

# The Brexit White Paper: what it must address

# Foreword by Anand Menon



Brexit rolls on. In recent weeks we have seen members of both Houses of Parliament passionately debate the process of leaving the EU, as well as what they consider to be the optimal outcome of this process. Business leaders have begun to voice their concerns about possible outcomes too, clearly hoping to win the ear of the Prime Minister and shape the direction of travel. The timing is not coincidental. The government has pledged to produce a white paper setting out a “detailed, ambitious, and precise” explanation of what it is hoping for from the final deal with the EU.

In what follows, we provide a guide of what to look out for in that white paper and outline the key issues it needs to address. We point out where and how the white paper can provide the much needed (and long promised) clarity and what the government might do to shift the negotiations forward. This is not about caving in to Brussels. It is about addressing the tensions and contradictions inherent in the government’s own negotiating stance and reaching a coherent and credible position in order to achieve a deal.

The UK in a Changing Europe is not a traditional think tank. We do not see it as our role to propose or promote specific policy outcomes. That being said, it is our role to point out the issues that need to be addressed to alleviate the chronic uncertainty that shrouds the Brexit process. We bring together a team of experts and task them with considering the kinds of issues the government white paper should tackle in order to move the Brexit process forward to a mutually beneficial conclusion. I am delighted that we have been able to gather some of the best minds working on these questions to make this contribution to the debate at this crucial time.

As ever, I am immensely grateful to all those who contributed to this report. They have tolerated my questions and comments with efficient good humour. Jonathan Portes and Matthew Bevington worked incredibly hard on the text. Navjyot Lehl managed the design and production processes with her usual patience.

I hope you find this interesting and informative.

A handwritten signature in blue ink, appearing to read 'Anand Menon'. The signature is fluid and cursive.

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# 1. What to look for

- **Politics** Political battles await whatever course the Prime Minister chooses. But a choice is necessary.
- **Ireland** The issues here go beyond customs, regulations and the border, extending to the need to support North-South co-operation more broadly.
- **Customs** The government needs to provide detailed, rigorous and viable proposals on customs as the basis for negotiations.
- **Trade** The government needs to go beyond customs and address how it is going to minimise non-tariff costs to trade. It must acknowledge the inevitable trade-off between pursuing optimal economic policies, adhering to its red lines and satisfying the EU's refusal to allow the UK to cherry-pick subsections of its institutions.
- **Regulation** Uncertainty cannot be reduced unless the government squares its red line over the European Court of Justice with its desire for close regulatory alignment in some areas, while also recognising the implications of the EU's insistence on the impossibility of partial single market membership.
- **Dispute settlement** Despite being constrained by fewer EU rules post-Brexit, the UK will still face real-world constraints on its ability to act autonomously. Careful thought is needed on the choice of dispute resolution model that must take account of these trade offs.
- **Governance** The UK can broadly choose from two post-Brexit models, or negotiate some kind of hybrid with the EU. Again, the choices and trade offs must be made explicit.
- **Immigration** There are potential compromises that could work for both sides, but the white paper is likely to continue to avoid the choice between single market access and obligations on free movement.
- **Devolution** The nature of the future trading arrangement will clearly impact on relations between London and the devolved authorities. The white paper must acknowledge these interconnections and spell out how it will approach relations with the devolved authorities in a post-Brexit world.

- **Fisheries** If choices regarding the movement and regulation of goods are likely to result in delays for the fisheries sector, the white paper needs to set out how these can be minimised given the crucial impact this would have on fisheries revenue.
- **Agriculture** The priority here revolves around plans for future trade relations, and governmental clarity on how the implications of different future models for the agricultural sector will be dealt with.
- **Financial services** The white paper needs to address issues of market access in future and recognise a trade-off between regulatory autonomy and access to EU markets.
- **Foreign and security policy** While there should be greater scope for a deeper relationship in this area, the evidence to date suggests the UK will simply find itself in a standard third-country position in future. The government could pledge specific forms of future co-operation in the white paper in the hope that member states argue for greater flexibility from the EU, but there is little indication that such an approach will be successful.

## 2. Introduction

### By Anand Menon

Two years in. One European Council summit left to resolve the final issues around the withdrawal deal. Yet so much remains to be done. In each of Theresa May's major Brexit interventions she has recognized the desire for certainty, particularly on the part of businesses. As early as January 2017, [she promised to](#) "provide as much clarity and certainty as we can at every stage". Yet, since then, uncertainty has reigned. This has confused and dismayed the UK's negotiating partners, damaged goodwill and trust in the negotiations, and made it extremely difficult for businesses to plan for a post-Brexit world.

Leaving the EU would be a momentous task for any member state, and the Prime Minister is operating in a political context that constrains her ability to address the many challenges of the negotiations. Yet it is remarkable how little formal government policy has shifted since Theresa May first sketched out her 'red lines' for the negotiations at the Conservative Party Conference in October 2016. Those positions have hit reality on many fronts—in Brussels, in Whitehall, in Westminster, as well as well as in Belfast, Cardiff, Edinburgh and, of course, Dublin.

More than a year since formal negotiations began (and with around six months to go), there is an enormous amount still to be done, both in the ongoing negotiations with the EU and in preparing the country for life after Brexit. The two are, of course, intimately linked. The outcome of the negotiations will shape the options open to us as a country. Yet, with trade talks yet to begin in earnest, the government has not yet satisfactorily addressed the various circles that need to be squared.

The government's white paper offers an opportunity: to acknowledge the way British red lines conflict with those of the EU; to undertake a realistic strategic reassessment of how to achieve its priorities in the negotiations; and—last but certainly not least—to arrive at a position the whole Cabinet can support.

The nature of any final deal will also determine the scale and scope of the internal adjustment the country needs. What kind of customs arrangements should be put in place? How will the future relationship between the UK and the EU be managed? How much scope will the government have to devise wholly new agriculture, fisheries or immigration policies? The white paper can provide a comprehensive audit of what is needed.

# 3. The Context

**By Anand Menon, Matt Bevington and Alan Wager**

Although this report is focused on the policy choices the government faces, it is essential, first, to recognize the political reality within which those decisions must be made. Both in Brussels and at home, the government is confronting difficult negotiations over how best to move the Brexit process forward.

One difficulty the Prime Minister faces is that several sets of negotiations with the EU are taking place simultaneously. The two sides are wrapping up talks on the old relationship (albeit that the Irish border, which focuses on the future, is included with the 'Article 50' issues), negotiating how the transition period will work and beginning discussions on the future. The first two sets of talks ideally need to be concluded by October and by the end of the year at the very latest.

The deal needs to be signed off by the British Parliament, the European Parliament, and the European Council before the exit date of 29 March 2019. Should this work out smoothly (which is by no means certain), the transition period is currently set to run until the end of 2020. By this time, the second phase of talks will have to be completed. It looks increasingly like the UK will need this period to be extended further. Regardless, there is a desperate need to crack on with negotiations.

## The negotiating deadlock

Brexit boils down, in effect, to a battle between two different approaches. Theresa May declared at Lancaster House in January 2017 that it “is not the means that matter, but the ends”. The UK approach to the EU is transactional, stressing the substantive importance of maintaining cooperation. The EU, for its part, is more procedurally minded. Process, rules and precedent matter enormously when trying to accommodate the interests of a diverse group of member states.

For the British government, the talks are—as the Prime Minister said—all about outcomes. Ministers routinely emphasize the breadth and depth of UK-EU collaboration, ranging from trade in goods to co-operative approaches to extradition; joint military co-operation, to the role of the City of London. For them, the UK and the EU simply have a mutual interest in continuing their close co-operation.

Michel Barnier, acting on instructions from the heads of the governments of the EU27, has made clear that any agreement must “respect the institutional architecture of the integrity of the European Union [sic]”. What London sees as mutual interests are viewed in Brussels as an attempt to maintain

rights while shedding obligations. Barnier’s whole approach—summarized in [one infamous graphic](#)—is predicated on what the British government sees as a stark and unimaginative choice: the UK can pick from existing models. There will be no special treatment, however close the relationship.

