INSTITUTE FOR GOVERNMENT

Trade after Brexit

Options for the UK's relationship with the EU

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About this report

Brexit means that, for the first time in 40 years, the UK will have to renegotiate its trade and economic relationship with its largest trading partner. This paper sets out the options and trade-offs for the UK Government in negotiating its future trade relationship with the EU.

Our Brexit work

Following the UK's vote to leave the European Union (EU), the Institute for Government launched a major programme of work looking at the negotiations, the UK's future relationship with the EU and how it governs itself after Brexit. Keep up to date with our comment, explainers and reports, read our media coverage, and find out about our events at: www.instituteforgovernment.org.uk/brexit

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Contents

List of figures and tables

Summary

The UK rejects a binary choice between the Norway and Canada models

The European Commission has suggested that the UK faces a choice for its trading relationship post-Brexit – to become a rule taker with full market access like Norway, or have a standard free trade agreement like Canada. The UK has rejected this "stark and binary choice" between two existing models, calling for a bespoke free trade agreement. The Prime Minister rejected the Norway model on the grounds that becoming a rule taker with no formal vote would be politically unsaleable. The standard Canadian-style free trade agreement, which does not cover much of the service sector (around 80% of the UK economy), represents such a step change in market access that it would almost inevitably cause severe damage to the UK economy.

The European Union has been more flexible with other countries – but access to the Single Market always comes with obligations

The UK is right that there are precedents for deals in the "middle ground" between Norway and Canada. Contrary to the European Union's (EU) frequent statement that no partial integration in the Single Market is possible, it has allowed some exceptions for non-EU countries. But where such arrangements exist, that access has carried strict obligations.

The agreements with Ukraine and other eastern neighbours provide for partial integration into the Single Market but tie market access rights to the adoption of EU rules and oversight by EU institutions. Even if this was attractive for the UK, the circumstances are different: Ukraine is moving towards the EU, while the UK has chosen to leave.

Switzerland has a network of agreements with the EU that allows for sector by sector participation in the Single Market, but without institutions to oversee and enforce the agreements. This arrangement might also seem attractive to the UK, but it has become increasingly unpopular with the EU, which is unlikely to agree to offer the UK the same.

The EU has used a limited form of mutual recognition to remove some barriers to trade with countries like the US, New Zealand and Israel. But an agreement with the UK based on broad mutual recognition is highly unlikely. Its absence of oversight and institutions would contradict the EU's approach to trade.

The UK could adapt these precedents to propose a model that better suits its priorities

Leaving aside the issue of tariffs on industrial goods, which are mostly eliminated in all free trade deals, the UK's aim is to retain the freest possible access to the Single Market for services and to avoid the creation of regulatory barriers.

No precedent offers the UK an immediate solution. But the Government might look to adapt them in its negotiations with the EU. We set out three models which try to do this:

- An **EU–UK Economic Area ('Bespoke Norway')**. The UK broadly accepts Single Market rules and parallel institutions, but negotiates a new arrangement on freedom of movement and greater input on devising regulation (though it would not have a final say).

- An **EU–UK Deep and Comprehensive Free Trade Area ('Reverse Ukraine')**. This would allow participation in the Single Market in sectors which remain aligned and subject to oversight. Non-harmonised sectors would face barriers.

- An **EU–UK Comprehensive Free Trade Agreement ('Canada plus')**. This would be modelled on the EU-Canada Comprehensive Economic and Trade Agreement (CETA), but with the aim of agreeing better access for services and provisions for enhanced regulatory co-operation, to try to minimise trade barriers where possible.

The UK could propose a new approach based on 'managing divergence'

The UK and the EU start negotiations from a unique position, with complete convergence of rules. The final option this paper explores is a new approach, which takes into account this starting point and focuses on 'managing divergence'. This **'regulatory partnership' model** would allow the UK-EU relationship to develop over time.

This approach would give more flexibility, as the UK could choose whether to align with the evolving EU rulebook. But it would come at the price of uncertainty – any decision by the UK to diverge from EU rules might create barriers to trade, creating a complex legal landscape and potentially deterring investment.

The UK can't escape a fundamental choice: the more access it has to the Single Market, the more obligations it must accept

The EU so far has shown no willingness to come close to any agreement that combines the "weak constraints" of CETA with the access of Norway. Ultimately the UK will not be able to duck fundamental choices on how close it wants to stay to the EU market and the obligations it will have to accept as a consequence. The deeper the relationship, the more onerous the obligation, and the more likely it will cross the UK's current red lines.

The UK may be able to make the EU's offer a bit less stark. But it needs to be prepared to make trade-offs. High access and alignment can minimise disruption, but are likely to bring politically difficult obligations in the form of free movement and a role for supranational institutions. If the UK wants maximum control, and no longer be constrained by EU rules and institutions, it will face significant barriers to trade with the 27 member states (EU27).

A middle way does not remove the need for those trade-offs. Where it wants to continue to participate in the Single Market, it will need to accept commitments that come with it. There is limited scope for differentiating between very broad sectors, given the degree of integration.

The Government needs to put forward its preferred option

The Government is clear on what it does not want – but has failed to articulate what it does. The UK must put forward a concrete proposal on the relationship it wants with the EU and the Single Market as a basis for negotiations with the EU. This should be based on a clear analysis of the impact on the UK economy, including the likelihood and benefits of divergence. The Government should make clear to Parliament and the public the assessment it has made of why that option is the best for the UK's future.

The UK also needs to show more appreciation for the concerns of the EU if it wants to encourage flexibility. Any option in the 'middle ground' between Canada and Norway will require some compromise from the EU27. While the EU27 will prioritise maintaining the integrity of the Single Market and ensuring the UK does not appear to benefit from 'cherry picking', they are also concerned at the prospect of a regulatory competitor next door. The UK needs to shape its proposals in a way that meets the EU's concerns rather than requiring the EU to abandon them.

There is very little time – even with a transition – to agree and ratify a new trading relationship

The UK must act quickly if it wants to influence the EU27 before detailed negotiating guidelines are agreed. With the EU expected to come to a position in March, the window for persuading European capitals is tight. Unless the UK uses this time wisely, it might find its preferred option never makes it on to the table.

Negotiations need to move at great speed. The more an agreement departs from precedent, the longer it will take to agree – unless both sides can rapidly accept a process of managing divergence over time. That means the UK may be forced back to the binary choice it has sought to avoid.

1. Introduction

The Prime Minister set out her dilemma in the Florence speech: a Norway-style deal of joining the European Economic Area (EEA) would be "unacceptable to the British people"; it would mean adopting future European Union (EU) rules that govern the Single Market "automatically and in their entirety" without having a say on what they look like. In contrast, a standard free trade deal like the EU has recently signed with Canada (EU-Canada Comprehensive Economic and Trade Agreement; CETA) would "represent such a restriction on our mutual market access that would benefit neither of our economies".[1]

The UK, instead, wants to forge a middle way that could build on the UK's "unique starting point" of full regulatory conformity with the EU and lead to a "new, bold and ambitious" free trade deal that will be unlike any other.

> "We do not start with a blank sheet of paper, like other external partners negotiating a free trade deal from scratch have done. We start from an unprecedented position. For we have the same rules and regulations as the EU. [...] The question for us now in building a new economic partnership is not how we bring our rules and regulations closer together, but what we do when one of us wants to make changes."[2]

Michel Barnier, the EU's chief Brexit negotiator, has suggested that the UK faces a binary choice:

> "If the UK wanted to go further than the type of free trade agreement we have just signed with Canada, there are other models on the table. Norway and Iceland have chosen to be in the Single Market, to accept the rules, and to contribute financially to cohesion policy. But one thing is sure: it is not – and will not – be possible for a third country to have the same benefits as the Norwegian model but the limited obligations of the Canadian model."[3]

But he, too, accepts the Prime Minister's point about the unique nature of the negotiations:

> "This free trade agreement will be unprecedented in European history. Until now, all trade agreements with the EU – which cover more than 60 countries, for example with South Korea and recently with Canada – are all signed within the framework of regulatory convergence. Here we are in a different situation: at the outset of the negotiations, our standards and rules are perfectly integrated between the UK and the EU27 [the 27 EU member states]. What we have here is not regulatory convergence but the risk, or the probability, of regulatory divergence, which could harm the Single Market."[4]

This paper explores the options facing the UK and asks what the scope is to negotiate an arrangement between Norway and Canada.

In Chapter 2 we look at the differences in rights and obligations between the Norway (EEA) and Canada (CETA) options. We then look at precedents for deals in the space between these two models, from the EU and beyond. In Chapter 4 we use those precedents to explore possible options for a new 'bespoke' relationship between the UK and the EU. Finally, we assess the potential negotiability of those options and the choices the UK needs to make.

While we set out potential models that may sit in the space between CETA and EEA, we are not advocating a single option. This paper is intended to highlight the key choices and trade-offs that need to be made.

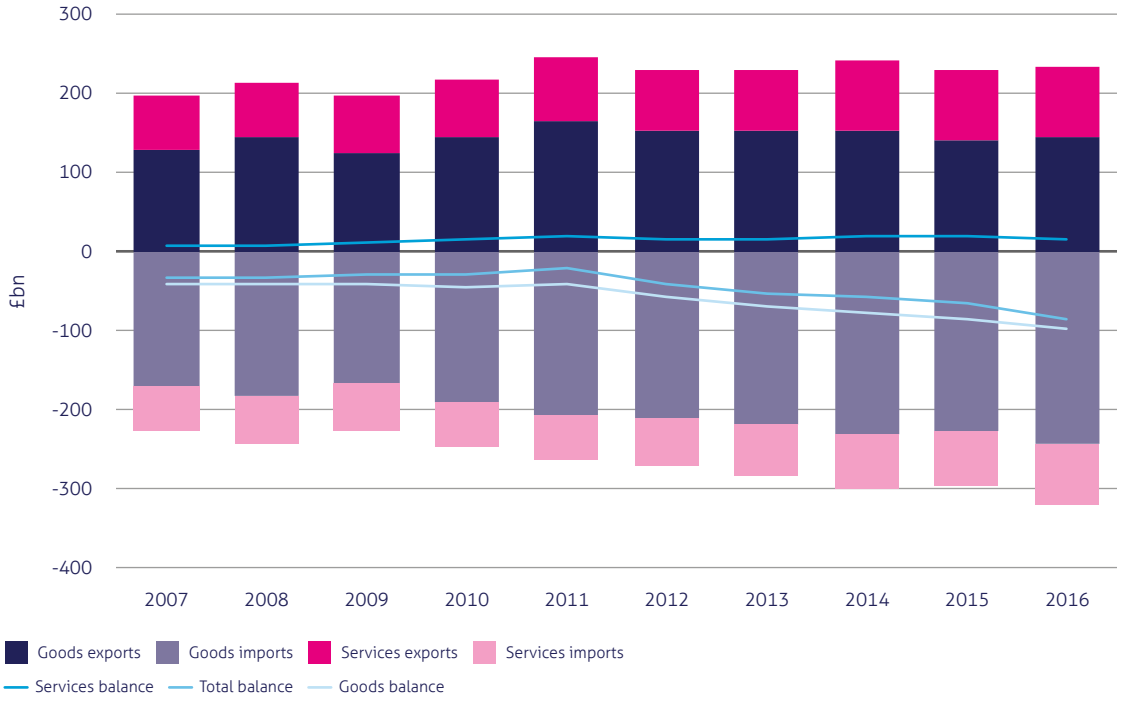
The starting position

As the Prime Minister and Michel Barnier have said, this negotiation will be unlike any other. While trade negotiations are usually about bringing two different systems together, the UK starts from a unique position of being fully compliant with EU regulations.

The UK, as an EU member, is currently fully integrated into the EU Single Market and Customs Union. This enables mostly unimpeded access to the markets of the other 27 EU countries (EU27) for goods and services. The UK's participation in the Common Agricultural Policy (CAP) and Common Fisheries Policy (CFP) provides easy access for agricultural products.

The EU is currently the UK's largest trading partner. In 2016, trade between the UK and EU was valued at £520 billion (bn), accounting for 47% of the UK's total trade with all countries. The US, the UK's next-biggest trading partner, accounted for 16% of the total.[5] In trading with the EU27, the UK exported goods worth over £144bn and services worth £90bn to the EU. While the UK had an overall deficit of £82bn on trade with the EU, it had a surplus of £14bn on trade in services, mostly due to its competitive strengths in financial services, and professional and business services.[6]

Figure 1. UK trade in goods and services with EU27, 2007–2016 (£bn)



Source: Institute for Government analysis of Office for National Statistics Pink Book data 2017.

UK trade is likewise very important to the EU27 – more trade flows between the UK and the EU27 than between the EU27 and any of its third country trading partners.[7]

This interdependence between UK and European markets is enabled by the UK's membership in both the Single Market and the EU Customs Union. The Customs Union* binds all members to charge the same external tariff to countries outside, ensuring that members do not import goods from outside the bloc using lower tariffs. There are no customs duties inside the union and there is no need for traders to prove the origin of their goods at internal borders. Frontier checks for goods were abolished when the Single Market came into being in 1993, removing most remaining non-tariff barriers on intra-EU trade.[8]

The Single Market, with four 'indivisible' freedoms of goods, services, capital and people, allows the products manufactured in one member state to be sold in another country without the need for any additional checks. In services, it gives businesses the right of establishment in all member states and allows for cross-border trade in sectors such as financial services.

