TRADING PLACES:
Is EU membership still the best option for UK trade?

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EXECUTIVE SUMMARY

Membership of the EU customs union, and the free movement of goods, remains beneficial to UK firms exporting to the EU. The UK has been instrumental in developing the Single Market in goods and promoting EU enlargement, which has helped to generate new markets, increased competition and reduced costs.

The EU remains by far the biggest destination for UK trade in goods, but for exports in services the picture is less positive. Services account for 71% of total EU GDP but only 3.2% of this is a result of intra-EU trade. The failure to liberalise services within the Single Market and member states' reluctance to compete on the global stage in this sector means the EU is punching below its weight in global talks on services, to the detriment of UK interests.

Plainly, trade is only one part of the equation when it comes to assessing the costs and benefits of EU membership. There is a value to the UK's ability to influence not simply the terms of trade but also EU foreign policy and enlargement.

However, the price of membership remains high. Many of these costs are not directly related to trade, such as the UK's contribution to the EU budget, the loss of national control over key political decisions that affect the British economy and society, and an increasing regulatory burden. Growing frustration with these costs has led some to suggest the following alternative trading arrangements outside the EU:

- *The 'Norwegian' option or EEA membership:* This would free the UK from the CAP, EU fishing rules, EU-wide regional policy, and reduce its budget contribution. However, while guaranteeing access to the Single Market in services and goods, outside the customs union, access for goods would be subject to complex rules of origin and Britain would still be subject to EU regulations on employment and financial services but with no formal ability to shape them.

- *The 'Swiss' option or free trade agreement:* The Swiss-EU bilateral deal, without the CAP, EU fishing rules, EU-wide regional policy, and reduced financial contribution, offers more sovereignty and less EU regulation. However, the UK's access to the Single Market would be dependent on the deal it could negotiate with the EU – the Swiss deal currently excludes the vast majority of services, including financial services.

- *The 'Turkey+' option:* The UK would continue to benefit from full access to the EU's Single Market in goods by remaining in customs union with the EU but Britain would be bound by any external deals that the EU strikes in trade in goods without any formal way of shaping them. A separate deal on services would be required to maintain UK access to the Single Market in these sectors. It would be free from EU social and employment regulation, the CAP, CFP and EU-wide regional policy.

- *The clean break 'WTO' option:* If the UK left the EU without securing a version of the options above, the UK could fall back on its World Trade Organisation membership. This would see some exports facing relatively high tariffs (i.e. 10% on car exports) and market access for services would be limited.

From purely a trade perspective, these options all come with major drawbacks and EU membership remains the best option for the UK. Additionally, contrary to popular belief, all the alternatives to EU membership, except the 'WTO option', would require negotiation with and the agreement of the other member states, which would come with unpredictable political and economic risks.

This means that negotiating a new UK relationship with Europe outside the EU Treaties, i.e. leaving the EU, would present similar difficulties to renegotiating membership terms while *remaining* a member of the EU.

However, there are three factors that could alter the cost-benefit analysis of the EU in future:

1) If EU trade liberalisation stalls over the long-term;
2) If the EU moves in a more protectionist direction in the wake of the eurozone crisis;
3) If the EU prevents the UK from taking advantage of growth opportunities in non-EU countries in future trade talks. The UK relies on the EU to negotiate on its behalf, which can be a disadvantage if UK interests are watered down as part of an EU compromise deal.

In light of these trends and an increasingly sceptical UK public, in order to continue to justify membership, the UK Government should seek to achieve a new model for EU cooperation based on different – and equally legitimate – circles of EU membership. In this structure, the UK should remain a full member of the single market in goods and services and of the EU's customs union, but take a 'pick and mix' approach in other areas of EU policy. This would achieve a vital reduction in the non-trade costs of EU membership, such as the EU budget and the burden of regulation, while allowing the UK to remain at the heart of the EU's cross-border trade.

As the Eurozone is likely to need a new set of EU Treaty arrangements to move towards further integration, which the UK must approve, Britain will have a unique opportunity to stake out its own model for EU membership.

In addition the UK should take the following practical steps to ensure it maximises the benefits of EU trade:

In the UK the Government should:

- Develop far greater expertise in trade policy in Whitehall and Westminster, and use it to lobby EU and global partners;

- Step up 'commercial diplomacy', promoting UK businesses and exports to non-EU countries to facilitate trade. The current government has been commendably active but more can always be done. Although trade negotiation remains an exclusive EU competence, the UK retains the power to promote UK business.

- Commission an extensive cost-benefit analysis of EU membership and the alternatives, to educate all sides of the debate. At the moment, the level of discussion is woefully inadequate.

In the EU the UK Government should:

- Build alliances around free trade issues, and explore EU Treaty provisions (enhanced cooperation) allowing a smaller group of countries to pursue further liberalisation if this is not possible at the level of all 27 member states;

- Be far more proactive in influencing and setting the agenda in the EU institutions, including staffing key trade posts with UK officials, including one of the commercial portfolios in the European Commission when they come up for renegotiation in 2014 – opting for the foreign policy portfolio in 2009 was a major strategic mistake.

TABLE OF OPTIONS

	Access to Single Market	Non EU trade	Social & Employment legislation	Product regulations	EU budget contributions	CAP, CFP and regional policy	Sovereignty
1 **EU** Full EU membership	Full access via the customs union. Additional "four freedoms": labour, capital, goods and services.	Conducted under the EU's Common Commercial Policy CCP) and EU FTAs.	All	All	Yes	Yes	Ability to influence and vote (or be outvoted).
2 **EEA** The EEA – nearly but not quite an EU member: the "Norwegian option"	Full access via EEA agreement subject to rules of origin (ROO). Four freedoms.	Conducted under EFTA's FTAs or separate bilateral agreements.	All	All	Contribution for areas of participation on a % GDP basis. + "Voluntary" contribution to EEA grants fund.	No	Limited influence and no votes. Regulations legally enforceable.
3 **Switzerland** A free trade agree-ment – a tailored bilateral deal: the "Swiss option"	Access in most areas subject to ROO. Limited access in services. Free movement of labour, capital and goods.	Conducted under EFTA's FTAs or separate bilateral agreements.	None	All (voluntarily)	"Voluntary" contribution to Swiss development fund and EU infrastructure.	No	Bilateral adoption of regulations.
4 **Turkey** A stripped back customs union with the EU: the "Turkish option"	Full access for goods. Agricultural products and services are not covered by the customs union, as customs unions only cover physical goods.	Subject to the EU's CCP for industrial goods and processed agricultural products but not agricultural produce. Required to start FTA negotiations with any country that signs a EU FTA.	None	All	No	No	Product regulations apply. Limited scope to influence CCP in goods.
5 **WTO only** A clean break: the 'WTO option'	All trade conducted under Most Favoured Nation (MFN), with tariffs applied on EU trade subject to any Free Trade Agreement (FTA) negotiated.	MFN, trade conducted by UK acting alone at WTO.	None	EU regulations only for exports to the EU.	No	No	Full sovereignty, but no influence on EU.

1. INTRODUCTION

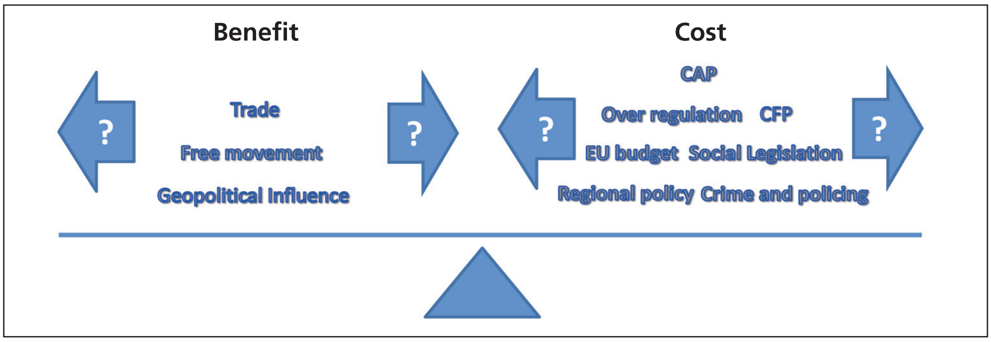
The UK was one of the earliest and foremost proponents of free trade and open markets, dating back to the repeal of the Corn Laws and Navigation Acts in 1846 and 1849. The UK's membership of the European Union is now one of the central elements that define its place in the world economy and trading system. EU membership currently shapes the UK's ability to trade both with other member states but also, through the EU's exclusive competence to negotiate external trade deals on the UK's behalf, markets elsewhere across the globe.

The EU is subject to the common misconception that it is a free trade area. It is actually something very different – it is a customs union with a common external tariff and an internal market designed to facilitate the free movement of goods, services, people and capital within a Single Market. Free trade areas (such as NAFTA) differ in that they only govern trade between contracting states, leaving states free to conduct external trade themselves (see illustration iv and Box G). The EU has also acted as a vehicle for UK geopolitical influence in Europe, be it through Britain's ability to influence the Single Market, its support for EU enlargement or via its ability to veto EU foreign policy.

However, EU membership is far from cost-free and, as a result, it has become increasingly politically controversial. The associated costs of EU membership include the common agricultural and fisheries policies, EU-wide regional funding, the impact of EU social and employment regulation on the UK economy and contributions to the EU's budget. In addition, successive rounds of political integration have resulted in greater losses of democratic control to Brussels in the form of qualified majority voting, European Court of Justice jurisdiction and the increased powers of the European Parliament.

The ultimate justification for UK membership rests on the assumption that the benefits of EU trade (internally within the Single Market and as a large bloc negotiating with third countries) and UK influence in its European neighbourhood outweigh the associated political and economic costs. But these costs or benefits are not static as their value depends both on current EU policies and future political and economic circumstances.

Illustration i: How the benefits of EU trade are weighed against costs



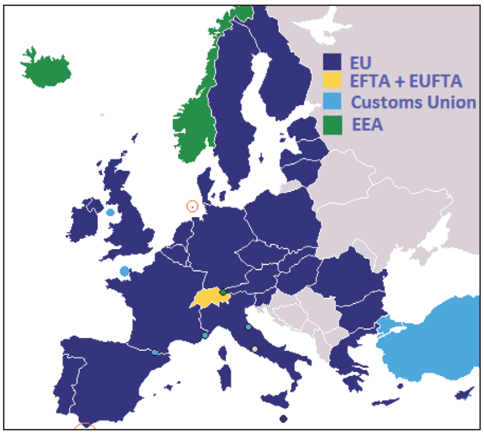
Although the equation above by and large reflects how the UK evaluates its EU membership, many other member states would see EU trade and EU social legislation or regulation as two sides of the same coin and have always recognised that the EU is as much a political union as an economic one.

Nevertheless, the growing political frustration in the UK with the costs of EU membership has led an increasing number of politicians to suggest alternatives to full EU membership and that the UK would be 'better off out'. These alternatives include:

- Joining the European Economic Area (EEA) – the "Norwegian option"
- A bilateral free trade agreement – the "Swiss option"
- A new customs union with the EU – the "Turkish option"
- A clean break – "the World Trade Organisation (WTO) option"

A greater understanding of the alternatives to EU membership and their consequences is vital to any debate on the UK's role in Europe.

Illustration ii: Different economic relations with the EU



[1]

The options we examine in this paper are illustrative and intended to identify the issues the UK would be likely to face should it opt for one of these alternatives to full EU membership. The exact nature of any new UK-EU relationship would depend very much on the UK's particular negotiating hand (it is not Norway, Switzerland or Turkey) and the circumstances of its withdrawal from the EU.

All of the alternative options have implications for some or all of the costs and benefits outlined above, which makes summarising the costs and/or benefits of the 'out' option(s) hugely complicated. In this paper, we will primarily assess their impact on UK trading opportunities, versus the status quo, both with the EU member states but also with third countries.

1.1 The 'trade case' for EU membership

The traditional trade-based case for the UK's EU membership rests on a number of premises:

- *Taking advantage of economic growth in Europe*
  The UK's involvement in European integration presents an opportunity to increase trade with a steadily growing market. The UK Government's decision to join the European Economic Community in 1973 was sold to the British public along these lines. In addition, the UK, as a member of the EU, is able to drive liberalisation in the other member states, increasing trade and export opportunities for UK firms. The extent to which EU membership offers trade and economic benefits to the UK needs to be assessed against these principles.

- *Increased competition leads to productivity gains*
  A larger 'domestic' market leads to greater competition as more companies in different states compete across borders. Increased competition leads to increased efficiency, a better utilisation of resources and innovation. This should in turn lead to lower prices and make UK exporters more competitive in new markets outside the EU.

- *Increased foreign direct investment (FDI)*
  Although there are many reasons why firms invest in the UK, one major consideration for large investments is market size. Investors in the UK often do so to take advantage of the EU's Single Market. This argument is often associated with Japanese and US investment in the manufacturing sector when deciding on regional manufacturing hubs. Although there may be some displacement of domestic investment, FDI is relatively more productive than domestic investment as only the most productive firms invest abroad. FDI also has second order effects such as skills and knowledge transfers.

  This is a two way process, as the free movement of capital also allows savers and investors in wealthier or lower growth economies to finance investment in poorer, faster growing economies, boosting returns on UK outward investments in the process.

1 As well as Turkey, Andorra, San Marino, the Channel Islands, Isle of Man and the SBAs in Cyprus are within the customs union. A number of overseas territories or parts of EU states are not in the customs union, i.e Gibraltar and Heligoland.

- *One set of regulations reduces costs*
  The EU has one set of legislated product regulations and, in principle, once these are met, goods can move freely within the Single Market. This reduces costs for companies that wish to take advantage of the Single Market. If it was not in the EU, the UK would either have to follow the EU's regulations for domestic production or its manufacturers would have to bear the cost of multiple standards.[2]

- *EU's market clout to UK's advantage in global trade talks*
  The EU can potentially have a major role in liberalising world trade. Acting as one, and as a sizeable market, the EU can have a greater effect on opening up markets, removing non-tariff barriers and promoting UK interests than if Britain acted alone.

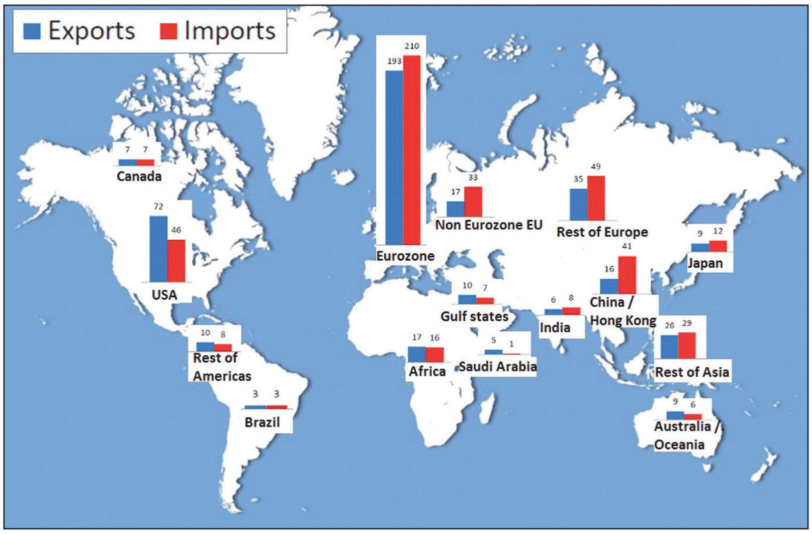
- *EU enlargement as a trade opportunity*
  The EU through previous enlargements has opened new markets to UK companies. These new markets are obliged to adopt the same product regulations and protection for trade and investment. The EU could potentially continue this trend expanding to large markets to the East and South.

- *The UK has no other options*
  If the UK was not in the EU it would be on its own in a world of powerful regional trading blocs such as NAFTA, ASEAN or MERCOSUR. Growing trade regionalisation, remaining tariffs and non-tariff barriers, are continued obstacles to free trade. These large blocs would all have the advantages of large domestic markets in global trade negotiations, leaving the UK at a comparative disadvantage.

1.2 The UK's trade priorities

The UK remains a global trading nation with interests around the world. The EU accounts for 48% of total UK goods and services exports. This breaks down as 53.5% of UK goods exports and 39.7% of services exports.

Illustration iii: UK imports and exports of goods and services 2010 (£bn)



Source: Open Europe based on the ONS Pink Book 2011

Although the EU accounts for 48% of total UK goods and services exports, there are some distortions. Ireland, for instance, accounts for 5.8% of total UK goods and services exports, Belgium 3.7% and the Netherlands 7.1%. In the case of Ireland trade is increased by brisk cross border trade, but in the cases of the Netherlands and particularly Belgium the larger than expected proportion of trade will to some extent be accounted for by the 'Rotterdam Antwerp' effect, whereby goods exported to these ports are re-exported to non-EU states, but despite this, final destination are classified as exports to the EU.[3]

2 It should be noted that product 'regulations' given force through EU legislation differ from 'standards', which are developed on a voluntary basis between manufacturers, consumer groups and regulators. These can be developed at international, European, or national level and the British Standards Institution is active at all three levels. Trade Policy Research Centre, 'Standards', 2012

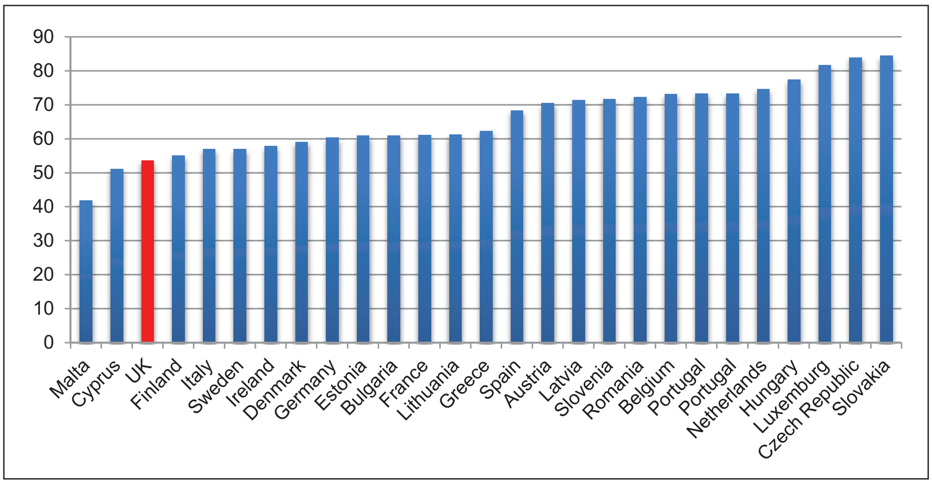
3 For a discussion of the likely effect of the 'Rotterdam Antwerp' distortion see: *Global Britain*, briefing note 64, 2011, www.globalbritain.org/BNN/BN64RotterdamAntwerpNethDistortion.pdf and Ian Milne's, 2002 briefing note on UK exports, www.globalbritain.org/BNN/BN22.pdf

a) The UK is less dependent for trade on the EU than other EU states

Although the EU and the eurozone remain the UK's biggest export markets, the UK relies far less on the EU market than the majority of other member states.

Close to two thirds of the EU member states' total trade in merchandise or non-agricultural goods was carried out internally within the EU Single Market in 2009.[4] But while, for Slovakia, intra-EU merchandise trade made up 84% of total trade, only 53.5% of the UK's merchandise trade was within the EU in 2010.[5] Nevertheless, the share of UK goods that are exported to other EU member states illustrates that the Single Market remains a hugely important market for UK goods trade.

