" in its bilateral trade deals, which asks trading partners to negotiate a similar agreement with Turkey. Despite this, Turkey remains dependant on EU enforcement of this article.

Another problem is that the EU's FTA negotiations result in trade-offs between issues of importance to third countries and the EU Member States, priorities which may differ to those of Turkey or which are not even covered by its customs union agreement with the EU. This includes an emphasis on high-end goods and agreements on services and intellectual property. However, as one report has noted (See 54) this leads to an asymmetrical and unsustainable relationship that can only be maintained over the longer term if concrete progress is made towards Turkey's full membership of the EU.

Conclusions

This model's attractiveness depends entirely on how the UK could influence the EU, and how appealing its market would be to third countries. The Turkish relationship is largely based on its candidacy status. The UK could seek to negotiate an agreement with the EU, based on a customs union with free movement of goods and rights of access to the EU for UK services businesses. Other sections could be negotiated to cover intellectual property, investment, public procurement and competition. While maintaining access to the market and remaining within the customs unions, the UK would see its trade policy largely directed by the EU, an obligation that would considerably limit its sovereignty regarding trade policy.

WTO Option

What is it?

The UK could leave the EU and fall back upon the current multilateral trading system in place, that of the WTO. Most favoured nation tariffs would apply to UK exports while the UK would use the WTO framework to establish its own trading regime with trading partners.

This break with the EU would have to be done in the context of Article 50 TFEU; this would give the UK the right to withdraw unilaterally if a mutually agreed basis for it doing so could not be negotiated within two years of the UK’s original notification to the European Council of its intention.

Benefits

This option would return full sovereignty and the UK would be free to negotiate trade deals with willing partners, it would maintain the right to negotiate these deals specifically within WTO rules to best suit specific trading interests.

Moreover, the UK would no longer be obliged to take part in the CAP, CFP or the EU's structural and cohesion funds and would not contribute to the EU budget.

Costs

If this action were to be taken then the UK would no longer be party to FTAs negotiated by the EU on its behalf. In the absence of preferential trade agreements with the EU and other countries the UK would have to pay MFN rates on all exchanges until new regimes could be put in place, a process that could take many years, and could cause permanent damage to the UK economy.

This would be extremely damaging and destabilising for UK business, which would be forced to adapt to a radically different trading regime, unless the UK can assign some of the existing EU arrangements to a bilateral agreement.

Manufactured exports could be particularly badly hit, and exports to the EU could face the same tariffs as countries like the USA, China and Japan which all have no preferential regime in place with the EU. According to one expert, "World Trade Organization (WTO) statistics give the weighted average of such tariffs as 2.7%, which may sound low. But over half such imports enter the EU duty-free. That suggests that around half the UK's manufactured exports to the EU would face an average tariff of over 5%, a decisive handicap in many price sensitive markets. UK car exports to the EU would be particularly hard hit as the EU tariff on "completely built units" is 10%.[27]" Of course, the UK Government could make efforts to mitigate the damage.

The potential loss of competitiveness of UK business could result in pressure on the Government to introduce protectionist measures to ensure the short term survival of UK companies. Foreign firms might see the UK as a less attractive location for their outward investment as the UK would no longer remain within the world's largest market. In addition, the UK would lose its influence within the Single Market, allowing for continental rivals to negotiate the rules of the EU in their favour, giving preferential treatment to domestic producers.

The Options for change

The colour-coding used below for possible UK action follows the categorisation for all the Fresh Start Project's Green Paper chapters. Green are those measures that can be achieved within the current EU legal framework; Amber are those measures that require negotiated EU treaty change; Red are those steps that the UK could take unilaterally that would involve breaking its treaty obligations.

A number of options exist for the UK to minimise the costs of membership of the EU. Specific ideas on how to improve the CAP, CFP, Regional Policy and Social Policy have been covered in other chapters of this Green Paper.

Further, the UK has a number of options to maximise the benefits of full EU membership.

It can continue to press for the EU to negotiate free-trade agreements with countries and trading blocs throughout the rest of the world. The EU is currently pursuing a number of bilateral FTAs with Canada, Singapore, India, and Mercosur. The UK could push for the EU to add more resource to its efforts to expand free trade through bilateral deals, and through

[27] Vacuity of UKIP's flagship policy, Ronald Stewart-Brown, Conservative Home, April 11, 2010.

the WTO.

The UK also has a number of options to enhance the ability of UK businesses to compete in the wider world. The government can continue to develop bilateral relationships to help UK businesses prosper in non-EU markets. In many respects, the UK is well placed to access these markets through historical ties, and through the Commonwealth.

The UK could continue to negotiate the completion of the single market, particularly in services to increase opportunities for trade for UK businesses.

The UK could place greater emphasis on trying to secure an economic portfolio, such as the Trade Directorate, in the next European Commission.

The UK government could seek a unilateral brake on EU financial services regulation through a legally binding protocol attached to the Treaties. This would assert the special circumstances that are the UK's stake in financial services, requiring the Commission to reconsider proposals that impact disproportionately on the UK, and would give the UK a right of appeal for any proposal before it had been agreed by the Council and European Parliament. This would give the UK a veto, because unanimity applies at the European Council level.

The UK could negotiate changes to the treaties to allow member-states to pursue their own bilateral deals on investment.

If the EU bureaucracy and regulation prevents the UK from developing global reach and makes the intra-EU trade no longer attractive, each of the alternative models described above would constitute withdrawing from our existing EU treaty obligations.