For EU member states, the Single Market also contains a common framework for customs formalities, the current incarnation is called the 'Union Customs Code'.** This means goods are treated in the same way regardless of where they cross the EU's external border.[9]

The four freedoms of the Single Market are achieved through three key mechanisms: the single rulebook, the principle of mutual recognition and supranational institutions (explained further in Box 1). Taken together, these elements provide mostly unhindered trade between EU and EEA members, and a level playing field across national boundaries, designed to ensure that all members of the Single Market can trade on the same terms. They also make the Single Market more than just a free trade area; they create a common regulatory and legal space. As Michel Barnier said, "the single market is a set of rules and standards and is a shared jurisdiction. Its integrity is non-negotiable, as is the autonomy of decisions of the 27. Either you're in or you're out."[10]

Leaving the Single Market, as the Prime Minister has committed the UK to doing, inevitably brings consequences. The UK will, in EU jargon, become a 'third country'.

* The EU also has a customs union with Turkey (for industrial goods and processed food), Andorra and San Marino.

** Importantly, the EEA EFTA states – Norway, Iceland and Liechtenstein – are exempt from the Union Customs Code.

Box 1: The building blocks of the Single Market

1. The single rulebook

In the Single Market, EU member states are bound to observe the same regulations. In some areas the EU replaces national legislation with harmonised rules. These common standards exist in areas such as technical regulations, and food safety and animal health. In other areas, the EU sets minimum standards and common objectives, and member states are free to vary rules within bounds (so-called 'minimum harmonisation').[11]

The single rulebook also includes so-called 'cross-cutting regulations', such as competition and state aid laws, common environmental protection rules, workers' guarantees, and data protection. They are designed to prevent one member state gaining competitive advantage at the expense of another.

2. The principle of mutual recognition

Where rules are not harmonised, the Single Market guarantees that products and services can be sold irrespective of their differences through mutual recognition of member state regulations. About one-fifth of all goods are traded in the EU under the mutual recognition principle.* This guarantees that any product lawfully sold in one EU country can be sold in another, even if the product does not fully comply with the technical rules of the other. The EU has also attempted to extend the principle of mutual recognition to services, for example by allowing mutual recognition of professional qualifications and allowing cross-border trade in services sectors, such as financial services and transport. But there remain regulatory barriers to trade in services in the Single Market.[12]

3. Supranational institutions

The rules of the Single Market are underpinned by institutions to ensure they are enforced. The European Commission ensures that Single Market rules are followed; European regulatory agencies provide surveillance in some sectors and supply expert advice in others; and the Court of Justice of the European Union (ECJ) resolves disputes.

Immediately after leaving the EU, the UK will be fully aligned with EU rules. But even if the UK has (as it intends to through the EU (Withdrawal) Bill) transferred EU laws into UK law, that will not in itself prevent new regulatory barriers. There is a difference between having the same rules and having those rules legally recognised as being the same as the EU's.

* The principle of mutual recognition is defined by ECJ case law ('Cassis de Dijon') and EU regulations (Mutual Recognition Directive 2008). For an in-depth discussion of the mutual recognition in the Single Market, see Pelkmans J. 'Mutual recognition in goods and services: an economic perspective' in *The principle of mutual recognition in the European integration process*, 2015, (pp. 85–128), Palgrave Macmillan UK.

In the absence of formal recognition of the UK's regulations as being equivalent to the EU's, the EU would still be required by its own laws to treat the UK as a third country and impose checks equivalent to any other third country with no deal. That means UK firms would face regulatory barriers and customs checks in doing business with the EU. Member states would, among other things, have to apply customs checks at the border on all exports from the UK – which would have a large impact on just-in-time high-value supply chains that British and European businesses have developed over the period of the UK's membership of the union.*

Some of that friction could be eliminated by negotiating a uniquely deep free trade agreement, as the UK intends to do. But how far such agreement could go in preventing future barriers will depend largely on how close the UK chooses to continue to align to EU rules, and what institutions there will be to support that relationship in practice. Finding solutions to these two issues is the key to agreeing an ambitious and bespoke partnership of the kind sketched out in the Prime Minister's Florence speech.

Moving towards a new relationship: what will the negotiaion cover?

The overall shape and nature of the future UK-EU trade relationship will be the result of choices in a number of key areas. Table 1 sets out the principal components of any deal, and the questions that will need to be answered.

This list is not exhaustive. It focuses on the overarching decisions that will determine the nature of the future trade relationship with the EU, and which may form the basis for the framework agreement to be negotiated as part of the Article 50 process in the coming year.

* The Institute for Government has discussed the implications of different Brexit scenarios on UK-EU supply chains in its paper *Frictionless trade? What Brexit means for cross-border trade in goods*, published in August 2017.

Table 1: Key components of a UK-EU future trade agreement

	Key component	Questions
Market access	Goods	What will be the tariff arrangements for manufactured goods, agriculture and fisheries?
	Customs and rules of origin	What will be the new customs arrangements? What are the rules of origin?
	Services	What will the terms of market access be for services? What will the 'national treatment'* commitments be and where might access be limited?
Regulatory co-operation	Regulatory alignment**	How far, and in what areas, will the UK maintain alignment with EU regulations? And how will this alignment be achieved? This includes areas like technical standards and regulations, food safety and animal health regulations, and services regulations.
	Level playing field rules	How far will the UK align with the EU on 'level playing field' rules? These cross-cutting regulations affect both goods and services, and include competition and state aid laws, environmental protection, workers' rights, and consumer and data protection rules.
Institutions	Mechanisms for updating the agreement	How will the agreement be updated or amended to reflect changes in the regulations of one side? What will be the process for managing any changes?
	Mechanisms for monitoring compliance	Who will have the responsibility for monitoring whether the UK and EU live up to the commitments they agreed?
	Mechanisms for enforcement and dispute resolution	How will the agreement be enforced and how will disputes be resolved if one side does not comply?
	Mechanisms for co-operation and decision making	How, if at all, will the UK be able to shape EU decisions in areas where it remains close to the bloc? How will the UK continue to interact with EU regulatory bodies?
Additional obligations	Future migration	Will there be any obligations relating to future migration, ranging from free movement of people to allowances for professionals to work temporarily?
	Financial contributions	Will there be any financial contributions for access to the Single Market?

* Trade in services includes two types of main commitments: 'Market access' commitments, which set how far each party lets other party's services suppliers or investors have access to their services market. 'National treatment' are the commitments to treat foreign services suppliers or investors no less favourably than one's own.

** We use 'regulatory alignment' to refer to a degree to which the countries are required to align their regulations with each other.

2. Between Norway and Canada: the space to negotiate

The UK wants a relationship with the EU that falls between EEA membership and CETA. As shorthand, we describe these as 'Norway' and 'Canada' options.

The two agreements reflect two entirely different approaches to a trade agreement. CETA is a traditional free trade agreement (FTA), negotiated chapter by chapter and built from the bottom up. The EU regards this trade agreement as one of its most advanced free trade agreements, with the third country to date. It took seven years to negotiate.

By contrast, the EEA agreement was designed entirely around the four freedoms of the Single Market – goods, services, people and capital – and what is needed to guarantee them. Created in 1989 as an agreement between the EU and a number of European Free Trade Association (EFTA) countries, it aimed to expand the EU Single Market, together with commensurate obligations. But the EEA countries* – Norway, Iceland and Liechtenstein – remain outside the EU's political institutions, and outside the Customs Union, allowing them to negotiate their own trade deals.

The EEA agreement represents the maximum possible access to the Single Market for a country outside the EU. Over 70% of Norway's trade is with the EU.[1] CETA offers Canada significantly less access to the European market, reflecting the fact that, while the EU is an important market, it only accounts for around 10% of Canada's trade.[2]

The UK has said it wants a bespoke arrangement that would involve fewer obligations than Norway but more market access than is granted to Canada. In this chapter, we map the space between EEA membership and a Canadian-style deal by looking at their key differences. We highlight what each option means for trade with the EU and then set out some key considerations for the UK.

What are the differences between Norway and Canada?

1. Regulatory alignment

EEA countries fully align to EU Single Market rules

Norway, like other EEA countries, has agreed to follow almost the entire Single Market acquis – a body of nearly 900 EU directives and over 3,600 regulations – and relevant ECJ case law. This acquis includes about 45% of all EU directives, which amounts to about 30% of all EU legislation that the UK currently adopts as an EU country member.[3] Nearly two-thirds of that acquis accounts for goods-related regulations, such as technical rules, and food safety and animal health regulations, while only 16% are composed of services-related regulations.**

* We use the term 'EEA states' to denote 'EEA EFTA states' rather than the EU parties to the agreement throughout the paper. This refers to Norway, Iceland and Liechtenstein.

** The figures reflect the state of the EEA agreement as of August 2016. EFTA Secretariat, *How the EEA Agreement works*, 2017, EFTA Seminar on the EEA Agreement – 7 February 2017, www.efta.int/sites/default/files/documents/eea/seminars/eea-s17/EEA-Seminar-7-February-2017-How-the-EEA-Works.pdf

Like EU member states, EEA countries are required not only to comply with specific product rules and services regulations, but also the EU's cross-cutting regulations in areas such as competition, state aid, environmental and social protection, and data. EEA countries have negotiated a small number of exceptions to these rules, but they are not significant.*

The EEA agreement does not cover agriculture and fisheries policies, foreign and security policy, justice and home affairs rules, or the rules related to the EU's Economic and Monetary Union.

EEA countries have some influence but no vote on the rules they adopt
Norway must automatically follow new Single Market rules. While EEA states have, in theory, the right collectively to refuse new rules under a so-called 'right of reservation',[4] this has rarely been used in practice.** There is some opportunity to contribute to the formation of new Single Market rules through consultation with the EU. But EEA states have no vote in deciding those new rules. EEA states can be partial members of, or observers in, some EU regulatory and executive agencies, but still do not have a formal right to vote – a concern to some of them.[5]

By contrast, CETA includes only modest regulatory co-operation provisions
Canada is not required to align its laws and regulations with the EU, and the deal contains provisions for voluntary co-operation between regulators.

In trading goods, CETA allows an element of mutual recognition of 'conformity assessment' in selected areas of goods, allowing regulators from either side to assess goods to one another's regulations before they are traded.[6] For food safety and animal health regulations, CETA provides limited veterinary equivalence, where different regulations are deemed to achieve the same outcome.[7] However, there is no wider recognition of food safety regulations, which reflects the difference between Canada's and the EU's approach to risk management.[8]

In services, CETA allows for some limited mutual recognition of professional qualifications, but there is no general regulatory alignment. There is no requirement on Canada to maintain a level playing field beyond a few general commitments to uphold international standards.

2. Market access

Norway and Canada have a similar deal with the EU when it comes to tariffs on goods
Norway can trade tariff-free in the Single Market in industrial goods. CETA, similarly, provides for tariff-free trade on 99% of industrial goods, with a few exceptions for politically contentious goods.

* For example, EEA countries are exempted from certain environmental regulations, such as the EU's Wild Birds Directive and the Habitats Directive.

** EEA states have negotiated substantive exemptions only in a very limited number of cases. One notable example is Norway's exemption from using the EU's rules on emergency exits in certain tunnels. Fredriksen HH and Franklin CN. 'Of pragmatism and principles: The EEA agreement 20 years on'. *Common Market Law Review*, 2015, vol. 52, no. 3.

Norway is not part of the EU's CAP or CFP, so trade in these areas is governed by special bilateral deals. These deals have managed to eliminate most tariffs, but not all: some goods, such as meat and dairy, either have tariffs or are subject to tariffs if imports exceed a tariff rate quota.*

Canada's deal eliminates tariffs for over 90% of agricultural products, leaving duties on a number of politically sensitive goods, such as poultry, and tariff rate quotas limiting market access for some other products.[9]

As Canada and Norway are both outside the Customs Union, each has to cope with customs procedures, including the need to prove origin – but these are more streamlined for Norway

Customs and rules of origin costs apply to both Norway and Canada, but to a different degree.

Exports from Norway do not need regulatory checks but exporters do need to be able to meet 'rules of origin' requirements to benefit from preferential treatment. Typically, an export arriving in the EU from Norway needs to be 60% local value added to be eligible for tariff-free access.[10] Shared IT systems and joint control zones allow for a high degree of streamlining for exports crossing Norway's land border with the EU. EEA countries also have a waiver from the requirement to submit entry and exit summary declarations, which reduces the administrative burden on traders.

CETA, too, contains provisions on customs co-operation. But while it contains provisions to streamline processes, such as issuing advance rulings on the tariff classification of goods, Canadian businesses face greater customs costs. They still have to provide entry summary declarations (with additional specialist documentation for highly regulated goods), transport permits and insurance certificates. They also have to satisfy the rules of origin specified in CETA.

And there is a big difference in the non-tariff barriers they face

Norway applies EU regulations and, as a result, it avoids most non-tariff barriers when trading with the EU. In comparison, Canada faces significant barriers to trade. Canadian exports must meet Single Market rules in order to enter the European market, and checks take place at the border to ensure they meet the right product standards. Similarly, goods of animal and plant origin are tested at border inspection posts, and regulated goods, such as chemicals, must be granted prior approval.