The UK, for its part, wants a deep and comprehensive relationship going beyond anything the EU currently enjoys with other ‘third countries’. But while the EU is happy to have a relationship of (formal) equality, as with Canada, the deep relationships it has fostered with neighbours such as Ukraine or Norway have tended to rest on the latter becoming rule-takers.

And here’s the rub. The UK wants a special relationship, but one that leaves it free of EU-imposed constraints. Co-operation must take place within the framework of the red lines laid down by the Prime Minister: ending the jurisdiction of the ECJ, ending free movement, leaving the customs union and not paying “huge sums” into the EU budget. This has been a constant refrain since the Conservative Party conference of 2016 and there has been little sign of change, at least publicly.

Little surprise, then, that the word ‘creativity’ features so frequently in prime ministerial speeches. On security, Theresa May exhorted her audience at the Munich Security Conference to do “whatever is most practical and pragmatic” and demonstrate “real creativity and ambition” to ensure continued data sharing. Some months earlier, in Florence, she had spoken of the danger of a “stark and unimaginative choice” between Norwegian-style membership of the European Economic Area and a more traditional free-trade agreement.

However, the UK should not kid itself. Certainly, EU officials insist that, should the UK change its red lines, they would make a different offer. Yet different red lines would merely mean a wider range of choices between existing options for ‘third country’ relationships with the EU. What it would not imply is that the UK could secure the bespoke—‘creative’—deal it has set its sights on.

In other words, the UK is not considered a former member with special privileges, but a third country with a choice to make between the closeness of the relationship and the level of autonomy. This approach was best [summed up](#) by Barnier himself: “What is sometimes hard for the British to understand is that we don’t want to negotiate, and we don’t want to compromise on who we are. They want to leave, that’s their choice.”

Bluntly, the deal Theresa May has been attempting to achieve over the past 18 months is not on offer. Her Mansion House speech in March this year essentially listed yet again the bunch of cherries she would like to pick: UK courts considering ECJ judgments “where appropriate”; respect to the EU courts in those areas where the UK decided to stay in specific agencies; and comprehensive mutual recognition. Stubbornly unanswered to date has been the question of how these objectives can be achieved in practice.



## The politics of Brexit in the UK

At some point, Mrs May (or a successor) is going to have to either change (or ‘pink’, in the jargon) those red lines, accept a vastly inferior deal to the one she’s been selling or walk away altogether. And each option carries its own dangers. After all, aside from the negotiations with Brussels, she is engaged in (at least) three parallel domestic debates over Brexit, each made more complex by her weak political position.

The first is within her own government. Mrs May isn’t keen on sacking ministers, even when they publicly undermine her. So, she has chosen to try to appease the various Brexit factions via the only possible mechanism: studied ambiguity. This has led to a revitalization of cabinet government, albeit by accident rather than design. The paradox is this has happened at the same time as collective cabinet responsibility has all but disappeared.

The cabinet’s Brexit subcommittee makes the big decisions on negotiations, and skews towards those advocating a consolidation of the government’s red lines. These internal negotiations are increasingly conducted by megaphone diplomacy, or via journalists’ dictaphones. But any meaningful agreement will have to be thrashed out within the cabinet itself. At the time of writing, the Prime Minister is due to hold another ‘[peace summit](#)’ to secure unity around the white paper. That crunch talks are being demanded most publicly, and vocally, by David Davis is an indication that present cabinet dynamics suggest compromise with the EU.

The Prime Minister is also conducting a running battle with her backbenches and the two wings of her party. On one side is the European Research Group, numbering over sixty backbench MPs and led by Jacob Rees-Mogg. It is an open question whether this grouping will accept a direction of travel that precludes leaving the customs and regulatory orbit of the EU.

On the other are Europhile Conservatives, numbering between a dozen and twenty MPs. Mooted rebellions from this grouping have so far largely dissolved on impact. This has served to undermine claims that they could make common cause with Labour in resisting any final withdrawal agreement. It may be that these rebels have the numbers to force the government towards an explicit customs union with the EU. Whether this plays out as a government defeat on the floor of the House of Commons on the Trade Bill, just before Parliament breaks for summer, remains to be seen.

On the other side of the Commons is a Labour Party that is itself divided at least three ways on Brexit. A small band of MPs who oppose any deal that does not end freedom of movement wield disproportionate influence. A vocal group of backbenchers favour a soft Brexit or, in some cases, a reversal of Brexit. Finally, a more pragmatic group is associated with the party’s Brexit lead, Sir Keir

Starmer. While the party's position thus remains fundamentally ambiguous, Labour's principal aim is the destabilization of the government, rather than support for a coherent alternative negotiating stance.

Less immediately, but equally importantly, the government must achieve support for its negotiation outcomes across the UK's devolved administrations, as Nicola McEwen sets out in this report. Many of the policy areas of the UK-EU relationship most dependent on the outcome of trade negotiations—for example agricultural tariffs and fisheries quotas—are also areas of acute interest to the devolved administrations. Their future is thus tied up not only with negotiations in Brussels, or within the government, but also with Belfast, Cardiff and Edinburgh.

## **The white paper: squaring the circle?**

Enter the government's white paper. [Trailed](#) by David Davis as providing “detailed, ambitious and precise explanations of our positions”, it is an opportunity to square the circles the British government has helped construct and to answer the many questions that remain unresolved.

The government's previous stab at a Brexit white paper consisted of a series of highlights from the Lancaster House speech. Less a policy position than a greatest hits collection. We really do not need a Volume 2.

Most importantly, though, if the government's new white paper is to achieve anything, the Prime Minister has to do something she has proven spectacularly reluctant to do to date: fully recognize the consequences of the choices she has made. That ending free movement means leaving the single market, with little if any possibility of partial membership thereof; that an independent trade policy means either a border on the island of Ireland or in the Irish Sea; that no ECJ involvement means regulatory divergence and greater barriers to trade; and crucially, that some members of her own party, indeed her own government, are going to be disappointed with whatever choices are made. Time is running out. Will the Prime Minister be bold enough, finally, to pin her colours to the mast?

## 4. Ireland

**By David Phinnemore**

Throughout the withdrawal negotiations it has been clear that the Irish border simply cannot be ignored in the UK's plans for its post-Brexit relationship with the EU. Indeed, a 'backstop' solution to avoid a hard border needs to be agreed before the EU will sign off on the withdrawal agreement. Securing a Brexit deal is therefore contingent on not merely a resolution of the Irish border question but also a number of other issues related to the island of Ireland.

The centrality of the Irish border stems from the commitments that the EU and the UK have made to not merely avoiding a hard border but also upholding the 1998 Belfast 'Good Friday' Agreement in all its parts and supporting North-South co-operation on the island of Ireland. To deliver on these commitments, the UK requires an extremely close economic and political relationship with the EU.

As the backstop debate has made clear, the only available solution to avoiding a hard border on the island of Ireland—and delivering on the further commitment to “no physical infrastructure at the border or associated checks and controls”—is for Northern Ireland, with or without the rest of the UK, to remain in a customs union with the EU and maintain regulatory alignment with the internal market *acquis*, at least as far as goods are concerned.

However, delivering on commitments also requires, as the proposed backstop envisages, regulatory alignment in other areas if, for example, current and future cross-border co-operation is to be supported. The list of areas is extensive: environment, health, agriculture, transport, education, tourism, telecommunications, broadcasting, inland fisheries, justice and security, higher education and sport.

In the absence of other solutions, what has been proposed for the backstop will form part of the future UK-EU relationship and the white paper needs to make this clear.

The backstop, moreover, represents merely the minimum needed to deliver on commitments regarding the border and Northern Ireland. For example, it does not provide for the free movement of services, crucial to delivering areas such as cross-border health services. As for free movement of people, this is limited to UK and Irish nationals under the Common Travel Area.

