

SPICe Briefing

Options for the United Kingdom's future trading relationship with the European Union

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This briefing for the European and External Relations Committee outlines the options for the UK's trading relationship with the EU after Brexit. It sets out what different trading options mean, from European Economic Area membership through to relying only on World Trade Organisation rules without any specific bilateral or regional agreement in place. It also shows the results of the possible economic impact of the different options on the Scottish economy when compared to European Union membership based on modelling by the Fraser of Allander Institute.



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EXECUTIVE SUMMARY

This briefing considers various options that may be available to the UK for trading with the EU once it leaves the EU. It also shows the potential impact of these different options on the Scottish economy. The options are summarised below as well as the impact they would have on the current position of the UK in relation to the EU, from the option that leaves it the most integrated with the EU, to the one that leaves it the least integrated.

European Economic Area – the ‘Norwegian’ model

What is it?	Free trade area covering EU states, Norway, Lichenstein and Iceland
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What are the requirements?	UK needs to join European Free Trade Association (EFTA) and then the EEA
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Whose approval is required?	<ul style="list-style-type: none"> All EFTA states (Iceland, Liechtenstein, Norway and Switzerland) to join EFTA All the EEA states to join EEA
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What stays the same?	<ul style="list-style-type: none"> Some financial contribution to EU Free movement of people Application of Single Market rules and regulations
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What changes?	<ul style="list-style-type: none"> No customs union EU agricultural and fisheries policies excluded UK would not have a vote on Single Market rules and regulations UK would not be party to trade agreements that the EU negotiates with other parties
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The ‘Swiss’ model

What is it?	Series of bilateral agreements
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What are the requirements?	<ul style="list-style-type: none"> UK rules would need to be consistent with relevant EU Single Market rules and regulations¹ The UK may have to accept the jurisdiction of European Court of Justice
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Whose approval is required?	All EU States
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What stays the same?	<ul style="list-style-type: none"> Some financial contribution to EU (lower than EEA) Free movement of people Application of Single Market rules and regulations where appropriate
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What changes?	<ul style="list-style-type: none"> Does not include agricultural and fisheries policies UK would not have a vote on Single Market rules and regulations
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¹ This covers all EU treaties, legislation, international agreements, standards, court verdicts and fundamental rights provisions.

- UK would not benefit from trade agreements that the EU negotiates with other parties
- No single market for services

The 'Turkey' model

What is it? Customs union agreement

What are the requirements? Turkey has taken on certain aspects of EU legislation in exchange for access to Single Market

Whose approval is required? All EU states

What stays the same?

- Single market for goods
- Subscription to the EU's common customs tariff for imports from third countries
- UK would have to meet certain EU rules when exporting to the EU e.g. industrial standards

What changes?

- Does not address agriculture (except certain agricultural products), services or procurement
- UK would not have a vote on setting EU's common customs tariffs
- UK would not benefit from trade agreements that the EU negotiates with other parties

The 'WTO' model

What is it? Series of agreements and rules that members have to adhere to (each has its own negotiated schedules of commitments)

What are the requirements? UK has to normalise its position with WTO as a non-EU member and needs a schedule of concessions to negotiated with trading partners and approved by WTO

Whose approval is required? Trading partners it negotiates schedules with, and General Council or Ministerial Conference of the WTO (decisions generally taken by consensus)

What stays the same?

- Adherence to WTO rules
- UK would have to meet certain EU rules when exporting to the EU e.g. industrial standards

What changes? UK would need to negotiate concessions and commitments with its trading partners (including the EU) and would no longer benefit from EU trade deals with other countries

ACRONYMS

CETA	Comprehensive Economic Trade Agreement
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
MFN	Most Favoured Nation
NTB	Non-Tariff Barrier
PTA	Preferential Trade Agreements
UK	United Kingdom
WTO	World Trade Organisation

GLOSSARY OF TERMS

Anti-dumping measures	Measures that are put in place to counter dumping.
Common market	A customs union that additionally allows for free movement of labour and capital.
Customs union	A FTA in which partner states additionally have a common set of policies on imports from non-partner states, including agreement on a common level of tariffs on all imports from third countries.
Dumping	Situation where a product is sold in the importing country for less than the price of that product in the market of the exporting country.
Economic union	A common market that additionally includes the adoption of a common currency and/or the harmonization of monetary, fiscal and social policies.
Free trade agreement	Agreement that aims to reduce or eliminate trade barriers between its signatories.
Free trade area (FTA)	Group of countries which have signed a free trade agreement to reduce trade barriers between each other. There is generally no common external tariff for imports from third countries.
Non-tariff barrier (NTB), also known as non-tariff measure	<p>Measures other than tariffs that have the effect of restricting trade including:</p> <ul style="list-style-type: none">• Quantitative restrictions on imports and exports such as import quotas.• Import and export licensing.• Product standards.• Conformity assessments such as technical, sanitary and phytosanitary measures.
Preferential Trade Agreements	Agreements between two or more countries to discriminate favourably in their treatment of goods and/or services traded amongst themselves.
Rules of origin	Criteria needed to determine the national source of a product.
Single Market	This refers to the EU as one territory without any internal borders or other regulatory obstacles to the free movement of goods and services. The four freedoms are: free movement of goods, free movement for workers, right of establishment and freedom to provide services, and free movement of capital.
Tariff	A tax or duty to be paid on a particular class of imports or exports, generally imports. Tariffs are defined according to the rate, the classification and the valuation of the goods being taxed.
Tariff Rate Quotas	Tariff rate quotas exist to allow lower tariffs within established quotas for exports, and higher rates for quantities outside the quotas.

CONTEXT

The United Kingdom (UK) has a number of options for a future trading relationship for when it leaves the European Union (EU). The chosen option will be subject to successful negotiation with the EU27. The UK could seek a European Free Trade Association (EFTA) style agreement which would give it access to the Single Market as a member of the European Economic Area (EEA). Alternatively, it could seek to remain part of the EU's Customs Union whilst staying out of the Single Market or it could seek to negotiate another type of free trade agreement with the EU. In the absence of securing agreement for any of these options, the UK would have to rely on World Trade Organisation (WTO) rules to manage its future trading relationship with the EU.

This briefing provides some background on general trade policies, attempts to remove barriers to trade and the increasing prevalence of preferential trade agreements (PTAs). It then analyses the nature of the UK's current trading relationships as a member of the EU and finally it provides details of the different options that may be available to the UK in negotiating a future trading relationship with the EU.

MODELLING THE IMPACT OF THE DIFFERENT TRADE OPTIONS

The Fraser of Allander Institute (FAI) were commissioned by the Scottish Parliament's Culture, Tourism, Europe and External Relations Committee to undertake economic modelling work exploring the potential long-term implications (10+ years) of Brexit for Scotland. Their findings were published in the report "Long-term Economic Implications of Brexit" (FAI [2016](#)). SPICe Briefing The Economic Implications of Brexit summarises their results (Hudson [2016](#)).

The FAI started by assuming there is an "export shock" to the UK (a decrease in UK exports). It then used macro-economic models to estimate the impact of the export shock on the Scottish economy in terms of GDP, exports, wages, employment and population. The results look at the difference between a baseline scenario where there is no export shock and various options. A 4% decrease in GDP for instance should be interpreted as "GDP will be 4% lower in the long-term than it otherwise would have been if there had not been an export shock".

Three options were considered:

- A 'Norway' model
- A 'Switzerland' model
- A WTO model

For each option, a "pessimistic" and an "optimistic" scenario in terms of the magnitude of the export shock were considered. In all three scenarios, Brexit is predicted to have a negative impact on Scotland's economy and the stronger the economic integration with the EU, the smaller the negative impact on the economy. The estimates for each scenario are presented at the end of each relevant section in this briefing.

THE TRADE LANDSCAPE

For many economists the growth in world trade has been a key driver of global economic growth. According to the International Monetary Fund (2016) “If there is a point on which most economists agree, it is that trade among nations makes the world better off”. The World Bank (2016) also states that “evidence shows that countries open to international trade tend to grow faster and provide more opportunities to their populations.” Clearly therefore the UK’s trading arrangements are closely tied to its economic future.

Countries negotiate trade agreements with each other in order to expand markets for their domestic suppliers and/or to increase access to their domestic markets for their trading partners. These agreements aim to reduce or eliminate barriers to trade.

The reasons why trade costs may increase after Brexit include:

- Higher trade barriers between the UK and the EU.
- Higher trade barriers between the UK and countries the EU has negotiated commitments and concessions with in the WTO and/or signed preferential trade agreements with.
- The UK will not participate in future steps that the EU takes towards deeper integration which may lead to an increase in trade barriers.

BARRIERS TO TRADE

Barriers to trade are national policy measures that have the effect of restricting trade between countries. They are generally divided between tariffs and non-tariff barriers (NTBs) (Table 1).