The EEA agreement includes the EU's level playing field provisions, including the EU's competition regime. Being part of this regime means there is no prospect of new barriers to trade being introduced between Norway and the EU as a result of trade defence measures.** CETA contains no such obligations, meaning the EU can introduce barriers to Canadian trade if they consider it unfair, overly subsidised or harmful to the European economy (and vice versa).

* A combination of tariffs and quotas, in which imports below a specific quantity are subject to a low or zero tariff rate, while imports above that quantity face a higher tariff rate.

** With the exception of agriculture and fisheries where trade remedies have been applied in the past.

Norway has complete access to the Single Market in services, Canada does not

For services, EEA membership provides exactly the same benefits as EU membership: EEA firms have the rights of establishment in all EU countries and the rights to provide cross-border trade in services in the same way as EU businesses do.[11] Services providers in all sectors, including regulated industries like financial services, transport and telecommunications, enjoy full access to the EU27 markets.

By contrast, the treatment of services in CETA is far less favourable. CETA has opened up some services markets between Canada and the EU, allowing Canadian firms to set up subsidiaries in EU markets and trade services from their home market. But there remain hundreds of exceptions from the agreement and some sectors, such as audio-visual services, public services and air transport, are excluded from the deal entirely.* Canadian airlines, for example, are able to operate routes in Europe only if they start or end at a Canadian airport, unlike EEA airline providers, which are free to operate routes between and within EU member states.

In financial services, CETA falls well short of the financial services 'passport' that EEA membership provides. Canadian financial services firms can only sell cross-border services in the EU under the EU's 'third-country equivalence' regime, which relies on the EU unilaterally deciding if Canada's rules are sufficiently similar.[12] To date, the EU has recognised Canada as equivalent in 16 different areas of financial services.[13] But because the scope of the EU's third-country regime is limited, some of the most important areas such as lending have not been recognised as equivalent. CETA, like most other FTAs, includes a 'prudential carve-out' – a provision that gives either side the right to unilaterally revoke market access if they consider it necessary to preserve financial stability.[14] That means Canadian firms face the introduction of new barriers to trade if the EU decides it is necessary to do so.

3. Institutions

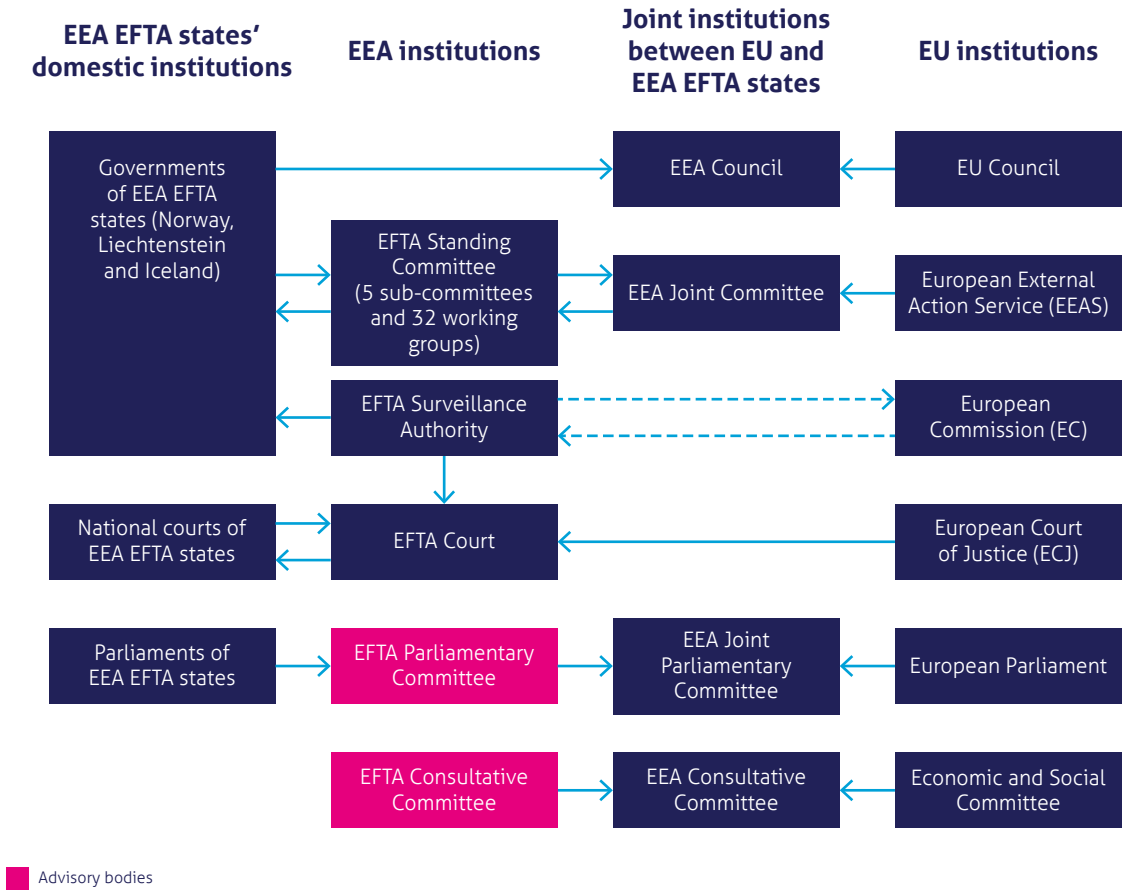
Robust institutions ensure regulatory alignment is maintained by EEA countries

Underpinning the EEA states' market access and regulatory alignment is a set of robust institutions. These institutions operate using a 'two-pillar structure'.[15] The EFTA pillar comprises the institutions that govern the EEA agreement for Norway, Liechtenstein and Iceland. The EU pillar comprises the EU institutions which govern the agreement for the EU. The two pillars are bridged by a number of joint committees, which meet regularly. This structure is shown in Figure 2.

The EEA states have agreed to implement and comply with EEA law. The EEA Joint Committee decides which new EU laws are relevant to the Single Market, and need to be incorporated into EEA law.[16] This means that as the Single Market changes over time, new barriers do not arise between the EEA states and the EU.

* CETA has adopted a so-called 'negative list' approach to opening up services. In international trade, this represents an approach that opens up all relevant services sectors, and under all four modes of supply, with the exception of those which both parties agree to exclude. *CETA*, Chapters 9–11.

Figure 2: The EEA institutional framework



Source: Institute for Government analysis of EEA agreement.

With its own court and surveillance authority, the EEA agreement has stronger mechanisms for its enforcement than any free trade deal. The EFTA Surveillance Authority (ESA) is the EFTA equivalent of the European Commission. It ensures that the EEA states adopt and apply EEA law. The ESA can bring cases against the EEA states for failure to comply with their obligations. It is also in charge of monitoring state aid granted by the EEA states.[17]

To deal with disputes, the EEA states use the EFTA Court, which is the EFTA equivalent of the ECJ. Generally, the court follows and interprets ECJ case law in line with EU law. The court has three main functions:

1. It hears cases brought against the EEA states by the ESA, just as the ECJ hears cases brought against EU member states by the Commission.

2. It can clarify the meaning of EEA law after a reference from the domestic courts of the EEA states, just as the ECJ can receive references from the domestic courts of EU member states. However, courts in the EEA states are not obliged to make use of this procedure, and it has been noted that the Norwegian courts have been reluctant to refer cases.

3. It can review the legality of decisions made by the ESA, just as the ECJ can review the legality of decisions made by the Commission.

Finally, the agreement provides for high-level diplomatic engagement through the EEA Council, which meets twice a year. It covers topical foreign policy issues as well as the development of the agreement.[18] It also includes formal consultative committees and working groups for more granular issues.

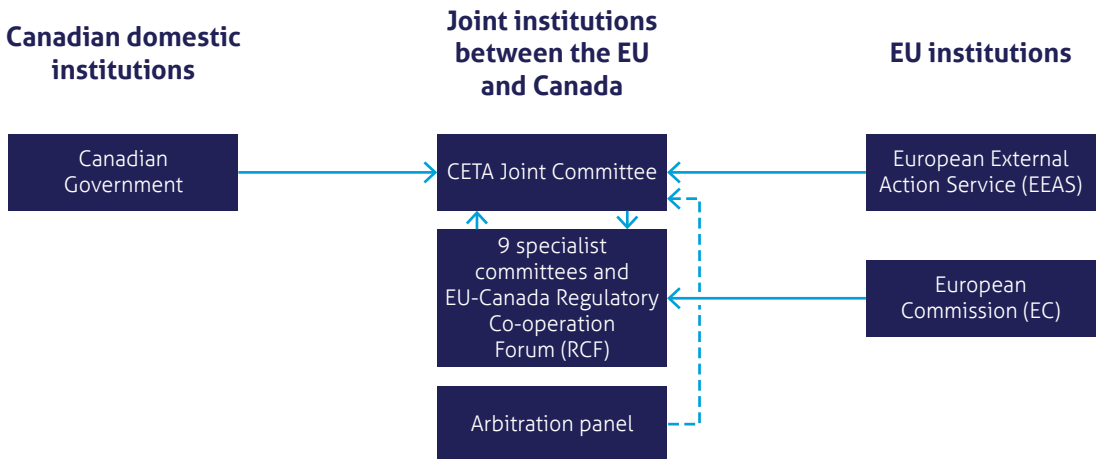
CETA has nothing like the EEA institutions

Since CETA has nothing like the EEA's level of alignment with EU law, it has no need for similar structures. Like all conventional trade deals, it has a joint committee consisting of EU and Canadian representatives that decides on any changes to the agreement. It also includes specialist sub-committees and a specialist body that allows regulators to co-operate and exchange information. The Regulatory Cooperation Forum, modelled on a similar institution between the US and Canada, allows regulators to co-operate early on.[19]

For resolving disputes, CETA largely follows the ordinary system found in most trade agreements.* States appoint arbitrators on an *ad hoc* basis to rule on the dispute. Prior to this, disputes can be resolved informally by the CETA joint committees, which meet once a year or on request of either party. The committees monitor the smooth functioning of different chapters of the agreement, but have no legal powers. The highest-level joint committee meets once a year and is responsible for the implementation of the agreement.[20]

CETA's institutional structure is fundamentally different from that of the EEA agreement. Figure 3 illustrates its simplicity compared with the EEA.

Figure 3: Institutional framework in CETA



Source: Institute for Government analysis of the CETA agreement.

* For an in-depth discussion of different types of dispute resolution mechanisms in FTAs, see Hogarth R. *Dispute resolution after Brexit*, Institute for Government, 2017.

4. Movement of people

EEA countries accept the EU's principle of free movement for people; CETA only has provisions for temporary movement of professionals

Norway has to accept the EU's principle of freedom of movement: their citizens are entitled to be treated in the same way as EU nationals, which includes the right to live, work and access public services and benefits. There is a special exception in the EEA agreement for Liechtenstein, which applies a safeguard that allows them to limit the number of people who can move there to live and work.

This safeguard can be invoked 'if serious economic, societal or environmental difficulties of a sectorial or regional nature liable to persist are arising'.[21] Any action taken in response must be 'limited in its scope and duration to what is strictly necessary to remedy the situation'[22] and priority must be given to measures that are the 'least disruptive' to the Single Market. Liechtenstein's use of the safeguard is a special case – the country is half the size of the Isle of Wight, and has established that it is already disproportionately affected by migration.[23]

CETA does not impose freedom of movement obligations on either Canada or the EU. However, like other free trade agreements, it does contain provisions for 'mode 4' services, which allow the temporary entry for certain services professionals on a short-term basis for work.

5. Financial contributions

Membership of the Single Market has a financial price, but it is lower than EU membership

Norway and other EEA members are required to make payments, which contribute towards reducing economic and social disparities in EU accession states, particularly in Eastern Europe. The EEA states' contributions are typically smaller than those of comparable EU member states: Norway, for example, contributes 0.16% of its annual gross domestic product (GDP), compared with the UK's current contribution of 0.25%, despite Norway's GDP per capita being 52% higher than the UK's.[24] Norway also pays to participate in specific EU programmes, for example in research and education. Canada makes no financial contribution to the EU.

6. External trade policy

Both countries can conduct an independent trade policy – but Norway's scope is constrained by its degree of regulatory alignment with the EU

Being outside the Common Commercial Policy gives Norway and other EEA members the freedom to strike new trade deals with third countries. Iceland, for example, recently concluded an FTA with China. However, trade deals signed by EFTA countries tend to be shallower than the EU's, which reflect its close alignment to the EU's regulatory model.[25]

Canada's ability to negotiate its own deals is not constrained by its deal with the EU. This reflects the relatively low level of regulatory obligations embedded in CETA. It is worth noting that Canada does not have total freedom to put its regulations on the table during trade negotiations due to its integration with the US through the North American Free Trade Agreement (NAFTA).

What does this mean for the UK?

These two options set the space within which the UK and EU are likely to negotiate their future trade agreement.