To deliver on the commitments the UK has made, continued participation in key programmes and co-operation mechanisms is necessary. Continued involvement in the INTERREG – an EU funded

programme – has been agreed in principle, at least for the immediate future, but should be formalised. In terms of supporting the softening of the border and the promotion of North-South cooperation, shared UK and Irish participation in different EU initiatives in the areas of police and judicial cooperation, for example the European Arrest Warrant, has proven extremely valuable, and arguably essential. There is much concern over Brexit's potential impact should involvement in such mechanisms cease. There are also concerns about how Brexit will affect the rights of individuals and whether and how the UK government can uphold its commitment to 'no diminution of rights' under the 1998 Agreement.

The white paper must recognize the numerous ways in which EU membership has facilitated the softening of the Irish border and the promotion of co-operation on the island of Ireland. In doing so, it needs to avoid a narrow focus on trade and customs and set out clearly the areas in which wider co-operation will be pursued and how.

That being said, trade and customs are vitally important and the white paper also needs to spell out how frictionless movement of goods across the border can actually be delivered. If the government is serious about its commitments to avoiding a hardening of the Irish border, upholding the 1998 Agreement and supporting North-South co-operation, it must make clear how, if at all, this can be reconciled with its red lines.

The white paper, therefore, should also engage with the EU's language of "flexible and imaginative solutions' for addressing the 'unique circumstances on the island of Ireland". That will require an openness to differentiated arrangements. The white paper should demonstrate how an ambitious UK-EU relationship would negate the need for the backstop's implementation except as a temporary or partial measure. Perhaps then the UK will be in a position to persuade the EU to extend its 'lean' free-movement-of-goods-only version of the internal market to the overall UK-EU relationship.

# 5. Customs

## By Meredith Crowley and Oliver Exton

The UK's future trade relationship with the EU has evolved into one of the most problematic aspects of the Brexit negotiations. This difficulty has arisen because the UK wants to achieve three objectives that are jointly incompatible under standard trade agreements:

- (1) conduct an independent trade policy with non-EU countries post-Brexit;
- (2) maintain an open border with Ireland;
- (3) and minimise the disruption and time costs associated with customs checks at UK-EU borders.

Two options at one point seemed likely to be included in the government's white paper: a new customs partnership and a maximum facilitation ('max fac') arrangement. The government has also recently provided a technical note on a temporary customs arrangement that will be implemented if the future customs relationship cannot be operational by the end of the implementation period.

A customs partnership would be a free-trade agreement between the UK and the EU. Under this arrangement, the UK would assume additional responsibilities to implement EU customs practices—and, specifically, collect tariff revenue for the EU—in order to ensure an open border for UK-EU trade. A maximum facilitation arrangement would also be a free-trade agreement and would rely on a technological solution to minimise the need for checks at border crossings, although the technology required to enable this solution does not currently exist.

On 1 July, media reports suggested the government was scrapping the two models discussed here in favour of a third, unspecified plan. At the time of writing, we have no information about what this new plan will be.

The government is yet to agree on its preferred option, and whichever it does settle on will take time to put into place—even assuming that the EU is willing to accept it. HM Revenue and Customs (HMRC) estimates that it will take three to five years to implement either of the proposed solutions. It therefore seems impossible for a new customs relationship to be in place for the end of the proposed transition period in 2020. Time-limited, continued participation in the EU's customs union could bridge this gap and provide the opportunity for the development and implementation of the new customs partnership or 'max fac' options.

That being said, the government will need to begin to address the potential costs to business of its preferred options. The new customs partnership will introduce new bureaucratic and administrative costs for UK businesses, estimated by HMRC to be up to £3.4 billion per year. If we add to this HMRC's estimate that rules of origin requirements—which make sure that only goods eligible for low or zero tariffs receive them—will cost UK businesses approximately £7 billion, then the total cost could increase to over £10 billion. It is unclear whether the New Customs Partnership will necessitate the filing of rules of origin paperwork. However, it is typically a requirement in free trade agreements. The Customs Partnership would also impose an estimated implementation cost of £700 million, with an additional 5,000 staff and annual running cost of £280 million for HMRC.

HMRC also does not believe that the EU is likely to reciprocate the arrangement. Therefore, the UK could lose considerable tariff revenues for goods that clear customs in the EU before arriving in the UK. There are also concerns that the Customs Partnership could impinge upon the UK's ability to negotiate future trade agreements with third countries as, under a complex bureaucratic system, access to the UK market may appear less attractive to potential third-country partners.

The 'max fac' arrangement, for its part, would also impose considerable administrative costs on businesses trading between the UK and the EU. HMRC estimates the costs to UK businesses at £17-20 billion per year. This is primarily because of the costs of customs declarations for both imports and exports (£13 billion total) and up to £7 billion in costs for rules of origin administration. This option would also require 5,000 additional staff and cost £250 million each year for HMRC. The UK would be able to sign new free-trade agreements with third countries, but the increased friction in UK-EU trade will considerably reduce the appeal of the UK market to potential third-country partners.

Finally, customs arrangements are not enough in themselves. The sustainability of any future UK-EU customs arrangement depends on the long-term regulatory systems of the UK and the EU. Both proposed options are only feasible solutions to the Irish border problem if the UK and the EU have similar enough regulation that both are satisfied to freely exchange goods. This means both on exit day itself and thereafter, possibly with the UK automatically adopting new EU regulation in future without a say on its design and implementation. However, crucially, the EU may not be willing to accept mutual recognition of standards. Divergence in accepted regulatory standards would necessitate border checks and violate the aims of both the proposed customs arrangements.

The EU has expressed doubts about both the customs partnership and max fac options, although this position may change if the UK presents rigorous, detailed and viable proposals. Based on this analysis, we would expect the government to spell out credible negotiating options that would lay the foundation for constructive negotiations.

# 6. Trade, regulation and non-tariff barriers

**By Josh De Lyon and Swati Dhingra**

The government has set some clear red lines for its post-Brexit trade policy. It will not remain a member of the single market because it is not willing to accept free movement of people and does not want to be under the jurisdiction of the European Court of Justice (ECJ). The UK will also leave the EU customs union, instead pushing for a bespoke customs arrangement that allows it to negotiate independent trade agreements with non-EU countries, as Meredith Crowley and Oliver Exton explain in this report.

Yet the UK also hopes to maintain a special relationship with the EU. As is a consistent theme throughout this report, the challenge that the white paper must address is how the UK can remain deeply integrated with the EU to minimise trade costs whilst satisfying its own red lines as well as those of the EU—currently, a seemingly impossible conundrum to resolve.

The discussion of trade policy in recent weeks has focused on customs. But customs is just one component of trade. The bulk of the cost of doing business across borders comes from non-tariff barriers, such as complying with different regulations and standards, obtaining licenses for investing internationally and settling cross-border disputes. These are not covered by the proposed customs arrangements.

Outside the EU, the UK could face high non-tariff barriers to trade. [A recent review of studies](#) found the non-tariff costs on all goods between the EU and the US, for example, was around 13-14%, with some sectors such as agricultural products, beverages and tobacco, pharmaceuticals and processed foods being considerably higher. In contrast, the average customs duties [between the EU and the US](#) are under 2%. The most important objective for the UK, therefore, is to ensure that non-tariff barriers to trade with the EU27 do not rise after Brexit.

The focus on non-tariff barriers is even more important in the services sector, which makes up 80% of the UK economy. There are no tariffs in services, and [it is estimated](#) that non-tariff barriers arising from Brexit could reduce the UK's services exports by anywhere between 6-13% over a ten-year period. The main constraint for many businesses will be the divergence in regulations and standards that could arise when the UK exits the single market. For instance, [thousands of financial services firms](#) depend on passporting rights for their operations with the EU. The Chancellor Philip Hammond [acknowledged](#) the importance of agreeing a bespoke deal on financial services that goes beyond EU equivalence regimes, and more detail is expected in the government's white paper, as John-Paul Salter explains in this report. However, as with all of the government's plans, this must be compatible with the position of the EU.

