April 2017

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The best possible UK-EU trade deal

By John Springford

CENTRE FOR EUROPEAN REFORM

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- ★ Since Britain voted to leave the EU, the 27 other member-states have made 'no cherry-picking' their mantra. The UK will not be allowed to pick the parts of the single market it likes (such as trade and investment) and avoid the parts it does not (such as free movement and the supremacy of EU law). For her part, Prime Minister Theresa May insists that free movement and the supremacy of the European Court of Justice (ECJ) will end. This policy brief outlines the best possible trade deal for Britain and the EU, given each side's red lines.
- ★ Despite the 27's 'no cherry-picking' rule, any trade agreement between the UK and the EU will require both sides to decide which sectors of the economy should continue to have the lowest trade barriers possible, given Theresa May's decision to leave the single market. Thus, the negotiation will be an exercise in sectoral bargaining, as with all free trade agreements.
- ★ A new empirical analysis of trade barriers, set out in more detail below, shows three things. First, trade barriers in goods with the EU has almost halved since the UK joined in 1973, while barriers with the US has only fallen by one quarter.
- ★ Second, Switzerland's barriers in goods with the EU are now almost as low as the UK's, despite its partial membership of the single market, and its arm's-length relationship with the EU's institutions.
- ★ Third, barriers in both goods and services between the UK and the EU have barely fallen since the year 2000. This suggests that the single market is reaching its limits, given that further falls would require more sharing of sovereignty, especially in the highly-regulated services sector. It also suggests that the losses foregone by Britain from further single market integration will be limited: the priority must be to limit the costs of the divorce.
- ★ How might that be done? The focus should be on goods trade, not services. The barriers to trading goods between the UK and the EU are less than half as large as those in services, according to our analysis. The exception is in capital markets and the business services that support them, such as accountancy, law and consulting. But the UK's dominance in finance – Britain exports three-quarters of all capital market services within the EU – means that the 27 are keen to repatriate that activity.
- ★ In recent years, the most contentious ECJ cases involving Britain involved disagreements over financial regulation or the free movement of people. The 27 will not be willing to allow financial services access without closely aligned rules and the power of the ECJ to arbitrate disputes with the UK government.
- ★ The best hope for the UK, then, is a comprehensive trade agreement focussed on goods and those services, such as aviation, where both sides have a strong incentive to maintain the freest trade possible. This would be similar to Switzerland's deal with the EU. Despite the Commission's frustration with the Swiss relationship, a Swiss-style agreement largely limited to goods is Britain's best hope: it represents the limit of market access that the EU has been willing to accept without the full supremacy of EU law.

★ The Swiss-EU bilateral agreements show that compromises between sovereignty and economic integration are possible. Bilateral committees in the sectors where the Swiss and EU co-operate closely determine whether the Swiss should update their regulations to match those of the EU. The ECJ does not adjudicate disputes (although Swiss updates to their regulations must take account of ECJ case law). Something similar would be a potential 'landing zone' for the EU-27 and the UK in their forthcoming negotiations.

★ Such an outcome would have significant economic costs for Britain, given its advantage in services trade. But it provides a middle way between two extremes: severe trade disruption and full sovereignty on the one hand, and continued single market membership and the wrath of Brexiteers on the other.

During the referendum campaign, the Leave campaign claimed that Britain could become sovereign and maintain the economic ties developed as a member of the EU. But in her Lancaster House speech in January, Prime Minister Theresa May confirmed that Britain would leave the single market and seek a free trade agreement (FTA) with the EU, since "being out of the EU but a member of the single market would mean complying with the EU's rules and regulations that implement those freedoms, without having a vote on what those rules and regulations are."

However, she left open the possibility that a new agreement "may take in elements of current single market arrangements in certain areas – on the export of cars and lorries for example, or the freedom to provide financial services across national borders – as it makes no sense to start again from scratch when Britain and the remaining member-states have adhered to the same rules for so many years".[1] And Britain's Department for Exiting the EU has been working on a sector-by-sector approach to Brexit. It has said that it wants the car industry to have special arrangements to help it cope with the UK's withdrawal from the EU's customs union. A transitional deal allowing favourable market access for UK-based financial firms has been mooted for the City of London, to maintain financial stability. And a leaked document, obtained by *The Times*, shows that the government has prioritised different sectors into 'high, medium and low' categories, with pharmaceuticals, banking, car making, textiles and clothing, aerospace and air transport among the industries facing the biggest difficulties from leaving the single market.[2]

> *"If the UK and EU-27 seek to keep trade barriers to a minimum, institutional questions will be central."*

This approach has a narrow, rather mercantilist ring to it. The principle of the single market was to free the movement of products – goods and services – and the factors of production needed to make them – capital and labour. The idea was not to pick which industries should benefit (although, as the limited progress in freeing trade in services shows, it has not always worked out that way). But it is certainly true that the EU has been more successful at integrating some sectors than others – and thus Brexit poses a bigger headache for some industries than others. If the UK and EU-27 agree that some British sectors will continue to enjoy benefits approaching membership of the single market, institutional questions will be central. Who makes the rules? And who enforces them?

