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Brexit: where is the EU–UK relationship heading?

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The JCMS Annual Review Lecture 2018

Brexit:

Where is the EU-UK Relationship Heading?¹

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I am delivering this lecture almost two-thirds of the way between the June 2016 referendum and the day the UK is scheduled to leave the EU, yet the long-term relationship between the UK and the EU still remains unclear. The basic elements of the Article 50 Withdrawal Agreement and the transition arrangements seem to be in place (except for the issue of the Northern Irish-Ireland border), but there has been far less discussion of the post-transition “future relationship” between the UK and EU27. The basic options for the future relationship have been known for some time: such as a “soft” form of Brexit represented by the UK remaining in the European Economic Area (EEA); a “hard” form of Brexit represented by the UK leaving the EU’s single market and signing a free trade agreement similar to the EU’s agreements with Canada or South Korea; or “no deal” and the UK trading with the EU as a member of the World Trade Organization (WTO). The British government has started to clarify its preferred outcome: what the Secretary of State for Leaving the EU described in December 2017 as a “Canada plus plus plus” agreement.² Only the basic features of the future relationship need to be agreed before March 2019, and the final agreement and ratification will only take place after the UK has become a third country. Hence, the final settlement is unlikely to be known before late 2020 at the earliest.

So, I focus my lecture today on precisely this: where the UK’s relationship with the EU is heading in the medium-term. You might reasonably say that only a fool would try to predict this future, especially with so many uncertain moving parts. So, to simplify the considerations I focus my analysis on the economic and political interests of the UK government and the EU27 as a bloc, and how these interests are likely to shape the bargaining strategies. My analysis leads me to conclude that the most likely outcome – the equilibrium in the bargaining game between the UK and the EU27 – is a

² <http://www.bbc.co.uk/news/uk-politics-42298971>, 10 December 2017.

basic free trade agreement, mainly covering trade in goods with not much on trade in services. Of course, the outcome might be very different from a basic trade agreement, but the aim of my analysis is to help us think about what would need to change on either side for a different/better outcome to emerge. Having solved the bargaining 'game', I will then briefly discuss what a basic FTA might mean for ongoing relations between the UK and the EU27. Let me start, though, by briefly reviewing the main options for the future relationship.

I. Options for the Future Relationship

Although "hard" or "soft" Brexit sound like discrete choices, the possible terms of a future relationship between the UK and EU27 are better characterised as a continuum of five "harder" or "softer" variants, as Figure 1 shows.

[FIGURE 1 ABOUT HERE]

First, at the "hard Brexit" end of the continuum is the UK leaving the EU without an agreement and trading with the EU as a normal WTO member. There are two possible scenarios of this **No Deal (or "WTO") outcome**: 1) the UK and EU fail to agree or ratify a Withdrawal Agreement (which requires a qualified-majority vote in the EU Council, and majorities in the European Parliament and UK parliament) and the EU fails (by unanimity) to extend the 29 March 2019 deadline; or 2) a Withdrawal Agreement is agreed and ratified, with a transition period included, but the UK and EU then fail to agree or ratify the future relationship before the end of the transition period, and the transition period is not extended. Either way, the UK would leave without any new agreement on the terms of trade with the EU27. Such a No Deal outcome could have significant economic costs for both sides, but particularly for the UK. On the other hand, the UK would be free to set its own regulatory standards and customs rules, within

WTO rules, and would probably not have any financial liabilities owed to the EU, although it would have to contribute during a transition period, the EU may pursue a claim through international courts, and there would be diplomatic costs for not honouring liabilities.

Second, at the “soft Brexit” end of the continuum is the **EEA (or “Norway”)** option. Here, the UK would leave the EU institutions but would re-join the European Free Trade Area (EFTA) and apply to become a member of the EEA, like Norway, Liechtenstein and Iceland. Joining the EEA would mean a continuation of the free movement of goods, services, capital and persons between the UK and the EU27 and other EEA states, applying EU single market rules (with some derogations), and largely accepting the jurisprudence of the Court of Justice of the EU (ECJ), although via the fig leaf of the EFTA Court. The UK would also have to make a contribution to the EU’s finances. Nevertheless, the UK could leave the EU customs union (although a customs agreement could be agreed), and so sign its own trade agreements with third countries, and the UK would regain sovereignty in some policy areas, including fisheries, agriculture, and home affairs.

Between these two extremes are several “bespoke” options. Third, at the “harder” end is a basic **FTA (or “Canada”)** option: a free trade agreement similar to the EU agreements with Canada, South Korea, and now Japan. These FTAs mainly cover trade in goods, with some limited regulatory equivalence and mutual recognition. However, these agreements do not cover trade in services in any comprehensive way, for example with the ability of service providers who are registered in one market to be established in or to trade freely in the other market.

Fourth, a slightly “softer” version of an FTA would be what has become known as the **FTA+ (or “Canada Plus”)** option. Although the UK government has talked about

various aspects of co-operation with the EU that go beyond a basic FTA – such as security co-operation, data sharing, and defence co-operation – the “plus” here mainly refers to an agreement which includes financial services. Financial services is the UK’s largest economic sector, constituting 3.1% of total UK employment for example (Taylor 2017). From the EU’s side, Sapir et al. (2017) estimate that approximately 90% of the European financial services wholesale market is located in the UK, and 92% of the total European revenue of the top five US investment banks is generated in the UK. Hence, financial services is the key industry both sides will focus on, in terms of how to include financial services in an FTA.

There are various options here (e.g. Alexander et al. 2018). The most liberal version would be the continuation of “passporting”, whereby banks and insurance companies registered in the UK would continue to sell their services in the single market. Even if passporting is discontinued, there could be continued free trade in financial services via “mutual recognition” of the regulatory standards of the two jurisdictions. Alternatively, there could be some rules on what would constitute “regulatory equivalence” and a joint mechanism for policing equivalence and for adjudicating disputes – although market access could be unilaterally withdrawn by either side. And, at the more restricted end, there could be an agreement that UK financial services firms gain access to the EU single market if the UK applies all EU financial services regulations and is subject to the jurisdiction of the ECJ.

Fifth, and finally, an even “softer” option would be what has become known as **EEA- (or “Norway Minus”)**. Here, the UK would remain a member of the EEA, as described above. However, there would be some specific opt-outs for the UK. In particular, there would be special derogations on the free movement of people, such as allowing the UK to cap the number of EU migrants registering to work each month or

applying an “emergency brake” if the number of EU migrants exceeded a certain amount in a particular period, region or sector (cf. Pisani-Ferry et al. 2016; Portes 2017). A Norway minus outcome would hence be “softer” than a FTA+ outcome because it would mean the UK applying all EU single market rules, but it would be “harder” than an EEA option, as it would mean the UK having more freedom in a highly-salient area of public policy.