The white paper is expected to include a significant section on preventing regulatory divergence between the UK and the EU, as Hussein Kassim points out below. Prime Minister May's [Mansion House speech](#) indicated that the UK hopes to remain part of some EU regulatory agencies. This is a sensible objective given that businesses would face higher costs of doing business under multiple regulatory regimes. Further, the cost of setting up regulatory agencies can be substantial. For instance, a UK version of the European Aviation Safety Agency has been [estimated at £400 million](#) over a decade and there are around 40 such agencies that would need to be established. The problem for Mrs May is that it is not clear how regulations can remain aligned in the long run if the UK is not willing to remain under the jurisdiction of the ECJ. The issue will be even more difficult because the solution proposed in the white paper will also need to be accepted by the EU—which to date has been consistent in insisting that the UK cannot selectively opt in to certain EU institutions.

Overall, deep commitments on non-tariff barriers with the EU will determine the extent of the economic impact from Brexit. Studies on the expected economic effects of Brexit are clear in their projections of different trade policy scenarios. In reports by [the Treasury](#), [the government](#) and [Dhingra et al.](#), the negative economic impact of Brexit is minimised when non-tariff barriers are kept low through membership of the single market.

Maintaining low non-tariff barriers means the UK would need to reduce any potential divergence in standards and regulations with the EU. This could potentially tie the hands of the government in undertaking deep commitments with other trade partners. Outside the EU, [the UK could benefit](#) from negotiating new trade agreements with non-EU countries such as the US, China or India which are large or growing trade partners. Lowering tariffs and other trade costs with these trade partners would increase economic activity in the UK. However, the extent of the gains would be limited, as the regulatory structures in the US, China and India [are very different](#) from those in the UK. It will therefore be difficult for the UK to simultaneously undertake deep commitments on non-tariff barriers with the EU and other trade partners.

The potential gains from new trading arrangements are likely to be much smaller than the costs of losing market access to the EU27. For instance, a UK-China deal would need to raise bilateral trade by over ten times to get to the levels of trade the UK has with the EU. This seems unlikely in light of the recent Swiss-China trade deal. A [survey by the Swiss Chamber of Commerce](#) two years after the introduction of the free trade agreement concluded “it appears the FTA is not very attractive”.

The government therefore has an enormous challenge ahead: minimizing the costs of doing business with its largest trade partner while getting enough flexibility to undertake reductions in non-tariff barriers with countries outside the EU. This may be an impossible circle to square. The government must accept the inevitable trade-off between pursuing optimal economic policies, adhering to its red lines and satisfying the EU's refusal to allow the UK to cherry-pick subsections of its institutions.



# 7. Regulation

## By Hussein Kassim

Many of the rules governing key sectors of the UK economy—ranging from aviation to telecommunications, as well as areas such as intellectual property and innovation, and quality of life, including the environment, food safety, and consumer protection—were agreed within the EU. A great deal is at stake, since these regulations affect every business and household in the UK.

The UK faces an uncomfortable choice: it can ‘take back control’ over regulation and gain regulatory autonomy, or it can remain aligned with the EU. Neither option is cost-free, but there is also little room for a compromise. There are two problems with the first choice. First, the UK’s ability to trade with the EU—its main trading partner—would be harmed. The main barriers to trade are no longer tariffs, as Josh De Lyon and Swati Dhingra point out in this report, but instead are rules and regulations in the form of standards. In order for trade to be frictionless after Brexit, the EU would require not only regulatory alignment with the UK, but a system for ensuring that standards remain aligned and for arbitration where conflicts arise. Yet such an arrangement would be unacceptable to many supporters of Brexit, not least because the EU is likely to insist on a role for the ECJ, which crosses one of the UK’s red lines. Second, UK regulators would need to assume responsibilities, together with the additional resources necessary to carry them out, that have been performed by EU-level bodies. This outcome would be costly, lead to duplication and be economically inefficient.

But there are also problems with the second choice. If the UK were to remain in regulatory alignment with the EU, Brexiters would protest that the Leave vote had not been respected. UK regulators would not be able to set standards independently and would have to submit to monitoring and arbitration arrangements to ensure that UK rules and norms were equivalent to those of the EU. As mentioned in the introduction, this is the essential dilemma at the heart of the Brexit negotiations. How the regulation issue is decided will largely determine what kind of future relationship the UK and the EU have.

Although the UK has proposed a mutual recognition of standards between the UK and the EU, such an arrangement would be unacceptable to the EU. Moreover, since the EU would insist on oversight mechanisms to ensure that UK rules are equivalent to EU regulations, Brexiters are likely to oppose this option. Until this question is answered, there cannot be a significant reduction in the uncertainty that the negotiations have created, and a resolution ought to be one of the main focuses of the government’s white paper.

The regulation issue is especially acute in certain sectors. Financial services are an important sector in the UK for both the economy and employment, as John-Paul Salter explains later in this report. Without regulatory alignment, the UK is likely to have reduced access to an important market and jeopardise international investment.

Moreover, aircraft safety is regulated at EU level and standards are enforced by the European Air Safety Agency (EASA). Since there is no WTO fall-back equivalent for aviation, the choice faced by the government is stark: either ‘take back control’, with the implications that the UK Civil Aviation Authority would have to take on greater obligations, require substantially more resources and would in any case be duplicating much of what EASA does; or remain a member of EASA.

Even if the UK chooses the latter option, continued membership of this particular agency would conflict with the EU’s position that the UK cannot ‘cherry pick’. There is currently no member which is not part of the various European structures—such as EU membership or the European Economic Area—all of which the government has either committed to leaving or not joining as an alternative to EU membership. Once more, not least to provide certainty to businesses, the white paper should deal with these difficult choices and identify a way forward potentially acceptable to both the EU and the British government.

# 8. Dispute settlement

**By Steve Peers and Catherine Barnard**

Assuming the transition period goes ahead as negotiated, dispute settlement would work much as now, with the European Court of Justice (ECJ) having the same jurisdiction regarding the UK as it currently does (albeit with no British judges sitting on it). Following transition, the Court might continue to have a limited say over the rights of the EU27 citizens in the UK, and possibly some jurisdiction over disputes concerning the withdrawal treaty, although the UK has not yet agreed to this.

Thereafter, there are several possible scenarios. First, that no deal on the future is agreed—the World Trade Organisation (WTO) outcome. In such a circumstance, the withdrawal treaty (if it is agreed) would still be in force. But disputes over trade would be litigated via the cumbersome WTO system.

That system is already under considerable pressure, as the Trump administration is blocking appointments to the WTO's Appellate Body. However, its basic elements are clear and have been well established since 1995. First, there are negotiations between the WTO members involved in a dispute. Then, should negotiations fail, a panel of experts is set up, and rules on the argument. If either or both sides dispute its findings they can appeal to the WTO's dispute settlement Appellate Body, which gives a final ruling.

If a member is found to have breached WTO law, it has to fix the breach within a 'reasonable time', usually around fifteen months. If the winning WTO member disputes whether the losing member has done that in time, the issue goes to arbitration. If the losing member continues to breach WTO law, the winning member can retaliate with proportionate restrictions on the losing party's exports to it. In short, WTO rulings do not have legal effect in the national legal systems of all its parties. However, they still have a practical impact, because if the losing member defies a WTO ruling it is likely to face trade retaliation.

The EU is an old hand at both using and defending itself in front of this WTO system. In contrast, it does not tend to make use of the very similar dispute settlement systems included in many of its free trade agreements with non-EU countries. Nevertheless, it is worth thinking about these systems, if only to consider their suitability for an EU-UK agreement.

In association agreements, such as that which the EU has with Ukraine, there are obligations on the EU's partner to apply EU legislation. As soon as it has been applied, the EU insists on the ultimate authority

of the ECJ to interpret EU legislation if a dispute cannot be settled politically. The government is thus faced with a stark choice: regulatory divergence, with the attendant economic costs, or applying EU law, which means continued jurisdiction of the court if a dispute is not settled by other means. To date, the government has fudged or ignored this issue. But the time for stark choices is fast approaching. The possible role of the court can be avoided in a free trade deal like that with Canada, but such a deal will provide for less market access to the EU.

