



BRIEFING PAPER

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Brexit: trade aspects

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Summary

The UK's future trading relationship with the EU is a key issue, given that nearly half of the UK's trade is with other EU Member States. At the moment, as a member of the EU, the UK is part of the EU single market and the customs union. This means no tariffs, customs duties or quotas on trade between Member States. It also means elimination of non-tariff barriers, such as differing technical specifications and rules on labelling of products. Given that average tariffs are now low, these non-tariffs barriers are considered to be a more important barrier to trade, although tariffs on some individual products are still high. The EU tariff on cars is around 10%. Agricultural tariffs are generally higher than those on non-agricultural products. The single market also extends to services although progress here is generally thought to be slower than for goods.

The key feature of the customs union is that all EU member states set the same tariff on goods imported into the EU from non-EU countries. This facilitates trade between Member States by removing the need for rules of origin checks. However, being part of the customs union makes it very difficult for a country to negotiate its own free trade agreements.

While the Government has said it does not want an off the shelf option, existing trade arrangements provide a starting point for considering what the UK's future trading relationship with the EU might look like. Three options are considered in this note: membership of the European Economic Area (EEA), a free trade agreement (FTA) and trading under World Trade Organization (WTO) rules.

The WTO (World Trade Organization) option would apply in the absence of a negotiated deal with the EU. In this sense it can be thought of as the default option, although some argue for it on its own merits. This would involve access to the single market on the least advantageous terms. The UK would still have "access" to the EU market in the same way that any other country without a trade agreement with the EU (such as the US) can export to it. Exports of UK goods to the EU would be subject to the EU's tariffs and vice versa. The EU would not be able to set discriminatory tariffs on imports from the UK. The WTO option would mean no contribution to EU spending or free movement of people.

A free trade agreement between the UK and the EU would be an intermediate option between EEA membership and trading under WTO rules. It is not possible to know with certainty what such a deal would look like as this would depend on the outcome of negotiations between the UK and the EU.

The last option would be UK membership of the European Economic Area (EEA). The EEA includes all EU Member States plus Iceland, Liechtenstein and Norway. The EEA option involves considerable (but not complete) access to the single market. It also involves contributions to EU spending and free movement of people.

The Government's negotiating objectives were set out by the Prime Minister in a speech in January. A White Paper is to follow. The Prime Minister said that the UK would "pursue a bold and ambitious free trade agreement" with the EU. This would involve "the freest possible trade in goods and services". However, the UK would not seek continued membership of the EU single market, as this would mean complying with the EU's four freedoms (freedom of movement of goods, services, people and capital). It would mean a continuing role for the European Court of Justice. The proposed trade agreement might "take in elements of current single market arrangements in certain areas" such as cars and financial services.

On the customs union, the Prime Minister said that she wanted the UK to be able to negotiate its own trade deals. This would mean not being bound by the common external tariff. However, "a customs agreement" with the EU would be sought.

The Prime Minister said that she wanted an agreement about the future relationship with the EU to be concluded within the two year timetable set out by Article 50. After that, a "phased process of implementation" was proposed.

While the Government was hopeful that such a deal could be reached as it would be in the economic interest of both the UK and the EU, the Prime Minister said that "no deal for Britain is better than a bad deal for Britain."

The speech raised a number of issues including the effect on the economy, whether a trade deal could be negotiated within two years, and how the proposed customs agreement would work.

1. Introduction

This paper looks at the UK's trading relationship with the EU. This is clearly of huge significance given the scale of UK exports to and imports from the EU.

The paper is structured as follows. Section 2 describes how UK-EU trade works at the moment while the UK remains an EU Member State and provides some statistics on the scale of this trade. It also describes the UK's relationship with the WTO.

Section 3 sets out the three main options for the UK's future trading relationship with the EU:

- trading purely under World Trade Organization (WTO) rules
- a free trade agreement between the UK and the EU
- membership of the European Economic Area (EEA)¹

The EEA option would be the closest to EU membership while the WTO option would be the biggest break. Most economic analyses published before the referendum found that the EEA option would do the least harm to the UK economy with the WTO option having the largest negative impact.

Section 4 summarises the Government's negotiating objectives as set out in the Prime Minister's January 2017 speech and some of the reaction to it.

There are a number of important issues not discussed in this paper. These include the issue of the UK's capacity and expertise to undertake trade negotiations, given that these have been done at EU level for over 40 years and the question of the UK's future trade relations with countries outside the EU.

More information on a range of Brexit-related issues is available [here](#).

¹ The EEA members are the EU Member States, plus Iceland, Norway and Liechtenstein

2. Background

2.1 How does UK-EU trade work at the moment?

The single market

The EU single market is an economic area where barriers to trade between its members have been removed. The single market is based on the “four freedoms”: free movement of goods, services, capital and people.

The EU forms a single market with no tariffs² or quotas³ on trade in goods between EU Member States. The single market also removes non-tariff barriers to trade, such as differing technical specifications and labelling requirements.

The single market also extends to trade in services but it is generally thought that progress towards a single market in services lags behind that in goods.

There has been much debate about “access to the single market”. This phrase is used to cover a wide array of trading arrangements. Member States of the EU clearly have access to the single market. But countries like China and the US also export large amounts to the EU so also have a form of “access” to the single market. The key question is the terms on which this access is possible and the costs and benefits imposed by these terms.

Countries outside the single market have access to it in the sense that they can export to the EU but their exports must comply with EU rules and regulations. Imports into the EU from these countries will be subject to any relevant tariffs, quotas or non-tariff barriers, unless these are removed by a free trade agreement with the EU. Countries trading with the EU on these terms are not required to accept free movement of people, make contributions to the EU’s finances or be subject to the European Court of Justice.

“Membership” of the single market (or being “in” the single market), defined as membership of the European Economic Area, means there are no tariffs or quotas on trade between members. Non-tariff barriers are also reduced. Members accept free movement of people, make a financial contribution to the EU and are required to adopt EU legislation on the single market. Non-EU EEA members are subject to the EFTA Court which closely follows the European Court of Justice.⁴

² Tariffs are taxes levied on imports. They are sometimes referred to as customs duties.