This policy brief seeks to answer three questions. First, has the EU reduced the cost of doing business between the member-states, in both goods and services sectors? Second, in which sectors of the economy do the EU-27 and Britain have the strongest mutual interest in keeping trade costs low after Brexit? And third, what institutional arrangements might minimise the economic cost of ending the free movement of labour and withdrawing from the jurisdiction of the ECJ? The paper starts with an appraisal of the EU's efforts to reduce trade barriers. It continues by showing the sectors in which both sides of the negotiation have strongest interest in maintaining barrier-free trade. And it concludes with a proposal: that the EU-27 and UK follow the example of the deal the EU struck with the Swiss: a trade agreement, focussed on goods, not services, which maximises regulatory alignment now and in the future, and with a mechanism for dispute settlement that follows ECJ rulings, but is not the ECJ.

1: Theresa May, speech at Lancaster House, 'The government's negotiating objectives for exiting the EU', January 17th 2017.

2: 'Leak reveals low-priority industries for Brexit talks', *The Times*, February 10th 2017.

Has the EU reduced trade barriers?

The consensus among most economists is that Brexit will be costly to the UK economy. This view is founded upon the principle that trade flows between two big economies are larger than between two small ones. But trade is also larger between neighbouring countries than those that are distant from one another. This is intuitive – it costs less to ship goods between neighbouring countries, and the value of trade between big economies will always be higher than between small ones, simply because large economies suck in more imports. The CER's 'gravity' model of trade, which focussed on goods, found that Britain's trade with the EU was 55 per cent higher than the model predicted.[3] Using similar models, the National Institute of Economic and Social Research (NIESR), found that it was 60 per cent higher for both goods and services, and the UK Treasury found that it was 76 per cent higher in goods.[4]

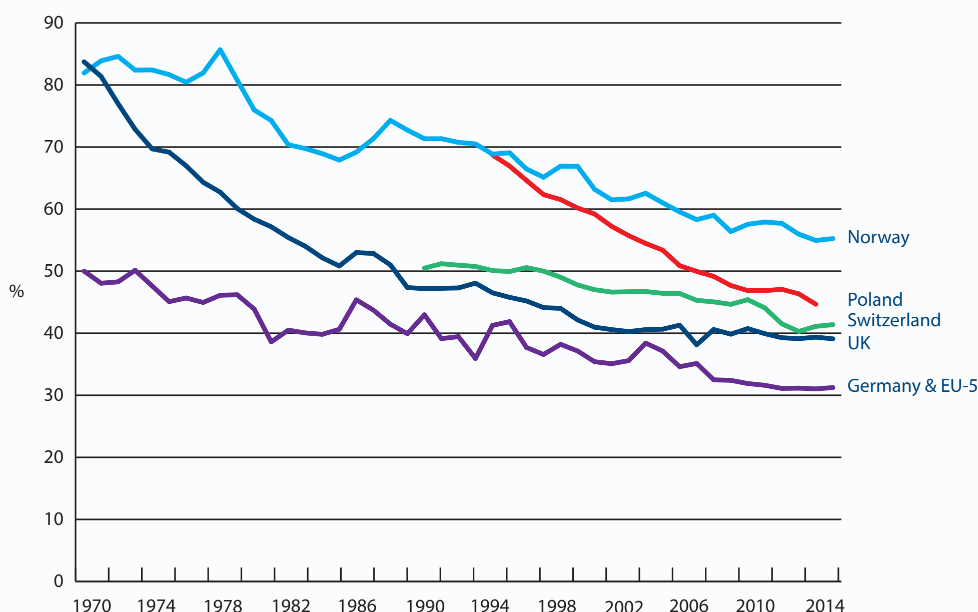
Another way of observing the effect of size and geography on trade flows is to use an 'inverse gravity' equation, which was developed by Dennis Novy at the University of Warwick.[5] This allows us to observe how big barriers to trade between two countries are. For example, if car plants are making the same number of cars in two countries, but the two countries are selling more of their cars to one another, barriers to trade between the two economies must be falling. This measure of the trade costs is expressed as a percentage equivalent to a tax rate – such as a tariff. If the cost of trading a widget were zero, it would cost the same to sell that widget abroad as at home.

