

Possible models for the UK/EU relationship

This paper summarizes some potential alternative models for the UK's future relationship with the European Union, together with the key differences between the models which will need to be addressed in determining both the shape and impact of that new relationship.

The purpose of this paper is to enable business to understand the principle features of the potential outcomes to the political process underway, rather than to address specific issues, of which there are many, in detail.

In this note you will find:

- A summary of the key features of the UK's current membership of the EU;
- Four potential alternative models for the UK's future relationship with the EU, together with their key features;
- An overview comparison of each of the four potential alternative models.

Known-unknowns

This process is political as well as legal, and so we have not attempted to assess the probability of any outcome, instead we have tried to describe some of the possible factors and areas of potential trade off in the political process.

A "pick and mix" solution?

As we describe in the final section of this note, although various "models" are helpful in understanding the spectrum of possibilities, it is quite probable that the eventual outcomes, whilst lying somewhere on this spectrum, will not precisely reflect any of these models but a "pick and mix" combination of elements from them.

Current model: EU membership

Background

The EU creates a framework through which the UK and 27 other Member States cooperate. At its core is the principle that the combined territory of those states form a Single Market within which goods, services, capital and people can move freely, there is fair competition and consumers and workers are protected. The fundamental principle is that EU citizens must not be discriminated against on the grounds of their nationality, including in relation to free movement.

The rules are set out in EU law which exists in parallel with the laws of the individual Member States. The EU has its own legal personality and institutions through which legislation is enacted, executive decisions are made and EU law disputes determined. The EU also has a series of areas in which it has exclusive competence such as trade matters (including a common external tariff on imports from outside the EU) and negotiates arrangements with external countries in areas such as trade.

Whilst the EU is responsible for the rules governing large areas of economic activity (with the aim of ensuring a common approach throughout the EU territory), these rules are, in many cases, implemented in some part via the institutions and laws of individual Member States as well as via EU law. In addition, the EU has no role or a limited role in many areas of law (including much of that governing contracts, companies and real estate) or in relation to direct taxation.

Key features

The relationships between the UK, the EU, other Member States and countries outside the EU have expanded into a complex network within the world trading system. However, in comparing various models, some key aspects can be summarized as follows:

- **Single market:** Goods, services, people and capital can move freely within the EU. This has several notable features:
 - **No tariffs:** no tariffs are imposed on trade within the EU but there are common tariffs on imports to the EU;
 - **Common standards:** goods and services fulfilling EU-based rules or standards in one Member State automatically comply with the equivalent rules or standards EU wide.

Opt-outs

The UK (and some other Member States) has, by agreement, opted out of various aspects of the EU's operation. In the UK's case these include opt-outs from membership of the single currency (the Euro), Banking Union, and the Schengen Agreement (which removes border controls between certain Member States).

In many areas, country-by-country compliance is not required;

- **Regulatory passport:** where provision of goods or services requires an EU derived regulatory authorisation, an entity established and authorised in one Member State satisfies equivalent requirements throughout the EU. In many areas country-by-country authorisation is not required;
- **Trade agreements:** the EU negotiates and concludes trade agreements with non-EU states for the benefit of all Member States; and
- **Movement of People:** Citizens of any EU Member State are free to travel, work and study throughout the EU;
- **Influence:** The UK has the right to participate in EU decision-making (and so influence EU policy and law), other than in the areas from which the UK has opted-out;
- **Law:** EU law (which, in the areas where the EU has a role, extends from fundamental principles to detailed regulation) applies to, and within, the UK, except in the areas of the UK's opt-outs; and
- **Contribution:** The UK makes a financial contribution to the EU budget¹ on the basis of its GDP.

¹ The calculation of the UK's contribution is complex as, in practice, a significant amount of the headline figure is credited back to the UK Government

Alternative 1: New terms model

Background

The UK's referendum is consultative and does not commit the UK to leaving the EU.

With political developments in the UK and the EU currently being extremely fluid and the likelihood that any process to finalize the UK's departure will take several years, it is possible that the outcome of the political process is that the UK remains a member of the EU.

However, it is likely that this scenario would also involve changes to terms of the UK's membership to address the key concerns raised by the "Leave" side in the referendum campaign; in particular, unrestricted freedom of movement of people and the size of the UK's financial contribution to the EU budget.

A further unknown in this scenario would be whether any changes are limited to the UK's terms of membership or would take effect as more wide-ranging changes to the EU, i.e. affecting all Member States.

Key features

The essence of this model is that the status quo would remain largely unchanged, subject to specific additional qualifications or opt-outs. The UK would continue to enjoy the benefits of being a full member of the EU and be subject to the common legal, political and economic commitments required of all EU members.