Table 1 Barriers to trade

Trade barrier	Definition
Tariff	A tax or duty to be paid on a particular class of imports or exports, generally imports. Tariffs are defined according to the rate, classification ² and valuation ³ of the goods being taxed.
Non-tariff barrier (NTB), also known as non-tariff measures	Measures other than tariffs that have the effect of restricting trade including: <ul style="list-style-type: none">• Traditional border measures such as:<ul style="list-style-type: none">○ Quantitative restrictions on imports and exports such as import quotas○ Import and export licensing• Newer trade barriers such as:<ul style="list-style-type: none">○ Product standards○ Conformity assessments such as technical, sanitary and phytosanitary measures○ Other behind-the-door policies in importing countries

Tariffs have three main functions:

² Most countries use a harmonized system of six-digit tariff numbers based on the “Harmonized Commodity Description and Coding System” which was developed by the Customs Co-operation Council (also known as the “World Customs Organization”).

³ GATT Article VII and the “Agreement on Implementation of Article VII” (Customs Valuation Agreement) define international rules for valuation.

- They are a source of revenue for the government.
- They protect domestic industries by making imports more expensive. This may lead to a reduction of the amount of imported goods and higher domestic prices for those goods. This could lead to a rise in domestic prices in the country imposing the tariff.
- They are used to remedy trade distortions arising from other countries' barriers to trade. For instance, some countries have "tariff quotas" which work by assigning lower or no duties at all to imports up to a certain volume (primary duties) and then higher rates (secondary duties) to imports above that level.

Export tariffs (i.e. tariffs on goods to be exported) are used mainly by developing and least developed countries to gain revenue and to encourage the processing of products (generally natural resources) in the country rather than in another country.

The effects of NTBs on trade and economic welfare is much harder to analyse than tariffs (OECD [2005](#)). Since World War II, there has been a significant decrease in tariffs (their number and rates) in the world, but there has also been a strong *increase* in NTBs. This has not been the case so much with traditional border measures (see Table 1) as newer NTBs such as product standards. In addition, various customs and charges are frequently applied on imported goods which significantly add to the costs of trading in many parts of the world (OECD [2005](#)) and in general, the more complicated rules of origins requirements are, the higher the costs in this regard. Rules of origin are the criteria needed to determine the national source of a product. They are important for example in free trade areas because these countries have reduced or eliminated tariffs between each other but not with non-partner states, so it is fundamental to be able to determine what the country of origin is. Governments vary widely with regard to their treatment of rules of origin.

A relevant example of rules of origin exists in the Comprehensive Economic Trade Agreement (CETA) between Canada and the EU. CETA requires that Canadian companies prove that a sufficient proportion of a product is made in Canada to qualify for preferential tariff rates. According to a 2013 report by the Centre for Economic Policy Research, implementing rules of origin obligations on all UK trade with the Single Market would cost just under £2.8 billion per year (Centre for Economic Policy Research [2013](#)).

PREFERENTIAL TRADE AGREEMENTS

Preferential Trade Agreements (PTAs) are agreements between two or more countries to discriminate favourably in their treatment of goods and/or services traded amongst themselves. The WTO distinguishes between regional trade agreements (RTAs) and preferential trade arrangements. Examples of PTAs include Free Trade Agreements, Customs Unions and Common Markets.

PTAs have been on the rise since the 1990s. The rise in PTAs coincides with the lack of progress on the multilateral front as the latest trade round in the WTO has been bogged down for many years.

There are different types of PTAs, according to the degree of integration of states' markets and regulations, from the least integrated to the most integrated. Table 2 shows the different types of PTAs.

Table 2 Different types of Preferential Trade Agreements (PTAs)

	Definition
Free trade area	Reduction or removal of trade barriers on goods and services. Partner states are free to choose how they treat goods and services from non-partner states (there is no common external tariff). More than 90% of PTAs are FTAs. Examples include the North Atlantic Free Trade Area (NAFTA).
Customs union	In addition to being a FTA, partner states have a common set of policies on imports from non-partner states, including agreement on a common level of tariffs on all imports from non-partner states. Governments therefore have to give up at least some autonomy on their international trade policies. There are relatively few customs unions including the MERCOSUR or Common Market of the South (comprising Argentina, Brazil, Paraguay and Uruguay).
Common market	In addition to being a customs union, a common market allows for free movement of labour and capital. This means governments have to cooperate in other policy areas to ensure comparable treatment in all countries within the common market. The EU Single Market is an example of a common market.
Economic union	In addition to being a common market, an economic union includes the adoption of a common currency and/or the harmonization of monetary, fiscal and social policies. Only the Eurozone has reached this level of integration.

Source: Ravenhill 2014

THE UK'S CURRENT RELATIONSHIP WITH THE EU

THE SINGLE MARKET

A cornerstone of the EU economy, the European Single Market came into effect at the beginning of 1993. According to the European Commission's website, the Single Market:

“...is all about bringing down barriers and simplifying existing rules to enable everyone in the EU – individuals, consumers and businesses – to make the most of the opportunities offered to them by having direct access to 28 countries and 503 million people.” (European Commission [2016a](#))

According to the European Commission, the Single Market is generally regarded as having provided increased competition, benefiting consumers with a wider choice of products and lower prices. It also makes it easier, and more economical, for businesses to conduct work and trade across borders (European Commission [2016a](#)).

The Single Market has four cornerstones laid out in the Treaties (EurLex [2016](#)):

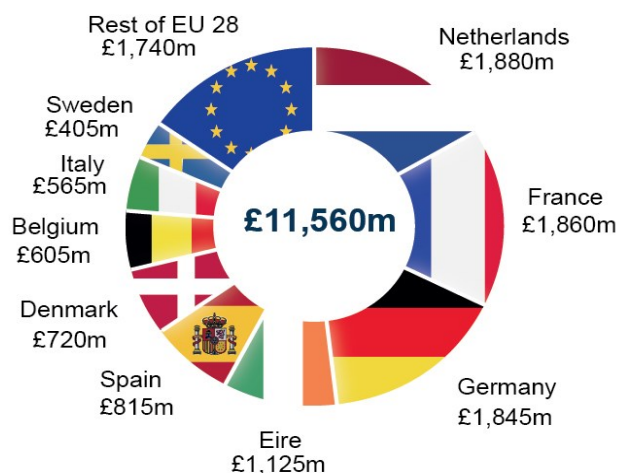
- Free movement of goods: with the abolition of customs tariffs, the EU became a single territory without internal frontiers. Single market membership also removes NTBs such as technical specifications and labelling requirements. This means Scottish businesses can effectively sell their goods to a 'home market' of over 500 million consumers.
- Free movement of workers guarantees every EU citizen the right to move freely, to stay and to work in another member state..
- Right of establishment and freedom to provide services – the objective being to provide a genuine internal market in services. This is to be done by removing barriers (both legal and administrative) to the development of service activities between Member States.
- Free movement of capital – the aim is to remove all restrictions on movement of capital within the EU and between Members States and third countries have to be removed (with some exceptions).

In addition to providing tariff free access to EU markets, a common framework of regulations means companies in countries such as the UK, France, Italy or Poland have to abide by common standards - whether they trade across the EU or not. The purpose of this is to stop one business or country having an unfair advantage based on its location.

THE CURRENT VALUE OF SINGLE MARKET MEMBERSHIP

The EU is currently both the UK's and Scotland's biggest international trading partner. In 2015 it accounted for 44% of UK goods and services exports (£222 billion) (ONS [2016](#)) whilst it was the destination for 15% of Scotland's exports (42% of its international exports - this is down from 54% in 2002) worth £11.56 billion in 2014 (Scottish Government [2016](#)). Figure 1 shows EU destinations for Scotland's exports by Member State. It should be noted that the value of trade with the Netherlands is generally overstated. This is because Rotterdam is one of the largest ports in the world and acts as a gateway to other countries. For example exports with Germany as the final destination could go via Rotterdam meaning they would appear as exports to the Netherlands. This is known as the 'Rotterdam Effect' (SPICe [2015](#)).

