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Brexit and External Differentiation in Single Market Access

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Abstract

This policy brief develops two possible scenarios (closer vs. looser cooperation) of a future EU–UK economic relationship. After analysing how they fit into the existing EU landscape of external differentiation, it assesses these two scenarios in terms of effectiveness – defined as the capacity to reduce economic disruption – and their potential effects on the EU’s political unity. The paper concludes that the scenario of closer cooperation is superior in its capacity to minimise economic harm both for the UK and for the EU, and to provide a climate for long-term economic cooperation. Regarding the impact on EU cohesiveness, we contend that the biggest threat to its unity would be an “unbalanced” agreement providing a level of advantages not matched with a corresponding set of obligations. This could spark desires for more differentiation among EU member states and trigger third-country demands to renegotiate existing EU regimes of external differentiation.

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Executive summary

The UK's withdrawal from the EU is the first major instance of European disintegration. Following Brexit in January 2020, the UK and the EU have entered into complex negotiations of their future economic relationship. With little convergence in negotiation positions so far and overshadowed by the COVID-19 crisis, a "no deal" exit cannot be excluded. At the same time there are pressures on both sides to come to an agreement in order to avoid major economic distortions.

Given the current negotiation positions, the respective "red lines" as well as existing EU regimes of third countries' access to the Single Market, this policy brief develops two possible scenarios (closer vs. looser cooperation) for what such a future EU–UK economic relationship could look like. The scenario of closer cooperation mirrors the EU's negotiating position, central elements of the withdrawal agreement's political declaration and the expected new institutional framework agreement of the EU with Switzerland. It includes a comprehensive governance system and considerable level playing field obligations for the UK in exchange for broad market access. The scenario of looser cooperation is built upon the UK's negotiating position which borrows from existing free trade agreements between the EU and countries such as Canada and Japan. It is driven by the UK government's objective of regaining economic and political sovereignty.

The policy brief assesses these two scenarios in terms of effectiveness – defined as the capacity to reduce economic disruption – and their potential effects on the EU's political unity. It finds that the scenario of closer cooperation is clearly preferable to minimise economic distortions both for the UK and for the EU, and to foster long-term economic cooperation. Regarding the impact on EU cohesiveness, the biggest threat to its unity would be an "unbalanced" agreement providing a level of advantages not matched with a corresponding set of obligations. Such an agreement would likely lead to calls for more differentiation among EU member states and create third-country demands to renegotiate the conditions of existing EU regimes of external differentiation, which could be difficult to manage in the long term.

Given the persistent divergences between the EU and UK negotiation positions, it is difficult to provide clear policy recommendations for the way forward. Our findings however suggest that the EU should prioritise a balanced agreement in terms of rights and obligations over other negotiating objectives. In the absence of a last-minute turn towards close cooperation, it should accommodate the UK's strong preference for a loose cooperation agreement while leaving – as much as possible – the door open to a further reinforcement of the economic relationship. It should also make sure that the future EU–UK deal includes effective mechanisms to address potential disagreements in the interpretation of the agreement, so as to avoid a climate of mistrust which could endanger cooperation over time.

Introduction

After having agreed on the terms of its withdrawal from the Union, the United Kingdom (UK) and the European Union (EU) have embarked on the complex negotiations of the future EU–UK economic relationship. With the COVID-19 crisis drawing attention away from Brexit and the UK government refusing so far to extend the one-year transition period, the outcome of these negotiations is very uncertain and the prospect of a “no deal” cliff-edge exit is becoming increasingly likely. At the same time there seems to be a general consensus on the need to avoid major economic distortion by establishing some kind of economic partnership.