The other alternative is the ‘Norway model’ of European Economic Area (EEA) membership. Here, too, there are extensive obligations to apply EU law. However, EEA law is interpreted by a separate international court: the EFTA court. EEA law and the EFTA court’s rulings have more limited effect than EU law in the national legal system (akin to the effect of international law). National courts are not obliged to follow EFTA court rulings and the two pillars of EU law—that it takes ‘direct effect’ in and supersedes national law—do not apply. But there is the possibility of dispute settlement in the event of divergence in legislation or case law, or in the event one of the parties uses a safeguard clause. Ultimately, such disputes could be settled by arbitration or result in trade retaliation.

Whatever the outcome of the Brexit process, the UK’s relations with the EU will still require a form of dispute settlement, whether that is through arbitrators, panels, Appellate Bodies or the ECJ itself. This will differ from EU law in legal form. EU law is unique in that it is directly incorporated into the legal systems of its member states rather than simply applying to that state. Moreover, the UK will likely also be constrained by fewer EU rules than at present. But as a matter of substance, a ruling which is binding at the international level and which is likely to be enforced by trade retaliation if it is not applied will have a real-world impact too. The UK may well welcome this, if it wins a complaint against the EU or others; but it will rue it if it loses or is deterred from doing something popular because of the risk of losing. In the modern world, freedom to act is always relative.

# 9. Governance arrangements

**By Catherine Barnard and Steve Peers**

When considering the governance structures that will regulate UK-EU relations post-Brexit, there are, broadly, two alternatives for the white paper to choose between: the intergovernmental and the supranational. Under the former, the parties meet as equal sovereign states. There may be a secretariat, but it has no authority over the parties. It certainly has no adjudicatory power. Issues are resolved through diplomatic channels. Failure to resolve those disputes may ultimately result in the agreement withering on the vine or being terminated.

The governance arrangements of the European Free Trade Agreement (EFTA), the agreement between Iceland, Liechtenstein, Norway and Switzerland, broadly follow the intergovernmental model. There is an EFTA Council which meets at ambassadorial level eight times a year and at ministerial level twice a year. The EFTA Council is advised by the EFTA Parliamentary Committee, a forum for parliamentarians in the four member states, and the EFTA Consultative Committee, a forum for trade unions and employers' associations in the four member states. The EFTA secretariat deals with the management and negotiations of free trade agreements with non-EU countries and provides support to the EFTA Council.

In the supranational model, which characterises the EU, states participate in the institutions, which have characteristics of a (quasi-federal) state. So there is an executive (the Commission), a legislature (the Council and the European Parliament) and a judiciary (the Court of Justice—ECJ). While all member states have representatives on these bodies the decisions of these bodies are binding on the member states, which can be subject to fines if they do not comply. Unlike under traditional international arrangements, individuals and firms have access to the ECJ, often via national courts.

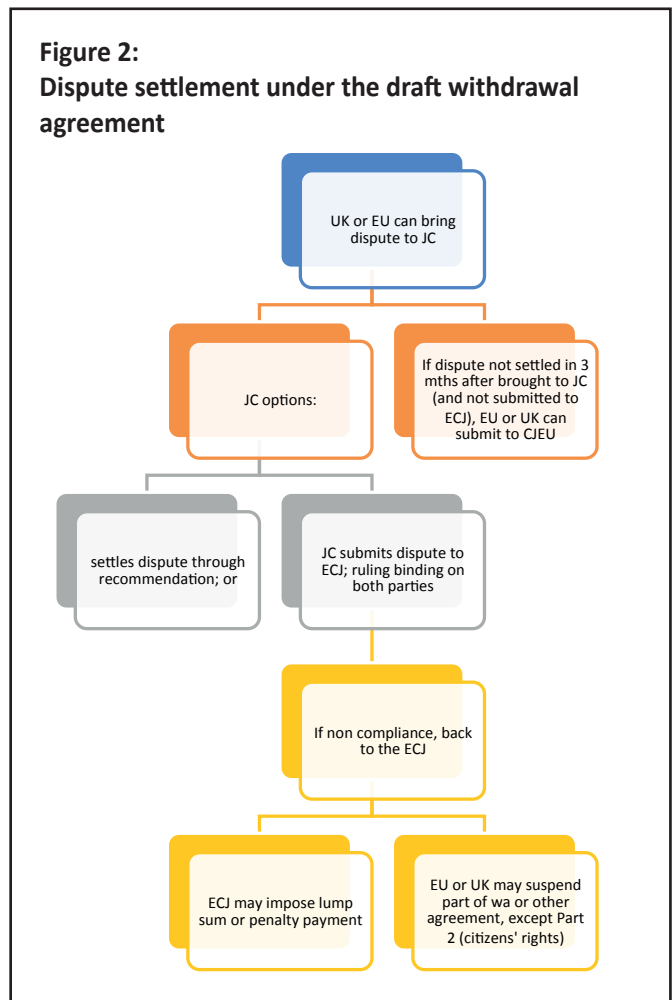
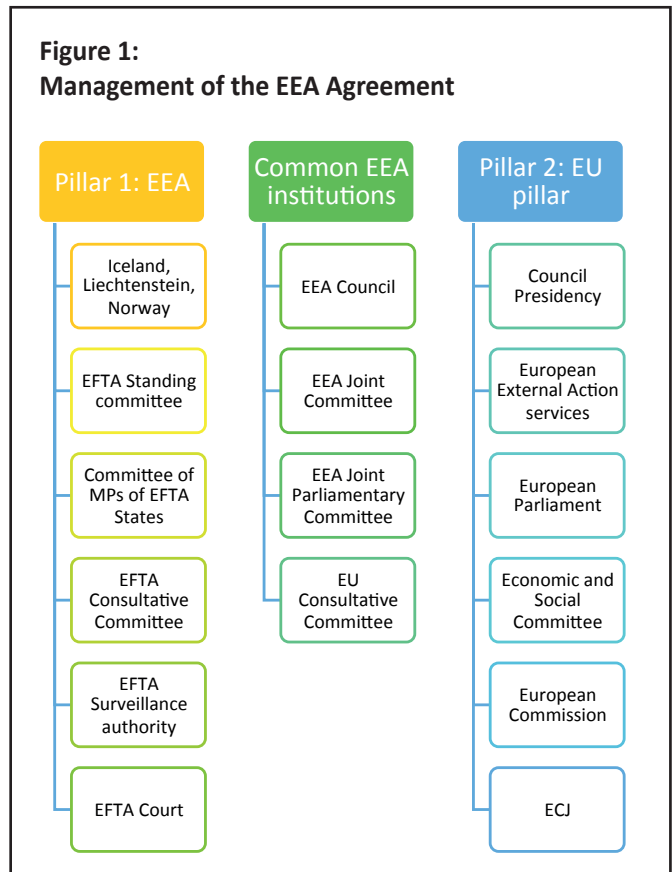
There are also a number of hybrid models. The EEA agreement between the EU and the EEA states (Norway, Liechtenstein and Iceland) is an example. There are two pillars in the EEA agreement: (1) the EEA pillar and (2) the EU pillar. There are also common institutions (see figure 1 on the next page).

The question facing the UK is which of these two models it wants going forward. Much depends on how close and deep the new partnership is: the closer the relationship, the more the EU will push for something like the existing arrangements. This is particularly so if the UK stays in the customs union (or something very much like it). Conversely, the more distant the relationship, the more intergovernmental the governance arrangements will be.

The draft withdrawal agreement gives a flavour of what the future governance arrangements might look like. For ongoing management and supervision, it prescribes a Joint Committee between the EU and the UK which makes decisions and recommendations by mutual consent. It can be helped by specialised committees on, for example, the island of Ireland and financial provisions. This, like the EEA’s Joint Committee, has an intergovernmental feel.

