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DEPARTMENT OF EUROPEAN POLITICAL AND ADMINISTRATIVE STUDIES

Bruges Political Research Papers 57 / 2017

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European Political and Administrative Studies /
Etudes politiques et administratives européennes

Bruges Political Research Papers / Cahiers de recherche politique de Bruges
No 57 / March 2017

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About the author

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Abstract

'Brexit' – the departure of the UK from the European Union – will have important implications for international trade in Europe and beyond. This paper explores two related questions. First, how may the trade arrangement between the UK and the remaining EU countries be reconfigured? The spectrum appears to run from free trade and elements of the Single Market ('soft Brexit') to the full re-imposition of tariffs across the Channel ('hard Brexit'). Secondly, what scope does the UK possess for re-organising its future trade relationship with non-EU countries? Is there, for example, a glittering range of free trade possibilities around a dynamic globe, or are the openings for a small player very restricted? The outcome of the imminent negotiations with the EU on Brexit and its trade policy dimensions are likely to have profound consequences for the future prosperity of the UK.

1. Introduction

'Brexit' – the departure of the UK from the European Union –[1] will have important implications for international trade in Europe and beyond. This paper considers how the trade arrangements between the UK and the remaining EU may be reconfigured, and how the UK may organise its future trade relationship with non-EU countries. The postwar development of European integration led analysts to explore the economics of regional trade arrangements against a background of non-discriminatory tariffs as espoused by the architects of the world trade system.[2] In this system, leaving a regional group implied a simple reversal of the trade effects of joining. Today the situation appears more complex. In particular (1) the alternative to membership of a regional group is more likely to be establishing a network of bilateral free trade deals, (2) non-tariff barriers touching on regulatory systems are more prominent in impeding trade than customs duties, and (3) arm's length trade has given way to complex supply and distribution chains; hysteresis may lead trade patterns to be slow to respond to policy changes. Against these general considerations, this paper explores the particular case of Brexit at a moment (February 2017) when issues have been identified but the shape of the negotiating outcome has yet to be determined.

The paper is organised as follows. Section 2 establishes the trade context of Brexit. In (2a) the significance of international trade for the UK economy and the nature and extent of UK trade with the rest of the EU (EU*) is reviewed. The current policy framework of the EU Customs Union and the Single Market is summarised in (2b) while (2c) outlines relevant aspects of the Common Commercial Policy. Sections 3 and

[1] In a non-binding referendum held on 23 June 2016 the UK electorate voted by a narrow majority (52%) to leave the European Union ('Brexit'). The UK government has committed to implement the referendum result by invoking Article 50 of The Treaty on European Union by the end of March 2017.
[2] From 1948 until 1994, the General Agreement on Tariffs and Trade (GATT) and thereafter the World Trade Organisation (WTO).

4 examine the impact of Brexit on future UK trade arrangements. First, Section 3 identifies and assesses the possible frameworks for post-Brexit trade between the UK and EU*. Section 4 then examines the UK's prospective trade relationships with non-EU* countries. In (4a) a possible shift towards more protectionist trade policies is probed; this leads to a discussion in (4b) of how an independent UK trade policy might be structured, in particular through the negotiation of free trade agreements with non-EU countries. Section 5 concludes.

2. UK trade and trade arrangements pre-Brexit

The UK economy has a long history of openness to international trade. As a pioneer of technical change and industrial transformation, the UK exploited its powerful initial comparative advantage in manufacturing through international trade over a sustained period. Even when global trade barriers were re-erected in the 1930s, the UK maintained a high level of trade through its preferential links with a network of countries later to form the Commonwealth. Post 1945, as these countries became politically independent and as intra-European trade grew strongly, the UK re-focused its trade first within the European Free Trade Area (EFTA) and then, from 1974, within the European Economic Community/ European Union. Brexit thus marks a potentially dramatic new phase in UK trade arrangements.

2a. How important for the UK economy is the trade relationship with the EU?

For several decades until the 2008 crash, the openness of the world economy to trade and investment progressively increased as the globalisation of production spread. Supply chains became much more complex with parts and components assembled in one location and then passed on elsewhere for further processing. The ratio of global exports to global output grew from close to 12% in 1960 to over 30% by 2008. This is particularly remarkable in that during this period the biggest economies became more services-oriented. Services tend to be traded much less than goods.

The UK shared these broad trends: openness grew strongly.[3] Meanwhile, manufacturing shrank dramatically relative to services[4] but became much more international. Today, the value of exports comfortably exceeds the gross value added in the sector reflecting especially the importance of imported inputs.[5] As production has become more specialised, the national market is insufficient for sustained viability for many manufacturers. Easy access to foreign markets is critical both for supplies of inputs and for delivery to an international clientele. Exports of services, especially financial services,[6] are particularly important – at 13% their share of total exports is higher than in any other G7 country.

Trade strengths and weaknesses. The UK trades in a wide range of commodities, but from a Brexit perspective it should be emphasized that UK exports and imports in manufactures are dominated by machinery and vehicles categories (see Table 1). These are the areas where changes in border arrangements will be most important in volume terms. In a more detailed way, the ratio of exports to imports by commodity suggests a 'revealed comparative advantage' (UK export strength) in mechanical machinery, medicinal and pharmaceutical products, and aircraft. By contrast, among the heavily traded commodity sectors, the UK has a strong 'revealed comparative disadvantage' (UK import dependence) in areas such as electrical machinery, vehicles and clothing. But arguably even more significantly in the context of Brexit, UK trade is characterized

[3] Exports as % GDP rose from 20% in 1960 to 31% in 2011 (World Bank).
[4] From 41% in 1948 to just 14% in 2013 (value added including oil and gas extraction and utilities).
[5] In current prices, exports in 1998 were £142 billion relative to gross value added of £141 billion; by 2011 the comparable figures were £224 billion and £146 billion.
[6] Financial services represent 29% of total services exports. Although the financial services sector has contracted since the 2008 crash, its share of output in the economy remains substantial at 7%.

by a high degree of 'intra-industry trade' – a two-way exchange of products in each category (cars for cars, furniture for furniture etc). This reflects a high degree of product specialisation for capital goods – including customised equipment for niche markets and, in the consumer goods sectors, a wide range of choice and diversity balanced against the scale economies needed for viability. After Brexit, UK producers who have adapted to diversified EU market characteristics may find it difficult to find suitable replacement markets elsewhere.

