
DISCUSSION PAPER

Brexit: Towards a deep and comprehensive partnership?

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An amicable divorce?

Negotiations for the United Kingdom's (UK) withdrawal from the European Union (EU) have reached a critical juncture: at the 14-15 December European Council, the EU27 will decide whether there has been sufficient progress in the first phase of the negotiations on EU citizens' rights, the financial obligations of the UK to the EU and how to safeguard the Northern Ireland/Ireland peace process, including keeping the border as frictionless as possible.

Following significant movements of the UK position in response to EU demands, agreement on sufficient progress seems possible, despite the failure to move forward on 4 December. The UK appears to have agreed a sizeable unconditional exit payment (reputed to be around GBP 50 bn) and accepted that the protection of the rights of EU citizens living in the UK will include a role for the European Court of Justice (ECJ) post-Brexit. London has also conceded that a transition period is required and that it would essentially entail membership obligations without voting rights.

The trickiest issue is the Northern Ireland border: the Irish Government has made it clear that further commitments are required to maintain an open border as the UK's intent to exit the Single Market and the Customs Union will inevitably lead to some friction. But a compromise seems possible, in part driven by the need of Prime Minister Theresa May to show a result that justifies the perceived concessions she has made, although she needs to convince the Democratic Unionist Party (DUP) that is propping up her government.

The recent progress made by the UK Government in the withdrawal negotiations is evidence of the pressure on the UK to remain economically close to the EU. A withdrawal deal is necessary to reassure UK businesses and maintain the momentum in the Brexit negotiations. But it is far from certain that the UK Government will be able to maintain a majority backing this withdrawal agreement over time. The EU's conditions are domestically unpopular and reaching an agreement has implied accepting some uncomfortable political realities. Some Brexiteers have already put their marker down that many cornerstones of the tentative deal are unacceptable, including, for example, the ongoing role for the ECJ¹, and the DUP has objected to the tentative deal on Northern Ireland, maintaining that Northern Ireland will exit the Single Market and Customs Union together with the rest of the UK.²

Anarchy in the UK

Reaching a Phase 1 agreement is unlikely to lead to a settling down of UK politics. Driven by a polarised debate on Brexit, with clear divisions and indiscipline within government, turmoil will continue. Westminster is further shaken by scandals and ministers resigning. Further scalps are likely to follow. Growing speculations that the UK Government will collapse at some point fuels the uncertainty.

Some believe that the current chaos will lead to a resolution on Brexit: the closer the cliff edge comes and the more costs mount, the more likely are concessions by the UK leading, first, to a withdrawal agreement and, then, to a trade deal. Without real progress, there might well be a shift in public opinion, which could put the government at risk in case of new elections. While there is no evidence of a decisive shift so far³, there are some signs that UK voters want to have their say on any final deal struck with the EU.⁴ In this narrative, if the May Government cannot reach good agreements, there will be new elections that might even lead to an exit from Brexit.

But will this logic prevail? A political change and a new government could lead to a new approach but not necessarily a radically different stance on Brexit. There are many in the Labour Party that believe that the result of the referendum must be honoured. Its position is still close to having-the-cake-and-eat-it-too with respect to freedom of movement: Jeremy Corbin wants the benefits of the Single Market with control over EU migration. While some recent think tank proposals⁵ have received some traction in the UK, there is little appetite in the EU27 to make any special provisions to keep the UK in at any cost.

