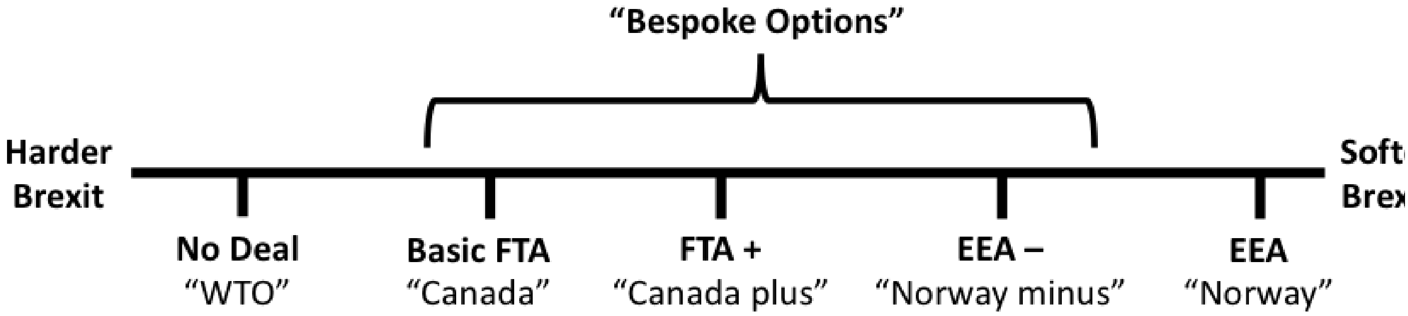
Two years after the vote, there is little certainty where the UK-EU relationship is heading

Two years after the vote, there is little certainty regarding the UK's political and economic future. Brexiters themselves are split between wanting a Singapore-on-Thames or a Belarus-on-Trent. ***Simon Hix*** *(LSE) assesses where the UK-EU relationship is heading. He argues that despite persisting uncertainty, a No Deal is the least-preferred option of both the UK or the EU27, and hence the least likely. He suggests that some sort of agreement will be reached before March 2019.*

While there has been much debate about the Brexit "withdrawal agreement" and the transition arrangements there has been less discussion of the longer-term "future relationship" between the UK and the EU27. The choice between a "Hard" or "Soft" Brexit has been known for some time, but the options are better characterised as a continuum rather than a dichotomy.



No Deal – leaving the EU without a deal, and trading as a World Trade Organization member.

Basic FTA – EU-UK free trade agreement (FTA) similar to the EU agreements with Canada, South Korea and Japan, which mainly cover trade in goods but contain very little on services.

FTA+ – an FTA which includes an agreement on financial services, such as "mutual recognition" of regulatory standards, a "regulatory equivalence" agreement, or the UK applying EU regulations and EU Court jurisdiction in return for access.

EEA- – the UK remains in the European Economic Area (EEA) but secures some opt-outs, in particular on the free movement of people (such as a cap on the number of EU migrants registering to work each month or an "emergency brake").