There are, of course, other variants: such as the “Swiss model”, of a series of bilateral agreements covering sector-specific access to the EU single market; or the “Turkish model”, of a customs agreement with the EU but remaining outside the single market; or the “Ukrainian model”, of an Association Agreement with the EU covering some access to the single market as well as co-operation on economic and other policies. Nevertheless, the main elements of these other models are largely subsumed within the five basic choices.

To help think about which of these outcomes is most likely, I now consider the economic and political interests of the UK and the EU27, which will determine how the UK and EU27 rank these options.

II. The Economics of Brexit

In terms of the economic impacts of the various options, there is remarkable consistency in the research. Put simply, the “harder” the Brexit, the bigger the likely economic impact to both the UK and the EU27. The main reason for this, of course, is the assumption that the more physical, fiscal or regulatory barriers to the current complete free movement of goods, services, capital and labour between the UK market and the EU27, the greater the costs to businesses and consumers, and the greater the impact on employment and public tax revenues. The UK would save in terms of its

contributions into the EU budget, and the UK could claim back some of the losses in EU trade with new trade agreements with countries the UK does not currently have trade agreements with via its EU membership. But, standard trade “gravity” models suggest that agreements with countries that are further away are unlikely to compensate for any loss of trade with the UK’s closest and largest external market.

For example, one of the most comprehensive analyses of the likely economic impact of Brexit is by Dhingra et al. (2017). Using a standard, and empirically robust, general equilibrium trade model, Dhingra and her colleagues estimate that the EEA option would immediately cost the UK 1.3% of GDP, whereas trading under a no deal/WTO outcome would cost 2.7% of GDP, with presumably the intermediate options falling somewhere between these extremes. However, when modelling the dynamic effects of Brexit on trade, productivity and investment, the estimated losses of a “hard Brexit” are much higher: 6.3 to 9.4% of GDP.

These estimates are consistent with the calculations in the UK government’s leaked cross-Whitehall report on Brexit. In the report, the UK Treasury estimated that a no deal/WTO outcome would reduce UK GDP by 8% over 15 years (relative to current trend growth), a free trade agreement along the lines of the EU-Canada agreement would reduce GDP by 5% over the same period, and the EEA option would lower GDP by 2% (House of Commons Exiting the European Union Committee 2018).

There would also be an economic cost if there is a significant reduction in EU immigration to the UK, as a result of the replacement of the free movement of people from the EU27 with a restrictive immigration regime. For example, using existing patterns of migration to the UK and models of the relationship between migration and economic performance, Portes and Forte (2016) estimate that the likely reduction in immigration to the UK resulting from Brexit could cost between 2.7 and 8.2% of UK GDP

by 2030. Hence, “frictionless migration” between the EU27 and the UK, for both high-skilled and low-skilled labour – for example in the EEA scenario – would minimise further economic welfare losses.

Migration from the UK to the EU27 is less of an issue for the EU side, although perhaps in some high-skilled sectors. Similarly, the broad economic interests of the two sides are not symmetric. After Brexit, the EU27 and the UK will continue to be critical export markets for each other: the EU27 will be the UK’s largest export market, while the UK will be the EU27’s second largest export market outside the EU, after the United States. However, the proportional size of trade between the two economics will be asymmetric. In 2016, the EU27 constituted 43% of UK exports in goods and services,³ while the UK constituted only 16% of EU exports in goods and services.⁴ Also, a far larger percentage of the UK’s goods exports go to the EU27 than the other way around: in 2016 total UK trade with the EU27 (exports plus imports) constituted 12% of UK GDP while total EU27 trade to the UK constituted only 3-4% of EU27 GDP.

As a result, most of the economic analysis from the EU’s side suggests that Brexit would not have a major effect on the EU27’s economy, in aggregate. For example, Emerson et al. (2017) review several studies of the likely impact of Brexit on the EU27 and conclude that an EEA outcome would cost the EU27 approximately 0.1% of GDP by 2030, a basic FTA deal would mean a loss of approximately 0.3-0.6% of GDP, and a no deal/WTO outcome would cost the EU27 0.3-0.8% of GDP. There would, however, be considerable variation between the EU member states, with Ireland suffering the most (a loss of 2.3-3.7% of GDP in the event of a no deal/WTO outcome) and Germany taking

³ Office for National Statistics balance of payments dataset: <https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/balanceofpayments>.

⁴ Eurostat trade dataset: <http://ec.europa.eu/eurostat/web/international-trade-in-goods/data/database>.

only a minor hit (0.2-0.5% of GDP in the event of a no deal/WTO outcome) (cf. Schoof et al. 2015; Wen et al. 2017).

In addition, there are other asymmetric economic interests that will shape negotiations. In particular, the balance of trade between the two sides means that the UK and EU27 have different interests in terms of the content of a free trade agreement. Figure 2 shows the UK-EU27 balance of trade in goods and services in 2016, when there was an overall deficit in trade between the UK and the EU27 of just over £80 billion. The relative balance of trade in goods and services would suggest that the EU has a significant incentive to sign a generous trade agreement with the UK. Nevertheless, whereas there was a large trade *deficit* between the UK and EU27 in goods in (of £96 billion), there was a trade *surplus* in services (of £14 billion). In short, the EU27 sell more goods to the UK than they buy, whereas the UK sells more services to the EU27 than it buys.

[FIGURE 2 ABOUT HERE]

The asymmetric balance of trade has strategic implications for the negotiations. Both sides have an economic interest in securing a trade agreement, and it is incorrect to see exports as positive and imports as negative, as any reduction in either imports or exports will have negative implications for consumers and/or employees and/or businesses in both the UK and the EU27. Nevertheless, at the aggregate level, which is what politicians tend to focus on, the sectoral balance of trade suggests that the EU27 are likely to be more eager to sign a deal that secures zero tariffs and quotas, and as frictionless trade as possible, for goods, yet will be less eager than the UK for a deal that includes free trade in services. Services trade from the EU27 to the UK is important, worth £76 billion in 2016, but the value of EU27 services trade to the UK is swamped by the value of goods exports from the EU27 to the UK, of £241 billion.

