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'Brexit' lessons from third countries' differentiated integration with the EU's internal market

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Executive Summary

> The 'Brexit' debate has triggered new interest in the European Union's close economic relations with its neighbours.

> This external 'differentiated integration' flourished since the 1990s, ranging from narrow, bilateral and static models to broad, multilateral and dynamic models.

> Major lessons can be drawn from these models for the UK's 'differentiated disintegration':

1. deep economic integration involves domestic regulatory issues and tends to be based on the *acquis*;
2. cherry-picking, such as excluding the free movement of persons from a comprehensive access to the internal market, is not on offer; and
3. even the European Free Trade Area members of the highly institutionalised European Economic Area have very limited access to EU decision-making.

On 23 June 2016 the voters in the United Kingdom (UK) decided by 52% to 48% that the UK should leave the European Union (EU). A 'Brexit' raises the question of how the UK, or possibly some parts of it, can organise future relations with the EU. The referendum has revived the debate on differentiated integration in Europe – a debate that in the past was particularly lively during the era of 'Eurosclerosis' in the 1970s and in the pre-enlargement period of the 1990s. This debate has been enriched by an external dimension: over the past two decades, the EU's neighbours have developed various forms of participation in the internal market. As a result, references are made in the 'Brexit' debate to the 'Swiss approach', the 'Norwegian model', the 'Liechtenstein solution' for the free movement of persons, or simply a comprehensive free trade agreement. This Policy Brief discusses these models and clarifies the main implications of such external differentiated integration to draw some lessons for 'Brexit'.

Differentiated integration within the EU

The EU's dogma of 'an ever closer union' implies a uniform process of deepening integration among all member states. Any flexibility in this integration process has mainly played a role in the form of transitional periods in case of limited capacities of acceding countries and of 'opt-outs' on the occasion of treaty revisions in the absence of political will for closer integration. The debate on differentiated integration has generated many concepts, ranging from 'multi-speed Europe' and 'variable geometry' to 'concentric circles' or a 'core Europe'. The 1992 Maastricht Treaty had in fact authorised selective integration among EU member states by granting 'opt-outs' to the governments of the UK and Denmark and by establishing an economic and monetary union at different speeds. In 1997 the Treaty of Amsterdam institutionalised the possibility of 'enhanced cooperation' – further facilitated by the 2001 Treaty of Nice. Enhanced cooperation allows a group of member states to advance integration among themselves within EU structures (whereas the Schengen Area was still initiated outside the EU treaties and institutions).

External differentiated integration

In contrast to internal differentiation, external differentiation refers to different forms of integration that non-members have with the EU and in particular its core project: the internal market with its free movement of goods, services, capital and persons. Third countries with

'a stake' in the internal market subscribe to deep economic integration. Deep integration – as opposed to 'shallow' integration which focuses on the removal of barriers at the border – involves 'behind-the-border' integration with regulatory cooperation and common standards and rules in areas such as competition policy, intellectual property or investment. In the EU's external relations, deep economic integration normally implies legal approximation to and/or adoption of parts of the *acquis*. In other words, external differentiation entails outsiders, especially neighbouring countries, adopting EU rules to differing degrees. This leads to a system of EU 'external governance' where parts of the *acquis* are extended to non-member states without an equivalent parallel inclusion in EU policy-making.

This section discusses the main models of such external differentiated integration: the Agreement on the European Economic Area (EEA), the EU's bilateral approach with Switzerland, the customs union agreements with Turkey, Andorra and San Marino, and the evolving European Neighbourhood Policy (ENP). They appear to fit the concept of 'variable geometry' best. Out of these, the most far-reaching affiliation with the internal market, the EEA, has become an important reference point in the debate: for the Swiss Confederation which, according to Article 128 EEA Agreement, may at any time apply to become a contracting party, for the ENP countries as a long-term source of inspiration, for the small-sized European countries but also for Turkey and, most recently, the UK. To join the EEA as a non-EU member, a country would currently have to accede to the European Free Trade Association (EFTA) first.

The multilateral EEA: a blueprint?

The EEA extends since 1994 the internal market's four freedoms as well as horizontal and flanking policies to the members of EFTA, except for Switzerland. Excluded are the common agricultural and fisheries policies, budget contributions, regional policy, taxation, economic and monetary policy as well as the EU's external relations. All EFTA countries have concluded additional bilateral agreements with the EU, for instance governing participation in the Schengen Area.