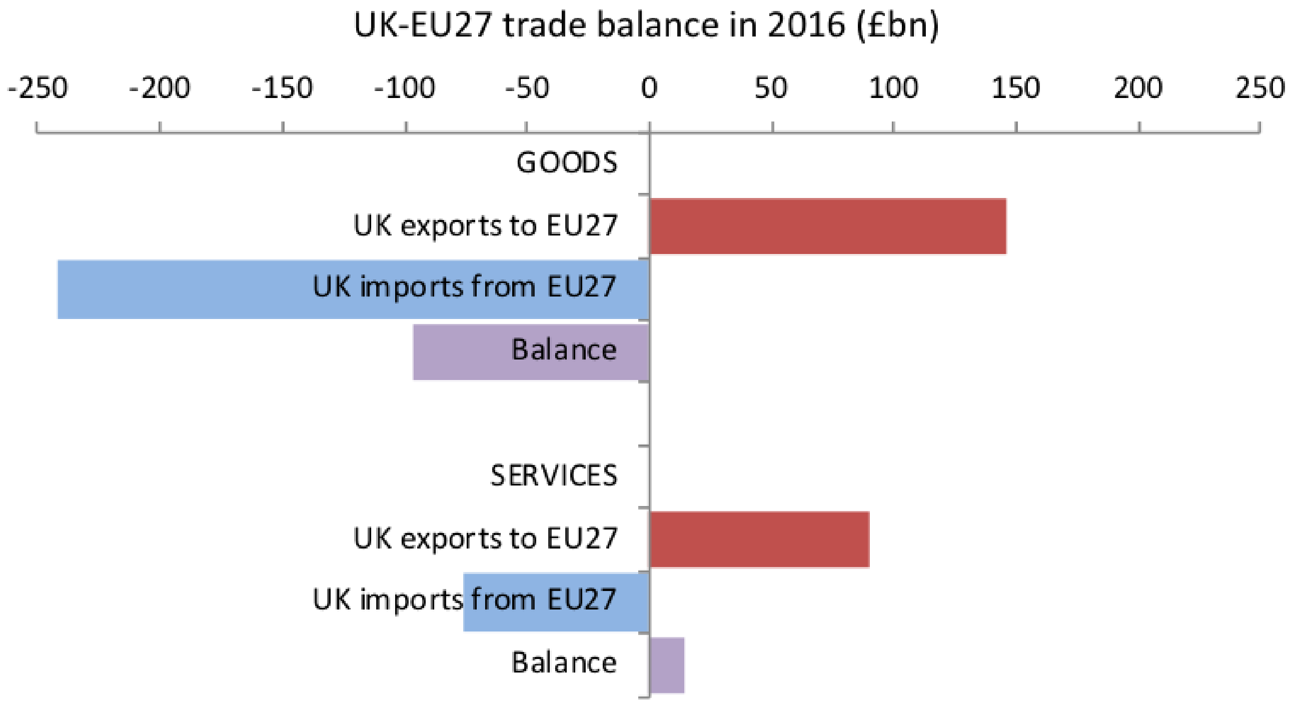
EEA – the UK remains in the EEA, so stays in the single market (the free movement of goods, services, capital and persons, EU rules, and EU Court jurisdiction) and pays into the EU budget, but leaves the customs union (to sign FTAs with third countries) and gains control of fisheries and agriculture.

The key question, then, is which of these options do the UK and the EU27 prefer independently and jointly? To answer this, let's consider the economic and political interests of the two sides.

Starting with economics, the "harder" the Brexit, the bigger the likely economic impact to both the UK and EU27, as a result of the loss of trade due to new physical, fiscal or regulatory barriers. The UK would save in terms of its payments to the EU and could claim back some of the losses in EU trade with new trade agreements with third countries. 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 EU. As a result, in the UK government's leaked cross-Whitehall report, HM Treasury estimated that a No Deal 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%.

The EU is unlikely to be hit as hard as the UK. In 2016, the EU27 constituted 43% of UK exports in goods and services, while the UK constituted only 16% of EU exports in goods and services, and 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, analysis from the EU's side suggests that an EEA outcome would only cost the EU27 approximately 0.1% of GDP by 2030, a basic FTA would mean a loss of 0.3-0.6% of GDP, and a No Deal outcome would cost 0.3-0.8% of GDP.

The content of the trade between the UK and EU27 is also asymmetric, as the following figure shows. In 2016 there was an overall trade deficit between the UK and the EU27 of £80 billion. Also, whereas there was a large UK to EU27 trade deficit in goods (of £96 billion) there was a trade surplus in services (of £14 billion).