³ Quotas are restrictions on the volume or quantity of goods which may be imported.

⁴ EFTA is the European Free Trade Association whose members are and Iceland, Liechtenstein, Norway and Switzerland.

The customs union and rules of origin

The EU Member States also form a “customs union”. The key characteristic of a customs union is the common external tariff. All members of the customs union apply the same set of tariffs on goods imported from outside the EU. Goods will therefore be subject to the same tariffs irrespective of which Member State they are imported into.

In 2014, the EU’s average tariff was 2.3% for non-agricultural products.⁵ This is an average figure: tariffs on some individual products are much higher, however, especially on agricultural goods. The EU tariff on cars, for example, is 10%. The average EU tariff on sugars and confectionery, and on beverages and tobacco is around 20%.⁶

Membership of the customs union means EU Member States are severely limited in their ability to operate independent trade policies, for instance by pursuing bilateral free trade agreements with non-EU countries. Goods move freely within the customs union without incurring further tariffs.

The customs union means goods can move freely between EU Member States without the need for rules of origin checks as goods have paid the same tariff regardless of which Member State they were imported into. This is different from a free trade agreement where tariffs are abolished on trade between the parties but they are free to set their own tariffs on trade with third countries.

Exports to the EU from countries outside the customs union are still subject to rules of origin even if they have a free trade agreement with the EU. This is to ensure the correct tariff is paid and prevent exports entering the EU via a low tariff country.

Take the following hypothetical example. The EU tariff on cars is 10%. Suppose country A has a free trade agreement with the EU but sets its own tariff on cars at 5%. Without rules of origin, country B could export cars to country A, pay a tariff of 5% and then export them on to the EU paying no further tariff. Rules of origin are required to prevent this happening and ensure that only goods originating in country A benefit from the free trade agreement.

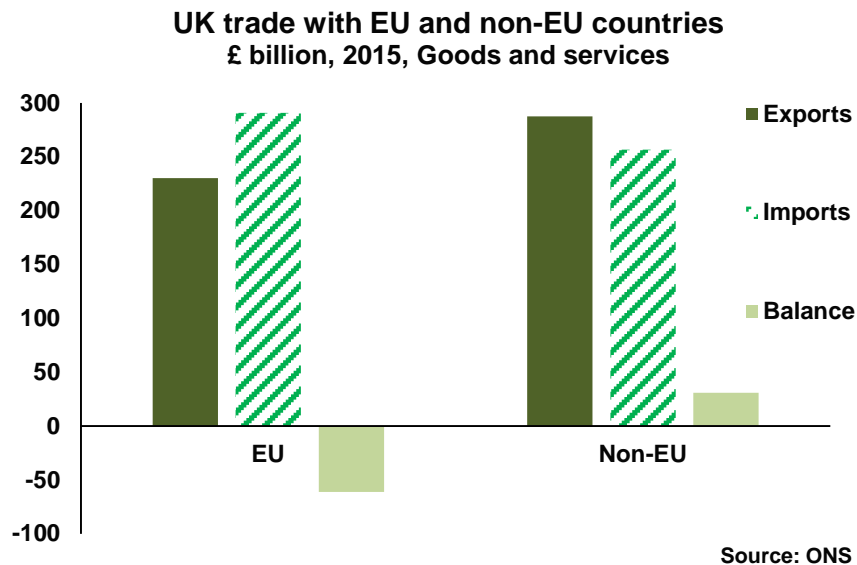
Rules of origin can be complex when products are assembled in more than one country and can introduce bureaucracy and delay into cross-border trade.

⁵ World Trade Organization, WTO Tariff Profiles 2016, p81. Trade-weighted average

⁶ World Trade Organization, WTO Tariff Profiles 2016, p81

2.2 Statistics on UK-EU trade

Taken as a group, the EU is by far the UK's most important trading partner. In 2015 it accounted for 44% of UK goods and services exports (£230 billion) and 53% of UK imports (£291 billion). These figures are shown in the chart and table below.



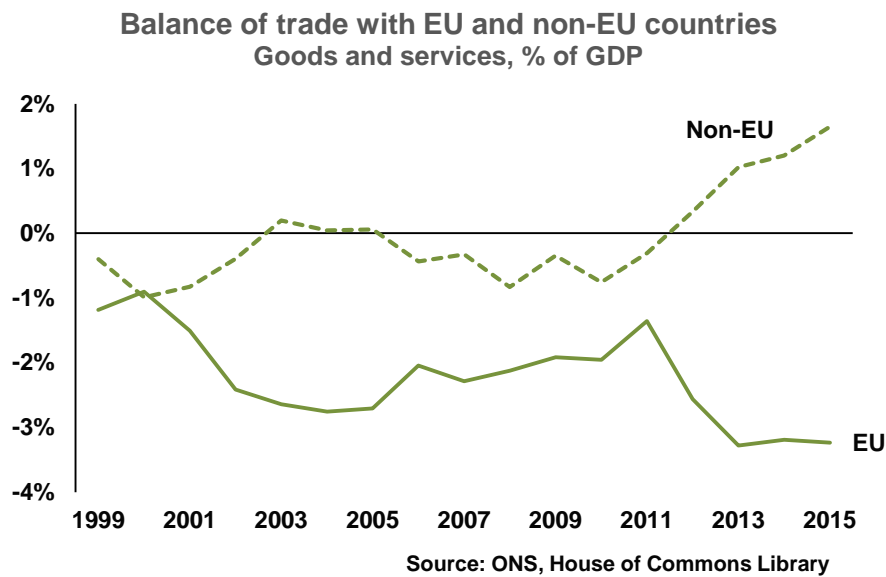
UK trade with EU and non-EU countries 2015
Goods and services

	Exports		Imports		Balance
	£ billion	%	£ billion	%	£ billion
EU	230	44.5%	291	53.1%	-61
Non-EU	287	55.5%	257	46.9%	31
Total	517	100%	547	100%	-30