The asymmetric balance of trade presents a challenge for the UK, as one of the key elements of the “plus” in the FTA+ model would be an agreement in services, and financial services in particular. One challenge to an agreement on financial services is that this sector is not included in any current FTA the EU has signed with any third country, even with Switzerland. The reason for the absence of financial services in EU-third country trade agreements is because the EU has not been willing to allow the access of financial services providers to the EU single market without the service provider being subject to EU regulation and oversight by EU financial services regulators and the ECJ, or the application of regulatory equivalence and the possibility that access to the EU market could be unilaterally withdrawn by the EU at any time. The UK, on the other hand, seems to want mutual recognition of financial services regulatory standards, yet such a concession would be largely incompatible with the way the EU single market works in this sector (Weatherill 2017). In addition, the EU27 suspect that as soon as the UK is outside the EU it will be tempted to reduce the regulatory burdens in this sector in particular, and so compete “unfairly” with the EU27.

Both sides would suffer an economic shock if there is a significant drop in trade in financial services between the UK and the EU27. Financial services make up 7% of UK GDP, while Continental European firms rely heavily on the “deep pockets” of the City of London, as well as London’s connections to experienced ancillary services, such as accountancy and law firms. Nevertheless, Sapir et al. (2017) estimate that Brexit could mean 30% of the wholesale financial services market leaving the UK for Frankfurt, Paris, Dublin, Amsterdam or Luxembourg. This would hit both sides in the short-term, but in the medium-term, Frankfurt, in particular, could replace many of the services London-based banks supply to Continental European clients.

In sum, from a purely economic-interest perspective, the UK and EU27 share a similar rank-ordering over the Brexit options: an EEA outcome would minimise potential economic consequences, while a no deal/WTO outcome would be the worst outcome for both sides, and the various bespoke arrangements would be somewhere between these extremes. Nevertheless, the asymmetric economic costs suggest that the UK is more eager to avoid a no deal outcome than the EU side, which gives the EU an upper-hand in bargaining. In addition, whereas for the UK an FTA+ deal covering financial services is strongly preferred to a basic FTA agreement, the EU27 are indifferent between these two options.

III. The Politics of Brexit

Economic calculations are only one side of the story. The other side is politics. The vote on 23 June 2016 was driven less by economic interests and more by cultural and ideological values. For example, looking at the NatCen survey data from immediately after the vote, Curtice (2017: 34) concludes that:

Only a minority felt that leaving the EU would be bad for Britain's economy. Meanwhile around a half expressed concern about the impact of EU membership on the country's distinctive sense of identity while over half reckoned that immigration would fall if Britain left.

The key "project fear" message of the Remain campaign, which emphasised the likely economic consequences of leaving the EU, was trumped by the emphasis on national sovereignty of the "take back control" message of the official Leave campaign and the explicitly nationalist message of the unofficial UKIP-led Leave.EU campaign.

Mirroring the two Leave campaigns, there are now two competing narratives about where the UK is heading post-Brexit. The so-called "liberal leavers" present a free market vision of the UK outside the EU: regaining sovereignty to deregulate the

economy, abolishing “Brussels red tape” (EU social and environmental standards, presumably), signing free trade agreements with partners across the world and even unilaterally cutting tariffs and quotas on imports, and pursuing a liberal immigration policy. This narrative is often characterised as a “Singapore-on-Thames” strategy for the UK and is associated with libertarian think-tanks like the Adam Smith Institute (Smith 2016), the Economists for Free Trade (Minford 2017), the Legatum Institute (Singham et al. 2017), and the Institute of Economic Affairs (Booth 2018), and the Initiative for Free Trade.⁵ Some of these groups are more liberal on immigration than others, and not all of them support the UK unilaterally removing tariffs and quotas. Nonetheless, prominent Leavers in the Cabinet, including David Davis, Boris Johnson and Liam Fox broadly support this liberal-leaver case and are closely linked to one or more of these groups.

The problem for these “liberal leavers”, though, is that the second narrative, of a Britain which is more socially conservative and economically interventionist post Brexit is supported by a far larger number of Leave voters, as well as many Remain voters. This is illustrated in Figure 3, which shows the results of a multivariate analysis of the relationship between different social and economic values and the probability of voting Leave in the June 2016 referendum, using the Wave 9 survey of the British Elections Study in July 2016 (see Appendix Table A1 for the full results).

[FIGURE 3 ABOUT HERE]

Every “socially liberal” value in the survey is *negatively* correlated with voting to Leave the EU. Leave voters are more likely to support the death penalty, believe that children should be taught to obey, be in favour of censorship, be opposed to equality for women, ethnic minorities, and gays and lesbians, and be opposed to more immigration

⁵ <http://www.ifreetrade.org/about>.

(cf. Kaufmann 2016). Opposition to immigration most strongly correlates with voting to Leave the EU. These results also hold when controlling for party identification; meaning that these views predict support for Leaving the EU independently of which political party a person supports.

Perhaps more strikingly, given the debate about ending the free movement of people from the EU27, in other research with Eric Kaufmann and Thomas Leeper (2017), we found that not only do Leave voters want to reduce net immigration more than Remain voters, but no matter how the British public is divided up – for example, by referendum vote, party support, age, income, education, region, or gender – every subgroup wants to reduce immigration from outside the EU *more* than immigration from the EU27 (which, of course, is unrelated to the UK's membership of the EU). This underlying opposition to non-EU immigration will be a major challenge for the UK government, as successive governments have failed to bring down non-EU immigration despite increasing restrictions on visas and family reunification. Against public attitudes, then, Brexit is likely to lead to a growing gap between falling immigration from the EU and stable, or even increasing, immigration from outside Europe.

In addition, Leave voters do not have clearly “liberal” economic values. Leave voters tend to support public spending cuts and oppose higher taxes and wealth redistribution. But, Leave voters are also more likely to oppose the interests of businesses and employers, to believe that there is “one rule for the rich”, and to neither oppose nor be support privatisation. Indeed, following their own survey of public attitudes, the Legatum Institute reluctantly conceded that the British public post-Brexit generally support higher taxes, more public spending, nationalisation of key industries, and more regulation of markets and labour markets in particular (Elliott and Kanagasooriam 2018). Similarly, YouGov found that after the 2017 general election a

clear majority of the public now supports the re-nationalisation of the railways and the energy and utilities companies, including over 40% of Conservative voters.⁶ In short, so-called “liberal leavers” are a minority amongst the public, but are concentrated amongst the Conservative elite.

Furthermore, if the UK government is to deliver a Brexit that satisfies the political preferences of Leave voters, then the final settlement should maximise the sovereignty of the UK parliament and bring an end to the free movement of people from the EU27. Not surprisingly, these are the two main “red lines”, that hence make the EEA option politically unacceptable, despite the fact that it was favoured by many liberal leavers immediately after the referendum. An EEA- option would end the free movement of people, but would breach the sovereignty red line. Hence, from a political perspective, a FTA+ (or even a basic FTA option) is preferred to the two softer versions of Brexit, as YouGov indeed find in their own survey of public preferences of the eventual outcomes (Wells 2016).