Table 1. Major categories of UK exports and imports in 2015 by commodity
(£ billion)

	Exports	Imports
Electrical machinery	24	53
Mechanical machinery	39	36
Cars and other road vehicles	32	50
Medicinal/ pharmaceutical	24	25
Other road vehicles	6	18
Clothing	6	18
Aircraft	12	10

Source: www.statista.com

UK trade with the EU. Turning to the direction of UK trade in goods and services, in 2016 roughly a half of UK trade was with other member countries of the EU. The share for exports was 44%, while for imports it was 53% (Office for National Statistics 2016). UK trade flows with most EU countries are rather balanced between exports and imports, with the notable exception of Germany. Outside the EU, the UK's main trade partners are the United States and Switzerland (trade surpluses) and China (trade deficit). However, the complexity of modern supply chains makes such summary statistics potentially misleading. To illustrate, the UK's trade deficit with Germany in parts and components may be vital for the trade surplus with the US in finished goods.

The standard economics workhorse for analysing trade patterns is the gravity model.[7] Trade flows between a pair of countries are expected to reflect their economic size (bigger economies trade more with each other), distance apart (reflecting costs of communication) and trade arrangements. Empirical analysis confirms that the UK's position close to the major markets of the other EU countries with a combined population of 450 million makes them a 'natural trade partner'. Liberal trade arrangements have further facilitated that through the customs union and Single Market.

Most non-EU markets are significantly more distant from the UK. However, improvements in transport and communications, the globalisation of many businesses, and trade liberalisation within the World Trade Organisation (WTO) have helped to offset the distance factor. Much of the growth in the UK's non-EU trade reflects traditional patterns of comparative advantage, for example with countries where labour costs are markedly lower (e.g. China, Bangaldesh). It is also driven by the greater dynamism of many non-EU economies.

Summing up, the UK economy is very trade dependent both in consumption and production. Before joining the EU in 1974, exports were around 20% of GDP. That share increased notably into the 1980s where it reached 25 to 27% and has remained broadly at that level since.[8] About a half of UK trade is with other EU countries, much of it two-way trade in similar products. These trade characteristics underscore how important the precise trade arrangements negotiated for Brexit will be for the trade and prosperity of the UK.

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[7] See e.g. Céline Carrere (2006), 'Revisiting the effects of regional trade agreements on trade flows with proper specification of the gravity model', *European Economic Review* 50, pp. 223-247.

[8] There was a fall back in the late 1980s before the completion of the Single Market and a peak in 2011, since subdued. www.theglobaleconomy

2b. How does being in the EU Customs Union and the Single Market currently affect the UK?

The UK trades within the EU customs union and the Single Market. A **customs union (CU)** requires member countries to remove customs duties (taxes) between themselves and introduce a common external tariff (CET) towards other countries. This means that, for example, a consignment of clothes coming into the EU CU from China will face the same import taxes regardless of the point of entry into the EU, be that Rotterdam, Rome or Rouen. The advantage is that once cleared through customs into the EU, goods are released into 'free circulation' – no more customs inspections or import taxes. Since 1988, the EU has used a Single Administrative Document to process imports from outside and this becomes the transit document for these goods on intra-EU trade.[9]

> Among the most notable achievements of the SM in goods are the following:
> **Abolition of border controls within the EU** (1988). Goods can transit freely across internal borders without delay or formalities. As necessary, formalities e.g. data collection on trade, can be carried out away from the border.
> **Dealing with indirect taxes** has been a major challenge. All EU countries are obliged to use the same system, Value Added Tax (VAT) but the rates may vary. Exports are exempt from VAT but on sale in another member country are subject to that country's VAT. In this way, tax discrimination between imports and competing home products is largely avoided, though there are problems of tax evasion. A body of case law has built up to deal with concealed discrimination, as when closely similar imported products are made to fall into a different tax category than the local rivals.
> **Opening up public procurement**. Government purchases represent a substantial proportion of consumption and historically have been preferentially awarded to local suppliers. EU laws now require these purchases to be publicly advertised and the awarding of contracts to be unbiased. There is an appeals system. However, in practice foreign firms are more likely to access public buying by establishing themselves locally. Such **'freedom of establishment'** is a major achievement of the SM.
> **Conformity assessment to ensure product safety** without requiring border controls.

[9] By further agreement, the SAD is used by the EFTA countries, Turkey and FYR Macedonia on their trade with the EU.

Conformity assessment to ensure product safety without requiring border controls. The EU has established safety requirements for broad categories of products which are translated into product standards by standards agencies. Where there are agreed standards (e.g. toys, electrical products), goods to be released into the SM must carry the CE mark to confirm that conformity tests have been completed satisfactorily. In areas where harmonized health and safety requirements have not been established, goods may also circulate freely under mutual recognition of national standards.

The EU's **Single Market** (SM) has taken the CU achievement to a higher level because the SM tries to tackle the many non-tariff obstacles that may hold back trade between countries, especially differing government regulations. Over 30 years many of these 'non-tariff barriers' (NTBs) have been slowly harmonized in the EU, or national rules made subject to mutual recognition/ equivalence. The general aim is to eliminate discrimination based on nationality within the EU. It has been a tougher task with trade in services, compared with goods, but there are some notable successes. Under the passport system, for example, national banks may operate in other member countries but be subject to prudential control from the home country. In addition to the free movement of goods and services within the EU, the SM also provides for the **free movement of persons**. This is an integral part of the SM package as is the provision of major financial support from the **EU Budget** to those regions whose economies are weak and not yet in a position to fully benefit from the advantages of the SM.