Chart 1 shows the change in trade barriers in goods between latecomers to the European project and the six founding member-states of the European Economic Community: Germany, Belgium, France, Italy, Luxembourg and the Netherlands (hereafter EU-6). Between 1973 and 2000, the UK converged with the level of integration in goods trade achieved by the EU-6, as shown by Germany's relationship with the other founding members of the EU. Thereafter the convergence almost ground to a halt. Around that time, Britain's trade balance fell into deficit, with exports growing slower than imports, and trade with countries outside the EU growing faster than those within it.

Norway's barriers to trade with the then European Economic Community fell much more slowly. Norway did not join the bloc in 1973, but joined the single market in 1992 by signing the European Economic Area (EEA) agreement. In 1970, trade barriers between the UK, Norway, and the EU-6 were very similar: equivalent to an 80 per cent tariff on trade. By the time the Single European Act was signed in 1986, the UK's trade barriers with the EU-6 were nearly a third lower than Norway's, and remained so, despite Norway's accession to the EEA. (Norway's specialism in oil and other commodities, alongside its distance from the core of the European economy, may partly explain why its trade barriers continue to be so high, despite its participation in the single market.)

Chart 1: Trade barriers in goods with EU-6

Source: CER analysis of OECD structural analysis database and IMF direction of trade statistics.



3: John Springford, Simon Tilford, Christian Odendahl, 'The economic consequences of leaving the EU', CER report, April 2016.

4: Monique Ebell, 'The long-term economic impact of leaving the EU', National Institute of Economic and Social Research, May 2016. 'The long-term economic impact of EU membership and the alternatives', HM Treasury, April 2016.

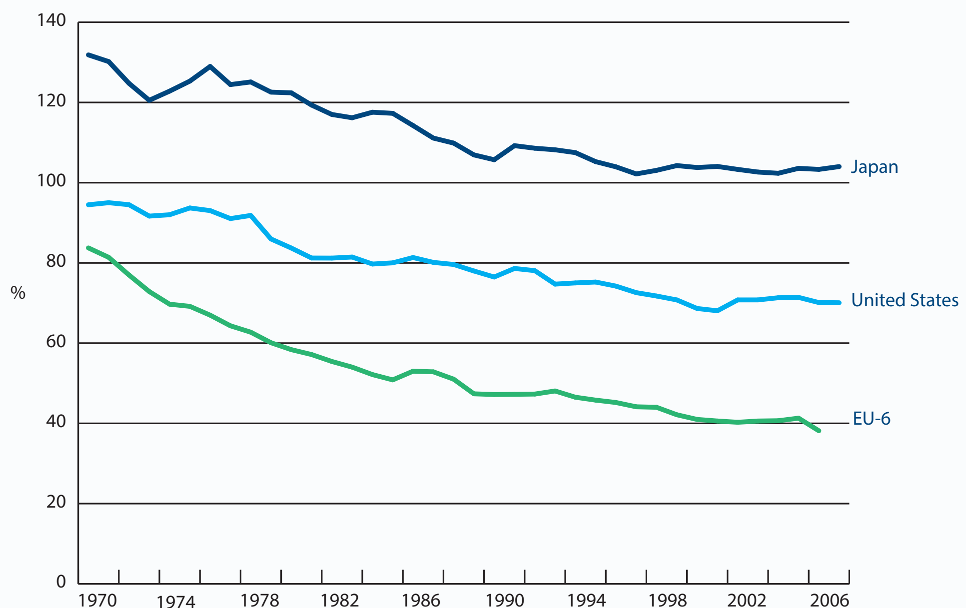
5: Dennis Novy, 'Gravity redux: Measuring international trade costs with panel data', University of Warwick, July 2011. For more details of the inverse gravity method, see the appendix.

Poland's case shows that EU membership is a sure-fire way to reduce the cost of trading with Europe's economic core: it began where Norway was in the early 1990s but is now considerably more integrated with the EU-6. Switzerland's bilateral agreements, which started in 1992, essentially brought Switzerland into the single market for goods. The case of Switzerland suggests that single market access significantly boosts trade. Despite the fact that the Alpine country is sandwiched between Germany, France and Italy, it had higher trade barriers in goods with the EU-6 than Britain did from 1990 to 2014 (the years for which we have comparable data for Switzerland), although it is now very close to Britain's level of integration with the EU-6.

Britain's trade barriers with major trade partners outside the EU have fallen much more slowly. Chart 2 shows that barriers with the US and Japan have fallen at half the pace of those with the EU-6. This reflects these countries' distance from the EU, as well as higher tariff and non-tariff barriers.