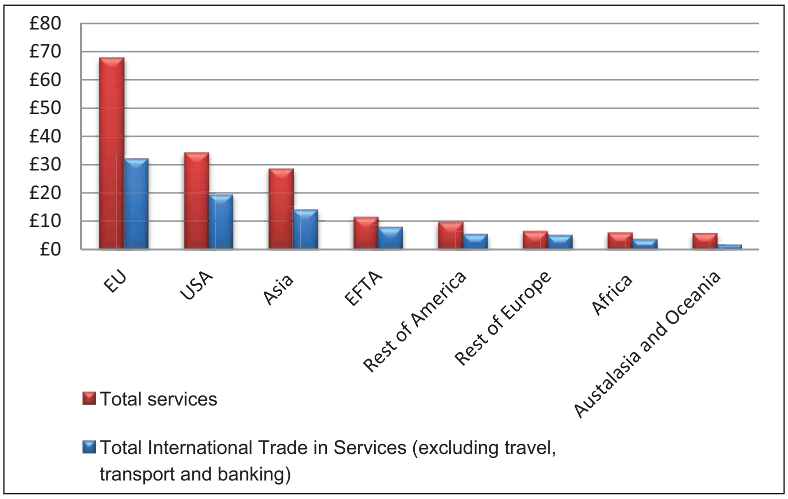
Graph 1: Intra-EU trade as a share of member states' total goods exports in 2010 (%)



Source: WTO

Similarly, in services, the EU remains the UK's biggest trading partner, accounting for 39.7% of total UK services exports (£68bn out of £171bn)[6] ahead of the USA with 20%.

Graph 2: UK services exports by destination (£bn)



Source: ONS International Trade in services survey and 2010 'pink book'

b) The UK's export markets do not correlate well with future growth opportunities

Increasingly, the geographical distribution of UK trade does not correspond to the areas of the world with the most economic growth potential. Illustration iii above showed that UK imports and exports are heavily orientated towards the EU and, in particular, the eurozone. Around a quarter of the UK's trade is with other developed countries outside the EU, while a comparably smaller share of Britain's trade is with the emerging economies to the East and the South.

4 *WTO*, 'Trade policy review: European Union', 2011, p7
5 *WTO*, Country profiles, October 2011
6 *ONS*, Pink book 2011 and 'International Trade in Services – 2010', http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-250820

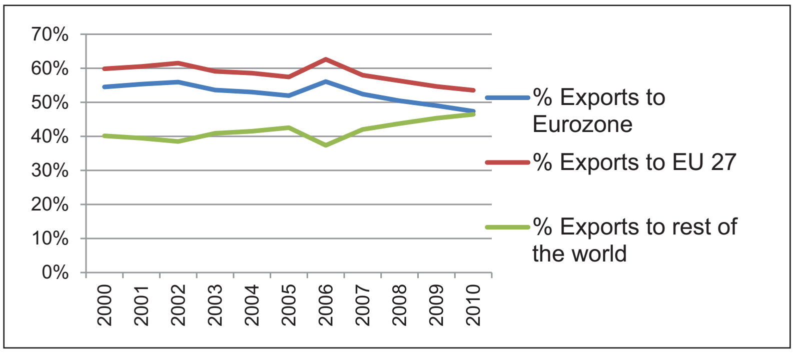
In its 2011 White Paper, Trade and investment for growth, the Government stated that the EU is "likely to remain the major market for British trade and investment over the medium term," but, recognised that,

> *"…long-standing structural weaknesses in the European economy, in particular product and labour market rigidities, could slow recovery in the short to medium term. The World Bank predicts 1.8% GDP growth in the eurozone in 2012 compared with 3% in the US and 8.2% in China. This means that boosting European growth, through further Single Market reforms for example, is central to trade and investment growth for UK firms within the EU, as well as in our national economic interest."*[7]

However, while reform of the Single Market and greater EU trade liberalisation would indeed be welcome, the fact that the EU's contribution to future global growth in the medium term is likely to be limited illustrates that the UK's ability to penetrate and compete in more vibrant growing developed and developing markets in the rest of the world will also be vital.

In fact, some trade diversification away from the eurozone began in the 2000s, particularly for trade in goods, a trend which has been accelerated by the euro crisis. In broard terms a recent decline in the volume of goods exports to the eurozone as a result of the crisis has increased the share of UK exports to the rest of the world.

Graph 3: UK goods exports by destination %

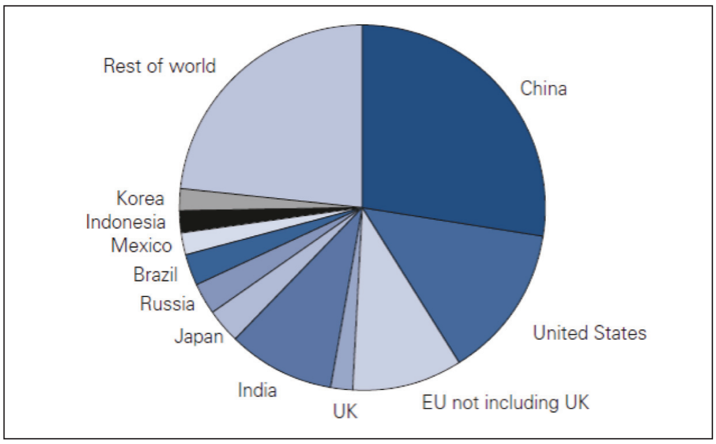


Source: ONS, Open Europe

In contrast to the goods sector, UK services exports have remained flat in both real terms and in terms of exports to the eurozone, as the recent downturn in services exports does not seem to have been limited to the eurozone.

Nevertheless, with the eurozone crisis expected to drag on and with it a degree of economic stagnation in the member countries, the UK must do better in exporting to other parts of the world, especially those parts where future economic growth is expected to be strongest.

Graph 4: Top 10 contributors to global growth 2010 to 2015



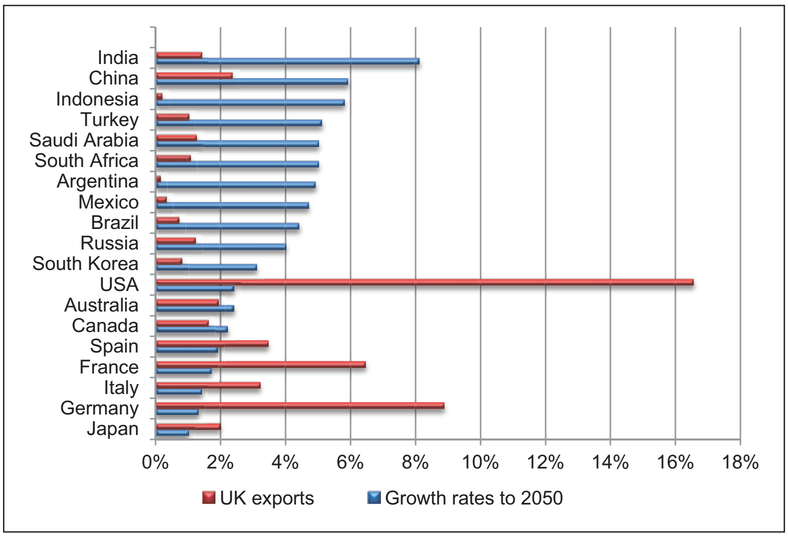
Source: BIS, and World Economic Outlook[8]

7 *HM Government*, 'Trade and investment for growth', February 2011, p29

8 *HM Government,* 'Trade and investment for growth', February 2011, p27

As Graph 5 below shows, the destination of the UK's exports does not correlate well with forecasted GDP growth in various world markets.

Graph 5: Growth rates to 2050 of the UK's current export markets (goods and services)



Source: PwC[9] and ONS

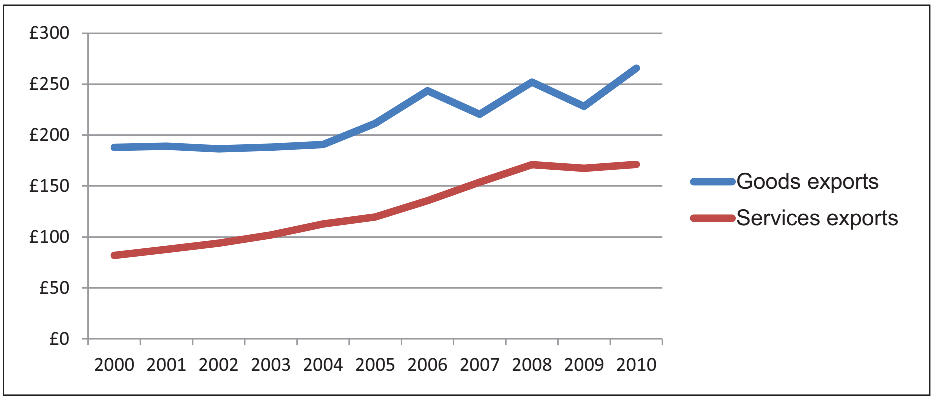
The graph above shows that Spain, Italy, France and Germany together account for 22% of the UK's goods and services exports – an area forecast to grow at under 2% a year up to 2050. However, India and China together account for only 3.75% of total UK goods and services exports yet are predicted to grow at between 6% and 8%.

c) Which sectors are of most importance to the UK?

Since 1973, the UK economy has undergone major transformation. Like many other advanced economies (and some emerging economies), there has been a major shift in the structure of the UK economy away from manufacturing and towards services (particularly knowledge-based business and financial services). The share of business, financial and professional services in UK GDP rose from 15% in 1992 to 22% in 2008, while the share of manufacturing fell from 21% to 12%.[10]

This is reflected in the UK's exports. Graph 6 below shows that, while exports of both goods and services have grown, exports of services have grown in importance – in the last ten years services have grown from around 30% to around 40% of UK exports.

Graph 6: UK services and goods exports (£bn)



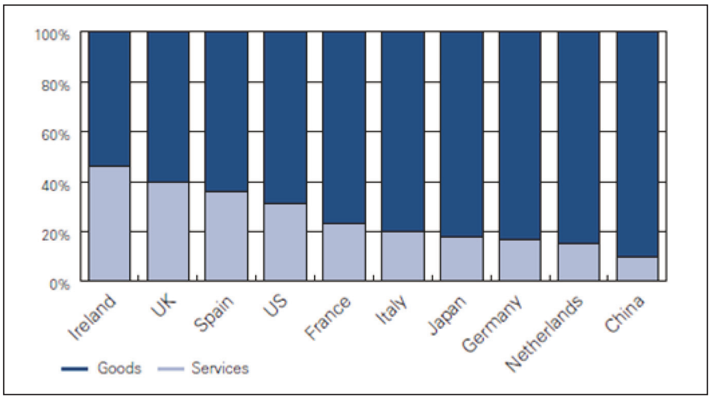
Source: ONS, Open Europe

9 *PwC*, 'The World in 2050' (2011), http://www.pwc.com/gx/en/world-2050/the-accelerating-shift-of-global-economic-power.jhtml

10 *BIS*, Sources for Economic Growth, Trade and Investment Analytical Papers, Topic 6 of 18; 2011; www.bis.gov.uk/assets/biscore/international-trade-investment-and-development/docs/s/11-723-sources-of-economic-growth

The UK remains a major exporter of high value added goods. As well as cars, aerospace, pharmaceuticals and oil the UK exports parts for nuclear reactors and space craft.[11] Although the current Government is seeking to 'rebalance' the economy away from services, and financial services in particular, the UK is the world's second largest exporter of services by total volume, behind the US,[12] and second by share of total exports behind Ireland.

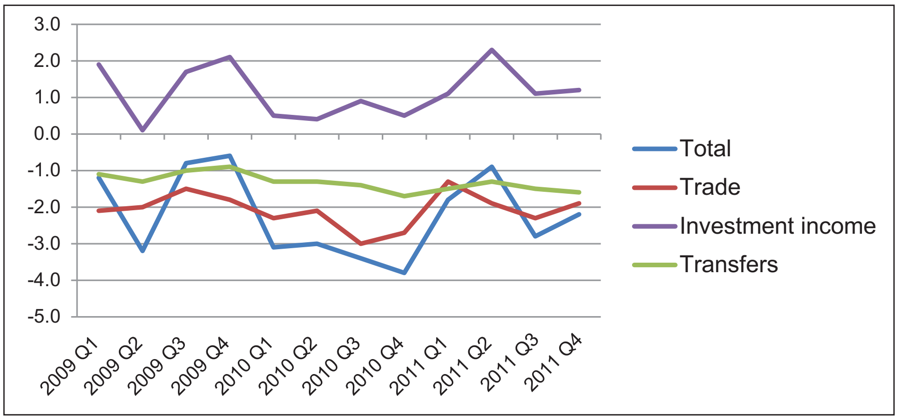
Graph 7: The UK is a world leader in services exports (% of total exports 2009)



Source: HM Government[13]

While the overall scale of trade is important equally so is the balance of trade – essentially, can the UK produce exports in sufficient quantities in order to pay for its imports? The UK has run a trade deficit for more than ten years. With the notable exception of the US, the UK is exceptional in that it also runs a deficit in what the McKinsey Global Institute describes as "knowledge intensive manufacturing".[14] At present the overall trade deficit remains at around £27bn (2011). The trade deficit is a major contributor to the UK's current account balance, which in 2011 totalled a deficit of £29bn.

Graph 8: UK current account balance (% of GDP)



Source: ONS[15]

The offsetting effect of net investment income illustrated in the graph above also highlights the importance of inward and outward FDI to the UK economy.

The UK's overall trade deficit masks a growing divergence between the UK's trade in goods and its trade in services. In the graph below we can see that in goods, the UK has run an ever growing deficit starting in the 1980s but rapidly increasing in the years after 1997, reaching nearly £100 billion in 2011. Services exports have, by contrast, been a UK success story rising to over £70 billion, helped by a strong financial services sector.

11 *Guardian Datablog* (2012), http://www.guardian.co.uk/news/datablog/2010/feb/24/uk-trade-exports-imports#zoomed-picture, Nuclear Industry Association, http://www.nuclearsupplychain.com/faq, BiS, Space Innovation and Growth Strategy, 2010 – 2030, http://www.bis.gov.uk/ukspaceagency/what-we-do/space-and-the-growth-agenda/uk-capabilities-for-overseas-markets/the-space-innovation-and-growth-strategy

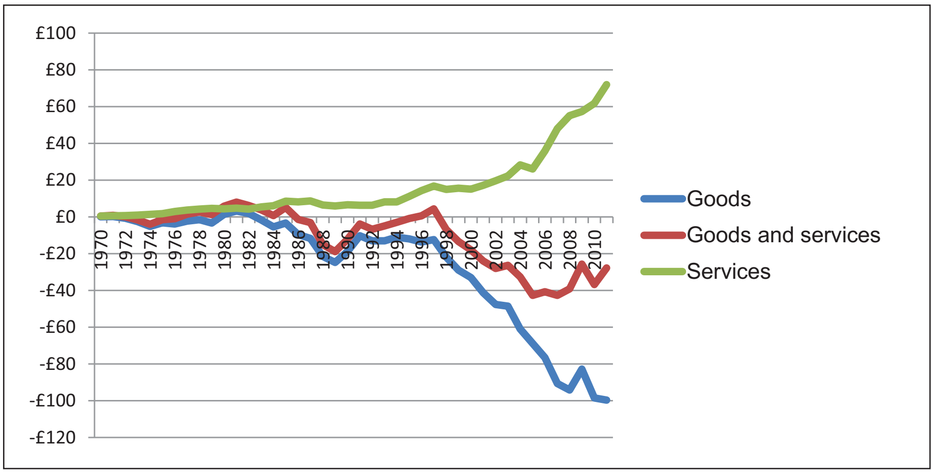
12 *WTO* country profiles 2011; http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=US,GB

13 *HM Government*, 'Trade and investment for growth', February 2011, p51

14 *McKinsey Global Institute*, 'Trading myths: Addressing misconceptions about trade, jobs, and competitiveness', May 2012, by Charles Roxburgh, James Manyika, Richard Dobbs and Jan Mischke; http://www.mckinsey.com/Insights/MGI/Research/Productivity_Competitiveness_and_Growth/Six_myths_about_trade

15 The UK's current account deficit is driven by the trade deficit and net transfers abroad (including the UK's EU budget and foreign aid contributions). This is offset somewhat by UK investment income. See *ONS*, 'Statistical bulletin: balance of payments – 4th quarter and annual 2011', March 2012; http://www.ons.gov.uk/ons/dcp171778_261403.pdf

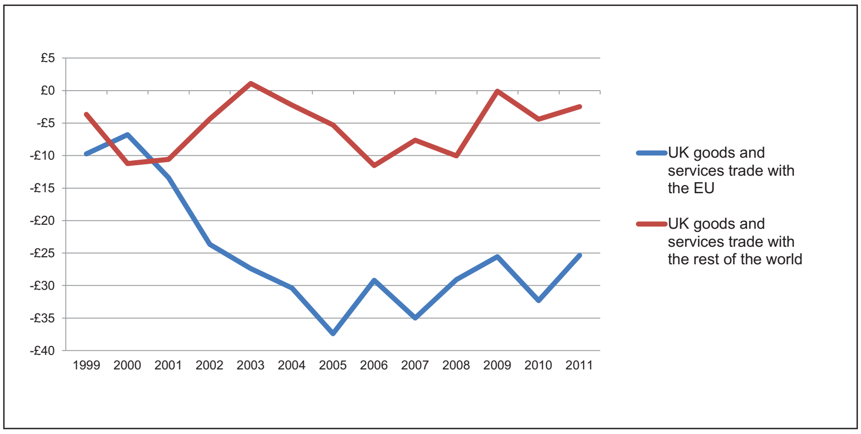
Graph 9: UK trade balance in goods and services (£ bn)



Source: ONS

As we can see, the UK's deficits and surpluses are split between goods and services but they are also split between the EU and non-EU states. The UK's trade with the rest of the world has run a small deficit over the past decade. However, Graph 10 shows that, when it comes to the EU the UK has run a much larger deficit, which is dominated by an imbalance in goods trade.

Graph 10: UK trade balances with the EU and rest of the world (£bn)



Source: ONS

There is a common view, espoused among others by Germany, that trade surpluses are virtuous. This is simplistic, as the sum total of world trade must necessarily be zero. However, a trade deficit does mean a country pays other states for more items it could perhaps produce at home by the use of its own workers than it exports. To follow this logic, a deficit potentially means employing fewer people than would otherwise be the case. A brief look around the EU employment statistics might seem to bear this out, with surplus states such as Germany suffering lower unemployment than deficit states such as Spain.

It is, however incorrect to argue that the UK's deficit in goods is the cause of the majority of job losses in the manufacturing sector. As McKinsey argues, manufacturing jobs losses are predominantly the result of increases in productivity.[16] It is also the case that mature economies are creating new jobs in labour and knowledge intensive service industries. A focus on closing the UK's deficit, by increasing exports, may have some beneficial effects, but would not necessarily produce jobs in the quantities expected. A better strategy would be to focus on economic growth and new job creating sectors.

The significant deficit the UK has with the EU, mainly in goods, shows that the EU also has a vested interest in continuing trade relations with the UK. The deficit however is only a small proportion of total trade between the two, meaning the real relationship is interdependent, benefiting both sides.