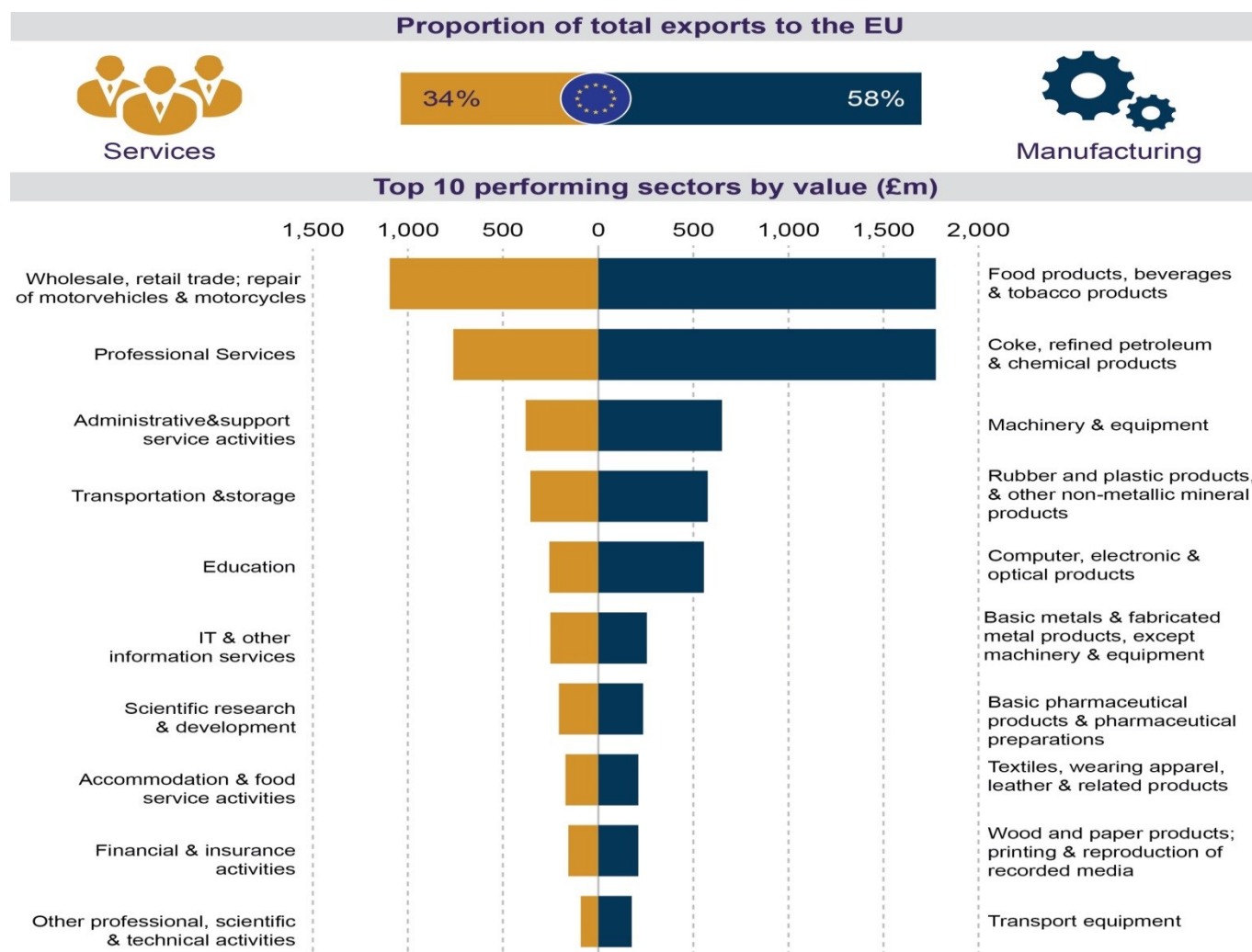
Figure 1 Scotland's exports to EU states, 2014



Source: Scottish Government [2016](#)

Figure 2 shows the top performing export sectors to the EU. 58% of Scottish exports to the EU are in manufacturing (with food products, beverages and tobacco products at the top) and 34% are in services.

Figure 2 Scottish exports to the EU, 2014



Source: SPICE [2015](#)

THE CUSTOMS UNION

As currently constituted in the EU Treaties, membership of the Single Market also means membership of the Customs Union.

The Customs Union applies a common tariff to all goods entering from outwith the EU. As a result of this common tariff, individual Member States are unable to adopt their own independent trade policies. Instead, the EU has competence for negotiating trade agreements on behalf of the Member States.

In addition, trade agreements have been finalised with Canada and Singapore but have yet to be ratified. The European Commission is also negotiating (on the EU's behalf) further trade agreements with, amongst others, the United States of America (TTIP), Japan, India and China.

TRADE IN GOODS AND SERVICES: PASSPORTING

Single Market membership provides for the free movement of capital and services, for example, provision for passporting of financial services which are a key export for the UK. This means that financial services firms authorised in the UK can provide their services across the EU without the need for further authorisations. As the EU financial services passport is currently only available to firms authorised in the EU or the EEA, any international firm wishing to have access to the passport needs to set up a subsidiary in a Member State to qualify (Bank of England [2016a](#)).

INWARD INVESTMENT

Membership of the Single Market also allows businesses based in other EU countries to invest in the UK and also makes the UK an attractive investment destination for non-EU companies looking to access to the Single Market. This was underlined by a report from the Japanese Government ahead of the the G20 summit in Hangzhou, China in September 2016. The report, published by the Japanese Government's Foreign Ministry warned of the implications of the UK leaving the EU in terms of Japanese investment in the UK if a number of concerns were not addressed. The report said:

"There are numerous Japanese businesses operating in Europe, which have created 440,000 jobs. A considerable number of these firms are concentrated in the UK. Nearly half of Japanese direct investment intended for the EU in 2015 flowed to the UK, and the UK was one of the major destinations for Japan's investment stock within the EU as of the end of last year. While benefiting from the single market of the EU, Japanese businesses have contributed to the development of the European economy. Since Europe including the UK is a major trading partner and investment destination for other countries in Asia as well as of Japan, it is in the common interest of all Asian countries as a whole that they continue to have access to the free market of Europe, including the UK. It is of great importance that the UK and the EU maintain market integrity and remain attractive destinations for businesses where free trade, unfettered investment and smooth financial transactions are ensured. In light of the fact that a number of Japanese businesses, invited by the Government in some cases, have invested actively to the UK, which was seen to be a gateway to Europe, and have established value-chains across Europe, we strongly request that the UK will consider this fact seriously and respond in a responsible manner to minimise any harmful effects on these businesses. " (Japanese Government Ministry of Foreign Affairs [2016](#))

SINGLE MARKET MEMBERSHIP IS NOT JUST TRADE

Securing access to the Single Market places a number of other commitments on Member States. The requirement to ensure all Member States are in the Single Market on an equal basis means that the EU Treaties also include common rules on competition and taxation. These rules cover areas such as public procurement, state aids and VAT policy.

SINGLE MARKET MEMBERSHIP OR ACCESS TO THE SINGLE MARKET

Since the referendum on the UK's membership of the EU, there has been confusion about whether access to the Single Market is the same as membership of the Single Market. Membership of the Single Market comes with EU membership and includes membership of the Customs Union (discussed above).

Access to the Single Market can be arranged in a number of different ways. For instance, membership of the European Economic Area is the closest option to full Single Market membership as it removes all tariffs and NTBs and requires observation of the rights of free movement of goods, services, capital and people. Another form of preferential access to the Single Market which can be negotiated with the EU is a bilateral free trade agreement such as that negotiated between the EU and Canada whilst countries without any form of free trade agreement can still trade with the EU using WTO rules. These options are all discussed below.

The implications for trade of leaving the EU were addressed by Graeme Roy from the FAI when he appeared before the European and External Relations Committee on 28 July 2016. In response to a question about whether being in the EEA would deliver the economic benefits currently enjoyed as a result of EU membership, Graeme Roy said:

“It is probably best to think about a sliding scale. The closer that we are to remaining in the single market, the lesser the impact will be on trade and investment. The difference between the sort of arrangement in which we would meet all the various regulations and have no tariff barriers or non-tariff barriers, if that can be secured, and the current arrangement is relatively small. The question is whether such an arrangement can be delivered.

On that scale, if we move towards membership of the EEA, for example, we would have proof-of-origin requirements, and customs checks are needed between EEA members and the EU. Further along, the Swiss model would not give us access to the services of the single market and the Turkish model would not give us any access to services at all. Something like a free trade arrangement would mean that we would not have any tariff barriers, but it would not give us full access to the single market. If we were to come out completely, into a WTO type of model, we would have tariff barriers. We are thinking about the issue on that scale.” (Scottish Parliament [2016](#)).

EU FREE TRADE AGREEMENTS

The EU (and as a consequence the UK) currently has in place PTAs with some 50 partners including Chile, South Korea, Mexico, South Africa and the Central American countries (European Commission [2013](#)) (see Annex). Upon leaving the EU, the UK will lose its preferential access to those markets (some of which are key markets for Scotland's exports such as Brazil, the United Arab Emirates, Singapore and Australia) unless it renegotiates these agreements. It will also have to renegotiate new EU trade agreements currently in progress such as CETA. Formal talks cannot begin until after the UK withdraws from the EU. Additionally, the EU is a larger trader and has a larger market than the UK and it has been argued that this puts the EU in a stronger position to negotiate PTAs than the UK by itself. This

might have an impact on the concessions that the UK obtains through negotiations with other countries.

ALTERNATIVE TRADING OPTIONS TO THE EU

The next section of the briefing examines the different options the UK has for its trading relationship with the EU. These can loosely be summarised as retaining EEA membership by joining EFTA, adopting a bilateral trade agreement with the EU like Switzerland or Canada, remaining attached to the Customs Union like Turkey or 'WTO membership' which means relying on a schedule of commitments the UK has to negotiate with its trading partners based on WTO principles such as not discriminating against third countries.

