CENTRE FOR EUROPEAN REFORM

Insight

UK + EU = Canada+?

by Beth Oppenheim and Charles Grant

1 December 2017

The European Commission believes that the only plausible future economic relationship between the EU and the UK is one modelled on the EU's free trade agreement with Canada. That would pose problems for the UK economy. Can the British hope for something better than 'Canada'?

After a meeting at the Department for Exiting the EU in September 2016, a Conservative aide accidentally flashed their notes to the press. "What's the model?", they had written. The answer? "Canada Plus".

The note referred to the EU-Canada Comprehensive Economic Trade Agreement (CETA), which is the EU's deepest free trade agreement yet, covering most goods but offering little on services. Brexiters like Boris Johnson hope for a 'Canada Plus' agreement, with more services included. In Theresa May's Florence speech, she remarked: "We can do so much better than this [CETA]". Britain is likely to open the second phase of the Brexit talks by asking for a tailored arrangement that is neither Canada nor 'Norway' (single market membership via the European Economic Area). Some British officials talk about a bespoke model, based on regulatory alignment, that would allow the UK to diverge from EU rules if it paid a price; in certain sectors this would give the UK something close to single market membership. The British are hoping that, under the pressure from national governments and business lobbies, the EU will in the end agree to much closer economic ties than Canada has.

So far there is little evidence that the EU or its member-states are contemplating Canada Plus. A leaked document by Michel Barnier said that Britain should expect a "standard FTA [Free Trade Agreement]". Barnier has also said that the UK is likely to end up with a model "close" to Canada's, and not significantly better.

CETA has been lauded by the EU and Canada as "the gold standard for future trade deals". It abolishes almost all tariffs on goods, with most eliminated immediately, and some phased out over three to seven years. The agreement also reduces some non-tariff barriers, promising greater co-operation between Canadian and EU regulatory authorities. The agreement establishes mutual recognition of Conformity

Assessment Bodies in some sectors, for instance for machinery and electrical goods, meaning that the EU allows Canada's assessment bodies to certify that goods made in Canada meet European standards, and vice versa. This is narrow in scope, and does not mean mutual recognition of the standards themselves. Furthermore, these mutual recognition agreements do not cover sectors that are important for the UK, like chemicals, food and drink, so such products would need to be checked at the border. CETA offers improved access to some services markets, like telecoms, energy and maritime transport, and allows firms to bid for public procurement contracts in the other market.

But Canada without any pluses would not suit the UK at all well. A CETA-style deal would be a step backwards from the harmonisation of standards and mutual recognition that the UK enjoys as a member of the single market. Some agricultural products are excluded, such as poultry and eggs, while 15 types of fruit and vegetables face tariffs of up to 20 per cent. The deal also fails to achieve any significant mutual recognition of technical standards. Nothing is established, for instance, on medicines, cars or on the labelling and regulation of agricultural products. Non-tariff barriers in such areas would increase costs for UK exporters and disrupt trade flows.

In some areas, Canada has agreed to abide by EU rules without reciprocation by the EU. Whereas Canada has no say in setting EU rules and standards, all exports into the EU must meet its product regulations, which are more stringent than Canada's. CETA has required some legislative changes in Canada, for instance on its Patent Act and its Food and Drug Act, while its businesses are aligning to European standards in many sectors like food, chemicals and electrical equipment. In contrast, the EU has not changed a single technical regulation in response to the agreement. The UK should expect similar asymmetry in any future free trade agreement with the EU: if it wants to minimise the friction of trading with the single market, it will need to maintain European regulations, just like any other non-EU country.

Still more problematic is the narrow scope of CETA's liberalisation of services. This is where the 'plus' comes in. The agreement would be inadequate for a service-driven economy like Britain's, where services account for 80 per cent of output. The British service sector is heavily reliant on the EU market, with which it enjoys a trade surplus of £14 billion. CETA excludes audio-visual and cultural services, as well as public services like health and education. It offers little on aviation, electricity or, crucially, financial services.

Until now, the City has benefited from the EU's 'passporting' scheme, which allows British financial services companies licensed by the UK to operate throughout the EU without setting up subsidiaries (and vice versa). The EU bought over a quarter of British financial services exports in 2014, worth £22.7 billion. But speaking at a CER conference in Brussels on November 23rd, Barnier confirmed that passporting would end under a Canada-style agreement.

CETA's provisions on financial services do not go much beyond the WTO's General Agreement on Trade and Services (GATS), of which the EU and Canada are already signatories. CETA provides for trade in financial services by repeating the WTO principles, which include 'national treatment', meaning that financial firms from the other territory must be treated equally to domestic ones. But GATS has a number of important exclusions, including financial stability rules and consumer protection. GATS does not allow cross-border provision of financial services to consumers, or passporting. So in reality, trade in services under GATS and CETA would offer significantly less market access than EU membership. Such a framework would have serious consequences for the UK's service industries.