The EU27 also have some key political interests. The EU27 and UK share many defence and security concerns, and so are likely to be able to reach agreement on some flanking agreements on continued defence co-operation, security data sharing, and even the application of the European Arrest Warrant in the UK. Nevertheless, the EU27 have other political interests that conflict with the UK’s interests. In particular, the EU27 does not want to undermine the integrity of the four freedoms (of goods, services, capital, and persons) in the single market. One aspect of this preference relates to the current agreements the EU has with third countries. Any special arrangement for the UK, for example for financial services access, would lead Switzerland, South Korea,

⁶ <https://yougov.co.uk/news/2017/05/19/nationalisation-vs-privatisation-public-view>. 19 May 2017.

Canada, and others to demand similar arrangements, under the WTO most-favoured-nation rules.

A second aspect of the “no cherry picking” line is against the potential unravelling of the EU itself; driven by a fear of Brexit contagion to other member states. Support for anti-EU populist parties has grown in a large number of member states since the mid 2000s. Several of these parties, such as the Danish People’s Party, have called for a “British style in/out referendum”. Regardless of how painful the process of Brexit will be for the UK, once the UK is out the other side of the process, there will be a new exit model: a “British model” (cf. Hix and Sitter 2018). This model might be attractive to several countries who, like the UK, are not members of the Euro nor support deeper political integration, especially if the new “British model” means considerable access to the EU single market and a special customs relationship to minimise transactions costs for supply-chains while at the same time controlling the free movement of people. Hence, the EU27 have a strategic interest to refuse a deal that would give the UK free movement of goods, services and capital but allow the UK to control the free movement of people.

Nevertheless, as Figure 4 shows, the level of trade integration in the single market of almost all the other EU27 states is considerably higher than for the UK. These different levels of trade integration suggest that while the potential economic consequences of Brexit might be large for the UK, the economic consequences would almost certainly be an order of magnitude larger for any other country. The even larger economic consequences of leaving the EU for other member states suggests that the threat of Brexit contagion to other member states is probably lower than some people claim, and also perhaps explains why several anti-EU populist parties that once

supported leaving the EU or the Euro have started to tone-down their rhetoric, including the French *Front National* and the Italian *Lega*.

[FIGURE 4 ABOUT HERE]

That said, the EU is not a united front in its interests vis-à-vis the UK. In addition to the differential economic exposure to Brexit of each member state, there are close political relations between the UK and several member states. In particular, the traditional economic allies of the UK in Northern Europe – Ireland, the Netherlands, Denmark, Sweden, and Finland – fear being marginalised in an EU27 without the UK, which could be dominated by a renewed Franco-German axis (e.g. Huhe et al. 2017). Also, without the UK, the Eurozone will dominate the EU: constituting 87% of the EU27's GDP, as opposed to 73% of the EU28's GDP. Of the UK's traditional strategic allies, the dominance of the Eurozone in the EU27 could put Sweden and Denmark, as non-Eurozone member states, in a particularly difficult position going forward. As a result of these different political interests it might be difficult for the EU27 to maintain a united front when dealing with the UK as an external actor (cf. Durrant et al. 2018, Springford et al. 2018).

IV. The Bargaining Game and Likely Outcome

On the basis of this analysis we can estimate how the two sides rank the five Brexit outcomes. If the UK and EU27 have “single-peaked preferences” along a common dimension, then the bargaining solution would be straightforward. For example, the two sides would have single-peaked preferences if, on the continuum in Figure 1, the UK's most-preferred outcome was a basic FTA and the EU's most-preferred outcome was the EEA, and the two sides ranked the other outcomes in decreasing order of preference the further they were from these “ideal points”. In such a situation, the

bargaining agreement would be somewhere between the EEA and a basic FTA, such as either an FTA+ or EEA-; although the outcome would probably be closer to the EU27's ideal point because of its larger bargaining power.

However, the Brexit bargaining game is not so simple, because the two sides do not have single-peaked preferences on a common single dimension. From the UK's side, on the assumption that political interests – and particularly the red-lines on sovereignty and ending the free movement of people – over-ride economic interests, the UK rank-order of the five outcomes is probably as follows:

1. FTA+/Canada Plus
2. FTA/Canada
3. EEA-/Norway Minus
4. EEA/Norway
5. No Deal/WTO

Meanwhile, from the EU27's side, the two most preferred outcomes from a political point of view – in terms of maintaining the integrity of the single market – are the EEA and a basic FTA. Of these two, the EEA would have a lower negative economic impact for the EU27. Then, amongst the other two outcomes, the EU27 are probably indifferent. On the one hand, an FTA+ would undermine the four freedoms less than an EEA-, since allowing the UK a derogation on the free movement of people in the EEA would effectively end the EEA as it currently works. On the other hand, an EEA- deal would have a smaller economic impact for the EU, as the effect on trade in goods and services would be smaller than from an FTA+. So, this gives an EU27 ranking of:

1. EEA/Norway
2. FTA/Canada
- 3.= FTA+/Canada Plus

3.= EEA-/Norway Minus

5. No Deal/WTO

As both the UK and the EU27 prefer any outcome to No Deal, this takes No Deal off the table. Some radical Brexiters, such as Jacob Rees-Mogg, claim that they prefer no agreement and a chaotic Brexit to any compromise, but these views are not held by a majority of Conservative MPs, let alone a majority of MPs in the House of Commons.

This reasoning, hence, leaves us with four outcomes, and a bargaining game as shown in Figure 5. There is only one equilibrium in this game: a basic FTA. In this set-up, the EU27 would play “hardball” because they prefer an EEA and a basic FTA to any other outcome. The UK’s “best response” to this strategy would be to also play hardball, as they prefer a basic FTA to an EEA. Furthermore, neither the EU27 nor the UK have an incentive to deviate from this equilibrium. As a result, neither side has an incentive to “compromise”.

[FIGURE 5 ABOUT HERE]

This analysis does not mean that other outcomes are not possible. In fact, the analysis helps us think about what would have to change for a different outcome to emerge. For example, for the final outcome to be an FTA+ rather than a basic FTA, the EU27 would need to be willing to compromise rather than play hardball, while the UK’s preferences over the outcomes would not need to change. This would require either EU politics to shift, to allow UK “cherry picking”, or the UK to make significant “side payments” to the EU27, so that the EU27’s interests shift – such as further payments into the EU budget (which is unlikely), or a major defence and security agreement. On the last of these issues, the weakness for the UK is that the two sides have mutual security and defence interests, so threatening not to reach a security and defence agreement is not a credible threat for the UK.

