Institute for Public Policy Research

THE SHARED MARKET

A NEW PROPOSAL FOR A FUTURE PARTNERSHIP BETWEEN THE UK AND THE EU

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INTRODUCTION AND EXECUTIVE SUMMARY

The UK is set to leave the EU in March 2019. There are now only 15 months until the date for Brexit, notwithstanding the unlikely scenario that the Article 50 deadline is extended. Yet the government is divided on the nature of the UK's post-Brexit relationship with the EU. With the first stage of the negotiations now complete and discussions set to turn to the future partnership, now is the time for the UK to decide what it wants for its long-term future outside of the EU.

Over the past year and a half since the referendum result, there has been a great deal of sound and fury about the destination of Brexit and the UK's future trading relationship with the EU. The debate has been conducted almost wholly within Britain's economic and political elite. It has become increasingly mired in confusion over language, far-fetched claims, and divisive accusations. The very terms used – "staying in" versus "access" to the single market – have led to a confused and circular debate.

As things stand, the UK and the EU have made 'sufficient progress' on the three initial issues identified in the Brexit negotiations: citizens' rights, the financial settlement, and the framework for dealing with the circumstances of Northern Ireland. The stage is now set to move on to the next phase of the negotiations: discussing the transition arrangements and the framework for the UK and the EU's future partnership. But, despite the eagerness of the UK government to move on to the next phase of talks, it has not yet offered a clear and consistent vision of how a future partnership could work in a way that is politically sustainable, avoids a cliff edge, and secures our long-term economic future.

A strategy that is political sustainable and brings the country together should aim to address the main concerns of Leave voters – particularly on immigration and sovereignty – while also protecting the main priorities of Remain voters – particularly on the economy. Many of these objectives are opposed to each other, which makes the government's task of negotiating a Brexit agreement an exceptionally difficult one. But provided that the negotiating strategy is sufficiently nuanced, and takes into account both sides of the argument, we believe there is scope for a compromise position that secures public consent.

Of course, even if the UK is able to develop a coherent strategy that unites a majority of the public, it is clear that any future agreement with the EU will require a deeply challenging period of negotiations. The European Commission and EU27 leaders have expressly stated that the four freedoms are 'indivisible' and that the UK cannot pick and choose in which aspects of the internal market it wants to participate (Barnier 2017). The UK government's own red lines – ending freedom of movement, reducing budgetary payments to the EU, removing itself from the jurisdiction of the European Court of Justice – appear incompatible with its ambitions to secure a long-term comprehensive trading partnership with the EU.

Recognising these constraints, we set out here a plan for a new UK-EU partnership that we believe would meet the UK's priorities and have the maximal chance of securing an agreement with the EU27. This plan is ambitious, and necessarily so – anything else would not be a suitable starting point for the UK's negotiating

strategy. Our proposal recognises the reality that 40 years of membership of the European Union cannot and should not be undone in the space of two years. It prioritises regulatory alignment but allows for an orderly divergence over time, if that is judged to be in the UK's interests. Under the model we propose, the implications of divergence are clear and the consequences proportionate.

We first define four types of relationship with the single market.

1. **Membership** of the single market. As a member, a country is a 'rule-maker': that is, it has a formal role in deciding the rules of the single market. Currently the only countries that are members, according to this definition, are the EU member states.
2. **Participation** in the single market. As a participant, countries abide by the rules of the single market but do not have a formal role in deciding policy – i.e. they are 'rule-takers'. Participation allows for little scope for divergence from single market rules. We include Norway, Iceland and Liechtenstein as participants in the single market. They are signatories to the Agreement on the European Economic Area (EEA), which binds participants to the four freedoms of the single market. The EEA agreement is designed to create a homogeneous set of rules and conditions of competition across the EEA EFTA states and the EU, and therefore the agreement has to be dynamic – i.e. it is continually updated to reflect additions to single market legislation.
3. **Alignment** to the single market. It is possible for a country to be outside the single market – neither a member nor a participant – and yet choose to align its regulatory regime with the EU27. Some countries outside the single market have closer relationships with the EU than a straightforward Free Trade Agreement offers, because, in the relevant areas, their legislation mirrors (or is on course to mirroring) the legislation of the EU. Alignment does not constitute such a comprehensive and intertwined relationship with the single market and allows greater scope for divergence. Switzerland and Ukraine are both examples – though in different ways – of countries that are partially aligned to the single market.
4. **Access** to the single market. This we simply define as the ability to trade with the single market. According to this definition, nearly all countries have some form of access to the single market – though of course some have better access than others through preferential trade agreements. Therefore, access alone does not constitute a close trading relationship with the single market.

We then propose a new relationship between the UK and the single market once the UK leaves the EU. First, as reflected in the European Council's Article 50 guidelines, we propose a transition arrangement based on **full participation** in the single market, in order to give the UK and the EU sufficient time to agree the future long-term partnership. This would constitute the prolongation of the EU acquis, including with respect to the four freedoms, competition-based measures, and horizontal and flanking policies. It would also require the direct supervision of the European Commission and the adjudication of the Court of Justice of the European Union. However, the UK would no longer have political representation in the EU's institutions.

In the longer term, we propose a new model of **alignment** that we describe as a 'shared market' between the UK and the EU. The 'shared market' would aim for continued alignment between the UK and the EU across most of the single market, but would recognise the potential for regulatory divergence over time. This model would have the following features.

- The agreement would stipulate that continued regulatory alignment in all aspects of the single market, with the exception of the free movement of people, is required in order to access the full benefits of the single market.

This would include regulatory alignment on competition-related measures such as state aid, intellectual property rights and public procurement, as well as horizontal and flanking policies, such as company law, consumer protection, employment rights, environmental protections, and gender equality and anti-discrimination legislation.

- With respect to the free movement of people, there would be an agreement on 'quasi-alignment' – i.e. an agreement that upholds the key principle of free movement of people while allowing new controls on immigration. This could constitute a 'safeguard measure' that allows the UK to impose temporary controls on EEA migration during periods of exceptionally high inflows, as have been experienced in recent years.
- Enforcement and dispute resolution would be carried out through a 'two pillar' mechanism modelled on the EEA agreement. A new UK Surveillance Authority and UK Court of Justice, including representatives from the UK and the EU, would monitor and adjudicate over the agreement. To ensure homogeneity, the UK Court of Justice would follow the Court of Justice of the European Union (CJEU)'s interpretation of single market rules with respect to case law up to the signing of the agreement, and would then pay due account to subsequent CJEU case law. A joint UK-EU committee would be created to resolve disputes.
- The agreement would allow for the possibility of divergence between the UK and the EU, either with respect to existing or future single market legislation. If divergence occurred, a 'declaration of incompatibility' would be issued, which would initially give either side an opportunity to realign, and, if they did not, would result in the suspension of areas of the agreement. Crucially, the extent of the suspension would be proportionate to the extent of the regulatory divergence in question. The UK-EU committee would then review the suspension after a predetermined time period (e.g. six months) to monitor if divergence remained and the suspension was still necessary.
- The UK and the EU would also agree a joint customs union to cover all goods. This would limit friction in trade in goods between the UK and the EU. In return, the UK would continue to align itself to the EU's trade policy.
- As part of the agreement, the UK would make a continued financial contribution to Europe and the EU, recognising the benefits that it would receive from these investments. This would include solidarity contributions (to help reduce regional economic and social disparities across Europe through a 'UK Grants' programme), programme contributions (to pay for programmes and agencies in which the UK continues to participate), and security contributions (to support the EU's foreign and security policy, including both financial and in-kind contributions through equipment, personnel and operational support).

This proposal would prioritise trade with by far our largest market, rather than seeking new trade deals further afield. It would also recognise that the EU has more —and better quality — trade deals (more than 50) than comparator countries to the UK such as Australia or Canada (each with around 15). A dispute resolution mechanism would both end the direct jurisdiction of the CJEU in the UK and protect the CJEU's own autonomy. And divergence would be a real choice for the UK, though it would of course have substantial consequences for trade and the economy. Such an agreement would not please everybody, and it may prove elusive in negotiations with the EU27. But it is the most plausible route for delivering a Brexit outcome that respects the vote to leave; it takes into account the priorities of the public, and at the same time protects the UK's deep and closely integrated economic relationship with the EU.

We believe this proposal could serve as a long-term model for the UK's future relationship with the EU. Nevertheless, we cannot yet know if such a model is negotiable; if the proposal set out here – or something like it – does not prove a viable option for the EU27, then both the EU and the UK government must prioritise safeguarding jobs and living standards over other considerations. A 'no deal' scenario – or a thin trade deal that represents a significant economic rupture between the UK and the EU – would be entirely insufficient for both the UK and the EU's trade needs post-Brexit. Whether or not the UK and the EU can agree a 'shared market' along the lines we discuss, it is in both sides' interests to negotiate a close and well-integrated long-term partnership.

1. WHAT ARE THE OPTIONS?

In this chapter we set out the available options for the UK's future partnership with the EU. We try to outline the options as clearly and comprehensively as possible. While we draw on the EU's relationships with third countries, we will look beyond these – aiming for a set of options that are mutually exclusive and completely exhaustive. At this stage, we do not comment on which options would be most straightforward to negotiate with the EU; we simply aim to outline the feasible alternatives available for the UK and the EU27 to pursue.