The EEA's institutional set-up is a complex, 'quasi-supranational' system of two 'pillars', the EU and EFTA. For Norway, Iceland and Liechtenstein, the multilateral EEA is a dynamic *acquis*-based form of integration which leads to the incorporation of on average more than 300 new EU acts per year. The main discussion of new law takes place within the EEA Joint Committee in the so-called 'decision-shaping phase' after the Commission has transmitted its proposals to the Council and the European Parliament as well as to the three EEA EFTA states. The EEA Joint Committee decides by consensus as soon as possible after the EU's adoption of new *acquis*. In the EFTA countries, enforcement is carried out by the independent EFTA Surveillance Authority in Brussels and the EFTA Court in Luxembourg. If the EFTA countries, which need to 'speak with one voice', wish to 'opt out' from new rules, the EU could suspend the related parts of the EEA Agreement. This has not happened so far. Overall, the EEA attempts to reconcile the principles of internal market homogeneity and EU decision-making autonomy, with the result that EFTA lacks a real right of co-decision.

Regarding the free movement of persons, Liechtenstein is clearly a special case for which a 'special solution' was found. In addition to a transitional period and a review clause, it obtained a joint declaration with the EEA Council. This declaration recognised Liechtenstein as a very small area of rural character with an unusually high percentage of non-national residents and employees. It also acknowledged the principality's vital interest in maintaining its own national identity. Although the free movement of persons applies to Liechtenstein, EEA citizens wishing to live in the country have to obtain a residence permit. The number of permits is limited, with a yearly net increase, and half of them are granted by a ballot procedure. There are no restrictions preventing family members of holders of a residence permit from joining them. The arrangement is reviewed every five years.

Despite significant treaty reform in the EU during the past two decades, the EEA Agreement itself has – unlike its annexes listing the relevant *acquis* – remained largely unchanged. There have been controversies in particular about the selection of new EU acts as 'EEA-relevant' internal market legislation. Moreover, the EU increasingly adopts packages instead of individual acts. This creeping extension of the scope of the EEA Agreement is not matched with the participation of the EEA EFTA states in the relevant decision-shaping processes, for instance in new bodies and forms of governance. The EEA EFTA states are not represented in either the Council or the European Parliament, which has gained more powers. As a result, the absorption of new EU rules increasingly requires adaptations to the legal acts, which leads to delays in the implementation and risks weakening the homogeneity of EEA law. A comprehensive review of the EEA in 2010-13 did not, however, lead to any significant reforms, not least for fear of opening 'Pandora's box'.

EU-Switzerland bilateralism: at its limits?

EFTA member Switzerland opted through a referendum in 1992 not to participate in the EEA. Instead, the country pursued a bilateral approach *vis-à-vis* the EU, building on its 1972 free trade agreement with the European Communities. In two package deals in 1999 and 2004 it concluded 16 new sectoral agreements with the EU (free movement of persons, technical barriers to trade, public procurement, civil aviation, overland transport, agriculture, research, Schengen and Dublin association, taxation of savings, fight against fraud, processed agricultural products, environment, statistics, media, education, and pensions). A few more agreements have followed since and some are still under negotiation.

Most of these 'bilaterals' are based on the notion of equivalence of laws between the EU and Switzerland and any changes need to be negotiated, albeit with two exceptions where Switzerland accepts the EU *acquis*: in civil aviation − where the Commission and the Court of Justice of the EU (CJEU) have competences in surveillance and arbitration in specified areas; and with regard to Schengen and the Dublin Convention where Swiss adoption of any new acts requires approval from the Swiss legislature (and Swiss representatives participate without a vote in the relevant EU committees and working groups). In these two cases, if new acts are not adopted, the relevant bilateral agreement could be terminated. This sectoral approach lacks an overarching structure to deal with the ca. 20 main agreements, most of which are run by a consensus-based Joint Committee of officials from both sides, and the more than 100 secondary agreements.