Quantifying the economic impact of the SM has attracted much effort, especially using gravity models. Most researchers conclude that the goods trade effect has indeed been substantial (e.g. Straathof et al 2008,[10] +18%), although leveling out in recent years. Even so, 'home-market bias' remains stronger in the EU than amongst

[10] Sebastiaan (Bas) Straathof et al (2008), *The Internal Market and the Dutch economy; implications for trade and economic growth*, CPB Netherlands Bureau for Economic Policy Analysis.

the states of the US (e.g. Pacchioli 2011).[11] Empirical studies also suggest that the SM has had a significant positive effect on cross-border investment, complementing the trade effects (e.g. Flam and Nordström 2007).[12] However, the impact of the SM on trade in services, especially business services, has so far been much more muted. Given the important fact that services, as noted earlier, are by far the dominant element in the EU economy, what do the trade findings imply for European living standards? An authoritative recent review of the empirical literature (Kommerskollegium 2015)[13] concludes that the SM raised overall efficiency and may have boosted EU gross domestic product (GDP) by a total of 2-4%. For the UK, membership of the EU has certainly increased trade with the other EU countries: +38% according to HM Treasury (2005)[14] with a further SM trade effect of +9%. These large trade effects again translate into a rather modest impact on GDP of +2% for the UK.

2c. How does the EU's Common Commercial Policy currently affect the UK?

Externally, trade agreements are negotiated by the European Commission under the supervision of Member States acting through the Council of Ministers. Under the Common Commercial Policy (CCP), trade agreements with non-EU countries are concluded by the EU. However, where the agreement also covers regulatory matters beyond the CCP – 'mixed competence' – the Member States as well as the EU will be parties to the agreement.[15] The CCP imposes common EU rules for trade with non-member countries, including the CET. The height of the CET has been substancially

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11 Consuelo Paccioli (2011), *Is the EU internal market suffering from an integration deficit? Estimating the 'home-bias effect*, CEPS Working Document No. 348, May.

12 Harry Flam and Håkan Nordström (2007), *The Euro and Single Market impact on trade and FDI*,

13 Kommerskollegium (2015), *Economic effects of the European Single Market, Review of the Empirical Literature*, National Board of Trade, Stockholm.

14 HM Treasury (2005), *EU membership and trade*. http://www.hm-treasury.gov.uk/d/foi_eumembership_trade.pdf

15 See Lawyers for Britain (2016) *Brexit and International Trade*. http://www.lawyersforbritain.org

reduced since the UK joined the EU under multilateral negotiations in the GATT and WTO. Significantly for Brexit, tariffs on imports into the EU vary widely by product category. The highest tariffs apply to certain agricultural products such as dairy products (39.5%); among manufactured goods, average tariffs vary from 11.9% on clothing and 11% on footwear to zero on pharmaceuticals. Most tariffs are relatively minor but still have a nuisance value administratively. Were the UK to leave the EU without special arrangements, these are the tariffs that could be expected to apply on trade between the UK and the rest of the EU. They would also form the starting point for trade agreements between an independent UK and other WTO members. Beyond the CET, the EU also deploys common rules for example to deal with dumped or subsidised products. Such measures are not applied on trade within the EU where the EU relies instead on the Common Competition Policy to create a level playing field.

The WTO trade system, as an exception to the general non-discrimination rule allows for the creation of customs unions and free trade areas among member countries.[16] They must cover 'substantially' all trade of the partner countries and be completed in a 'reasonable' period of time. After the Uruguay Round, when progress on multilateral trade liberalisation faltered, there was an upsurge in bilateral trade agreements, based on free trade areas (FTAs). In a FTA there is tariff-free trade between members in goods that have been largely or wholly produced in the FTA. This requires 'rules of origin' to determine eligibility for tariff-free treatment. Unlike a CU however, FTA members are free to establish their own tariff rates on trade with non-member countries. The real attraction of the new FTAs has been to tackle non-tariff barriers thereby attracting investment and trade from multinational companies. The WTO and other bodies have supported this process by developing global rules on regulatory issues

[16] Under Article 24 of the GATT/WTO.

such as technical standards, conformity assessment, public procurement, access to services markets, and trade facilitation[17] (reduction of unnecessary red tape and speeding the product flow through customs).

The EU, while supporting the general principle of non-discrimination in world trade, has in practice played a leading role in the spread of preferential trade agreements including FTAs. The reasons for this are several: facilitating the entry of new member countries into the EU (e.g. Turkey-EU customs union), providing economic stability for neighbouring countries (e.g. free trade areas with the EFTA countries and with the countries bordering the southern Mediterranean) and supporting economic development in poor countries (Generalised System of Preferences, Economic Partnership Agreements). More recently, the EU has signed FTAs with a number of countries that already have FTAs with the US: South Korea, Mexico and Canada. This approach may avoid trade losses or create advantages, depending on the extent to which NTBs are addressed. An important aspect of post-Brexit trade policy will be how far the UK can replicate these trade arrangements after it leaves the CCP.

The impact of Brexit on future UK trade arrangements

Article 50 of the Lisbon Treaty requires the European Council to negotiate and conclude an agreement with a member country seeking to leave the EU 'setting out the arrangements for its withdrawal, taking into account the framework for its future relationship with the Union'. The UK Government has indicated that it will invoke Article 50 before the end of March 2017. Article 50 negotiations have a time limit of 2 years unless the Council, in agreement with the member country seeking to leave,

[17] The WTO Agreement on Trade Facilitation – the most significant multilateral trade deal since the establishment of the WTO – entered into force on 22 February 2017. https://www.wto.org/tradefacilitation

unanimously decides to extend the period. It appears therefore that the UK will leave the EU, including the CU and CCP, at the latest by the end of March 2019.