1.1 AN OVERVIEW OF THE OPTIONS

To date, the debate within the UK about its future relationship with the EU has revolved around whether the UK should "stay in the single market" or whether the UK should have "access to the single market". This terminology is imprecise and has been rather unhelpful as a result. On the one hand, the former is ambiguous: it is not clear what being "in the single market" truly means, which has led to confused claims that the UK cannot be in the single market once it leaves the EU. On the other hand, the latter is essentially meaningless, as virtually every country in the world has some form of "access to the single market". Brazil, Botswana and Belarus all have "access to the single market", albeit on very different terms to the UK today. We therefore need a different way of understanding and evaluating the UK's relationship with the single market.

There are four broad ways to understand the possible future relationship between the UK and the single market. We define them as follows.

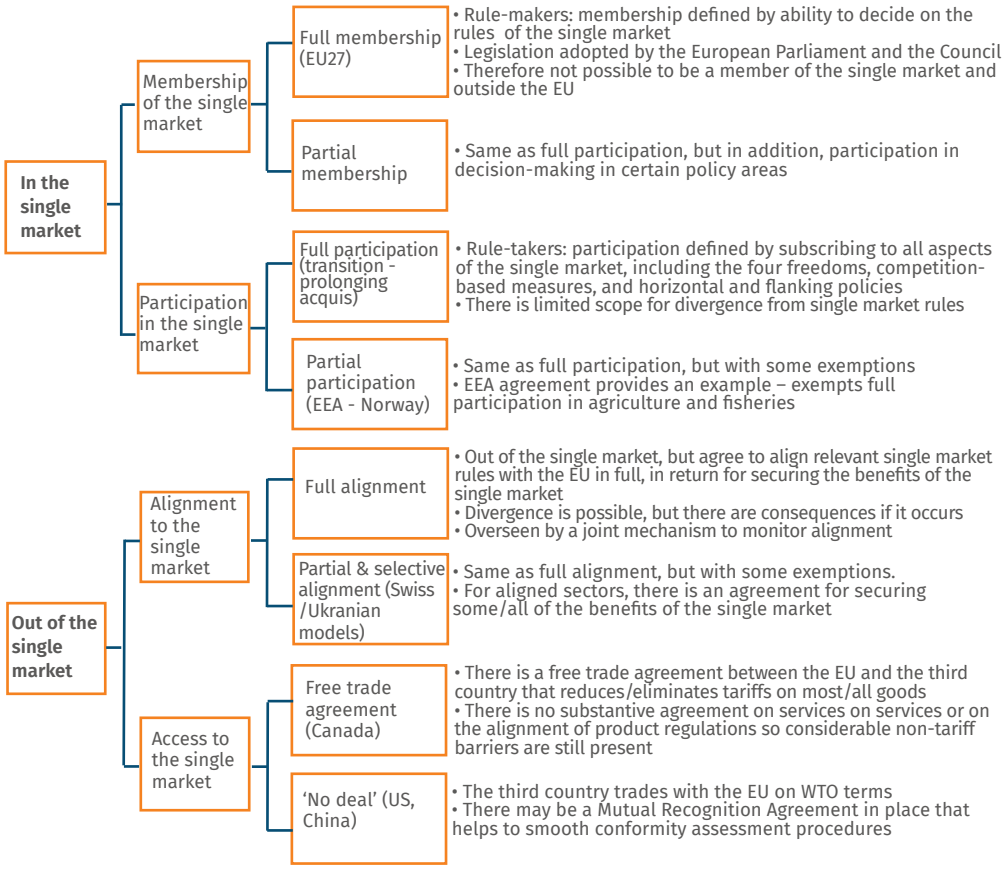
1. **Membership** of the single market. As a member, a country is a 'rule-maker': that is, it has a formal role in deciding the rules of the single market. Currently, the only countries that are members of the single market, according to this definition, are the EU member states. The rules of the single market are contained in EU legislation (the treaties and secondary legislation). They are monitored by the European Commission and interpreted and enforced by the Court of Justice of the European Union (CJEU).
2. **Participation** in the single market. As a participant in the single market, countries abide by the rules of the single market but do not have a formal role in deciding policy – i.e. they are 'rule-takers'. Participation allows little scope for divergence from single market rules. We include Norway, Iceland and Liechtenstein as participants of the single market. Along with Switzerland, these three countries are members of the European Free Trade Association (EFTA). Through their membership of EFTA, they have an agreement with the EU, known as the European Economic Area (EEA) Agreement, to participate in the single market. The EEA agreement binds participants to the four freedoms of the single market, as well as competition-related measures and horizontal and flanking policies. The EEA agreement is designed to create a homogeneous set of rules and conditions of competition across the EEA EFTA states and the EU, and therefore the agreement has to be dynamic – i.e. it is continually updated to reflect additions to single market legislation (EFTA 2017a).
3. **Alignment** to the single market. It is possible for a country to be outside the single market – neither a member nor a participant – and yet choose to align its regulatory regime with the EU27. Some countries outside the single

market have closer relationships with the EU than a straightforward Free Trade Agreement offers, because, in the relevant areas, their legislation mirrors (or is on course to mirroring) the legislation of the EU. As with membership and participation, alignment can be either full or partial. Alignment does not constitute such a comprehensive and intertwined relationship with the single market and allows greater scope for divergence. Switzerland and Ukraine are both examples – though in different ways – of countries that are partially aligned to the single market.

4. **Access** to the single market. This we simply define as the ability to trade with the single market. According to this definition, nearly all countries have some form of access to the single market – though of course some have better access than others through preferential trade agreements. Therefore, access alone does not constitute a close trading relationship with the single market.

FIGURE 1.1

Options for the single market



Source: Authors' analysis

1.2 WHAT IS THE SINGLE MARKET?

The single market is a regulatory union that serves to extend the free movement of goods, services, capital and people around the EU (and its additional participants). The single market is not 'complete' – in the sense that there are still different barriers to movement between participating countries – but it is one of the most ambitious global efforts to achieve multi-national borderless trade.

The single market is comprised of four freedoms.

1. The **free movement of goods** is achieved through the abolition of duties and quantitative restrictions on trade and other physical and technical barriers. But the free circulation of goods is not simply a question of barring tariffs: it also addresses non-tariff barriers to trade that are equivalent to duties or quantitative restrictions. This is achieved through harmonisation – that is, standardising relevant legislation across participating countries so that companies selling goods across the single market do not have to comply with different rules – and, even in situations where standards are not harmonised, through the principle of mutual recognition, which holds that any product manufactured and marketed according to the rules of one participating country must be allowed on to the market in any other (the 'Cassis de Dijon' principle) (European Parliament 2017a).
2. The **free movement of services** is achieved by allowing businesses and self-employed professionals in one participating country to establish themselves or set up agencies, branches, and subsidiaries in another ('freedom of establishment') or to provide services temporarily while staying in their home country ('freedom to provide cross-border services'), without facing discrimination on the basis of nationality. The EU has sought to guarantee these rights through 'horizontal' legislation such as the Services Directive, which aims to remove the legal and technical barriers preventing cross-border trade in services across most sectors, as well as specific legislation to guarantee free movement of services in particular sectors (European Parliament 2017b). For instance, in finance and insurance, companies authorised in one participating country are able to 'passport' certain services to other participating countries without further authorisation, via either establishing branches or providing cross-border services (Bank of England 2017).
3. The **free movement of capital** is achieved by preventing all restrictions on capital movements and payments between participating countries. It goes further than the other freedoms by also applying to capital movements between participating countries and all third countries. Capital movements include things such as foreign direct investments, real estate investments, and loans and credit (European Parliament 2017c; European Commission 2017a).
4. The **free movement of people** is achieved by ensuring that a citizen of any participating country can freely travel, reside, work, study, join family, and live self-sufficiently in any other participating country. Workers, the self-employed, jobseekers, students, 'self-sufficient persons', and family members are all guaranteed free movement rights. Those who move to and reside in a participating country legally and continuously for more than five years are granted permanent residence. The free movement of people prevents discrimination on the grounds of nationality between workers of all participating countries (European Parliament 2017d).

Alongside the four freedoms, there are a number of **competition-related measures** that are necessary for creating a 'level playing field' across the single market. These largely relate to rules to prevent anti-competitive or market-distorting practices, rules to limit the use of state aid, rules for public procurement to ensure that public sector contracts do not discriminate between suppliers, and rules to harmonise intellectual property rights within the single market, in order to protect against abuse (EFTA 2016).

There are also a series of **horizontal policies** that cut across the four freedoms and help them to operate more smoothly. These include: company law (which, for instance, helps companies in different participating countries to

merge without facing the typical legal impediments involved in international mergers), consumer protections (which ensure that all consumers within the single market are guaranteed minimum rights), employment rights and occupational health standards (which guarantee minimum protections for workers within the single market, including gender discrimination protections), environmental protections (which, for instance, ensure minimum standards in water and air quality and treatment of waste), and harmonised statistics (which ensure consistent information for monitoring social, economic, and environmental developments across the single market) (ibid).

Finally, there are a series of **flanking policies** outside the four freedoms that help to facilitate the functioning of the single market. These include: employment and social policy (including participation in employment and anti-poverty programmes), research and innovation policy (including participation in the Horizon 2020 research programme) and equality and anti-discrimination policy (including participation in gender equality and social inclusion programmes) (ibid; EFTA 2017b).

1.3 MEMBERSHIP OF THE SINGLE MARKET

We delineate two ways for a country to be 'in' the single market. First, a country can be a **member** of the single market. As a member, the country is a 'rule-maker'; that is, it has a formal role in deciding the rules of the single market.