The Norway option represents near-complete participation in the Single Market. It provides full integration with the Single Market for goods and services, with the exception of agricultural goods and fisheries. In this way, Norway, with other EEA states, avoids the introduction of many of the most disruptive non-tariff barriers in trading goods and services with EU markets. But at the same time, Norway is outside the Customs Union, CAP and CFP. It can pursue an independent trade policy, albeit one constrained by its adherence to the EU's regulatory framework.

However, such a high degree of participation in the Single Market comes with significant obligations. Norway must accept EU rules without having any final say on those rules, with influence but no vote, supranational institutions, and obligations relating to free movement of people. Each of these obligations crosses current UK red lines.

A Canadian-style trade deal would come with far fewer obligations. The UK would not be constrained in pursuing an independent trade policy, there would be no role for a supranational court and it would not need to accept the principle of free movement.

Yet this option would represent a dramatic reduction in access to the Single Market, particularly for the UK's key services exports. While CETA is one of the most advanced trade deals the EU has negotiated, it reflects the very different commercial interests of the two sides. If the UK were to opt for the Canada option, trade in services would face disruption. Market access rights for some of the UK's most important areas such as financial services would be severely restricted. While CETA provides better market access for goods than for services (which benefits the EU, which has a trade surplus in goods and a deficit in services), traders on both sides would face significant regulatory and other non-tariff barriers in comparison to now.

Given the Prime Minister's negotiating objectives, it is clear why she has rejected both EEA and CETA for the UK. In the next chapter we look at whether other trade agreements, including some signed by the EU, can be used as a precedents for the sort of relationship the UK seeks.

3. Precedents for a different approach

The previous chapter made clear why the UK wants to seek a middle way between Norway and Canada. In the Florence speech, the Prime Minister herself mentioned the"diverse array of arrangements with neighbouring countries outside the EU"[1] that the EU has already negotiated.

This chapter looks at existing agreements that provide possible precedents for an agreement that would go further than Canada, but that would not amount to full participation in the Single Market, like Norway.

Each of these precedents was negotiated in different political and economic circumstances. Nonetheless, they provide instructive examples as to what the EU could find acceptable and some types of 'tools' that could be used in designing a new relationship.

What precedents exist?

The EU has a small number of trade relationships that go beyond the Canadian-style free trade agreement. These could potentially offer the UK greater scope for access to the Single Market. They include:

1. The EU's recently negotiated Deep and Comprehensive Free Trade Area (DCFTA) agreements with countries in the 'eastern neighbourhood', including Ukraine, Georgia and Moldova, which provide partial integration in the Single Market in specific areas.

2. The EU-Switzerland relationship, which is built on partial Single Market integration through sectoral agreements.

3. The EU's use of mutual recognition and equivalence with third countries. We also consider an international precedent, the Trans-Tasman Mutual Recognition Agreement (TTMRA).

4. The proposed text of the Transatlantic Trade and Investment Partnership (TTIP), which did not go far beyond Canada's trade deal with the EU, but included provisions for enhanced regulatory co-operation.

Ukraine: partial integration into the Single Market, but on the EU's terms

The EU's recent association agreement with Ukraine goes far beyond standard FTAs, including Canada's agreement. At the core of this agreement is a so-called 'Deep and Comprehensive Free Trade Area' (DCFTA), which allows Ukraine to participate in areas of the Single Market where it adopts EU rules. This, according to a former EU trade commissioner Karel De Gucht, is "the most ambitious deal of its kind ever negotiated by the EU".[2]

Single Market access for both goods and services where EU rules are implemented

This agreement grants Ukraine near-complete access to the Single Market in goods, but does not eliminate all tariffs on agricultural products.[3] Critically, it does extend significant access to services. Ukraine has similar rights to access the EU's Single Market as EU member state providers for regulated services, including financial services and telecommunications.[4] But, like in CETA, the deal contains a 'prudential carve-out' in services – meaning the EU can revoke market access at any point if it deems it necessary for financial stability.

This access is contingent on Ukraine implementing EU rules on services and the EU then recognising those rules as being equivalent to its own.[5] That comes close to an EEA-like arrangement for services and procurement – two areas where the UK has strong offensive interests.[*]

Similar agreements that the EU has signed with two other eastern neighbourhood states, Georgia and Moldova, include less onerous obligations to adopt EU rules. They merely include 'best endeavour' clauses.[6] But the price these states pay for that weaker obligation is less access to the Single Market than Ukraine, particularly in services sectors.[7]

In return for access, Ukraine must continue to accept EU rules – automatically in services

Another condition for Ukraine's access to the Single Market is an obligation to observe EU cross-cutting regulations in areas such as competition, state aid, and environmental and social regulations. Ukraine, for example, has to observe EU state aid rules – and those also have to be interpreted in line with ECJ case law.[8] While state aid rules in the EU are enforced by the European Commission, in Ukraine these rules are enforced by a domestic state aid authority.[9]

One important feature of this agreement is that it has varying obligations, depending on the degree of regulatory integration in different chapters of the agreement:[10]

- For regulations that concern trade in goods, such as technical regulations and food safety standards, Ukraine's market access is conditional on the adoption of EU rules in those areas. But it is not under an obligation to adopt new rules automatically.

- For services-related regulations, Ukraine not only has to show alignment with existing EU rules, but is also under an obligation to implement new regulations automatically, as decided by the EU.[11]

* However, there remain important exclusions from market access commitments in the agreement. As a consequence, Ukrainian financial services firms will not enjoy the same 'passporting' rights and flexibility as EU/EEA firms in how they deliver their services to the EU27 markets, because different EU member states negotiated exemptions from granting full Single Market treatment to Ukraine in specific areas.

The Commission decides where market access rights should be granted, and there is a role for the ECJ

Surveillance of the Ukraine agreement is undertaken by a joint committee that monitors whether Ukraine lives up to its obligations under the agreement. Ukraine also has to provide regular updates on its progress in adopting EU rules, and EU officials can undertake monitoring missions at their own discretion. It is the prerogative of the European Commission to decide whether new market access rights should be granted to Ukraine.[12]

Disputes are resolved by an ordinary arbitration panel – but with a special preliminary ruling procedure that ties Ukraine indirectly to the ECJ. Rulings of the arbitration panel are binding, and the EU and Ukraine must take any measure necessary to comply with them.[13] Importantly, the agreement also includes a mandatory reference procedure: in cases of disputes that concern the interpretation and application of provisions relating to EU law, the arbitration panel has to request the ECJ to give a ruling on the question, which is then binding on the arbitration panel. This preserves the ECJ's autonomy over interpretation of rules that are derived from the EU acquis.

The Ukraine deal also includes a requirement for uniform interpretation in line with EU case law. But this obligation only applies to three chapters – services, procurement and competition – and not to the entire agreement.

No free movement and no financial contributions, but the EU has other priorities in Ukraine

Despite its unprecedented access to the Single Market, Ukraine is not required to accept freedom of movement, or to make any financial contribution. But given that their GDP per capita is well below the EU average and the EU has strategic political interests in Ukraine, the EU was not interested in seeking either freedom of movement or a financial contribution from Ukraine.

The agreements with Eastern European countries, like Ukraine, show that the EU is prepared to countenance partial integration into the Single Market, but only on its own terms. As a price for this unprecedented access to the Single Market, these states have to accept EU rules and, in many cases, oversight by European institutions. While the concessions that the EU has granted to these countries often go further than the EU's standard trade deals, these agreements should be seen as part of the EU's 'Eastern Neighbourhood' policy that attempts to bring these countries closer to the EU, with potential for converging with the EU's political union over time.[14]

Switzerland: sectoral participation in the Single Market, but with weak institutions

Switzerland has negotiated partial access to the Single Market through more than 120 specific agreements, but it falls well short of the full membership of the Single Market that the EEA provides. This approach came about after Switzerland, uniquely among the EFTA states, rejected joining the EEA following a referendum in 1992.[15] Since then, Switzerland has developed its relations with the EU through a series of bilateral agreements.

Near-complete integration for goods, but services have limited access

Switzerland has near-complete and barrier-free access to the Single Market for industrial goods, based in part on a special form of mutual recognition which, in most cases, allows the products of one party to be lawfully sold in the Single Market of the other without additional testing and conformity inspection, and vice versa.[16] But this requires Switzerland to adopt EU rules in some product areas, where Switzerland has agreements on conformity assessment.[17] Like Ukraine, some tariffs still remain on more sensitive agricultural products.[18]

For services, Switzerland has far more limited access to the Single Market than for goods. While it can take part in the Single Market for some regulated business professions, air transport, public procurement and audio-visual services, it has no overarching deal on services.[19] Nor does it have a deal on financial services, with the exception of non-life insurance. As a result, Swiss financial intermediaries access EU financial markets by establishing subsidiaries in the EU.

There is limited institutional oversight; until that is addressed, the EU has refused to increase market access

Switzerland does not have to automatically accept new regulations from the EU in the areas of the Single Market in which it participates, with the exception of aviation. Instead, it unilaterally decides whether or not to adopt them. There is also no surveillance mechanism for checking the agreements are being implemented.*

But because of the lack of overarching institutions, the EU has said its relationship with Switzerland has become too 'complex and unwieldy' to manage and, since 2014, it has been trying to reform it.[20] The EU has said that a new institutional arrangement will be a prerequisite for any increased market access. Switzerland has been similarly unhappy about the current arrangements: while they allow it to remain formally sovereign by retaining full autonomy over its regulations, Switzerland adopts many EU laws without having a say on what they look like.

The EU has set four conditions that must be met in any future agreement with the Swiss, all of which require some institutional architecture:[21]

1. Switzerland must dynamically update its rules in line with new developments in EU law, in the same way that EEA states are required to.

2. There must be an independent surveillance mechanism to ensure that both sides implement new rules; a role played by the European Commission for the EU and the ESA for the other EEA countries.

3. Both sides must agree an approach that guarantees consistent interpretation of the agreements, in line with ECJ case law. This is a role that is carried out by the EFTA Court in the EEA agreement.

4. There must be a robust mechanism for settling disputes.

* The EU and Switzerland monitor the compliance with the agreements on their respective territories, which is based on the principle of 'good faith' in international law. If there are problems with the implementation of the agreements, they are discussed in one of the existing 27 joint committees.

The EU has taken the same position in ongoing negotiations with Andorra, Monaco and San Marino – three countries which are currently aiming to increase their access to the Single Market.[22]

Switzerland must accept the principle of free movement and make financial contributions

Switzerland is also obliged to accept the free movement of people and has also agreed to contribute financially to the EU. It has committed to paying grants to reduce social disparities in EU accession states. It also pays in for participation in specific EU programmes, for example in education, research and science.

The EU would not sign another agreement like this, but it still provides valuable insight

While the Swiss case does not provide a reliable precedent for the UK's future relationship with the EU, it does indicate under what conditions the EU could be willing to partially integrate the UK into the Single Market. The EU's demands of Switzerland – dynamic updating and robust institutions – indicate the obligations they are likely to insist on if the UK if it decides to seek similar levels of access to the Single Market. The weak institutional oversight in the Swiss case means the EU has refused to sign major agreements with Switzerland for nearly 10 years. It is highly unlikely that the EU would accept a UK deal that took the same approach.

Mutual recognition: improved access in specific areas, but on a less stable footing

Mutual recognition can be a useful tool in reducing regulatory barriers to trade. It is used by the EU to reduce barriers between member states and is an essential part of the Single Market, as explained on page 7. However, the EU's use of this tool with third countries is much more limited. The EU has only signed a handful of mutual recognition agreements, with the likes of Israel and the US.

Box 2: Quick guide to the language of trade: mutual recognition[23]

- **Mutual recognition of rules:** Involves two countries recognising each other's standards or regulatory regimes as equivalent. Their rules often look different but achieve the same regulatory objectives and/or outcomes. These rules are typically 'managed' by shared processes or institutions.*

- **Mutual recognition of conformity assessment:** A more limited form of recognition, which involves two countries recognising each other's testing tools, such as conformity inspection procedures, as being equivalent. A country can test an exporter's product to ensure it meets the importing country's regulations, reducing some barriers at the border.

- **Equivalence:** One side recognises the other's standards or regulatory regimes as being 'equivalent' to its own. This is a unilateral decision by the importing country that can be withdrawn at any time.

* See Shaffer KNG and Nicolaidis K, *Managed Mutual Recognition Regimes: Governance without global government*, IILJ NYU Law School Working Paper, 2005, 6, p. 8.

The EU does use mutual recognition, but mostly in a limited form

The EU has signed 'mutual recognition agreements' (MRAs) in order to minimise non-tariff barriers.[24] Almost all of the MRAs signed by the EU have been 'mutual recognition of conformity assessment'. While other types of mutual recognition are focused on removing barriers to trade, this kind of agreement is much more limited and just tries to reduce the volume of frontier checks required.

The EU has signed this kind of mutual recognition agreement outside of FTAs. It has such bilateral agreements with countries like the US, Japan, Australia and New Zealand. But there are examples – such as CETA – where the EU has included mutual recognition provisions within a broader deal.