Ahead of the referendum, the UK Government published a table (below) outlining the different possible models and what they mean in terms of different elements of EU membership.

Summary Table – Models of relationship to the European Union

			Access to the Single Market in goods and services								
		Votes on EU law	Tariff-free trade	Customs Union and external trade	Level playing field for business	'Ever closer union'	Justice and Home Affairs (JHA)	Free Movement of People	Schengen border-free area	Contribution to EU financing	Eurozone membership
UK membership of the EU								a)		b)	
Standard EU membership											
Norway (non-EU EEA)											
Bilateral Agreements	Switzerland										
	Canada										
	Turkey										
WTO membership			c)		d)						

Legend	
Full	
Partial / voluntary / special arrangement	
None	

- a) Free movement of people: at the 2016 February European Council the Prime Minister secured a new settlement that will enable the UK to have a new emergency brake to limit full access to in-work benefits by newly arrived EU workers for up to four years when they enter our labour market. This will be in force for seven years.
- b) The UK receives a rebate on its contributions to the EU budget.
- c) Except where the EU has bound tariffs at zero per cent in WTO commitments.
- d) Except where the EU has made commitments under General Agreement on Trade and Services.

Source: HM Government [2016](#)

THE EUROPEAN ECONOMIC AREA

One of the options closest to continuing its current arrangements with the EU upon leaving would be to join the EEA. Based on current EEA arrangements, the UK would be outside of the common agriculture and fisheries policies. It would still contribute financially to the EU, free movement of labour would continue, and the UK would have to comply with the Single Market's rules and regulations but would not be able to vote on them.

The EEA is currently made up of the 28 EU Member States and three other countries, Norway, Iceland and Lichtenstein. Whilst Switzerland is an EFTA member it is not an EEA member. EEA countries are part of the Single Market however, non-EU EEA countries (Norway, Iceland and Lichtenstein) are not part of the EU Customs Union. Norway, Iceland and Lichtenstein have an independent trade policy, which means they negotiate their own trade agreements outside the EEA.

HOW DO YOU JOIN THE EEA?

If the UK wished to join the EEA it would first need to join the European Free Trade Association (discussed below) and then gain the unanimous approval of all the EEA states – there would be 30 of them assuming the UK had left the EU.

Article 128 of the EEA Agreement outlines how a new member would join the EEA. It states that

“Any European State becoming a member of the Community shall, and the Swiss Confederation or any European State becoming a member of EFTA may, apply to become a party to this Agreement. It shall address its application to the EEA Council.

The terms and conditions for such participation shall be the subject of an agreement between the Contracting Parties and the applicant State. That agreement shall be submitted for ratification or approval by all Contracting Parties in accordance with their own procedures.” (EFTA [2016a](#))

WHAT ARE THE RULES OF EEA MEMBERSHIP?

The key rules for membership of the EEA are compliance with the EEA Agreement. The EEA Agreement provides for the inclusion of EU legislation covering the four freedoms – the free movement of goods, services, persons and capital – throughout the 31 EEA States. In addition, the Agreement covers cooperation in other important areas such as research and development, education, social policy, the environment, consumer protection, tourism and culture, collectively known as “flanking and horizontal” policies. It also guarantees equal rights and obligations within the Internal Market for citizens and economic operators in the EEA.

The EEA Agreement does not cover the following EU policies:

- Common Agriculture and Fisheries Policies (although the Agreement contains provisions on various aspects of trade in agricultural and fish products);
- Customs Union;
- Common Trade Policy;
- Common Foreign and Security Policy;
- Justice and Home Affairs (even though the EFTA countries are part of the Schengen area); or
- European Monetary Union.

Membership of the EEA also requires non-EU members to incorporate most EU law related to the Single Market into domestic legislation. This legislation needs to be incorporated despite the non-EU EEA members having little say in its development other than in a consultative role.

EFTA EEA membership which leaves the UK outside the Single Market for fisheries and agricultural products would mean that exporting these products to the EU would incur tariff barriers.

THE IMPLICATIONS OF BEING OUTWITH THE CUSTOMS UNION

As those EEA members who are not members of the EU are outwith the EU's Customs Union, they are able to negotiate their own trade policies with non-EEA countries. Absence from the Customs Union does mean that customs controls are required at borders between EU Member States and EEA members, for example the border between Norway and Sweden. The customs checks exist to ensure goods are not using an EEA member as a point of entry to the Single Market unlawfully. This issue was addressed in the UK Government's publication "Alternatives to membership: possible models for the United Kingdom outside the European Union" which was published before the referendum and states:

"In a Customs Union goods can be shipped across national borders without tariffs being imposed. This makes internal trade cheaper and less bureaucratic because it removes costly and time-consuming processes. These checks can be complex, for example where they require manufacturers to say where they sourced the components in their products, in order to make sure the whole product complies with all the different external trade policies (the so-called 'Rules of Origin'). An engine made in the UK may contain parts from all over the world. Without the Customs Union, some of those parts would be liable for tariffs and have to prove their origin. The engine therefore would need to be inspected and checked, and tariffs paid as it crossed the border into another EU Member State. The Single Market means none of that expense and bureaucracy is necessary." (HM Government [2016](#))

In evidence to the House of Lords Select Committee on the EU as part of their inquiry on Brexit: Future Trade between the UK and the EU, Professor John Manners-Bell, the Chief Executive of Transport Intelligence Ltd explained how rules of origin work and what their potential impact on trade can be, he also suggested why he thought rules of origin would not be imposed on trade between the UK and the EU:

"Any parts or components which are imported into a country would have to have some sort of certificate if they are to be re-exported to the EU. For example, if they were to come into the UK from any country around the world, such as China, then that part may need to have a certificate of origin and if the overall amount of imported goods from non-EU countries made up more than a certain proportion of that particular good, it would have a tariff imposed on it. The problem with that is that, if the system becomes very bureaucratic and administrative, it can add a large amount of costs to the overall process of the export of the good. I think that some people have estimated it as anywhere between 5% and 15%, in which case the exporter may decide that it is easier to accept a tariff rather than go through all the administrative burden of getting certificates of origin for all the different parts of these products, which are then assembled and re-exported. So in theory—this is what a lot of the literature has been warning about the impact of Brexit—that could be a major cost. However, we could look at a trade deal with South Korea. The negotiations for that started in 2007 and ended in 2009, so there were only two years of negotiation, and it then came into force two years afterwards in 2011. But rules of origin and non-tariff barriers were all integrated into that agreement. It can be done. We are always thinking about it from the UK perspective, thinking that others will insist on this burden, but to be honest it is more an issue for EU exporters to the UK because of the trade deficit. So if

they insisted that we must have rules of origin—other non tariff barriers (NTBs) on our goods—presumably the reverse would apply as well. In which case, there would be bigger hit for EU exporters. I cannot see that being an acceptable state of affairs for the major European manufacturers such as BMW, Mercedes and the like.” (UK Parliament [2016](#))

DO EEA MEMBERS MAKE A FINANCIAL CONTRIBUTION TO THE EU?

The EEA Agreement includes a goal to reduce social and economic disparities in the European Economic Area (EFTA [2016a](#)). As a result, Norway, Switzerland and Lichtenstein contribute to cohesion efforts.

The EEA Grants are related to the EEA Agreement and provide social and economic development funding by the EEA EFTA States. This financial support aims at reducing economic and social disparities in the EEA and strengthening bilateral relations with the beneficiary states: Bulgaria, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, Slovenia and Spain. In addition to the EEA Grants, Norway has funded a parallel scheme since 2004 – the Norway Grants.

For the funding period 2014-2021 Iceland, Liechtenstein and Norway will contribute with a total amount of €2.8 billion to reduce economic and social disparities in Europe and strengthening bilateral relations with 15 EU member states (EEA Grants [2016](#)). Of this total, Norway’s annual contribution will be €391 million (The Norwegian Mission to the EU [2016](#)).

EEA Participation in EU Programmes

The non-EU EEA members also participate in EU programmes. The EEA EFTA states normally fund their participation in EU programmes and agencies by an amount corresponding to the relative size of their GDP compared to the GDP of the whole EEA (proportionality factor). The EEA EFTA states participation is hence on equal footing with EU member states. According to the Norwegian Government, between 2014 and 2020:

Norway participates in a number of EU programmes through provisions in the EEA Agreement or on the basis of bilateral agreements with the EU. The largest are the Horizon 2020 and, Erasmus+, Galileo and Copernicus. Norway (and our EEA partners Iceland and Liechtenstein) contributes to the budget of the programmes we participate in. For the period 2014 – 2020, Norway’s average annual commitment is 447 million euro” (The Norwegian Mission to the EU [2016](#)).

Economic consequences of the ‘Norway’ Option

Table 3 summarises the effect of the ‘Norway’ model according to the Fraser of Allander Institute.