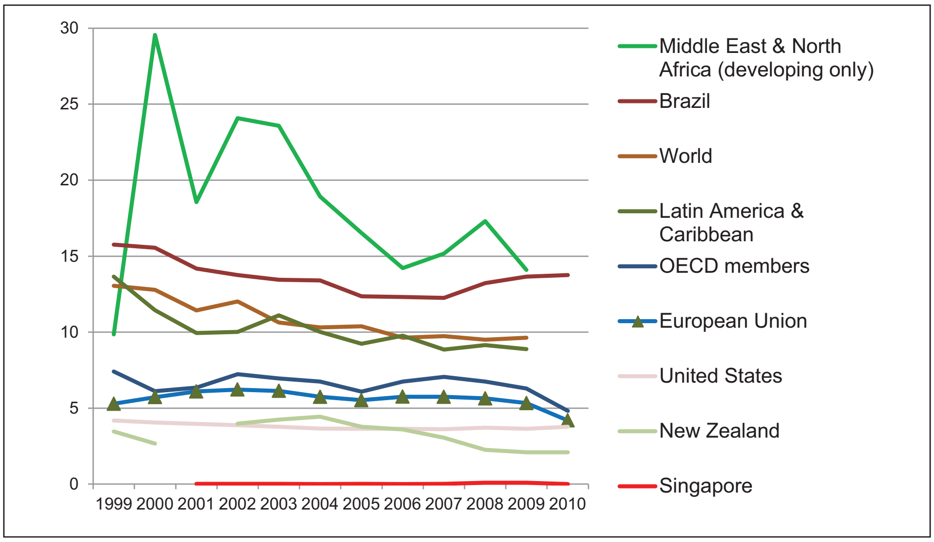
16 Ibid, See McKinsey's "Myth 4" p.19

1.3) The global trading environment is undergoing change

Despite the global financial and economic crisis of 2008, trade tariffs across the globe remain low, with successive rounds of liberalisation through the WTO and its predecessor, the General Agreement on Trade and Tariffs (GATT), leading to a substantial global reduction in average tariffs. The graph below shows that for all states standard Most Favoured Nation (MFN) tariffs have decreased with the global average now sitting at c.10%. The current stalled Doha trade round would have decreased these further.

It could be argued that, with future negotiations on trade liberalisation likely to decrease tariffs further, and as transport and communication become even cheaper, the benefits of belonging to a trading block such as the EU will diminish.

Graph 11: World Most Favoured Nation (MFN) tariffs (%)



Source: WTO

However, relatively high tariffs remain in some important sectors, for instance the car manufacturing industry and agriculture.[17]

Although tariffs have decreased, the relative importance and significance of non-tariff and technical barriers to trade (NTBs and TBTs) has increased. This is illustrated by the case of the EU's free trade negotiations with Singapore. As we can see in Graph 11, Singapore applies an average tariff of zero, meaning that negotiations must necessarily concern other issues. These non-tariff barriers are of particular importance to the UK as they often have the most impact on trade in services (services are not subject to tariffs).[18]

As well as a move away from tariffs towards non-tariff barriers, the forum for world trade talks has changed and is perhaps set to change again. The most important change in recent times has been towards multilateral talks under the auspices of the WTO and then back to bilateral deals following the breakdown of the Doha round in 2008.

- *Multilateral talks under the World Trade Organisation:* The latest round of these talks stalled at Doha. Bilateral free trade deals: The EU and other parties reacted to the failure of Doha by putting a renewed emphasis on bilateral free trade deals. The EU in particular after 2008 concluded deals with South Korea, Columbia and Peru, as well as starting negotiations with a series of other states including Singapore, Canada and India.

- *Plurilateral deals:* The most recent development in the structure of international talks is the 'plurilateral approach'. This has already seen two agreements: the Information Technology Agreement and the Government Procurement Agreement. In these cases the EU joined together with other states in the WTO system to reach an agreement where agreement by all WTO states

17 In the UK's case (as an importer) the EU's agricultural protectionism adds costs to the UK consume (see Graph 19)r. The case of the car industry is more complicated due to the UK's position as a significant EU exporter as well as net importer (see box A) and how the EU's 10% external tariff affects this.

18 For a list of potential NTBs see page 33.

would not be possible. This has even led to the development of an informal grouping called the group of 16 advanced "Really Good Friends".[19] This group is now at the beginning of talks on pushing the Doha Development Agenda on services.

1.4) Conclusions

- The EU and the eurozone, in particular, remain the UK's most important export markets. However, the UK is less reliant on the EU market, and therefore more reliant on non-EU markets, than other large member states.

- The continuing eurozone crisis is likely to suppress demand and growth is likely to be slow in these markets over the medium term. In order to take advantage of future growth potential in developed and developing states, the UK needs to be able to reorient its exports to these countries.

- The UK's comparative advantage is primarily in the export of services and some hi-tech and high value added goods.

- The UK's continued ability to attract FDI and investment income is important to the UK economy and overall current account balance. Therefore access to investment markets and investment protection is vital.

- Tariffs have fallen substantially across the globe and the focus of trade negotiations is increasingly on the removal of NTBs and TBTs. The UK is likely to be a major beneficiary of the removal of NTBs and TBTs, since this would tend to boost cross-border trade in services.

- With multilateral trade negotiations at an impasse, negotiations are increasingly bilateral and potentially becoming plurilateral. This could alter the negotiating dynamic among countries in various trade talks.

19 The "Really Good Friends" group includes the United States, European Union, Australia, New Zealand, Hong Kong, Taiwan, Singapore, Japan, Colombia, Chile, South Korea, Pakistan, Mexico, Norway, Switzerland and Canada.

2. STATUS QUO – FULL EU MEMBERSHIP: COSTS AND BENEFITS TO UK TRADE

EU membership currently defines both the UK's trade with the other EU member states via the Single Market and with non-EU countries via a common external trade policy. As a customs union, the EU therefore represents and negotiates on behalf of all 27 members at the WTO and negotiates bilateral free trade deals under what is called the Common Commercial Policy. Therefore, nearly all aspects of the UK's trade, internal, external, goods and services are conducted by the EU, leaving only trade promotion in the hands of the member states.

As well as the EU's other free trade agreements, the UK, as a member of the EU, is also a signatory to the EEA agreement and bilateral agreements with Switzerland, giving it access to the markets of the four EFTA states – Switzerland, Norway, Lichtenstein and Iceland.

2.1) The Single Market: reaching the political limits of liberalisation?

The EU's Single Market Programme (SMP), championed by Britain, came into force in 1992 and, in combination with competition rules, was designed to eliminate the remaining physical, technical and fiscal obstacles to trade after the establishment of the customs union.

The European Commission's ten year review of the Single Market estimated that EU GDP would have been 1.8% lower in 2002 without the SMP.[20] A 2007 Commission report estimated that the development of the Single Market had led to a 2.2% increase of EU GDP in 2006 and the creation of 2.75 million additional jobs.[21]

In 2005, HM Treasury estimated that trade between member states was boosted by 38% by membership of the EU, with only 5% of trade diverted from non-member countries, and with a 'Single Market effect' of 9%.[22] UK trade with EU members was seen to have increased by 7%, with only 4% of trade with non-EU countries suffering diversion. However, the econometric analysis revealed that while the EU trade effect for the UK was significant, it was smaller than the average effect for EU member states. It was thought that this reflected the fact that the UK "was more open to trade than some Member States before accession, and therefore the relative impact may have been less."[23]

The Department for Business, Innovation and Skills has suggested that given that, according to the OECD, "a 10 percentage point increase in trade exposure is associated with a 4 per cent rise in income per capita, increased trade in Europe since the early 1980s may be responsible for around 6% higher income per capita in the UK."[24]

a) Liberalisation in services trade lags well behind goods liberalisation

However, while most studies point to an increase in trade and the associated economic benefits of the Single Market, it should be noted that internal EU trade liberalisation is far more developed for goods than for services which is a particular problem for the UK. Even in goods, there remain substantial obstacles to trade.

20 *European Commission*, 'The Macroeconomic Effects of the Single Market Programme after 10 Years', 2002

21 *European Commission*, 'Steps towards a deeper economic integration: the internal market in the 21st Century', 2007; http://ec.europa.eu/economy_finance/publications/publication784_en.pdf

22 *HM Treasury*, 'EU membership and trade', 2005; http://www.hm-treasury.gov.uk/d/foi_eumembership_trade.pdf; Trade creation produces a benefit because trade takes place which previously did not exist. Trade diversion, however, is deemed negative because, for example, imports switch from a more efficient third country to a less efficient partner country.

23 *HM Treasury*, 'EU membership and trade', 2005, p7; http://www.hm-treasury.gov.uk/d/foi_eumembership_trade.pdf;

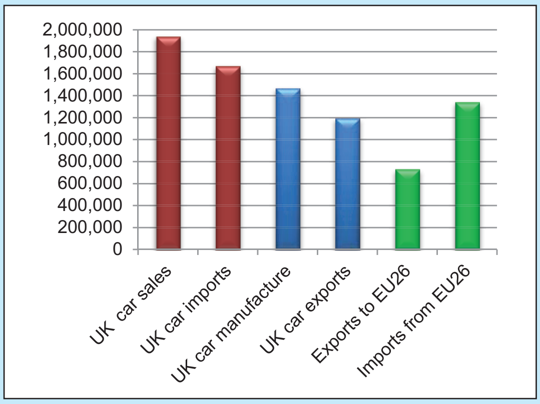
24 *BIS*, 'Written evidence to the House of Lords Select Committee on the European Union: Inquiry into re-launching the Single Market', 2010, p110; http://www.parliament.uk/documents/lords-committees/eu-sub-com-b/singlemarketinquiry/singlemarketwo.pdf

Box A: The UK car industry in 2011 – sectoral example of the integrated Single Market

The UK car industry is fully integrated into the EU's Single Market, behind the EU's 10% external tariff on car imports and 5% external tariff on imported components. The car industry, perhaps more than any other[25], is fully integrated across borders with intricate supply chains spread across the continent and the world. The UK still has a major car industry, directly employing 145,000 people in UK manufacturing and more in associated industries.

The UK industry is heavily geared towards exports and imports, with a majority of cars sold in the UK imported from abroad and those manufactured in the UK exported. The EU is the largest trading partner accounting for a large proportion of imports and exports. Although the UK has traditionally been a net importer of cars, in 2012, the UK became a net exporter.

Graph 12: UK car production and trade



Source: Society of Motor Manufacturers and Traders, ONS[26]

In addition to its 10% tariff on car imports, the EU protects its car industry in the form of product regulations. The UK car industry is fully adapted to the Single Market, with components and products moving more or less freely within the customs union. It is difficult to know how the industry would cope in its absence, and there are non-EU export markets and a large domestic market the industry could take greater advantage of, but it is clear that major adjustments would need to be made.

The Single Market for goods in the EU has created a broadly open and level playing field upon which to carry out cross-border trade. The customs union means that not only must UK exports to the EU be compliant with EU standards, but products sold domestically in the UK market must also comply with Europe-wide standards. This means that UK firms need only manufacture to one set of specifications, lowering costs. However, the potential benefits of a single compliance standard can be offset by overly complex regulations set at an EU level that do not take into account local circumstances.

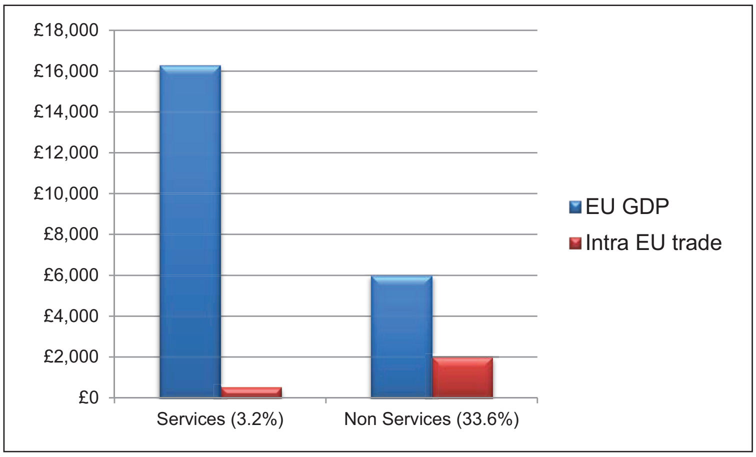
Nevertheless, although the SMP has made the most progress in liberalising goods trade, evidence suggests that barriers remain and will vary across particular goods sectors. For example, intra-EU trade for manufacturing goods is around 70% below intra-US states as a percentage of GDP, despite the fact that the EU population is much more concentrated.[27] This is probably a reflection of the fact that, as part of a single country, US states have a greater ability to specialise than EU member states, but illustrates that the Single Market in goods could be developed further if member states were willing to specialise in sectors where they have a comparative advantage.

About 58% of total EU trade in services in 2009 was within the Single Market, a share that has remained more or less stable since 2000. However, services trade within the Single Market grew slower between 2004 and 2008 than exports to third countries.[28]

However, while services are a large proportion of the EU economy, services remain a small proportion of EU trade. The graph below shows that, although the share of the EU economy devoted to services significantly outweighs the non-services economy, only 3.2% of EU services output is accounted for by intra-EU trade. The figure for non-services trade is by contrast 33.6%.

25 The Chemical industry is another very integrated sector.
26 Unit numbers are not the same as value (ONS, 2010: UK exported £17.2bn and imported £20bn worth of cars). Figures for EU imports estimate based on product brands
27 Ilzkovitz et al, 2007, cited in *BIS*, 'The economic consequences for the UK and the EU of completing the Single Market', 2011, p3; http://www.bis.gov.uk/assets/biscore/economics-and-statistics/docs/e/11-517-economic-consequences-of-completing-single-market
28 *World Bank*, 'Golden growth: restoring the lustre of the European economic model', 2012, p104

Graph 13: Unrealised potential: intra-EU trade as a share of services and non-services EU GDP (€ bn)

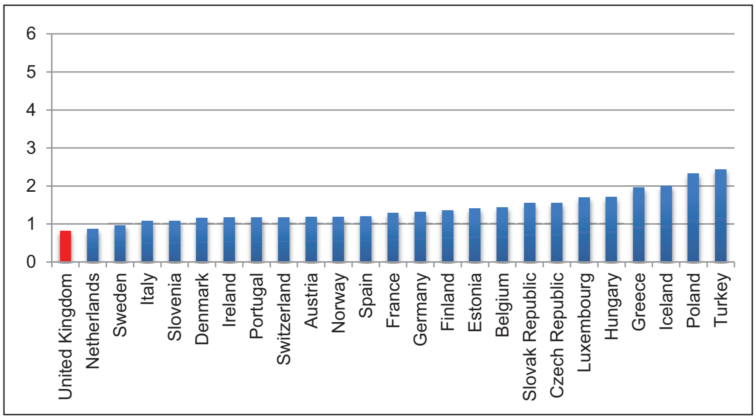


Source: Eurostat[29]

b) Further services liberalisation faces practical and political opposition

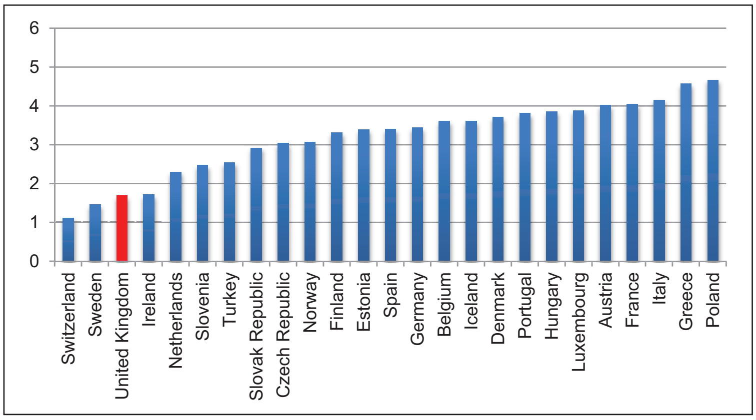
OECD product market regulation indicators help to measure regulatory barriers and quantify the obstacles to services sectors. According to the latest figures (from 2008), while EU member states have removed many of the major restrictions that affect businesses, there has been far less progress in removing domestic regulation that affects services trade.

Graph 14: Barriers to entrepreneurship (2008)



Source: OECD,[30] *indicators range from 0 to 6, with 6 the most restrictive*

Graph 15: Barriers to entry in services (2008)



Source: OECD[31]

29 *Eurostat*, trade integration, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Trade_integration,_EU-27_(1)_(%25_of_GDP).PNG&filetimestamp=20090430100045 http://epp.eurostat.ec.europa.eu/tgm/web/table/description.jsp

30 *OECD*, 'Indicators of Product Market Regulation', Barriers to entrepreneurship, mid-level indicators, 2011; http://www.oecd.org/document/36/0,3746,en_2649_34833_35790244_1_1_1_1,00.html

31 *OECD*, 'Indicators of Product Market Regulation', Barriers to entrepreneurship, low-level indicators, 2011; http://www.oecd.org/document/36/0,3746,en_2649_34833_35790244_1_1_1_1,00.html

Clearly, given its already advanced services sector and its comparably liberalised domestic market, the UK could make further gains from services liberalisation. 'Completing' the Single Market, including in services, is estimated by BIS based on theoretical studies to include the raising of EU income by 14% over 10 years.[32] Yet 'completion' is rather a vague term and, in a multilingual region with diverse political and legal cultures, a huge challenge.

Developing and liberalising trade in services is far more complex than trade in goods, and is contingent on a number of factors, often requiring the movement of people across borders, ease of establishment in another state, and comparable regulation between home and host state to create a level playing field. Many of these factors are inherently 'domestic' and greater liberalisation of services within the EU Single Market has often faced political opposition in many of the member states.

The absence of further liberalisation in services sectors not only acts as a brake on the trade of services within the EU but it also constrains the EU's ability to take a lead in global developments on services trade (see section 2.2) and damages the EU's global competitiveness in a fast-growing economic sector.

Box B: The EU's Services Directive – watered down under political opposition

The various services sectors are subject to different EU-level regimes of liberalisation or regulation. The Services Directive[33] is often thought of as the centrepiece of legislation designed to liberalise market access for cross-border service providers in the EU. However, the Directive was watered down after negotiations between member states and the European Parliament and a long list of services remain excluded from its scope.[34]

Similar to tariffs on goods, burdensome regulations and other NTBs prevent new firms from entering markets in other countries. Three examples of obstacles include:

- favourable tax treatment reserved for services purchased from local providers;
- residence requirements for shareholders, staff and regulated professions;
- lack of recognition of foreign diplomas.

The European Parliament and the Council reached agreement in 2006 on what had become an extremely contentious proposal. As a result, the proposed Directive was severely watered down. The Directive does not, as originally envisaged, allow service providers to work in other member states according to the rules of their home countries, the so-called 'country of origin principle'. Instead, the Directive simply tells member states to give service providers free access to their country and allow them to exercise their business freely and that their authorisation schemes for service providers are non-discriminatory, proportionate, and justified by an overriding reason relating to the public interest. However, governments retained the right to impose restrictions for reasons relating to the protection of consumers, protection of the environment, public safety and health.[35]

In addition, several member states missed the end-2009 deadline to transpose the Directive into national legislation. The publication in early 2011 of the results of a "mutual evaluation process" of the Services Directive found that, despite significant progress, burdensome requirements remain in place and continue to restrict intra-EU services trade.[36]

Services have increased in tradability due to new technologies that have changed the nature of many services from "traditional" to "modern." Traditional services often require face-to-face contact, while modern services can be delivered over longer distances. Modern services, such as banking and financial services, telecom support, and technical support, are now more "impersonal" and can be stored and traded digitally. They provide new opportunities to create employment and promote innovation.