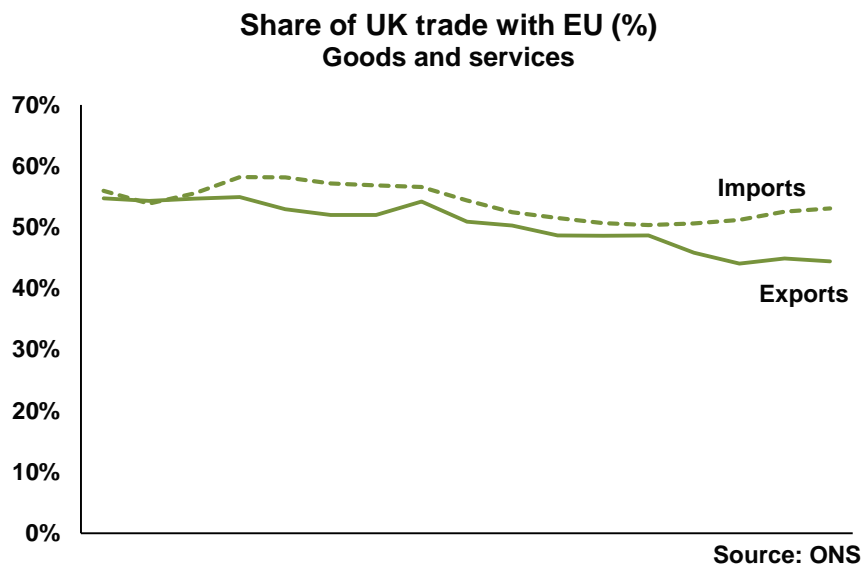
Source: ONS Balance of Payments Stat Bulletin, 23 Dec 2016, Tables B & C

These estimates take no account of the "Rotterdam effect". This is the argument that UK trade with the EU is overstated by these figures. The UK does a large amount of trade with the Netherlands, some of which may ultimately be with countries outside the EU but be recorded as EU trade. There are no official estimates of how big this effect might be, but, even making allowance for it, the EU is still the UK's largest trading partner by a large margin.

The UK imports more from the EU than it exports to it. In 2015, the UK's deficit on trade in goods and services with the EU was £61 billion while the surplus with non-EU countries was £31 billion. The chart below shows the UK balance of trade since 1999 with EU and non-EU countries.



The share of UK exports going to the EU has declined gradually over recent years. In 2006, the EU accounted for 54% of UK exports. By 2015, this had fallen to 44%. The picture on imports is slightly less clear. In 2002, 58% of UK imports were from the EU. By 2011, this had fallen to 50% but increased slightly to 53% in 2015.⁷ More information on the UK's trade with the EU is in another Library note: [Statistics on UK-EU trade](#).



2.3 The World Trade Organization (WTO)

The WTO's website describes its role as follows:

There are a number of ways of looking at the WTO. It's an organization for liberalizing trade. It's a forum for governments to

⁷ The figures are for trade with the EU as it is now (ie 27 countries, plus the UK) for all years from 1999.

negotiate trade agreements. It's a place for them to settle trade disputes. It operates a system of trade rules.⁸

The UK is a founding member of the World Trade Organization in its own right.⁹ Lord Price, the Minister for Trade, told the House of Lords EU External Affairs Sub-Committee "we do not need to accede to the WTO as we are already a member."¹⁰ As an EU Member State the UK is, in practice, represented by the European Commission at the WTO.¹¹

The UK's "membership terms are bundled with the EU's."¹² At the moment, the UK is bound by a number of WTO trade commitments (known as "schedules"). These are for the EU as a whole and are negotiated by the EU.¹³ In December 2016, the Department for International Trade said that in unbundling the UK's schedules, it would seek to replicate the UK's current obligations. The Department's statement said:

The United Kingdom is a founding member of the World Trade Organisation (WTO). In addition to the general obligations of membership, all WTO members undertake specific commitments in their goods and services schedules: WTO members' goods schedules set out upper limits for tariffs and detail any tariff rate quotas, and WTO members' services schedules set out commitments and reservations across all sectors and list specific sectoral commitments and reservations.

The UK's WTO commitments currently form part of the European Union's schedules. When we leave the EU we will need UK-specific schedules. In order to minimise disruption to global trade as we leave the EU, over the coming period the Government will prepare the necessary draft schedules which replicate as far as possible our current obligations. The Government will undertake this process in dialogue with the WTO membership. This work is a necessary part of our leaving the EU. It does not prejudice the outcome of the eventual UK-EU trading arrangements.¹⁴

The UK's schedule can only be adopted if none of the WTO's 163 members object.¹⁵ Views differ on how easy the process of establishing the UK's schedules at the WTO will be.¹⁶ Agriculture is one area which presents particular challenges (see box below). The House of Lords EU Committee concluded:

⁸ [WTO website](#)

⁹ [PQ 2954 8 November 2016](#)

¹⁰ House of Lords Select Committee on the European Union, Internal Market Sub-Committee and External Affairs Sub-Committee, [Brexit: future trade between the UK and the EU](#), Evidence volume, 13 October 2016, Q40

¹¹ WTO, [European Union - Trade Policy Review](#), para 2.16, 18 May 2015

¹² Peter Ungphakorn, [Nothing simple about UK regaining WTO status post-Brexit](#), International Centre for Trade and Sustainable Development, 27 June 2016

¹³ Brexit and the WTO option: Key questions about a looming challenge, Financial Times, 12 July 2016

¹⁴ [HCWS316](#) Written Statement 5 December 2016

¹⁵ Julian Braithwaite (UK Permanent Representative to the WTO), [Ensuring a smooth transition in the WTO as we leave the EU](#), 23 January 2017

¹⁶ The Government has said it intends to follow the WTO rectification procedures (see [PO 58537 13 January 2017](#)). Rectification is for changes which do not alter the scope of concessions. The alternative, modification, is for substantive changes (see House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 173

Although the Government is confident that this process will be purely technical, a number of political factors could complicate certification. For example, the views of other WTO members, particularly on tariff rate quotas, and on whether the UK and the EU's actions could be considered to be a 'modification' rather than simply a 'rectification' of the EU's schedules, may complicate agreement.¹⁷

The WTO will be important to UK trade policy even if trade with the EU is not on the default WTO rules basis. For example, the WTO has rules on free trade agreements and customs unions. In particular, these must cover "substantially all trade". These rules have implications for the UK's future trade arrangements with the EU and mean that deals applying only to certain industries might well be open to challenge at the WTO.