In our view, by virtue of their rule-making status, the only countries that are meaningfully members of the single market are the EU member states. The rules of the single market are contained in EU legislation, which is for the most part jointly adopted by the Council and the European Parliament – bodies made up solely of representatives of the EU member states. They are monitored and enforced by the European Commission and interpreted and adjudicated by the CJEU.

We can consider two potential forms of membership: **full membership**, whereby a country is a member of all policy areas of the single market, or **partial membership**, where a country is a member only with respect to some policy areas. Currently there are no countries that are partial members of the single market, but for completeness we include this as an option.

1.4 PARTICIPATION IN THE SINGLE MARKET

Alternatively, a country can be a **participant** in the single market. We define participants as countries that abide by the rules of the single market but which do not have a formal role in deciding policy – i.e. they are 'rule-takers'. Participation allows little scope for divergence from single market rules.

We include Norway, Iceland and Liechtenstein as participants of the single market. Along with Switzerland, these three countries are members of the European Free Trade Association (EFTA), a small trade bloc that the UK helped to found in 1960. Through their membership of EFTA, they have an agreement with the EU, known as the European Economic Area (EEA) Agreement, to participate in the single market. The EEA agreement binds participants to the four freedoms of the single market, as well as competition-related measures and horizontal and flanking policies. The agreement is designed to create a homogeneous set of rules and conditions of competition across the EEA EFTA states and the EU, and therefore the agreement is dynamic – i.e. it is continually updated to reflect additions to single market legislation (EFTA 2017a).

The EEA agreement is governed through a 'two-pillar' structure, comprised of EU institutions and EEA EFTA institutions. A series of joint governing bodies oversee

the development of the agreement: most importantly, the EEA Council, which is made up of foreign ministers (as well as representatives from the Council and the Commission) and leads the political development of the agreement, and the EEA Joint Committee, which is comprised of Commission officials and EEA EFTA ambassadors and makes amendments to EEA legislation to incorporate new single market rules (EFTA 2017c).

Implementation is then overseen and enforced by the Commission and the CJEU, for the EU, and the EFTA Surveillance Authority and the EFTA court, for the EEA EFTA states. The latter two bodies are effectively mirror images of the Commission and the CJEU that apply to the EEA EFTA states. The EFTA court must interpret EU law in the same way as the CJEU has done with respect to case law prior to the signing of the agreement and is obliged to "pay due account" to future CJEU case law (but not vice versa) (EFTA 2012).

Despite these parallels, there are some technical differences between the EFTA court and the CJEU. While the rulings of the CJEU are legally binding, the EFTA court's decisions are in some cases technically only 'advisory'. While EU laws can have direct effect (i.e. they allow individuals to invoke EU law directly before national courts), the provisions of the EEA agreement only have 'quasi-direct' effect (i.e. they allow individuals to invoke EU law before national courts, but only once implemented at the national level). Similarly, while the concept of primacy applies in EU law (i.e. in case of an incompatibility between EU law and domestic legislation, the former overrules the latter), in EEA law there is only 'quasi-primacy' (i.e. EEA law has primacy only once implemented at the national level). In practice, however, the EEA EFTA states generally comply with EFTA court decisions, and there is little substantive difference between the operation of the EFTA court and the CJEU (Baudenbacher 2012).

If a disagreement arises between the EEA EFTA states and the EU on the interpretation or application of the EEA agreement, the EEA Joint Committee has the power to settle disputes. Where the dispute concerns parts of the agreement that are identical to EU law, after three months both sides can agree to refer the matter to the CJEU. If they choose not to and no agreement can be found within six months, each side may either provisionally suspend part of the agreement or apply 'safeguard measures' of a proportionate and appropriate nature to address economic, social or environmental difficulties arising from the dispute. If this creates an imbalance in the agreement, this may be countered by 'proportionate rebalancing' measures by the other side (EFTA 2016).

While the EEA agreement does not allow for a formal role in rule-making (such as representation in the Council or in the European Parliament), it does allow for opportunities to shape EU legislation. This is done largely through two ways. First, EEA EFTA representatives can participate (but not vote) in committees to influence draft legislation. These include programme committees (which develop the substance of programmes such as Horizon 2020 and make project funding decisions), expert groups (which bring together experts to help advise on drafting legislation at the early stages), and comitology committees (which help to draft legislation where powers are delegated to the Commission to address subsidiary matters over how to implement EU law). Second, EEA EFTA states are often informally consulted for comments and written contributions to EU policy over the course of the legislative process (EFTA 2009).

As with membership, we can also think of two forms of participation in the single market: **full participation**, where a country participates in all policy areas of the single market, and **partial participation**, where a country participates in some areas and not others. Given the importance of ensuring the smooth functioning of the single market, it is implausible to imagine a situation where a country

participates in some areas of the single market while excluding itself from substantial number of other areas. Indeed, under World Trade Organisation (WTO) rules for goods, trade agreements must apply to "substantially all the trade" in goods between the relevant countries (GATT 1994). However, this does not preclude the possibility of participating in the majority of the single market while at the same time not participating in a small number of other areas. Indeed, the EEA EFTA countries would most suitably be described as partially participating in the single market, as they do not participate in some areas – notably in agriculture and fisheries (EFTA 2017d).

1.5 OUTSIDE THE SINGLE MARKET

What are the options for the UK if it chooses to be outside the single market? Outside the single market, it would no longer necessarily observe the four freedoms. Some have argued that the UK will still have 'access' to the single market from the outside. This depends on how 'access' is defined. At its broadest, 'access' simply means the capacity to trade with the single market.[1] According to this meaning of the word, it is trivially the case that the UK will continue to have access to the single market post-Brexit, even from the outside. However, it is clear that there are very different types of single market access, depending on the trading arrangement agreed between the UK and the EU.

1.6 ACCESS TO THE SINGLE MARKET: FREE TRADE AGREEMENTS

One way a country can have 'access' to the single market is through a **free trade agreement (FTA)** with the EU. An FTA is an agreement between two or more countries to form a 'free trade area' that lowers barriers to trade in goods and services. The EU has negotiated a number of FTAs with third countries – most recently including Canada, Japan, and South Korea. These agreements typically include some of the following components.

- **Reduction/elimination of tariffs for goods**: This involves the phased removal of duties and other charges on imports and exports of goods between the EU and the third country.
- **Technical barriers to trade**: This involves commitments to work together on regulations for the testing and accreditation of products ('conformity assessments') and other measures. It is typically voluntary and does not require harmonisation of standards, as with the single market. It may also involve a formal Mutual Recognition Agreement (see section 1.7).
- **Sanitary and phytosanitary measures:** This involves commitments to facilitate trade through collaboration on food safety and animal and plant health rules. It may include agreements where particular sanitary and phytosanitary measures can in certain cases be regarded as mutually equivalent.
- **Customs and trade facilitation:** This involves the streamlining of customs processes, including simplified procedures for releasing goods from customs.
- **Cross-border services trade:** This involves easing access into each other's services markets in particular sectors by moving towards equal treatment for service suppliers. Normally this does not preclude formal requirements such as a licence or certificate, which distinguishes it from, for instance, the passporting rights conferred by single market membership.
- **Investment:** This involves bringing down barriers to foreign direct investment (e.g. lifting caps on foreign equity) and ensuring that each government treats foreign investors fairly.

1 Sometimes representatives from the EU institutions use 'single market access' to refer to single market participation, as defined here. We do not use the term in this context in this paper.

- **Temporary entry for professionals:** This involves agreeing mutual minimum rules to allow professionals temporary entry and right to stay in each other's countries for business purposes. It might also involve an agreement on the mutual recognition of professional qualifications for particular regulated occupations. Unlike the single market, it does not extend to long-term migration and free access to each other's labour markets.
- **Public procurement:** This involves allowing suppliers in one country to compete for public sector contracts in the other on the same footing as suppliers from the home country. This generally does not apply to all goods and services and in all circumstances.
- **Dispute settlement:** Most agreements include a system, such as a joint arbitration panel, for resolving disputes about the interpretation and enforcement of the agreement.[2]

1.7 ACCESS TO THE SINGLE MARKET: 'NO DEAL'

A country can also 'access' the EU's single market without a free trade agreement – i.e. under a **'no deal'** scenario. However, under these circumstances the barriers to trade in both goods and services are substantial. Without a trade agreement with the EU, the principle of 'most-favoured-nation' (MFN) treatment would apply. This means that, aside from some strictly limited exceptions, the EU has to trade with all WTO member countries which it does not have a trade agreement with in the same way. Countries without a deal therefore face tariffs on their exports into the EU – particularly high in the case of agricultural products – and, unless they unilaterally eliminate import tariffs for all countries, will need to impose tariffs on goods from the EU. 'No deal' also means an array of additional non-tariff barriers for goods and services, including authorisation and licensing requirements, product safety testing, and public procurement rules.

Some countries that trade with the EU without an FTA do have less wide-ranging agreements to facilitate trade. For instance, Australia, Israel, New Zealand and the US have 'mutual recognition agreements' (MRAs) with the EU that set out rules for how the EU and the third country should treat each other's conformity assessments. (Some countries with trade agreements with the EU have also negotiated MRAs, including Canada and Japan.) The function of conformity assessments is to test and certify imported products to ensure they meet relevant technical regulations before they enter the market from abroad; MRAs help to smooth this process by agreeing how certain bodies from the exporting country may carry out conformity assessments on the products to ensure they meet the importing country's regulations before they reach the new market. This eliminates the need for doubling up conformity assessments and thereby eases the process of trade. Traditional MRAs do not harmonise technical regulations and do not fulfil the same wide-ranging function as the principle of mutual recognition within the single market described above; they simply help to smooth the process of testing and certifying traded products (European Commission 2017b). However, in some cases the EU has also agreed 'enhanced' MRAs that do require harmonisation of rules and thereby also ensure the mutual acceptance of certain products onto each other's markets (Correia de Brito et al 2016).