However, arrangements for the settlement of disputes over the interpretation and application of the withdrawal agreement feel more supranational (and follow the EEA model closely). The details are explained in figure 2 on the right. It remains to be seen if the UK can agree to this. Another alternative could be that the EFTA court (the court of the EEA agreement), perhaps renamed and certainly refigured to include UK judges, is used to decide the issues. If no agreement can be reached, the WTO rules will apply (see the Dispute settlement chapter).

Whatever the preferred outcome, there are, in this area as in so many others, difficult choices the government needs to make if the negotiations are to progress.



# 10. Immigration

**By Jonathan Portes**

‘Taking back control’ of immigration policy, and in particular ending free movement, may have been the most important single issue driving the Brexit vote. And it was that issue which drove the Prime Minister’s fateful decision, at the October 2016 Conservative Party Conference, to set out her three “red lines”—“control over our borders, our money, and our laws”—a decision which, more than anything, has led to the current impasse in the negotiations and the need for the UK to reset policy with the white paper.

The EU27 have been clear from the outset that the ‘four freedoms’ are indivisible—that is, if we want to remain part of the single market after Brexit, then that means accepting freedom of movement. It may not necessarily be in precisely its current form or without restrictions—the versions of free movement that apply to Norway and Switzerland, within the single market but outside the EU, are not identical to the rules that apply to the UK now—but these countries nevertheless accept the principle. It is not impossible, as I’ve [argued](#) previously, that they may be prepared to make concessions as part of a wider deal that keeps the UK in much of the single market and the customs union, but it will likely be a compromise very much on the EU’s terms.

So if, as recent reports suggest, the Prime Minister plans to use the white paper to set a course towards a much softer Brexit, then some blurring of the government’s red lines on free movement will be required—if not now, then soon after. One approach would be to confront the issue head on; that is, to accept that the level of access to the single market the UK wants after Brexit will require us to accept some form of free movement (or, if we don’t want to call it that, ‘enhanced labour mobility provisions’). Another would be to explain why free movement in its current form is so problematic politically for the UK and to seek to negotiate with the EU27 modifications that might be acceptable to both sides. I set out some [proposals](#) on these lines a year ago, based on the new system just introduced in Switzerland.

Many across the political spectrum would welcome this. It would delight business, which would very much like a system that is as close as possible to free movement, both on its own merits and as part of a wider move towards a softer Brexit. The Business Secretary Greg Clark has made his position clear—that free movement is both an economic benefit to the UK, and an integral part of the wider single market. And it would wrongfoot the Labour Party, which is itself split on the issue. There is a significant minority within the party which shares the view of many Brexiters that “honouring the result of the referendum”

requires an end to free movement, but the leadership and the majority of the parliamentary party would find it impossible to oppose such a move.

But despite these attractions, such a move seems unlikely at present. It would be several steps too far for those who prefer a ‘clean’ Brexit; and while the Prime Minister appears to be prepared to abandon her original vision of Brexit in almost every other respect, to admit that the UK would not regain full control over immigration policy would almost certainly be politically fatal.

So, to put it mildly, this will not be an easy square to circle. On past form, the Prime Minister is likely to pretend that the choice can be avoided—that the UK can secure some form of limited or modified single market access without accepting the compromises on free movement that this would almost certainly require. If accompanied by enough concessions elsewhere this may be just enough for the present both to keep her own party together and to avoid an immediate rejection by the EU28. But it is likely only to postpone the inevitable confrontation with reality – the form of Brexit she now seeks will require her to blur, if not entirely erase, this last, and politically most charged, “red line”. Immigration and free movement remain, as they have been from the beginning, absolutely central to the UK’s Brexit choices, but in this white paper, they are likely to be the dog that doesn’t bark.



# 11. Devolution

## By Nicola McEwen

The impact of Brexit on Northern Ireland and the island of Ireland has been a prominent issue in the Brexit negotiations to date. By contrast, its implications for Scotland and Wales have been largely overlooked in the UK-EU negotiations. And yet, Brexit is having a profoundly destabilising effect on devolution.

Despite early assurances from the Prime Minister to the contrary, the preferences of the Scottish and Welsh governments have had little impact on the government's negotiating position. Both devolved governments have argued strongly for the UK to remain within the EU internal market and the Customs Union. They collaborated recently, ahead of the white paper, to urge the Prime Minister to pledge to stay in both. The Scottish government, buoyed by a large majority of Scots voting Remain in the Referendum and initially backed by cross-party agreement in the Scottish Parliament, had also argued that if the UK was to leave the internal market a way should be found to enable Scotland to remain within or closely aligned to it. This was formally rejected by the UK government over a year. However, if such a solution is agreed for Northern Ireland we can expect renewed demands from the Scottish government for a differentiated solution for Scotland.

The devolved governments will look to the white paper to provide greater detail on the nature of the future economic relationship with the EU. They are seeking maximum regulatory alignment with the internal market and frictionless trade in goods. They also want assurances on participation in EU programmes, including research and innovation funding which has benefited Scotland disproportionately. The Welsh government has expressed particular concern about the UK government's commitment to sustaining regional investment at the levels Wales receives from the EU. The devolved governments have championed continued labour mobility for EU citizens and demanded assurances for EU citizens living in Scotland and Wales. Scottish and Welsh ministers wrote jointly to the Home Secretary Sajid Javid in June to express concern about the lack of clarity over the EU Exit Settlement Scheme, and to seek a greater role in its implementation.

The devolved governments have had a bigger voice within the domestic Brexit process, though they may dispute the extent to which that voice has been heard. Intensive intergovernmental discussions have focused on the EU (Withdrawal) Bill. Following unprecedented collaboration between the Welsh and Scottish governments, some concessions were secured which placed limits on the Bill's impact

on devolution. These amendments, and the accompanying commitment from the UK government to refrain from making legislative changes without seeking agreement from the devolved institutions, were sufficient to secure consent from the National Assembly for Wales. But they were insufficient to win the backing of the Scottish government or the Scottish Parliament.

That the bill was passed without the latter's consent—the first time the Westminster Parliament has altered devolved competence in the face of opposition from the Scottish Parliament—has cast doubt over the future of the Sewel Convention, one of the founding principles of devolution. The Scottish government's Brexit minister called it a “dark day for devolution”, and the SNP Westminster group staged a walk-out from parliament in protest. If, in the raft of Brexit-related legislation in the pipeline, the UK government continues the practice of legislating in areas of devolved competence without consent, it is likely to lead to a further deterioration of Scottish-UK government relations.

One of the tests the Prime Minister set out in her Mansion House speech in March was that the Brexit deal “must strengthen our union of nations and our union of people”. Much discussion has focused on the need (or otherwise) for common UK regulatory frameworks after Brexit. [Intergovernmental agreement](#) was reached, in principle, that these may be necessary to preserve the UK internal market, manage common resources, safeguard justice and security, and to protect the UK government's ability to negotiate and implement international treaties and trade deals. The white paper may include proposals for post-Brexit governance arrangements. But if it also includes a commitment to adopt or mirror broad areas of EU law, this may undermine the case for new UK common regulatory frameworks, as there would be limited scope for either the Westminster or the devolved governments to go their own way.

If new governance arrangements are to strengthen the ties that bind the UK's four nations together, it would be more advisable to design and build them on the basis of intergovernmental co-operation. The Joint Ministerial Committee has already initiated an intergovernmental process to review whether existing structures are fit for purpose in a post-Brexit context. From a devolution perspective, new UK governance arrangements must provide space for a meaningful voice for the devolved governments and legislatures, including consenting powers in areas of devolved responsibility. Without this, further strains in the UK's internal territorial relationships seem likely.

# 12. Fisheries

**By Craig McAngus, Christopher Huggins, John Connolly and Arno van der Zwet**

Fisheries is one example of a policy area that will receive its own legislation. This is expected in the coming months following the recently published fisheries white paper in July 2018. Nevertheless, the white paper on the UK's future relationship with the EU will be crucial in setting out the context within which fisheries will operate, especially the UK's future trading relationship with the EU.