However, while the EU market for trade in travel and financial services developed considerably in the 1990s and 2000s, trade in other services, such as transport, other business services and newer technologies, has not. In 2008, for travel more than two-thirds of total exports were transactions within the EU and for

32 HM Government, 'Let's choose growth: we need reform to unlock Europe's potential', 2011; http://www.number10.gov.uk/wp-content/uploads/EU_growth.pdf; BIS, 'The economic consequences for the UK and the EU of completing the Single Market', 2011; http://www.bis.gov.uk/assets/biscore/economics-and-statistics/docs/e/11-517-economic-consequences-of-completing-single-market

33 *Eur-Lex;* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:376:0036:0068:en:PDF

34 These include financial services, electronic communication services and networks, transport services, healthcare and pharmaceutical services, audiovisual and broadcasting services, gambling activities, and private security services. While some of these areas (financial services, telecommunications and transport) were not included because they were already subject to other legislation, the EU has not legislated to liberalise in other areas. See *WTO*, 'Trade policy review: European Union', 2011, p116

35 See speech by Frits Bolkestein, the European Commissioner responsible for proposing the Directive, 'The Services Directives', 2009. Available at; http://www.fritsbolkestein.com/site/references#this

36 *WTO*, 'Trade policy review: European Union', 2011, piX

transportation half of total exports were within the Single Market. For business services however – which do not include financial services but do include the types of ICT-facilitated digital trade that tends to be fragmented in the EU – the Single Market accounted for just two-fifths of the trade.[37]

Europe, then, has generally performed poorly in the most technology-intensive areas, such as the Internet, biotechnology, and computer software, while the likes of Korea, China, and the US have been doing well in these new sectors. The EU has tended to do better in the more established manufacturing sectors, especially industrial machinery, electrical equipment, telecommunications, aerospace, automobiles, and personal goods.

Box C: Financial services and the Single Market

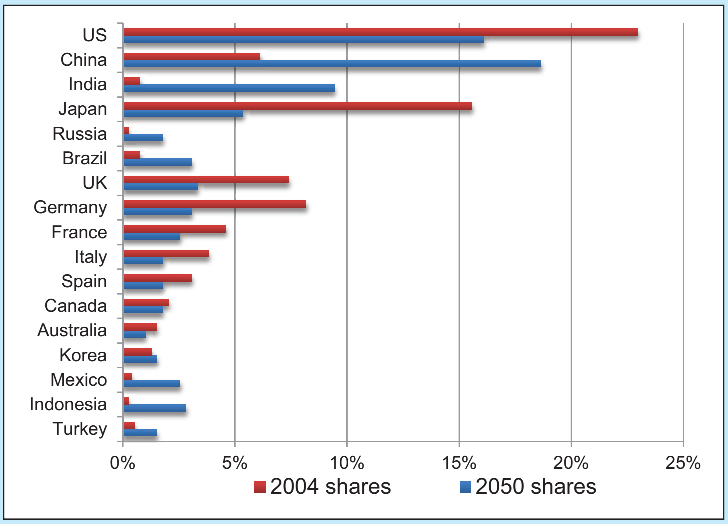
The financial services industry in particular is vital to the UK economy. The UK accounts for 36% of the EU's wholesale finance industry and a 61% share of the EU's net exports of international transactions in financial services.[38]

In the 1990s and 2000s, the benefits to the UK of EU financial regulation rested on two premises. Firstly, while EU-wide financial rules often increased compliance costs for firms in Britain, they generally allowed the UK to influence regulation across Europe in line with its thinking, reducing barriers to trade and creating opportunities for UK-based firms. Secondly, London was and is seen as an entry point to the EU's Single Market in financial services – a market which experienced significant growth in the 2000s as financial services developed rapidly.

However, as a result of the financial and eurozone crisis, the UK is increasingly losing influence over the shape and thrust of new EU financial regulation, reinforced by EU voting rules which under-represent Britain relative to the size of its finance industry.[39] Equally importantly, over the next decade, growth opportunities for financial services within the EU are likely to be more limited than elsewhere in the world.

Many European countries are likely to undergo economic stagnation and deleveraging. In 2005, the five largest EU economies accounted for 27% of global banking assets. In 2050, that will have decreased to 12.5%. Meanwhile, the BRIC countries' share of these assets will have increased from 7.9% in 2005 to 32.9% in 2050. Therefore, the benefits to London of acting as the gateway to the Single Market in financial services, while significant, are becoming less convincing and the need to keep the door open to emerging markets elsewhere across the globe far more important.

Graph 16: Shift in share of global banking assets (2004 to 2050)



Source: PwC[40]

37 *World Bank*, 'Golden growth: restoring the lustre of the European economic model', 2012, p16 and p109; http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/0,,contentMDK:23074045~pagePK:146736~piPK:146830~theSitePK:258599,00.html

38 In the 2009/10 tax year, the UK financial services sector as a whole made a total tax contribution of £53.4bn, 11.2% of the Government's total tax receipts for that year. Financial services accounted for a £35.2bn trade surplus in 2010 – the only industry sector in Britain that generated a substantial surplus apart from 'other business services', many of which are closely linked to financial services. See Open Europe, 'Continental shift: safeguarding the UK's financial trade in a changing Europe', 2011; http://www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf

39 While the UK accounts for 36% of the EU financial wholesale market and 61% of the EU's net exports in financial services, it only has 72 out of 736 seats in the European Parliament and, from 2014 (or 2017 if a member state requests it) when new rules come into force, it will possess 12.3% of votes in the Council of Ministers. Moreover, decisions within the EU's European Supervisory Authorities are taken by simple majority, meaning that the UK has exactly the same voting weight as all other EU member states, despite being home to the bulk of the bloc's financial sector. The exception is that, for decisions on technical standards, QMV is used. See *Open Europe*, 'Continental shift: safeguarding the UK's financial trade in a changing Europe', 2011, p21-22; http://www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf

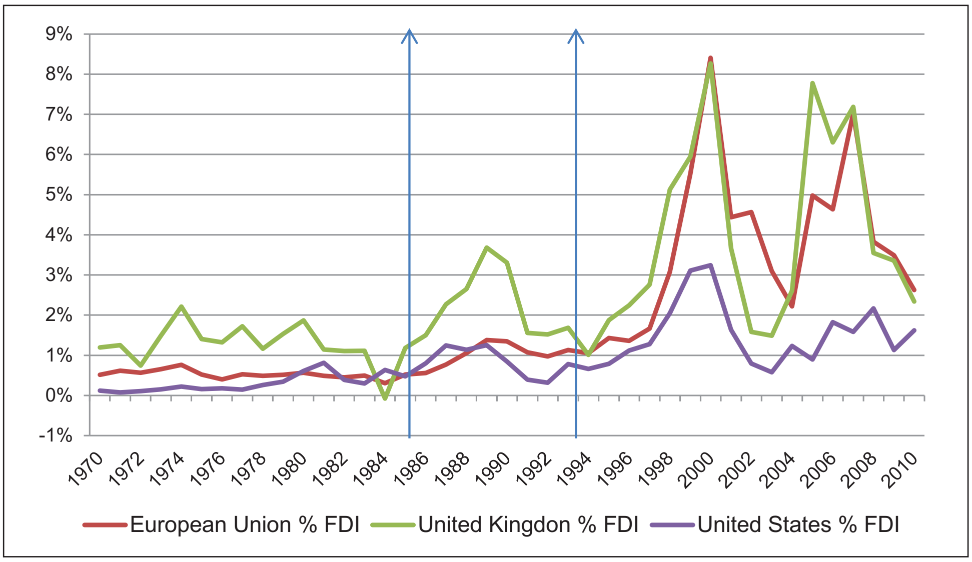
40 *PricewaterhouseCoopers*, 'Banking in 2050: How big will the emerging markets get?', 2007, baseline scenario projections; http://www.pwc.com/gx/en/banking-capital-markets/banking-in-2050-how-big-will-emerging-markets-get.jhtml

c) The Single Market as a driver of FDI?

A major argument made in favour of the Single Market is that it helps the UK attract more investment than would be the case if it was a market on its own. The UK has a historically good record in attracting inward investment, for a range of reasons ranging from the English language, law and investor protection, infrastructure, innovation as well as proximity to the Single Market. It is therefore difficult to quantify the amount of inward investment dependent on the UK's membership of the EU. Graph 17 below demonstrates that the flow of investment into the UK has increased following the Single European Act (1986) and Maastricht (1993). However, when the US' record is compared it is clear that a part of the expansion of investment is due to global factors unrelated to the EU, such as the 'dot-com bubble'.

Nonetheless, there is clear anecdotal evidence to suggests that overseas investments in sectors such as the car industry (see Box A), aimed at a regional EU market, were made with the Single Market in mind and could suffer in its absence.

Graph 17: Foreign direct investment into the UK compared to the US and EU (% of GDP)



Source: World Bank Data[41]

d) EU enlargement has opened new markets

As a member of the EU, the UK has promoted and received the benefits of past enlargements. EU enlargement has expanded the internal market and with it EU standards that now apply in new member states. This has allowed for considerable economic growth and, as an EU member, the UK has enjoyed preferential access to these new markets.

The EU enlargement process could potentially continue, bringing in the states in South-East Europe as well as Turkey and the Ukraine. This, however, seems unlikely in the immediate future, meaning the EU no longer holds open the prospect of preferential access to new, fast growing economies.

2.2 EU external trade: market clout or lowest common denominator?

External trade policy is an area of exclusive EU competence, under the so-called Common Commercial Policy, and the Lisbon Treaty stipulates that the EU's external trade policy includes trade in services, intellectual property, in addition to trade in goods and foreign direct investment.[42] The CCP means that all member states must apply the same external tariff. The extension of EU exclusive competence to foreign direct investment[43] has for instance allowed the inclusion of investment protection into preferential trade deals such as the recent EU-South Korea FTA.

41 *World Bank* data; http://data.worldbank.org/?display=graph
42 Article 207(1) TFEU. The Lisbon Treaty broadened the exclusive competence of the EU to encompass foreign direct investment.
43 The Treaty of Amsterdam had already given the EU some role in services; http://ec.europa.eu/trade/creating-opportunities/trade-topics/investment/

As well as being a member of the WTO's MFN programme, the EU has a complex system of unilateral trade preferences and reciprocal FTAs with third countries. Prior to the EU gaining exclusive competence over foreign direct investment under the Lisbon Treaty, member states were able to conclude bilateral agreements with third countries. However, the UK is no longer competent to negotiate international agreements on foreign direct investment with third countries unless empowered to do so by the EU.[44]

Since the Lisbon Treaty entered into force in December 2009, the EU's external trade and investment policy has been conducted under a new legal and institutional framework, which has greatly increased the power of the European Parliament.[45]

The Parliament now has rights equal with the Council of Ministers in adopting EU trade legislation, and must give its consent before the Council can ratify international trade agreements. Although the Parliament does not pre-authorise the negotiating mandate or have the power to ask for specific amendments to agreements, as it has to vote on final trade deals as a whole, it does now have considerable influence in negotiations derived from its potential veto of final agreements. The Commission must also keep the Parliament informed of the progress of talks.

In practice, the Commission drives the process by drafting proposed negotiating mandates that it puts before the Council, which votes by qualified majority, although unanimity in the Council is still required for trade agreements in some areas.[46] If granted a mandate, the Commission then conducts negotiations with third countries in consultation with the Trade Policy Committee[47] (Article 218, ex-Article 113), made up of senior officials from each member state.

Once negotiations are concluded, the agreement must be ratified by the Council by QMV[48], and by MEPs by simple majority.

Box D: EU-India Free Trade Agreement and the growing power of the European Parliament

One of the first chances for the European parliament to use its new power of veto, given to it under the Lisbon Treaty, was exercised during the negotiation of the EU-India Free Trade Agreement. The parliament passed a resolution saying that it would veto agreement unless the Agreement took into account concerns regarding the production of generic drugs in India and related to the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)[49] as well as other issues.

The Parliament had no power to alter the Commission's negotiating mandate, but by expressing its concerns managed to bring its new influence to bear. The growth in the Parliament's influence has implications for the future.

Given that external trade is an exclusive EU competence, the UK has very limited room for manoeuvre in pursuing its own trade policy.[50] A recent report on the UK's trading opportunities by the Department for Business, Innovation and Skills (Trade and Investment for Growth) makes this clear.[51]

However, the UK can use its resources for trade promotion and what is referred to as 'commercial diplomacy'. Indeed, the current Government has put a new emphasis trade promotion, undertaking major trade delegations to a number of states. This has been backed up by increasingly focussing the resources of the FCO to better help UK businesses.

44 The Commission may withdraw authorisation for Bilateral International Treaties that: conflict with EU law; overlap with an existing agreement between the EU and a third country, and the overlap is not addressed in the agreement with the EU; or undermines EU investment policy. Member States must also notify the Commission of, and seek its authorisation for the modification of existing BITs, or the conclusion of new ones. See WTO, 'Trade policy review: European Union', 2011, p25-26.

45 *ECIPE*, 'The Treaty of Lisbon and the European Union as an actor in international trade', 2010; http://www.fes.de/cotonou/DocumentsEN/Official%20ACP-EU%20Documents/Further%20EU%20Documents/the_treaty_of_lisbon_and_the_EU_as_an_actor.pdf

46 These are: cultural and audiovisual services that "risk prejudicing the Union's linguistic and cultural diversity", and for agreements in the field of social, education, and health services that "risk seriously disturbing the national organization of such services and prejudicing the responsibility of a member State to deliver them". For the conclusion of agreements in the "fields of trade in services and the commercial aspects of intellectual property, as well as foreign direct investment, the Council shall act unanimously where such agreements include provisions for which unanimity is required for the adoption of internal rules." Article 207(4) TFEU.

47 Formerly known as the Article 113 committee

48 Except where unanimity applies.

49 *European Parliament*; http://www.europarl.europa.eu/sides/getDoc.do?type=MOTION&reference=B7-2011-0294&language=EN

50 The UK has most independence of action when it comes to defence procurement deals. This is because defence procurement deals largely excluded from EU competence.

51 *BIS*; http://www.bis.gov.uk/policis/trade-policy-unit/trade-white-paper

2.3 UK input into and influence over the EU's external trade policy

The UK along with other EU states is represented on the EU Council which takes the ultimate decision on EU trade agreements. The UK can also second an official to the influential Trade Policy Committee. In the past the UK has also exercised significant influence through its role in the Commission. However, this influence has declined over recent years for a number of reasons. Firstly, the institutional memory of negotiating trade agreements, from pre EEC membership era, in the FCO and BiS no longer exists and there has been little effort to keep it alive. The UK has also failed to retain an economic portfolio within the current Commission, with serious implications for the direction of EU economic policy and economic liberalism.

There are signs that the current Government is seeking to improve the situation. The Foreign Secretary has recently set out that the FCO is strengthening its Economics Unit and that senior diplomats are being given specific training in commercial diplomacy as well as commercial secondments."[52] These new skills could in time help the UK place officials, with the right skills, into the EU Commission and so help maintain influence.

These are welcome signs but the Government can do more on a cross-departmental basis to improve UK influence in EU institutions, become a centre of trade policy knowhow and importantly ensure that the next Commission has economically liberal representation and UK representation in an economic portfolio.

a) The EU's market size as a negotiating tool

The EU, taken as a whole, remains the world's largest economy and trading block, with almost 29% of global output, a population of over 500 million people, 15% of global merchandise trade, and 24% of global commercial services trade in 2010.[53] As a result, the EU has a major influence in world trade talks.

Central to recent EU trade policy, and that of other major trading powers, has been the negotiation of reciprocal concessions on market access. The traditional principle is that the larger the domestic market relative to that of one's trading partners, the greater one's negotiating power by virtue of the ability to withhold, or withdraw, access to one's market. The EU, with the combined weight of its members, therefore has the potential to be a vehicle for the UK to further its interests in global trade talks and with particular partners.

The EU has been good at using its weight in talks with large partners such as China and the USA where the UK on its own could struggle. EU companies doing business in China have for instance gained EU support for the protection of their intellectual property rights through a series of talks.[54] The EU has also, with less success pressed for the opening up of China's public procurement system to EU firms.[55]

The EU has also used its combined weight in negotiations with the USA. Examples of this include the 'Open Skies' agreement on air travel between the EU and USA which included tough negotiations on landing slots, access to domestic markets and the 'fly American' provisions for US state employees. A further example would be the 2002 WTO dispute between the EU and US with regards to steel tariffs.[56] In this the EU's combined weight in negotiations probably aided negotiations in a way that the UK may not have been able to do on its own.

The EU is also a major player in the Doha WTO talks that broke down in 2008. As a block the EU has generally argued for more trade liberalisation. This is even the case in protected areas such as agriculture (see page 24). However the Doha talks have stalled as a result of disagreements between the USA and developing nations over market access.[57] This has led the EU to put its efforts into focusing on bilateral agreements.

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52 *FCO*, William Hague, speech to CBI, 21 November 2011, http://www.fco.gov.uk/en/news/latest-news/?view=Speech&id=694968482

53 *WTO*, Country profiles, October 2011. Share of global trade excludes intra-EU trade; http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=GB,E27

54 EU Commission dialogue with China on IP, http://ec.europa.eu/trade/creating-opportunities/trade-topics/intellectual-property/dialogues/ *Telegraph*, 24 June 2011; http://www.telegraph.co.uk/finance/china-business/8597660/EU-and-China-trade-flows-and-tensions.html

55 EU bilateral relations with the EU; http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/china/

56 *BBC News*, 11 November 2003, http://news.bbc.co.uk/1/hi/business/3259749.stm

57 *EU observer*; 22 June 2010, http://euobserver.com/19/30344

b) Trade-off between EU clout and UK interests

The nature of the EU as an aggregate of its member states' national interests can act to hold back liberalisation or particular issues of UK interest. In this the UK has to weigh up a trade-off – greater clout as a part of the EU compared to a set of priorities better suited to the UK.

i) Case of Pakistan – special interests hold up negotiations

This trade-off is seen in the EU's negotiations with Pakistan where an interest group in other EU states has held up trade negotiations that are seen to be a UK priority. The UK for commercial, strategic and cultural reasons has supported the EU efforts to extend trade concessions for Pakistan based around duty free exports under the Generalised System of Preferences in response to the recent Pakistan floods. At stake however is Pakistan's access to the EU's textile market. This is not of huge concern to the UK which no longer has a sizable domestic textile industry. However, other EU states such as Portugal, do, and have voiced opposition, slowing down and watering down negotiation.[58]

ii) Case of Singapore – special interests prioritised over UK interests

The EU's negotiations with Singapore illustrate how competing interests in negotiations can be prioritised over the UK's interests, in this case financial services. Singapore is a major financial services market and therefore a key market for UK exports. As we have seen in Graph 11, Singapore has zero tariff rates meaning that all negotiations would be on the subject of non-tariff barriers. At present the following are still outstanding:

- issues related to financial services;
- geographical indications, rules of origin (regional cumulation), tariffs and non-tariff barriers.[59]

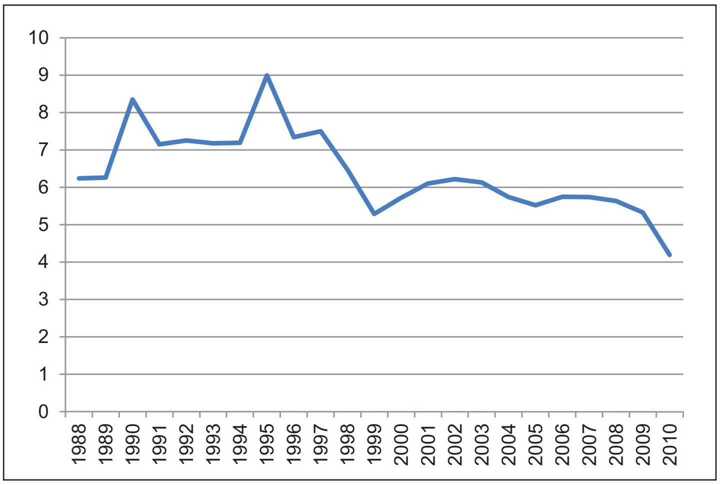
Obviously for the UK, financial services are of key importance whereas for other EU states the protection of goods by geographical name (i.e. Champagne) is of more importance. Going into the future, the UK is likely to continue to develop its services exports to a greater extent than other member states and if the EU does not prioritise these issues, UK services exporters could suffer.

c) Constraints on external EU trade liberalisation

i) National sectoral protectionism

As discussed in Section 1, there has been a global reduction in tariffs, and, in general terms, EU tariffs have followed this trend, although tariffs in individual areas, such as agriculture, cars and textiles have remained relatively high (see Graph 19).