1.8 ALIGNMENT WITH THE SINGLE MARKET

Are there other alternatives for a relationship with the EU's single market that extend beyond simply 'access', which don't constitute participation or membership? Some countries outside the single market have closer relationships

2 This list is based on the EU-Canada Comprehensive Economic and Trade Agreement (CETA): for further details see European Commission (2016)

with it than a straightforward FTA offers, because, in the relevant areas, their legislation mirrors (or is on course to mirroring) the legislation of the EU. We can describe this type of arrangement as **alignment** with the single market and allows greater scope for divergence. As with membership and participation, alignment can be either **full** or **partial**.

Participation – as we saw above, in relation to the EEA EFTA countries – is highly dynamic; if new legislation is introduced to further the integration of the single market, then these countries will be obliged by law to adapt their legislation accordingly. Moreover, there is limited scope for divergence: the concept of quasi-primacy means that implemented single market rules take precedence over national legislation. Alignment, on the other hand, does not constitute such a comprehensive and intertwined relationship with the single market and allows greater scope for divergence. There are different ways that countries can be aligned to the single market; in the next sections, we explore the examples of Switzerland and Ukraine.

The recent publication of the joint progress report on the Brexit negotiations has heightened public interest in the concept of regulatory alignment with the single market (European Commission 2017c). The term appears to have an ambiguous meaning in the context of this document. While some have argued that alignment has a broad meaning focused on identical 'outcomes' of regulations rather than identical content, we will use the term in this report to refer to legislation that mirrors EU law - i.e. legislation that is substantially similar, if not identical, in both purpose and content. (Indeed, this is typically how the term has been used in the past with respect to prior EU trade agreements.) Our discussion of the examples of alignment in Switzerland and Ukraine should make this clear.

1.9 THE SWISS BILATERALS

Switzerland is the prime example of a country that is (partially) aligned with the single market. Switzerland is a member of EFTA but does not participate in the EEA agreement, because the Swiss public voted against joining in 1992 (European Parliament 2017e). Instead, it has agreed a series of bilateral treaties with the EU that align various pieces of legislation with single market rules (European Parliament 2010).

The Swiss bilateral treaties were contained in two packages ('Bilateral 1' and 'Bilateral 2'), which were voted on and endorsed by the Swiss electorate in 2000 and 2005 respectively (Integration Office FDFA/FDEA 2009). They cover a range of aspects of the single market, primarily the four freedoms.

1. For the **free movement of goods**, Switzerland and the EU have a Free Trade Agreement that prevents tariffs or quantitative restrictions for industrial products. Agreements also exist to reduce tariffs on agricultural and processed agricultural products. Switzerland also has an 'enhanced' Mutual Recognition Agreement with the EU to reduce technical barriers to trade. The general principle of mutual recognition is not included (European Parliament 2010).
2. For the **free movement of services**, Switzerland and the EU do not have a comprehensive agreement, but do have a series of sectoral deals. This includes: an agreement on insurance, which allows firms selling casualty insurance from Switzerland to open up branches in the EU and vice versa; an agreement on overland transport, which harmonises rules and standards and improves access to each other's road and rail markets; and an agreement on civil aviation, which gives Swiss airlines access to EU aviation markets and vice versa (ibid; Integration Office FDFA/FDEA 2009). The Agreement on the Free Movement of Persons also ensures the right to provide temporary services within each other's territories (for up to 90 days) (AFMP 2002).

3. For the **free movement of capital**, there are no formal bilateral agreements, but the wide-ranging nature of the EU's free movement of capital rules means that Switzerland still benefits to a considerable extent from this freedom despite being a third country (European Parliament 2010).
4. For the **free movement of people**, the EU and Switzerland have an agreement in place (the Agreement on the Free Movement of Persons (AFMP)), which broadly reflects the free movement of people in the EU and the EEA agreement (ibid). There are some differences, however, as the AFMP does not incorporate the more recent Citizens' directive: for instance, there is no concept of permanent residence under the Swiss agreement and there are fewer rules to prevent the expulsion of jobseekers (Jay 2012). Like in the UK, there has been considerable disquiet about the free movement of people in Switzerland, and in 2014 the Swiss public's vote in a referendum to impose quantitative limits on immigration contravened the AFMP. A compromise was reached in 2016 that agreed the continuation of free movement while allowing Swiss-based jobseekers to be given priority for job openings (ECAS 2017).
5. As with the EEA agreement, there are also a number of **competition-related measures** and **horizontal and flanking policies** to ensure a level playing field and smooth the functioning of the single market. These include: rules on public procurement to allow Swiss and EU companies reciprocal access to compete for public contracts, Swiss involvement in EU research programmes, an agreement on taxation of savings to stop tax evasion, Swiss membership of the European Environmental Agency, and Swiss participation in the MEDIA programme for the European film industry (Integration Office FDFA/FDEA 2009).

The bilateral Swiss-EU agreements have considerably weaker governance arrangements than the EEA agreement. Unlike the EEA agreement, there is no surveillance authority to monitor compliance, or a supranational court to adjudicate and enforce the treaties. Instead, the agreement is, for the most part, managed on the Swiss side at the national level, alongside a series of joint EU-Swiss committees for each of the agreements to manage disputes diplomatically rather than legally (European Parliament 2010). This model has made it difficult to resolve differences in the interpretation of the agreements, and the EU is now looking to instil a more formal set of governance arrangements for the future (Buchan 2012).

Moreover, unlike the EEA agreement, which is highly dynamic, the majority of Swiss-EU bilateral agreements are static; they have no inbuilt mechanism that obliges Switzerland to continually update legislation to reflect changes in the single market (European Parliament 2010).[3] This could create divergence with the EU over time. More recent agreements – for instance, in relation to the Schengen agreement – between the EU and Switzerland have begun to include dynamic provisions (Jenni 2016). The first package of Swiss-EU bilateral agreements also contains a 'guillotine clause', which mean that if one of the individual agreements is terminated, the rest are also terminated.

Alongside the bilateral agreements, the Swiss government has also pursued a policy of 'autonomous adaptation'. This means effectively aligning Swiss law to EU law without a bilateral agreement in place. For instance, Switzerland has adopted the 'Cassis de Dijon' principle of mutual recognition for products manufactured in EEA countries (with some exemptions) to make it easier to import to Switzerland; however, because this decision is 'autonomous' and not 'bilateral' it has not been reciprocated in the EEA states for Swiss exports (European Parliament 2010).

3 While there is typically no formal in-built mechanism for updating legislation, there is nevertheless still scope for Swiss adaptation of laws where appropriate.

1.10 THE EU-UKRAINE DCFTA

Another set of countries that have progressively aligned with the single market are the future accession states. Notably, the EU's association agreement with Ukraine (as well as Moldova and Georgia) includes a 'Deep and Comprehensive Free Trade Area' (DCFTA) that opens up reciprocal access to each other's markets and extends far beyond a typical FTA. The DCFTA includes the following elements.

- For the **free movement of goods**, the DCFTA eliminates tariffs on industrial products and significantly reduces tariffs on agricultural products (albeit with exemptions for some goods). It obliges Ukraine to progressively align its product standards to the EU's, in return for the future negotiation of an 'enhanced' Mutual Recognition Agreement for particular sectors. It agrees to simplify customs procedures and work to prevent fraud. It also agrees for Ukraine to align its animal safety and sanitary and phytosanitary standards to those of the EU, in return for the EU recognising their equivalence to EU standards under certain conditions (European Commission 2013; AA 2014).
- For the **free movement of services**, the DCFTA goes significantly beyond a standard FTA by guaranteeing freedom of establishment across the economy, excepting a limited number of sectors where reservations apply. It also agrees to full participation in the internal market (including freedom to provide cross-border services) in certain sectors – including finance, telecommunications, and postal and courier services – provided that Ukraine adopts the EU acquis for these sectors (ibid).
- For the **free movement of capital**, the DCFTA agrees that Ukraine should liberalise transactions in its capital and financial accounts, in line with EU standards. This is necessary for unlocking the agreement for market access in financial services (ibid).
- There is no agreement on the **free movement of people**, though there is a commitment to progress towards visa-free travel (ibid).
- There are also a number of **competition-related measures** and **'horizontal and flanking' policies** agreed within the DCFTA, including: a chapter on public procurement, which gives Ukrainian providers access to compete equally for public contracts in the EU (and vice versa) in return for aligning Ukrainian legislation accordingly; a chapter on intellectual property rights, which aims for Ukraine to align its intellectual property laws with the EU acquis to provide adequate protections for companies; a chapter on competition policy, which ensures Ukraine will align its competition legislation with the EU acquis to prevent anti-competitive practices; and a chapter on trade and sustainable development, which includes protections for workers' rights and the environment (ibid).

The DCFTA is enforced via a three-person arbitration panel, based on the WTO's dispute settlement mechanism. Disputes are first addressed through consultation; if this does not elicit a resolution, they then go to an arbitration panel, which provides a ruling within 120 days of its formation. Each party should comply with the ruling within a reasonable time period; if they fail to comply, the other party may ask for compensation, and, if this is not forthcoming, then they are entitled to "suspend obligations" that relate to the relevant part of the DCFTA where there has been a failure to comply (provided this is proportionate to the original issue). However, where the issue under dispute relates to regulatory alignment with EU law, the arbitration panel is obliged to ask the CJEU to make a binding ruling on the matter (AA 2014).