The UK exports around 75% of the fish it produces, and 66% of these exports go to the EU. This seafood trading relationship is predicated on membership of the Common Fisheries Policy (CFP), which essentially creates a free market *within* a free market. This is why countries like Iceland and Norway, members of the European Economic Area (EEA), have to contend with tariffs and non-tariff barriers when it comes to exporting seafood into the EU despite having full access to the single market. This obstacle is balanced by, as they see it, not being members of the CFP and thus having full discretion as to which countries are allowed into their waters to fish.

The government has committed to the UK becoming an independent coastal state once the transition period is over. For its part, the EU is keen to ensure its vessels will continue to benefit from access to the UK's exclusive economic zone (EEZ), the territorial waters that the UK will be legally responsible for after Brexit. Overall, how closely aligned it remains to the CFP is yet to be seen. In the fisheries white paper, the government says it expects questions of fisheries access and the wider trading relationship to be treated separately in its negotiations with the EU. But the EU has already indicated that it sees the two linked together as part of a larger package deal. This was illustrated in March 2018 when the announcement was made that the UK and EU would work towards a transition period. Here, the EU offered the UK continued tariff-free trade, but on the explicit condition that existing access arrangements for EU vessels in UK waters are maintained. In the longer term, further diversion from the CFP may take place, but is more likely to occur incrementally rather than via a radical reform.

Ultimately, while the mantra of taking back control of the UK's waters is politically important, there is also a need to balance wider interests (both within and beyond the fishing industry) in negotiations on the future relationship with the EU. The catching sector overwhelmingly backed Brexit, but much of the seafood processing sector, for example, relies on exports to the rest of the EU. Even within the catching sector there are differences. Those fishing shellfish, for instance, rely on frictionless trade. On

the other hand, the UK fishing industry only represents a small proportion of total GDP although it has a significant impact in certain areas of the country.

It remains to be seen what sort of system is created to monitor and check goods that flow across the UK's borders. The export sector will be particularly keen on a system that is as frictionless as possible. France, for example, is a very important buyer of fresh fish landed in UK ports. Fish landed in Peterhead on a Monday morning can, as things stand, be transported and delivered to French buyers on a Tuesday morning. Any delays in that fish getting to France would have an obvious impact on its freshness and therefore its price. The reduced value of sterling is good news for exporters in one sense, but they will be keen to see a system in place that implies minimal delays for their product given that, in the trade of fresh fish, time is of the essence.

Despite wanting to keep the issues of fisheries access and the trading relationship separate, the UK's wider desire to secure a frictionless trading relationship with the EU might mean some overall compromise can be expected. EU vessels would likely still get some favourable access in return for the UK continuing to enjoy some, if not all, of the benefits of frictionless trade in seafood. To this end, the fisheries white paper recognises the importance of reciprocal access to fishing waters to both the UK and the EU.

In practical terms, the UK's withdrawal from the CFP requires UK authorities to consider what capacities and technical areas they need to develop for the areas that were once managed by the CFP. This is particularly the case for international policy coordination, as the UK will have responsibilities under the UN Convention on the Law of the Sea to co-operate on the management of shared stocks. Relationships with non-EU countries and international bodies, such as the International Council for the Exploration of the Sea and the North-East Atlantic Fisheries Commission, are currently handled by the EU, so the UK will need to develop these links in addition to managing its relationship with the EU.

The CFP can have an external impact on non-EU member state fisheries and, as such, it is important for the UK to think about how it wishes to engage with EU partners in future. This could be achieved, for example, through a mission to the EU through an embassy similar to Iceland. Furthermore, clarity on what trade and custom arrangements are to be put in place are of key interest to the fishing industry. The Brexit white paper needs to address how goods are to flow in and out of the UK and what sort of checks and delays are likely to result from that. Such detail would provide the industry with a better idea as to how their exports would reach European markets.

# 13. Agriculture

## By Carmen Hubbard and Anne Liddon

Brexit will have significant implications for UK agriculture, a sector that has strong trade links with the EU. Many businesses rely on the Common Agricultural Policy (CAP) income support. The government has stated that UK farmers will continue to receive the same level of subsidy as they do under the CAP until the end of 2022. What will happen thereafter is much less clear, with only vague statements suggesting a shift to “public money for public goods”, but with no definition of what this might mean. Some restructuring of the industry does seem inevitable, with possible land abandonment in more remote, particularly upland, areas.

What is needed from the white paper is a much clearer statement about domestic agriculture policy: objectives regarding trade relations with the EU, a plan about how the UK will cope if the negotiations with Brussels fail, and a clarification of the position of the migrant workforce. These questions—particularly decisions on trade agreements—will be key for the future of the agricultural industry.

Different trading arrangements will have very different implications. Under a free trade agreement with the EU (i.e. the UK leaves the single market leading to some additional trade facilitation costs at the border, with tariff and quota free access between UK and EU trade flows are at zero), agricultural impacts would be relatively modest. In contrast, an extreme trade scenario such as a unilateral trade liberalisation (elimination of all import tariffs between the UK and EU and the rest of the world) would have significant negative impacts on farm prices, production and incomes.

The adoption of the EU’s World Trade Organisation (WTO) tariff schedule will favour some net import sectors, such as dairy, but may harm some export sectors, such as sheep production. Given the dependence of many UK farms on direct payments, their removal would worsen the negative impacts of new trade arrangements and offset positive impacts. Moreover, the effect on UK agriculture will be far from uniform, with significant differences between the devolved administrations. Hence, for Scotland, Wales and Northern Ireland, there need to be decisions on where power will lie for the agricultural industry; who will decide on spending; and what flexibility there might be in allocating agricultural support.

Clarification is also needed on the Irish border and how smooth agricultural trade might be achieved, given the strong integration of the agri-food sectors across the island of Ireland. Any form of border,

accompanied by different tariff arrangements would be likely to slow the flow of trade. This would disrupt highly integrated agri-food supply chains and might even encourage the illegal movement of animals and other goods.

For consumers, the implications will depend not only on any tariff schedule that the UK puts in place and its impact on import supply, but also on the value of sterling in foreign exchange markets. This is a factor that may be more difficult to influence. A return to WTO tariffs, for example, would increase domestic food prices, with more serious effects on poorer households who spend a higher proportion of income on food. But low (or no) tariffs could be more beneficial for consumers, leaving prices lower or unchanged, at least in the short term. However, there might also be disruption to the supply chain as trade barriers (whether tariff or non-tariff) involve higher administrative costs.

The white paper has to take all these elements into account if it is to be effective, while the EU's reaction is yet another unknown. They will certainly have an interest in how to resolve trade arrangements with the UK. In the event of 'no deal' WTO arrangements, future UK tariff rate quotes and import access, for example, will have to be clarified with the agreement of both WTO and the EU. How easy this process will be in practice remains to be seen. The EU will balk at any suggestion of reinstating a hard border with the Irish Republic and could resist proposals for severe restrictions on migrant labour.

Hence, any UK policy measures that will restrict trade and the movement of migrant labour will come at a cost for the UK economy as whole, particularly the agri-food sector. Moreover, given the diversity of farms across the UK, trade deals that will focus upon the needs of a typical UK farmer could put businesses across the devolved administrations at a higher risk (e.g. beef in Scotland). A hard Irish border will create not only a significant disruption of the day to day activities but it might rekindle historical tensions. Thus, the white paper should consider making trade with the EU as frictionless as possible and include solutions that might be acceptable for all parties. It should also consider how policies designed to drive economic and social growth and sustainability can be relevant and applicable to businesses and communities across the entire United Kingdom.

# 14. Financial services

## By John-Paul Salter

The financial services sector is a significant part of the UK economy. It accounts for 7.2% of Gross Value Added and 11% of total tax receipts. However, its continued success, at least in the short and medium term, depends upon a number of questions being resolved regarding market access. It is clarity on these questions that we need to see in the forthcoming white paper.