The system of rules within which the UK economy operates has been closely shaped by EU integration for over 40 years. There is a close alignment with other member countries. This convergence will largely remain after 2019. Beyond Brexit, however, the UK will have a fundamental choice between, on the one hand, independence in rules formulation and growing EU*-UK divergence in rules and, on the other hand, retaining similarity in rules with the EU* but with less influence in shaping them. For rules on trade policy, Brexit generates two immediate challenges for the UK. The first is: **How should the trade policy relations between the UK and the remaining EU (EU*) be reconfigured after Brexit?** What should be the framework of rules for this future relationship? The second complementary policy challenge is: **After Brexit, how should the UK organise its trade relations with the non-EU rest of the world?** For the first time since 1974, the UK will be able to negotiate trade agreements independently of the EU.

3 How should the trade policy relations between the UK and the EU* be reconfigured after Brexit?

UK negotiators are under conflicting domestic pressures. Some pro-Brexit lobbyists are calling for a complete withdrawal from EU arrangements. By contrast, many UK businesses are anxious to retain as much of the trade advantages of the CU/SM as possible after Brexit. As noted earlier, the affluent EU* market with a population of about 450 million is the destination of about 50% of UK exports; this generates some 16% of UK GDP. Many firms have invested heavily on the assumption that they would have free access to supply chains and markets in the SM. The UK Government has undertaken to negotiate the best possible terms of access to the EU* market subject to its own constraints. These in particular include the desires to

(a) control more effectively the immigration flows from the EU* to the UK;

(b) reclaim sovereignty over rule-making and in particular to end the supremacy of the European Court of Justice in the UK; and

(c) reduce the net UK contribution to the EU Budget.

What are the possible templates for the new trade relationship between the UK and EU*? Based on the current EU arrangements with (high-income) third countries, there would appear to be four main options.[18] Three of these involve a free trade area (FTA). To reiterate, within a FTA goods circulate free of tariff *provided that they have been largely produced within the are*a,[19] as determined by rules of origin. To implement such rules requires that, in principle, border controls remain between the member countries of a FTA whereas a CU obviates the need for any customs frontiers between its member countries.

The four main options are:

(1) **FTA plus SM** (Norwegian / Swiss style

(2) **FTA plus** (Canadian style)

(3) **FTA only**

(4) **Standard WTO**: 'Hard Brexit'

[18] Turkey, which has applied to become a member of the EU, has had a CU with the EU since 31 December 1995 for non-agricultural goods. However, a CU seems very unsuited to the post-Brexit relationship between the UK and EU* since it would preclude the UK from negotiating new trade arrangements with non-EU countries. The CU would set the common customs tariff. In the Turkey– EU CU, Turkey does not automatically benefit from preferential trade agreements negotiated by the EU with third countries, putting it in an inferior commercial position.

[19] This qualification is needed because a FTA allows each member country to set its own tariffs towards non-member countries. Suppose member A sets a 20% tariff on TVs imported from non-member countries, while member B sets a 5% tariff. Without 'rules of origin' TVs could come into country A via low tariff country B and face a 5% rather than 20% tariff: 'trade deflection'.

(1) FTA plus SM (Norwegian / Swiss style)

This option would retain most of the trade advantages in the EU market now enjoyed by UK exporters of goods and services. Moreover there are precedents since the EU has already granted this arrangement to neighbouring countries. **Norway**, for example, is a member of the European Economic Area (EEA) with a FTA in industrial goods. The EEA gives its non-EU members a high level of access to the SM. However, this depends on them accepting a raft of SM legislation[20] without a voice in shaping it. Moreover, there is often a significant delay (6 to 24 months in Norway) in adopting EU legislation. [21] The legislation extends to employment, consumer protection, environmental and competition policy. Added to the loss of sovereignty for EEA members, is a substantial contribution to the EU budget,[22] and acceptance of free movement of persons. If the UK were to retain its current membership of the EEA and hence SM access, there would be little possibility to negotiate trade deals with non-EU countries with any serious services provisions.[23] In her Lancaster House speech on 18 January 2017, the UK PM ruled out full membership of the SM, so the Norwegian option will not be sought.

Switzerland also has a high level of access to the SM, if not 'full' membership. This has been achieved through a FTA with the EU together with some 120 bilateral treaties covering many aspects of the SM, though not for most financial services. This has enabled Switzerland to become the EU's fourth largest trade partner. Of course, as

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[20] By the end of 2015 some 11,500 legal acts were incorporated into the EEA Agreement. EFTA website: http:// www.efta.int/eea-lex.
Cited by Slaughter and May (2016) *Brexit essentials: alternatives to EU membership.* http://www.slaughterandmay.com

[21] House of Commons Library (2013), *"The Economic Impact of EU membership on the UK"*, p. 26.

[22] In 2011, Norway contributed £106 per person, compared with £128 per person in the UK. Slaughter and May, *op. cit.*, p. 5.

[23] See Shanker Singham, *"Cost of EEA Membership for the UK"*, Legatum Institute Special Trade Commission Briefing, November 2016.

Dhingra and Sampson (2016) observe,[24] the EU would be under no obligation to offer the UK similar terms to the Swiss. Further, SM access requires acceptance of much EU legislation and all bills passing through the Swiss Parliament have to be scrutinized for their compatibility with EU law. In addition, Switzerland makes a substantial contribution to the EU Budget – about 40% of the UK's contribution per person.[25] Switzerland also agreed to the EU's requirement of free movement of persons. However, a referendum in 2014 subsequently rejected this, and Switzerland is struggling to find an acceptable compromise. It would appear that the 'price' of Swiss-style access to the SM would also be unacceptable to the UK Government.

It is important to recognise that, unlike non-EU countries seeking to strike a trade deal with the EU, the UK currently fully implements the rules of the SM. The forthcoming Great Repeal Bill will end the primacy of EU law over UK law[26] but it is expected to incorporate most EU law into UK law on the UK's departure from the EU. However, even if all EU law were incorporated into UK law that does not necessarily mean that the EU would regard the UK as compliant for EU purposes. Hence UK-EU trade barriers could still arise. Furthermore as EU law develops, the UK will have to decide whether to progress with the EU rules (while having no say their formulation) or to diverge, in which case trade barriers could appear.[27] What the UK government seems to favour, at least in certain areas, is a form of 'mutual recognition' so that even if rules and compliance procedures are not identical they can be regarded as 'equivalent'. This would represent an added complication for the EU. However, it is an

[24] S. Dhingra and T Sampson (2016) *Life after Brexit: What are the UK's options outside the European Union?* LSE Center for Economic Performance PAPERBREXIT01, p. 6.
[25] House of Commons Library (2013), *op. cit.*, p. 26.
[26] By repealing the European Communities Act 1972 which gives effect to EU Treaties.
[27] Debbie Heywood (2016) How Great is the 'Great Repeal Bill'? 19 December 2016 www.law.ox.ac.uk

issue that the EU will have to face in dealing with other trade partners such as the US, Canada or South Korea where there is a serious attempt to tackle NTBs.