The DCFTA operates on a different basis to both participation in the single market via the EEA agreement and alignment via the Swiss bilateral treaties. It contains a mix of static and dynamic provisions – that is, some agreements require updating

with EU single market law while others do not, depending on the extent of single market integration the agreement aims to secure (Van der Loo 2016).

However, in contrast to the highly homogenous and dynamic approach of the EEA agreement, the DCFTA applies a conditionality principle: if Ukraine aligns itself with EU single market legislation in one area, this 'unlocks' full access to the single market in that field. The idea is that Ukraine will gradually and progressively align itself with EU legislation, unlocking various parts of the single market along the way. This applies in particular to aligning Ukrainian legislation with the parts of the acquis on technical barriers to trade (which will unlock an 'enhanced' MRA), on services sectors such as postal and courier services, electronic communications, financial services and international maritime transport services (which will unlock market access to these sectors), and on public procurement (which will unlock access to public procurement markets) (Van der Loo et al 2014).

1.11 THE CUSTOMS UNION

We have set out as comprehensively as possible the different options available to the UK in relation to the single market. Alongside these choices, there is also a parallel decision to be made in relation to the EU's customs union. While the customs union is related to the single market – because it brings down barriers to trade in goods – it is best treated as a distinct question, because the UK's relationship with the EU customs union is not predicated on being inside or outside of the single market (at least, according to how the single market is typically delineated). That is, the UK can have a close relationship with the EU customs union but be outside the single market (e.g. Turkey), or conversely it can have a more distant relationship but be inside the single market (e.g. the EEA EFTA states).

In its simplest form, a customs union is an agreement between two or more countries to not impose tariffs on each other's goods, while at the same time upholding a 'common external tariff' for goods imported into the territories of any of the participating countries (House of Lords 2017).

A customs union is a necessary – but not a sufficient – condition for borderless trade. It is necessary because, without a customs union, imports into a country would typically be subject to tariffs. Even if an FTA existed between two countries that eliminated tariffs on all products, without a customs union in place, border checks would still be necessary to ensure imported products originated from the country in question (known as 'rules of origin') (ibid). 'Rules of origin' are necessary to prevent the FTA being used to dodge higher tariffs on imports from third countries.

A customs union in principle removes the need for 'rules of origin' because it agrees a 'common external tariff' for third countries. But a customs union is not sufficient for borderless trade because, even with a customs union, there may be other border checks necessary for imported goods (e.g. food safety checks) (Holmes 2017).

The EU customs union is one of the world's most advanced customs unions and does indeed provide for borderless trade between its members. This is because the customs union operates alongside the regulatory union of the single market; it is the combination of the customs union and the single market that has allowed for the removal of internal customs borders within the EU (ibid). Goods entering the EU's customs union face a harmonised customs system and then go into free circulation within the EU once they pass through. The EU's customs union requires its members to adhere to the Common Commercial Policy, which is the entirety of the EU's external trade policy, including its FTAs and other agreements with third

countries. This includes the Common External Tariff, which is the setting of import tariffs for goods from third countries (House of Lords 2017).

The EU customs union therefore prevents its members from pursuing their own independent trade agreements. This is to ensure that goods from third countries do not enter the EU via the 'back door'; if an individual member state could agree a separate FTA with a third country to reduce tariffs on certain products, then exporters from that country would be able to circumvent the higher tariffs across the rest of the EU by sending their products through the member state with the independent FTA. This would undermine the integrity of the EU customs union.

1.12 FUTURE OPTIONS FOR THE UK'S RELATIONSHIP WITH THE EU CUSTOMS UNION

There is no country outside of the EU that is in the EU customs union. (Although technically some microstates and territories are outside the EU and inside the customs union, as they already had pre-dated close customs relationships with member states – e.g. Monaco with respect to France (EEAS 2016).) It is unlikely that any country outside the EU could stay in the EU's customs union, unless agreed simply as a temporary measure (Holmes 2016).

However, it is possible to agree a **customs union with the EU**. A customs union with the EU can be a **full customs union** or a **partial customs union**. According to WTO rules, customs unions must cover "substantially all the trade" for products originating in the relevant countries; but partial customs unions are still possible (ibid; GATT 1994).

For the reasons explained above in relation to the EU customs union, members of a customs union with the EU must adhere to the Common Commercial Policy, at least in relation to the goods that the customs union applies to. A customs union with the EU would therefore prevent an independent trade policy for the goods in question (though it would not necessarily prevent striking trade deals on services or unrelated goods).

A partial customs union is not simply a theoretical construct; there are existing examples. For instance, Turkey has a customs union with the EU that covers (most) industrial and processed agricultural goods, but not other agricultural goods. This does not remove the need for a customs border, because Turkey is not part of the single market (and, in any case, the customs union does not cover all goods). As with the EU's customs union, Turkey is obliged to align itself to the EU's external trade policy (at least for the goods for which the customs union applies); for every trade agreement the EU negotiates with a third country, Turkey is meant to strike a similar deal. However, as third countries have little incentive to negotiate a deal on similar terms with Turkey as they have with the EU, Turkey has sometimes struggled to negotiate such deals in practice. This has left Turkey susceptible to trade deflection, as imported products from third countries can enter Turkey tariff-free by being sent via the EU. Turkey therefore has little control over its own trade policy (Holmes 2016).

A country can also have **no customs union with the EU**. Most third countries with trade agreements with the EU – including the EEA EFTA states, Switzerland, Ukraine, and Canada – do not have a customs union with the EU. This means a customs border is necessary (for instance, for collecting tariffs or for 'rules of origin' checks) – though of course in many of these cases it would most likely be necessary anyway for other types of checks on goods. Without a customs union, it is possible to agree provisions to simplify customs procedures and speed up customs processes, but frictionless trade is not possible.

2. THE FREE MOVEMENT OF PEOPLE

As we discussed in the previous chapter, the free movement of people is one of the 'four freedoms' of the single market. Yet the recent scale of immigration of EU citizens to the UK was one of the core considerations behind the vote to leave (Swales 2016). This poses a fundamental challenge in securing a new relationship between the UK and the EU's single market. An arrangement that continues freedom of movement in its current form is unlikely to be politically sustainable. At the same time, the EU has asserted that the four freedoms are indivisible. In this chapter, we consider whether there is scope for a viable compromise that allows for greater controls over EU immigration while still in part respecting the core principles of freedom of movement.

2.1 OPTIONS ON IMMIGRATION POLICY

In IPPR's previous research, we have set out a series of options for the UK on future immigration policy post-Brexit, ranging from continued free movement to full controls in line with the current system for non-EU nationals (Morris 2017). In particular, we have highlighted six proposals that fall between these two ends of the spectrum.[4]

Option 1: Temporary controls on free movement

The government would be able to temporarily introduce limits on free movement for particular sectors or nations/regions during periods of high EU inflows. The UK and the EU would, for instance, negotiate a provision for time-limited 'safeguard measures' where there is evidence of inflows of an 'exceptional magnitude' detrimentally impacting the labour market, public services, or social security systems in particular sectors or nations/regions.

Option 2: Free movement for those with a job offer

Free movement would continue as before for workers, the self-employed, students, family members and the self-sufficient, but jobseekers would no longer have a right to reside in the UK. This means that EU citizens would need a prior job offer before coming to reside in the UK to work for an employer. Portes (2017) has recently offered a variation on this option: EU jobseekers would lose their right to reside if they have been in the UK for three months and have been unable to find a job.

Option 3: Free movement for certain flows

Free movement between the UK and the EU would continue for particular workers – for instance, certain professions and workers in particular sectors – as well as non-active groups. For instance, the UK and the EU could agree a set of 'key workers' in particular occupations for which the free movement of people would continue to apply.

4 For further details of these options, see Morris (2017). In referring to EU nationals in this section, we also include (non-EU) EEA nationals.

Option 4: A points-based system

EU citizens seeking the right to work in the UK would need to meet the requirements of a points-based system. Points could be allocated on the basis of criteria such as highest qualification level, age and language ability. The right to work would not be attached to a particular job offer or employer sponsorship; EU citizens meeting the criteria of the points-based system would have full work rights in the UK.

Option 5: A 'preferential' system for EU nationals

EU nationals coming to the UK to work would face a more relaxed version of the rules non-EU nationals currently face. The exact details of the preferential rules – for instance, relaxed salary or skills thresholds – would depend on negotiations between the UK and the EU.

Option 6: Controls on EU labour migration and free movement for others

The UK would be free to set its own rules for EU workers and the self-employed – in practice, most likely applying a similar system to the one that currently operates for non-EU nationals – but would agree to facilitate continued free movement, as far as is feasible, for students, family members, and the self-sufficient. This proposal would constitute full control over the labour migration system for EU workers.

2.2 NEGOTIATING A COMPROMISE ON FREEDOM OF MOVEMENT

The negotiability of these options depends on the overarching framework of the UK's future trading relationship with the single market. In the previous chapter, we set out four broad options for this framework: membership, participation, alignment, and access.

Membership of the single market would almost certainly require full adherence to the free movement of people. On the other hand, for simply securing access – that is, either through a FTA or a 'no deal' scenario – the free movement of people would not be required, and any of the six compromise options highlighted above could be available. In the case of 'no deal', these proposals would be introduced unilaterally, since by definition there would be no bilateral agreement between the UK and the EU. Indeed, even in the case of negotiating an FTA, it is possible that the EU would not be open to agreeing a wide-ranging provision for labour mobility, given that, in past FTAs, any provisions on labour mobility have been limited in scope (Morris 2017). Therefore, in this case too they might have to be introduced unilaterally.