This policy brief explores what such a future partnership could look like by developing two possible scenarios (closer vs. looser cooperation) based on the analysis of current UK and EU negotiation positions. The paper discusses how these two scenarios would fit into existing EU models of external differentiation. Subsequently, it assesses how they would score in terms of effectiveness – understood in this paper as the capacity to minimise economic disruption for both sides and support a fruitful economic cooperation – and how they would affect the EU’s political unity. We conclude that the scenario of closer cooperation is clearly preferable to minimise economic harm both for the UK and for the EU, and foster long-term economic cooperation. As for the impact on the EU’s cohesiveness, we contend that the biggest threat to its unity would be an “unbalanced” agreement providing a level of advantages not matched with a corresponding set of obligations. This could spark desires for more differentiation among EU member states and create third-country demands to renegotiate existing regimes of external access to the Single Market.

1. The complex landscape of external differentiation in Single Market access

Today’s landscape of EU economic external differentiation is very complex. Over time, the Union has negotiated different agreements with various neighbouring countries and trade partners, leading to a wide variety of modes and degrees of access to the European Single Market.¹ To make this complexity manageable for this policy brief, we distinguish three levels of Single Market access particularly relevant for the ongoing negotiations: (1) the European Free Trade Area (EFTA) states, (2) members of the EU Customs Union(s), and (3) signatories of comprehensive free trade agreements (FTAs). These three levels presented below are organised according to the extent

1 For a more detailed description of the different existing types of arrangements see the following literature: EEA (Egeberg and Trondal 1999, Gstöhl and Frommelt 2017), EU–Swiss bilateral agreements (Vahl and Grolimund 2006, Schimmelfennig 2014, Jenni 2015), EU Customs Union agreements (Willems and Kamau 2019, Müftüler-Baç 2017, Karakas 2013), deep and comprehensive free trade areas (DCFTAs) (Van der Loo 2016), Stabilisation and Association Agreements (SAAs) (Osbold and Bartlett 2019), comprehensive FTAs (D’Erman 2016, Frenkel and Walter 2017).

and depth of their integration in the Single Market.²

The most integrative level includes all the four member states of the *EFTA*. Three of them (Norway, Iceland, Liechtenstein) fully participate in the Single Market via the European Economic Area (EEA), while the fourth country, Switzerland, has concluded a large number of bilateral agreements with the EU. EEA countries are obliged to dynamically align their legislation to the evolving EU *acquis*. Implementation is guaranteed by a two-pillar structure that emulates key EU institutions, in which the EFTA Surveillance Authority and the EFTA Court have equivalent functions to the European Commission and the European Court of Justice (ECJ). While not directly subjected to the ECJ, these institutions “shall pay due account” to the principles laid down by its relevant decisions. In the case of Switzerland there are generally no mechanisms to guarantee dynamic alignment but in practice the so-called “guillotine clause” (the possibility for the EU to end a considerable number of agreements simultaneously in case of non-alignment) constitutes a powerful leverage to ensure that Swiss legislation remains aligned to the European counterpart.

A more intermediate level comprises all those countries that are part of the *EU Customs Union(s)* (Turkey, Andorra, San Marino) but are not part of the Single Market. These countries benefit from tariff-free movement of goods and are not able to fix their own individual tariffs with other third countries. They commit to align most of their technical goods regulation with the EU in order to simplify cross-border trade and assume some level playing field obligations in limited areas.³ Customs Union agreements, however, do not or only marginally cover services. Neither do they include effective dispute settlement mechanisms to resolve conflicts.

The least integrative level covers *comprehensive FTAs*, or *CFTAs*, which the EU has established with countries such as Canada and Japan in recent years. While allowing each signatory to continue independent trade policies with other countries, these agreements go beyond “classic” FTAs by containing more comprehensive level playing field commitments. These include, for example, non-regression clauses and requirements to enforce domestic rules in policy areas such as competition policy. While being governed by joint committees, there are generally few means to ensure rule alignment over time.

2 Beyond the three levels of third-country access to the Single Market, there are several other forms of external differentiation that are, however, less relevant for the two scenarios that are discussed in this policy brief. Among them are the so-called DCFTA agreements with Ukraine, Georgia and Moldova, as well as SAAs with six Western Balkans countries. In terms of Single Market access, they take on a more intermediate status between the EFTA states and the signatories of comprehensive FTAs. Depending on the specific policy areas, especially the DCFTAs also contain a comparatively high level of integration. The fragmented nature of these complex agreements and the differences between, e.g., Ukraine and the UK in terms of economic size and development, however, make DCFTAs less suitable as a basis for the negotiations of the new EU–UK economic partnership.