¹⁷ House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 212

Box 1: Agricultural trade

The UK's exports of agricultural goods were worth £18.0 billion in 2015 of which 62% were to the EU. UK agricultural imports were £38.5 billion, of which around 70% were from the EU.¹⁸ The main destinations for UK exports were the Irish Republic, France, the US and the Netherlands. The largest sources of UK imports were the Netherlands, the Irish Republic, France, Germany and Spain. The largest category of exports was whisky (£3.9 billion) while the largest category of imports was fresh fruit and vegetables (£5.2 billion).¹⁹

Agricultural issues can be a sticking point in trade negotiations. In evidence to the International Trade Committee, Peter Ungphakhorn, a former WTO official, said that "agriculture is particularly political in trade issues" and was "particularly difficult to negotiate".²⁰

EU tariffs on agricultural products are, on average, higher than on non-agricultural products and, in some cases, very high (although there is considerable variation). Imports of agricultural products from least developed countries, and some developing countries, can enter the EU market at zero or reduced tariffs under various EU preferential trade arrangements or free trade agreements.²¹

The EU also has a system of tariff rate quotas (TRQs) which allow a certain volume of agricultural imports into the EU at low or zero tariffs. The EU TRQs will need to be divided between the UK and the EU. This process may well be difficult.²² TRQs are likely to become the "most contentious issue" for the UK at the WTO, according to Luis González García of Matrix Chambers.²³ In addition, some way of dealing with UK-EU trade will need to be found.²⁴

There are also rules on subsidising agriculture. Professor Alan Winters of Sussex University told the House of Commons International Trade Committee that:

The obligation is not to subsidise above a certain amount, but the EU is well inside the limits that it negotiated in 1994 and therefore allocating subsidies should not be a significantly difficult issue.²⁵

The Government has said that it wants "a reciprocal deal that delivers no tariffs on trade between the UK and EU" and that it is "working to minimise burdensome non-tariff-barriers to such trade, while maintaining high standards for food safety, animal welfare and the environment."²⁶

¹⁸ EU External Affairs Sub-Committee, Written evidence from [Agriculture and Horticulture Development Board](#), paras 2 and 4

¹⁹ Defra, [Agriculture in the United Kingdom 2015](#), p84

²⁰ International Trade Committee, [UK trade options beyond 2019](#), 13 January 2017, HC 817-ii, 2016-17, Q208

²¹ WTO, [Trade Policy Review – The European Union](#), 18 May 2015, para 4.53

²² House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, paras 178 and 185

²³ The "WTO Option" for Brexit is far from straightforward, *The Economist*, 7 January 2017

²⁴ Peter Ungphakhorn, [The limits of possibility: splitting the lam-mutton quota for the UK and EU-27](#), 6 January 2017

²⁵ International Trade Committee, [UK trade options beyond 2019](#), 10 January 2017, HC 817-ii, 2016-17, Q208

²⁶ [PQ 908265 19 January 2017](#)

3. Possible models for UK-EU trade

3.1 Introduction

The possible models for the UK's future trade arrangements with the EU fall into three broad categories:

- Trading under WTO rules
- A free trade agreement with the EU
- The EEA (or "Norway") model.

This chapter discusses each of these in turn. The EEA model would be the closest to EU membership with the WTO option being the most radical break.

The Government has announced that its preferred option is a free trade agreement with the EU but, if no acceptable deal can be reached, it is prepared to trade on WTO rules (see section 4 below for more on the Government's negotiating objectives). Continued membership of the single market has been rejected by the Government, effectively ruling out the EEA option.

3.2 Trading under WTO rules

Under this option, there would be no preferential trade agreement between the UK and the EU. Trade would be based on WTO rules. This is the "default" option – ie the one which would apply in the absence of a preferential trade agreement between the UK and EU.

The WTO option would mean the imposition of tariffs on trade in goods between the UK and the EU. UK exports to the EU would face the EU's tariffs and imports into the UK from the EU would face whatever tariffs the UK decided to impose.²⁷ This is in contrast to the current arrangements – while the UK is a member of the EU there are no tariffs on UK-EU trade.

There are, however, WTO rules on tariffs which govern how they are applied. The principle of non-discrimination requires WTO members not to treat any member less advantageously than any other: grant one country preferential treatment, and the same must be done for everyone else. There are exceptions for regional free trade areas and customs unions like the EU, but the principle implies that, outside of these, the tariff that applies to the 'most-favoured nation' (MFN) must similarly apply to all.

In practice, this would prevent discriminatory or punitive tariffs being levied by either the EU on the UK, or vice versa. The maximum tariff would be that applied to the MFN. The EU's MFN tariffs have generally fallen over time, meaning that in this particular context the 'advantage'

²⁷ As noted above, the Government has said that it intends to replicate the EU's tariff structure as far as possible, at least in the short term.

of membership has declined. In 2014, the EU's average tariff was 2.3% for non-agricultural products.²⁸ This is an average figure: tariffs on some individual products are much higher, however, especially on agricultural goods. The EU tariff on cars, for example, is 10%. The average EU tariff on sugars and confectionery, and on beverages and tobacco is around 20%.²⁹

This would mean many UK exporters to the EU becoming less price competitive, to varying degrees, than their counterparts operating within the remaining EU, and those within countries with which the EU has preferential trading relationships. However, given that the average tariff is low, any loss of competitiveness might well be offset in many cases by the depreciation of the pound which has occurred since the referendum.