Chart 2: UK trade barriers in goods with EU-6, US and Japan

Source: CER analysis of OECD structural analysis database and IMF direction of trade statistics.



What about the barriers to trading services? Services exports now make up over 40 per cent of total UK exports, largely thanks to fast growth in financial and business services, such as consultancy, law and accountancy. NIESR's gravity model shows that the EU has boosted services trade by around 60 per cent between its members: the UK has benefitted disproportionately from this because of its comparative advantage in finance and other traded services.

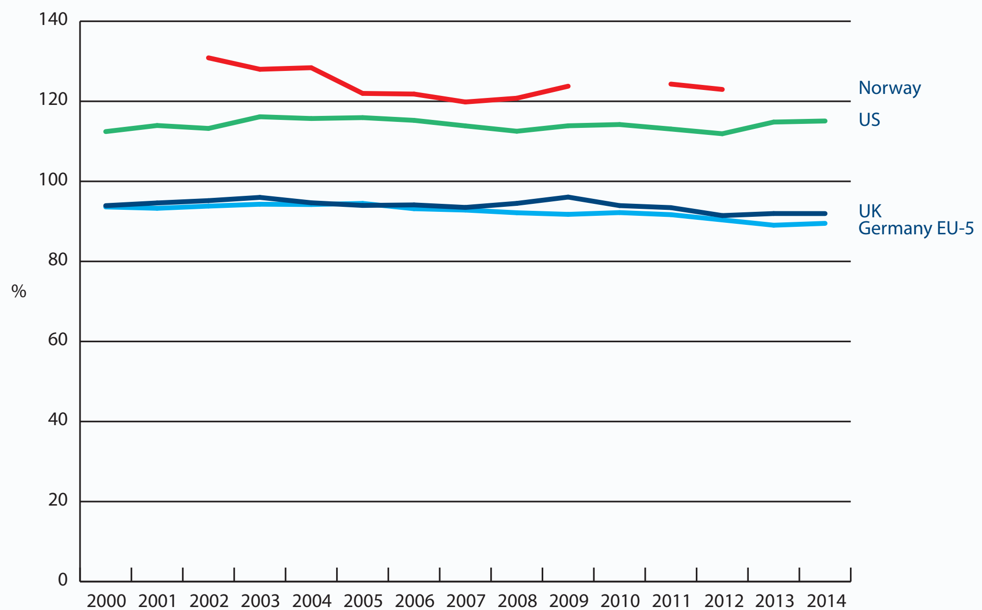
> *"The UK's trade barriers in services with the EU-6 have been broadly unchanged since 2000."*

But that integration appears to have happened before the year 2000, the first year that we have accurate bilateral services trade data.[6] The UK's trade barriers in services with the EU-6 have been broadly unchanged since 2000 (Chart 3). So too have Germany's, although the barriers to trading services are much lower within the EU than between the US and the EU. The EU's recent attempts to liberalise services, such as the 2004 services directive, have had little impact on cross-border trade.[7] (Free movement of people, on the other hand, has led to significant growth in services output in the UK since 2004, as the number of employed EU citizens in the UK economy, largely in services, grew rapidly. But trade data does not capture that, so neither does this trade cost calculation.)

6: NIESR's gravity model will pick up services trade integration before 2000, because it compares how much services trade there is between EU member-states and between countries outside the EU, to arrive at a level of integration. Novy's calculation picks up changes in trade costs over time.

7: John Springford, 'How to build EU services markets', CER policy brief, September 2012.

Chart 3:
UK, Germany, Norway and US services trade costs with the EU-6



Source: CER analysis of OECD structural analysis database and bilateral services trade database.

Note: Switzerland did not record bilateral services trade data before 2010.

This evidence, when combined with more standard gravity models, should lead readers to two conclusions. First, the EU has been successful at reducing the cost of trading goods and services, both for its member-states and for its non-members who have aligned with its rules. But the majority of that trade integration occurred before the turn of the millennium. The second conclusion, which leads on from the first, is that unless there is some big shift in the willingness of EU member-states to share more sovereignty in order to integrate markets further, future reductions in trade costs will be limited. The priority for the UK should therefore be to minimise the loss of the integration that has already been achieved.

In which sectors do the UK and the EU-27 have strongest mutual interests?

How can the costs of Brexit be minimised, given Theresa May's insistence that the UK should leave the single market, that free movement must end, and that the ECJ should have no supremacy over British courts? One option would be to perform a U-turn on those commitments, but that is unlikely to happen, unless public opinion shifts significantly. The other would be for the EU-27 and the UK to confine Britain's subjection to EU rules largely to the trade in goods, rather than services, for reasons outlined in Chart 4.