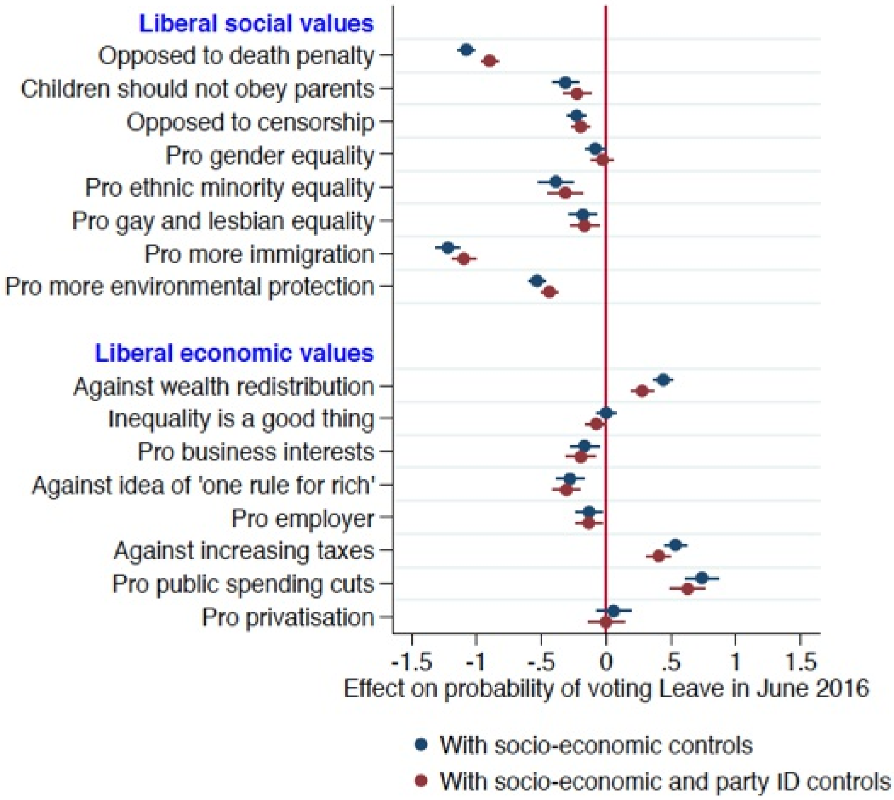


This trade asymmetry has strategic implications for the negotiations. Both sides have an interest in securing a trade agreement, and any reduction in imports or exports will have negative implications for consumers and businesses in the UK and EU27. Nevertheless, at the aggregate level, which is what politicians tend to focus on, the sectoral balance of trade suggests that the EU27 are more eager to want a deal that secures as frictionless trade as possible for goods yet will be less eager than the UK for a deal that includes free trade in services.

Image by Paul Bissegger, CC Attribution-Share Alike 4.0 International.

The negotiations will also be shaped by politics, of course. As many commentators have noted, the referendum outcome on 23 June 2016 was driven more by cultural and ideological values than by economic interests. The "project fear" message of the Remain campaign, which emphasised the economic costs of Brexit, was trumped by the "take back control" message of the official Leave campaign and the explicitly nationalist message of the unofficial Leave.EU campaign.

Mirroring the two Leave campaigns, there are now two competing narratives about a post-Brexit Britain. The so-called "liberal leavers" present **"Singapore-on-Thames"** vision: regaining sovereignty to deregulate the economy, abolishing "Brussels red tape", pursuing a liberal immigration policy, signing free trade agreements with partners across the world, and even unilaterally cutting tariffs and quotas on imports. This narrative is often associated with libertarian think-tanks like the Adam Smith Institute, Economists for Free Trade, Legatum Institute, Institute of Economic Affairs, and Initiative for Free Trade.



Source: Author's calculations from British Election Studies 2015 Wave 9 (July 2016) data. The models are multivariate logit estimates of voting Leave in June 2016, controlling for educational level, household income, ethnicity, age, gender, and region.

The problem for these "liberal leavers" is that most Leave voters actually prefer a **"Belarus-on-Trent"** vision of Britain: more socially conservative and more economically protectionist. For example, the above figure shows the relationship between liberal social and economic values and the probability of someone voting to Leave the EU. Every "socially liberal" value in the survey is negatively correlated with voting to Leave the EU, and Leave voters do not have clearly "liberal" economic values. Indeed, following their own survey of public attitudes, the Legatum Institute reluctantly conceded that the British public post-Brexit generally supports higher taxes, more public spending, nationalisation of key industries, and more regulation of markets and labour markets in particular.

The EU27 also have some key political 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 "no cherry-picking" line 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, Canada, and others to demand similar arrangements, under the WTO Most-Favoured-Nation rules.

A second aspect relates to the potential unravelling of the EU itself, driven by a fear of Brexit contagion. Support for anti-EU populist parties has grown in a large number of member states since the mid-2000s. Regardless of how painful the process of Brexit will be for the UK, once the UK is out the other side, there will be a new exit model: a "British model". 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, a special customs relationship, and some control on the free movement of people.