3 For instance, Turkey is required to implement EU rules on intellectual property rights and on merger control, and enforce EU rules on collusive and monopolistic practices and behaviour. It was also obliged to create a State Aid Monitoring and Supervision Board to align the control of state aid with the EU framework but at present the law is only partially enforced (see Hakura 2018).

The experience with these various regimes of external differentiation has influenced the EU preferences for any future EU–UK agreement. In particular, the high degree of complexity and practical difficulties to govern different arrangements is seen as problematic.⁴ This explains recent EU efforts to harmonise regimes while strengthening their governance. The ongoing renegotiations of the Custom Union agreements with the microstates Andorra, San Marino and Monaco,⁵ as well as the not yet ratified new institutional framework agreement negotiated with Switzerland (Framework Agreement 2018)⁶ exemplify this new approach. In both cases, there is an effort to render the various regimes more similar to the EEA regime (albeit without copying its two-pillar structure).⁷ This implies the establishment of a unified institutional framework, the introduction of dynamic alignment obligations to the evolving EU *acquis* in key areas, the creation of effective dispute settlement mechanisms securing a role for the ECJ in the interpretation of EU law and, generally speaking, securing an appropriate balance of rights and obligations to participate in the Single Market.

2. The EU and UK negotiating positions

Whereas existing EU regimes of external economic differentiation are driven by both parties' willingness to strengthen their economic ties, Brexit constitutes the first clear example of a process of disintegration (see Schimmelfennig 2018, Leruth et al. 2019). In this respect, existing regimes of third-country access to the Single Market can offer some guidance but cannot be taken as true templates for the future EU–UK relationship. The latter will be strongly shaped by both parties' preferences as regards the level of detachment and cooperation, encapsulated into their respective negotiating mandates.

The *UK Government (2020: 3ff)* has set a clear preference for a level of autonomy and limited obligation that suggests a *CFTA similar to the EU agreements with Canada and Japan*. This would cover trade in goods but, unlike the agreements with Canada and Japan, would also include regulations to facilitate trade in services (a key element for a service-based economy such as the UK). It would exclude the free movement of persons and would allow the UK to develop its own trade agenda.

Under this regime, the UK would only abide by *limited level playing field obligations*. There would be a vague commitment not to weaken or reduce the level of protection in areas such as social, labour or environmental policy and to avoid major regulatory divergence in areas such as competition policy, state aid or the regulation of

4 Interview DG Trade, Brussels, 27 February 2020; Interview EU Institution, 4 March 2020.

5 Interview Swiss EFTA/EP Delegation (phone interview), 12 March 2020; Interview EU Institution, 4 March 2020.

6 This new framework agreement between the EU and Switzerland has been negotiated from 2014 to 2018.

7 Interviews EEA Joint Parliamentary Committee (phone interviews), 26 February 2020, 23 March 2020.

financial services.⁸ Regarding its *governance*, the UK proposes the adoption of separate bilateral agreements covering different policy areas (trade, fisheries, judicial cooperation, etc.) rather than a unified institutional framework. It envisages the establishment of dispute resolution mechanisms but *explicitly refuses any role for the ECJ in these mechanisms* (not even as an interpreter of EU law). Besides, many issues (competition policy, subsidies, labour and environment, taxation) would be excluded from the dispute resolution mechanisms, “in line with precedent such as CETA and the EU-Japan EPA” (UK Government 2020: 15).⁹