"By picking sectors where the interests of both sides are most aligned, compromise might be struck."

By picking those sectors where economic interests between the UK and the EU-27 are most coincident, a compromise might be struck. There are two ways to identify those sectors both sides can agree on. First, those sectors in which trade barriers are lowest; and second, those sectors in which the UK does not have a large share of exports within the EU.

Chart 4: Trade costs between UK and EU, and UK share of intra-EU exports, various sectors, 2014

Source: CER analysis of World Input-Output Database, University of Groningen.

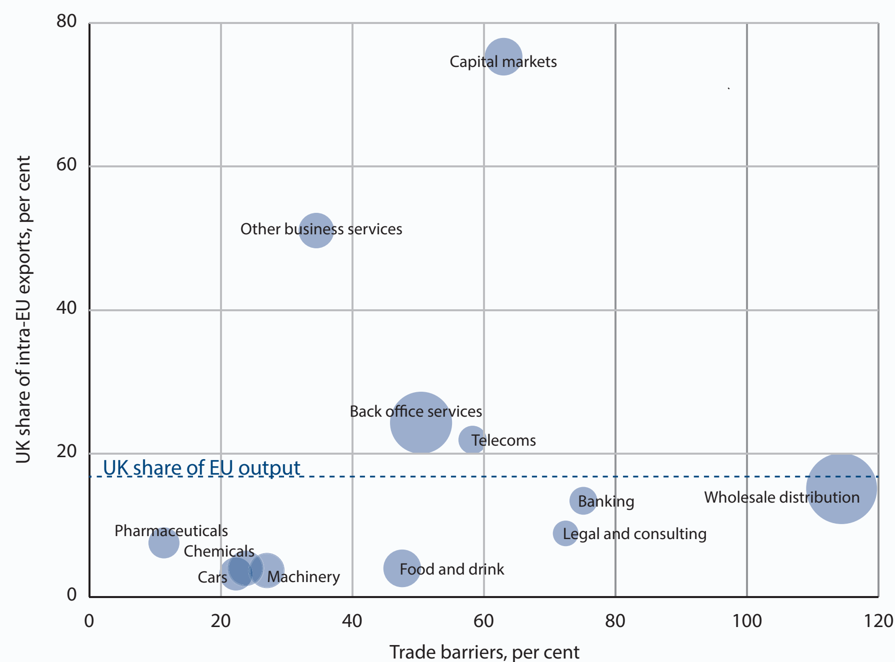


Chart 4 plots Britain's share of exports between member-states in different sectors against the trade barriers between the UK and the EU in those sectors. The wholesale distribution sector faces high barriers to trade within the EU, while pharmaceuticals trade has very low barriers. The size of the bubbles corresponds to the value of the UK's exports in that sector.

Broadly speaking, the higher the UK's share of EU exports within a particular sector, the more the EU-27 will seek to restrict its access to the single market. The chart shows that the UK's specialism in traded services makes it vulnerable to a loss of single market access, because it has very large shares of intra-EU exports. In cross-border capital markets, for example, Britain accounts for over three-quarters of all exports within the bloc. It also has very large market share in 'other business services', a sector which includes intellectual property, deal-making in mergers and acquisitions, and many types of consultancy. And it has a very large share of back office services traded across borders, which is also linked to its dominance in traded financial services.

It would be helpful to the UK if the EU-27 realised the advantages of specialisation and exchange, and saw the City of London and traded business services as a European asset. However, Germany and France have already made clear that they are keen for banks and other financial institutions to relocate to the EU once Britain has left. First, these industries are big sources of both high-paying jobs and tax revenue. Second, they believe that the City of London poses financial stability risks to the EU-27. They want financial activity to be regulated by the EU authorities and greater restrictions to be placed on the City of London's ability to provide capital market services across the EU.

This will have a knock-on impact on traded business services, such as accountancy, law and consulting, in which the UK also has sizeable share of the single market, because they provide support for the core business of the City of London: wholesale financial markets.

Britain and the EU-27's interests coincide much more when it comes to trade in manufactured goods, which also have extremely low trade costs – the single market is almost 'complete' in sectors such as pharmaceuticals, chemicals and cars and other motor vehicles, alongside most other manufactured goods, meaning that it costs almost as little to sell cars, chemicals and pharmaceuticals across the single market as it does to sell them at home. But the UK and the 27 have similar interests in the production and exchange of manufactured goods. Trade barriers are very low in these sectors, and neither side wants complex supply chains to be interrupted.