Table 3 ‘Norway’ model: long-term changes relative to baseline

	Optimistic % change	Pessimistic % change
GDP	-2.0	-3.1
Exports	-4.4	-6.7
Real wages	-2.9	-4.3
Employment	-1.2	-1.8
Population	+0.8	+1.2

Source: Fraser of Allander Institute [2016](#)

THE EUROPEAN FREE TRADE ASSOCIATION (EFTA)

If the UK wished to join the EEA, it would first need to join EFTA to be eligible for EEA membership.

The EFTA is an intergovernmental organisation set up for the promotion of free trade and economic integration. It has four Member States: Iceland, Liechtenstein, Norway and Switzerland. It was established by a Convention signed in Stockholm on 4 January 1960. EFTA's main objective was to liberalise trade among its Member States. EFTA manages:

- EFTA Convention;
- EFTA's worldwide network of free trade and partnership agreements;
- EEA Agreement, which applies to trade relations between Iceland, Liechtenstein and Norway.

HOW DO YOU JOIN EFTA?

Article 56 of the EFTA Convention sets out the procedure for a country to join EFTA ([EFTA 2010](#)). In essence joining EFTA requires the unanimous agreement of all four members and also requires the applicant to take on the obligations set out in the EFTA Convention and the Annexes and Protocols.

Article 56 states:

“Accession and association

1. Any State may accede to this Convention, provided that the Council decides to approve its accession, on such terms and conditions as may be set out in that decision. The instrument of accession shall be deposited with the Depositary, which shall notify all other Member States. This Convention shall enter into force in relation to an acceding State on the date indicated in that decision.

2. The Council may negotiate an agreement between the Member States and any other State, union of States or international organisation, creating an association embodying such reciprocal rights and obligations, common actions and special procedures as may be appropriate. Such an agreement shall be submitted to the Member States for acceptance and shall enter into force provided that it is accepted by all Member States. Instruments of acceptance shall be deposited with the Depositary, which shall notify all other Member States.

3. Any State acceding to this Convention shall apply to become a party to the free trade agreements between the Member States on the one hand and third states, unions of states or international organisations on the other.” ([EFTA 2010](#))

WHAT IS COVERED BY THE EFTA AGREEMENT?

The EFTA website provides an overview of the EFTA Convention ([EFTA 2016b](#)). This is reproduced below.

The updated EFTA Convention was signed on 21 June 2001 and entered into force on 1 June 2002, in parallel with the EU-Swiss Bilateral Agreements. It included several significant changes, including the integration of the principles and rules established between the EU and the EEA EFTA States in the EEA Agreement, and between the EU and Switzerland in the EU-

Swiss Bilateral Agreements. Important new provisions included the free movement of persons, trade in services, movement of capital and protection of intellectual property.

The Convention covers all the important aspects of modern trade and reinforces the ties between the EFTA countries. It strengthens economic relations between the EFTA Member States and provides for a common platform for developing their relations with trade partners around the world. The EFTA website notes: "The EFTA States now benefit from virtually the same privileged relationship among themselves as they do with the EU". The Convention effectively applies to the relations between Switzerland and the EEA EFTA States. It is updated by the EFTA Council regularly to reflect developments under the EEA Agreement and the Swiss Bilateral Agreements.

The areas covered by EFTA Convention are listed in Table 4.

Table 4 Areas covered by the EFTA Convention

Area covered	Comment
Trade in goods	<p>Free trade area between its members through:</p> <ul style="list-style-type: none"> • Free trade in industrial goods, including fish and other marine products (total elimination of customs duties for all industrial products); • Improved market access for agricultural products; there is a difference between: <ul style="list-style-type: none"> ○ Basic agricultural products - preferential market access, but no common agricultural policy; ○ Processed products - trade is liberalised (in principle); • Including trade disciplines; • Establishing rules on customs and origin matters.
Services and investment	<p>General liberalisation of trade in services and investment (including establishment and movement of capitals)</p> <p>Commitment to undertake to extend to each other benefits that may accrue from any new agreement that they conclude with the EU.</p>
Services and investment in land and air transport	<p>Integration of elements of the "EU-acquis" and relevant bilateral Switzerland-EU agreements.</p>
Intellectual property rights	<p>Builds on principles of national treatment and MFN treatment as stipulated in the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights.</p>
Government procurement	<p>No obligations regarding government procurement. EFTA States are members of the WTO GPA and have non-discriminatory access to each other's markets.</p>
Movement of	<p>Free movement of persons was introduced in 2002. The Convention</p>

persons, social security and mutual recognition of diplomas.	specifies the rights of entry, exit and residence and the right to work for the employed, the self employed and service providers. Special rules govern individuals living in border areas and working in Switzerland as well as public service activities and the acquisition of real estate in Switzerland. The free movement of persons also covers social security issues by establishing a system of coordination between the EFTA States. The objective is to apply common principles and rules so that differences in national legislation do not hinder the mobility of persons who move within the EFTA area. Additionally, the mutual recognition of professional diplomas has been introduced under the EFTA Convention, which further facilitates the free movement of persons.
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Technical barriers to trade	<p>Mutual recognition of conformity assessments and notification of draft technical regulations.</p> <p>EEA Agreement extends the Union's internal market rules to the three EEA EFTA States. This comprises the entire body of technical regulations determining the requirements products need to fulfil concerning safety, consumer protection, health and the environment, as well as the procedures for testing conformity with such requirements. The Convention incorporates the rules established under the bilateral agreement between Switzerland and the EU in this area, as well as the corresponding provisions of the EEA Agreement.</p>
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Competition, public undertakings and monopolies, and state aid	Consultations and safeguard measures to deal with possible difficulties resulting from anti-competitive practices of another EFTA State.
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DOES EFTA NEGOTIATE ITS OWN TRADE AGREEMENTS?

Since 1990 EFTA has established an extensive network of contractual free trade relations across the world. The EFTA Member States also developed trade relations with the EU through the EEA Agreement (1994) and the EU-Swiss Bilateral Agreements (1999).

As the EFTA States do not form a Customs Union, there is no requirement to negotiate trade agreements as a group, this means each EFTA state is free to negotiate its own trade arrangements. However, often the EFTA states do choose to negotiate as a bloc. As a result, the EFTA States currently have 27 free trade agreements (covering 38 countries). Agreements exist with amongst others Canada, the Republic of Korea and Singapore (EFTA [2016c](#)).

At present EFTA does not have free trade agreements with the United States of America, India (negotiations are on-going) or China (though it does have an agreement with Hong Kong, China).

EFTA trade agreements with third countries focus on traditional market access requirements. Details of the usual contents of EFTA trade agreements are available on EFTA's website (EFTA [2016d](#)).

ESTABLISHING A FREE TRADE AGREEMENT WITH THE EU

BACKGROUND

If the UK decides not to seek EEA membership, it could aim to negotiate a different type of trade agreement with the EU. This approach might be seen as an intermediate category between the EEA and purely relying on the WTO in terms of economic integration. This is what Switzerland, Turkey and numerous other countries have done (see Annex). The degree of integration will depend on the outcome of negotiations between the EU and the UK. Negotiating trade agreements can be a complicated and lengthy process. Ratification from the perspective of the EU would require unanimous agreement at the European Council, a majority vote in the European Parliament, and probably approval in national and some regional parliaments.

While a trade agreement between the UK and the EU would involve negotiating for access to the Single Market in different areas and agreeing tariff levels (as low as zero), it would not necessarily address NTBs. These include requirements to comply with EU standards before goods can be sold in the Single Market and also rules on quotas to prevent dumping of goods in the Single Market. Whatever is agreed, producers would still be required to ensure that goods complied with Single Market rules and regulations to allow them to be sold.

According to the 2013 report by the Centre for Economic Policy Research although NTBs are harder to put a cost on, they estimate that a Free Trade Agreement with the EU could still result in NTB costs of £15.2 billion per year for trade between the UK and the Single Market.

An example of a free trade agreement often cited is the recently agreed (but not yet ratified) trade agreement between the EU and Canada (Open Europe [2016](#)). According to the European Commission, CETA will remove customs duties, end restrictions on access to public contracts (public procurement), open-up the services market, offer predictable conditions for investors and help prevent illegal copying of EU innovations and traditional products (European Commission [2016b](#)).

The UK Government has described CETA as going “further than any existing EU trade deal”. However, CETA took seven years to negotiate and still requires to be ratified before it can come into force. As CETA has been adjudged to be a mixed agreement (meaning areas of the agreement relate to Member State and not just EU competences), ratification is also required by all the EU Member States.

Access to, but not membership of the Single Market would mean the UK would not need to implement EU regulations and laws. However this approach may present so-called non-tariff barriers in that UK produced goods might not comply with EU standards and so would not be able to be sold in the Single Market. CETA requires that Canada accepts EU product regulations when exporting to the EU.

In addition, under CETA, Canada will have no access to the banking passport system that would have allowed its banks and financial services to trade freely. The freedom of movement clauses are primarily focused on businesspeople.