Contrary to the UK (under the leadership of Boris Johnson), the EU has always expressed its desire to have as close as possible a partnership with the United Kingdom. The 2019 Political Declaration linked to the EU–UK Withdrawal Agreement reflected this ambition to a considerable extent (UK Government 2019: 2, 23-24). Yet, confronted with the UK government’s recent turn in its negotiating position towards firm rejection of any deeper forms of integration, the EU has developed its own vision of the future EU–UK agreement. The EU envisages an *EU–UK comprehensive economic agreement* that would go considerably beyond a CFTA. The EU argument for treating the UK differently considers the geographic proximity, the size of the British economy and the strong EU–UK trade links. The EU has made it clear that a privileged access to the Single Market would only be possible if the UK makes *robust commitments to ensure a level playing field* in certain areas (state aid, competition, social, labour, environment, etc.). In particular, the agreement should include an obligation to *dynamic alignment to the EU acquis* for competition policy and non-regression clauses for the other policy areas. Besides, the EU would like the governing body of the future agreement to be able to “modify level playing field commitments in order to include additional areas or to lay down higher standards over time” (European Commission 2020a).

Finally, the EU has a strong preference for a unified institutional framework and considers it essential to include appropriate mechanisms for its implementation and *dispute settlement*. The latter should be based on an independent arbitration panel, including a role for the ECJ “as the sole arbiter of Union law”¹⁰ for the policy areas covered by dispute settlement (UK Government 2019: 24).

8 The UK negotiating mandate proposes to establish general principles guiding EU and UK competition policy (such as transparency and non-discriminatory treatment) and to include a system of mutual information and transparency to monitor state aid, similar to that included in the Comprehensive Economic and Trade Agreement (CETA) and the EU–Japan Economic Partnership. For the financial services sector, “the agreement should include legally binding obligations on market access and fair competition, in line with recent CETA precedent” and entail “appropriate consultation and structured processes for the withdrawal of equivalence findings” (UK Government 2020: 13).

9 Interestingly, the UK negotiating mandate for a UK–US FTA, which has been published in March 2020, actually demands a number of institutional mechanisms from the US, which the UK does not want to grant the EU. The British side, for example, asks the US for “appropriate mechanisms for the implementation, monitoring and dispute resolution of environmental and labour provisions” in any deal (UK Dept for International Trade 2020: 11, Kane 2020).

10 In case of disagreements on the interpretation of EU law, the arbitration panel would have to refer to the ECJ and its ruling would be binding. In case of non-compliance of one of the contracting parties, according to the EU negotiating mandate the other party would then “be entitled to request financial compensation or take proportionate and temporary measures” in response (European Commission (2020a: Annex: 24).

3. Scenarios for the future EU–UK economic partnership

Based on the respective negotiating mandates, as well as recent trends in the organisation of third-country participation in the Single Market (Eisl and Fabry 2020), we can draw up two possible scenarios for the post-Brexit relationship between the EU and the UK.

3.1 A scenario of closer cooperation

The first scenario consists of an agreement which largely resembles the still unratified new framework agreement of the EU with Switzerland. This scenario would largely correspond to the EU's preferred model. There would, however, be some room for concessions from the Union's side to make it acceptable for the UK government without undermining the overall logic of this type of arrangement. It is possible that, seeing difficulties in reaching an agreement on some sectoral areas (e.g., fisheries), the EU could renounce the establishment of a unified governance framework and sign a separate economic agreement.¹¹ In addition, the EU could weaken the level playing field requirements by excluding some parts of social, labour and environmental policies from non-regression clauses, while keeping the most central elements (competition, state aid, state-owned enterprises) bound to the evolving EU *acquis*. Finally, it could also be possible to grant the UK some sort of "decision-shaping" influence in EU policy-making, similar to the EEA member states and the new agreement with Switzerland.

3.2 A scenario of looser cooperation

The second scenario would be the signature of a CFTA similar to the one with Canada. This would be closer to the UK position and come with looser level playing field commitments for the UK. For such an approach to be acceptable to the EU, the UK would have to agree on "less than frictionless" trade, including barriers on certain products and, especially, services. Besides, if the UK rejects any direct role of the ECJ in dispute settlement, the EU will probably demand other guarantees such as the right to unilaterally suspend concessions if the UK does not respect level playing field commitments (see Lowe 2020). Finally, the agreement would be set as a separate act, without any unified governance structure covering all cooperation agreements with the UK.