The EU has gone further than these conformity assessment agreements in a small number of cases, through deals that are called 'agreements on conformity assessment and acceptance of industrial products' (ACAA) in EU jargon. In these instances, the EU has required the third country to accept EU rules for certain products, in return for allowing these products to be sold in the EU market without checks required at the border. This is, for example, the sort of deal that the EU has done with Israel.[25]

There are some examples of the EU using mutual recognition of rules, but it tends to be in very specific areas

The use of 'mutual recognition of rules' is rare in trade deals around the world – and indeed the most advanced form of it is within the EU Single Market.[26] There are only very limited examples of the EU granting this form of mutual recognition to other countries.

Prominent examples include the EU-US organics and wine agreements,[27] which allow US manufacturers in those sectors to export relevant products to the EU under their domestic standards, and vice versa.

The EU does use equivalence, but decisions are made unilaterally by the European Commission and can be revoked at any time, resulting in uncertainty

The EU provides another form of regulatory recognition through its own equivalence regimes. But these are typically constrained to certain areas, such as parts of the financial services industry,[28] data protection[29] and air transport.[30]

These regimes allow the EU to 'recognise equivalence' of a third country's rules, but only if it deems them to meet the same regulatory objective or outcome. This decision is in the hands of the European Commission. As such, it can be revoked at any time and provides a much less certain basis for market access than a more formal agreement.

TTMRA is the only example of broad mutual recognition of rules outside the Single Market. The EU is unlikely to take this approach towards the UK

Other than the EU Single Market itself, the only international example of broad mutual recognition of rules across different countries is the Trans-Tasman Mutual Recognition Agreement (TTMRA).[31] Signed in 1997, the agreement allows Australia and New

Zealand* to recognise their products as equivalent, which has in turn removed non-tariff barriers relating to production, quality, labelling and packaging.[32] However, TTMRA is much more limited for trade in services, covering only some limited mutual recognition of professional qualifications.

TTMRA works by treating New Zealand as a *de facto* Australian state government. New Zealand participates in the Council of Australian Governments, set up by the Australian mutual recognition agreement, which monitors the operation of mutual recognition schemes.** When any relevant issues arise, New Zealand also has full membership and voting rights on Ministerial Councils.

The agreement is more robust than simple mutual recognition in some areas. There are shared institutions, such as a common food standards agency and a Trans-Tasman council on banking supervision. The deal includes a common rulebook in certain areas, using harmonisation, instead of mutual recognition.

TTMRA offers an attractive, though insufficient, precedent for the UK's future relationship with the EU.*** An analogous approach would require a massive shift in approach to regulatory policy for the EU and would involve granting a non-member state unprecedented voting rights. In the context of a departing and potentially diverging member state, the unique relationship between Australia and New Zealand is difficult to apply to the UK and the EU.****

TTIP: a novel approach to enhanced regulatory co-operation

The proposed text of the Transatlantic Trade and Investment Partnership (TTIP) included novel provisions to improve co-operation between EU regulators and their American counterparts.

While the negotiations stalled after December 2016, the draft text provides a useful precedent for a looser regulatory relationship that would not seek to alter the UK and EU's respective ways of making regulations (protecting 'regulatory autonomy' in EU jargon) at a price of better market access. However, the proposed model does not provide any substantive recognition of each other's regulations and is mostly procedural in nature. It does not oblige either party to accept the regulations of the other party as being equivalent to their own – both the EU and US would have retained their full regulatory autonomy.[33]

* Though the arrangement is informal as territories cannot sign treaties, both countries have enacted laws for the legal implementation and enforcement of the TTMRA. When standards are adopted they are incorporated into the different jurisdictions' law separately.

** The agreement states that Australia's Productivity Commission has to conduct a review every five years for both the MRA and the TTMRA. For the latter it must consult with stakeholders who are part of the Cross-Jurisdictional Review Forum. The forum present a response to the Australian government and the New Zealand prime minister with a response three months after the report is published.

*** The many exemptions in key sectors like pharmaceuticals and services would be a problem.

**** In addition, there is the EEA relationship to consider, and whether an agreement of this kind would impact that balance.

TTIP aimed to facilitate voluntary co-operation by using the concept of regulatory coherence – setting up a number of procedures that would make regulations of the EU and US more compatible over time.[34] This included:

- An early notification procedure designed to require the EU and US to publish, at least once a year, a list of planned regulatory acts and make publicly available, as early as possible, information on planning and timing for specific regulatory acts.*

- Regulatory impact assessments, which aimed to allow both parties to assess the impact of new regulatory and legislative proposals on their trade. However, their opinions would have been only advisory.

- A Transatlantic Regulators' Forum, a joint body that aimed to facilitate co-operation between each sides' regulators.[35]

TTIP is model for greater regulatory co-operation, but for the UK it would not prevent the introduction of major barriers to trade

For the UK it provides some useful tools to co-ordinate regulatory practice, rather than deal with the substance of regulations. This could prevent new barriers to trade being introduced in the longer term, but would not prevent their introduction on departure of the Single Market.

What are the lessons for the UK?

These precedents give some idea of what the EU has been prepared to concede in past negotiations. The key lessons for the UK from these precedents are:

- **Partial integration into the Single Market is possible.** Despite the language of no 'cherry picking', the EU has allowed other countries like Ukraine and the other eastern neighbourhood states, and Switzerland, to participate in some aspects of the Single Market and not others. While these agreements were negotiated in very particular political circumstances, the EU has found a way to make it technically and legally possible without undermining the functional integrity of the Single Market.

- **But that partial integration comes at the price of following EU rules and accepting strong institutional oversight.** As the examples show, the price the EU demands for deep integration is following the EU's rules, making provision for automatic updating, and establishing institutions to oversee and enforce compliance. That institutional oversight involves the ECJ interpreting EU law.

- **The Switzerland model might appear attractive, but is not on the table.** The EU has refused to do any more deals with Switzerland because of its concerns about the absence of automatic adoption of EU rules and weak institutional oversight. And the Swiss are frustrated by their lack of influence on EU rules.

* This was a controversial feature of the agreement for the US as the US federal government and the EU would be mandated to provide each other with a list of planned legislative acts.

- **The nearest another trading arrangement has come to the Single Market is the TTMRA, but even that requires shared institutions and leaves out contentious sectors.** Australia and New Zealand have far more relaxed attitudes to regulatory convergence – and more trust than seems likely to exist between the UK and the EU. But even so, their agreement which recognises each other's rules exempts highly regulated goods and services, and relies on common institutions. The EU's existing agreements include only very limited examples of mutual recognition of rules.

- **Voluntary adoption of EU rules can offer improved access, but leaves power in the hands of the European Commission.** Where third countries have decided to adopt EU rules voluntarily, the Commission has used its power to grant 'equivalence', but can revoke it at any time.

- **There is scope for regulatory co-operation in agreements.** As the TTIP example shows, there can be procedures in standard FTAs to make divergent regulations more compatible over time. But while these can help avoid future barriers to trade emerging, they do not reduce existing barriers.

- **The EU is traditionally much more protectionist in agriculture than in other goods.** Even EEA states' other close neighbours, such as Switzerland, face tariffs on some agricultural products. Georgia is one of very few non-EU countries which have 100% tariff-free trade in agriculture with the EU.[36]

- **The EU is likely to be more worried about the regulatory challenge posed by the UK than it has been about that from any of the other countries with whom it has agreements.** The EU's closest agreements are with smaller economies. But given its scale and proximity, the UK represents a potentially much more potent competitor to the EU. Michel Barnier has already made clear that, from the EU perspective, "[t]here will be no ambitious partnership without common ground in fair competition, state aid, tax dumping, food safety, social and environmental standards."[37] The EU does not want a post-Brexit Britain that tries to tilt the regulatory playing field in its own favour, and may demand more stringent guarantees than those included in standard FTAs.

These precedents are no guarantee that the UK could negotiate similar arrangements – but they do provide the starting point to construct models for a future trading relationship between the UK and the EU that is deeper than CETA but less restrictive than Norway's.

In the next chapter, we look at potential models based on past precedent – and a final one that starts explicitly from the position of convergence on day one after Brexit.

4. The UK's options

The EU has offered other countries or blocs arrangements that fall between Norway's EEA membership and the sort of free trade deal which it has negotiated with Canada. We set out three possible models based on adapting those existing EU arrangements: These are:

- **EU-UK Economic Area ('Bespoke Norway')**, which would follow the approach taken with EEA countries of agreeing upfront UK adherence to the EU's comprehensive regulatory rulebook with strong institutional oversight. But the UK would not become an EEA member, instead creating its own EEA-like relationship with the EU.

- **EU-UK Deep and Comprehensive Free Trade Area ('Reverse Ukraine')**, which would be a variation on trade provisions in the EU-Ukraine association agreement; it can be thought of as a 'reverse Ukraine', providing a model for selective divergence rather than convergence. The UK would selectively participate in the Single Market where it agreed to maintain alignment with EU rules.

- **EU-UK comprehensive free trade deal ('Canada plus')**, which would build on a Canada-style comprehensive FTA by adding enhanced provisions for regulatory co-operation and seeking to get better access for services.

Both sides have pointed to the unique starting point for the negotiations in that the UK currently complies with all EU regulations. As Michel Barnier has said, the key issue going forward is how to manage the UK's post-Brexit potential for divergence from the EU. We also look at a fourth possible model that takes the UK's existing integration into the Single Market as its starting point:

- **'EU-UK Regulatory partnership'**, which would set up a process for managing the UK's divergence from EU rules. It would allow the EU-UK trading relationship to develop over time, rather than being subject to a comprehensive agreement decided at the outset.

All four options would require the UK to make choices on the degree of regulatory alignment with the EU in order to secure the market access for industrial goods and services it wants; the institutional framework that it would be prepared to accept; and the potential other obligations the UK would face.

There is one option we briefly discuss which would not require the UK to make that choice – an agreement on comprehensive mutual recognition of rules. But that would be completely unprecedented and require a massive change of approach by the EU.

In these models, we concentrate on access for manufactured goods and services. We do not discuss agriculture and customs provisions at length.

One of the notable features from our earlier discussion of precedents is that the EEA states, like other countries that have agreed FTAs with the EU, have separate bilateral deals on agriculture. The UK would also seek to agree favourable terms for agriculture and fisheries where it has given notice it wants to leave the CAP and CFP. This is a particularly big issue in the island of Ireland where agri-food accounted for 41% of cross-border manufacturing trade in 2015.[1] The issue of regulatory alignment will arise in areas where the EU insists on adoption of its food safety and animal health regulations to avoid onerous border inspection. The UK may also face tougher negotiations on tariffs and potential protections for 'sensitive products', as well as concerns about future subsidy regimes. The EU27 currently have a trade surplus on agriculture with the UK (and there is extensive bilateral trade in fish) – so a deal should be in both sides interests. We do not discuss this further in this section.

The UK will also leave the EU Customs Union and has put forward proposals for a new customs relationship with the EU.[2] It has yet to put forward any proposals on what it wants to agree on rules of origin – that is, how to define a UK product for purposes of a preferential trade deal. Rules of origin are critically important for many UK-based exporters, who fear that, unless the UK can negotiate very liberal rules, their UK-manufactured goods may have too little UK content to benefit.[*] Rules of origin would need to be negotiated on top of any of the options set out below.

1. EU-UK Economic Area ('Bespoke Norway')

Key features

- **Continued Single Market participation –** the UK would retain a similar level of barrier-free access for manufactured goods and services as now.
- **Full alignment with EU regulations, but with enhanced influence on those rules –** the UK would be obliged to adopt all Single Market relevant rules, but it could try and negotiate greater influence than EEA countries or use its formal 'rights of reservation'.
- **Robust institutional oversight –** with the same or similar institutions to the EEA agreement.
- **Continued acceptance of the principle of free movement and financial contributions –** though lower contributions than now, and the UK could attempt to negotiate some safeguards on freedom of movement.
- **Freedom to pursue independent trade policy –** though constrained by commitment to the EU Single Market rulebook.

[*] In evidence to the Department for Business, Energy and Industrial Strategy (BEIS) Select Committee, the chief executive of the Society of Motor Manufacturers and Traders (SMMT) said current UK content was 20–25% and to reach 60% "will take many years". As a result, the SMMT called for 'cumulation with Europe', where European parts would count as UK parts and vice versa. House of Commons, *Oral evidence: Leaving the EU: implications for the automotive industry*, HC 379, 2017, retrieved 7 December 2017, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/leaving-the-eu-implications-for-the-automotive-industry/oral/73855.html

There are two potential routes to this option: one option would be for the UK simply to apply to join the EEA agreement – which other EEA states would need to accept – and seek a small number of exceptions. But those UK exceptions might cause problems with existing EEA states.

An alternative route, which we set out here, is to agree an EEA-like arrangement, but which reflects the different scale and structure of the UK economy. The specific modifications the UK would seek would be: safeguards on freedom of movement; and, more influence on regulations in critical areas, by virtue of the UK's economic size and international standing.

In return for maximum access to the Single Market, the UK would need to accept EU rules

This option would potentially give the UK the best possible access to the Single Market – but it would come with commensurate obligations. The UK would continue to be expected to automatically align to all EU Single Market legislation – approximately 30% of all EU legislation that currently applies in the UK.[3] Most of these EU rules would be technical regulations and standards, veterinary and food safety rules, and services regulations.