The prospects for negotiability are less clear in the case of participation or alignment. Some have argued that here too, as with membership, the EU will rule out anything other than full adherence to the free movement of people. But there are some (albeit limited) precedents for varying agreements on labour mobility with respect to countries that either participate or align with the single market. These include the following.

- The **'safeguard measures'** contained within the EEA agreement, which allow members to take unilateral action to restrict the free movement of people (or indeed other aspects of the agreement) if there are "serious economic, societal or environmental difficulties of a sectorial or regional nature liable to persist". Other than in Liechtenstein, these measures have not been applied to the free movement of people, but they provide some scope within the EEA agreement for the potential application of temporary controls (EFTA 2016).
- The **'sectoral adaptations'** applying to Liechtenstein agreed in Annex VIII to the EEA agreement, which allow Liechtenstein to place an annual quota on the

number of available residence permits for other EEA citizens. The arrangement is reviewed every five years. Liechtenstein was granted this opt-out due to its "specific geographic situation", which is clearly distinct from the geography and size of the UK. Nevertheless, it does provide a precedent for an agreement on labour mobility between the EU and a third country that is not equivalent to the free movement of people (EFTA 2017e; North 2016).

- The **'local preference system'** agreed by the EU and Switzerland in response to the Swiss immigration referendum in 2014. In this referendum, a majority voted for imposing quantitative limits on immigration, which would have violated the EU-Swiss Agreement on the Free Movement of Persons. After prolonged negotiations, a compromise was found which maintained free movement but meant that, in sectors or regions of high unemployment, Swiss-based jobseekers would be given a head start over workers from abroad in applying to fill vacancies (Reuters 2017).
- The **EU-Ukraine Association Agreement**, which, as explained in the previous chapter, does not contain a substantive provision on labour mobility. This is presumably in large part because the EU does not believe it is in its member states' own interests to open up their labour markets to Ukrainian citizens. Nevertheless, it provides a striking precedent of alignment in many areas of the single market without an accompanying commitment to the free movement of people.

Finally, there is also a precedent of member states negotiating partial limits on the free movement of people within the EU. The most prominent example is the **'alert and safeguard mechanism'** that former prime minister David Cameron negotiated in advance of the EU referendum in 2016. This agreement allowed for temporary restrictions on in-work benefits. This would be done via a mechanism that could be invoked when there were inflows of EU workers of an "exceptional magnitude over an extended period of time", to a degree that seriously affected a member state's labour market, public services, or social security system (European Council 2016). Moreover, the text of the accompanying Commission declaration expressly stated that the UK was currently experiencing "exceptional" inflows and would be justified in invoking the alert and safeguard mechanism (ibid). Although this was agreed under the assumption that the UK would remain a member of the EU, it provides an important and useful foundation for securing a compromise position on temporary controls on freedom of movement.

These prior examples suggest that, for the participation and alignment models, there may be scope for a compromise on freedom of movement between the UK and the EU, provided that the UK still broadly upholds the core principles of freedom of movement. This indicates that, for these models, only Option 1 (temporary controls on free movement) and Option 2 (free movement with a job offer) of the compromises listed above could prove to be feasible compromises. In particular, Option 1 has the potential to be acceptable to the EU because a temporary derogation from the free movement of people is most likely to be considered compatible with upholding the fundamental principles of the single market (Morris 2017).

However, the prospects of success are best judged in the context of the UK's wider strategy for the negotiations on the future partnership. This is what we turn to in the next chapter.

3.
CREATING A 'SHARED MARKET'

In this chapter we set out our proposals for the UK's trade objectives in the Brexit negotiations. We have based these proposals on a clear set of priorities for the negotiations.

1. The strategy for the negotiations should be **legally and practically feasible**. It should take into account the framework of the EU's single market and other pre-existing relationships between the single market and third countries, as we detail in chapter 1.
2. The strategy should aim to **meet the UK's needs**. It must safeguard jobs and living standards, provide certainty and clarity for business, and secure sufficient public backing to ensure it is politically sustainable in the medium to long term.
3. The strategy should aim to be **negotiable with the EU**. It must give enough persuasive reasons for the agreement to be in the EU's own interests, as well as the UK's.

It is clear that not everyone in the UK will support the proposal we set out here. Some will favour a more distant relationship with the EU, giving the UK greater controls over its own policymaking. Others will favour a closer relationship, or simply a return to EU membership. But no option will satisfy all sides; in our view, this proposal comes the closest to achieving broad support.

3.1 THE TRANSITION

First, we will set out our position on a transition agreement between the UK and the EU. A transition agreement is a necessary precondition of Brexit. This is because the government has invoked Article 50 and the UK is set to leave the EU and become a 'third country' in March 2019. Michel Barnier, the European Commission's chief Brexit negotiator, has indicated that there is little prospect of extending the Article 50 negotiations beyond this date (which would require unanimous agreement among the EU27) (Barnier 2017b).[5] Yet it is also clear that no future partnership deal can be agreed in full in time for March 2019. A transition period must therefore be agreed as a priority to provide clarity and certainty for the UK government, for the EU27, and for business.

The European Council guidelines on the second phase of negotiations adopted at the December meeting indicate that there is only one plausible option for a post-Brexit transition period: a prolongation of the EU acquis (European Council 2017). A prolongation of the EU acquis would necessitate the complete continuation of the four freedoms, as well as all competition-related measures and horizontal and flanking policies. It would also in effect mean continued

5 Some legal experts have suggested that it may be easier for the UK to simply extend the Article 50 period beyond two years, instead of negotiating a separate transition arrangement. While this would be more feasible from a legal and practical perspective, it nevertheless seems politically unlikely – both for the UK, where there is considerable political pressure for the UK to leave by March 2019, and for the EU, where there is concern that an extension would see the UK participating in the 2019 European Parliament elections.

temporary membership of the customs union (and therefore fully abiding by the terms of the customs union acquis).[6]

There would be some aspects of the acquis that the UK would not continue to follow during the transition period. But these would be confined to the UK's political representation in the EU institutions – e.g. participation in European Parliament elections. In all aspects of the single market, and in other areas of EU policy, the UK would continue to participate. Therefore, the model for the transition period is **full participation** in the single market, in line with our description in chapter 1.

The European Council guidelines indicate that any transition period of this kind would require the application of "existing [EU] regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures" (ibid). This indicates that the EU would require the direct supervision of the European Commission and adjudication of the Court of Justice of the European Union over the course of any transition arrangement. Given the tight timeline until withdrawal, these are in any case likely to be the only plausible adjudication and enforcement mechanisms practically available by March 2019. Over the longer term, however, this is not a sustainable settlement, given that it is not plausible to have direct supervision and enforcement of an international agreement by a body represented by only one party in the agreement.

3.2 THE FUTURE PARTNERSHIP: RULING OUT OPTIONS

If the most plausible transition arrangement is full participation in the single market, what should be the framework for the UK's long-term trading relationship with the EU? As many have noted, including Michel Barnier himself, the forthcoming talks on the UK's future partnership with the EU will be a unique set of negotiations (Barker and McClean 2017). For the EU, rather than setting out a plan for greater market integration with a third country (or accession into the EU acquis) from a starting point of substantially different laws and standards, the Brexit talks will focus on how to manage future divergence from a starting point of regulatory integration.

But while there is no precedent for the UK-EU Brexit negotiations, it should still be possible to understand the UK's negotiating objectives in relation to the option set outlined in chapter 1. It is first worth noting which of these options would be unsuitable or suboptimal for the UK. First, full membership of the single market as defined in chapter 1 – i.e. as 'rule-makers', not just 'rule-takers', of EU law – would mean a return to EU membership, which would not respect the referendum vote. Partial membership would not meet our test of legal or practical feasibility – the EU would almost certainly reject this is a potential option for the UK. On the other hand, a 'no deal' scenario or a straightforward FTA would signal a major rupture in trade with the EU, particularly for services, and would be a major economic risk. In the case of a 'no deal', the impacts would be felt across our economy – from ports to aviation; from car manufacturing to financial services; from nuclear energy to pharmaceuticals (UK in a Changing Europe 2017). Such a scenario must be avoided.

This leaves open the two middle options in our option set: participation and alignment. Full participation is the model we propose for the transition period, but it is unlikely to be sustainable for the long term, given public expectations over immigration and sovereignty. Similarly, partial participation – as with the EEA model – is likely to struggle to secure public backing. Indeed, the EEA model may not be sufficient to address some of the economic challenges of

6 It may not be legally possible for the UK to remain in the customs union during the transition period; if this is the case, the UK and the EU could agree a new customs union that mirrors precisely all aspects of the current arrangement.

Brexit, as it does not include a customs union with the EU. (Moreover, it is not clear whether a new customs union with the EU would be compatible with EFTA membership, given EFTA is a separate trade bloc.)[7] This leaves the option of alignment with the single market.

3.3 THE FUTURE PARTNERSHIP: A 'SHARED MARKET'

We therefore suggest the UK proposes **the creation of a 'shared market'** – a new type of arrangement with the EU that aligns the UK's and the EU's regulations while giving the opportunity for future divergence over time. This is a distinct relationship with the EU compared to other third countries, because the UK is in a unique situation. Unlike other countries that seek a closer relationship with the EU as a means of gaining the benefits of trade or as a step towards future accession, Brexit takes the UK and the EU in the opposite direction. It is therefore helpful to understand Brexit as a form of 'reverse accession' based on rules and regulations that are currently fully aligned.