Whilst Free Trade Agreements ensure access to the Single Market on preferential terms they often set limits or quotas on the amount of a good that can enjoy those preferential terms. For example, the CETA agreement sets limits on the amount of beef and pork that can be exported by Canada to the EU market. For beef, Canada will only be able to export 50,000 tonnes before it is required to pay tariffs of more than 12%.

CETA doesn't provide any tariff-free access to agricultural products such as eggs or poultry and whilst the trade deal aims to liberalise services, hundreds of exceptions are listed.

Although the details of any Free Trade Agreement between the UK and the EU will be agreed by negotiation, it is possible that the EU (like it has done with Canada) will insist on quotas and limits to the amount of goods that can be exported by the UK to the Single Market. It is also possible the UK might also choose to impose quotas on some EU exports to the UK.

WHAT GOODS AND SERVICES ARE COVERED BY THE EU'S FREE TRADE AGREEMENTS?

In the event that the UK secures some sort of Free Trade Agreement with the EU covering access to the Single Market, a crucial issue will be whether it covers all the areas that Single Market membership covers. For example, CETA does not fully cover services (it provides for only limited market access for services) and doesn't cover financial services at all. Whilst this would be subject to negotiation, adopting a Canadian style model might limit single market access for services. The UK Government's description of the Canadian Free Trade Agreement as compared to Single Market membership stated:

"Overall, a Free Trade Agreement along the lines of EU-Canada would bring less advantageous terms for UK trade than those we currently enjoy, with particular issues for UK services losing access to the Single Market." (HM Government [2016](#))

An agreement of this type between the UK and EU would also be likely to carry rules of origin requirements. It is worth noting that the UK has much stronger economic ties to the EU than Canada and thus negotiations would likely be more complex and it may take longer to reach an agreement.

LIKELIHOOD OF A FREE TRADE AGREEMENT BETWEEN THE UK AND THE EU?

Given it would require negotiation it is difficult to be certain about what would be included in a Free Trade Agreement between the UK and the EU. In terms of the likelihood of an agreement being reached, the House of Commons Library briefing on Brexit: Trade Aspects concluded:

"We do not know how keen the rest of the EU would be to enter into a FTA with the UK or what the terms of such an agreement might be. A comprehensive economic and trade agreement between the UK and the EU would probably need the agreement of all EU Member States' governments (and some parliaments of EU Member States). The UK is however, an important market for the rest of the EU. The rest of the EU has a trade surplus with the UK (just under £70 billion in 2015). In 2015, 21 of the other 27 EU Member States had a trade surplus with the UK. Germany's surplus was £25 billion. These commercial considerations might lead to pressure for a UK-EU free trade agreement."

A key question in achieving a Free Trade Agreement between the UK and the EU will be on the timing of negotiations and whether negotiations begin before the UK leaves the EU. If no agreement on a Free Trade Agreement is reached before the UK leaves the EU it'd leave the UK trading with the Single Market using WTO rules unless some sort of interim agreement was reached.

THE SWISS MODEL – EFTA BUT NOT EEA

BILATERAL TRADE AGREEMENTS

Switzerland is in EFTA and the Schengen area but is not a member of the EU or the EEA. Instead it has negotiated over 100 bilateral treaties with the EU. Importantly these do not cover services. According to the Swiss Government (2015a):

“Switzerland pursues its interests with respect to the EU via the so-called “bilateral path”. The two partners negotiate contractual agreements in selected sectors of mutual interest. On the one hand, these improve reciprocal market access for companies or regulate related aspects of product safety, employee protection and health. On the other hand, they enable closer cooperation in areas such as research, security, asylum, the environment, education and culture. Switzerland also contributes towards the development of Europe through various commitments. Examples are the enlargement contributions to reducing social and economic disparities in Europe, Switzerland’s involvement in peace missions in south-east Europe, and its participation in the Council of Europe’s efforts to promote respect for human rights.”

This approach means Switzerland has access to the Single Market in many areas and each time legislative changes to the Single Market are agreed it requires a new agreement with the EU. According to the Centre for European Reform ([2012](#)):

“Switzerland signed up to the EU’s customs union in 1972, which abolished subsidy and tariff barriers. Since then, it has also decided to sign up to the majority of the single market: it is a full member of the single market for goods, a signatory to the Schengen agreement, and it has signed up to most of the single market for capital. In many areas, therefore, Switzerland is effectively a member of the single market. But like Norway, it does not have the ability to affect the rules that govern it.”

Switzerland’s agreements with the EU only provides partial access to the Single Market with services only partially covered and the banking and professional services sectors not being covered at all. As Switzerland is not an EEA state it does not enjoy passporting rights under any of the single market directives. EEA general insurers do have the right to set up an establishment in Switzerland (and vice versa) under the provisions of special bilateral treaties between the EU and Switzerland (Bank of England [2016b](#)).

Although Switzerland is not required to ensure its domestic law complies with EU law in the way in which the EEA requires of Norway, Switzerland is required to ensure its domestic law reflects EU rules. Failure to achieve this could mean the EU could block Swiss access to related areas of the Single Market. As such, Switzerland in effect needs to mirror EU internal market law and in areas such as competition policy, state aid and environmental regulations.

SWISS FINANCIAL CONTRIBUTION TO THE EU

Switzerland contributes financially to both enlargement costs ‘to reduce economic and social disparities’, and to the EU programmes in which it participates under its array of bilateral agreements.

Switzerland makes an Enlargement Contribution to finance specific, high quality projects aimed at reducing the economic and social disparities in the twelve new EU-Member States. In this way, it supports the EU objective of strengthening the economic and social cohesion (to be understood as internal cohesion), and it does so in its own particular way.

According to the Swiss Government, since 2008, Switzerland has contributed CHF 1.3 billion (just under €1.2 billion) to projects and programmes in the ten states that joined the EU in May 2004 (Confederation Suisse [2016](#)).

Before the referendum, the UK Government suggested the UK would be unlikely to secure a similar relationship with the EU to the one Switzerland has:

“It is unlikely that the UK could secure an arrangement like Switzerland. Even if we wanted to do so, it is unlikely that the remaining EU Member States would be willing to offer the UK a similar arrangement. The EU-Swiss bilateral agreements are complicated, and increasingly controversial both with the EU and in Switzerland. Both the EU and the Swiss are calling the viability of this model into question.” (HM Government [2016](#))

ECONOMIC CONSEQUENCES OF THE ‘SWITZERLAND’ MODEL

Table 5 summarises the effect of the ‘Switzerland’ model according to the Fraser of Allander Institute.

Table 5 ‘Switzerland’ model: long-term changes relative to baseline

	Optimistic % change	Pessimistic % change
GDP	-2.7	-3.9
Exports	-5.9	-8.4
Real wages	-4.5	-5.8
Employment	-1.4	-2.2
Population	+1.8	+2.3

Source: Fraser of Allander Institute [2016](#)

TURKEY AND THE CUSTOMS UNION

Another potential option for the UK upon leaving the EU would be to adopt a Customs Union with the EU's Customs Union. Though not actual membership of the Customs Union, this approach would provide Single Market access for UK goods in the areas covered by the Customs Union agreement. An example of this approach is Turkey which adopted a relationship with the EU's Customs Union in December 1995.

The Customs Union agreement covers all industrial goods but does not address agriculture (except processed agricultural products), services or public procurement. In areas where the Customs Union applies, Turkey is required to adopt legislation to the same standards as the EU's, this includes standards in areas such as competition, product and environmental rules.

As a result of its agreement with the Customs Union, Turkey is required to align its external tariffs with those of the EU. This means that when the EU concludes a trade agreement with a third country, in areas covered by its Customs Union membership Turkey is required to provide access to its market on the same terms as those agreed by the EU.

Turkey can however sign its own bilateral free trade agreements as long as the terms do not cut across its Customs Union commitments.

In evidence to the House of Lords Select Committee, Dr Peter Holmes from the University of Sussex provided details of Turkey's Customs Union membership:

“the only country that is linked to the EU in a Customs Union relationship which is not a member is Turkey. It is not a member of the Customs Union; it is a country that has a Customs Union with the Customs Union. That is quite different, because the coverage of the customs union with Turkey is different from that of the EU Customs Union. As you point out, it does not cover services or agriculture...

... the fundamental point is that a Customs Union is a trade bloc where the partner countries agree to remove tariff barriers on each other's goods and to have a common external tariff against third countries, whereas a free trade agreement is where countries agree to remove tariff barriers on each other's goods but they do not have a common policy against third countries. The consequence is that within a free trade agreement you have to have customs barriers to check whether a product really comes from the partner or whether it is a third-country good, in which case it is not entitled to duty-free access. With a free trade area, you have to have rules of origin to check whether a product originated within the free trade area. With a Customs Union, in principle you do not have to have rules of origin, so the goods can flow completely freely.