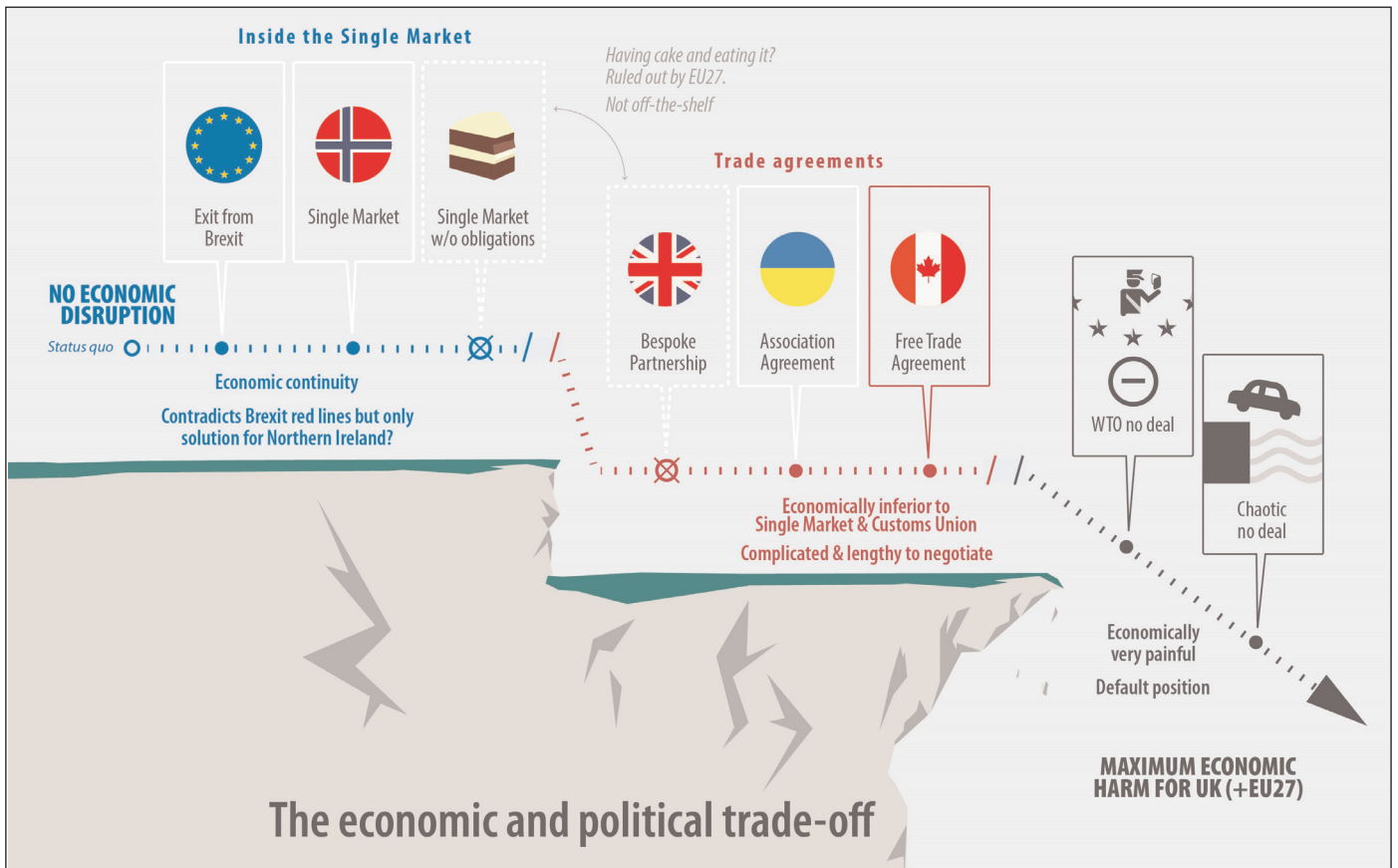
In any case, a re-run of the in-out referendum might not lead to a resolution. It is far from clear how people would vote and the result could still be indecisive. Let us not forget that any attempt to make a change in direction would require some good will on the other side of the Channel and will cost more time. It could also trigger a political backlash with a subsequent general election potentially returning a majority for an immediate Brexit. The defeated supporters of Brexit are likely to vote cohesively for a party promising an immediate Brexit. With a first-past-the-post electoral system, the geographical concentration of Brexit voters in populous Southern England and an unwritten constitution that allows decisive shifts in direction driven by a simple majority in Westminster, a future Brexiteer-dominated government might well trigger a chaotic and immediate exit.

Scenarios for a future relationship

For the EU27 and their Brexit negotiation team the political uncertainty in the UK poses significant challenges. The lack of developed and agreed negotiation positions on the UK side has made progress far too slow. There is also no guarantee that any agreement reached with the UK government will hold up in domestic politics, immediately or some time in future. For instance, if there was no progress in the trade talks, the UK Government would most likely question the payment of its financial obligations and the Phase 1 deal. So how should the EU react to the continuing uncertainty in the UK? There can be no question of conceding on principles: preserving the unity of the EU27 and integrity of the Single Market, with a country leaving not benefitting in the same way as those remaining. But the EU27 could help to move the negotiations on the future trade relationship forward as fast as possible.