A future agreement that was close to CETA would suit the EU much better than the UK. Services exports matter more to the UK than the EU. The UK currently has a trade deficit in goods with the EU of £96 billion a year. Under a CETA-style deal, the EU would continue to export goods to the UK without tariffs. This would benefit British consumers, since the alternative of WTO tariffs would raise prices on imports from the EU, of up to 8 per cent on dairy products and 6 per cent on meat for example. But while the EU could continue its most important trade, British exporters of services would find access dramatically restricted. A CETA-type deal would only intensify the existing trade imbalance between Britain and the EU.

Losing access to European services markets would hurt the British economy. Treasury analysis conducted before the referendum predicted that the UK would be "permanently poorer" under a negotiated bilateral agreement like Canada's. The Treasury estimated that by 2030, GDP would have shrunk by 6.2 per cent, trade would fall by up to 19 per cent and foreign investment by up to 20 per cent, compared to what they would otherwise be. Both the figures and the methodology were contested, and branded as scaremongering, but the OECD produced a similar estimate of a loss of 5.1 per cent of GDP by 2030 under a CETA-style agreement. The CBI predicted a more conservative loss of 3.1 per cent of GDP by 2020, and 1.2 per cent by 2030.

CETA also establishes a new investment court system, which has drawn sharp criticism, particularly from trade unions and NGOs. The agreement aims to alleviate barriers to investors entering the other territory's market. Investors can take a government to the court if they believe that a new domestic law has affected the value of their investment. Currently, a Swedish energy company is suing the German government for €4.7 billion, for allegedly breaching the Energy Charter Treaty – which uses a similar kind of investment court – following Angela Merkel legislating to close Germany's nuclear power stations. Critics have expressed concerns that this mechanism could allow foreign investors to de facto shape domestic laws, due to threat of heavy financial penalties. With a CETA-style deal, the British government could find its ability to legislate in the public interest restricted.

The EU will have to accept some tailoring of a Canada-style trade deal to suit the UK, because the structure of its trade is very different to that of Canada. Most of Canada's top export items (including precious metals and pearls) were duty-free before CETA, and in high demand in Europe. In contrast, many of the UK's exports are in sectors with high levels of regulatory protection (such as food and chemicals), where mutual recognition would be required to prevent costly compliance checks when goods cross the EU's border – recognition that the EU has been unwilling to offer in CETA. The UK would also want far more services included, particularly in financial, electricity and aviation markets. But the more bespoke the deal, the more protracted the negotiations will be; CETA took seven years to negotiate.

Legal experts have also pointed out that previous EU free trade agreements might prove an obstacle. The EU has already signed FTAs, not only with Canada but also countries like South Korea and Singapore. These deals contain 'Most Favoured Nation' clauses, which mean that if the EU signs a better trade deal with another country, all the original countries are entitled to the upgrade (in the specific sectors covered by the clauses). The countries concerned have no obligation to offer the EU anything in return. So the EU will be reluctant to grant significant openings on services to the UK, lest it be obliged to make similar offers to others.

There would be political as well as legal obstacles to the EU offering Canada Plus. CETA and many of the EU's FTAs are 'mixed agreements', which means the EU and its member-states exercise shared competence. So if one member-state disliked concessions made to the UK, it could block an FTA. CETA was initially delayed by a rebellion in the Walloon assembly, before being approved by the European Council and European Parliament. It is still undergoing ratification by individual member-states' parliaments. A deal that is too generous could risk rebellion – in the European Council guidelines from April 2017, member-states agreed that any FTA "cannot … amount to participation in the single market … there can be no cherry picking". EU leaders care deeply about preserving the integrity of the single market. No other countries participate in it, bar those in the EEA, and they pay a heavy price.

Low politics as well as high principle will influence the EU stance. In services markets such as finance, aviation and audio-visual, some member-states hope to pick up business that may leave the UK – or at least protect home firms from British competition. Many EU governments, including France and Germany, have never been enthusiastic about liberalising services.

So does the UK have any hope of achieving Canada Plus? Many British politicians and officials believe that, ultimately, the EU will prioritise economic interest and agree to Canada with substantial pluses. It is possible that the EU may come to see an interest in negotiating more mutual access than CETA entails for specific sectors, though such access could never amount to single market membership. A bold and generous UK offer on security co-operation could also be persuasive.

The UK should not rely upon the EU softening. EU officials point out that just as the British are putting political principles ahead of economic wellbeing, so can the EU. But if the British Government did achieve such a Canada Plus arrangement, it would almost certainly have to pay a high price – in terms of offering money for access, accepting something close to freedom of movement, becoming a rule-taker not rule-maker, or submitting to the jurisdiction of the European Court of Justice (or a similar court). Canada Plus, though a much more attractive option than Canada, may prove costly.

Beth Oppenheim is a research assistant and Charles Grant is director of the Centre for European Reform.