Graph 18: EU's average weighted MFN external tariff (%)

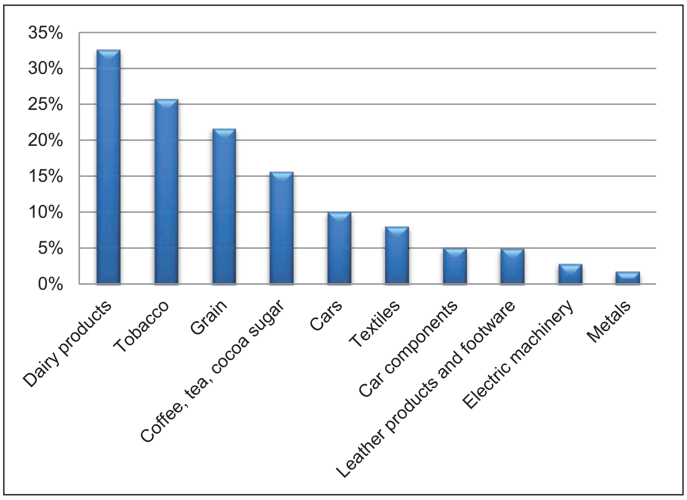


Source: World Bank, Most Favoured Nation tariff rate

58 *Number 10 Downing Street,* http://www.number10.gov.uk/news/pm-announces-pakistan-trade-boost/

59 See *EU Council*; "BACKGROUND FOREIGN AFFAIRS COUNCIL - TRADE ISSUES" Friday 16 March 2012; www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/128948.pdf

Graph 19: EU tariff on selected product lines



Source: WTO Trade policy review WT/TPR/S/248[60]

However, despite this general reduction in tariffs there are signs that the EU has reached a sticking point on the road towards further liberalisation. This is firstly due to agricultural protectionism, and secondly the failure of the EU to liberalise its own internal services market, making it unable and unwilling to argue for services liberalisation globally.

ii) Protection for EU farmers under the CAP and tariffs

According to the OECD, during the ten years to 2009, taxpayers and consumers in the EU have transferred nearly €1 trillion to agricultural producers, keeping production and export levels higher, and imports of cheaper products lower, than would otherwise be the case.[61]

A significant reduction of trade distorting support under the CAP has taken place following various rounds of reforms, with payments becoming decoupled from production. However, total support remains considerable, and imports of agricultural products remain lower than for many other goods. Despite reform to export subsidies and trade-distorting domestic support, tariffs on imports from non-African, Caribbean and Pacific countries remain relatively high. The average MFN agricultural tariffs are at 15%[62] and in some areas such as dairy products and fruit and vegetables, can reach as high as 156%, effectively keeping much produce out of the EU and protecting domestic farmers from competition. In the highest tariff product group which includes animal products, dairy, sugars and confectionary, in which imports account for nearly 21% of the EU market, the average tariff is above 20%.[63]

At the Doha WTO round of negotiations, the EU made a substantial offer to significantly reduce agricultural tariffs. In this case it was the reticence of other trading blocs and countries to agree to the deal rather than opposition from the EU.

Radical reform of the CAP is essential to improve the EU's economic dynamism.[64] Advanced industrial and services sectors continue to pay a price for the emphasis the EU puts on protecting its agricultural sector in trade negotiations. If the EU is not prepared to give improved market access to imports of agricultural produce from third countries, these countries will maintain barriers against the EU's services sector.[65] Consequently, the CAP and EU agricultural tariffs act as a barrier to greater trade liberalisation in a sector of vital importance to the UK.

iii) A reluctance to compete globally on services

As we have outlined above, the EU's Single Market is far more developed in goods than in services, with cross-border trade in the latter still hindered by non-tariff barriers in the member states. As global tariffs have come down, with the exception of some of those above, the importance of non-tariff barriers have increased.

60 It is worth noting that the % rate of EU agricultural tariffs have reduced partly as a result of agricultural commodity prices rising. This is because agricultural tariffs are set "*Ad Valorem*" on a set weight.

61 In *WTO*, 'Trade policy review: European Union', 2011, p115

62 *OECD*, 'Economic survey: European Union', March 2012, p12; http://www.oecd.org/dataoecd/52/24/49950244.pdf

63 *Trade Policy Research Centre*, Research Paper - EU Agricultural Protection, 2012, Felix Bungay and Ronald Stewart-Brown, pg10-12; http://tprc.org.uk/media/PDF_documents/TPRC_EU_Agricultural_Protection_-_Tariffs_and_the_CAP.pdf

64 See *Open Europe*, 'More for less: making the EU's farm policy work for growth and the environment', 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/CAP2012.pdf

65 *ECIPE*, 'A modern trade policy for the European Union', 2010, p30

Non-tariff barriers can include issues relevant to goods such as customs procedures and access to public procurement but also increasingly ones specifically relating to services such as:

- The provision of licences to operate including banking licences and educational establishments
- Intellectual property
- The recognition of regulations and qualifications
- Barriers to foreign ownership
- Requirement to establish a local legal entity

However, the EU's lack of domestic liberalisation in services trade limits the enthusiasm of member states to push and prioritise these issues with third countries.[66]

iv) Trade policy is bundled together with other EU objectives

The Treaty states that the EU "shall ensure consistency between the different areas of its external action and between these and its other policies,"[67] which means that EU trade policy must also address other issues such as development, environmental, social and human rights objectives. The desire to add non trade issues into trade agreements is likely to be increased by the European parliament.

The EU includes human rights as "essential elements" within Free Trade agreements. This allows the EU to take a view as to whether states with which it trades are respecting the "fundamental values" as included within the UN's Universal Declaration of Human Rights.[68] The impact of these provisions is difficult to assess as they are rarely acted upon but can be the cause of negotiation delay.

A new trend in EU trade negotiations has been what could be described as "Green Protectionism". This was first seen in the debate over biofuels, which were seen by some as a way of providing further subsidies to EU farmers.[69] This has now grown to include topics such as the EU's attempt to block Canadian tar sands oil. This precedent has now been followed by the EU's trade rivals, with China using environmental grounds to block the export of rare earths.[70]

As well as allowing for retaliation, the bundling of other issues into trade agreements can slow down agreement and become an excuse for protectionism.

v) Will the euro crisis feed protectionism?

The long-term effects of the eurozone crisis are as yet unclear but there are signs of creeping protectionism. This has arisen in the French Presidential election, with the emergence of a "Buy European" proposal put forward by Nicolas Sarkozy.[71]

Box E: Buy European" proposal – an example of protectionism re-emerging?

The EU Commission has put forward proposals for "reciprocity" in EU procurement.[72] This proposal aims to allow access to EU state procurement only to those states that provide similar access in their markets. Although it is not explicitly named, its main target is evidently China.

Although on first reading this is a reasonable proposal, it could become a serious tool for protectionism. In particular, the proposal gives (Article 10) the Commission the power to close the whole EU procurement market to specific third countries, or to allow individual EU states (i.e. France) to close their markets following a Commission investigation. This potentially gives the Commission the power to prevent Chinese firms gaining state contracts.

As well as giving the EU disproportionate influence, this proposal would increase costs to member state governments and risk retaliatory action thus hindering trade.[73]

66 An example could be the requirement for establishment under the AIFM directive.

67 Article 21 TEU

68 *WTO*, "The Wedding of Trade and Human Rights: Marriage of Convenience or Permanent Match?" (2011), http://www.wto.org/english/res_e/publications_e/wtr11_forum_e/wtr11_15feb11_e.htm EU Commissioner De Gucht: Speech delivered at the S&D conference, 13 October 2010, "Can trade policy improve human rights?" *House of Commons*, research note, 16 April 2004, www.parliament.uk/commons/lib/research/rp2004/rp04-033.pdf

69 *ECIPE*; "THE RISING TREND OF GREEN PROTECTIONISM": Biofuels and the European Union, http://www.ecipe.org/media/publication_pdfs/OCC22012.pdf

70 *BBC*; http://www.bbc.co.uk/news/business-17348648

71 *EUbusiness*, 11 March 2012, http://www.eubusiness.com/news-eu/france-vote-sarkozy.fmx

72 EU proposal for reciprocity in public procurement, http://ec.europa.eu/internal_market/publicprocurement/modernising_rules/international_access/index_en.htm

73 *Economist*, Charlemagne column, 20 April 2011, "The Trade War Within", http://www.economist.com/node/18586846

2.4 Non-trade costs and benefits of EU membership

The EU is clearly more than a trading organisation and therefore comes with additional costs and benefits that have to be looked at as a whole.

a) Costs

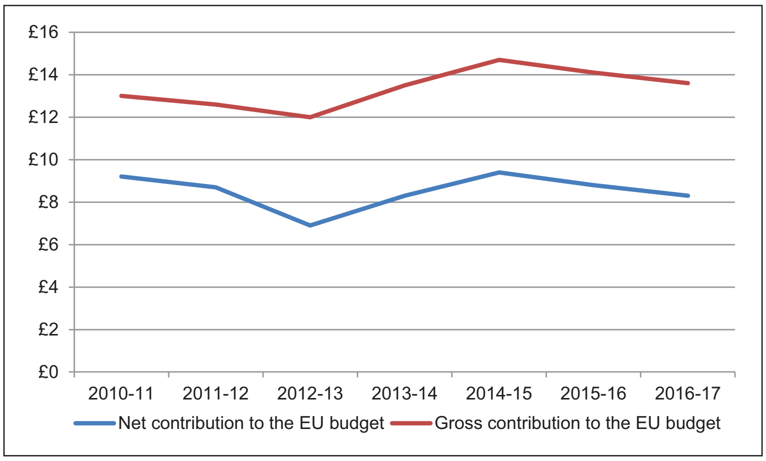
i) Loss of national democratic control

Foremost among the EU's additional costs are the implications for national democracy of making decisions under a Qualified Majority Vote (QMV) where the UK can be outvoted, or has to concede before losing a vote. The jurisdiction of the ECJ and the increasing power of the European Parliament represent further losses of national political control. This is the case in a wide range of areas but is of foremost importance in the areas where the UK has an overwhelming economic interest such as in financial regulation.

ii) EU budget contributions

UK budget contributions to the EU budget are considerable, with gross contributions to the EU budget expected to remain around £14bn a year, dependant on budget negotiations, CAP and EU regional policy reform.

Graph 20: UK contributions to the EU budget (£bn)



Source: OBR[74]

iii) Common Fisheries Policy

In addition, to the CAP, EU membership entails the common ownership of the UK's waters under the Common Fisheries Policy, which has been hugely damaging to UK fisheries and fishermen.

iv) Justice and Home Affairs

The EU also has an impact on the UK's criminal justice and asylum system, although, under its opt-out arrangements, the UK can choose to stay out of future EU JHA rules and opt out of over 100 crime and policing laws in 2014.[75] The UK has chosen to opt into EU JHA laws that Governments have believed to be beneficial to the UK.

v) Regulatory costs

In 2010, based on analysis of 2,300 impact assessments, Open Europe calculated that EU regulation imposed costs on the UK economy of £124 billion since 1998.[76] In particular, EU social, employment and health and safety regulation, including the Working Time Directive (WTD) and the Agency Workers Directive (AWD), currently costs UK business and the public sector £8.6bn a year.[77]

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74 *OBR*, 'March 2012 Economic and fiscal outlook', Table 2.15, gross contribution less UK abatement; http://budgetresponsibility.independent.gov.uk/pubs/March-2012-Fiscal-Supplementary-Tables1.xls

75 See *Open Europe*, 'An unavoidable choice: more or less EU control over UK policing and criminal law', 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/JHA2014choice.pdf

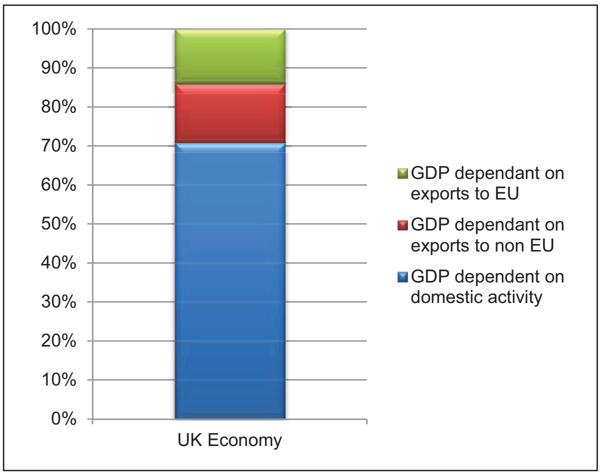
76 *Open Europe*, 'Still out of control? Measuring eleven years of EU regulation', 2010; http://www.openeurope.org.uk/Content/Documents/PDFs/stilloutofcontrol.pdf

77 *Open Europe*, 'Repatriating EU social policy: the best choice for jobs and growth?', 2011; http://www.openeurope.org.uk/Content/Documents/Pdfs/2011EUsocialpolicy.pdf

There is some truth in the argument that many of these costs (and benefits which are often difficult to quantify) would exist absent EU regulation because the UK would have regulated in many of these areas anyway. However, there are clearly areas, particularly the WTD and the AWD, which impose large costs on the UK, where, if it had the ability to act, the UK Government would seek to reduce costs and burdens on business and the public sector.

The EU's regulatory burden falls on the entire UK economy whereas over 70% of it is dependent only on UK domestic demand. Only 13% of the economy is dependent on EU exports, and not all of that would require EU regulations in the absence of the EU (i.e oil would be compliant etc).

Graph 21: % of UK GDP dependant on foreign trade



Source: ONS, Open Europe[78]

b) The benefit of 'influence'

The principal non-trade benefit of EU membership is the ability to influence political and economic events in Europe. Inside the EU, the UK has been able to argue for the development of the Single Market in goods and continues to make the case for services liberalisation.

Aside from trade, EU membership has allowed the UK to argue for EU enlargement to the East and ensures it retains a veto over future enlargements. With large parts of EU foreign policy still decided by unanimity and as a major military power, the UK is also able to influence Europe's wider relations with the rest of the world. One's view of the importance or desirability of European influence via the EU may differ. However, in order to come to a full evaluation of the costs and benefits of EU membership, the UK must also come to an assessment of the value of EU membership in its ability influence its European neighbourhood.

2.5. Conclusions

- The UK's trade with the EU is considerable and it benefits from tariff-free access and a single set of regulations. Access to the Single Market, despite lower growth rates compared with elsewhere, will remain a key UK trading interest.

- The UK has driven forwards the Single Market and has benefited from past liberalisation and enlargements particularly in goods trade. It has also potentially benefited from greater FDI. However, liberalisation of services, a key UK export industry, has lagged behind that of goods with the Services Directive delivering disappointing benefits.

- The EU's external trade policy has also delivered gains for the UK. We have seen the EU as a force for liberalisation in trade talks, particularly in goods trade liberalisation, greater market access and

78 For a discussion of the merits of an exports to GDP calculation please see Ruth Lea's "UK-EU Trade creates far fewer jobs in the UK than in the rest of the EU", Global Vision 2008 , http://www.global-vision.net/files/downloads/download456.pdf: of the total £1,505 bn UK economy in 2010, £227 bn is exported globally and £209bn to the EU. This does not take into account the proportion of the EU economy dependant on UK demand and that UK exports to the EU can be exaggerated by the "Rotterdam effect" whereby goods exported to Rotterdam are re-exported globally but are counted as a UK export to the EU.

investor protection. In this, the fact that the EU has liberalised the internal market, particularly in goods, has translated into a force for liberalisation globally.

- Multiple EU priorities can mean that UK priorities are compromised. This is particularly true of services where the lack of Single Market liberalisation reduces the incentive for the EU to be ambitious in talks with third countries.

- Further EU trade benefits, particularly in services, may be difficult to realise due to political and practical barriers.

Therefore, while the EU currently provides the UK with several trade benefits, there are three factors that could alter this cost-benefit analysis in future:

1) If EU trade liberalisation stalls over the long-term;

2) If the EU moves in a more protectionist direction in the wake of the eurozone crisis;

3) Or, if the EU prevents the UK from taking advantage of growth opportunities in non-EU countries in future trade talks. The UK relies on the EU to negotiate on its behalf for greater market access to third countries, which can be a disadvantage if UK interests are watered down as part of an EU compromise deal.

In the next sections, we look at the most commonly suggested alternative trading arrangements the UK could opt for outside the EU.

3. THE EEA – NEARLY BUT NOT QUITE AN EU MEMBER: THE "NORWEGIAN OPTION"

The European Economic Area (EEA) agreement is a comprehensive free trade deal between the EU and three of the European Free Trade Association (EFTA) members (Norway, Iceland and Lichtenstein, Switzerland decided to stay out). This allows for tariff-free access to the EU's Single Market but leaves these countries largely free to control their own external trade policy.

3.1. What does is it involve?

The EEA goes further than a traditional free trade agreement in that it allows for the extension of the four EU Single Market "freedoms" (free movement of labour, goods, services and capital) to the non-EU signatories. However, under the EEA agreement, the free movement of goods is subject to rules of origin (see Box G), which is more bureaucratic than the free movement provided within the EU customs union.

With these "freedoms" come obligations regarding social security for people who move, as well as some related social and employment legislation, such as the Working Time Directive, which EEA states have to adopt.

There are provisions in the EEA agreement for states to influence, although not vote on, Single Market rules. Input can take the form of participation by EEA experts in European Commission and Council committees.[79] However, these formal arrangements do not take into account the growing influence of the European Parliament in shaping EU/EEA legislation.

The EU's CAP, the Common Fisheries Policy (CFP), criminal justice and asylum policy, Schengen, foreign policy and defence, and external trade are excluded from the EEA agreement. However, this has not stopped EEA states from reaching further agreements with the EU. Norway signed the EEA Agreement in 1992 but has also decided to cooperate with the EU outside the bounds of the EEA agreement in the following areas:

- *Schengen.* Norway is a member of the Schengen free passport area and as such has adopted many of the rules and laws regarding police cooperation.

- *Justice and Home Affairs (police cooperation).* Norway has agreed to a number of EU policing measures and has joined a number of Agencies. It should be noted that the UK already has opt-outs from large parts of Schengen and justice and home affairs.

- *Defence.* Norway has joined the European Defence Agency, which oversees cooperation in defence procurement and has taken part in a number of EU military operations including operation Atalanta off Somalia and is a standing member of the EU's Nordic Battle Group, one of the EU's 18 battle groups under the Common Security and Defence policy.

As a result, Norway has the closest relationship with the EU of any non-member state. Norwegian goods exporters have access to the internal market but the country has the power to negotiate its own third party free trade agreements, often in conjunction with its EFTA partners Switzerland, Iceland and Lichtenstein.

Box F: The European Free Trade Association (EFTA)

EFTA, founded in 1960, is responsible for the management of three sets of trade agreements:[80]

The EFTA Convention: this forms the legal basis of the organisation and governs free trade relations between the EFTA member states (Norway, Iceland, Lichtenstein and Switzerland).