The EU-wide market in financial services rests on a common regulatory framework and the system of ‘[passporting](#)’: once a firm has obtained authorization in one member state, it can conduct business in all others without needing further authorization. Passporting, however, applies only within the single market. Outside it, one-stop authorizations will no longer be available. Thus, a new arrangement will be needed if UK-domiciled firms are to continue offering services to clients in the EU.

Broadly speaking, there are three possible options. The first is that an eventual free trade agreement signed with the EU after Brexit would include provisions covering financial services; this is, however, unlikely as such agreements rarely (if ever) cover trade in services.

The second and third are essentially variations on a theme. EU legislation for financial regulation contains provisions allowing for access based on ‘regulatory equivalence’: if EU regulators judge the regulatory framework of a non-member state to be equivalent, they can allow access to the single market for its firms. However, these provisions do not cover all aspects of financial services activity. In simple terms, the scope is restricted to wholesale services, so there would be areas of business—like retail banking, for example—from which UK firms would be barred. Moreover, in order for firms to be able to commit to long-term financing arrangements with EU clients, the UK would have to keep its rules very closely aligned with those of the EU. And the ECJ would continue to operate as the arbiter in case of any disagreements, meaning that the UK would still be subject to its jurisdiction.

The third option is ‘mutual recognition’. Here, EU regulators would accept that the UK’s rules are similar to their own in intent and outcome, if not in process and content, and would allow access to EU markets for British firms. This would be a bespoke arrangement put together specifically for the UK (as opposed to regulatory equivalence, which is available to all and has been used by the US, Australia, Canada, Switzerland and Bermuda). However, the EU’s Brexit negotiators, and the commissioner responsible for financial regulation, have already all but rejected the idea.

Leaving aside the possibility of a financial services chapter in a future trade agreement, there is an important tension lurking behind the second and third options. Regulatory equivalence would be relatively simple to obtain and could be done quickly; it would mean UK-domiciled financial services firms would retain access to the EU’s markets for at least part of their business. However, the UK would

become a ‘rule-taker’, having to adopt and implement in law new regulations issued by the EU in order to protect its status as ‘equivalent’. Theoretically, mutual recognition could result in less restricted access, but would still allow the UK greater autonomy in its financial regulation. The Treasury, keen to sustain the health of the financial services sector and protect tax revenues, has favoured the former; while the Bank of England, keen to assert its independence as a rule-making body, prefers the latter.

The UK government seems to have taken a fairly muted position on this issue. This has created significant unease in the sector, as both viable options require detailed negotiation. The UK would have to apply for regulatory equivalence. Mutual recognition would require not only agreement over principles and the trajectory of regulation but also the construction of the associated institutional framework: an oversight mechanism, an independent arbitration body, and so on.

Alongside all these concerns of market access is the equally important but perhaps more arcane matter of the governance of the UK financial sector. There are two layers to consider here. First, the harmonised set of regulations originating from the EU is accompanied by a dense web of supervisory partnerships: British authorities oversee EU firms operating on UK soil, and vice versa, acting in small ‘colleges’ organised by the European Supervisory Authorities. This system works because all the national authorities are bound together in the same institutional structure; after Brexit, however, the mechanism will have to be adapted so that close co-operation can be maintained between EU authorities and what will then be a third country. To facilitate this, detailed memoranda of understanding regarding supervision between British and EU regulators will be required. Judging by the recent signals coming from the European Central Bank, this is an area of considerable concern for the EU, as pockets of risk could develop, unseen, in the gaps between the British regime.

Second, and more broadly, there is the question of what the government intends to do regarding the financial sector’s place in the overall economy. The financial crisis exposed just how reliant the economy was on this sector—and since this remains the case, there have been calls for the economy to be rebalanced towards, say, manufacturing. The government appears to have heeded these (recall, for example, the Industrial Strategy), but efforts to bolster other sectors or industries all rely on a healthy and vibrant financial sector at the core of the economy. Thus, if the decoupling from the EU’s financial regulatory regime is not handled with care, and the financial sector spends five years adapting to life outside the EU, then there will be a knock-on impact on the wider economy.

As in many other areas, the problem is layered uncertainty, not only of outcome, but also of aspiration. As long as there is no clear government line on the various financial services related issues, work cannot progress on underlying technicalities. The white paper thus needs to articulate exactly what the UK government seeks. Thought should be given to the practicalities of each option: a financial services chapter in a free trade agreement is highly improbable, and the EU is unlikely to accept a mutual recognition arrangement.



# 15. Foreign and security policy

## By Anand Menon

Foreign and security policy are different to other sectors under discussion in the Brexit negotiations. First, Britain has, by some measures, played a leading role in driving European integration in these areas—the Common Security and Defence Policy was an Anglo-French initiative, for example. Second, it is a leading security provider measured in terms of the capabilities it possesses and its willingness to deploy them. The UK accounts for about 15% of EU GDP, but for 25% of all defence equipment procurement spending. Finally, and crucially, flexibility in terms of co-operation with non-members should, in theory, be easier here than in other sectors. Much foreign and security collaboration is intergovernmental, so is far less embedded in the EU legal framework than other sectors.

This is of course not true for all areas of security. Data sharing—a crucial aspect of internal security—is governed by EU law, and hence falls under the competence of the ECJ. Here, the trade-off between the government's red lines and the workings of the system are as apparent as they are in many of the other areas mentioned in this report.

Take Galileo, the EU's GPS space project. The UK expected to get a special deal because of its crucial involvement in the project to date. But that has not been the case. In a recent speech, Michel Barnier said starkly “The UK decided unilaterally and autonomously to withdraw from the EU. This implies leaving its programmes as well.” The same is true for the EU Defence Fund. The EU is developing regulations that will shut out any UK companies, even subsidiaries, from EU-funded projects. That means in the future manufacturers might have to decide between taking part in the EU's schemes and working with Britain.

Again, as we set out in our earlier discussion of the politics of the white paper, there is something of a culture clash between the UK government and the EU. The UK sees continued full participation in programmes such as Galileo as mutually beneficial, whereas the EU sees the integrity of its legal structures as the primary concern—the UK can move to third-country participation, for which there is a legal precedent, and that's about it

However, particularly when it comes to foreign and security policy in the traditional sense, there ought to be fewer constraints. The government has made clear it wants to continue co-operating as before. This may be unrealistic, but there certainly ought to be scope for greater co-operation than standard

third country participation when it comes to decisions around the deployment of EU military missions, for instance. The Prime Minister, in her Munich speech, stressed the close co-operation that exists with European partners and that she would like this to continue. The strong emphasis was on the indivisibility of security: “Europe’s security is our security. And ... the United Kingdom is unconditionally committed to maintaining it.”

The UK, of course, cannot have a formal vote on EU defence matters—which the EU treaties forbid—but excluding it from detailed planning and a leading role in running operations seems like the EU cutting of its nose to spite its face. Here, the Prime Minister has a point.

The emphasis on pragmatism, noted in the Introduction to this report, is all too evident in the British approach to the security negotiations in particular. As Mrs May put it, this “cannot be a time when any of us allow ... rigid institutional restrictions or deep-seated ideology to inhibit our cooperation and jeopardize the security of our citizens”. The government’s technical note on foreign and security policy cooperation, published in May 2018, lists a number of possible ways in which this co-operation could continue post-Brexit.

The government must hope that, eventually, some member states become frustrated at what they come to see as overly rigid Council guidelines. Pledges for specific forms of future co-operation could also underline the government’s determination to maintain co-operation in this area, whether in the form of troops or the readiness to provide operational headquarters if necessary, or the promise of investment in collaborative procurement schemes.

Member states have had little input in the defence negotiations, which are being led by the Commission. This was clearly something the Prime Minister attempted to address at last week’s European Council when she effectively went above the heads of the Brexit negotiators and appealed directly to European leaders. The white paper will likely continue with this appeal. There are as yet, however, few indications it will be successful.





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