The EU has in recent years insisted on the limits of such a static approach and on finding a more efficient institutional solution for taking over relevant new EU acts and case law and for ensuring the surveillance and enforcement of existing agreements. In 2012, the Swiss Federal Council submitted some institutional proposals to the EU, accepting the overall objective of homogeneity and the incorporation of future changes to the *acquis*, provided that this was not automatic and that Switzerland could in turn participate in the decision-shaping process. However, the EU did not approve a two-pillar model, whereby each party would retain responsibility for ensuring the application and interpretation of the common rules on its territory (that is, Swiss national market surveillance). In 2013, it was agreed as a negotiation basis that the CJEU should interpret the EU *acquis* adopted by Switzerland to strengthen legal certainty. Yet, in February 2014 the talks have been stalled as a result of the Swiss acceptance (by a slim margin of 50.3%) of a popular initiative requiring the introduction of immigration quotas. This constitutional amendment, which the Swiss government has to implement within three years, is not compatible with the agreement on the free movement of persons. The non-extension of the latter to Croatia after its accession to the EU in 2013 triggered Switzerland's (partial) loss of access to the EU's research and education, 'Horizon 2020' and 'Erasmus+', programmes. The Commission rejected the suggestion of a unilateral safeguard clause with a national ceiling on EU migration to Switzerland. If no solution is found, the so-called 'guillotine clause' in the 1999 package risks terminating the entire series of bilateral treaties. The 'Brexit' vote has certainly not facilitated a compromise for the Swiss problem in light of the UK's intention to curtail migration from the EU as well.

EU-Turkey customs union: stepping stone or dead end?

Turkey has been associated with the EU since 1963 and in 2005 commenced accession negotiations. Turkey's customs union with the EU, established in 1996 as a step towards membership, allows all industrial goods and processed agricultural products that comply with EU norms to be traded freely in the EU. For this purpose, Turkey adopted the EU's common external tariff and the *acquis* in the area of technical barriers to trade. Turkey also aligns its legislation in other essential internal market areas, notably competition policy and protection of intellectual property rights. Moreover, in order to ensure the proper functioning of the customs union, Turkey is expected to interpret provisions which are identical in substance to the corresponding EU treaty provisions in conformity with the relevant EU case law. An EU-Turkey Association Council, composed of ministerial-level representatives from both sides, tries to find a solution to any conflict and may unanimously decide to submit a dispute to the CJEU, another court or an arbitration tribunal. The Commission informally consults Turkish experts when drafting relevant new *acquis*, and further consultations may take place in the Joint Committee. Yet these input opportunities are less developed compared to those offered in the EEA.

The customs union constitutes a narrow, bilateral and only partially dynamic model. It binds Turkey to the EU's common commercial policy without offering it proper means of influence. Also, the EU's trade agreements have opened up third markets for EU exports but not for Turkish exports − despite granting the partners access to the Turkish market. The 1963 Association Agreement had envisaged agriculture being included in the customs union but this was not pursued. Moreover, the provisions in the Additional Protocol of 1970 on the free movement of workers, services and capital were not implemented. Nevertheless, the customs union has contributed to the considerable economic growth of the Turkish economy.

Very small states: from absorption to association

The three small-sized European countries of Andorra, San Marino and Monaco are – unlike the Holy See and Liechtenstein – also part of the EU's customs territory. Their relations with the EU have developed from indirect integration based on their historical relations with neighbouring EU member states to direct agreements with the EU. Whereas Andorra and San Marino have concluded bilateral cooperation and customs union agreements with the EU, Monaco still relies on its close relationship with France. The three countries have no participatory rights in the EU's decision-making processes, but have to implement the relevant *acquis*. They have also concluded bilateral monetary agreements with the EU, which allow them to use the Euro and grant competence to the CJEU.

All three countries have in recent years expressed a wish to enhance their relations with the EU since they still face obstacles in accessing the internal market. In a declaration on Article 8 TEU, introduced by the Lisbon Treaty, the EU promises to 'take into account the particular situation of small-sized countries which maintain specific relations of proximity with it'. Several options ranging from joining the EEA or bilateral sectoral agreements to EU membership have been discussed. In March 2015, the EU opened negotiations on a multilateral (or several bilateral) framework association agreement(s) with the three states. The negotiations envisage special governance and consultation arrangements as well as an independent monitoring and enforcement of the *acquis,* possibly by the EU institutions.

In Article 8 TEU the Treaty calls on the Union to 'develop a special relationship with neighbouring countries, aiming to establish an area of prosperity and good neighbourliness, founded on the values of the Union and characterised by close and peaceful relations based on cooperation'. This includes the conclusion of agreements containing reciprocal rights and obligations as well as periodic consultation on their implementation. The Article targets mainly the EU's post-enlargement neighbours to the east and south but a 'future neighbour' like the UK might also be interested in the association agreement that this provision is hinting at.