The UK would also need to decide the level of tariffs on imports into the UK. Under WTO rules, the UK would not be able to discriminate between imports from different countries, except where there was a free trade agreement. Setting the level of tariffs would involve a trade-off between lower prices for domestic consumers on the one hand, and bargaining power in future trade negotiations on the other. Setting relatively high tariffs would increase prices for consumers but give a bargaining chip in future negotiations. Eliminating or setting low tariffs would tend to reduce prices, but give trading partners little incentive to reduce their tariffs in any future negotiations. The Government has announced that it intends to replicate the EU's tariff structure, as far as possible, at least initially.

Non-tariff barriers to trade include, for example, differing product standards. These might be in the areas of labelling, packaging and sanitary requirements. The terms of WTO agreements limit the circumstances in which such measures can be applied, and in particular uphold the principle of non-discrimination that would prohibit punitive measures against the UK.

Without further negotiation, the UK's trade in services with the EU would be governed by the WTO General Agreement on Trade in Services (GATS).

The WTO option would impose the fewest obligations on the UK. There is no requirement to implement EU legislation although UK businesses would still have to comply with EU rules in order to export to the single market. Under the WTO option, there would be no obligation to accept free movement of people or make a financial contribution to the EU budget. Studies generally find this option to be the most costly in economic terms.

²⁸ World Trade Organization, WTO Tariff Profiles 2016, p81

²⁹ World Trade Organization, WTO Tariff Profiles 2016, p81

3.3 A free trade agreement with the EU

The third option is a free trade agreement (FTA) between the UK and the EU. The EU's relations with Switzerland are governed by a series of bilateral agreements. The EU has recently finished negotiating a trade agreement with Canada (although this has yet to be ratified or implemented).

A FTA is an intermediate category between the WTO and EEA options. It is less clearly defined than the other options – as its scope would depend on what the EU and UK were able to agree. A FTA would be likely to mean reduced access to the single market, especially in services, compared with EU or EEA membership, but would mean no need to accept free movement of people or make financial contributions to the EU. A free trade agreement would allow the UK to make its own trade agreements with non-EU countries.

We do not know how keen the rest of the EU would be to enter into a FTA with the UK or what the terms of such an agreement might be. The UK is, however, an important market for the rest of the EU. The rest of the EU has a trade surplus with the UK (£61 billion in 2015). In 2015, 21 of the other 27 EU Member States had a trade surplus with the UK. Germany's surplus was £25 billion. These commercial considerations might lead to pressure for a UK-EU free trade agreement.

Also, negotiations would start from a position of close integration between the EU and the UK. The aim of the negotiations would be to loosen this to some extent. This is different from most trade negotiations which aim to increase economic co-operation.³⁰

A free trade agreement with the EU would also need to comply with WTO rules. In particular, free trade agreements must cover substantially all trade. The House of Lords EU Committee report explains this as follows:

Importantly, the GATT and the GATS stipulate that such customs unions or free trade agreements must liberalise “substantially all the trade” in goods or have “substantial sectoral coverage” for trade in services. This means that sectoral agreements (those covering just telecoms, for example) are not legal under the rules of the WTO. We note that these conditions have rarely been raised in dispute settlement procedures at the WTO, have been poorly enforced, and there is considerable uncertainty over the definition of “substantially all”. Nonetheless, the UK Government is a member of the WTO and thereby bound by the rules laid out in the GATT and the GATS, which restrict the parameters of the deal the Government will be able to negotiate with the EU.³¹

On the other hand, political considerations may make reaching a deal more difficult. The Maltese Prime Minister has said that any deal “needs to be inferior to membership”.³² An article in the Economist cast doubt

³⁰ Treasury Committee, [The economic and financial costs and benefits of the UK's EU membership](#), HC 122, 27 May 2016, para 149

³¹ House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 45

³² UK Brexit deal with EU must be ‘inferior to membership’, Financial Times, 18 January 2017

on the argument that the lobbying power of the German car industry would help ensure a free trade deal between the UK and the EU. Matthias Wissmann, president of the German Association of the Automotive Industry said “But we are at least as interested in keeping the European Union together—in fact, that is our priority.”³³

A trade agreement might take a long time to negotiate. The EU’s trade agreement with Canada took seven years to negotiate and has yet to be ratified. A trade agreement with the EU would need to be approved by the European Parliament and possibly by each Member State.

Also the UK has not negotiated a trade agreement while it has been in the EU. The UK’s experience and capacity to negotiate trade deals is likely to be limited at the moment.

A free trade agreement would mean the UK would be outside the customs union meaning UK exports to the EU would be subject to customs checks and rules of origin. The UK would, however, be free to negotiate its own trade agreements with third countries.

3.4 The European Economic Area

What is the EEA and what is its trade relationship with the UK?

The European Economic Area (EEA) is made up of the EU Member States plus three other countries: Norway, Iceland and Liechtenstein.³⁴ EEA membership gives access to the single market with some exceptions in agriculture and fisheries. The EEA countries are outside the EU customs union so can set their own trade policies with countries outside the EEA.

The EEA Agreement extends the EU single market and free movement of goods, services, people and capital, together with laws in areas such as competition policy, state aid, consumer protection and environmental policy to include Norway, Iceland and Liechtenstein. In addition, the EEA Agreement covers cooperation in policies such as research and technological development, education, training and youth, employment, tourism, culture, civil protection, enterprise, entrepreneurship and small and medium-sized enterprises.

The Agreement does not cover the following EU policies:

- Common Agriculture and Fisheries Policies (CAP and CFP, although the Agreement contains provisions on various aspects of trade in agricultural and fish products);
- Customs Union;
- Common Trade Policy;
- Common Foreign and Security Policy;

³³ German business lobbyists will not stop tariffs against Britain, The Economist, 15 October 2016

³⁴ Iceland, Norway and Liechtenstein are also in the European Free Trade Association (EFTA) along with Switzerland. Switzerland is not in the EEA. Its trade arrangements with the EU are governed by bilateral agreements.

- Justice and Home Affairs (even though the EFTA countries are part of the Schengen area);
- Direct and Indirect taxation; or
- Monetary Union (EMU).³⁵

EEA members do not benefit from the EU's trade agreements with other countries. If it were to adopt this model, the UK would be able to negotiate its own free trade deals with other countries. Most of Norway's free trade agreements have been negotiated through EFTA although it does have bilateral agreements with Greenland the Faroe Islands.³⁶ As they are outside the customs union, exports of goods from non-EU EEA members to the EU must comply with potentially costly customs procedures.