EFTA's free trade and partnership agreements: EFTA has actively pursued trade relations with third countries in and beyond Europe.

The EEA agreement: this allows three of the four EFTA states (Iceland, Liechtenstein and Norway) to participate in the EU's Internal Market.

Membership of EFTA therefore grants the member states free access to each other's markets, but the EFTA states' trade relations with the EU are governed by different agreements. Norway, Iceland and Lichtenstein's relations with the EU are governed by the EEA agreement, but Switzerland's relations are governed by a free trade agreement and a series of bilateral deals (see Section 4, page 31).

79 See *EFTA* website; http://www.efta.int/eea/decision-shaping.aspx
80 See *EFTA* website; http://www.efta.int/about-efta/the-european-free-trade-association.aspx

3.2. Costs

a) Norway has to adopt regulations over which it has little influence

As an EEA member, Norway has to abide by EU regulations with regard to the Single Market, such as product regulations as well as EU social and employment laws. This is a significant body of legislation over which Norway has no voting rights, although it does have some influence.

A recent report, *Outside and inside: Norway's agreements with the European Union*,[81] estimated that Norway had decided to implement 75% of all EU laws as compared to a state such as Germany that has agreed to all of them. Norway has, however chosen to cooperate in areas outside the scope of the EEA and therefore not all EU regulations Norway accepts stem from its original membership of the EEA (for instance Norway accepts the Schengen rules and regulations and has joined a number of EU agencies). Compare Norway to the UK, which is not in Schengen and the Euro, and the difference may not be as great.

This would be of particular importance to the UK as the UK's economy is disproportionately affected by issues such as EU financial regulation and social and employment legislation which often clash with UK models of regulation. These are of less importance in Norway due to a smaller financial services industry and high social costs that outstrip those imposed by the EU.

b) Rules of origin (ROO)

As Norway is not in the EU customs union and does not apply the EU's common external tariff, it can import goods from non-EU countries under its own tariff regime.

Box G: The key difference between a Free Trade Area and a Customs Union

A customs union has a common external tariff (duty) wall. Once the tariff has been paid, goods can travel in free circulation. A free trade area has no common external tariff, but goods originating in the area still travel tariff free . As there is no standard external tariff, Rules of Origin (ROO) apply to specify the conditions under which a good becomes eligible for zero tariffs within the free trade area and that there is no backdoor. ROO can be relatively simple for products wholly produced and assembled in one country. However, when a product involves complex supply chains, determining origin can be a "very complex, sometimes subjective, and time-consuming process."[82]

As countries within a customs union apply a common external tariff to external countries they must harmonise their external trade policy on trade covered by the customs union.

The EU has one standard set of 'preferential ROO'[83] for both the EEA Agreement and for its free trade agreements with Switzerland, other European countries and certain non-European countries such as Egypt, Israel, Jordan, Lebanon, Morocco and Tunisia, creating a complex pan-European system of rules of origin.[84] Under these rules, components manufactured in these states are given preference under so called 'cumulation' rules.

As an EEA member, Norway has access to the EU's Single Market subject to ROO. In a simple example, if you import a car from China to Norway and then export it to Germany it would fall foul of EU rules of origin and be subject to duty.

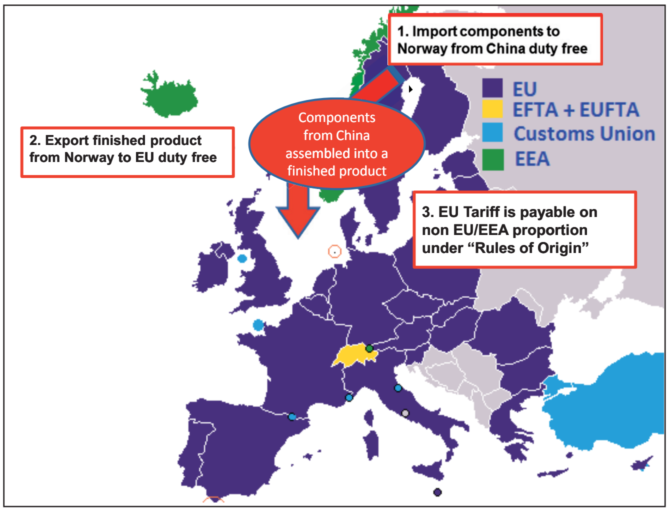
81 *Official Norwegian reports, 'Outside and inside: Norway's agreements with the European Union'*, 2012; http://www.regjeringen.no/pages/36798821/PDFS/NOU201220120002000EN_PDFS.pdf

82 See V. Jones and M. Martin, 'International trade: rules of origin', *Congressional Research Service*, June 2008; http://fpc.state.gov/documents/organization/108074.pdf

83 The EU has two forms of ROO: preferential and non-preferential. Under preferential trade agreements most goods originating in the preferential partner country can enter the EU after paying less duty than the Common External Tariff, or none at all. The rules of origin are necessary to establish whether a particular import originates in a preferential partner country, and to prevent goods from other countries being routed via a preferential partner country and so avoiding higher duties. See *BIS*, 'A guide to European Community rules of origin', http://www.bis.gov.uk/files/file45006.pdf

84 For more information see *European Commission* website, 'System of pan-Euro-Mediterranean cumulation'; http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_783_en.htm (accessed 12 April 2012).

Illustration iv: Rules of origin applied to non-customs union states



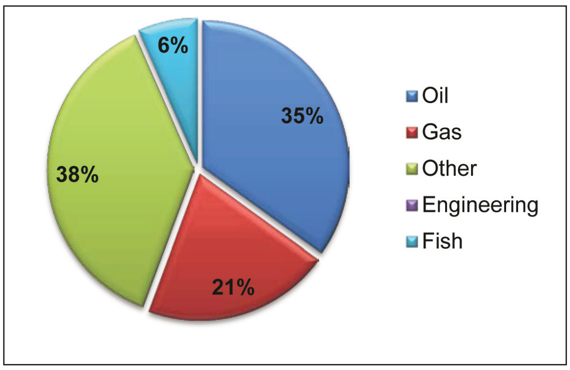
To take a more complicated example, if a Norwegian firm imports Chinese components for a car to be built in Norway, which is then exported as a finished car to the EU, is this a Norwegian or a Chinese export? In this case you would have to consult the rules of origin to decide what duty is payable. In this case, the rules allow for 40% of the car to come from a non-EU state before duty is payable.[85]

Each type of good is listed separately and has different allowances, which are affected by the EU's preferential arrangements with third states (i.e. components from Mediterranean states are classed as EU for ROO purposes). Although many goods are exempt, these rules do add another level of compliance and administrative cost to firms, which would be a new cost to UK firms. As the Trade Policy Research Centre argues:

> *"The process of adapting to rules of origin-based duty-free trade under a new UK-EU free trade agreement would be tedious, costly and disruptive to trade. This might be acceptable to many British-owned manufacturers in the context of a return to UK self-government. But the prospect of loss of free movement of goods would probably be unacceptable to a number of important and largely foreign-owned UK manufacturing sectors such as cars, chemicals and processed foods. And it would certainly be unpopular with most continental exporters to the UK."*[86]

Although Norway's trade is highly dependent on the EU (its combined export and import trade constitutes more than half of its GDP and 75% of its trade is with the EU[87]), Norway's exports are concentrated in a few areas for which ROO are not relevant. For instance, fish caught in Norwegian waters or Norwegian oil and gas have no component non-EU parts. In a mixed economy, such as the UK, the situation would be different and ROO of more significance.

Graph 22: Norway's goods exports in 2010



Source: Statistics Norway (statistisk sentralbyra)[88]

85 *Global Britain,* Briefing Note 11; http://www.globalbritain.org/BNN/BN11.htm
86 R. Stewart-Brown and F. Bungay, 'Rules of origin in EU free trade agreements', *Trade Policy Research Centre*, February 2012; http://tprc.org.uk/pages/posts/rules-of-origin-in-free-trade-agreements-10.php
87 *Norway's mission to the EU*; http://www.eu-norway.org/eu/policyareas/Trade/
88 *Statistics Norway*; http://www.ssb.no/english/subjects/09/05/uhaar_en/

c) Norway's contribution to the EU for access to the Single Market

As an EEA and EFTA member, Norway contributes to the EU budget in two ways. Firstly for the programmes it is a part of it has to contribute in proportion to its percentage of EU GDP and secondly by way of a substitute contribution to the EU's regional policy under the EEA funds.[89] The EEA EFTA contribution is therefore comparable with EU member states for those areas it participates in. Norway will therefore contribute to areas such as Schengen but not the CAP. In addition, the EEA EFTA states pay to second several national experts to posts in the European Commission. The total EEA EFTA commitment amounts to 2.4% of the overall EU programme budget.[90]

3.3. Benefits

a) Access to the Single Market while avoiding the costs of the CAP, CFP and EU-wide regional policy

The main benefit of the EEA agreement is that it allows access to the Single Market. In addition, this access comes without the costs of the CAP or CFP, two areas of great importance to Norway for cultural, in the former, and economic reasons in the latter case. EEA states are also exempt from the EU-wide regional policy, which acts to redistribute funds across all member states at a substantial deadweight cost, and instead only provide support to the EU's poorer member states via the EEA fund.[91]

b) National control of non-EU trade policy

Outside the EU customs union, EEA EFTA states have the ability to negotiate their own FTAs with third countries. The biggest third party deal the EFTA states have negotiated is of course with the EU in the form of the EEA (to which Switzerland is not a party). However, the EFTA states have in addition negotiated a fairly extensive network of agreements covering the globe. The EFTA states currently have 24 free trade agreements, covering 33 countries, and are working on many more.

EFTA as a negotiating platform is an unlikely partnership. Switzerland and Norway are the only two with real capacity to negotiate and they have divergent interests. Norway tends to be interested in fish exports and Switzerland is landlocked, Norway is keen on including human rights stipulations into trade agreements whereas Switzerland is less keen, and Switzerland has interests in industries such as pharmaceuticals that are not shared by Norway. That said, the small size, and limited range of interests of the EFTA states can be an advantage in negotiations allowing for faster conclusion of talks and, balancing fewer competing interests than the EU has to, a more tailored product. For instance, the EFTA free trade agreement with South Korea came into force on 1 September 2006,[92] whereas the EU took a further five years with its agreement coming into force on 1 July 2011.[93]

All EFTA members are also free to negotiate bilateral deals outside the EFTA framework.

c) Public support and legitimacy

The Norwegian Government's comprehensive study on the EEA agreement concludes that the agreement is the product of Norwegian circumstances. Norwegians have been given the choice to join the EU but voted No in a referendum in 1994 by a margin of 52.4% to 47.6%. For both those who still wish to join and those who do not, the EEA maintains a measure of public support as most people's second choice.[94]

89 *Norwegian Foreign Ministry*, http://www.regjeringen.no/upload/UD/Vedlegg/eu/Norway%20and%20the%20EU.pdf

90 *Norwegian Foreign Ministry*, EEA Grants: "NOK 15 billion for the period 2009–2014… to reduce social and economic disparities and promote cooperation in Europe in the period", http://www.regjeringen.no/en/dep/ud/press/news/2010/eea-new.html?id=611778; This equates to 0.12% of GDP

91 See *Open Europe*, 'Off target: the case for bringing regional policy back home', 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/2012EUstructuralfunds.pdf

92 *EFTA*, http://www.efta.int/free-trade/free-trade-news/2006-09-01-efta-korea-fta-enters-into-force.aspx

93 *EU Commission* http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/korea/

94 *Norwegian Government*,. http://www.eu-norway.org/news1/Report-by-the-EEA-Review-Committee-Norways-agreements-with-the-European-Union/

3.4. Conclusions

- If the UK were to opt for EEA membership, it would retain access to the EU's Single Market in goods and services. However, outside the EU's customs union, access for goods could be impeded by complex rules of origin. Switching to such a system could introduce a new administrative burden to merchandise trade with EU countries, which remains the UK's biggest goods export market.

- Outside the EU customs union, EEA member states have the ability to negotiate and conclude their own FTAs with non-EU countries. The UK would no longer benefit from the EU's market size in negotiations but greater independence in trade talks could become increasingly attractive should EU liberalisation stall, or if the EU were to prevent the UK from taking advantage of future growth opportunities outside Europe.

- Inside the EEA, the UK would remain bound by most EU laws, particularly those with a significant impact on its economy such as social and employment regulation and financial services regulation. However, the UK would have less democratic control over these rules than it has in the EU, without the right to vote on them and with only limited formal influence in shaping them.

- If the UK was in the EEA, it would no longer be subject to the EU's agricultural, fish and EU-wide regional policies.

- Whether the UK would have to contribute to the EU budget is an open question. If Norway is a precedent, it is likely the UK would have to contribute in one way or another, for example via a bilateral development fund, although substantially less than it does now.

4. A FREE TRADE AGREEMENT – A TAILORED BILATERAL DEAL: THE "SWISS OPTION"

An alternative to seeking EEA membership would be for the UK to negotiate a free trade agreement (FTA) with the EU. This would be another step removed from EEA membership, and a variant of Switzerland's trade relations with the EU.

4.1. What would it involve?

Switzerland is a member of EFTA but, unlike Norway, Iceland and Lichtenstein, not of the EEA. Therefore, Swiss-EU relations are conducted on a bilateral rather than supranational basis, a relationship that has evolved since the Swiss people rejected accession to the EEA in a 1992 referendum, despite the country taking a leading role in the EEA negotiations. The Swiss-EU relationship has since been shaped by often very specific concerns and issues of importance to either the EU or Switzerland and therefore does not represent an 'off-the-peg' model but it does however provide a basis to explore the costs and benefits of a bilateral arrangement with the EU.

The basis and core of Swiss-EU cooperation is a 1972 FTA and a series of bilateral arrangements, including "Bilaterals I" and "Bilaterals II" concluded in 1999 and 2004. Together with a 1972 FTA, this package of bilateral agreements grants Swiss companies tariff and duty free access to the EU's Single Market in the areas covered.

The key areas are the agreements on technical barriers to trade, with testing and admission of products to the European market now the responsibility of a single certification authority, the free movement of persons, access to public procurement markets, the dismantling of tariffs on certain agricultural products (cheese and dairy products) and Swiss researchers' access to the EU's research programmes.[95] Switzerland has also sought agreements on collaboration and participation in Europe's Schengen border-free travel area, including cooperation in policing, judicial and immigration matters, and the 'Dublin System', which helps to prevent 'asylum shopping'.[96]

Box H: Chronology of Swiss-EU relations and agreements

1972 – FTA with the EU

1989 – Insurance Agreement

1990 – Agreement on Customs Facilitation and Security

1992 – Rejection of the EEA agreement in referendum

1999 – Bilaterals I (free movement of persons, technical barriers to trade, public procurement, agriculture, transport, civil aviation, research)[97]

2004 – Bilaterals II (Schengen/Dublin agreement, taxation of savings, fight against fraud, processed agricultural products, environment, statistics, MEDIA programme, pensions)

2005 – Extension of free movement to the ten new EU member states

2009 – Continuation of free movement and extension to Bulgaria and Romania

2009 – Agreement on customs facilitation and security

2010 – Agreement on education, vocational training and youth

Switzerland conducts the majority of its external trade relations with third countries via EFTA, which has signed various FTAs and partnership agreements with countries across the world (see above).

95 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland's policy on the European Union', August 2011

96 Several other areas were incorporated in the negotiations, including processed agricultural products, environmental cooperation, harmonisation of statistics, and Swiss film makers' participation in the EU's promotional MEDIA programme. Negotiations were later concluded on common educational programmes, however, negotiations on the liberalisation of services were suspended after nine months due to lack of progress.

97 The Bilateral I agreements were linked legally by a common "guillotine clause" stipulating that they can only take effect together, and that if one of the agreements is terminated the other six would cease to apply.

4.2. Costs

a) No decision making power and very limited political influence on EU rules

Due to the nature of the Swiss-EU bilateral deal, the Swiss government has no say in the decision making forums of the EU. Switzerland is able to influence debate and legislation, through formal and informal channels, but unlike the EEA states it has no participation rights or observer status in the EU agencies or via the EEA-EU committees.

Swiss-EU bilateral agreements, of which there are over 120 in force,[98] are based either on the equivalence of legislation, in the case of product standards and access to public procurement markets, or on the literal adoption of EU law, in the case of civil aviation and rules governing the Schengen border-free travel area. There are also cooperation agreements underpinning Swiss participation in EU research programmes or agencies, such as the European Environment Agency.[99]

The administration of the agreements and their future development is undertaken by 'joint committees', in which the two parties must reach decisions unanimously.[100] The bilateral agreements can only be amended with joint Swiss-EU agreement and are not subject to automatic amendment.[101] This means that, particularly in areas based on equivalence such as technical trade barriers, Swiss law and standards constantly need to be updated in order to maintain access to the Single Market – a major bureaucratic challenge.[102] No surveillance authority or court is in place to enforce the agreements or settle disputes between the two parties.

b) Rules of origin

Moving outside of the EU customs union to a FTA arrangement would, as we have seen, mean that UK manufactured goods exporters would face EU rules of origin. Swiss exporters have had 38 years to adjust to rules of origin based trade since the original Swiss-EU free trade agreement was signed in 1972, and ROO are therefore not seen as a major issue of contention in Swiss-EU relations.

c) The lack of a dynamic, evolving relationship means new barriers to trade can be created

Where the EU adopts new laws not covered by the bilateral agreements, Swiss firms could find themselves locked out of the Single Market and new trade barriers erected. For example, the EU's REACH Regulation on the marketing of chemicals has led to substantial divergences in Swiss and EU law on chemicals, a potential problem for the Swiss chemical industry, which exports the majority of its products to the EU.[103]

The rules, which require manufacturers and importers to gather information on the properties of their chemical substances and register them with the European Chemicals Agency, has "resulted in trade barriers due to complex certification and registration requirements" for Swiss firms.[104] The Swiss government noted that a parallel agency in Switzerland "would not make much sense and would lead to extensive duplication"[105] and therefore Switzerland is now exploring the possibility of a new agreement with the EU on chemicals.

d) No agreement on the free movement of services

Swiss-EU negotiations on an agreement on the liberalisation of trade in services broke down. As a result, the free movement of services between Switzerland and the EU is complex and covered by the bilateral agreements "only selectively and under different instruments."[106]

98 Prof. Dr. C. Tobler, J. Hardenbol and B. Mellar, 'Internal market beyond the EU: EEA and Switzerland', *European Parliament DG for Internal Policies,* 2010, p15; http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=29109

99 Switzerland also has observer status on various EU committees regarding research, civil aviation, social security and the recognition of diplomas. See *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland's policy on the European Union', August 2011, p7

100 The committees only have power over the areas set down by the agreements i.e. they may authorise changes of a technical nature but changes in the provisions of the agreements or new obligations must be approved by internal government/parliamentary procedures.

101 The joint committee on Schengen and the Dublin system for cooperation on asylum has more power in that it both oversees the current agreement and further developing the existing legislation.

