

BREXIT UNIT

Where are the 'free market' red lines for phase 2?

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15th December 2017

A transition period may now be a necessary evil, but the EU's proposed terms would effectively put Brexit on hold. The UK risks being boxed in permanently to a 'soft Brexit' where it retains the obligations of EU membership with no control over the rules and none of the benefits of leaving.

The transition should therefore be time-limited, short, and different from the status quo. The UK must be allowed to start to negotiate its own trade deals and should be exempted from any new EU rules that are not absolutely necessary for the transition to work. At the end of this period, a 'Canada ++' deal is probably the most realistic way to deliver a 'free market' Brexit, but the UK should retain the option of a clean break.

The challenges posed by Ireland could shape Brexit for the whole of the UK. It should be possible to avoid a 'hard border' while still regaining control of domestic regulations and external trade. This may require compromises by all. However, the alternative of continuing to replicate the single market and customs union would prevent the UK from ever making the most of the opportunities created by Brexit.

UK remains on course for Brexit, but what sort?

The joint report from the EU and UK negotiators, published on 8th December, has cleared the way for the second phase of talks on what is perhaps optimistically being described as the 'orderly withdrawal'.

To recap, the two sides have agreed to preserve the existing rights of each other's citizens and on the principles of a financial settlement that the UK hopes to keep below £40bn. However, there are still no clear answers to the challenges posed by the unique position of Ireland.

The UK has repeated its commitment to avoid a 'hard border' between Northern Ireland and the Republic – meaning an absence of visible infrastructure such as customs posts and passport checks.

The question is whether this is consistent with the UK's departure from both the Single (or Internal) Market and the Customs Union. Many EU leaders fear that an open border could allow the import of goods from or via the UK that do not meet EU standards, or evade the EU's common external tariffs.

The UK's intends to resolve this conundrum 'through the overall EU-UK relationship', that is as part of a comprehensive free trade deal. If that is not possible, the UK will propose technical solutions, such as electronic customs procedures which do not require physical checks at the border. Lastly, and only if these solutions cannot be agreed, the UK has said it will maintain 'full alignment with those rules of the Internal Market and the Customs Union' necessary to honour its commitments over Ireland.

Key points

- The EU has confirmed that phase 2 of the Brexit talks, covering the future relationship, can now begin. However, there are still no clear answers to the challenges posed by the unique position of Ireland.
- The UK has said it will maintain 'full alignment' with the rules of the single market and customs union. But this commitment is subject to specific conditions.
- It only applies if other solutions are not found, and then only to the extent necessary to avoid a 'hard border'. The meaning and scope of 'alignment' is also open to interpretation.
- It is therefore premature to conclude, as some have, that a 'soft Brexit' is inevitable.

Some commentators have concluded that the UK will inevitably be obliged to stay in both the single market and customs union in all but name, and even that the commitments made already amount to this. This is premature, for three main reasons. First, we do not yet know the shape of any future trade deal, or enough about the feasibility of any technical solutions. Regulatory alignment is only a backstop.

Second, both the meaning and the scope of 'alignment' is open to interpretation. On nuclear issues, for example, the UK has already committed to a future regime that provides coverage and effectiveness equivalent to existing Euratom arrangements. But this does not necessarily mean having exactly the same rules and regulations as the EU, or applying them to every sector of the UK economy.

Third, much still depends on the degree of pragmatism shown by all sides. In particular, an open border between Northern Ireland and the Republic might allow some goods to bypass EU barriers, but would this activity really take place on a scale large enough to threaten the integrity of the entire union?

Overall, there is a risk that the UK sleepwalks into a 'soft Brexit' where it must obey all the rules of the single market and customs union. This would cross the thickest and boldest of red lines. However, it should be avoidable.

What next?

'Phase 2' on the future relationship between the UK and the EU looks set to start (let's call it phase 2a) with an agreement on a transition period, before negotiations begin (phase 2b) on a permanent trade deal.

Ideally, of course, the two sides would now move immediately to finalise a comprehensive free trade agreement (FTA) in time for March 2019. This should be straightforward, because they are no barriers to begin with.

However, given the political constraints faced by both sides, the unresolved issues over Ireland, and how long it has taken just to get this stage, some form of transitional period is now a necessary evil. The EU has suggested that this can only take the form of continued membership of both the single market and customs union, with all the rights and obligations. This is debatable. Even if the UK left the single market, WTO rules would not require either side to impose tariffs immediately provided a new FTA is being negotiated. And since regulations will still be the same at the point of departure, there should be no rush to erect non-tariff barriers either.

Whatever the form, any transition period should be short (two years after March 2019 should be more than enough) and time limited (to prevent the negotiations from dragging on). There should also be some material differences from the status quo. This is important to ensure that Brexit day is meaningful and to make it harder to roll back later.

At the very least, the UK should be able to negotiate its own FTAs with other countries, even if their implementation has to be delayed, and should be exempted from any new EU rules which are not absolutely necessary for the transition to work. Nor is there any case for additional budget contributions on top of those already agreed in the financial settlement.

The final deal

At the end of this period, a 'Canada ++' deal is probably the most realistic way to deliver a 'free market' Brexit. The existing EU-Canada agreement removes almost all tariffs on goods without requiring Canada to run its entire economy along EU lines, or preventing Canada from trading on its own terms with the rest of the world.

Admittedly, the coverage of services is patchy, and some important non-tariff barriers remain. However, the UK should be able to improve substantially on the Canada deal (the '++' bit), because it is a much more important trading partner. For example, the rest of the EU exported goods worth €220 billion to the UK in the first nine months of this year, far exceeding the €28 billion that the EU28 (even including the UK's share) sold to Canada. What's more, the rest of the EU is far more dependent on services provided by the UK, including financial services.

Nonetheless, the EU might still be reluctant to offer a good deal to a country that is potentially a more important competitor, and there will be some who want to ensure that the UK is in a much worse position than remaining EU members. The UK should therefore retain the option of making a clean break at the end of the transition period.

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- Ideally, the two sides would now move immediately to finalise a comprehensive free trade agreement (FTA). But given how long it has taken just to get to this stage, some form of transitional period is now a necessary evil.
- The EU is proposing that the UK continues to abide by all the rules of the single market and customs union during this period. This would effectively put Brexit on hold and may not even be necessary
- The UK should at least insist on being able to open negotiations on trade deals with other countries. In the meantime, there is no case for additional budget contributions over and above those already agreed in the financial settlement.
- At the end of this period, the UK should be able to improve substantially on the EU-Canada trade agreement ('Canada ++').
- But the UK should also retain the option of a clean break as a credible alternative to secure the best possible deal.