Similar to EEA countries, the UK would be required to adopt the EU's set of cross-cutting regulations that underpin the level playing field in the Single Market. This would include competition and state aid laws, consumer protection, environmental and labour protection regulations, and data protection regulations, unless it could negotiate specific exceptions from these requirements.

The UK would also be able to participate in many of the EU's regulatory and executive agencies, either as an associate member or an observer, removing the cost and duplication involved in establishing some of our own parallel bodies.

In the area of financial services, high alignment would mean accepting the EU's financial supervisory powers in a way similar to the EEA states. But this is an area where the UK might seek to negotiate enhanced regulatory co-operation to ensure it could continue to influence the development of EU financial regulation. This would, however, be a significant concession from the EU.

But it could seek greater influence over rule making and retain the right to not adopt new laws

One suggested route that would offer the UK greater influence is involvement in the European Council's readings of relevant draft EU legislation relevant to the Single Market. The UK would have a right to provide advisory opinions or amendments, though those opinions would not be binding on the EU.[4] This would give higher-level engagement than EEA countries enjoy, particularly important in financial services where the UK is concerned about being reduced to a 'rule taker'.

A key difference to the status quo is that EEA states have 'the right of reservation', which in theory allows them not to implement an EU law. However, invoking this right would allow the EU to suspend the affected part of the agreement, which could in turn result in a loss of market access rights or suspension of the entire agreement. While

Norway has only ever used this right once, the UK might seek to use it more often. But in response, the EU would be likely to restrict market access and there could be consequences for the stability of the overall agreement.

An EU-UK Economic Area would need to be underpinned by strong institutions

This model relies on an extensive framework of institutions. It would need a mechanism for automatically updating rules in line with EU law, an independent surveillance authority to make sure that the UK complied with the rules (the role the Commission plays now); a means for uniform interpretation of the agreement and a robust dispute resolution mechanism.

The UK could either:

- **Dock to the EFTA's existing institutions.** The UK could 'dock' to the EEA's own institutions – the ESA and EFTA Court. Brussels has previously proposed a similar 'docking solution' to Switzerland as part of their negotiations, which suggests that such solution could be politically acceptable for the EU, though the EEA states would also have to agree.

- **Design its own institutions.** Alternatively, the UK and EU could design their own institutional structure that would satisfy the EU's requirements. To get the same level of market access as the EEA, it is likely that these institutions would have to copy EFTA institutions. That could mean a UK-only version of the EFTA Court and a UK version of the ESA. Or, it could mean a new joint UK-EU surveillance authority and UK-EU dispute resolution mechanism.

The UK would need to accept the principle of free movement and continue to contribute financially to the EU

This option would also come with obligations. The UK would be expected to contribute financially to the EU, for example through grants for reducing economic and social disparities in accession states, as the EEA states do now. This contribution would also be smaller than now. But the price of continued participation in the Single Market would also be an EU insistence on continued free movement or at least the principle of free movement.

The UK could try and seek safeguards on migration or specific mechanisms to help manage it. However, the EU was unwilling to concede a Liechtenstein-style emergency brake to the UK while it was a member, and is more likely to insist that the UK uses domestic measures to manage migration.[5]

This option minimises disruption but it requires the UK to soften some of its red lines

In terms of negotiability, this looks a long way from where the UK Government currently is. Nonetheless, it is the model that best fits business concerns about leaving the Single Market, though there would still be additional compliance costs from leaving the Customs Union. It would require the UK to agree to supranational supervision and jurisdiction, though over a much more limited range of issues

than now. Although the UK would become a rule taker – subject to its formal right of reservation – it is arguable that it would still be able to influence new regulations and rules.

It could either use access and influence to shape EU proposals before they are adopted, although would have no formal vote, or use its independent voice in international standard-setting bodies, which often influence EU rules. The more the UK can enhance that influence the better, particularly in the critical area of financial services, where the industry is worried about becoming a rule taker.

The question is whether the UK could deal with its migration imperative through a mixture of (permissible) domestic controls and a willingness by the EU to concede some safeguards (a principle already conceded to Liechtenstein). The formal safeguards option is currently off the table, but it has recently been suggested by German business leaders as a route the EU should consider in order to keep the UK as a close as possible to the Single Market.[6]

The EU would need to show some flexibility, but in return it would get to keep the UK close to its rulebook

The EU may be unwilling to offer anything other than EEA membership on existing terms to the UK. But this could easily be presented as the UK having a worse deal than now: the UK would suffer a significant loss of influence compared to EU membership and this has the advantage for the EU of keeping the UK as close as possible to its rulebook; maintaining barrier-free access for EU exporters to the UK market and the UK continuing to provide budgetary support. It also prevents the fragmentation of the EU's financial services markets across the EU; a risk if London is no longer the EU's centre for the industry.

As the current Norway model could be the starting point for the negotiation, this may be one of the faster options for negotiation – though the more bespoke the UK tried to make the deal, the longer it would take.

2. EU-UK Deep and Comprehensive Free Trade Area ('Reverse Ukraine')

The second option would be for negotiators to build on the EU's 'new generation' FTAs – so-called Deep and Comprehensive Free Trade Areas (DCFTAs) – that the EU has signed with Eastern European countries like Ukraine, Georgia and Moldova.

Key features

- **Participation in selected pre-defined areas of the Single Market –** where the UK would agree to maintain alignment with EU rules and be subject to oversight.
- **Freedom to vary in other areas –** with potentially greater scope for independent trade policy.
- **Reduced financial contributions but unlikely to avoid the principle of free movement.**

The major point of difference with Ukraine's DCFTA is that, while Ukraine is moving toward the EU acquis, the UK wants to move away. This means that whereas the focus in the Ukraine agreement is on assessing progress on convergence, in the case of the UK, the deal would focus on monitoring compliance in areas where the UK sought continued unrestricted market access.

The UK could agree to participate in specific areas of the Single Market, but sector carve-outs are difficult to implement in practice

This model removes the UK's obligation to accept all Single Market legislation. At the outset, the UK and the EU would agree on specific areas where the UK would continue to align fully with the EU. In those areas, the UK would have 'a stake in the EU's internal market',[7] without being a formal member. In other areas, the UK would not be required to align with the EU, but market access would be correspondingly restricted. Nonetheless, this model would provide greater market access than a conventional FTA.

The extent and ease of access would depend on how selective the UK's participation in the Single Market was. The UK and EU would need to agree in which sectors the UK would maintain alignment and which not. One point to note is that varied levels of alignments in specific sectors would be hard to implement because industries and sectors are interlinked. It would be complicated to manage as exporters would have to differentiate between inputs that were part of the Single Market and inputs that were not.[8]

Under this option, one of the issues for the UK to consider would be where it would like to retain regulatory flexibility. The ability to diverge from EU rules in selected areas could make striking trade deals with third countries easier than in the previous option, the EU-UK Economic Area.

The UK would still need to accept EU rules in key areas and commit to regulatory co-operation in others

Market access rights would come with the obligation to continue to align with the relevant regulations, and automatically update them, in areas where the UK wanted to retain access on current terms. The EU would also be likely to insist on compliance with level playing field regulations, including competition and state aid laws, environmental and labour protection regulations, and data protection regulations, although there would be scope for negotiating.

In areas where the UK had not committed to alignment, there would be provisions for regulatory co-operation. For example, an obligation to notify a partner of the intention to diverge, and an opportunity to comment on the draft legislative proposals, as was suggested in the proposed TTIP text. But it would not have the same insider influence as in the previous model.

The UK would need to accept some continued role of EU institutions in monitoring compliance

It might be possible to use the EFTA Court and the ESA for oversight in areas where the UK had decided to stay integrated into the Single Market. Alternatively, as with Ukraine, oversight could be provided by the European Commission, supported by joint expert committees drawn from both the EU and the UK. However, the more distant relationship would mean less likelihood of insider influencing.

It is likely that free movement and budget contributions would have to continue to some degree

While the model of selective participation may provide a precedent, Ukraine's lack of obligations on freedom of movement or financial contributions may not. As a less advanced economy, Ukraine is not required to contribute financially to the EU, and the EU has not sought to negotiate freedom of movement. The EU would be much more likely to seek these from the UK. Financial contribution could be related to the extent of UK participation in the Single Market – and this sort of agreement could contain provisions for a preferential (but controlled) migration regime between the EU and the UK.

For the UK, selective participation might make continued obligations easier to sell domestically

There are elements of the Ukraine model that could suit both sides quite well (and trading provisions of this sort could fit within a wider association agreement reflecting the much broader co-operation both sides say they are keen to see). The fact that the UK could choose where to participate, rather than have to swallow the whole Single Market acquis, might make it easier to accept the alignment and enforcement obligations.

But the Ukraine agreement was designed to incentivise reform, the dynamic in a UK-EU deal is completely different

But the politics for the EU behind the two agreements are completely different – one is about providing incentives to internal reform by holding out the prospect of moving closer to the EU, the other about accommodating a departing member state. Although this model would offer the UK significantly less influence even than the bespoke Norway option, sectoral differentiation might still be seen as too much cherry picking. On the other hand, it would keep the UK closer to the EU regulatory model and would be significantly less disruptive for business than moving to a Canada-style FTA.

3. EU-UK comprehensive free trade deal ('Canada plus')

The third option would be for negotiators to build on an ordinary free trade agreement. The EU regards its agreement with Canada as representing the furthest it has gone. So the question is what might be added to a Canada-style FTA.

Unlike the previous options, the UK would have no obligations associated with integration into the Single Market. However, that would mean a dramatic increase in the barriers to access to the Single Market, as UK exporters to the EU would still be required to prove they meet EU regulatory standards on products they wanted to export to the EU. Market access rights for some services sectors would be severely restricted.

Key features

- **Bottom up negotiation**, similar to any other comprehensive FTA.
- **Tariff-free access for goods**, but UK exporters still required to meet EU standards for exports and checks required to prove that they met them.
- **Limited access for services –** greater access would require greater alignment with EU rules.
- **No requirement to align with EU regulations**, with potential provisions for mutual recognition of conformity assessment across a wide range of products and provisions for regulatory co-operation.
- **No financial or free movement obligations.**
- **Maximum flexibility for independent trade policy.**

There are some possible additions to CETA; the most desirable would be on services, but it would be the hardest to achieve

The UK could still attempt to negotiate improvements on the Canada deal, with four areas likely to be of particular interest to negotiators.

First, the UK and EU could try to agree comprehensive mutual recognition for conformity assessment for goods, eliminating the need for duplicatory checks. CETA initially only covered goods where Canada had pre-existing mutual recognition agreements with the EU – though with a provision to extend.

Second, it could include stronger provisions on 'regulatory coherence', similar to TTIP, which would allow for voluntary recognition of equivalence of the other party's regulations and create ongoing processes for co-operation between British and European regulators.

Third, it could include agreements on specific sectors or issues such as air transport, data sharing or energy, including potential relationships with EU regulatory and executive bodies, or add in issues like science collaboration.

Finally, the UK could seek to negotiate improved market access commitments for UK services. To achieve this, however, the UK would likely have to commit to continue to align its regulations in relevant sectors with the EU. More importantly, the extent to which the EU would be likely to agree could be constrained by the so-called 'most-favoured nation' (MFN) clause in some of the EU's other FTAs, such as CETA, which obliges it to offer the terms in any later FTA on services to those countries.*

* The inclusion of MFN clauses in other EU FTAs ensures that parties to EU FTAs that are subject to this clause benefit from any concessions that the EU might grant in the future in areas covered by the prior agreement. In CETA, this applies to commitments made under the services chapters.

While there would be very few obligations, the UK would face significant barriers to trade, particularly in services

This model comes with the fewest obligations of any we have considered. But the UK could decide unilaterally to follow EU regulations and then seek equivalence decisions from the European Commission.

Because there is no obligation to align to EU rules, this option provides the most restricted access. Border regulatory checks could disrupt cross-border supply chains, but the biggest impact of a CETA-style deal would be the impact on services. While the UK could probably negotiate mutual recognition of some professional qualifications, the most disruption would occur in the regulated services sectors, including financial services.

In the absence of the EU recognising UK services regulations as 'equivalent' to the EU's, market access rights for cross-border trade would be automatically curtailed. Even if the Commission did recognise some of the UK's regulations as equivalent, this would still represent a significant reduction in market access compared with the current arrangements. It would also be vulnerable to being rescinded by the Commission at any point, reducing business certainty.

Even under this option the EU might insist on some 'level playing field' rules

Standard FTAs do not generally include requirements to align with cross-cutting regulations designed to secure a level playing field, and CETA was no exception. But the EU negotiating guidelines already indicate its concerns at the prospect of undercutting from a large, nearby economy. The EU could require stronger provisions on cross-cutting regulations than most typical FTAs.

There would be no need for robust institutions, but there would need to be some means of co-operation

This sort of agreement does not need the strong surveillance and enforcement mechanisms of the earlier options.

If the agreement included provisions for granting equivalence for specific regulations, it would require the establishment of monitoring procedures. The EU and the UK could agree a forum for regulatory co-operation to pre-empt future trade barriers. This could, like TTIP, include an early notification procedure for new legislative and regulatory measures that could affect UK-EU trade. Like all standard FTAs, the agreement could include an ordinary ad hoc arbitration mechanism, with no role for the ECJ.