102 Prof. Dr. C. Tobler, J. Hardenbol and B. Mellar, 'Internal market beyond the EU: EEA and Switzerland', *European Parliament DG for Internal Policies*, 2010, p6; http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=29109

103 See *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office* website http://www.europa.admin.ch/themen/00499/00503/00954/index.html?lang=en (accessed 10 April 2012)

104 See *European Commission* website http://ec.europa.eu/environment/chemicals/reach/reach_intro.htm (accessed 10 April 2012)

105 See *Swiss Federal Office of Public Health* website http://www.bag.admin.ch/themen/internationales/07419/07440/index.html?lang=en (accessed 10 April 2012)

106 Prof. Dr. C. Tobler, J. Hardenbol and B. Mellar, 'Internal market beyond the EU: EEA and Switzerland', *European Parliament DG for Internal Policies*, 2010, p17; http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=29109

Outside the scope of specific agreements on transport, aviation and public procurement, the right to provide services exists for a period not exceeding 90 days of work per calendar year.[107] Switzerland therefore misses out on the potential economic benefits that greater access for Swiss firms would provide. A 2005 study by the Dutch government Bureau for Economic Policy Analysis estimated that if Switzerland were to take on the EU's Services Directive,

> *"Swiss exports of commercial services to the EU could increase by 40 to 84 per cent, while Swiss foreign direct investment stocks in EU services industries could increase by 20 to 41 per cent. EU services exports to Switzerland may rise by 41 to 85 per cent, while EU direct investment stocks in Swiss service markets could rise by 29 to 55 per cent."*[108]

However, it should be noted that these estimates were based on the Commission's proposed directive rather than the final directive which had the liberalising 'country of origin' principle removed from it. Therefore, the benefits to Switzerland of gaining greater access to the EU's Single Market in services, as it currently stands, are likely to be far lower but, according to Professor Tobler et al, "still significant".[109]

e) EU financial services regulation increasingly likely to lock Swiss firms out

EU financial markets legislation is not applicable to Switzerland as it is not part of the EEA. There is one small bilateral agreement with Switzerland in financial services, namely on non-life insurance (regarding the setting up of branches, but this is hardly used as most Swiss insurance companies have subsidiaries in the EU).[110]

This means that Swiss financial service providers cannot access the Single Market in financial services. Until recently, this has largely resulted from national member state regulation rather than EU regulation, because the EU did not tend to regulate the cross-border provision of services from countries outside the EEA.[111]

However, since the financial crisis, the EU has been in the process of introducing stricter regulation. In order to force financial institutions from third countries 'on-shore', the EU is creating barriers to entry from third countries, in some cases sealing off its borders to the provision of certain services. For services that can be delivered cross-border, registration with the European Securities Markets Authority (ESMA), conditional on strict requirements, will often be necessary. As a recent KPMG note points out, Swiss banks "will have to weigh by means of a cost-benefit analysis whether cross-border business still makes sense and whether cross-border business should and can be maintained."[112]

In 2009, the Swiss government noted that "The existing barriers to market access place Switzerland at an economic disadvantage." It said that Swiss banks' inability to enter the Single Market unless by way of subsidiaries means that "Switzerland loses out in terms of jobs, value creation and tax receipts. This also makes it difficult to obtain economies of scale and thus a more cost-effective handling of financial services."[113] Using subsidiaries also increases costs for firms, which means that only the big market players that can afford to open subsidiaries tend to gain access to the EU market.

The Swiss government has identified three approaches to ensure better EU market access for Swiss financial institutions:

- Mutual recognition of equivalence of supervision and regulation: The aim is to ensure that Switzerland's regulatory framework meets EU requirements. For example, Switzerland and the European Commission have already agreed a formal process with the objective of the EU recognising the equivalence of Swiss insurance supervisory law, which will mirror member states' implementation of the Solvency II Directive.

107 Prof. Dr. C. Tobler, J. Hardenbol and B. Mellar, 'Internal market beyond the EU: EEA and Switzerland', *European Parliament DG for Internal Policies*, 2010, p17; http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=29109

108 H. Kox and A. Lejour, 'Liberalisation of the European services market and its impact on Switzerland: assessing the potential impacts following the EU's 2004 Services Directive', *CPB Netherlands Bureau for Economic Policy Analysis*, December 2005

109 Prof. Dr. C. Tobler, J. Hardenbol and B. Mellar, 'Internal market beyond the EU: EEA and Switzerland', *European Parliament DG for Internal Policies*, 2010, p34; http://www.europarl.europa.eu/committees/en/studiesdownload.html?languageDocument=EN&file=29109

110 A. Makipaa and J. Kamerling, 'Overview of EU rules applicable to EEA/EFTA countries in financial services, competition and taxation', *European Parliament DG for Internal Policies*, 2008; http://www.europarl.europa.eu/document/activities/cont/201108/20110818ATT25100/20110818ATT25100EN.pdf

111 *Swiss Federal Council*, 'Strategic directions for Switzerland's financial market policy', 16 December 2009, p42-43; http://www.efd.admin.ch/dokumentation/zahlen/00578/01622/index.html?lang=en

112 *KPMG*, 'Provision of services by financial intermediaries from third countries in EU financial markets regulation', December 2011

113 *Swiss Federal Council*, 'Strategic directions for Switzerland's financial market policy', 16 December 2009, p43; http://www.efd.admin.ch/dokumentation/zahlen/00578/01622/index.html?lang=en

- Voluntary alignment of national law to EU law: For example, numerous provisions from the Markets in Financial Instruments Directive (MiFID) have been voluntarily adopted by Swiss banks. However, this only helps to improve market access in so far as the EU recognises Swiss measures as equivalent.

- Financial services agreements with the EU: A further option would be to resurrect negotiations on a Swiss-EU bilateral deal on services, which failed in 2003, or establish an agreement on financial services specifically. However, as the Swiss government noted in 2009, "In wealth management, in particular, barriers to market access exist not only with respect to EU law but also in the national legislation of certain member states. It is therefore necessary to proceed both bilaterally and at EU level."[114]

f) Direct financial costs associated with EU relations

Although Switzerland does not contribute directly to the EU budget, it has made substantial financial contributions to EU policies and to European infrastructure, both of which are directly or indirectly linked to its relations with the EU.

Since 1991, Switzerland has contributed 3.5bn Swiss Francs (€2.7bn) to development and stabilisation in Eastern Europe and the Balkans.[115] In addition, following the EU enlargements in 2004 and 2007, Switzerland pledged 1.3bn Swiss Francs (€1bn) in support over five years to the new member states, supporting 'cohesion' within the EU. However, these funds are not part of the EU's dedicated 'cohesion fund' but are managed under bilateral framework agreements with the recipient countries and a 'Memorandum of Understanding' with the EU.[116]

Switzerland's Integration Office describes these contributions as "an investment in partnerships with growing economic potential". However, it notes that "Switzerland's acceptance of a share of the cost of EU enlargement is also essential for maintaining good relations with the EU and for the continuing success of the bilateral approach to its policy on the EU."[117]

In addition to these financial contributions, Switzerland has also funded major infrastructure projects to allow the transportation of goods between EU countries through its territory, a major demand of the EU member states. The combination of a referendum in the 1990s stipulating that large freight transport through Switzerland must transit by train rather than road, and the Commission's desire for EU goods transporters to be able to transit through Switzerland, led to the Swiss' decision to build the Alps Transit, or transalpine railway network (NEAT). The project required €15bn of public investment with little direct benefit to Switzerland other than to satisfy EU demands for access through its territory.[118]

4.3. Benefits

a) Flexibility over external trade

Switzerland's membership of EFTA allows it to cooperate with the other EFTA countries in seeking FTAs with third countries independently of the EU. In practice, EFTA FTAs often tend to follow or mirror EU free trade agreements with third countries.

However, the flexibility to negotiate independently of the EU would allow an individual country to push for more liberalisation in sectors of particular national significance.

b) Democratic legitimacy

A defining feature of Swiss-EU cooperation is Switzerland's system of direct democracy and the need for public approval of its EU agreements – a source of democratic legitimacy often lacking from EU or even EEA cooperation.

114 *Swiss Federal Council*, 'Strategic directions for Switzerland's financial market policy', 16 December 2009, p45; http://www.efd.admin.ch/dokumentation/zahlen/00578/01622/index.html?lang=en

115 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland in Europe – a first rank partner', March 2011

116 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland's policy on the European Union', August 2011, p9. The initial agreement to fund the 2004 accession states was approved by referendum, while the decision to contribute support to Bulgaria and Romania was approved by the Swiss parliament. For details of the programmes, see http://www.erweiterungsbeitrag.admin.ch/en/Home/Countries

117 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland's policy on the European Union', August 2011, p10

118 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Switzerland in Europe – a first rank partner', March 2011

The Bilaterals I package was approved by 67.2% of Swiss voters in 2000. The only area of Bilaterals II subject to referendum was the agreement on Schengen/Dublin, which was approved by 54.6% of Swiss voters in June 2005. Switzerland also concluded an extension to the free movement of persons to the EU's ten new member states in 2005, including gradual controlled access to the Swiss labour market. This was further extended to Bulgaria and Romania when they joined the EU in 2007. Both agreements were approved in referendums, respectively, by 56% and 59.6% of the Swiss electorate.

c) No loss of sovereignty

Unlike the EEA, Swiss-EU bilateral agreements do not, in theory, involve the transfer of legal or decision making power to supranational institutions, with Switzerland solely responsible for implementing and enforcing its commitments under its agreements with the EU. In theory, this means that Switzerland can refuse to implement measures demanded by the EU, initiating new rounds of negotiation between the two partners.

However, since 2008, the EU via both the European Commission and the Council of Ministers, has called for a more comprehensive approach to cooperation, involving stepped up enforcement and dispute settlement mechanisms to ensure that Swiss law is compatible with EU law and, significantly, ECJ case law.[119]

Following a December 2010 meeting, the Council stated:

> *"Since Switzerland is not a member of the European Economic Area, it has chosen to take a sector-based approach to its agreements in view of a possible long-term rapprochement with the EU. In full respect of the Swiss sovereignty and choices, the Council has come to the conclusion that while the present system of bilateral agreements has worked well in the past, the challenge of the coming years will be to go beyond this complex system, which is creating legal uncertainty and has become unwieldy to manage and has clearly reached its limits."*[120]

The Swiss have committed themselves to "looking at the possibility of dynamically adjusting the agreements to comply with the new EU legislation, how to ensure the coherent application and consistent interpretation of future agreements, and the development of an effective dispute procedure." The Integration Office stated, however, that "Any solution must respect the sovereignty of both parties and the efficient operation of their institutions."[121] This highlights the inherent tension that the Swiss approach has so far been able to overcome, through a mixture of circumstance and canny negotiation, but it remains to be seen how the EU's hardening stance will shape relations in future.

d) Exemption from CAP, CFP and EU-wide regional policy

Like Norway and the other EFTA countries, Switzerland is not party to the CAP or the EU's regional funding programme. While Switzerland does contribute to regional development in the EU's newer member states, it does so voluntarily, bilaterally and does not have to contribute to the EU's structural funds, which are spent in the EU's richer states as well as the poorer member states.[122]

e) Exemption from EU social and employment regulation

Whereas the EEA countries have to implement all EU internal market legislation, including those aspects that regulate labour markets, such as the Working Time Directive and the Agency Workers Directive, Switzerland does not, and only needs to implement EU equivalent legislation covered by a Swiss-EU bilateral agreement.

The fact that Switzerland does not have to implement one-size-fits-all EU social and employment regulation allows it the flexibility to pursue its own employment law tailored to its own economy and work-life culture.

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119 *Council of the European Union*, 'Council conclusions on EU relations with EFTA countries', 14 December 2010, paragraph 42; http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/118458.pdf

120 *Council of the European Union*, 'Council conclusions on EU relations with EFTA countries', 14 December 2010, paragraph 6; http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/118458.pdf

121 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office*, 'Conclusions of the Council of the EU on relations with Switzerland dated 14/12/10', 14 December 2010

122 See *Open Europe*, 'Off target: the case for bringing regional policy back home', 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/2012EUstructuralfunds.pdf

4.4. Conclusions

- The 'Swiss model' for relations with the EU is a product of particular historical circumstances and is therefore not an 'off-the-peg' solution. Switzerland's Integration Office notes that before negotiations on the second round of bilateral EU agreements got underway the European Commission was "sceptical about further negotiations."[126] However, the EU wanted to address two main concerns: the cross-border taxation of savings and efforts to combat fraud regarding indirect taxation such as VAT, which the EU relies on as a source of funding for its budget. These concerns constituted an incentive for the EU to reopen negotiations but also gave Switzerland the opportunity to impose some conditions of its own and that the talks would include areas of particular Swiss interest. The UK would need to be prepared for a similarly difficult negotiation.

- Unlike the EEA, Switzerland has the freedom to pursue its own social and employment policies. An FTA arrangement would allow the UK to legislate independently on employment law, potentially reducing the burdens on employers caused by EU legislation such as the EU's Working Time Directive and the Agency Workers Directive.

- An FTA is a bilateral arrangement which means that both partners retain national sovereignty over issues covered by the agreement.

- The lack of an agreement on services, and financial services in particular, may prove a concern for Switzerland in the future. EU moves to tighten regulation, with some recent proposals specifically designed so that firms that trade in the Single Market need to be based within it, could hamper market access for non-EU firms. If the UK were to find itself outside the Single Market, it would need a comprehensive agreement on market access for services, and financial services in particular. An additional issue would be how UK firms' activities in the EU were regulated.

- The ability to pursue an independent external trade policy could allow the UK to push for more market access and liberalisation in services trade with third countries than would otherwise be the case under the EU's Common Commercial Policy.

- Switching to a system whereby UK manufacturers had to comply with EU rules of origin could be a shock to the system and introduce a new administrative burden to merchandise trade with EU countries, which remains the UK's biggest goods export market.

- The UK would no longer be subject to the EU's agricultural, fish and EU-wide regional policies.

123 *Swiss Federal Departments of Foreign and Economic Affairs, Integration Office,* 'Switzerland's policy on the European Union', August 2011, p4

5 A STRIPPED BACK CUSTOMS UNION WITH THE EU: THE "TURKISH OPTION"

Another option for the UK would be to negotiate to stay in customs union with the EU outside the framework of the EU treaties and institutions.

5.1. What does it involve?

Remaining in customs union would allow the UK and the EU to retain the free movement of goods between the two parties and avoid the need for UK manufacturers to adapt to EU rules of origin (and EU manufacturers to UK rules of origin). Opting for this option would be based on the premise that the free movement of goods under the Single Market is superior to rules of origin-based trade under a free-trade agreement.[124]

Retaining a customs union with the EU would mean maintaining the EU's common external tariffs for the vast majority of merchandise imports. However, the rules contained in Article XXIV of General Agreement on Tariffs and Trade (GATT) only require that "substantially" the same duties and other regulations of commerce are applied by each of the members of a customs union to trade with third countries.[125]

The Trade Policy Research Centre argues that,

> *"This would leave scope for the UK to negotiate with the EU for the exclusion from the common tariff commitment of some high tariff agricultural product groups such as sugar. In practice most free trade agreements negotiated under Article XXIV of the GATT exclude significant portions of agricultural trade from their product coverage, and there would seem no reasons why the same principles should not be applied to a customs union agreement."*[126]

Indeed, such an example of this type of cooperation currently exists. Turkey has a customs union with the EU for industrial and processed agricultural goods, which was agreed in 1995 and came into force in 1996, and, for example, does not cover non-processed agricultural goods.[127] Once again, the Turkey-EU customs union precedent is illustrative but the context is rather different because, in Turkey's case, the customs union was designed as a supranational step towards full membership rather than an end in itself.

With a customs union with the EU limited to the free movement of goods, the UK would need to negotiate additional intergovernmental deals with the EU on services, financial services and other issues such as the movement of people as it required.

5.2. Costs

a) No decision making power over product regulations

Turkey's customs union agreement with the EU requires it to adopt the EU acquis' provisions on technical barriers to trade and product regulations.[128] Turkey was also required to adopt rules on competition and state aid in line with EU practice.

In a customs union, the EU's uniform product regulations would apply to goods in the 'domestic UK market', even if they were not exported to the EU. However, it would have no formal political power to shape EU decision making on these legislated standards.

124 See Ronald Stewart Brown, 'Britain must now think through European trade options', *Telegraph*, 5 January 2012; http://tprc.org.uk/pages/posts/britain-must-now-think-through-european-trade-options-5.php

125 *WTO*, 'General Agreement on Tariffs and Trade', Article XXIV, 8(a)(ii); http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm

126 R. Stewart-Brown and F. Bungay, 'EU agricultural protection: tariffs and the CAP', *Trade Policy Research Centre*, March 2012; http://tprc.org.uk/media/PDF_documents/TPRC_EU_Agricultural_Protection_-_Tariffs_and_the_CAP.pdf

127 Non-processed agricultural products are not included and neither are European Coal and Steel Community products. These two categories are subject only to preferential agreements based on their originating status and rules of origin.

128 S. Ulgen & Y. Zahariadis, 'The future of Turkish-EU relations: deepening versus widening', *CEPS*, August 2004, p15 and S. Togan, 'The EU-Turkey customs union: a model for future Euro-Med integration', *MEDPRO*, March 2012, p8-9

b) Limited room for manoeuvre in negotiating external trade agreements on goods trade

Article 16 of the Turkey-EU custom union agreement[129] requires Turkey to align its external commercial policy with that of the EU in order to maintain the common external tariff on imports on goods. The UK would need to do the same.

Turkey had to negotiate and adopt free trade agreements with the EU's preferential trade partners by January 2001 and was subsequently obliged to sign FTAs with any country the EU signs an FTA with. In addition, Turkey has been required to adopt the EU's customs provisions in the fields of origin of goods, customs valuation of goods, introduction of goods into the territory of the customs union, customs declaration, release of goods for free circulation, and movement of goods.[130]

However, even after the completion of the customs union (which by definition requires a common commercial policy), the EU signed various new FTAs with third countries with little or no consultation with Turkey. Without being a member of the EU, Turkey is not automatically included in the EU's free trade negotiations and this has created problems.

A preferential agreement with the EU means that third countries can export tariff-free (although indirectly) to the Turkish market, via the customs union, but at the same time they need only grant EU, and not Turkish, exporters preferential access to their markets. This has made many countries reluctant to conclude FTAs with Turkey, or at least conclude them in a timely manner. The EU does now introduce a 'Turkish clause' in its new bilateral trade agreements in which it asks its trading partners to negotiate a similar agreement with Turkey,[131] but Turkey is nonetheless reliant on the EU to enforce this.

In practice, Turkey has managed to conclude FTAs with countries following an EU FTA. Turkey also concluded FTAs with Macedonia and Bosnia-Herzegovina before the EU did. However, countries' reluctance to sign FTAs with Turkey often causes delay. The "average time gap with the EU to finalise FTAs with Morocco, Tunisia, Palestine, Egypt, Jordan, and Chile was almost over eight years."[132] Some have argued that this means Turkish firms can face disadvantages compared to EU exporters, which are able to penetrate these markets earlier.

Another issue is that the EU's FTA negotiations result in trade-offs between issues of importance to third countries and the EU member states, priorities which may differ to those of Turkey or which are not even covered by its customs union agreement with the EU. This includes an EU emphasis on upmarket goods, and agreements on services and intellectual property. For example, the Doha round of world trade talks revealed the incompatibility of many Turkish and EU priorities. While Turkey was largely aligned with the EU in non-agricultural market access negotiations, this was not the case in agriculture or intellectual property negotiations, where it cooperated with developing countries.[133]

Indeed, Ulgen and Zahariadis argue that "an asymmetric customs union is an inherently difficult arrangement to sustain in view of the requirement of establishing and maintaining a common commercial policy between the partners." They argue that the Turkey-EU customs union is a specific product of the 1963 Ankara association Agreement, and that therefore an FTA relationship was not considered. They add,

> *"The customs Union will only be sustainable in the longer term if there is concrete progress towards Turkey's full membership. The policy-dependency aspect of the customs union would otherwise create a political cost that would militate for a modification of the trade regime into a free trade area in the long run."*[134]

How such an arrangement would work for the UK would entirely depend on how attractive its market would be to third countries and how much influence the UK was able to exert on the EU's CCP as an 'outsider'.