11 Even in this case, the EU would still demand a role for the ECJ in conflict arbitration, as this is also part of the new EU–Swiss framework agreement.

4. The effectiveness of the two scenarios

How effective would these two scenarios be? Any future EU–UK economic relationship would have to be judged according to its capacity to minimise economic disruption and foster long-term economic cooperation. From this perspective, the first scenario seems clearly superior. Given the UK’s geographical position and the level of economic interdependence with the Union, a closer cooperation arrangement would imply much less economic harm both for the Union and the UK (European Commission 2020b, Raess 2020, UK Government 2018).

Besides, Northern Ireland will remain – de facto – in the EU Single Market for goods until 2024, or later, according to the terms of the EU–UK withdrawal agreement (see Hayward and Phinnemore 2020). An agreement with the rest of the UK which does not depart too far from the Northern Ireland solution would thus help to facilitate economic exchanges both within the UK territory and across the Irish border.

More broadly, the looser cooperation scenario would allow the UK to considerably diverge from the EU *acquis*, which potentially undermines the conditions for a long-term economic cooperation. Even if the UK government does not use this capacity to significantly lower social, environmental or labour standards (turning the UK into a “Singapore-on-Thames” economy), the introduction of changes in UK regulation and the lack of effective mechanisms to address potential disagreements in the interpretation of level playing field obligations may create a climate of mistrust and ultimately endanger cooperation over time.¹²

Finally, experiences with different forms of external differentiation have shown clear limits to the effectiveness of arrangements that are fragmented and do not have a unified governance structure.¹³ Even the most integrated form of external differentiation, the EEA, has had recurring issues to ensure homogeneity in the application of Single Market legislation across all participants (see Frommelt 2017). That is why recent EU attempts to renegotiate the arrangements of third-country access are generally aimed at creating an overarching institutional framework. The ultimate aim is to ensure a consistent interpretation of EU law and dynamic alignment with the EU *acquis*. The scenario of closer cooperation laid out above ensures such coherence considerably better than a CFTA.

5. The scenarios’ impact on EU political unity

There has been much debate about the potential effects of Brexit for the future of European integration, with some scholars pointing out possible centripetal and centrifugal effects (Cini and Verdun 2018). So far, Brexit negotiations have –

12 In the absence of any stringent level playing field requirements, the current coronavirus crisis might actually foster rapid regulatory divergence between the EU and the UK, particularly regarding state aid.

13 Interview DG Trade, Brussels, 27 February 2020; Interview EU Institution, 4 March 2020.

somehow unexpectedly – fostered cohesiveness among the remaining EU27. The complexity of Brexit negotiations has led to a realisation of the high economic and political costs of departure, muting calls for exiting among other Eurosceptic actors across the Union (see Chopin and Lequesne 2020). Unity among the EU27 governments has also persisted during the first months of negotiations on the future EU–UK economic relationship. It is, however, possible that this unity cannot be firmly maintained throughout the whole negotiation process. This could be particularly the case if the EU and the UK negotiate a comprehensive FTA, a process that would involve taking decisions on which specific sectors are open to trade with the UK, which may differently affect national vested interests. However, another question is which of the two scenarios (close vs. loose cooperation) would constitute a bigger threat for the EU’s unity once adopted.


In our view, the greatest risk to the Union’s unity would be to sign an “unbalanced” economic agreement, providing a level of advantages not matched with a corresponding set of obligations. A blurring of differences between the rights of member states and non-member states, which normally justify different levels of requirements, could unleash centrifugal forces inside the EU. In addition, it could also raise similar demands from other third countries, whose participation in the Single Market comes with a considerable set of obligations, and harm ongoing renegotiations of third-country access (see Eisl and Fabry 2020). Interviews with political decision-makers from Norway and Switzerland, for example, have shown that these countries observe the outcome of the EU–UK negotiations very closely and will draw their own conclusions for their future relationship with the EU.¹⁴ Of the two scenarios envisaged here, there is no strong evidence to affirm that the risk of an unbalanced agreement will be more pronounced under the scenario of looser cooperation than that of close cooperation. Existing forms of external differentiation illustrate this point. While the close economic relationship of Switzerland with the EU has been called a “cherry-picked” arrangement,¹⁵ subsequently leading to renegotiation pressures from the European side, looser forms of Single Market access such as CETA have not been deemed to contain an unbalanced approach to rights and obligations.