So it sounds as though a Customs Union is an attractive arrangement because you do not have to stop goods at the border. In reality, however, the Turkish-EU Customs Union does have customs posts because it is not a complete Customs Union in the way that the one inside the EU is. So the advantage of the Customs Union is that you get complete exemption from tariffs for all goods across the border, but in principle you have to have exactly the same external trade policy as your partner, which means that Turkey has to sign free trade agreements with everybody that the EU signs an agreement with. It has, in principle, to accept any negotiating outcomes that the EU secures at the WTO. If there ever is another WTO round, Turkey will have to go along with the EU position. Basically, in a Customs Union you completely lose your ability to have your own independent external trade policy.” (UK Parliament [2016](#))

THE WORLD TRADE ORGANISATION (WTO)

UNDERLYING PRINCIPLES OF THE WTO

The WTO is the biggest organisation in the world that aims to reduce trade barriers between countries. It is a rule-based, member-driven body: its agenda is driven by WTO Member States.

The WTO has its origins in the General Agreement on Trade and Tariffs (GATT) under which a series of trade negotiations, or rounds, were held in 1947. GATT's main aim was to reduce trade barriers on goods between countries. The first rounds dealt mainly with tariff reductions and members set ceilings on their tariff rates – known as bound rates – and committed to not raising their tariffs above these rates. Later negotiations included NTBs and anti-dumping measures. The last completed round of negotiations — the 1986-94 Uruguay Round — led to the WTO's establishment in 1995 (WTO [2016c](#)). While GATT focused on trade in goods, the WTO has an expanded remit that also covers services and agriculture, as well as trade-related aspects of intellectual property rights and investment. The ninth and current trade round of the WTO is the Doha Development Agenda (DDA) which was initiated in 2001 and initially scheduled to conclude in 2005. Reasons for delays in concluding the DDA include a divide between North America and the EU on the one hand on trade in agricultural products, and a coalition of states including BRICS (Brazil, Russia, India, China and South Africa) regarding namely the liberalisation of trade in agricultural products. The WTO currently has 164 members (since 29 July 2016, when Afghanistan joined).

The WTO exercises a number of different roles:

- Acts as a forum for trade negotiations.
- Administers trade agreements.
- Settles trade disputes.
- Reviews national trade policies.
- Assists developing countries in trade policy issues, through technical assistance and training programmes.
- Cooperates with other international organizations.

The WTO is run by its member governments. All major decisions are made generally by consensus by the membership as a whole, either by ministers (who meet at least every two years in the Ministerial Conference which is the highest authority of the WTO) or their ambassadors or delegates (who meet regularly). Power is not delegated to a board of directors or a head of the organisation.

At the heart of the WTO are the WTO agreements which are negotiated and signed by members states of the WTO and ratified in their parliaments. These are essentially the legal ground-rules for international commerce in form of contracts that guarantee member countries trade rights towards one another. They also bind governments to keep their trade policies within agreed limits. They include countries' commitments to lower trade barriers and set procedures for settling disputes. WTO negotiations produce general rules that apply to all members and specific commitments made by individual countries based on these rules. These commitments are listed in schedules of concessions and commitments that each WTO member has. For trade in goods, these usually consist of maximum tariffs levels known as "bound rates" for individual items. GATT rules stipulate that member countries should not apply tariff rates (the "effective rate") higher than their bound rates. Those who wish to raise their bound rates or withdraw tariff concessions must negotiate and reach agreements with other Members with whom they had initially negotiated and enter into consultations with major supplying countries that have a substantial interest in any change in the bound rate.

The main principles of the WTO which are inscribed in the agreements are:

- Non-discrimination, which has two major components:
 - Most-favoured nation (MFN) treatment. Under WTO agreements, countries cannot normally discriminate between their trading partners. If a country grants one of its trading partners a special favour (e.g. low import tariffs on one of its products), it has to grant all other WTO members the same treatment.
 - National treatment policy. This means giving others the same treatment as one's own nationals, in other words imported and domestic goods (as well as services, trademarks, copyrights and patents) should be treated equally. This only applies once goods or services have entered the domestic market. Therefore, charging import tariffs is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.
- Freer trade. This a gradual process that involves the progressive elimination of trade barriers through negotiation.
- Predictability. The WTO website states: "Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable" (WTO [2016c](#))

There are exceptions to the WTO's push for free trade. Firstly, while GATT prohibited quantitative restrictions as a general rule, it allowed for the use of "duties, taxes or other charges" for the regulation of trade. Thus the WTO permits RTAs if they fulfil certain requirements, for instance they are supposed to concern substantially all trade and be in place for a reasonable length of time. They are reviewed by the WTO's Committee on Regional Trade.

Secondly, the WTO allows some degree of retaliation amongst states. For instance, the Antidumping Agreement allows countries to use "anti-dumping duties" on imports from a particular source in excess of bound rates to remedy proven cases of injurious dumping. Dumping is a situation where a product is sold in the importing country for less than the price of that product in the market of the exporting country. Similarly, the Subsidies Agreement allows countries to impose countervailing duties when an exporting country provides its manufacturers with subsidies that, while not specifically banned, nonetheless damage the domestic industry of an importing country.

The MFN principle holds that all trading partners should be treated equally: if a concession is granted to one country, it should be granted to another. However, as the growth of PTAs in recent decades demonstrates, they constitute a key feature of the world trading system.=

Structure

In between ministerial conferences, work is handled by three bodies which are really all the General Council but which meet under different terms of reference:

- General Council.
- Dispute Settlement Body.
- Trade Policy Review Body.

All WTO members are present in these bodies. They report to the Ministerial Conference. The General Council acts on behalf of the Ministerial Conference on all WTO affairs. It meets as the Dispute Settlement Body and the Trade Policy Review Body to oversee procedures for settling disputes between members and to analyse member's trade policies.

Reviews are conducted on the basis of a policy statement by the member under review and a report prepared by the WTO Secretariat. The Secretariat has around 630 staff and provides administrative and technical support for WTO councils, committees and working groups.

Settling Disputes

Member states delegate authority to the WTO only in the case of trade disputes between members via the Dispute Settlement Body. The WTO website states that disputes in the WTO are "essentially about broken promises" (WTO 2016d). A dispute arises when a member of the WTO adopts a measure or takes action that one or more WTO members deem to be in breach of WTO agreements or to be a failure to live up to obligations. The first stage of a dispute is consultation between the concerned governments. Consultation and mediation are always possible at whatever stage of the process the dispute is.

The WTO aims for disputes to be settled through consultation if possible. Only if members fail to settle a dispute in a conciliatory way is a small panel made up of (generally) independent experts (i.e. not tied to any government) established by the Dispute Settlement Body to make an assessment of the dispute. This panel issues a report with its findings and recommendations to the Dispute Settlement Body namely establishing the legality of member states' policies in the case under dispute. This report then has to be adopted or rejected by the Dispute Settlement Body. The latter can only reject the panel report by consensus (all WTO members). The Body then monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling. The losing party is then expected to bring its policy into line with the ruling or recommendations and is given time to do this. The country must state its intention to do this within 30 days of the report's adoption. If the country fails to comply, it has to enter into negotiations with the complaining country in order to determine mutually-acceptable compensation e.g. tariff reductions. If this fails, the complaining side may ask the Dispute Settlement Body for permission to retaliate e.g. imposing tariffs. This is either rejected or accepted by the Body.

The WTO has an Appellate Body with seven members who are all legal experts with international standing. The appeal can uphold, modify or reverse the panel's legal findings and conclusions. The appeal report must be endorsed by the Dispute Settlement Body and can only be rejected by consensus.

JOINING THE WTO: NEW APPLICANTS

Few countries today are not WTO members. Article XII of the Agreement Establishing the WTO sets the rules for joining the WTO. It states that:

"1. Any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement and the Multilateral Trade Agreements may accede to this Agreement, on terms to be agreed between it and the WTO."

2. Decisions on accession shall be taken by the Ministerial Conference. The Ministerial Conference shall approve the agreement on the terms of accession by a two-thirds majority of the Members of the WTO." (WTO [2016d](#))

The General Council considers the applicant country's request and establishes a Working Party to examine the request. Membership of the working party is open to all Members of the WTO. The applicant must present a memorandum covering all aspects of its trade and legal regime to the Working Party. Subsequent Working Party meetings cover questions asked by WTO members based on the information provided in the memorandum and the replies provided by the applicant. Multilateral negotiations ensue whereby the terms and conditions of entry for the applicant country are determined. These include commitments to observe WTO rules. Joining the WTO requires that countries subscribe to all of the following:

- GATT: this is now the main rule-book for trade in goods
- General Agreement on Trade in Services.
- Trade-Related Aspects of Intellectual Property Rights.
- Trade-Related Investment Measures.
- The Dispute Settlement Mechanism.

At the same time, the applicant government carries out negotiations with interested Working Party members on concessions and commitments on market access for goods and services. Therefore becoming a WTO member requires both multilateral and bilateral negotiations. Once these have been completed to the satisfaction of the members of the Working Party, it presents its findings to the General Council or the Ministerial Conference for adoption.