Alternatively, for the final outcome to be the UK remaining in the EEA rather than a basic FTA, the UK would need to see compromising as the best response to the EU27 playing hardball. This would require domestic politics in the UK to shift, so that the “red lines” on ECJ jurisdiction, adhering to EU regulatory rules, and the continued free movement of people are removed. This is unlikely given the preferences of Theresa May, the composition of the UK Cabinet, or the views of the majority in the House of Commons. Nevertheless, these preferences could change, for example if there is a surprise defeat in the House of Commons, if public attitudes on the free movement of people start to change, or if there is a sudden and significant economic shock that shifts Conservative MPs’ views about staying in the single market.

Then, for the final outcome to be an EEA- rather than a basic FTA, both the EU27 and the UK would need to see compromising as securing a better outcome than playing hardball. This would mean both the EU27 preferences shifting on UK “cherry picking” *and* domestic politics in the UK shifting, to remove the key red lines on ECJ jurisdiction, EU regulatory rules and the free movement of people. This, then, is perhaps the least likely outcome of all.

Finally, even if the preferences of the UK or the EU27 change, a further limitation on any movement away from a basic FTA is the ratification hurdle for the final agreement – unanimity in the Council and ratification in more than 30 national and regional parliaments – will make it very difficult for the EU27 to shift from their most preferred position. Every “veto player” would need to prefer the same alternative to a basic FTA for a different deal to emerge. And, there is not much time to agree and ratifying an agreement: between March 2019 and the end of the transition period at the end of December 2020.

V. Longer-Term Implications

I am not suggesting that a basic FTA between the UK and the EU27 would be the end of the story. Rather, this outcome would only be the end of the initial Brexit process, and the beginning of an on-going set of negotiations that could lead to future “bolt-ons” to the initial agreement. And, in time, one of these bolt-ons could cover trade in financial services, particularly if the EU is persuaded that the UK outside the single market can be trusted to maintain high regulatory standards in this sector (as well as other sectors), which could help secure agreement on a regulatory equivalence framework. Other deals could cover the free movement of people, at least for highly-skilled workers, or UK universities participating in European research funding programmes, and so on.

One problem for the UK, though, is that these deals may turn out to be more difficult after the UK has left the EU, from a domestic point of view. The reason for this is that public opinion in the UK may become increasingly anti-European, not increasingly pro-European, after the UK has left. This is what happened in Norway and Switzerland after they decided not to join in the EU in the mid 1990s, as Figure 6 shows.⁷

[FIGURE 6 ABOUT HERE]

In the mid 1990s, public attitudes towards the EU in Norway and Switzerland were only slightly lower than in their neighbours who had decided to join the EU: Sweden and Austria, respectively. However, from the early 2000s onwards, whereas support for the EU rose in Sweden and Austria, support for the EU declined in Norway and Switzerland (cf. Christin and Trechsel 2002). This is probably explained by the fact that these two states had to accept deals from the EU that were more favourable to the

⁷ For the EU member states, the figure shows responses to the “membership” question and the “EU image” question in the Eurobarometer surveys because the membership question was not included in the surveys after 2011.

EU side than to Norway or Switzerland; such as access to the single market in return for applying EU rules which they have no say over. Even if the UK signs only a basic FTA with the EU, UK goods and services exporters will have to apply EU product as well as process standards to gain access to the single market. Process standards are likely to be more intrusive than produce standards, as they cover things like phytosanitary standards, the use and disposal of chemicals and other health and safety rules. Applying these rules will not feel like “taking back control”, and like the Swiss and Norwegian publics, the British public might gradually turn even more against the EU. There have already been headlines in some English tabloids that the EU is a “bully”.⁸ The EU will feel even more like a bully once the UK is outside the EU; just ask Switzerland and Norway.

VI. Conclusion

Much has been written and claimed about the potential economic costs of Brexit. What I have tried to focus on today is how political bargaining over the final Brexit deal might play out, based on underlying economic and political interests – although I have not addressed the unresolved Irish border question. This analysis leads me to believe that we are probably heading towards a basic free trade agreement between the EU27 and the UK, which mainly covers zero tariffs and quotas on goods and some special customs arrangements, but with not much more on services than is in the EU’s existing trade agreements with Canada, South Korea and Japan. Zero tariffs and quotas on goods would be relatively easy for both sides to agree, as this is the current status quo, and the EU27 has a significant net trade surplus in goods with the UK.

⁸ For example: “STOP BREXIT BULLYING: EU told they’ll LOSE if they take on UK as Leavers issue OWN threats”, *The Express*, 18 March 2018, “QUIT THE BULLYING: EU told to ‘stop pushing us around’ or UK will not hand over a penny”, *The Sun*, 18 March 2018.

What will be more difficult to agree will be the “plus” part of a free trade agreement that the UK wants, in the area of financial services. The EU27 would suffer an economic hit if there are limitations on the access of financial service providers in the City of London to the single market. However, the economic impact for the EU27 would be much smaller than for the UK. In the medium-term, large parts of the UK financial services industry could move to Frankfurt, Paris, Dublin, Amsterdam and Luxembourg. And, the political cost for the EU27 of compromising in this area could damage the integrity of the internal regulatory and mutual recognition frameworks of the single market, which the EU seems determined to avoid. On top of all that, the negotiating time will be short and the ratification hurdles will be high (unanimity in the EU Council, majorities in over 30 national and regional parliaments throughout the EU, and even possibly a referendum in Ireland and several other member states). Put another way: now is not the time to try to pass through the Wallonia regional parliament or the French National Assembly a trade agreement that gives City of London bankers easy access to the single market, and without having to apply EU rules or be subject to ECJ jurisdiction.

But, a basic free trade agreement would not be the end of the process. Instead, such an agreement could be the start of a new chapter in the UK’s relationship with the EU. As Switzerland has learned, renegotiating the terms of the UK’s agreements with the EU will probably become a permanent and highly-salient feature of domestic politics (a scary thought!). But, if this does become the case, and if the EU is seen to be repeatedly “winning” in the various bargaining rounds, as it has done with Norway and Switzerland, then public opinion in the UK might become even more opposed to closer co-operation with the EU, which could then mean that the UK becomes stuck with a rather basic free trade deal for quite a long time to come.