Formal requirements

New terms would need to be agreed by all of the other 27 Member States.

Implications for business

This model would provide business with a high degree of stability. Any changes to the principle of the free movement of people would be unlikely to affect highly skilled workers being recruited for specialist or management positions or the relocation of existing employees. However, restrictions could potentially increase administration and associated costs, and might make it more difficult to recruit candidates for less skilled roles.

New terms model: Summary

No tariffs	No change
Common standards	No change
Regulatory passport	No change
Trade agreements	No change
Movement of people	Additional restrictions?
Influence	No change
Law	No change
Contribution	Possible reduction

Alternative 2: EEA model

Background

Norway, Iceland and Liechtenstein are all members of EFTA and the EEA.

The UK was a leading player in the creation of EFTA in 1960 as a free trade driven alternative to the EU, which was seen as being too focused on political integration. In the following years, EFTA membership has declined as most of its members, including the UK, have left to join the EU.

The EEA model assumes that the UK, like Norway, is a member of both the EEA and EFTA. Switzerland, a member of EFTA but not the EEA, is a special case raising issues which have similarities to those facing the UK (see “Overview of Models and Possible Outcomes” overleaf).

Key features

Membership of the EEA provides access to the Single Market (whereas EFTA membership alone does not) but outside the structures of the EU. EU law does not apply directly within the members of the EEA.

However, in areas relevant to the Single Market, EEA Member States are obliged to adopt laws equivalent to those of the EU. EEA members have a limited veto right, the exercise of which could result in suspension of membership of the Single Market. In practice, in those areas the UK would be very likely to input into policy as a “best friend” and implement the EU’s decisions through UK legislation.

As a result, current UK rules in areas such as employment, consumer protection, competition law, financial services, life sciences regulation and environmental policy would remain substantively unchanged. EEA members comply with freedom of movement of people, meaning it would be difficult for the UK to secure a qualification to this without a change of view on the part of other Member States.

The UK would no longer benefit from trade agreements between the EU and non-EU Member States. The UK could set its own import/export tariffs and negotiate its own trade deals with non-EEA member states (through EFTA if applicable) but could need to apply new “rules of origin” requirements to demonstrate the underlying source of products if those products are to avoid EU tariffs.

Like other EEA members, the UK would make a financial contribution to the Single Market but would be excluded from the costs and the benefits of EU membership in other respects.

The EEA

The European Economic Area extends the EU Single Market to Norway, Iceland and Liechtenstein. EEA members benefit from, and are bound by, the EU’s Single Market rules covering free movement of goods, services, people and capital. They do not participate in the EU’s decision making structures or some other areas of EU competence.

EFTA

The European Free Trade Association consists of Norway, Iceland, Liechtenstein (members of the EEA and the Single Market) and Switzerland. EFTA concludes Free Trade Agreements with the rest of the world on behalf of its four members.

Formal requirements

The UK's membership of the EEA would require the agreement of all EEA members (i.e. the other 27 EU Member States plus Norway, Iceland and Liechtenstein).

As the EEA is an established framework, a UK transfer to the EEA rather than EU status could potentially be executed relatively quickly, so minimising the period of uncertainty as to future arrangements.

Implications for business

This model would provide business with continuity in most key areas. Whilst changes to the legal structure would likely result in some increased complexity, this would be limited. However, the loss of the UK's direct voice in EU decision-making could make it more difficult for business to press an "Anglo-Saxon" approach to regulation in EU policy development.

EEA Model: Summary

No tariffs	No change
Common standards	No change
Regulatory passport	No change
Trade agreements	Change: Via EFTA
Movement of people	Some restrictions?
Influence	Outside formal structures
Law	Indirect not direct
Contribution	Reduction

Alternative 3: Free trade agreement model

Background

A number of countries² currently have free trade agreements with the EU. Those countries are not part of the Single Market or the EU's other structures. Their agreements with the EU mean the reduction or removal of tariffs, and barriers to trade between them and EU Member States are minimised.

Historically, free trade agreements have focused on goods. The inclusion of services has been one reason for the complexity and duration of recent negotiations with Canada. This may be a relevant factor to consider, given the importance of services to the UK economy.

In practice, a free trade agreement with the EU will require that goods and services sold into the Single Market comply with EU rules. A free trade agreement is likely to include some liberalization with respect to services although this may well fall short of full Single Market access. Moving to a free trade agreement would significantly extend the UK's ability to set its own rules including in the area of immigration.