At the centre of the model we propose would be continued alignment with most aspects of the single market. With the exception of the free movement of people, the agreement would stipulate that continued regulatory alignment is required in order to access the benefits of the single market. This would include regulatory alignment on competition-related measures, including on state aid, intellectual property rights, and public procurement, as well as regulatory alignment on horizontal and flanking policies, including on company law, consumer protection, employment rights, environmental protections, and gender equality and anti-discrimination legislation. The agreement would also include provisions for alignment on future legislation within policy fields directly relevant to the single market.

On the free movement of people, the UK should negotiate a form of 'quasi-alignment': a compromise position that would give more control over EU migration into the UK while largely upholding the key principles of freedom of movement. As we discussed in chapter 2, perhaps the most plausible compromise position is an agreement on introducing temporary controls on freedom of movement in circumstances of exceptionally high levels of EU immigration. This is in our view the most negotiable option because, as with the 'alert and safety mechanism' negotiated by David Cameron, it would secure additional controls while recognising that any derogation from the free movement of people can only be temporary.

On the immediate date after Brexit, the EU Withdrawal Bill should ensure continued alignment with EU legislation on the single market in the short-term. But over time there is a chance of divergence – either through changes in EU policy post-Brexit that are not adopted by the UK or through revisions by the UK of existing pre-Brexit laws originating from the EU.

The agreement would manage this possibility of divergence. It would include a divergence mechanism – operating in effect like the reverse of the conditionality mechanisms within the EU-Ukraine DCFTA. This divergence mechanism would suspend access to the single market in the case of misalignment, with the extent of the suspension depending on the extent of the misalignment. While the EU-Ukraine DCFTA progressively 'unlocks' areas of the single market provided there is evidence of alignment in the relevant policy areas, the UK-EU agreement would progressively 'shut out' the UK from the single market where there was evidence of divergence. This model would therefore be distinct from participation in the single

7 Though Article 49 of the EFTA Convention does indicate that EFTA membership should not exempt member states from obligations arising from other multilateral agreements (EFTA 2013).

market (i.e. the EEA agreement) because, while it would prioritise alignment, it would recognise the possibility of divergence over time.

Finally, additional provisions would be necessary for any divergence in single market rules related to the Irish border or North-South cooperation. The recent joint progress report on the negotiations has committed to protecting both a 'soft' border and all areas of cooperation between the Republic of Ireland and Northern Ireland. This is through a 'triple lock' approach. The UK and the EU have agreed to guarantee these protections either through the "overall UK-EU relationship" (the UK's preferred model, presumably with the aid of technological solutions); or, if this proves unworkable, through "specific solutions to address the unique circumstances of the island of Ireland" (presumably a Northern Ireland-specific option); or, if this too proves unworkable, through "full alignment" with relevant areas of the single market and the customs union (European Commission 2017c).

Therefore, under our proposal, if the UK chose to diverge in any of these areas, it would only be possible if it could find an alternative way of protecting the soft border and North-South cooperation – i.e. either through a technological solution or a Northern Ireland-specific solution. If the UK did choose to diverge without an alternative solution in place, this would trigger a 'guillotine clause' that would suspend the entirety of the agreement.

3.4 THE FUTURE PARTNERSHIP: DIVERGENCE AND DISPUTE RESOLUTION

As part of the 'shared market', an adjudication system would need to be introduced to monitor any divergence and enforce the agreement. It is unlikely that a fully-fledged UK-EU court would be compatible with guaranteeing the autonomy of the CJEU, given a similar court was rejected by the CJEU during the negotiation of the EEA agreement (Garner 2017). The EFTA court could potentially be used as an ad hoc solution, but this could have problematic implications: the EFTA court only includes judges appointed by the EFTA states, and so the UK would presumably need to join EFTA to make use of the court.[8] It may also appear odd for EFTA judges to adjudicate over an agreement negotiated between the UK and the EU. Therefore, rather than directly using the EFTA court or a UK-EU court, we instead propose that the agreement is enforced using a system equivalent to the 'two-pillar structure' used for the EEA agreement.

A two-pillar structure would mean that the agreement would be enforced by a new 'Court of Justice' for the UK (the first pillar) and by the CJEU for the EU (the second pillar). The Court of Justice would need to follow the CJEU's interpretation of single market rules with respect to case law up to the signing of the agreement, and would then need to pay due account to subsequent CJEU case law. The Court of Justice would need to include representation from both UK and EU judges – if it solely had UK judges then the agreement would appear self-policing and so would almost certainly be rejected by the EU (Hogarth 2017; see also Frommelt and Gstöhl 2017 for the Swiss experience).[9] The agreement could also provide for a new UK surveillance mechanism (a 'UK Surveillance Authority') to monitor compliance, akin to the European Commission and the EFTA Surveillance Authority. Again, this would include representation from EU officials as well as UK officials, to guard against self-policing. A new EU-UK joint committee would then oversee and manage the agreement, making updates where necessary, and resolving disputes where they arose.[10]

8 However, there may be scope to 'dock' with the EFTA court by seeking associate EFTA membership – see Baudenbacher (2016) and Frommelt and Gstöhl (2017).

9 The new Court of Justice would therefore be supranational (as it would have judges selected by both the UK and the EU), but it would only have jurisdiction over the UK.

10 See Blockmans and Van der Loo (2017) for a similar proposal.

In the first instance, the UK Surveillance Authority and the UK Court of Justice would monitor and enforce the UK side of the agreement. Like the EFTA court, the UK Court of Justice would be responsible for investigating cases brought by the UK Surveillance Authority, individuals and businesses, as well as preliminary reference cases from UK courts.

In particular, the UK Surveillance Authority would monitor potential legislative divergence. Where the UK Surveillance Authority assessed a possibility of divergence, the UK Court of Justice would investigate and, in case of a misalignment considered sufficiently serious to undermine the functioning of the internal market, make a 'declaration of incompatibility' with respect to the relevant legislation.[11] If the UK chose to disregard the declaration, it would then be forwarded on to the EU-UK joint committee for further action. The EU would follow its own parallel process for monitoring divergence.

Where a 'declaration of incompatibility' was made, the EU-UK committee would then discuss potential remedies. Each party would first be given the opportunity to realign the relevant legislation. Then, if not redressed, a 'declaration of incompatibility' would afford the right of the other party to suspend the relevant parts of the agreement. This suspension would in most cases not solely apply to the policy area in question – since if it did, the UK would be free to select which parts of the single market it wished to participate in, which would not be considered justifiable from the EU's perspective. The consequences of a 'declaration of incompatibility' could therefore have a widespread impact on the functioning of the agreement. At the same time, the agreement should stipulate that any suspension should be demonstrably proportionate to the original incompatibility. The precise extent of the suspension should be decided on a case-by-case basis, depending on the extent of the divergence and the implications for the functioning of the single market. (Importantly, only in circumstances where UK divergence threatened the soft Irish border and North-South cooperation could the suspension of the agreement extend to these areas.) A provision should be included for the UK-EU committee to review the suspension after a fixed time period (e.g. six months) to monitor whether the divergence remained and the suspension was still necessary.

The EU-UK joint committee would also be responsible for managing disputes relating to the interpretation and application of the agreement. It would keep the case law of both courts under constant review to ensure uniform interpretation (without affecting CJEU case law). If there was a disagreement between the two parties, (e.g. the UK Court of Justice did not declare incompatibility in a particular field of the single market but this was argued to be inconsistent with prior CJEU case law), then the committee would investigate the dispute and look to find a mutually acceptable resolution.

Where disputes arose relating to matters of alignment with EU law, the joint EU-UK committee would also have an option (though not an obligation) to refer the decision to the CJEU for a final ruling on compatibility. If the UK declined to do so by a pre-determined deadline and no resolution to the dispute could be found, the EU would again have the right to suspend relevant parts of the agreement. This reflects similar provisions in the EEA agreement (EFTA 2016).

Given the UK's dualist legal system, the agreement would have to also be incorporated into national law for it to take effect. Under our proposal, however, unlike for EU or EEA membership, there would be no requirement for primacy or quasi-primacy of single market rules in UK law. Instead, the

11 This echoes the mechanism of the 'declaration of incompatibility' under the Human Rights Act.

agreement would be enforced through the system described above - if the UK chose to introduce legislation incompatible with single market rules, then a 'declaration of incompatibility' could be issued and the agreement could be partially suspended.

3.5 THE FUTURE PARTNERSHIP: A UK-EU CUSTOMS UNION

Alongside near-full alignment with the single market, the UK and the EU should also agree a joint **full customs union**. This customs union would allow for the continuation of zero tariffs on all goods (including agricultural goods) between the UK and the EU. The UK would continue to align its trade policy with the EU's and follow all relevant customs, VAT and anti-dumping rules. Alongside continued alignment with the relevant parts of the single market, this would help to smooth UK-EU trade flows and maintain a soft Irish border. If, in the longer term, the UK wanted to develop an independent trade policy, it would be free to do so. However, as with other areas of the agreement, if the UK diverged from the EU in an area that affected the functioning of the customs union, this would suspend the customs union agreement. As explained above with respect to the single market, divergence on areas of the customs union related to the Irish border would only be possible if the UK was able to develop an alternative solution to maintain a 'soft' border between the Republic of Ireland and Northern Ireland.