Partial Association. Although the UK Government has ruled out full membership of the SM, some form of partial association is seen as attractive. In the government's generally very vague background 'White Paper' published 3 February 2017,[28] point 8.3 states that 'agreement may take in elements of the current Single Market arrangements'. 'Cooperation' rather than membership is the key term employed in the White Paper. A critical area where the UK might seek such partial membership of the SM is in **financial services**. Point 8.26 of the White Paper refers for example to 'mutual cooperation in financial services', one of the areas where Brexit arouses strong concern in the UK. The White Paper proposes to 'establish strong cooperative oversight arrangements with the EU'.

London is the biggest centre for clearing Euro derivatives,[29] a critical function for Eurozone's financial structure and performance. According to the European Central Bank (ECB), this arrangement is only possible because of the ECB's solid cooperation with the Bank of England and the shared foundation of European law under the European Court of Justice. Fears that this could not continue under Brexit has led some London-based banks to consider relocating some of their activities. Already in January 2017, a number of banks, including HSBC, HBS, Credit Suisse and J P Morgan Chase have announced plans to move large numbers of posts to Paris and elsewhere in the Eurozone.[30] Further, Brexit raises important issues about passporting rights that allow

[28] HM Government (2017): *The United Kingdom's exit from and new partnership with the European Union,* Cm 9417.
[29] London-based platforms clear a daily average of $573 billion in €-denominated derivatives. *Financial Times,* 23 January 2017.
[30] *Financial Times* 19 January 2017 & 20 January 2017.

banks to bypass local licences. Far more passports are outbound from the UK (336,421) than are inbound (23,532).

By contrast, pro-Brexit supporters argue that <u>remaining</u> in the EU poses serious challenges to London's financial services sector because of the UK's declining ability to influence the regulatory agenda in the EU. [31] Pro-Brexit groups suggest that institutions from many non-EU countries already trade financial services across the EU. They use 'equivalence' rules that arguably could apply to the UK after 2019.

Another critical area in a future UK-EU trade arrangement is the **car industry**. Car output in the UK in 2016 at 1.72 million units was the highest for 17 years. Of this total 79% were exported and the largest market for these was the EU which took 57% of exports. The UK car industry has warned that the imposition of tariffs on UK car exports to the EU* would make the industry uncompetitive and that any Brexit trade deal must retain some of the benefits of the SM and CU.[32]

The position of EU negotiator Michel Barnier is reportedly very different[33]. He has cautioned that there will be no 'cherry-picking' of selected aspects of EU advantages. Indeed, he regarded a UK-EU trade deal ahead of Brexit in 2019 as 'implausible' and expectations of the UK achieving frictionless trade with the EU combined with an independent trade policy as 'unrealistic'. An orderly divorce, including settling financial compensation, would come before trade talks. These views are echoed in a recent cross-party report issued by the French Senate. It demands that any agreement does not leave the UK in a more advantageous position by being outside the EU than inside.[34] However, unnecessarily delaying trade talks increases economic uncertainty which will have damaging effects on all parties including the EU*.

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[31] Halligan and Lyons, *op. cit.*, p. 27.
[32] *The Guardian* 26 January 2017.
[33] *The Financial Times* 17 January 2017.
[34] *The Guardian* 15 February 2017.

(2) FTA plus (Canadian style)

Excluding substantial membership of the SM, the **second option** would be to establish a 'FTA plus' arrangement, as with the Comprehensive Economic and Trade Agreement (CETA) that the EU has negotiated with Canada. CETA eliminates all tariffs on mutual trade in industrial and fisheries products, nearly all on entry into force of the agreement, the rest at the latest after seven years. Most agricultural tariffs will be ended too: the EU and Canada will eliminate 93.8% and 91.7% of tariff lines, nearly all of them immediately.[35] Since UK-EU* trade is already fully tariff-free this aspect of an agreement should be relatively straightforward though it does imply the introduction of rules of origin.

The 'plus' element in this deal is a series of agreements, based on WTO rules, to tackle home-market bias. These aim, for example, to open up government procurement markets: CETA will liberalise significantly especially on the Canadian side. European companies will be permitted to bid for public contracts in Canada at all levels of government (with some restrictions in Quebec and Ontario provinces). CETA is most advanced where it builds on earlier agreements, such as on 'mutual recognition of conformity testing' – mutual recognition in this case avoids costly duplication of testing. Similarly on investment rules CETA goes beyond existing arrangements by setting up an Investment Court System. This will protect investors by giving them the right in certain, limited, circumstances to challenge governments. CETA also creates a modest framework for cooperation to coordinate future regulation. But on the key area of services, CETA is very limited as the list of 'reservations' – areas excluded from the deal – runs to hundreds of pages. On financial services specifically, Canadian firms

[35] Vincenzo Scarpatto (2016), 'What could the EU-Canada free trade deal tell us about Brexit?', *Open Europe*, 15 March, http;//www.openeurope.org.uk

wishing to take advantage of EU 'passporting' would have to establish themselves in the EU and be subject to EU regulations.

In sum, a CETA style deal could maintain largely tariff-free UK-EU trade, and provide a starting point for UK cooperation on NTBs with the EU. CETA does this without requirements in relation to free movement of persons, contributions to the EU Budget, or control from the European Court of Justice. However, CETA clearly **falls far short of the scale of market access created by the SM** whose regulatory convergence assures a substantially even playing field across open internal borders.