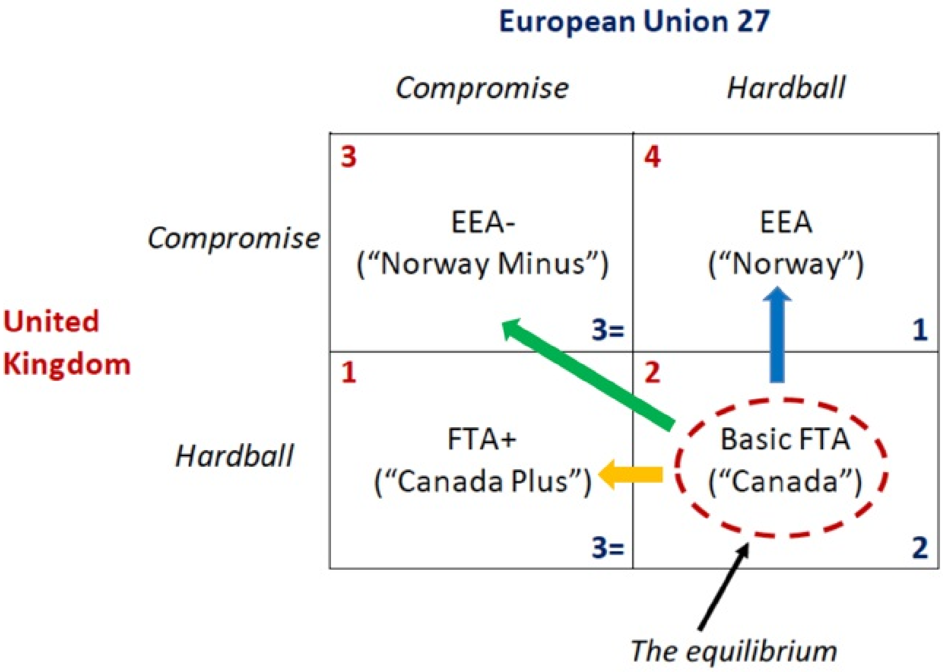
This discussion suggests the following rank-ordering of the options by the UK and EU27:

United Kingdom

1. FTA+
2. Basic FTA
3. EEA-
4. EEA
5. No Deal

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 FTA+ and FTA options outweigh the EEA- and EEA options. Meanwhile, from the EU27's side, the two most preferred outcomes, in terms of maintaining the integrity of the single market, are the EEA and a Basic FTA, whereas the EU is largely indifferent between the FTA+ and EEA- options, as either would involve a potentially dangerous precedent. Encouragingly, though, No Deal is the least-preferred option of both the UK or the EU27, which suggests that some sort of agreement will be reached.

These preference-orderings produce the following bargaining situation:



There is only one equilibrium in this game: **a Basic FTA**. The EU27 would play "hardball" because they prefer an EEA or 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 the EEA. Furthermore, neither the EU27 nor the UK have an incentive to deviate from this equilibrium; so neither side has an incentive to "compromise".

This does not mean that other outcomes are not possible. In fact, this analysis helps us focus on what would have to change for a different outcome to emerge. For example, for an FTA+ rather than a Basic FTA (as indicated by the **orange arrow**), the EU27 would need to compromise, to allow UK "cherry-picking". Alternatively, for the final outcome to be the EEA rather than a Basic FTA (as indicated by the **blue arrow**), UK domestic politics would have 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 public attitudes on the free movement of people change, or if there is a sudden and significant economic shock that shifts Conservative MPs' views about staying in the single market.

Then, for an EEA- rather than a basic FTA (as shown by the **green arrow**), the EU would need to allow UK "cherry-picking" *and* UK domestic politics would need to shift to remove the key red lines.

Finally, even if the preferences of the UK or the EU27 change, a further limitation is the ratification hurdle for the final agreement: unanimity in the Council and ratification in more than 30 national and regional parliaments. Every "veto player" would need to prefer the same alternative to a Basic FTA for a different deal to emerge. And, there will be 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.

I have tried to focus on is how political bargaining over the final Brexit deal might play out, based on underlying economic and political interests. This analysis suggests we are heading for a basic free trade agreement, which includes zero tariffs and quotas on goods and some special customs arrangements, but with not much on services trade.

It will be difficult to agree the "plus" part of a free trade agreement on 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. Put another way, now is not the time to propose to the Wallonia parliament or the French National Assembly a trade agreement that gives City of London bankers easy access to the single market, without the UK applying EU rules or being subject to ECJ jurisdiction.

This is a summary of the Annual Lecture of the Journal of Common Market Studies. The full text of the lecture is available online. This article gives the views of the author, and not the position of LSE Brexit, nor of the London School of Economics.

Simon Hix *is the Harold Laski Professor of Political Science at the London School of Economics and Political Science.*