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Figure 1. The Brexit continuum

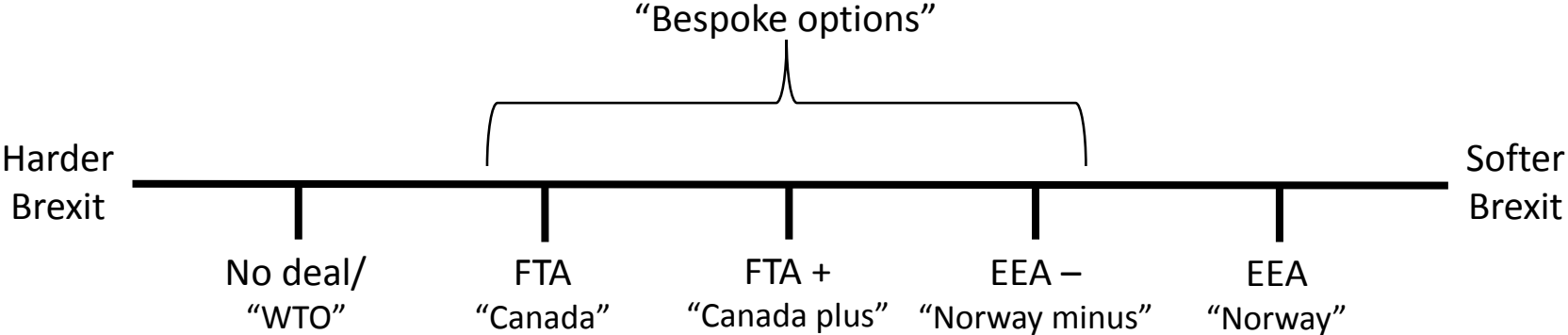
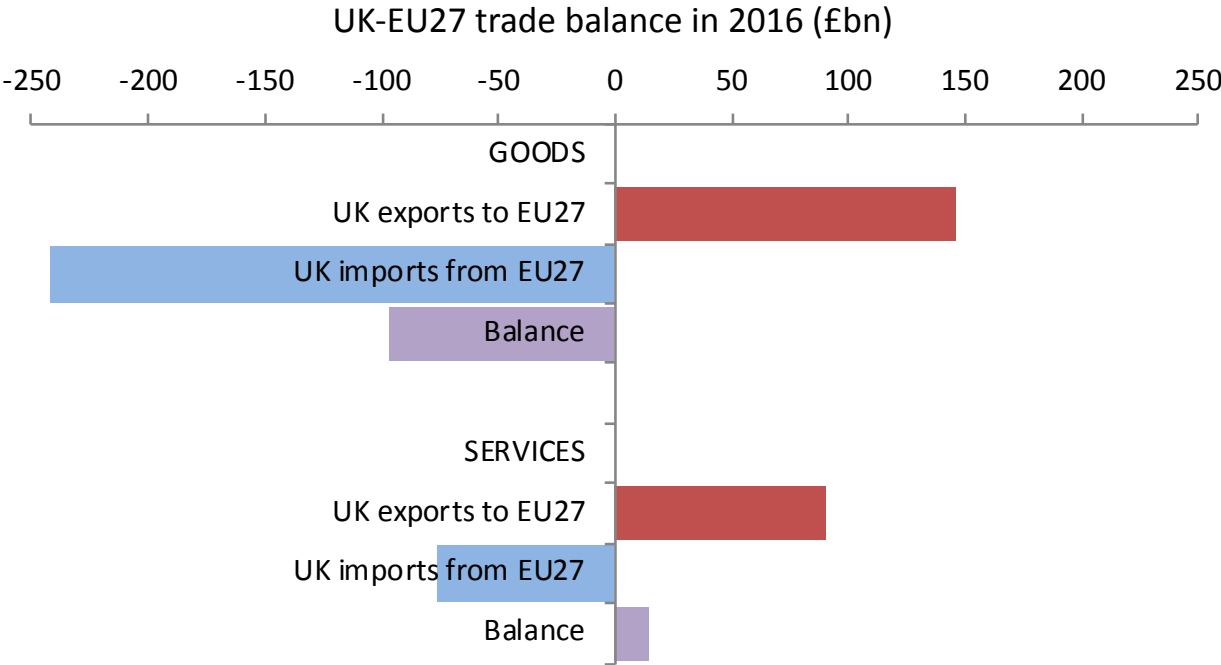
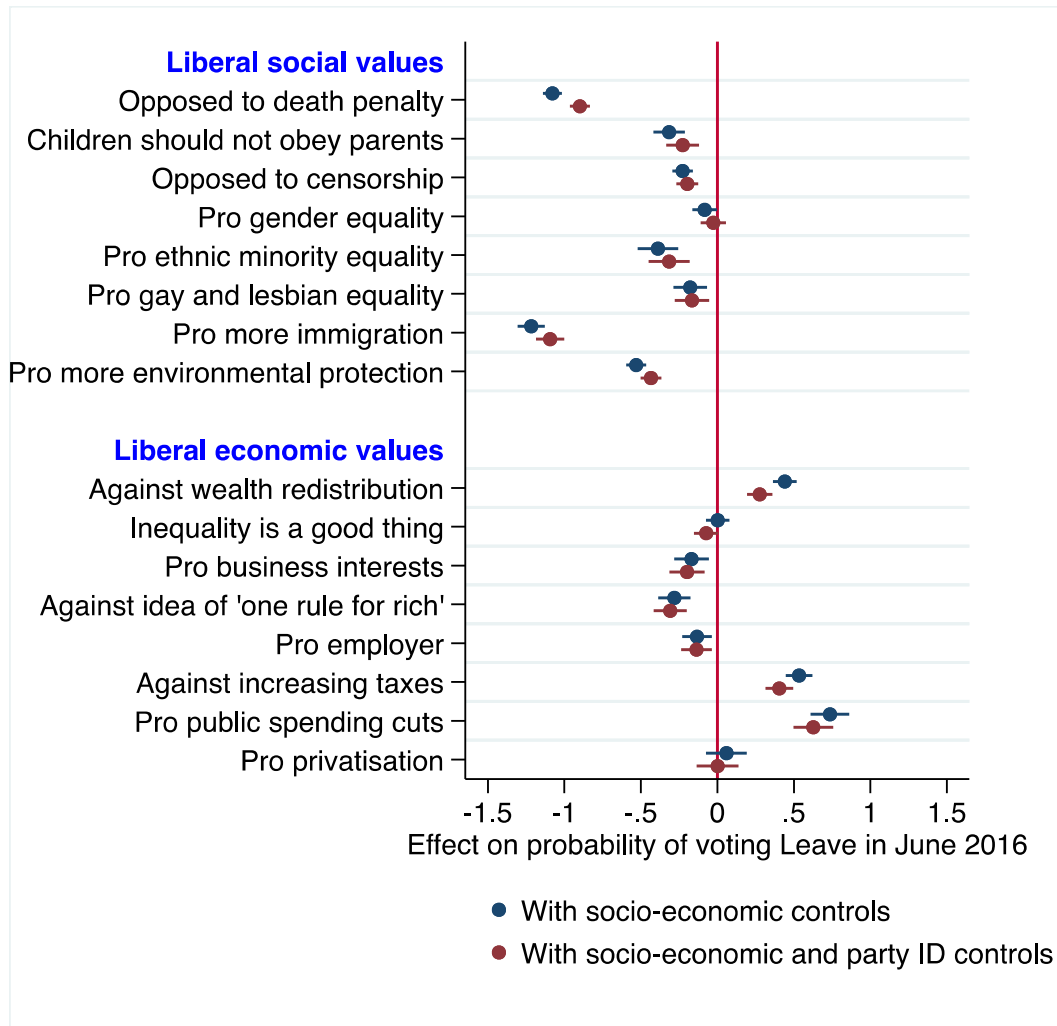