(3) FTA

A standard 'plain vanilla' FTA would ensure that after Brexit there would continue to be no tariffs on goods trade between the UK and EU* (at least where those goods have been largely produced within the UK plus EU*). With goodwill, a FTA agreement could be made at an early stage in negotiations to reassure firms in both parties that they will generally retain tariff-free access to EU markets. This might seem more advantageous to the UK than the EU* in terms of relative trade shares (44% mutual trade compared with 16%). But absolutely, the EU* countries export substantially more to the UK than the UK does to EU*. Halligan and Lyons (2017) suggest an agreement that – in all industries where the UK kept the same tariff rate as in the EU's CET – rules of origin would not be checked. This would reduce bureaucratic costs and delays.[36] The White Paper hints at this in calling for 'an ambitious and comprehensive free trade area **and** a new customs agreement'[37] (emphasis added).

At a later stage, this plain-vanilla FTA could be supplemented by agreements on NTBs to make it 'FTA plus'. Sir Ivan Rogers[38] is undoubtedly correct in arguing

[36] Halligan and Lyons, *op. cit.*, p. 27. Complications might arise where final goods in one industry include imported components from other industries.
[37] White Paper, p. 35.
[38] Permanent Representative of the UK to the EU, 2013-17.

that a comprehensive agreement of this kind could take until the mid 2020s to conclude. Some kind of transitional arrangement such as a plain vanilla FTA would then be imperative. This was accepted by the UK PM in her 18 January 2017 speech when she supported a ‘phased process of implementation’ but not ‘unlimited transitional status’.

(4) Standard WTO (‘Hard Brexit’)

The fourth and default option would be a hard Brexit with no agreement between the UK and EU. In this case, the UK’s trade arrangements with the EU* would fall back on to the WTO standard, the so-called ‘most-favoured-nation’ tariff (in reality, the worst-favoured-nation). The relevant tariffs, in both directions EU*-UK and UK-EU* would be the current EU tariffs bound in the WTO. In principle, the UK would be able to charge lower tariffs on imports from the EU and elsewhere, for example to limit the inflationary effect on consumers. However, the UK might prefer to retain the existing tariffs as a bargaining chip in negotiating trade deals with non-EU countries. As described in Section 2c, EU tariffs are mostly very lown[39] though significant in some areas.

Advocates of hard or clean Brexit contend that attempts to negotiate partial deals in relation to the SM would delay Brexit in achieving its aims of controlling migration, reducing EU budget contributions and ending the primacy of the ECJ in the UK. The delays would cause uncertainty, harming investment, jobs and growth.[40] They advocate instead an early statement that the UK will trade with the EU under standard WTO rules, but is open to negotiation. The UK should therefore act now to prepare for a new trade regime and its associated administration. For example, the number of import declarations to be dealt with would roughly double, adding a significant cost

[39] 2.7% trade weighted average, 5.1% tariff line weighted; for non-agricultural goods the averages are 2.3% and 4.2% and for agricultural goods the averages are 8.5% and 10.7%.
[40] L. Halligan and G Lyons (2017), *Clean Brexit*, Policy Exchange, p. 13.

and requiring a significant increase in computing facilities, staff and training. Extra bureaucracy would also be generated to deal with rules of origin outside the customs union. More positively, the latest electronic systems of customs administration could ease the burden.

The UK PM has said that she would prefer 'no deal' to a 'bad deal'. Other EU leaders perhaps see this as just a bargaining posture, 'so unpalatable that we won't do it' (Sir Ivan Rogers). It would certainly be very unattractive to multinational companies based in the UK that buy components from EU* countries and sell finished products there. They would come under strong economic pressure to leave the UK, though that would also depend on what happens to exchange rates. It might also depend on government taxation policies. In the event of a hard Brexit, the UK government has spoken of a possible radical change of economic policy. This might mean a significant lowering of corporation tax as a counterbalance for firms to the lost access to the EU* market.

Summing up, by ruling itself out of the full SM, the UK government seems to be opting for a FTA area with possible deals on NTBs – partial access to the SM or a high-level version of CETA. Failing such agreements, the UK could find itself, for the first time since the 1970s, back to facing tariff discrimination vis-à-vis other European countries in the EU* market. The trade effects could be very substantial. Baier et al (2008) concluded that, after taking into account other factors influencing bilateral trade, EU members trade substantially more with other EU countries than they do with their free trade partners in EFTA. On this basis, were the UK to leave the EU and join EFTA, UK trade with the EU could fall by a quarter.[41] However, this assumes that trade effects

[41] S. L. Baier et al (2008): 'Do Economic Integration Agreements Actually Work? Issues in Understanding the Causes and Consequences of the Growth of Regionalism', *The World Economy* 31(4), pp. 461-97.

are symmetrical between joining and leaving a trade arrangement. It is arguable that once a trade effect is established it is unlikely to be quickly reversed. A hysteresis or 'beachhead' effect could maintain many existing trade links even if new trade is impeded. Nonetheless the damage to UK-EU trade could be severe, especially under hard Brexit where no special arrangements are negotiated. Ottaviano et al (2016) come to the alarming conclusion that even under the optimistic scenario that the UK negotiates a free trade agreement with the EU, UK incomes could fall by between 6.3% and 9.5%.[42] This would certainly add urgency to the negotiation of better access to non-EU markets.

4 How will Brexit affect the UK's trade arrangements with non-EU countries?

4a Brexit in a more protectionist world.

Over the last half century GATT/WTO have overseen a sustained reduction in multilateral and bilateral trade barriers, rising trade and extensive globalisation. Could that broad trend now go into reverse? Could trade policies around the world swing against openness? The 'elephant in the room' for post-Brexit trade policy is an aggressively, 'America First', protectionist US trade policy, particularly if this provoked retaliation from injured trade partners. President Trump has withdrawn the US from the TransPacific Partnership (TPP), a plurilateral move to create a regional free trade area; he is seeking to redraw the North America Free Trade Area with Mexico and Canada; and he threatens to impose punitive import taxes (45% on China). If a WTO dispute settlement panel were to rule against the US, would President Trump

[42] Ottaviano et al (2014): Brexit or Fixit? The trade and welfare effects of leaving the European Union. CEP Policy Analysis, p. 4. http://www.cep.lse.ac.uk

accept that or demand a change in the rules? The WTO system might not then survive as a truly global institution.