There would be no need for any agreement on migration beyond what is included in normal FTAs, and the UK could try and pay for access to specific programmes

Visa regimes are a normal part of FTA negotiations. There would likely be discussion on the future migration regime between the UK and EU, which would include provisions for 'mode 4' – movement of working professionals – at least.

Unlike in the previous options, there would be no general budgetary contribution. But the UK might seek to selectively participate in and contribute to EU programmes.

But ultimately, a 'Canada plus' deal is likely to suit the EU's commercial interests more than the UK's

A Canada-style agreement is on offer from the EU. But as the Prime Minister pointed out, an agreement modelled on CETA would mean serious loss of market access for the UK. The EU's ability to concede better access to the UK, particularly in services, is constrained by MFN clauses in its other FTAs, particularly with Canada and South Korea. If the EU conceded more favourable terms to the UK on services, Canada might claim it should have the same treatment.[9]

A 'Canada plus' deal is more favourable to trade in goods – an area where the EU27 have a surplus with the UK – rather than in services – where the UK has a surplus. The economic consequences of resorting to such arrangement would likely impose proportionately bigger costs on the UK than the EU27.

4. EU-UK Regulatory partnership

The three earlier options were all based on existing precedents. But the EU has shown creativity in the past – in creating the EEA, reacting to the Swiss refusal to join the EEA, and accommodating some of its closest neighbours in parts of the Single Market. While the circumstances of the UK's departure are different, they arguably offer scope to harness the starting position of full integration into the regulatory union and build a new model: that would be a process for managing the UK's regulatory divergence from the EU Single Market.

Key features

- **Recognises the unique starting point of convergence with the EU**, and allows for a different approach to negotiation focused on designing a process to manage divergence.
- **Three-tier approach to regulatory alignment**, which would keep the UK aligned to EU rules in a core set of areas ('core tier') that would provide an enforceable level playing field for UK-EU trade, but it would give it the freedom to diverge in other areas.
- **Robust institutions to manage divergence.**
- **Allows the future relationship to evolve over time under a managed process.**

The starting point of this model is that the UK is completely aligned with the rules of the Single Market and has complete access. The process it establishes is one that allows the UK to choose to diverge – but at the price of loss of market access if that divergence is shown to have significant impacts on the Single Market. The process would need to manage three routes to potential divergence:

1. Decisions by the UK to amend its 'EU retained' law.

2. Decision by the UK not to update its retained law or adopt new EU rules, when the EU updates its existing laws or introduces new ones.

3. Decision by the UK not to follow a post-exit ECJ interpretation of EU law.

The UK and EU would agree to three different types of regulatory alignment

Central to this model is a 'three-tiered approach' to regulatory alignment, similar to that set out by the Prime Minister in the Florence speech.[10]

- **'Core tier': areas of regulation where the UK continues to achieve the same goals as the EU and continues to meet them in the same ways.** In those areas, the UK would agree to continue to fully align to EU regulations and continue to adopt new rules automatically. At a minimum, this would include product regulations with detailed technical requirements, for example in areas like chemical regulations. If the UK diverged, it would immediately lose barrier-free market access. Given its concerns of potential 'regulatory dumping' by the UK, the EU would likely insist on including some of its most important level playing field rules, for example on competition and state aid, in this tier.

- **'Mid tier': areas of regulation where the UK could diverge from EU rules to achieve the same regulatory goals or outcomes by different means.** This would effectively be a form of managed mutual recognition of rules. If the UK's divergence was shown to have a material impact on the Single Market, it would lose market access. This could potentially include some other level playing field provisions, for example, environmental protection standards.

- **'Outer tier': areas of regulation where the UK would be free to diverge from EU rules from the start with no consequences for market access.** This would include everything currently outside the Single Market acquis, but could go further and include areas where it was agreed that rules had no impact on EU-UK trade.

Divergence would be managed through an expert-led process

There would be a specific **'test for regulatory parity'** defined by a committee independent of the EU and the UK, responsible for performing the surveillance function in the mid tier regulations. They would be required to judge whether there had been divergence, what impact it would have on the Single Market and therefore the remedy that could be imposed.

For mid-tier regulations, there could be a four-step process of monitoring and assessing compliance, broadly designed in line with the 'notification procedure' that already exists in the Single Market:[11]

1. **Notification:** The EU and UK would notify each other of the potential divergence, which triggers an assessment procedure.

2. **Independent assessment of divergence:** The expert committee would undertake independent technical assessment of whether the divergence would undermine regulatory parity. The assessment of the expert committee would be only advisory and the test would vary across different types of regulation.

3. **Determination of equivalence:** The committee's assessment would be provided to the European Commission for 'determination of equivalence' – a political decision on whether the scope of divergence is adverse enough to undermine the Single Market.

4. **Addressing consequences of divergence:** If the committee concludes that divergence has adverse consequences, the European Commission would have the right to notify the UK of its intention to withdraw market access rights from the UK or to apply other types of penalties. Any decision to withdraw access would not have immediate effect, but would come into effect after a time limit specified in the agreement.

The UK would be able to take parallel action where the result was loss of access – and also be able to take trade remedies in cases where the EU was judged to have acted unfairly.

This option is dependent on strong institutional architecture

The status of the three tiers would themselves be for negotiation. A periodic review of the agreement could decide to change regulations or groups of regulations between tiers.

At its core, this model rests on a robust institutional framework, with varying institutional requirements depending on the level of regulatory alignment:

- The **core tier** would need processes that are similar to existing EEA ones: automatic updating, surveillance and enforcement. It could even dock to the EFTA Court or devise a replica. If the UK did not want to give the ECJ direct oversight over these rules, it could instead dock to the EFTA Court, or attempt to design a new tribunal that respects the autonomy of the EU legal order.[12]

- The **mid tier** would require joint expert committees to advise on regulatory parity and perform surveillance of the agreement. It may be possible to design a dispute resolution mechanism that would allow the UK to appeal the Commission's determinations of equivalence in a judicial or quasi-judicial forum. This would be challenging, however, as the EU would likely consider such a system to threaten its legal autonomy. Failing this, dispute resolution would need to be political or diplomatic.

- The **outer tier** would not, in theory, require any institutional underpinning. However, there might be provisions for regulatory co-operation.

There would also need to be clear arrangements for the overall governance of the agreement – and, in particular, a means of adjudicating disputes about which rules fell in which tier.

Free movement and budgetary contributions would continue, unless the UK decided to diverge

Since this model is completely new, there are no precedents for wider obligations. However, the more EEA-like the core tier and concomitant access looks, the more the EU is likely to insist on freedom of movement. The UK might choose to diverge from regulations that underpin the free movement (if those are not included in the 'core tier'), but the consequences of such divergence could lead to withdrawal of market access rights.

The EU might seek further budgetary contributions to internal market support on a similar basis to the EEA countries, as well as contributions to specific programmes. In addition, the UK would be expected to cover some of the costs of running the joint institutions.

This option allows the UK-EU relationship to evolve over time

This model could be argued to combine the UK's desire for control with the EU's desire to preserve the 'integrity of the Single Market'. It makes explicit the trade-offs between access and divergence – but on a basis that can evolve over time, rather than be subject to upfront negotiation now. It is not just dynamic, but also flexible.

But flexibility results in uncertainty, which has consequences for business

However, that flexibility is also its downside. This would be a potentially very unstable model compared to the alternatives and would introduce a wide range of uncertainties about the future UK-EU relationship. The biggest uncertainty would be over access, which would continually be at the mercy of decisions on divergence and the trade consequences.

The UK's ability to exercise regulatory control would come at the cost of an unstable business environment. That would be compounded the more flexibility there was to move regulations between tiers. If the UK and the EU regulatory frameworks moved apart over time, that would give rise to a complex legal landscape, which would be particularly problematic for organisations that operate cross-jurisdictions. The mitigation to some of these challenges would be to expand the scope of the core tier, but that would come at the price of control.

This model has potential to satisfy demands on both sides, with a balance of access and obligations

The advantage of this model is that it offers the UK right to exercise control – but with the potential for maintaining close alignment and thus good access. It requires the UK to submit to supranational governance in some areas – but as a clear (and amendable) choice in return for market access. Rather than make a choice of regulatory model now, it enables (or forces) the UK Government to make a series of choices about the value of divergence versus the costs.

For the EU, it offers the clear safeguards to protect against a regulatory competitor on its doorstep. Because the core tier would include areas that guarantee the level playing field between the UK and EU, this would safeguard against any regulatory 'race to the bottom' by the UK and keep the UK close within its regulatory orbit.

It could, in theory, be negotiated more quickly than other options as the core is institutional design rather than traditional, bottom-up negotiation. Since its starting point is convergence, it could remove the need for transitional membership of the Single Market.

Is a radically different option possible?

A very different approach has been suggested that could, in theory, free the UK of any obligations to align with the EU, and enable it to pursue a global trade strategy.[13]

It is argued that the UK should be able to agree to a system of complete mutual recognition of rules, which would allow free trade in goods and services. This could be seen as an ambitious version of the TTMRA, which allows Australia and New Zealand to accept each other's regulatory standards and regimes without the obligations that the EU typically requires. However, Trans-Tasman itself is a limited agreement: highly regulated sectors are exempt from the mutual recognition provisions, even where there is a high trust environment between the two parties. Nor does the agreement provide extensive provisions for services.

If this were negotiable, it would have obvious attractions for the UK: access as now, with few of the obligations. However, it is clear that this proposal contradicts every precedent the EU has negotiated on access to the Single Market. It would end up granting the same mutual recognition that member states enjoy, with no obligation to harmonise with EU rules, with no comparable oversight by EU institutions.

The EU could be expected to resist conceding such preferential treatment to a third country – particularly one whose motivation in seeking such treatment was to allow it to conclude agreements with other countries with different regulatory approaches and in effect act as a bridge between the two systems.

Some suggest the UK could oblige the EU to accept this arrangement under World Trade Organization (WTO) rules. However, that provision is untested. If this approach to market access were a quick route in, other countries seeking access to the EU market, not least the US, would have tried it already.

Conclusion

In this chapter, we have looked at some options that appear to be technically feasible. But technical feasibility is not the same as political 'saleability' within the UK, nor negotiability with the EU. In the final chapter we look at those two critical issues.

5. Conclusion: choosing between the options

We have shown that there are potential options between Norway-style membership of the EEA and the Canadian FTA. But the crucial question is whether there is appetite on either side for accepting the compromises that would allow a movement to the middle ground.

The Prime Minister has set out the UK's high-level 'asks' in her speeches at Lancaster House and in Florence.[1] The EU27 set out its broad principles for the 'framework on the future relationship' in its Article 50 guidelines in March 2017,[2] and have reinforced their position in the guidelines opening up Phase 2 of negotiations at the December European Council. The EU27 will decide their detailed negotiating position at the meeting in March 2018. In this chapter, we look at how the options measure up against the declared objectives of the two sides and briefly discuss the likely negotiating timetable.

Even if the UK wants to seek a middle option that is neither Norway nor Canada, it needs to start making critical choices and put forward a positive vision for its new relationship with the EU. It needs to make that decision on the basis of robust analysis – and needs to engage constructively with the EU27, taking account of their concerns. This is a high stakes venture for the UK. If it cannot convince on a middle way, it will be forced back on the binary choice it has rejected, or face the economic disruption of reverting to trading with the EU on WTO terms alone – something that no major trading partner does.

Table 2: The UK and EU's negotiating objectives

	UK	EU
Objectives	• Secure the most frictionless possible trade in goods and services outside the Single Market and the Customs Union • Avoid any physical infrastructure around the Irish border	• Establish a close partnership with the UK, and a balanced, ambitious and wide-ranging FTA • Avoid a hard border in the island of Ireland
Red lines	• End the direct jurisdiction of the ECJ in the UK • End the freedom of movement of people • End mandatory contributions to the EU budget • Be free to pursue an independent trade policy	• Preserve the integrity of the Single Market, including the indivisibility of the four freedoms • Ensure a level playing field, particularly on competition and state aid, and create safeguards against unfair competitive advantages • Preserve the autonomy of EU's legal order and its decision making • Safeguard financial stability of the EU, and respect its regulatory and supervisory regime and standards • Ensure the UK does not have a better deal than EU member states • Avoid upsetting existing relations with other third countries

The UK's choices

The UK faces a critical choice between access to the Single Market and regulatory control

The EU fears that the UK is seeking the access of a Norway with the limited obligations of Canada. As the EU's chief Brexit negotiator Michel Barnier has made clear, that will not be on offer.

The UK will have to make a fundamental choice: does it want to stay as close as possible to the EU's regulatory model, with the restrictions and obligations that will impose, in order to maintain as friction-free as possible market access? Or does it want far fewer obligations and the option of choosing a different regulatory path, with greater potential for an independent trade policy – but at the cost of access to the EU market on significantly less favourable terms.

If the UK prioritises market access, the 'bespoke Norway' option could offer the least disruption

If the UK prioritises high market access, that would entail less flexibility and control over its regulations. The 'bespoke Norway' option, if negotiable, would provide the closest alternative to the current level of market access and would be the least disruptive option for UK-EU trade, not least because it would effectively maintain membership of the Single Market.