Figure 2. UK-EU27 balance of trade



Source: Author's calculations from data in Office for National Statistics (2017).

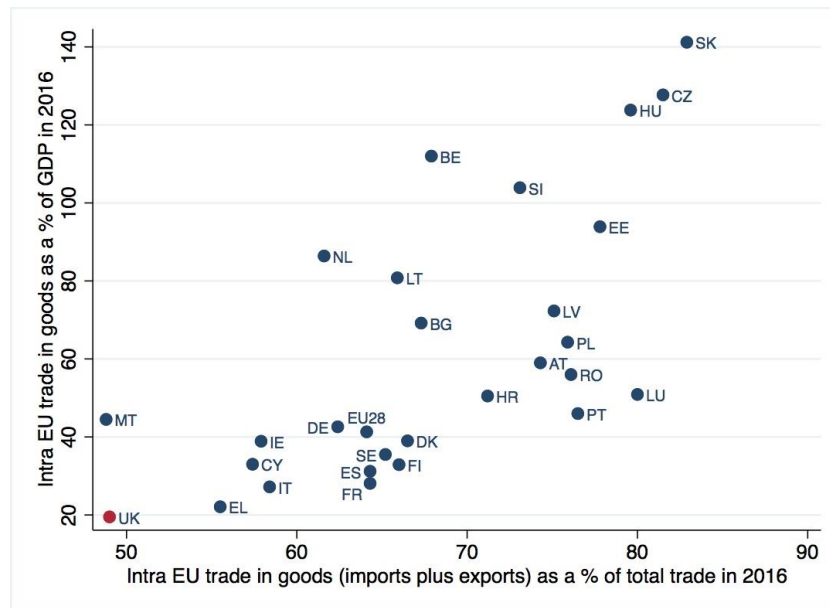
Figure 3. Social and economic values of Leave voters



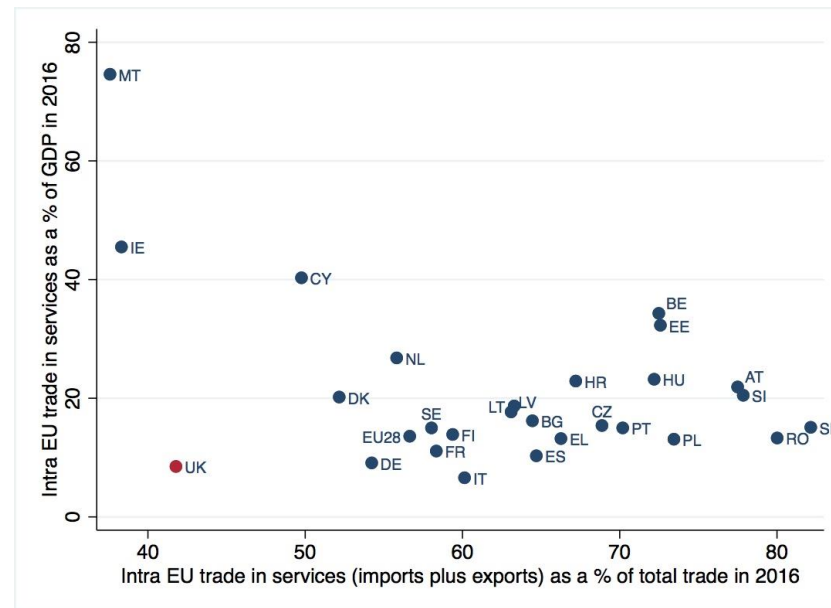
Source: Author's calculations from British Election Studies 2015 Wave 9 (July 2016) data. Appendix Table A1 shows the full results of the models. The models include control variables for educational level, household income, ethnicity, age, gender, and region.

Figure 4. Goods and services trade integration in the EU single market

a. Trade in goods



b. Trade in services



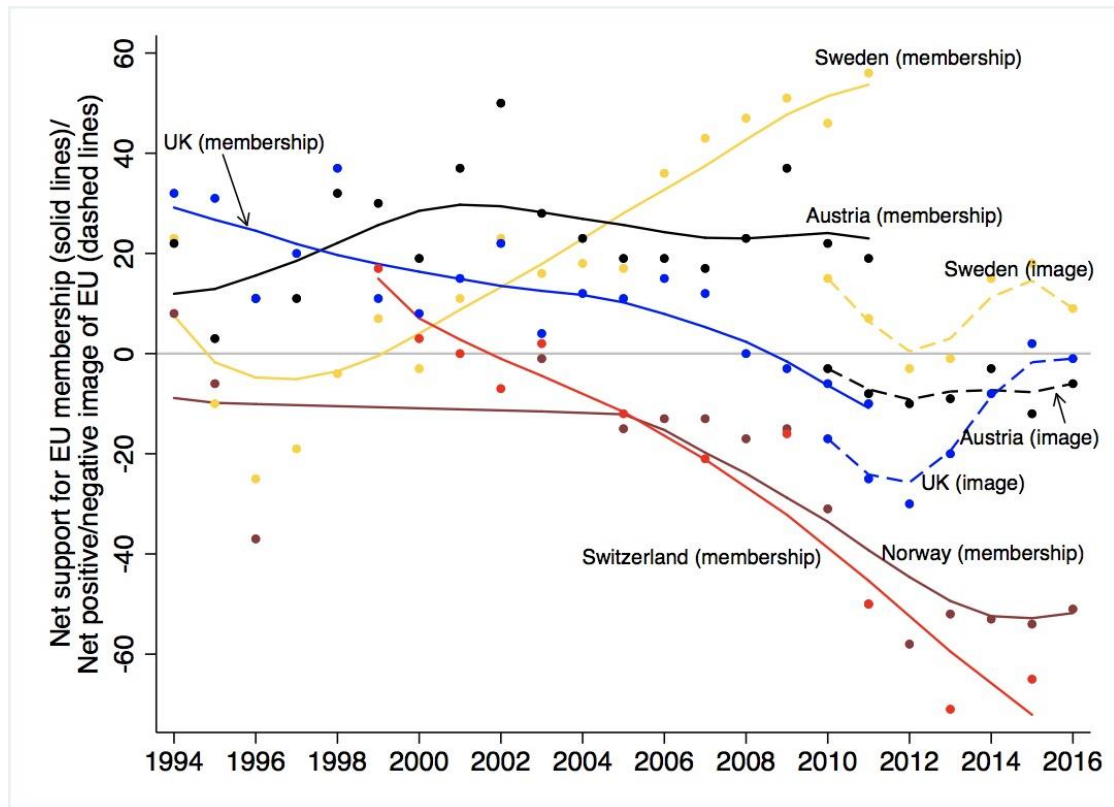
Source: Author's calculations from Eurostat trade dataset.