129 Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:21996D0213(01):EN:HTML

130 S. Ulgen & Y. Zahariadis, 'The future of Turkish-EU relations: deepening versus widening', *CEPS*, August 2004, p2

131 S. Ulgen & Y. Zahariadis, 'The future of Turkish-EU relations: deepening versus widening', *CEPS*, August 2004, p7-9

132 S. Akman, 'The European Union's Trade Strategy and its reflections on Turkey: an evaluation from the perspective of free trade agreements', *Dokuz Eylul Universitesi*, 2010, p28

133 S. Akman, 'The European Union's Trade Strategy and its reflections on Turkey: an evaluation from the perspective of free trade agreements', *Dokuz Eylul Universitesi*, 2010, p34-5

134 S. Ulgen & Y. Zahariadis, 'The future of Turkish-EU relations: deepening versus widening', *CEPS*, August 2004, p9

c) Turkey has no deal on services, the UK in this situation would have to negotiate one.

If the UK were to opt for this approach, it would have to negotiate a separate deal on EU market access for services and financial services in particular. Switzerland's failure to conclude a deal on services illustrates that this might not necessarily be an easy task. However, the UK's large trade deficit with the EU in goods could provide it with leverage in such a negotiation.

d) Very little influence over future EU liberalisation

A benefit of being in the EU has been the UK's ability to push for liberalisation within the EU – which remains the UK's biggest export market. The absence of the UK would not necessarily lead to the EU rowing back on goods trade liberalisation but could reduce the voice of those within the EU in favour of greater services liberalisation.

5.3. Benefits

a) Retain the Single Market in goods

A stripped back customs union with the EU would have the major benefit of retaining the free movement of goods, without the hindrance of rules of origin. The UK could also continue to work with the EU for global trade liberalisation in goods but via its own seat at the WTO.

b) Potential to negotiate external services trade agreements independently of the EU

Remaining in the EU customs union for the free movement of goods, would not necessarily prevent the UK from seeking bilateral intergovernmental agreements with third countries on services. Although the EU customs union necessitates a common external tariff on goods imports and therefore common commercial policies, the logic for trade in services, where tariffs do not apply, is different.

The WTO provides "a guide, not a straitjacket, to the negotiation of a customs union".[135] Neither GATT Article XXIV nor the General Agreement on Trade in Services (GATS) Article V contain specific provisions governing how customs unions should be formed, except the requirement that any common customs rules cannot impose, on average, higher barriers to third-market imports, than existed previously on an individual country basis.

This could give the UK some leeway to achieve bilateral deals with third countries that went further than the EU would be prepared to go on services liberalisation.

c) Exemption from CAP, CFP or Structural Funds

The UK could be exempt from the CAP, CFP and EU-wide regional policy. The UK could however contribute to development in poorer member states as Switzerland and the EEA states do.

d) Exemption from EU budget contribution

Turkey does not contribute to the EU budget, in fact due to its individual circumstances as an accession state it is a recipient of EU funding.[136]

e) Exemption from EU social and employment law

As under an FTA, the UK would be free to regulate its labour market independently, potentially allowing it to reduce the burden of regulation on businesses and the public sector.

135 *The Centre for Trade Policy and Law*, 'Policy Implications of a Canada-US Customs Union: Discussion Paper', June 2005, p12; http://publications.gc.ca/collections/Collection/PH4-19-2005E.pdf

136 *Open Europe*: "The EU and the Mediterranean: good neighbours? " www.openeurope.org.uk/research/enp2011.pdf

f) Repatriate financial services regulation and supervision

If in Turkey's situation the UK could repatriate regulation of its domestic financial services sector. However, as noted above in the Swiss option, UK financial services firms' access to EU markets would be subject to agreements with the EU.

5.4. Conclusions

- Like the arrangements for Switzerland and Norway, the Turkish agreement is a product of individual circumstances and characteristics.

- If the UK followed this model, it would be able to escape the CAP and CFP as well as costly social legislation. It would however, have to apply the EU external tariff and internal product regulations as the price for continued access to the Single Market. The UK would benefit from existing and future Single Market liberalisation in goods.

- Remaining inside the customs union and retaining genuine free movement of goods would suit the UK's large manufacturers with complex supply chains, in particular the car industry.

- The UK would need to conclude an agreement on services and financial services access to the EU market as this would not be covered by a customs union in goods.

- As a member of the customs union, the UK would not be able to conclude its own free trade agreements in areas covered by the customs agreement and, to keep the customs union intact, would need to replicate any FTAs the EU signed with third countries. This could result in an asymmetric and dependent relationship, with the UK as the smaller customs union partner disadvantaged. The UK could be forced to wait in line behind the EU in order to conclude FTAs.

- There could be scope for the UK to reach its own deals with third countries on services and agricultural products not covered by the customs union, but as EU FTAs increasingly include the non-goods aspects of trade it is unclear how this would work in practice.

6. A 'CLEAN BREAK': THE "WTO OPTION"

Ultimately, if it chose to leave the EU, the UK could simply opt to rely on the multilateral trading system through its membership of the WTO. The UK would no longer be party to the FTAs with third countries negotiated by the EU on its behalf.

This would give the UK full sovereignty over its future trading arrangements. It would be free to seek FTAs with partners, including of course the EU. It would also be freed of its commitments under the CAP, CFP, EU regional funding, EU social and employment regulations and would not need to contribute to the EU budget.

However, there would be a major price to pay for this. In the absence of preferential trade agreements with either the EU or other countries, exporters in the UK would suddenly be faced with new tariffs.

As we have seen above, the EU, which continues to apply substantial tariffs on some products, remains an important UK market. For example, UK car exports to the EU would be faced with 10% tariffs (this would still be a high 5% even if the Doha round were to come to fruition) and chemicals exports to the EU would also face problematic tariffs and the restrictive REACH Directives.

There would undoubtedly also be pressure from domestic producers (farmers, car manufacturers and so on) for the UK to impose tariffs on imports both from the EU and from the rest of the world. This would increase costs for consumers and likely reduce UK trade in the short term.

7. CONCLUSIONS

- Membership of the EU customs union, and the free movement of goods with the absence of tariffs and rules of origin, remains a benefit to UK firms exporting to the EU. The UK has been instrumental in developing the Single Market in goods and promoting EU enlargement, which has helped to generate new markets, increased competition and reduced costs.

- The EU remains by far the biggest destination for UK trade, which is particularly the case for the UK's trade in goods, with a 53.5% share exported to the EU, although the actual figure is lower due to the 'Rotterdam/Antwerp effect'. In services trade, the UK is less dependent on the EU market (39% of exports). The UK is also less reliant on the EU market than the other major member states but it relies on the EU to negotiate on its behalf for greater market access to third countries, with non-tariff barriers to trade of increasing importance.

- The EU, which has broadly been a positive force for global and internal goods trade liberalisation, has not shown the same focus on or enthusiasm for services liberalisation. Services account for 71% of total EU GDP but only 3.2% of this is a result of intra-EU trade. In comparison, 33.6% of the EU's non-services GDP stems from EU cross-border trade.

- The failure to liberalise services within the Single Market and member states' reluctance to compete on the global stage in this sector means the EU risks punching below its weight in global talks on services, which can be to the detriment of UK interests.

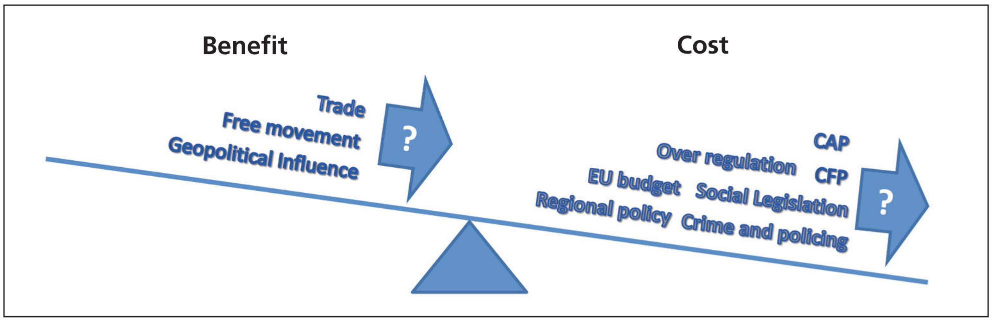
- Nevertheless, from purely a trade perspective, EU membership remains the best option for the UK. All the alternatives come with major drawbacks and would all, except for the 'WTO option', require negotiation with and the agreement of the other member states, which would come with unpredictable political and economic risks. This means that negotiating a new UK relationship with Europe outside the EU Treaties, i.e. leaving the EU, would present similar difficulties as renegotiating membership terms while remaining a member of the EU. Therefore, there is not currently a compelling trade case for EU withdrawal.

However, there are three factors that could alter this cost-benefit analysis in future:

1) If EU trade liberalisation stalls over the long-term;
2) If the EU moves in a more protectionist direction in the wake of the eurozone crisis;
3) If the EU prevents the UK from taking advantage of growth opportunities in non-EU countries in future trade talks.

- In addition, trade is only one part of the equation when it comes to assessing the costs and benefits of EU membership. Failure to make progress on EU services liberalisation will weigh more heavily if the real and perceived costs of the CAP, CFP, EU-wide regional funding, the budget and burdensome regulation cannot be reduced through reform. An honest assessment of the value of UK geopolitical influence within the EU, via its ability to influence not simply trade but also foreign policy and enlargement, must also form the basis of the calculation.

Illustration v: The EU equation without reform



7.1 Recommendations

A new type of EU membership for the UK

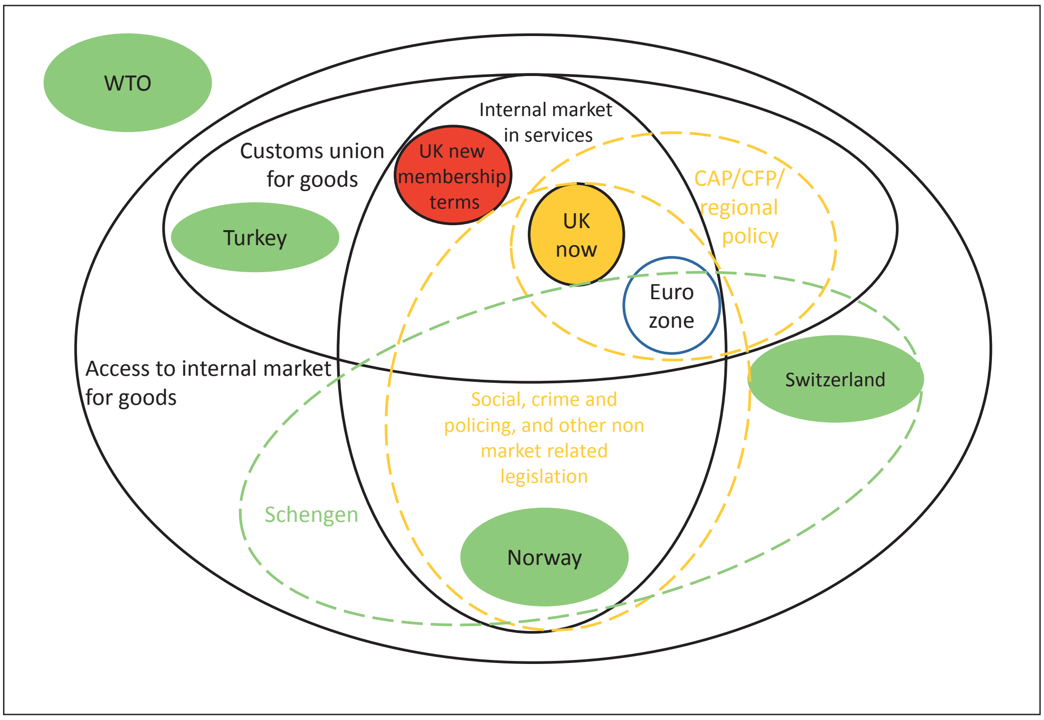
- In order to justify continuing commitment to the EU and avoid being driven by the electorate inexorably towards the exit door, Britain needs to carve out a new model for EU cooperation, remaining part of the customs union and Single Market in goods and services but substantially reducing the non-trade EU involvement and costs whenever possible.

- The Norwegian, Swiss and Turkish options do not constitute off-the-peg models that the UK can adopt, but are all products of individual countries' characteristics illustrating that a 'UK model' is achievable, but one that is a product of the UK's circumstances.

- What should such a model look like? As we have demonstrated in this paper, the trading benefits of the customs union and the Single Market should be retained but, in addition to these core trading rules, the UK should pick and mix in other areas of EU policy, which would achieve the reduction of the non-trade costs of EU membership that is increasingly necessary if the UK is to remain inside the tent in the long-term.

- The specific model that the UK should set out to achieve could look something like the illustration below, where the UK remains part of three circles: customs union for goods, access to internal market for goods and access to internal market for services. In addition, it is conceivable that the UK may wish to retain its opt-in arrangement in justice and home affairs and participate in a far better targeted and modernised EU budget.

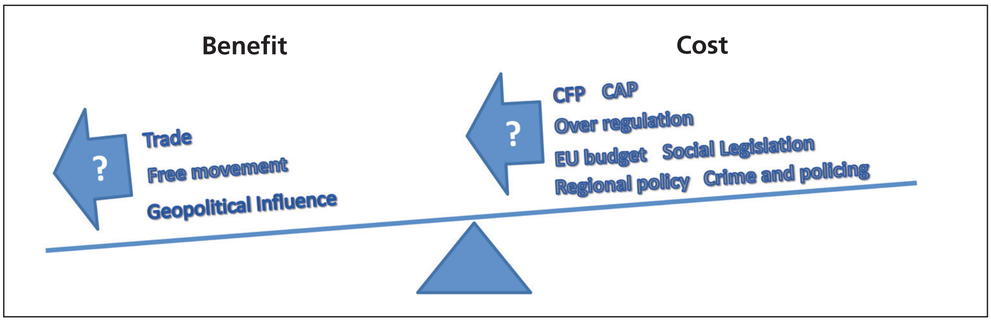
Illustration vi: A new model for the UK within the EU Customs Union and at the heart of the Single Market?



- There are usually three objections to such a model. First, it involves 'free riding', i.e. the UK wants all the benefits of the single market but to pay none of the costs. Second, it will trigger demands for carve-outs from other member states as well as potentially weaker state aid controls which would hurt liberalisation. Third, the UK could lose 'influence' by not being part of all EU policies. In addition, there may be difficulties in re-designing the EU institutions, such as the European Parliament, around different circles of membership, though this is likely to be overcome. Indeed, the Lisbon's Treaty 'enhanced cooperation' procedure has already set an institutional precedent for this. It could be achieved by member states in the Council or their MEPs in the European Parliament not voting on policies to which they are not party.

- While these counter-arguments need to be taken seriously, none of them fundamentally undermine the overwhelming case for renegotiation within the EU. In particular, the idea that the UK is free riding or will end up with a worse deal in trade assumes that EU membership for the UK (and other member states) is currently "Pareto optimal" i.e. there is no other possible outcome of European cooperation that makes every member state at least as well off and at least one member state strictly better off. Loss of influence is a more complicated argument, particularly if there is overlap between different policies, i.e. the euro and financial supervision and regulation. As we have pointed out elsewhere, these areas may require additional safeguards for the UK.[137] In the end, given trends in the eurozone and in UK public opinion, a new UK model for EU membership may not only be desirable, but also inevitable.

Illustration vii: The equation with a reformed EU



In addition the UK should take the following practical steps to ensure it maximises the benefits of EU trade:

a) UK-level

Continue to boost trade through commercial diplomacy

Although trade negotiation remains an exclusive EU competence, the UK retains the power to promote UK business and exports to non-EU countries, something which the current Government has made a priority. The current destinations for UK's exports do not correlate well with forecast GDP growth in various world markets. Only 1.4% of UK exports go to India, expected to grow on average by 8.1% a year up to 2050 and only 2.35% to China forecast to grow at 5.9%.

This is an important exercise for two reasons. Firstly, boosting UK trade with emerging and fast-growing economies is clearly beneficial in its own right but, secondly, the less the UK depends on the EU for trade, the stronger Britain's negotiating position when it comes to reforming other aspects of its EU relationship which represent the costs of membership.

The current Government has been commendably active but more can always be done.

Increase trade expertise in Whitehall

The UK should become a centre for international trade expertise. The UK should increase its input into EU and world trade talks by developing trade expertise on a cross-departmental basis in the FCO, HM Treasury and BIS. The UK cannot afford to outsource its trade policy to the EU. As we have seen, the UK's trade interests often differ from other member states, so it cannot rely on others to make its case for it.

A cost-benefit analysis of the EU and the alternative options

The UK Government should commission an extensive cost-benefit analysis of UK membership of the EU compared with the alternatives, a process that would serve to both inform and stimulate debate. It is evident that the choices are not simple and that a better understanding of the issues would focus minds on what the UK's priorities should be both within and without the EU.

137 *Open Europe*, 'Continental shift: Safeguarding the UK's financial trade in a changing Europe', 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/continentalshift.pdf

b) EU-level

Secure a 'free trade' EU Commissioner

One of the most significant recent UK failures in the EU was the failure to gain an economic portfolio in the current Commission. The deal reached in 2009, in which the UK gained the EU Foreign Minister and France's Michel Barnier was appointed Internal Market and Financial Services Commissioner, was a major strategic mistake, with the UK now often fighting rear guard battles on financial services regulation designed by officials who either do not understand or are hostile to financial services. When the next Commission is appointed in 2014 the UK should use all its influence to gain the Internal Market or Trade portfolios, or at least ensure they go to representatives of economically liberal states such as Sweden, the Netherlands, Ireland or the Czech Republic.

Continue to make the case for free trade and seek allies

The UK Government must continue the argument for EU free trade and remain on the lookout for creeping protectionism.

- The UK should increase its presence in the EU institutions at all levels.
- The UK should seek to create a durable alliance for free trade and liberalisation. There are a number of states, such as Sweden, the Netherlands and Czech Republic that see the need for reform. Better relations with Germany on economic matters could be a great strength.
- Push for 'better regulation' agenda. The UK should seek to apply a filter at an early stage of EU decision making, for instance pushing for a tough independent impact assessment board.[138]

To aid all of the above the UK should set out a clear consistent vision for the UK within a reformed EU based on an economic case for liberalism and structural reform that others can rally behind.[139]

Use 'enhanced cooperation' to restart services liberalisation

The UK should also explore all the possibilities under the EU Treaties' enhanced co-operation mechanism, which is currently being used to establish an EU patent office. There is further potential for likeminded states to continue liberalising services in other areas including, for instance, energy and the digital economy. In order to do this the UK would need to find eight other likeminded states and gain the approval of the EU institutions.[140]

Back an EU/eurozone structural reform agenda

The Lisbon Agenda aimed to make the EU "the most competitive and dynamic knowledge-based economy in the world" by 2010. It failed. However, the eurozone crisis presents an opportunity for the entire EU to embark on necessary long-standing structural economic reforms. The UK should get on the right side of the argument by throwing its weight behind a new liberalising economic agenda instead of succumbing to the temptation to lecture the eurozone on how it should be designed in future.

138 See Anthony Browne & Mats Persson "The Case for European Localism", *Open Europe*; www.openeurope.org.uk/research/EUlocalism.pdf

139 For ideas on this see Christopher Howarth's article "If he wants Britain to have a vision for Europe, David Cameron should appoint a European Secretary" on *Conservativehome*; http://conservativehome.blogs.com/platform/2012/04/christopher-howarth-if-he-wants-britain-to-have-a-vision-for-europe-david-cameron-should-appoint-a-e.html

140 See Articles 20 and 329 of the EU Treaties.