EEA members accept free movement of people, although there are some rights to suspend this in certain limited circumstances. EEA members make a financial contribution to the EU. EEA members must also incorporate much of EU law into their domestic legislation in return for access to the EU market:

An independent study commissioned by the Norwegian Government in 2012 calculated that, in return for its access to the EU market, Norway has had to incorporate approximately three-quarters of all EU laws into its own domestic legislation.³⁷

Liechtenstein, Norway and Iceland have no representation in any of the EU institutions and only indirect influence – including the right to be consulted – on EU proposals affecting them.

On leaving the EU, the UK would no longer be a member of the EEA. It would have to seek to rejoin EFTA and apply to join the EEA.³⁸ Continued UK membership of the EEA would require the agreement of all EEA members, including Iceland, Liechtenstein and Norway.³⁹

Advantages and disadvantages of EEA option

Some commentators have written in favour of this option. For example Wolfgang Münchau, writing in the Financial Times, argued that EEA membership was the most sensible option for the UK. This model had the advantage of existing already so would not need to be invented and would minimise the economic costs of Brexit. He noted that it would mean accepting free movement of people and would entail contributions to the EU budget.⁴⁰ A leader in the Economist said the "Norwegian option would do the least damage to the economy."⁴¹ Most studies of the economic impact of Brexit found this option would

³⁵ [EFTA website](#)

³⁶ European Parliament Research Service, [Free trade agreements between EFTA and third countries: an overview](#), April 2016, p1

³⁷ HM Government, [Alternatives to membership: possible models for the united Kingdom outside the European Union](#), March 2016, para 3.12

³⁸ House of Commons Library Briefing Paper, [Brexit: how does the Article 50 process work?](#) (p35)

³⁹ HM Government, [Alternatives to membership: possible models for the united Kingdom outside the European Union](#), March 2016, para 2.4

⁴⁰ "Brexit: The Norway option is the best available for the UK", Financial Times, 28 June 2016

⁴¹ "Adrift" [leader column], The Economist, 2 July 2016

lead to lower economic losses compared with other options.⁴² A Financial Times leader has said “the government may not like it but permanent membership of the European Economic Area is the best way of safeguarding Britain’s future as a trading power.”⁴³

There are drawbacks to the EEA option. Open Europe set these out as follows:

However, a Norway-style relationship is unlikely to be a viable long-term option for the UK. Firstly, it is a poor fit when set against the Leave side’s key arguments during the referendum campaign: restoring full control over UK immigration policy, restoring UK sovereignty over lawmaking including vis-à-vis the European Court of Justice, eliminating the UK’s financial contribution to the EU, and reducing the burden of EU legislation on business. Secondly, and perhaps just as importantly, it is unlikely that such an EU-satellite status would satisfy the national self-image of a major G7 economy with deeper trade and foreign policy links across the world, such as the UK.⁴⁴

3.5 A need for transitional arrangements?

The standard timetable for completing the Article 50 process is 2 years. This means, assuming no extension, that the UK will leave the EU in 2019. Trade negotiations often take longer than this. If the UK were to leave the EU without a new trading arrangement in place, trade would default to WTO terms. It is likely that these would be costly to some businesses. This has led to calls for a transitional agreement to cover the period between leaving the EU and the new trade deal coming into force. For example, the House of Commons Exiting the EU Committee said:

A “cliff edge” change in circumstances could be extremely disruptive in some sectors to businesses both in the UK and in the EU 27, whether it be the need to adjust to new provisions for regulatory approval, new customs requirements, or the need to adjust to new costs or restrictions in employing EU workers. The risk of a cliff edge – ie the absence of transitional arrangements – might also push some businesses to pre-empt the result of negotiations and minimise the risks to their business. For some, this could involve re-locating out of the UK or investing elsewhere in future. A period of transition, or adjustment, is a factor in most trade agreements. The Government must make clear from the outset that a period of adjustment to any change in trading arrangements or access to EU markets for UK service industries will be sought as part of the negotiations.

If final agreement is not possible by the time that the UK leaves the EU, it would be in the interests of both sides of the negotiations for an outline framework, with appropriate transitional arrangements, for the UK’s future relationship with

⁴² IFS, [Brexit and the UK’s public finances](#), IFS Report 116, May 2016, p35

⁴³ Welcome sense from UK on the customs union, Financial Times [leader column], 20 December 2016

⁴⁴ Open Europe, [As the UK searches for a post-Brexit plan, is the EEA a viable option?](#) 4 August 2016

the EU to be agreed in respect of access to the single market for goods and services and future trade policy.⁴⁵

The House of Lords EU Committee said:

Brexit will dramatically alter the UK's trading relationship with its biggest trading partner, the EU. The evidence we have heard underlines the importance of establishing transitional or interim arrangements to mitigate the shock that would follow were the UK to leave the EU under the terms of Article 50 without securing agreement on future trading relations with the EU.

A transitional agreement will therefore almost certainly be necessary. We see little evidence that agreeing a transitional arrangement would put the UK's wider interests at risk. Quite the opposite: a transitional arrangement would allow negotiations to be conducted in a less pressured environment, benefiting all concerned. We urge the Government to establish at the outset of negotiations a clear 'game plan' for a future transitional agreement, with specific proposals as to what form it should take.⁴⁶

⁴⁵ Exiting the European Union Committee, [The process for exiting the European Union and the Government's negotiating objectives](#), 14 January 2017, HC815, 2016-17, paras 163 and 164

⁴⁶ House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 262-63

4. The Government's negotiating objectives

4.1 The Prime Minister's speech

The Government's negotiating objectives for Brexit were set out in a speech by the Prime Minister on 17 January.⁴⁷ The Government has also said that a White Paper will be published, although the timing of this is not yet known.