That, however, is not to say that the EU-27 will allow the UK to have tariff-free trade in these manufactures without a legal framework to ensure that Britain continues to comply with the EU's product standards – and environmental and safety regulations governing the production process. Innovation in cars, pharmaceuticals and chemicals is much faster than in, say, the manufacture of furniture. And these products can impose significant 'externalities' on consumers and society. They can be dangerous to human health; and their use or manufacture may damage the environment. This means that the EU manages a continual process of legislation to regulate markets: the introduction of self-driving cars will require EU laws to ensure they can be used safely in any member-state, for example. And it also means that the EU

will not allow full market access for UK-based firms unless the British sign up to the *acquis* in that area.

This raises the question: what system of regulatory alignment – and what system of dispute resolution – is realistic, given Theresa May's red lines?

A proposal for a Swiss-style Brexit

Theresa May has set two red lines, which will mean Britain must leave the single market if she does not violate them in the negotiations. First, the UK will be free to restrict immigration from the EU. Second, the ECJ will no longer arbitrate on disputes between companies and individuals and the UK government. For their part, the EU-27 have said they will not allow Britain to 'cherry-pick', ending free movement of labour while retaining the same rights to sell financial services across the Union.

Britain will have to accept that financial services will take a hit, given the decision to leave the single market. It is true that the EU's 'four freedoms' do not have to come as a package, and that the free movement of goods can be conducted without free movement of labour.[8] In fact, the two are substitutes: manufacturing has shifted towards low-cost countries because goods made there can be easily shipped to richer ones. Rich countries could invite low-wage labour immigrants to come and work in their manufacturing plants as a substitute for trade.

> *"Financial services and free movement are the two areas where Britain and the continent have grown apart."*

But the trade in services and the movement of people are linked.[9] UK-based firms have a comparative advantage in high-value added services, and rely on the single market principles of non-discrimination and freedom of establishment, enshrined in EU law and enforced by ECJ judgements, to sell across the EU. The free movement of people is the only way that non-tradeable services – in construction, retail and so forth – can be traded, as construction workers and baristas cannot provide their services remotely. The single market is in essence a deal that allows both low- and high-value services to be sold across borders.

If the UK wants to leave the EU's regulatory and legal institutions in order to end free movement of workers and to regain sovereignty, it must accept that the City will no longer be protected by those institutions, just as EU migrants will not. That means that much activity currently restricted to financial institutions operating in the EU will have to move to the continent (or Ireland) after Brexit.

The costs of a single market exit will come in two forms. One is a rise in the barriers to trade following withdrawal. The other is missing out on future benefits as the single market moves forward. Yet that second cost is unlikely to be large in services. The EU has proved unwilling to share the sovereignty needed to 'complete' a single market in services; services trade barriers have barely fallen since the year 2000, and, given the non-tradable nature of many services, the opportunities for greater services integration, other than through higher migration, are small. Thus the UK and the 27 have a strong interest in keeping barriers to the trade in goods low. Their interests diverge on services and migration.

The 'landing zone' for a deal is therefore for the UK and the 27 to curtail both Britain's financial services exports and its import of European labour. Such a deal would also allow the EU-27 and the UK to compromise on the second of May's red lines: the ECJ. The free movement of financial services and the free movement of labour are the two areas where the continent and the UK have grown apart – and where ECJ dispute settlement would be most needed in the future, had Britain decided to remain in the EU. Under David Cameron's tenure as prime minister, the UK brought cases to the court against the European Central Bank for attempting to force the clearing and settlement of euro derivatives to take place in the eurozone; the EU's banker bonuses rules; and the proposals for a financial transactions tax among 11 EU member-states. As for free movement, the Commission brought a case against the UK government over its 'right to reside test' for EU migrants, arguing that it discriminated against immigrants from the EU. Cameron flirted with demanding free movement quotas during his renegotiation, and finally sought to limit migrants' access to in-work benefits. By reducing mutual exchange in workers and finance, the EU-27 and the UK limit the need for a shared rules and dispute settlement by the ECJ.

The 27's fears about the UK resorting to environmental and social 'dumping' can also be overcome. EU negotiators have said they will seek to constrain Britain's ability to slash regulations and taxes in an attempt to regain competitiveness after Brexit. The truth is there is little appetite in Britain for such libertarianism. The UK was a laggard in environmental regulation before it joined the EU, but has now become a champion of action to curb climate change, and has cleaned up its domestic environment

8: Jean Pisani-Ferry and others, 'Europe after Brexit: A proposal for a continental partnership', Bruegel, August 2016.

9: Camino Mortera-Martinez and Christian Odendahl, 'What free movement means to Europe and why it matters to Britain', CER policy brief, January 2017.