Key features

The terms of a new UK/EU free trade agreement would be specifically negotiated – a process which might be expected to take a number of years³. Based on experience of other agreements we can provide some insight into what it would, and would not, cover.

The UK and EU would likely commit not to apply tariffs and non-tariff barriers to a wide range of goods and services traded between them. Given the limited liberalization of services in free trade agreements, it is difficult to anticipate the depth with which a new agreement would cover services.

The UK would fall outside trade agreements between the EU and non-EU countries.

The UK would not formally fall within the scope of UK laws or benefit from “regulatory passporting”. In practice, it is likely that in some areas reflected in a new free trade agreement the UK would remain closely aligned to the EU approach and UK laws and standards would therefore follow those in the EU.

The UK would also be optimistic of achieving “third country equivalence” status for certain regulatory purposes leading to a degree of mutual regulatory recognition which might, to some degree, reduce the impact of the loss of full “passporting” or result in a redefined form of regulatory passporting in which similar outcomes are achieved by a slightly different mechanism.

The UK would set its own immigration policy and would not make a financial contribution to the EU.

² Excluding the EEA countries and Switzerland the EU has Free Trade Agreements fully in force with many countries ranging from Jersey and the Isle of Man to South Africa and South Korea. Other agreements (including with the USA and Japan) are in negotiation.

³ Under Article 50 – the formal process contemplates this negotiation starting only after the UK has agreed its withdrawal terms, although in practice negotiations on exit and the new relationship may well happen simultaneously.

Formal requirements

A new UK/EU Free Trade Agreement would need to be agreed between the UK and the EU and would then need to be ratified by all 27 remaining Member States. The UK would also need to agree new free trade deals with other countries to replace those from which it currently benefits via EU membership.

A UK/EU free trade agreement would be largely new and so, together with new third country free trade agreements, would likely take a significant period of time to finalise, so potentially increasing uncertainty.

Implications for business

Although the details are uncertain, this model could lead to an extended period of uncertainty and would be likely to result in some immediate significant changes. In particular, it is probable that there would be some (probably significant) reduction in “regulatory passporting” benefits currently enjoyed across some sectors. Controls on free movement of people would also be likely which could potentially have impacts particularly outside specialised or senior management roles.

Some of the core benefits of tariff-free trade and common principles applied in many areas may well survive, at least in some form and to some degree. In the longer term, the loss of the UK’s direct voice in EU decision-making could make it more difficult for business to press an “Anglo-Saxon” approach to regulation in EU policy development.

Free trade agreement model: Summary

No tariffs	Little change
Common standards	Reduced over time
Regulatory passport	Redefined or reduced
Trade agreements	Direct by UK
Movement of people	Set by UK (for UK) and EU (for EU)
Influence	Little specific influence
Law	Indirect some areas?
Contribution	None

Alternative 4: Full Divorce model

Background

It is possible that the UK will not wish, or will be unable, to agree any new relationship with the EU and will, eventually, leave the EU. In these circumstances, the UK's trading relationship with the EU (and other countries with whom the UK has no special trading agreements) would fall back on the structure and the default arrangements provided under the rules of the World Trade Organisation ("WTO").

WTO

WTO is an international organisation of 162 member countries.

Its main aim is to agree rules governing the conduct of international trade while reducing obstacles to trade (for example by setting limits on the maximum tariffs that countries can apply to trade in goods). However, the WTO has no provisions for free movement of labour. It also provides a forum for negotiating trade agreements and a dispute resolution process to monitor and enforce participants' adherence to WTO agreements.

The UK is a member of the WTO, not only through its membership of the EU, but also in its own right. If the UK leaves the EU the UK will continue to be a member of the WTO. Current understanding is that the UK will have to confirm to the WTO that it will maintain the EU tariffs in the short term, but that these may change over time.

Key features

The UK would not automatically be entitled to tariff-free trade with the EU or any non-EU country. This would need to be negotiated on a case by case basis. By definition, in this model the UK would have no free trade agreement with the EU so tariffs would be imposed on UK/EU trade.

There would be no requirement for UK laws or standards to align with those applicable in the EU (although the UK's exports to the EU would need to continue to comply with EU rules). Whilst initially there may be limited change, UK and EU rules would diverge over time.

It is also possible that the principle of "equivalence" might apply in respect of some regulatory activity (as it currently does between the EU and US) but it is unlikely this would go far enough to prevent the loss of current "regulatory passporting". In the absence of a free trade agreement it is also likely that the administrative burden of trade, such as paperwork and border inspections, would increase significantly.

If the UK wished to preserve the benefits of current EU free trade agreements with third countries, it would need to negotiate new agreements. In the absence of new agreements, any benefits of tariff or non-tariff barrier free trade with those non-EU countries would be lost.