On the other hand, it would entail obligations that are similar to those of the EEA countries. The UK would be expected to adopt most Single Market rules automatically (though it could exercise its right of reservation but would not need to accept the rest of the EU acquis).

The UK might be given special rights too, but there would likely be only limited opportunity to influence the rules governing the Single Market – and certainly significantly less than as an EU member state. With the UK standing outside the EU's formal decision-making processes, its financial services sector would be left vulnerable to EU regulations that it would have tried to prevent if it were still a member state.

Unless the EU proves much more flexible than it has been in the past, this option would also mean accepting a continuing, though less direct, relationship with the ECJ, supranational oversight and free movement. It might be possible to implement domestic measures that would reduce migration – but there is no sign the EU would be ready to compromise on the principle of free movement for the UK. Budget contributions, though lower than now, would continue.

The EU-UK Deep and Comprehensive Free Trade Area could provide greater flexibility at the outset, but less influence and access

An EU-UK Deep and Comprehensive Free Trade Area (DCFTA), built on the Ukraine model, would provide partial access to the Single Market, but only where the UK agreed to continue to align with EU rules and accept oversight by supranational bodies. The UK could maintain access the Single Market for services on that basis.

If the UK prioritises control, 'Canada plus' would meet most of the UK's political objectives but would hinder market access in important sectors

The UK's political objectives are most compatible with 'Canada plus' option, perhaps with better access for services and agriculture, and closer regulatory co-operation. But the introduction of non-tariff barriers for goods and the loss of access for services mean this option would entail the most significant economic disruption of all options.

The 'regulatory partnership' provides more flexibility but at the price of uncertainty

The new 'regulatory partnership' model would be a middle way that allows the UK and EU relationship to evolve over time. This will involve continued alignment with EU rules in some areas (so-called 'core tier') but in others, it would give the UK flexibility to choose whether to remain aligned to EU rules, with decisions to move away from the EU's regulatory sphere coming with market access consequences. That could allow for a high level of access, while giving the UK more control. But depending on the size of the core tier, this could in practice entail most of the obligations of the EEA model. Furthermore, the price of this flexibility would be a big loss of certainty for businesses, with longer-term market access in areas where the UK would want to retain flexibility never guaranteed.

The UK needs to make a realistic assessment of the benefits it is likely to gain from divergence from EU regulations. The evidence suggests clearly that companies operating in several countries with different rules typically adopt the toughest standards, particularly when they are needed to access a large market like the EU, rather than run several separate compliance systems.[3] In the evidence given by businesses to numerous parliamentary inquiries in recent months,[4] UK businesses expressed a clear preference for staying close to the EU's regulatory model rather than diverging from EU rules.

The EU's objectives

In pursuing any agreement, the UK also needs to consider how it measures up to the EU's concerns. So far the EU's interests have been primarily defensive and in the first phase of the talks they have maintained an impressive unity. It is not yet clear whether they can maintain that unity in the second phase. Some member states, such as France, appear keen to benefit from the UK's departure from the Single Market.[5] Others, particularly in Northern Europe, have strong economic incentives to maintain close trading links, particularly in goods, where they have a trade surplus with the UK. Analysis for the European Parliament showed that, as well as Ireland, the Benelux countries were particularly exposed to reduced trade with the UK.[6] Some countries, like Sweden and Italy, are already talking about the benefits of going beyond a CETA-style deal.[7]

'Bespoke Norway' would protect the integrity of the Single Market and be least disruptive to trade

The less bespoke the deal, the lower the threat to the integrity of the Single Market (though at the same time, the EU might argue, the less the point of not simply opting for EEA membership). The EU would also need to consider the acceptability of cutting a different deal for the UK to existing EEA member states.

However, if this could be agreed, it would impose the least short-term economic cost to both the UK and EU economies. Continuing UK contributions would ease budget pressures. It would also remove the potential risk of the UK becoming a hypercompetitive regulatory jurisdiction on the doorstep. Some member states who have traditionally allied with the UK might welcome an arrangement that gave the UK a continuing voice on the development of EU regulation. The key issue would be finding a way forward on freedom of movement that both the UK and EU could accept.

The EU-UK Deep and Comprehensive Free Trade Area could offer a workable framework, but the EU might see it as cherry picking

This would build on the EU's new generation association agreements. But this model was conceived as a way of extending some of the benefits of the EU to Eastern European countries as part of the EU's 'Eastern Neighbourhood' policy, where there was no short-term prospects for accession and the EU wanted to incentivise political reform. But the EU might regard this as a form of sectoral cherry picking. Having decided to leave the Single Market, the UK would be seen to 'opt in' to specific parts of the Single Market. However because the price of that opt-in would be EU supervision and acceptance of EU rules, this option would meet EU concerns about preserving the integrity of the Single Market.

An ordinary FTA would take the UK outside the EU's regulatory orbit

The EU could, of course, build on a recent deal with Canada and conclude a more advanced 'Canada plus' deal. Such arrangement would protect the Single Market – but would come at an economic cost to the EU too. While there might be scope for import substitution, with UK exports decreasing as they face new non-tariff barriers, there would also be a reduction in trade flows to the UK. But the real area of concern for the EU in this option would be the potential emergence of a regulatory competitor, at least in some sectors, on its doorstep.

Regulatory partnership recognises the unprecedented starting point – but would mean creating a new relationship from scratch

Michel Barnier has said that the key issue is how to manage divergence and this option puts that process at the core. It recognises that, with such a unique starting point, there is potential for a completely new approach. It offers two potential safeguards to the EU: the UK's obligation to abide by a set of 'core' regulations and a process which both sides accept for determining equivalence and access, with a recognition that divergence means loss of access. It combines the UK's desire for greater control with the EU's need to protect its internal rules and safeguard against the possibility of the UK becoming a hyper-competitive jurisdiction.

It could also provide a novel institutional model for other countries – including Switzerland, which has been negotiating its institutional agreements since 2014 with little success – to have more comprehensive but more flexible relationships with the EU along the lines the French President has floated.[8]

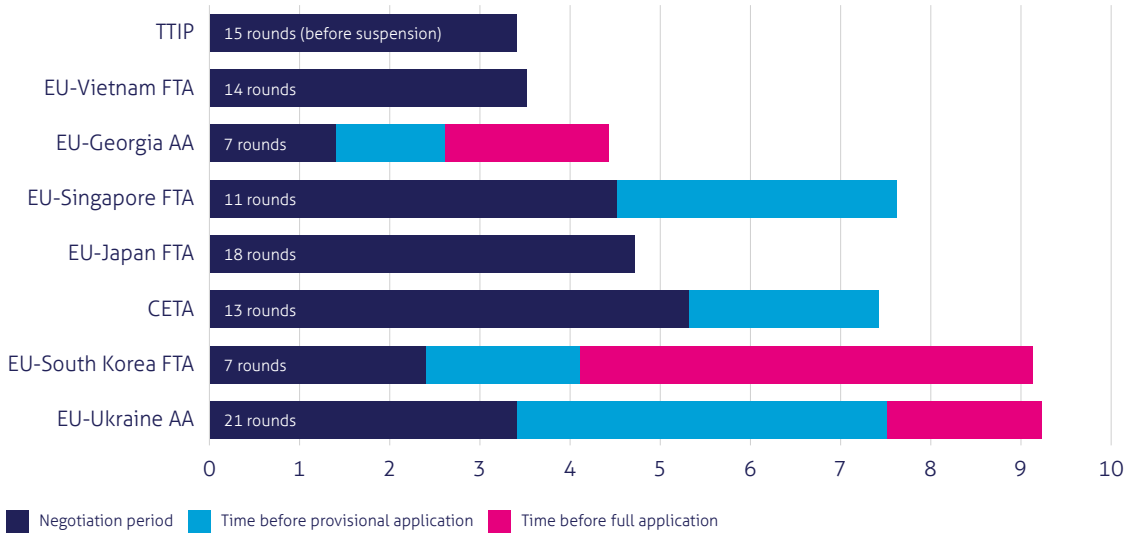
Negotiating a new relationship

Any agreement would require a substantial period of negotiation. At Lancaster House, the Prime Minister seemed to suggest that it would be possible to agree both the terms of withdrawal and the details of the UK's new relationship within the two-year Article 50 window – and she reiterated this in her letter invoking the Article 50 process of withdrawal

from the EU. The EU, and those with experience of EU negotiations, have always thought that timetable was wholly unrealistic[9] – and that all that could be reasonably expected during the Article 50 process would be a framework with the details taking much longer to agree.

The EU has taken at least four years to negotiate and implement every FTA it has signed in the last 10 years. That does not take in to account the time spent informally and formally scoping the agreement.

Figure 4: The duration of negotiating and concluding recent EU FTAs (in years)



Source: Institute for Government analysis of European Commission, Directorate-General Trade data.

The reason that this process takes so long is that the EU needs not only to get an initial mandate agreed to start negotiations, it then has a lengthy process to get agreement. Any deal of the depth the UK is seeking will end up being a mixed agreement which affects areas beyond sole EU competence. That means it will need not just the agreement of the European Parliament, but also national and subnational parliaments. It was a vote in the Walloon Parliament that nearly derailed the Canada agreement at the last minute. Deals are also often subject to challenge at the ECJ. It only takes one-tenth of Members of the European Parliament (MEPs) to ask for an opinion of the ECJ, which can then take 12–18 months to resolve.*

Even an off-the-shelf option like the EEA would not be a simple matter to agree, especially if the UK wanted to try to negotiate modifications as new annexes to the agreement.

A bottom-up approach based on CETA would take time. As Sir Ivan Rogers, former UK permanent representative to the EU, noted in his evidence to the Treasury Select Committee: "once you get into the trade discussion, they will start talking past you and there will be a huge number of fights on individual issues and they will get very, very difficult, which is one of the reasons why it takes so much time."[10]

* Rule 108 (6) of the European Parliament's Rules of Procedures makes clear that before the vote, the responsible committee, a political group or at least one-tenth of MEPs may propose for the European Parliament to seek an opinion from the ECJ on the compatibility of an international agreement with the Treaties. If the European Parliament approves such a proposal, the vote will be adjourned until the ECJ has delivered its opinion.

The more bespoke the agreement, the longer it is likely to take to reach agreement and secure ratification. The UK must recognise that a completely bespoke agreement is highly unlikely in the timeframe that they are working to. The UK must decide whether it is willing to be flexible on timelines or accept a less 'creative and imaginative' agreement.

Next steps

One area of agreement between the UK and the EU is that any transition or implementation period needs to be time limited – with the Prime Minister talking in Florence of a possible two-year period. That puts a premium on moving urgently to settle the new relationship between the UK and the EU – the alternative to falling back to trading on WTO terms, where the EU would be obliged to treat the UK no more favourably than it treats any other country with which it does not have a preferential deal, which would be extremely economically disruptive.

The judgement of 'sufficient progress' at the December European Council has opened the way to talk about the UK's future relationship with the EU – but it is far from clear that, despite the large amount of work going on within departments, the UK is ready to start serious negotiations.

The Government needs to make decisions on the shape of its future relationship – in particular, how close it wants to stay to the EU's regulatory model. In making this decision it needs to look not just to its political imperatives, but also make a clear and realistic assessment of the costs and benefits of likely future divergence – costs in terms of the introduction of barriers to trade with the EU, benefits in terms of regulatory flexibility and economic gains from potential future trade deals with the rest of the world. Most external estimates suggest that there are significant potential costs in moving away from the Single Market and Customs Union, and that the opportunities from concluding new FTAs with more distant trading partners are unlikely to compensate.

Early in 2018, the Government needs to publish a future partnership paper on its vision for the future trading relationship with the EU. It needs to explain to Parliament and the public the basis on which it is proposing that relationship. But it also needs a clear negotiating strategy to convince the EU27 why the proposals both meet their concerns and are in the EU's best long-term interests.

The UK must act quickly if it wants to influence the EU27 before negotiating guidelines are agreed. The first phase of talks has shown that the early EU position is a critical benchmark, once the guidelines are agreed the room for manoeuvre and flexibility is reduced. With the EU expected to come to a detailed position in March, the window for persuading European capitals is small. The UK needs to ensure that, when the guidelines are published, its preferred option is on the table.

If the UK cannot do that, it will be forced back on the binary choice it has thus far rejected – between becoming an EEA member or negotiating a standard, Canada-style FTA, or the economic damage from leaving the EU with no deal in place.

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List of abbreviations

AA	Association Agreement
ACAA	Agreement on conformity assessment and acceptance of industrial products
CAP	Common Agricultural Policy
CETA	EU-Canada Comprehensive Economic and Trade Agreement
CFP	Common Fisheries Policy
DCFTA	Deep and Comprehensive Free Trade Area
ECJ	Court of Justice of the European Union
EEA	European Economic Area
EFTA	European Free Trade Association
ESA	EFTA Surveillance Authority
EU	European Union
EU27	27 other EU member states
FTA	Free trade agreement
GDP	Gross domestic product
MEP	Member of the European Parliament
MFN	Most Favoured Nation
MRA	Mutual recognition agreement
NAFTA	North American Free Trade Agreement
TTIP	Transatlantic Trade and Investment Partnership
TTMRA	Trans-Tasman Mutual Recognition Agreement
WTO	World Trade Organization

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