But the next phase in the negotiations is not any easier: the UK government is caught between economic and political impossibilities regarding the long-term EU-UK relationship. As Chancellor Merkel put it: Brexit trade talks will be more complicated than the first phase.⁶

The diagram below illustrates the scenarios the UK government is grappling with:



You can't have your cake and eat it, too

In reality, the choices are more constrained than the diagram suggests. An exit from Brexit is not impossible but unlikely. The have-your-cake-and-eat-it-too scenario – having the benefits of economic integration without the obligations and the transfer of sovereignty that it implies – has been categorically ruled out by the EU27; a determination that is highly unlikely to waver, given the political costs such a scenario would impose on them. The bespoke deal that Theresa May called for in her Florence speech remains rather illusive: there are no details on what such a deal would involve. The negotiations may be running out of time to design something completely bespoke even if there is a two-year transition period. A degree of using off-the-shelf solutions will be necessary.

The Swiss and Turkish models are both unlikely, as they are neither seen as desirable by the EU27, nor do they offer a solution for an economy such as the UK that needs a much broader and more future-proof arrangement. The Swiss model makes extensive use of 'guillotine clauses', i.e. making all bilateral EU-Swiss treaties dependent on fulfilling all provisions simultaneously, which not only implies a certain level of future uncertainty for businesses but also compliance with free movement provisions, which are a required component from an EU27 perspective. The Turkish model implies severe limitations on independent trade policies, as well as being of limited use for a mostly service-based economy.

Hard choices

There are only a few choices left on the table. One option is some form of European Economic Area (EEA) membership, modelled loosely on Norway, implying participation in the Single Market (and most likely in the Customs Union too to address the issue of the Northern Ireland border). Alternatively, there could be a negotiated Free Trade Agreement (FTA) modelled on the comprehensive deal the EU has recently signed with Canada or a broader partnership modelled on the EU's association agreements, such as the one with Ukraine. The latter requires, however, some concessions from the EU that have so far been reserved for aspiring members.

But these scenarios are contentious within the UK. Membership of the EEA remains unlikely given the political concessions the UK would need to make. In essence, the UK government in power at that point would have to break every Brexiteer principle: continuing payments to the EU, abiding by EU rules and regulations with the ECJ as the ultimate backstop and continuing free movement of people as one of the defining freedoms of the Single Market. In addition, membership of the Customs Union implies that the UK could not negotiate trade deals with the rest of the world.

But while an FTA is politically far more acceptable, economically it is inferior to Single Market participation. It does not mirror the dynamic and adaptive nature of Single Market participation, making free trade the negotiated exception rather than the default. An FTA raises a number of questions for integrated supply chains and for particular sectors that are usually, at least partially, excluded from free trade negotiations: agriculture, fisheries, energy and, crucially, services, including financial services, and capital and data movement. But as long as the UK maintains its red lines – Brexit means exit from the Single Market and the Customs Union – this is probably the best outcome on the table.

Negotiating a free trade deal

Reaching an agreement on an FTA will be difficult. Timing is likely to be very constrained. At best, even with sufficient progress in December, the remaining period until March 2019 is unlikely to produce anything more than a very broad and general statement of intent. Even the two additional years of the transition period would only leave time for the most basic trade agreement, most likely excluding crucial areas such as financial services.

But not including them would create a huge political hurdle in the UK: a trade deal that covers goods, where the UK has a deficit, but not services, where the UK has a surplus would hardly seem worth the perceived concessions made in Phase 1, reopening the debate over the exit payment. This also highlights that the Article 50 Phase 1 issues are far from resolved. They will play a large role in the subsequent phases as well. The Irish border question, for example, will remain central in the negotiation; even consideration of a Northern Ireland within the Customs Union when the rest of the UK is outside will remain on the table.

Broadening out the negotiations will also be difficult. In relation to external trade, the UK and the EU need to take into account that a comprehensive deal is needed, rather than limited sectoral agreements, to ensure compatibility with World Trade Organization (WTO) rules. Any special provisions offered need to take into account Most Favoured Nation clauses, which implies that third countries will have equally favourable access.

A mixed, comprehensive trade deal would need to be ratified at member state level, as well as by the European Parliament. There is likely to be critical scrutiny of any mechanism for regulatory convergence or any possible slippage on environmental and social standards. And ratification takes time, reducing the negotiation period further.

Trade but not as we know it

In some ways, the talks between the EU and the UK are typical trade negotiations but this will not make them any easier. All 27 member states will draw up a list of demands, including politically and economically damaging demands for the UK, such as access to fishing waters or limitations on equivalence for UK firms. The Commission will be tasked to deliver on them, and has full and exclusive competences for trade negotiations, limiting the ability for the UK to 'divide-and-conquer'. In Phase 2, any discord between the 27 is counter-productive for the UK as it costs time and might lead to the no deal default position.