(the terrible air quality in London notwithstanding). While there has been some grumbling about the working time directive and the agency workers' directive, the UK's labour market is already highly deregulated; and it is in the process of raising the minimum wage, which suggests that domestic political appetite for even less regulation is small.

Thus, a slimmed-down common market in goods, research and some key services, such as aviation, with institutions to prevent regulatory divergence and dumping, and to arbitrate disputes, would be the way to save much of the economic integration that has already been achieved. What might those institutions look like?

The answer lies in a tweaked version of the Swiss-EU relationship. Switzerland's relationship with the EU rests on a series of bilateral sectoral agreements – 20 of them important, another 100 less so – but not all sectors are covered. Switzerland has free trade in goods with the EU even though there are customs controls, as Switzerland is not in the customs union. And unlike the EEA it has no broad agreement with the EU on services. Swiss access is limited to those parts of the EU services market for which they have brokered sectoral agreements with the EU, such as aviation. This is why Swiss banks serve the EU market through London. The UK's financial services industry would face the same challenges as its Swiss counterpart; Switzerland has no accord with the EU on financial services, except for a 1989 agreement on non-life insurance.[10]

"Despite the Commission's frustration with the Swiss, a similar deal is Britain's best hope."

In those sectors where the Swiss have a deal with the EU, they develop their legislation with the EU in mind, because they want to maintain reciprocal access to the single market on the basis that their legislation is equivalent to that of the EU. Bilateral EU-Swiss committees ensure that as EU law changes, and it has an impact on the bilateral treaties, the Swiss update their legislation accordingly. The ECJ is not directly involved in dispute settlement, which is largely handled through diplomacy in the bilateral committees that govern the agreements. However, the ECJ's single market case law – in which the ECJ has ruled on disputes over discrimination, and these have become rules applicable across the single market as a result – is binding. The case law is written into the bilateral treaties when they are updated by the bilateral EU-Swiss committees. The Swiss may refuse to update their legislation or the treaties, but rarely do, since the EU may revoke market access as a result.

The Commission is frustrated with the Swiss arrangements, which involves constant negotiation as EU legislation moves on. The Swiss-EU relationship is stuck, with no prospect of new bilateral treaties in the future. And the Swiss have been forced to accept the free movement of labour: after the Swiss voted to impose quotas on immigration from the EU in a referendum in 2014, the EU suspended scientific research co-operation and student exchange programmes, and the Swiss ultimately backed down.

The cause of much of the frustration is that the Swiss bilateral deals are more 'static' than the single market, meaning that Switzerland does not automatically change its laws as the EU's acquis is amended. The reason that services are largely excluded from the agreement is that Switzerland has been unwilling to align its finance rules with those of the EU, especially on tax and bank secrecy (although Switzerland has recently agreed to share bank account data with other countries, succumbing to US and EU pressure). Financial services rules are constantly evolving, as it is a highly regulated and fast-changing sector of the economy. The same is true of mobile and internet markets, where the pace of innovation is fast, and concerns over data-sharing and competition are leading the EU to intervene. Goods markets, on the other hand, tend to move more slowly (with the notable exceptions of pharmaceuticals and chemicals, where innovation is speedier). Britain might be able to convince the EU-27 to accept bilateral committees overseeing Britain's alignment with EU law. And if the UK-EU agreement included a court that took account of ECJ case law, some of the EU's problems with a Swiss-style Brexit would be overcome. Despite the Commission's frustration, a Swiss-style agreement largely limited to goods is Britain's best hope: it represents the limit of market access that the EU has been willing to accept without the sovereignty of EU law.

The UK-EU trade agreement would have to do three things. First, it would list the goods sectors (and some services, such as aviation) in which the UK would commit to maintain regulatory alignment, and in which the EU would forbid regulatory discrimination by EU member-states against the UK. Second, it would list those EU social and environmental rules that the UK would have to continue to uphold. And third, it would provide an institutional arrangement for the UK to update its legislation to accord with EU law in those sectors, and the measures that the EU would be able to take if the UK refused to do so; plus a dispute settlement system, taking account of ECJ case law, in case both sides disagree. Dispute settlement would have to be more formal than the diplomacy conducted in the Swiss-EU bilateral committees, given the EU's problems with the Swiss

10: David Buchan, 'Outsiders on the inside: Swiss and Norwegian lessons for the UK', CER policy brief, September 2012.

agreement. There would have to be a court or arbitration panel, whose decision was final. And the court would have to take account of ECJ case law as well as the text of the UK-EU agreement in its judgements.