Whereas the WTO states that accession is to be approved by a two-thirds majority, it also highlights that the WTO practice is to arrive at decisions by consensus; that, except as otherwise provided, a vote is only taken when it is not possible to reach a consensus.

Applicants have to agree with the WTO on timescales for putting these agreements in place. Members may in some circumstances delay application of agreements they sign up to for a particular period if other members approve. Other agreements such as the Government Procurement Agreement cover only some members of the WTO.

Members must also subscribe to the Trade Policy Review Mechanisms whereby members must undergo periodic scrutiny, each review containing reports by the country concerned and the WTO.

THE UK AND THE WTO

The UK has been a WTO member since the latter's establishment in 1995 (and a member of GATT since 1948). The EU is also a member of the WTO in its own right and its schedules of concessions are EU-wide – so the UK does not currently have separate schedules. If the UK leaves the EU, its trade would be governed by WTO rules once it negotiated its new position as a non-EU Member State, and any PTAs it negotiates. WTO rules by themselves would offer the UK considerably less market access than the options such as the EEA discussed above.

If the UK leaves the EU, as noted in a recent Financial Times article, “the UK would have to (...) regularise its position within the WTO before it could sign its own trade agreements, including with the EU” (Financial Times [2016](#)).

The UK, as a member of the EU, would be in a unique position if it left the EU in relation to the WTO. There are legal and procedural uncertainties around how the regularisation of its position would occur, for instance it is unclear *when* the UK could start formal discussions with the WTO. A recent Guardian article noted:

“Robert Azevedo, the WTO director-general, said he expected any talks to be long and difficult, adding: “We haven’t had any discussions about the process. We don’t know what the process would be. We do know it would be a very unusual situation (...)

Azevedo said the position [of the UK] was complicated by the fact that all Britain's trade commitments had been negotiated by the EU and that these would cease to apply in the event of a decision to leave. Warning that it would be impossible for the UK to "cut and paste" its old EU trade deals into new agreements, Azevedo said the UK would be starting from scratch without the institutional machinery necessary to negotiate trade deals" (The Guardian [2016](#))

An article by the International Centre for Trade and Sustainable Development (ICTSD) offers some clarification:

"these negotiations [between the UK and the WTO] would be about sorting out the UK's legal status quo in the WTO (...) Re-establishing the UK's WTO status in its own right means both the UK and the EU would negotiate simultaneously with the rest of the WTO's members to extract their separate membership terms. Agreement on the UK's terms is unlikely before those of the EU" (ICTSD [2016](#)).

As it is currently bound by EU-wide schedules, the UK could offer to adopt EU schedules. Speaking at the launch of the 2016 World Trade Report at the World Trade Organisation Public Forum on 27 September 2016, the UK Government's International Trade Secretary, Liam Fox appeared to suggest that adopting the EU's schedules was likely to be the UK's approach to addressing its WTO membership. He said:

"The UK is a full and founding member of the WTO. We have our own schedules that we currently share with the rest of the EU. These set out our national commitments in the international trading system. The UK will continue to uphold these commitments when we leave the European Union. There will be no legal vacuum." (UK Government [2016](#))

The UK's schedules would be subject to negotiation with its trading partners and the UK would likely not be in as good a bargaining position as the EU within the WTO given the size of their respective economies and markets. Any negotiation between the UK and WTO members on the UK's schedules of commitment may be lengthy and complex as the its trading partners may try and negotiate concessions in return for granting preferential market access to UK goods and/or services. Hoda ([2002](#)) describes tariff negotiations between WTO members in detail.

Tariff Rate Quotas

A key plank of the negotiations with other WTO members may revolve around the division of existing tariff rate quotas that the EU gives to countries which allows a certain number of exports into the market at lower or zero tariff rates. The quotas (particularly in agriculture and food products) may need to be renegotiated when the UK leaves the EU. These renegotiations will require the agreement of other WTO members and may be complicated as was discussed in a recent article by economist Alan Matthews:

"Some EU import TRQs are particularly important for the UK because a significant share of in-quota imports is destined for the UK market, such as butter from New Zealand. Whether the EU would want to share these quotas would be a matter for negotiation in the withdrawal negotiations. One could envisage that a more protectionist EU might be only too delighted to offload a larger than pro-rata share of its TRQs to the UK.

Getting agreement on any TRQ divvy up at the WTO would be more difficult. This is because different countries have different dependencies on the UK vs EU27 markets. No matter what allocation key is used, some third countries are bound to be aggrieved and feel that their exports (either to the UK or EU27 markets) would now face greater market access difficulties than before. If no agreement is forthcoming at the WTO, this could lead to a formal dispute over claims for compensation. To avoid this, or to be in a better position

to defend such cases, the more objective the basis for the allocation and the more consistently it is applied across all TRQs, the better the chance of a successful defence.” (Matthews [2016](#))

Most Favoured Nation Tariffs

As a WTO member, the UK's exports to other WTO members would be subject to importing countries' MFN tariffs in the absence of any free trade agreements. The MFN principles means tariffs should be the same for goods/services from all WTO members. However there are exemptions PTAs. For this reason, in a recent BBC interview Azevedo stated:

“Britain could have to impose £9bn worth of additional tariffs on imports (...) Exporters could face an extra £5bn of tariffs on their sales abroad”. (BBC [2016](#))

This is because the EU has PTAs with other countries in place and the UK would not be party to these agreements if it left the EU unless it had negotiated other agreements in the meantime. Because of MFN treatments, without PTAs the UK would have to put in place the same trade barriers on goods and services for all countries. Thus leaving the EU is likely to raise the cost of exporting to the EU for UK firms unless an agreement is reached with the EU (Ottaviano et al, [2014](#)).

The EU's current Most Favoured Nation Tariffs

If the UK failed to reach some sort of trade agreement with the EU, it would probably need to export to the EU using the Most Favoured Nation tariff. The table below provides some examples of the average MFN duties to be applied.

Product Group	Average MFN Applied Duties
Agricultural products	12.2%
Non-Agricultural products	4.2%
Animal products	17.7%
Dairy Products	42.1%
Fish and Fish products	12.0%
Fruit and vegetables	10.9%
Textiles	6.5%
Clothing	11.4%

World Tariff Profiles [2015](#)

Within each of the categories listed above are hundreds of individual lines providing different tariffs depending on the product involved. This shows the complexity of exporting using WTO rules and relying on the MFN tariffs.

In leaving the EU, the UK would also have to set its own MFN tariffs on imports – this means that its tariffs would have to abide by the MFN treatment. The average tariff charged on imports to the EU is only 1% according to the Centre for Economic Performance which notes this implies the UK would have limited scope to set its tariffs lower than the EU (Centre for Economic Performance [2016](#)).

The UK's services trade would also be subject to WTO rules. Since the WTO has made far less progress than the EU in liberalising trade in services, this would mean reduced access to EU markets for EU service producers (Centre for Economic Performance [2016](#)). The WTO has no provisions for free movement of labour. The EU prohibits restrictions on capital mobility not only with the EU but also with countries outside the EU so if the UK left the EU, so free movement of capital would likely continue even if the UK left the EU.

Economic consequences of the 'WTO' model

Table 6 summarises the effect of the 'WTO' model according to the Fraser of Allander Institute.

Table 6 'WTO' model: long-term changes relative to baseline

	% change
GDP	-5.3
Exports	-11.3
Real wages	-7.2
Employment	-3.2
Population	+3.0

Source: Fraser of Allander Institute [2016](#)

ANNEX

List of Preferential Trade Agreements that include the EU as notified to the WTO (WTO [2016b](#)):

- EC (10) Enlargement
- EC (12) Enlargement
- EC (15) Enlargement
- EC (25) Enlargement
- EC (27) Enlargement
- EC (9) Enlargement
- EC Treaty
- EU - Albania
- EU - Algeria
- EU - Andorra
- EU - Bosnia and Herzegovina
- EU - Cameroon
- EU - CARIFORUM States EPA
- EU - Central America
- EU - Chile
- EU - Colombia and Peru
- EU - Côte d'Ivoire
- EU - Eastern and Southern Africa States Interim EPA
- EU - Egypt
- EU - Faroe Islands
- EU - Former Yugoslav Republic of Macedonia
- EU - Georgia
- EU - Iceland
- EU - Israel
- EU - Jordan
- EU - Korea, Republic of
- EU - Lebanon
- EU - Mexico
- EU - Montenegro
- EU - Morocco
- EU - Norway
- EU – Overseas Countries and Territories (OCT)
- EU - Palestinian Authority
- EU - Papua New Guinea / Fiji
- EU - Rep. of Moldova
- EU - San Marino
- EU - Serbia
- EU - South Africa
- EU - Switzerland - Liechtenstein
- EU - Syria
- EU - Tunisia
- EU - Turkey
- EU - Ukraine
- EU (28) Enlargement
- European Economic Area (EEA)

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