Figure 5. Bargaining game between the UK and the EU27

| | | European Union 27 | |
|-----------------------|------------|--|--|
| | | Compromise | Hardball |
| United Kingdom | Compromise | 3 EEA- (“Norway Minus”) 3= | 4 EEA (“Norway”) 1 |
| | Hardball | 1 FTA+ (“Canada Plus”) 3= | 2 Basic FTA (“Canada”) 2 |

Note: EEA = European Economic Area
 EEA- = EEA minus free movement of people
 FTA+ = free trade agreement plus financial services
 FTA = basic free trade agreement, mainly covering goods.
 The values represent the rank-order preferences of the two sides.

Figure 6. Attitudes towards the EU in Austria, Sweden, the UK, Norway and Switzerland



Source: Author's calculations from Eurobarometer data (for UK, Sweden, Austria, and Norway before 2003), from Sentio, Norstaft and Response surveys in Norway after 2003, and from ISSP and Mosaich surveys in Switzerland.

The questions were as follows:

Membership question (UK, Sweden, Austria): "Generally speaking, do you think that (your country's) membership of the EU is: A good thing, A bad thing, Neither good nor bad, or Don't know?". The figure shows the % who responded "A good thing" minus the % that responded "A bad thing", excluding "Neither good nor bad" and "Don't Know".

Image question (UK, Sweden, Austria): "In general, does the European Union conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?". The figure shows the total % of positive responses ("very positive" plus "fairly positive") minus the total % of negative responses ("very negative" plus "fairly negative").

Membership question (Norway): "Generally speaking, do you think that (your country's) membership of the EU would be: A good thing, A bad thing, Neither good nor bad, or Don't know?". The figure shows the % who responded "A good thing" minus the % that responded "A bad thing", excluding "Neither good nor bad" and "Don't Know".

Membership question (Switzerland): "If a vote on Switzerland's accession to the European Union took place next Sunday, how would you vote? Don't know, Certainly for, Rather for, Rather against, Certainly against". The figure shows the total % of for responses ("Certainly for" plus "Rather for") minus the total % of against responses ("Certainly against" plus "Rather against")

Appendix

Table A1. Figure 4 results

| Independent variable | (1) | | (2) | |
|---|-----------|-----------|-----------|-----------|
| | coef. | std.error | coef. | std.error |
| Opposed to death penalty | -1.078*** | 0.039 | -0.899*** | 0.033 |
| Children should not obey parents | -0.316*** | 0.053 | -0.227*** | 0.055 |
| Opposed to censorship | -0.227*** | 0.035 | -0.197*** | 0.036 |
| Pro gender equality | -0.0831** | 0.041 | -0.0270 | 0.042 |
| Pro ethnic minority equality | -0.389*** | 0.067 | -0.315*** | 0.069 |
| Pro gay and lesbian equality | -0.178*** | 0.056 | -0.166*** | 0.058 |
| Pro more immigration | -1.217*** | 0.046 | -1.093*** | 0.047 |
| Pro more environmental protection | -0.531*** | 0.033 | -0.434*** | 0.034 |
| Against wealth redistribution | 0.441*** | 0.040 | 0.277*** | 0.042 |
| Inequality is a good thing | 0.002 | 0.039 | -0.073* | 0.041 |
| Pro business interests | -0.169*** | 0.058 | -0.198*** | 0.059 |
| Against idea of 'one rule for the rich' | -0.281*** | 0.054 | -0.308*** | 0.055 |
| Pro employer | -0.133*** | 0.050 | -0.137*** | 0.051 |
| Against increasing taxes | 0.534*** | 0.045 | 0.405*** | 0.046 |
| Pro public spending cuts | 0.736*** | 0.065 | 0.627*** | 0.066 |
| Pro privatisation | 0.059 | 0.068 | 0.001 | 0.070 |
| Education level: less than A-level | 0.397*** | 0.036 | 0.377*** | 0.037 |
| Education level: degree or above | -0.438*** | 0.034 | -0.399*** | 0.035 |
| Household income: less than £20,000 | 0.316*** | 0.038 | 0.329*** | 0.039 |
| Household income: more than £70,000 | -0.479*** | 0.070 | -0.453*** | 0.071 |
| White British | 0.108*** | 0.041 | 0.111*** | 0.043 |
| Black, Asian or minority ethnic | -0.542*** | 0.098 | -0.481*** | 0.101 |
| Age: 18 to 25 | -0.791*** | 0.058 | -0.840*** | 0.061 |
| Age: 66 or above | 0.154*** | 0.036 | 0.153*** | 0.038 |
| Male | 0.010 | 0.029 | -0.002 | 0.031 |
| Region: London | 0.204*** | 0.054 | 0.171*** | 0.056 |
| Region: North or Midlands | 0.244*** | 0.033 | 0.242*** | 0.035 |
| Party ID: Conservative | | | 0.017 | 0.042 |
| Party ID: Labour | | | -0.751*** | 0.040 |
| Party ID: LibDem | | | -1.091*** | 0.067 |
| Party ID: SNP | | | -0.771*** | 0.083 |
| Party ID: UKIP | | | 3.553*** | 0.205 |
| Party ID: Green | | | -1.218*** | 0.121 |
| Constant | 0.594*** | 0.042 | 0.756*** | 0.050 |
| Observations | 28,069 | | 28,069 | |
| Pseudo R-squared | 0.220 | | 0.275 | |

Note: Dependent variable: Vote "Leave" vote (1,0) in June 2016 referendum.

*** p<0.01, ** p<0.05, * p<0.10.

Source: British Election Studies 2015 Wave 9, July 2016.