A UK-EU customs union would reduce friction between UK and EU trade. This would be at the cost of a fully independent trade policy between the UK and third countries. But, provided the customs union is agreed fairly, it could allow the UK to benefit from future free trade agreements between the EU and third countries. The new customs union agreement should therefore include a provision obliging the EU to ensure – before agreeing future free trade agreements with third countries – that those countries commit to also negotiating parallel FTAs with the UK. This would aim to give the UK the benefits of future EU trade deals, while avoiding the problem Turkey struggles with of trade deflection (Holmes 2016; Artiran 2016) (this is similar to Protocol 12 of the EEA agreement (EFTA 1994)).

3.6 THE FUTURE PARTNERSHIP: FINANCIAL CONTRIBUTIONS

As part of the 'shared market', the UK should make a continued financial contribution to Europe and the EU. This should consist of three core elements.

- **Solidarity contributions:** In line with the EEA agreement, the UK should make financial contributions to reduce regional economic and social disparities across Europe. This would not be a direct contribution to the EU budget; it would be an independent 'UK Grants' programme, agreed between the UK and the European Commission.
- **Programme contributions:** The UK should make contributions to joint programmes and agencies in which it continues to participate – for instance, Horizon 2020 and its successors.
- **Security contributions:** The UK should also continue to support the EU's foreign and security policy, both through direct financial contributions and 'in kind' support (such as via equipment, personnel, research and development, and operational support).[12]

12 This reflects some of the suggestions in DExEU 2017.

3.7 WHAT'S IN IT FOR THE UK?

Would the agreement we have outlined here satisfy the public and prove politically sustainable in the UK?

While the political debate on Brexit is dominated by extremes, public attitudes to the UK's future relationship with the EU are somewhat more nuanced. This is not to say that the public do not feel strongly about the issues at hand; the evidence suggests they care a lot about Brexit. But the public cannot simply be divided into two homogeneous groups on the basis of their referendum vote. Indeed, the latest wave of the British Election Study suggests that, when asked to prioritise 'single market access' or 'controlling migration' on a sliding scale, around 70 per cent of the public do not place themselves on either end of the spectrum (BES 2017). A recent 'citizens' assembly' – a deliberative exercise involving approximately 45 participants, selected to be representative of the UK electorate – found that most people supported a future relationship with the EU somewhere between the status quo on the free movement of people and a limited trade deal with no preferential access for EU citizens (Citizens' Assembly 2017). There is therefore much greater scope than often assumed for a compromise Brexit outcome that wins over a majority of the public, Remain voters and Leave voters alike.

In our view, the proposal set out here has the potential to secure broad public support. On the one hand, it would seek to gain greater controls over immigration through 'quasi-alignment' on the free movement of people – for instance, via a 'safeguard mechanism' that would provide scope for temporary controls on EU immigration during periods of extraordinarily high inflows. It would also secure greater levels of sovereignty through a 'divergence mechanism' that would provide for the possibility of developing distinct policies relating to the single market.

On the other hand, the agreement would prioritise the economic ties with the EU by confirming continued alignment with the EU single market as the 'default' policy position. Any future divergence would be met with partial suspension of the agreement, which would come at a considerable economic cost. Key rights, such an employment and consumer rights, would also be protected as part of the horizontal and flanking policies within the agreement.

Our proposed agreement would therefore seek to balance the priorities of those who voted to leave the EU (greater control over immigration and greater sovereignty) with the concerns of those who voted to stay (the protection of jobs and living standards).

3.8 WHAT'S IN IT FOR THE EU?

The case for why the UK would favour a 'shared market' is therefore fairly clear. Far more uncertain is whether the EU27 would be interested in a bespoke arrangement of this type. Nevertheless, there are some reasons for why they might be open to negotiating a proposal along these lines.

To illustrate the case for a 'shared market' from the EU's perspective, it is worth considering the alternatives for the EU27. A 'no deal' scenario – or a bare-bones FTA that mirrored other recent agreements such as CETA – would pose a serious risk for the EU for at least three reasons.

1. A 'no deal' or a bare-bones FTA between the UK and the EU would not include a substantive agreement on the financial sector. Yet London is the EU's financial capital: approximately 78 per cent of European capital markets and investment banking revenue is transacted in the UK and around 75 per cent of EU foreign exchange and interest rate derivatives trading take place in the UK

(European Parliament 2016). A major rupture in the financial sector could have severe and immediate implications for the financial stability of the EU27.

2. Due to the sheer volume of trade between the UK and the EU, the impact of a 'no deal' or a bare-bones FTA would be negative across the EU27 (see European Parliament 2017f for a review). In particular, the Republic of Ireland would be highly exposed in such a scenario. The negative impact on GDP per capita by 2030 would be around 2–2.5 per cent, equivalent to the impact in the UK (Rahel and Felbermayr 2015). The Republic of Ireland has already had considerable influence over the EU27's negotiating strategy, given the prominent role of the Irish border in the first phase of the negotiations, so the implications of a 'no deal' or bare-bones FTA for the Republic of Ireland is likely to be an important consideration for the EU27.
3. A distant relationship between the UK and the EU would be against the EU's long-term strategic interests. Reduced cooperation and divergence in legislation relating to the single market risk a 'race to the bottom' in consumer, employment and environmental standards. The EU would be better protected from undercutting and social dumping if it retained the UK within its regulatory orbit.

Equally, the EEA option is problematic for the EU as well as the UK. This is because, in the current context, it does not appear politically sustainable in the UK. Without a deal that is politically sustainable, there is a real risk of the agreement collapsing. At best, this would lead to further protracted negotiations between the EU and the UK, distracting from other pressing issues for the EU; at worst, it could lead to a re-emergence of a 'no deal' scenario, which carries the risks described above.

The 'shared market' has the potential to avoid these challenges. By aiming to address public concerns over immigration and sovereignty, it is considerably more likely to be politically sustainable than participation in the single market (i.e. the EEA option). Yet, from the EU's perspective if not the UK's, it would still demonstrate unambiguously the disadvantages of EU exit. In particular, the UK would have no direct influence over EU policy but would continue to align to relevant single market legislation. While it could choose to diverge, this would come at a serious economic cost. The UK would therefore be directly exposed to the challenges of EU exit – the trade-off between regulatory divergence and market access – without any of the previous influencing benefits of membership.

Finally, the agreement would largely protect the EU (in particular, the Republic of Ireland) from an economic shock, as alignment would be the 'default' option for the UK with respect to single market legislation. If the UK did choose to diverge in the future and accept the economic consequences, the EU would have the right to restrict market access as and when it chose, giving it the time and flexibility to carefully manage the implications of restrictions in market access for the EU27, while demonstrating to the UK the material consequences of dealignment.

While we have sought to set out a plausible negotiating strategy that could gain traction on both sides of the negotiating table, taking into account previous agreements between the EU and third countries, we of course fully recognise the possibility that the EU will not find it acceptable to negotiate such a deal. We will not attempt to prejudge the negotiations at this stage, but it is our view that, if negotiating a deal of this sort proves impossible, any alternative agreement should prioritise jobs and living standards across the UK and the EU27. A 'no deal' scenario – or a scenario that dramatically weakened the UK's trade links with the EU's single market – would be a severe rupture with the status quo that

would significantly weaken the economies of both the UK and members of the EU27. Neither side should countenance such a damaging scenario.

3.9 SUMMARY

In total, our proposed framework would include: a new agreement on 'alignment' on three of the four freedoms, competition-related measures, and horizontal and flanking policies; a compromise position that secures 'quasi-alignment' on freedom of movement (e.g. an 'alert and safeguard mechanism' for exceptional EU worker inflows); a new customs union agreement with the EU for all goods; a mechanism for continued financial contributions, and, finally, a set of monitoring and enforcement institutions, including a new UK Court of Justice, a UK Surveillance Authority, and an EU-UK Committee for resolving instances of disagreement or divergence. In totality, we describe this arrangement as a 'shared market' – prioritising close trade ties and regulatory alignment while giving future opportunities for the UK to diverge from the EU (if at a considerable economic cost).

The framework would be concluded via one encompassing agreement, as opposed to the Swiss bilateral deals, since there is little appetite from the EU for a repeat of the Swiss arrangement. It would be concluded under Article 217 TFEU (Treaty on the Functioning of the European Union), which allows the EU to conclude agreements with third parties "establishing an association involving reciprocal rights and obligations, common action and special procedure" (TFEU 2007).

CONCLUSION

The proposed agreement outlined in this briefing would be a distinct way forward for the UK and the EU27. At its core would be the recognition that there is a fundamental trade-off between regulatory divergence and ease of access to the single market. The UK cannot 'have its cake and eat it'. At the same time, the agreement would acknowledge the unique and unprecedented nature of the Brexit negotiations. Unlike other arrangements between the EU and its neighbours – which seek closer ties in trade and other matters, often as a step towards future accession – Brexit will be a process of 'reverse accession'. This requires a new and subtle approach to the UK and the EU's future relationship.

Our proposal of a 'shared market' would prioritise alignment with EU legislation related to the single market and customs union, rather than seeking new trade deals abroad. A dispute resolution mechanism would both end the direct jurisdiction of the CJEU in the UK and protect the CJEU's own autonomy. And divergence would be a real choice for the UK, though it would of course have far-reaching consequences for trade and the economy. Such an agreement would not please everybody, and it may prove elusive in negotiations with the EU27. But it is the most plausible route for delivering a Brexit outcome that respects the vote to leave, takes into account the priorities of the public, and at the same time protects the UK's deep and closely integrated trading relationship with the EU.

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