The Government has said that the UK will leave the EU single market. In her speech, the Prime Minister said that remaining in the single market would mean accepting EU rules on the four freedoms (free movement of goods, people, services and capital) without having a vote on them. It would also mean accepting the role of the European Court of Justice. The Prime Minister said staying in the single market "would to all intents and purposes mean not leaving the EU at all".⁴⁸

Instead of membership of the single market, the Prime Minister said that the UK would "seek the greatest possible access to it through a new, comprehensive, bold and ambitious free trade agreement".⁴⁹ The Prime Minister said that the agreement:

may take in elements of current single market arrangements in certain areas – on the export of cars and lorries for example, or the freedom to provide financial services across national borders – as it makes no sense to start again from scratch when Britain and the remaining Member States have adhered to the same rules for so many years.⁵⁰

The Prime Minister also said that the UK would no longer be a full member of the EU customs union as this would prevent the UK negotiating its own trade agreements. While the UK would no longer be part of the EU's Common Commercial Policy or Common External Tariff, the Prime Minister said the UK would seek a customs agreement with the EU. She said:

I know my emphasis on striking trade agreements with countries outside Europe has led to questions about whether Britain seeks to remain a member of the EU's Customs Union. And it is true that full Customs Union membership prevents us from negotiating our own comprehensive trade deals.

Now, I want Britain to be able to negotiate its own trade agreements. But I also want tariff-free trade with Europe and cross-border trade there to be as frictionless as possible.

⁴⁷ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017. The Secretary of State for Exiting the EU, Rt Hon David Davis MP, made a statement to the House of Commons on the same date. See [HC Deb 17 January 2017 cc792-822](#)

⁴⁸ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017.

⁴⁹ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017

⁵⁰ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017

That means I do not want Britain to be part of the Common Commercial Policy and I do not want us to be bound by the Common External Tariff. These are the elements of the Customs Union that prevent us from striking our own comprehensive trade agreements with other countries. But I do want us to have a customs agreement with the EU.

Whether that means we must reach a completely new customs agreement, become an associate member of the Customs Union in some way, or remain a signatory to some elements of it, I hold no preconceived position. I have an open mind on how we do it. It is not the means that matter, but the ends.

And those ends are clear: I want to remove as many barriers to trade as possible. And I want Britain to be free to establish our own tariff schedules at the World Trade Organisation, meaning we can reach new trade agreements not just with the European Union but with old friends and new allies from outside Europe too.⁵¹

Leaving the EU's Common External Tariff means the UK will need to establish its own schedule of tariffs at the WTO.⁵²

The Prime Minister said that while she was confident a good deal with the EU could be reached, because it would be "economically rational" for both sides, the Government would not accept a bad deal. The Prime Minister said:

I am equally clear that no deal for Britain is better than a bad deal for Britain.⁵³

No deal would mean trading with the EU on WTO rules.

On the question of transitional arrangements, the Prime Minister said that it was in nobody's interests for there to be a "cliff edge". The Government would not be seeking "some form of unlimited transitional status". The Prime Minister said:

Instead, I want us to have reached an agreement about our future partnership by the time the 2-year Article 50 process has concluded. From that point onwards, we believe a phased process of implementation, in which both Britain and the EU institutions and member states prepare for the new arrangements that will exist between us will be in our mutual self-interest. This will give businesses enough time to plan and prepare for those new arrangements.

This might be about our immigration controls, customs systems or the way in which we co-operate on criminal justice matters. Or it might be about the future legal and regulatory framework for financial services. For each issue, the time we need to phase-in the new arrangements may differ. Some might be introduced very quickly, some might take longer. And the interim arrangements we rely upon are likely to be a matter of negotiation.⁵⁴

⁵¹ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017

⁵² Stephen Booth, [Open Europe responds to Theresa May's speech](#), 17 January 2017

⁵³ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017

⁵⁴ [The Government's negotiating objectives for exiting the EU](#), Speech by the Prime Minister, 17 January 2017

4.2 Reaction to the Government's negotiating objectives

The Government's proposals received a mixed reaction. Open Europe commented that it was "pleased by her position on free trade and immigration which appeared sensible and constructive."⁵⁵ The proposals were welcomed by Shanker Singham, of the Legatum Institute.⁵⁶ The Financial Times, which had opposed Brexit, said the speech provided welcome clarity but "leaves many details to be decided".⁵⁷

Others were more critical, however. For example, Peter Holmes, a trade expert at Sussex University, said that the Government was putting sovereignty before economic considerations. He went on to say:

The eventual deal will depend above all on what the EU-27 are willing to offer, which is likely to be at best a fairly shallow Canada-style FTA and at worst, and looking increasingly likely, MFN terms. The key question is whether this can be achieved before 2019 and if not whether a transition arrangement can be negotiated to avoid a "messy Brexit" on day one.⁵⁸

The Prime Minister's speech raised a number of issues, including:

- How realistic is the Government's timetable for the negotiations?
- How will the proposed customs arrangements work?
- What are the implications for the economy?

Timetable

Some commentators believe that the two year timetable for negotiating the UK's future trading arrangements with the EU is optimistic. Trade agreements can take several years to negotiate. The Government has argued that the UK and EU have a common interest in negotiating an agreement. Also, negotiations would start from a position of close integration between the EU and the UK. The aim of the negotiations would be to loosen this to some extent. As the Treasury Committee note, this is different from most trade negotiations which aim to increase economic co-operation.⁵⁹ This factor might help in the negotiations. On the other hand, some EU countries may have domestic political incentives to drive a hard bargain with the UK.