European Neighbourhood Policy: from soft to hard law

The ENP's legal bases are the bilateral Euro-Mediterranean Association Agreements and the Partnership and Cooperation Agreements with the transition countries to the East. The agreements encourage the approximation of legislation to the *acquis*; tailor-made bilateral Action Plans define jointly agreed reform priorities; and the EU supports the implementation process with technical and financial assistance. In a further step, (new) Association Agreements are complemented by Deep and Comprehensive Free Trade Areas (DCFTAs). The DCFTAs cover substantially all trade in goods and services as well as 'behind-the-border' issues such as standards, competition policy or intellectual property rights. They require the partners' capacity to approximate and take on elements of the EU *acquis*. In particular, the countries commit to the relevant *acquis* regarding technical barriers to trade and certain services.

Not all the countries are up to such far-reaching integration with the EU, and some of them are plagued by conflicts. The 2014 Association Agreements with Ukraine, Moldova and Georgia contain different legislative approximation mechanisms with varying degrees of obligation and various procedures to amend the incorporated rules. The Commission has to notify these ENP countries of relevant changes. The Association Council or Association Committee may modify the annexes to take into account the evolution of EU law, and in some sectors of the DCFTA a dynamic procedure to update the *acquis* is foreseen. Dispute settlement arrangements vary across sectors from consultation, arbitration or mediation to rulings by the CJEU. The DCFTAs *per se* do not, unlike the EEA, aim at the creation of a homogenous and dynamic legal space but are instead based on market access conditionality, which links additional access to the internal market to progress in implementation. They thus entail a shift from narrow, static soft law to a broader and binding hard law approach.

Lessons for 'Brexit' from differentiated integration

Several lessons can be drawn from this overview of the EU's evolving relations with neighbouring countries for what could be understood as a form of 'differentiated disintegration' of the UK.

First, internal differentiation – as the UK had at times practiced in the past – presupposes EU membership with a seat at the table and voting rights.

Second, when it comes to external differentiation, the EU generally does not grant any *à la carte* integration with its internal market in terms of picking and choosing. Indeed, rich countries such as the EFTA states, for instance, actually contribute to cohesion in the EU through special financial cooperation mechanisms. Moreover, the EU has – in return for internal market access – sought agreements in areas of its own interest such as taxation. This also means that a comprehensive participation in the internal

market without free movement of persons is hard to imagine. This has been confirmed by the Swiss case. The special solution applying to Liechtenstein is closely linked to its tiny territory (160 km^2) and high number of foreigners (representing about one third of the resident population and two thirds of the workforce). No EU or EEA EFTA state has contested Liechtenstein's limited absorption capacity.

Third, a customs union agreement based on the Turkish model is not an attractive long-term option for a country like the UK as it *inter alia* requires abandoning the capacity to determine one's own trade policy while aligning to relevant EU *acquis*.

Fourth, although often referred to as a blueprint, the EEA – the most far-reaching internal market association based on a free trade area – can only to a limited extent serve as a model for the UK. Unlike the other neighbours, the EFTA countries are eligible for EU membership but have so far chosen not to join. They are highly developed, small and 'like-minded' economies that have to 'speak with one voice' in EEA bodies, which is why they are not very keen on expanding EFTA's membership – although the UK was a founding member of EFTA in 1960. Compared to the UK's votes and seats in the EU institutions today, the EEA offers very little participation in EU decision-making yet entails similarly extensive internal market obligations.

Fifth, any close economic association with the EU requires an effective mechanism through which third countries keep up with the evolution of the *acquis* in order to safeguard market homogeneity. There is an inherent trade-off between the benefits resulting from the internal market and the lack of participation in the law-making process, which leaves little room for parliamentary control. Size can matter in this regard since what is acceptable to a small state in terms of a curtailment of its sovereignty might not be tolerable for a bigger state.

Finally, new models of external differentiation beyond the scope of this overview could be imagined. However, some crucial principles of EU law (such as non-discrimination) and politics (such as the setting of precedents, the preservation of the EU's decision-making autonomy or the maintenance of a balance of benefits and obligations) provide the boundaries to what seems feasible for the EU in the search for such alternative models.

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