How has the leadership of the US – the long-term advocate of open, non-discriminatory trade policies and champion of the GATT/WTO system – come to strike such a contrary posture? The theory of trade policy may offer some insight into the apparent volte-face in US trade policy. In the **median voter** model of Mayer (1984)[43] trade policy in capital-abundant rich countries is predicted to be more protectionist as income inequality increases. In a two-factor/ two-good world, the rich country should export goods whose production is intensive in the abundant factor, capital, and import goods whose production is intensive in the scarce factor, labour. Imports would tend to depress wages, so the (capital-poor)[44] median voter prefers a protectionist, anti-import policy.

The median voter model assumes that policies are determined by majority vote. However in representative democracies the electorate votes for legislators who then determine policies. Policies chosen will reflect jointly votes and the impact of lobbying by **pressure groups** (Grossman and Helpman 1994).[45] The size of the lobbying effort depends on the scale of the advantages to the group flowing from different policy choices by government. Firms in import-competing sectors might lobby for protection. However, the best-resourced lobby groups tend to include multinational corporations favouring an open trade policy, especially in concentrated industries where free-rider effects can be contained. Such an open trade policy would benefit capital-intensive export industries. In deciding on its trade policy stance, the government's decision

[43] Wolfgang Mayer (1984), 'Endogenous tariff formation', *The American Economic Review* 74(5), pp. 970-985.
[44] Assuming that capital ownership is largely concentrated in few hands, as in the US and EU see.
[45] Gene Grossman and Elhanan Helpman (1994), 'Protection For Sale', *The American Economic Review* 84(4), pp. 833-850.

balances the campaign contributions of lobbyists with the welfare of consumers. Empirical tests suggest that, in the US, the consumer interest predominates but that campaign contributions also play a role (Goldberg and Maggi 1999).[46]

Are we now observing a change of paradigm, away from the interest group open economy model to an anti-import median voter approach? A trigger for this could be the growing dissatisfaction amongst workers, particularly in the US, with open trade policies and globalisation. Such policies by lowering consumer prices potentially raise national welfare but make some interest groups worse off. Most countries have failed to establish and adequate system of compensation for trade-displaced worker even where trade-damaged industries are regionally concentrated. Their conflation of job losses in import-competing sectors with the much greater jobs erosion from technical change in manufacturing may aggravate employee discontent with open trade policies. A further potential grievance is the perception that the benefits of globalisation have largely accrued to the owners of major companies many of which have systematically practiced tax avoidance. Growing income inequality[47] might then fuel discontent with liberal trade policies.

What significance might this hold for Brexit? Brexit supporters pin their economic aspirations on better UK access to fast-growing global markets. Yet global trade growth has been sluggish over the last five years, and policy uncertainty including protectionist threats dampened trade growth further in 2016 (World Bank 2017).[48] In a world where the protectionist threat is rising and the leading WTO member questions

[46] Pinelopi K Goldberg and Giovanni Maggi (1999), 'Protection for sale: an empirical investigation', *The American Economic Review* 89(5), pp. 1135-1155.

[47] See especially Thomas Piketty (2014), *Capital in the Twenty-First Century*, Belknap, Harvard.

[48] Cristina Constantinescu et al (2017), *Trade developments in 2016: Policy Uncertainty Weighs on World Trade,* Global Trade Watch, World Bank, p. 1.

its rules, the timing is questionable for the UK to cut itself adrift from the EU and to search for trade deals with more distant partners.

4b Towards an independent UK trade policy

After leaving the EU, the UK will return to an independent national trade policy within the WTO. The UK expects to deploy the full range of trade policy instruments and approaches. Three aspects of this will be considered here:

(1) establishing an independent UK position in the WTO

(2) dealing with existing EU preferential trade agreements

(3) negotiating new free trade deals with non-EU countries

On (1), the UK itself is a founder member of the WTO and expects to take its independent place in the WTO after Brexit. The UK Government has indicated that priority is being given to establishing a UK tariff schedule to be bound in the WTO (White Paper 9.17), replicating the EU schedule[49] (White Paper 9.18). Sceptics counter that the WTO works by consensus. Therefore acceptance of the UK schedule could be held up by a small number of opponents. However, it seems more likely that non-trivial objections would be referred to dispute settlement to be resolved over the following years.

On (2), the UK government expects to be able to continue after Brexit with the 53 EU FTAs to which it is already a party[50] (Trade Minister Fox, 1 February 2017).[51] It plans to give priority to the South Korea and Switzerland FTAs.[52] The pro-Brexit view is that there would be no difficulty in the UK continuing to comply with the

[49] For details see http://stat.wto.org/TariffProfiles/E28_e.htm

[50] Beyond its multilateral commitments the EU has also negotiated bilateral and plurilateral deals with a large number of countries. The main FTAs have been negotiated as a match for the US (e.g. South Korea). They provide for zero tariffs on mutual trade and a limited regulatory convergence. Individually, the impact on the EU economy is minor (South Korea +0.05% EU GDP, Francois 2007), but collectively significant and important to the partners (+2.3% South Korea GDP).

[51] UK plans to adopt EU's trade agreements with third countries after Brexit: minister | Reuters uk.reuters.com

[52] as they account for 80% of the UK's trade with countries having a FTA with the EU (*ibid.*)

substantive provisions of the EU's FTAs after 2019. Some minor redrafting might be necessary, such as where there are specified quantities in the agreements. Also, detailed revisions to institutional arrangements for dispute settlement would be required to put them onto a bilateral basis. Beyond these aspects, all that would be necessary would be statements by the UK and the FTA partner that they would continue provisionally to operate the substance of the FTA. In this way, it is difficult to see why the FTA partner would not wish to continue with the agreement rather than face the re-imposition of MFN tariffs.[53] Problems could arise however with rules of origin. For example, on average only 41% of the components in cars exported from Britain are made in the UK, the rest are imported. Many of the components come from the EU* These count as local in EU FTA agreements. But the EU-South Korea FTA stipulates a local content of 55% for tariff free treatment. Unless EU* content continues to be regarded as local, this would be hard to achieve in a UK-South Korea agreement.