6. Outlook

Finding an agreement on the future EU–UK economic relationship will be difficult as there are important elements opposing the two negotiating partners. The EU’s room for manoeuvre is, first and foremost, limited by its adherence to the protection of the Single Market. But it is also constrained by the complex and fragile web of existing forms of external differentiation in the field of economic policy. The UK’s leeway for compromise is limited by political preferences towards preserving a high level of regulatory autonomy even at the cost of economic damage. Against this

14 Interview EEA Joint Parliamentary Committee (phone interview), 26 February 2020; Interview Swiss EFTA/EP Delegation (phone interview), 12 March 2020.

15 Interview DG Trade, Brussels, 27 February 2020.



background, and providing that – at the moment of writing – the UK government insists that it will not ask for an extension of the Brexit transition period, the “no deal” scenario remains a plausible outcome of the ongoing negotiations.

The current COVID-19 crisis creates additional uncertainty. On the one hand, it could lead the UK side to give in to the demands of the EU to avoid adding the bigger economic short-term costs of a looser cooperation to the already massive economic impact of the pandemic. On the other hand, it could also create an opportunity for the UK government to “hide” the costs of a looser economic relationship or no agreement with the EU in the large costs of the crisis.

If, despite these obstacles, an agreement on a future EU–UK economic partnership is reached, this policy brief has argued that a closer form of external differentiation, similar to the new framework agreement the EU has negotiated with Switzerland, would be preferable to the signing of an EU–UK comprehensive free trade agreement. It would create less economic distortions and create a climate favourable for long-term economic cooperation.

The paper also shows that the future EU–UK economic partnership will probably be a *sui generis* arrangement, different from any other existing model of external differentiation. Any post-Brexit agreement will have to allow for some recognition of the special status of the UK as a former EU member state, which could demand some concessions beyond those usually granted to other third countries. At the same time, to hold at bay criticisms from other third countries deeply integrated in the EU Single Market (see Eisl and Fabry 2020), the new partnership will have to be balanced in its rights and obligations. Otherwise, it would likely lead to calls for more differentiation among EU member states and create demands from third countries to renegotiate the conditions of their access to the Single Market, which could be difficult to manage in the long term.

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Differentiation has become the new normal in the European Union (EU) and one of the most crucial matters in defining its future. A certain degree of differentiation has always been part of the European integration project since its early days. The Eurozone and the Schengen area have further consolidated this trend into long-term projects of differentiated integration among EU Member States.

A number of unprecedented internal and external challenges to the EU, however, including the financial and economic crisis, the migration phenomenon, renewed geopolitical tensions and Brexit, have reinforced today the belief that **more flexibility is needed within the complex EU machinery**. A Permanent Structured Cooperation, for example, has been launched in the field of defence, enabling groups of willing and able Member States to join forces through new, flexible arrangements. Differentiation could offer a way forward also in many other key policy fields within the Union, where uniformity is undesirable or unattainable, as well as in the design of EU external action within an increasingly unstable global environment, offering manifold models of cooperation between the EU and candidate countries, potential accession countries and associated third countries.

EU IDEA's key goal is to address **whether, how much and what form of differentiation is not only compatible with, but is also conducive to a more effective, cohesive and democratic EU**. The basic claim of the project is that differentiation is not only necessary to address current challenges more effectively, by making the Union more resilient and responsive to citizens. Differentiation is also desirable as long as such flexibility is compatible with the core principles of the EU's constitutionalism and identity, sustainable in terms of governance, and acceptable to EU citizens, Member States and affected third partners.



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