This compromise should satisfy the UK's political imperative to minimise the economic cost of regaining sovereignty. Under this arrangement, Britain continues to benefit from the free trade of goods and some services, but commits to similar social, environmental and consumer safety regulations to those of the EU, and accepts bilateral institutions that would largely require it to do so or lose market access. The ECJ would be kept at arm's length, though any dispute settlement system, such as a bilateral UK-EU court, would have to take account of its rulings.

But would the compromise satisfy the EU's political imperatives? Surely such a fractious relationship is not one that the EU would be willing to repeat, especially since Britain will not accept free movement of people?

There can be no doubt that a Swiss-style relationship without free movement is a stretch, and the best that the UK can aim for unless Theresa May violates her red lines. But there are some important differences between Britain and Switzerland, which give some reasons for Britons to be hopeful. First, Britain is a larger market – its economy is six times the size, so reciprocal UK market access for EU companies is more important. Second, Switzerland has a higher value-added and more productive manufacturing sector than Britain, which means that the 27 should be more relaxed about granting the UK favourable market access. Third, Britain is an important ally for EU member-states, and matters much more to the maintenance of European order than neutral Switzerland.

The EU-27 have political imperatives of their own, including that the UK must lose from its decision to defect from the EU's institutions, because if it left unscathed, Britain would make it more likely that others do the same. But a Swiss arrangement would mean that the UK accepted EU rules in particular areas. And, since Britain's access to EU financial services markets would be curbed, EU leaders could 'take back control' from the City of London, and demonstrate to domestic eurosceptics that the price of exit was high.

Conclusion

The economic costs of a Swiss-style arrangement for Britain would be significant. By ending the free movement of labour, Britain would see labour shortages in some sectors, as well as slower growth in output, which would reduce tax revenues and raise the deficit over the long term. Britain's services exports have been growing quickly, and are now over 40 per cent of the total; withdrawal from the single market for services would hurt Britain's source of comparative advantage. The City of London would continue to be an important global financial centre, but would probably lose a sizeable chunk of activity to the EU after it leaves the bloc. This would also hit the public finances, as the City is a big source of tax revenues.

"A Swiss-style deal would be a middle way between 'no deal' chaos and single market membership."

It would be more economically rational for the UK to remain in the single market – or better yet, remain an EU member, so that it had a measure of control over future EU reforms. The benefits of 'global Britain' – the freedom to sign trade deals with non-European countries – are highly unlikely to offset higher trade barriers with the country's largest trade partner. And the gains from deregulation are unlikely to be large – and are very likely to be strongly resisted by the EU-27: any British attempt to become Singapore would probably scupper a free trade deal altogether.

Yet, according to our analysis, the single market programme has barely resulted in any trade integration between the UK and the EU-6 since the turn of the millennium; the benefits arising from further integration are likely to be limited. It is therefore most important to maintain the level of integration that has already been achieved in goods – where the cost of trade is very low – by avoiding tariffs and other discriminatory measures, than to obsess about further integration foregone in the future.

The UK has very large shares of capital markets and business services exports within the EU. And interests are most divergent over the regulation of financial markets and the free movement of people. The 27 are unconvinced that the City of London is a 'European asset'; and immigration is probably the main reason why Britain is leaving the EU.

The Swiss-EU bilateral agreements show that compromises between sovereignty and economic integration are possible. Something similar would be a potential 'landing zone' for the EU-27 and the UK in their forthcoming negotiations, and Britain has good reasons to demand that free movement should not be the price of continued participation in the single market for goods. Such an outcome would have economic costs, largely borne by the UK. But it would be a middle way between the chaos of 'no deal' and the political impossibility – at least for now – of full single market membership.

Appendix: The 'inverse gravity' method

The Warwick University economist Dennis Novy's equation for calculating the observed *ad valorem* cost of trade between two countries is as follows.[11]

$$\left(\frac{x_{ii}x_{jj}}{x_{ij}x_{ji}}\right)^{\frac{1}{2(\sigma-1)}} - 1$$

x_{ii} and x_{jj} are the gross outputs of the manufacturing or services sectors of the UK and the trade partner.

x_{ij} and x_{ji} are the manufacturing or services exports and imports between the UK and the trade partner.

σ is a constant elasticity of substitution. Novy uses the estimates for this elasticity from elsewhere in the trade literature, and finds σ to be 8.

Novy's paper applies this measure to goods trade between the US and its largest trade partners. We do the same for the UK, in both goods and services. Using the World Input-Output Database, we also apply the measure to particular sub-sectors of both goods and services, such as cars, capital markets and pharmaceuticals.

John Springford
Director of research, Centre for European Reform

April 2017

11: Dennis Novy, 'Gravity redux: Measuring international trade costs with panel data', University of Warwick, July 2011.