A no deal remains likely as this trade deal is unusual: for the first time, the negotiators are trying to construct a deal that distributes the costs of disintegration rather than gains from trade; a deal that makes everyone worse off in the end. This is politically hard to sell, especially within the UK. But without an agreement the cliff edge looms: the UK could drop out by March 2019 or after the transition period without any deal, bringing economic flows to and from the UK to a grinding halt. In the run-up, there is even the danger of a global financial crisis if UK financial institutions anticipate the full impact of no deal not only for their business with the EU27 but with the rest of the world.

Between the devil and the high sea

The scenarios have collapsed to a Norway-type arrangement, which is politically unacceptable to the UK Brexiteers or a Canada-type trade deal which imposes a very high economic cost on the UK. This is an impossible choice, especially since it risks splitting up the Conservative Party. But not making a choice is no option either. If the UK is unable to decide it will end up with the worst of all options, no deal at all.

A no deal scenario is not the benign picture many Brexiteers are painting of a UK trading at WTO standards. Even that requires some EU-UK agreement to replace the hundreds of treaties to which the UK will cease to be a party of in the event of a chaotic Brexit. In addition, some accommodation will have to be found with non-EU countries, including on some tricky questions related to tariffs. In the absence of such agreements, given legal uncertainty and logistical problems, the flow of goods, services, people and capital will grind to a halt, not only between the UK and the EU but also between the UK and the rest of the world.

A no deal, chaotic Brexit is not in the interest of the EU27, especially if the impact includes a global financial crisis, which the EU would need to counteract. But the Brexit process is seen as predominantly a UK domestic issue with an impact that can be contained in the EU27. While implying significant costs, there are also benefits for particular EU countries and sectors. In any event, despite some contingency planning, most of the EU27 still believe (wrongly) that the UK will not choose this most irrational economic outcome and make the pragmatic and rational choice in the end. But this could prove to be a false hope: domestic politics might well drive the UK down this route, inflicting significant damage on both sides.

A way out?

Given UK domestic politics, the EU27 still have to continue developing contingency plans in the case of no deal, either now or at a later stage in the negotiations. This is the worst outcome for both sides but given the prisoners' dilemma the UK government is trapped in, having to choose between economic and political harm, it remains the most likely default outcome. Contingency implies trying to find limited agreements on some of the crucial issues such as air transport to keep goods and people moving. But it also means planning for an economic and political crisis in the UK, which might trigger a global financial crisis, and dealing with the political fall-out.

At the same time, the EU should start preparing blueprints of a potential long-term settlement to help the negotiations progress quickly past Phase 1. This should include both the Canada/Ukraine and the Norway scenarios. While the latter is less likely, a political change in the UK should not be precluded. Having both of these ready will prepare the EU27 for a successful conclusion of the talks in case the UK is able to make up its mind on the described scenarios.

But the complexity and time required to reach either destination should not be underestimated. The UK needs more time, even beyond a two-year transition period. We should consider now how we can extend the negotiation/transition/implementation period to either give the UK the chance to come to its senses or to prepare, as much as possible, for a chaotic Brexit following a 'no deal' outcome.

Moving on from Phase 1 is a positive step but the negotiations will get trickier, not easier. As the negotiations continue, realisation in the UK will grow that this is the proverbial bad deal – but it is the best on offer. At that point, the UK might come to its senses, choosing to confront the Brexiteers head-on. Alternatively, and more likely, the UK will crash off the cliff edge for narrow domestic political reasons: a chaotic Brexit by accident, rather than design.

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The views expressed in this Discussion Paper are the sole responsibility of the author.

Endnotes

- ¹ See <https://www.theguardian.com/politics/2017/dec/03/tory-brexiteers-set-new-red-lines-over-ecj-and-free-movement>
- ² See <http://www.independent.co.uk/news/uk/politics/dup-theresa-may-tory-deal-ireland-border-brexiteer-irish-border-northern-ireland-a8085046.html>
- ³ See for example Chris Curtis "There has been a shift against Brexit, but the public still think we should go ahead with it", YouGov, 27.10.2017
- ⁴ See <https://www.reuters.com/article/us-britain-eu-vote/half-of-britons-support-a-second-vote-on-brexiteer-poll-finds-idUSKBN1DX0P6>
- ⁵ See for example <https://www.theguardian.com/politics/2017/sep/10/tony-blair-get-tough-on-immigration-to-stop-brexiteer>
- ⁶ As reported here: <https://www.theguardian.com/politics/2017/oct/20/brexiteer-trade-talks-more-complicated-than-first-phase-angela-merkel>

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