John Kerr, a former UK representative at the EU and Foreign Office official, has said that two years will not be long enough to translate the principles governing the UK's future trading relationship with the EU into practice and that "detailed new trade terms cannot be agreed

⁵⁵ Stephen Booth, [Open Europe responds to Theresa May's speech](#), 17 January 2017

⁵⁶ [Trade experts point to a problem with Theresa May's Brexit strategy](#), Newsweek, 17 January 2017

⁵⁷ May's bold vision of Britain after Brexit [leader], Financial Times, 18 January 2017

⁵⁸ Peter Holmes, [Reaction to PM Theresa May's Brexit speech](#), UK Trade Policy Observatory, 17 January 2017

⁵⁹ Treasury Committee, [The economic and financial costs and benefits of the UK's EU membership](#), HC 122, 27 May 2016, para 149

sector by sector and ratified in two years.”⁶⁰ A leader in the Economist said that the EU has never concluded a trade agreement in two years.⁶¹

Michel Barnier, the European Commission’s chief Brexit negotiator, has said that trade talks will take place only once the terms of the UK’s exit from the EU have been agreed. He said on Twitter:

Agreement on orderly exit is pre-requisite for future partnership.⁶²

This approach was described by the Financial Times as “divorce first, trade talks after.”⁶³ The Government has said that this does not seem practical:

Mr Peter Lilley (Hitchin and Harpenden) (Con)

Will the White Paper highlight the words of article 50, which says that the Union must

“negotiate and conclude an agreement...taking account of the framework for its future relationship”

with the UK? It is therefore impossible to start negotiations unless one has an outline agreement on what that framework should be. Only two frameworks are possible—a continuation of free trade, or a move to trading on most favoured nation terms. Will we press our partners to clarify that right at the beginning of the negotiations?

Mr Davis

We already have done. In my one meeting with Mr Barnier, he talked about a sequential approach, which does not seem practical to me. It really is not possible to reach an outcome on either of the negotiations without a clear idea of the trade aspect of the negotiations. My right hon. Friend’s description is pretty accurate. I have said in terms that we intend all of this to be concluded within the two years.⁶⁴

The Lords EU Committee recommended that the issue of whether the trade relationship would be included in the Article 50 negotiations be clarified:

The Government has made clear its desire to open negotiations on the future trading relationship between the UK and the EU as part of the withdrawal negotiations under Article 50. This desire will only be fulfilled if both sides agree. Before triggering Article 50, the Government must, as a priority, seek confirmation from all parties that the framework for a future trading relationship will be included within the Article 50 negotiations.⁶⁵

⁶⁰ John Kerr, The tortuous business of negotiating Brexit, Financial Times, 26 January 2017

⁶¹ A hard road, The Economist, 21 January 2017

⁶² [Michel Barnier Twitter](#)

⁶³ Barnier sticks to ‘divorce first, trade talks later’ mantra, Financial Times, 17 January 2017

⁶⁴ [HC Deb 26 January 2017 c421-2](#). Also the Financial Times reported that the Spanish Foreign Minister was sympathetic to a trade agreement being negotiated alongside the separation talks (Spain backs early trade talks in Brexit negotiations, 26 January 2017)

⁶⁵ House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 173

The Exiting the EU Committee called for the UK's future relationship with the EU to be negotiated alongside the Article 50 negotiation but noted that this would require the agreement of both sides:

The UK's future relationship with the EU should be negotiated in parallel with the Article 50 negotiation so that there is clarity about both the divorce settlement and the new relationship at the moment we formally leave the EU. This would appear to be the intention of the wording of Article 50 and it would be in the best interests of both the UK and the EU-27 were this to be the case. However, this will not be in the Government's gift to deliver; the sequencing of negotiations in this way will require the agreement of both sides in the negotiations.⁶⁶

Customs union

The Prime Minister's speech did not go into detail about the proposed customs agreement with the EU but raised a number of questions. WTO rules on customs unions require "substantially all trade" to be covered. This means a sectoral deal could be open to challenge at the WTO,⁶⁷ although countries are often unwilling to challenge agreements in case their own come under scrutiny. There could also be technical and political problems. Would rules of origin checks be needed on UK-EU trade?⁶⁸ How would the sectors in the custom union be defined? There may also be political opposition in Europe to any attempt to unpick the customs union.⁶⁹

Economic effects

The economic effects of Government's plans will depend on a number of factors including the nature of the trade agreement reached with the EU and the ability of the UK to take advantage of new trading opportunities with non-EU countries. A trade agreement with the EU is unlikely to give the same level of access to the EU market as membership of the single market and customs union. The Lords EU Committee observed:

Even the most advanced FTAs do not provide the level of market access for goods that the UK currently enjoys by virtue of membership of the Single Market. We also note that providing equivalent liberal market access for services in a FTA with the EU would be unprecedented.⁷⁰

As noted by the Economist, "Brexit will impose costs and ... a hard Brexit will make them heavier."⁷¹ Studies carried out before the referendum generally showed that remaining in the single market was the least economically harmful option. A study by the Institute for Fiscal Studies said:

⁶⁶ Exiting the European Union Committee, [The process for exiting the European Union and the Government's negotiating objectives](#), 14 January 2017, HC815, 2016-17, para 10

⁶⁷ [UK-EU trade deal: Another WTO issue](#), BBC website, 22 January 2017

⁶⁸ [Trade experts point to a problem with Theresa May's Brexit strategy](#), Newsweek, 17 January 2017

⁶⁹ Theresa May's version of post-Brexit trade puzzles experts, Financial Times, 23 January 2017

⁷⁰ House of Lords European Union Committee, [Brexit: the options for trade](#), 5th Report of 2016-17, HL Paper 72, 13 December 2016, para 163

⁷¹ Doing it the hard way, The Economist, 21 January 2017

most of the models suggest that the more we can replicate current access to the single market – for example, by membership of the EEA – the lower the cost of exit will be. By contrast, the further we move from that model – for example, relying on World Trade Organisation (WTO) rules – the greater the cost.⁷²

While the Government has said that a good trade deal between the UK and EU is possible as it is in the economic interests of both parties, there are also political implications. The Maltese Prime Minister has said that any deal “needs to be inferior to membership”.⁷³

The Government is seeking, via its proposed “bold and ambitious” trade agreement with the EU, to minimise the costs of leaving the single market. At the same time, it wishes to maximise trading opportunities outside the EU by striking new trade deals. Whether the latter can outweigh the former remains to be seen.

⁷² IFS, [Brexit and the UK's Public Finances](#), IFS Report 116, May 2016, p5

⁷³ UK Brexit deal with EU must be ‘inferior to membership’, Financial Times, 18 January 2017

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