The UK would set its own immigration policy and would not make a financial contribution to the EU.

Formal requirements

This model would not require the UK to agree any new arrangements – only formal exit from the EU. As such this model could be implemented simply by the UK serving 2 years’ notice to leave the EU and agreeing withdrawal arrangements.

Implications for business

This model would result in the most radical change with the likelihood of new tariff and non-tariff barriers applying to the UK’s relationship with the EU and with other countries with which the EU has existing free trade agreements. The UK would not be formally aligned with the EU in any way making it likely that UK and EU markets and regulation etc. would diverge over time.

Whilst the loss of the UK’s voice in EU decision-making could make it more difficult for business to press an “Anglo-Saxon” approach to regulation in EU policy development, the UK would be free to work with business to create a wholly distinct regulatory environment, as well as to negotiate its own free trade agreements with third countries.

Full divorce model: Summary

No tariffs	Probable tariffs between UK and EU
Common standards	Reduced over time
Regulatory passport	Eliminated or radically reduced
Trade agreements	Direct by UK
Movement of people	Set by UK (for UK) and EU (for EU)
Influence	No influence
Law	Separated
Contribution	None

Overview of alternative models and possible outcomes

This table summarises the basic models described above. In practice, the outcome of the process may well reflect an issue-by-issue solution.

	New terms	EEA	Free trade agreement	Full divorce
No tariffs	No change	No change	Little change	Probable tariffs between UK and EU
Common standards	No change	No change	Reduced over time	Reduced over time
Regulatory passport	No change	No change	Redefined or reduced	Eliminated or radically reduced
Trade agreements	No change	Change: Via EFTA	Direct by UK	Direct by UK
Movement of people	Additional restrictions?	Some restrictions?	Set by UK (for UK) and EU (for EU)	Set by UK (for UK) and EU (for EU)
Influence	No change	Outside formal structures	Little specific influence	No influence
Law	No change	Indirect not direct	Indirect some areas?	Separated
Financial contributon	Possible reduction	Reduction	None	None

Potential variations

Although the principle of these alternatives can be relatively simply stated, in reality the UK's relationships with the EU and other countries is highly complex. In assessing possible outcomes, and strategies to address the process, it is important for business to consider four particular questions:

- How will free movement of people be balanced against Single Market access? UK control of its own policy on immigration of EU nationals has been a core political theme of the referendum but there was no consensus within the “Leave” on the form or extent of controls or on the desirability and importance of the UK maintaining access to the Single Market. There also appear to be some differences of view between governments of various other Member States as to whether change in the application of the freedom of movement principle is desirable or appropriate.

If the UK is to continue to have full access to the Single Market (as envisaged in the New Terms and EEA models), the UK Government would need to accept that free movement of people would remain unchanged or the other Member States would need to accept some new restrictions on this principle. This question has, to date, proved insurmountable

in seeking to finalise Switzerland's EEA status. Unless the remaining Member States are willing to compromise or there is a further significant political change in the UK, this issue is likely to drive the UK's future relationship with the EU toward the Free Trade Agreement or Full Divorce models, which would represent the most radical change to the status quo.

- Will principles be applied consistently or variably? It is not necessarily the case that a single principle will be applied consistently across all activities. It is possible that the UK and EU could agree special treatment in some areas (e.g. mutual recognition of regulation of life sciences or financial services) without the UK remaining a full member of the Single Market. Indeed, the very preliminary implications from the UK Government's provisional working team are that the approach to the exit negotiations will likely be one which starts by taking a “pick and mix” issue by issue approach. In this context, businesses should consider how best to promote the issues most important to them as priorities in this process.

- Will there be change within the EU? The UK's referendum result has increased the level of debate within the EU as to the EU's future creating the possibility of change, either as part of a strategy to keep the UK within the Union or to reform a 27 member EU. Many of these initiatives are being examined by governments or politicians from individual Member States rather than the EU institutions themselves. Businesses should consider whether it would be appropriate to support these reform initiatives in individual Member States as well as at an EU level.
- How quickly will the process move? Any process to separate the UK from the EU will be complex as it will involve the unwinding of existing institutional, financial and legal arrangements large and small. However, finalising agreement on new arrangements which involve significant difference from those currently in place will require agreement almost certainly from the UK, EU and all member states. If the UK Government seeks a fundamentally new arrangement this is likely to be a prolonged process taking a period of several years. Business should consider whether there are some areas in which clarity can be secured at an early stage of the process to mitigate the risks of uncertainty.

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