For its trade arrangements with poor countries, the UK can be expected to retain the principal element, the Generalised System of Preferences in its various forms (White Paper, 9.11). This could be done by the UK replicating the existing array of EU preferential tariffs faced by developing countries. Such a solution might however be open to challenge in the WTO. Alternatively, the UK might create its own more development-friendly version. Even on a two-year time-scale this might be feasible since no external negotiations are involved (Stevens and Kennan 2016).[54] In addition, Economic Partnership Agreements give preferential access to the EU market for some developing countries on a reciprocal basis. The UK could offer temporary, unilateral

[53] See Brexit and International Trade. http://www.lawyersforbritain.org

[54] C. Stevens and J. Kennan (2016), *Trade Implications of Brexit for Commonwealth Developing Countries*, The Commonwealth Trade Hot Topics Issue 133, p. 6.

preferential access for exports from these countries pending new agreements (Jones, 2016).[55]

On (3), the UK government will in principle be able to negotiate trade deals with countries which as yet do not have a FTA with the EU. Australia and New Zealand have both expressed interest, but as distant partners the potential trade effect is relatively small. Both countries are already negotiating FTAs with the EU. Furthermore, what the UK can offer them may be constrained by any concessions on agricultural trade needed to strike a deal with the EU*.

Potentially more significant would be FTAs with the US, India and/or China. These would be mammoth tasks for a newly-established UK Department of International Trade whose Head has yet to be appointed. In any case, no official deals can be struck until the Art 50 process is completed. On a more positive note, the UK does not need to start with a blank sheet. It could follow the example of the EU, which based its South Korea deal on the US-South Korea FTA. Wignaraja (2016) argues that, given the UK's limited negotiating capacity, priority should perhaps be given to a FTA with China. The templates could be China's 2008 FTA with New Zealand and the 2015 FTA with Australia. An ambitious FTA should seek to cover rules on goods, services, investment, trade facilitation, intellectual property and dispute settlement. The possible impact of such an agreement is large: it is estimated that currently imports from China to the UK attract duties of $2.6 billion (te Velde 2016).[56] However, an agreement with China might be difficult to sell politically: an important part of the support for Brexit

[55] E. Jones (2016), *Brexit: opportunity or peril for trade with developing countries?*, in: M. Mendez-Parra et al (2016) The impact of the UK's post-Brexit trade policy on development. ODI & UKTPO http://www.odi.org

[56] te Velde (2016), *Scenarios for UK trade policy towards developing countries after the vote to leave the EU* In M. Mendez-Parra et al (2016), *op. cit*.

in the referendum came from those disaffected with globalisation and the associated job re-allocations.

Is all of this feasible in a **short enough timeframe** to help the UK recover from a post-Brexit shock? Australia has suggested that a deal is possible in 8 weeks, as with the Australia- US FTA. President Trump has indicated that a US-UK deal (on his terms perhaps) could be similarly speedy. However, critics are concerned that rushed deals will either have little content or be biased against UK interests.

Negotiations between the US and the EU on a free trade deal date back many years. The latest, a FTA plus deal known as the **Transatlantic Trade and Investment Partnership** (TTIP) started in 2013. However, there are strong indications that President Trump will not now pursue this. TTIP aimed to be very broad-reaching in covering tariffs, services and NTBs (such as cooperation on technical regulations). Some estimates suggest that a fully implemented and comprehensive agreement could have raised transatlantic trade by as much as 50%, but with an eventual displacement of perhaps a million jobs. However, EU opposition lobbies are vociferous about certain aspects of TTIP, such as the desire of the US to export genetically modified organisms (GMOs) to the EU, and the right of US corporations to sue EU governments. These same issues **might** prevent a deal with the UK. Further, President Trump has indicated that he is unhappy with the rules of origin in NAFTA. Any tightening of the rules in a US-UK deal could cause problems with UK supply chains in the EU. A free trade deal with the US could be very positive for the UK post-Brexit, but this would depend on the details. On the one hand, there are concerns that the US would impose its own preferences on any deal bringing few benefits to Britain. On the other hand, Münchau, for example, has suggested that the US could offer the UK very favourable terms in order to sow discord between the UK and EU.[57]

5. Conclusions

The UK's withdrawal from the EU is a monumental and risky undertaking. It is not too alarmist to state that future UK prosperity depends critically on the details of the negotiated outcome. At present it is very unclear whether the gap between EU* and the UK positions will be even partially bridged, especially given the two-year timescale for Article 50 negotiations. With goodwill, which is not yet evident, a deal to accommodate the principal interests of both parties should be possible but would likely be very complex. It would certainly take more than two years to complete.

Trade flows between the UK and EU* will be damaged by Brexit to a possibly significant extent. The UK Government appears to believe that some losses in UK-EU* trade can be made up by a more open UK trade policy towards the rest of the world. Unconstrained by the needs and interests of 27 other countries, the UK could quickly strike new deals. Pro-Brexit lobbyists have talked up such deals. But compared to the EU, the UK is a lightweight in trade, so it is not clear that significant new partners will engage, nor that any deals will be on advantageous terms. Nearly all trade policy changes involve lengthy negotiations and transition periods allowing firms time to adapt. By contrast, there is a danger of a cliff-edge Brexit with little time to change direction. The Government faces a tricky challenge of negotiating a satisfactory exit from the EU while maintaining business confidence in the face of a very uncertain future. Sink or swim? Thus far, economic pessimism has perhaps been over-done, but the main task lies ahead.

[57] Wolfgang Munchau @EuroBriefing 27 January 2017, mobile.twitter.com

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