

Part II
The Future of the Internal Market
and
its Social Dimension

Internal Market and Brexit

Paula Vaz Freire

Abstract

The economic effects of Brexit in the UK and in the EU are still uncertain. Although immediately after the referendum British GDP growth had not declined dramatically, neither did firms and consumers drastically changed their behaviour in advance of future scenarios. In the long run it's safe to say there will be reductions in trade and foreign direct investment, which will low UK living standards. In fact, living standards were already affected by Brexit, as it caused the value of the pound to decline and that in turn led to the depreciation of the terms of trade to higher inflation and to a lower real wage growth.

For the EU, as a whole, the economic effects of UK's exit may not be very significant, but they surely are very relevant to some European economies. That aspect, as well as the strategic and political importance of the UK, recommends the definition of a close economic cooperation that, nevertheless, cannot be conceived as a 'soft version' of EU's internal market.

1. Internal Market and the UK

As it is well known, since the mid 90's, the UK's development model evolved towards specialization in services, in particular, financial services. A prosperous financial hub was formed as "the financial sector has a natural tendency to form clusters and London – where English is spoken, the legal system is efficient, labour markets are flexible, and the regulatory regime is relatively streamlined – offered substantial advantages".¹

The financial market's success is inextricably linked to the UK's EU membership. Actually, the concentration of many types of wholesale financial services in the City of London began with the capital movements liberalization (under the internal market program, in the 1990s), and was

1 Daniel Gros, "The Economics of Brexit: It's not about the Internal Market", *CEPS Commentary* (2016), at <https://www.ceps.eu/publications/economics-brexit-it's-not-about-internal-market>.

fostered by the common currency, combined with the elimination of obstacles to cross-border capital flows and a global credit boom. Additionally, the European ‘passporting’ system – further assessed below – enabled London-based banks to sell their services directly throughout the EU.

The expansion of the financial services industry was one of the major economic benefits of the UK’s EU membership but at the same time led the British to reject the European project. In fact, the financial industry created few very highly paid jobs, contributing to raise income inequality, in a much more pronounced way than elsewhere in the EU; and inequality helped to fuel Brexit, by creating a widespread frustration towards globalization and the so-called ‘establishment elites’.

II. Economic Impacts of Brexit

Official institutions and independent economists have produced a considerable amount of economic studies on the consequences of Brexit.²

These studies cover a wide range of legal scenarios in the optimistic-pessimistic spectrum, but from them it can be concluded that for the EU 27 the losses are virtually insignificant (averaging between 0.11% and 0.52% of GDP for the optimistic versus pessimistic scenarios respectively); on the other hand, for the UK the losses average between 1.31% and 4.21 % of GDP for the optimistic and pessimistic scenarios respectively, or 0.13% to

2 Ian Begg & Fabian Mushövel, ‘The economic impact of Brexit: jobs, growth and the public finances’, The London School of Economics and Political Science, European Institute, London, UK (2016), at <https://www.lse.ac.uk/europeanInstitute/LSE-Commission/Hearing-11--The-impact-of-Brexit-on-jobs-and-economic-growth-summary.pdf>; Ian Begg, ‘Making sense of the costs and benefits of Brexit: challenges for economists’, *Atlantic Economic Journal* (2017), at <https://core.ac.uk/download/pdf/84310352.pdf>; R. Kierzenkowski et al., ‘The Economic Consequences of Brexit: A Taxing Decision’, *OECD Economic Policy Papers*, No. 16, (OECD Publishing, Paris 2016), at <https://doi.org/10.1787/5jm0lsvdkf6k-en>; Guntram B. Wolff, ‘The implications of a no-deal Brexit: is the European Union prepared?’, Policy Contribution Issue n° 2 (2019), at <http://bruegel.org/wp-content/uploads/2019/01/PC-2019-02-140119.pdf>.

0.41% of GDP annually.³ As an example, one of those analysis estimates that as a result of Brexit the UK may end up losing 2–3% of its GDP.⁴

The mentioned economic effects upon British economy result, mainly, from the fact that Brexit will strongly affect *foreign direct investment* (FDI) in the UK.⁵ Nevertheless, some factors will cushion the negative effects of Brexit, such as a probable depreciation of the national currency that will likely increase export competitiveness, and the strong commercial relation with non-EU markets.

As it is well known, UK's features have long made it a very important destination for FDI. The UK is a big and rich market, characterized by a strong rule of law, flexible labour markets and a highly educated workforce and all these aspects make it an attractive FDI location. Additionally, for non-EU firms the fact that the UK was fully in the internal market made it a very interesting export platform for the rest of the European countries.

After Brexit trade costs, coordination costs and compliance costs with different regulations will certainly increase, diminishing UK's attractiveness. Accordingly, some studies estimate that Brexit is likely to reduce FDI inflows to the UK by about 22%; as a consequence, it can also be expected a decrease in productivity and a fall in real income.

Two of the most important sectors in British economy will be affected: car industry and financial services industry.

The UK is now the world's fourth largest car producer but without the internal market the worst-case scenario predictions estimate a production fall of 12% (almost 180,000 cars per year) and prices faced by UK consumers raised by 2.55%, as the cost of imported cars and their components increase. This is mainly because European car manufacturers such as BMW will most probably move some production away from the UK, as it is ex-

3 Michael Emerson, Matthias Busse, Mattia Di Salvo, Daniel Gros & Jacques Pelkmans, *An Assessment of the Economic Impact of Brexit on the EU27*, European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy (2017), p. 8.

4 The estimated losses are a consequence of the exit from the single market; if the exit turns out to be a ten-year process, the losses would be borne gradually over that period, costing the UK about 0.2 – 0.3% of GDP per year, on average, see Daniel Gros, 'The Economics of Brexit: It's not about the Internal Market', *CEPS Commentary* (2016), <https://www.ceps.eu/publications/economics-brexit-it's-not-about-internal-market>.

5 Swati Dhingra, Gianmarco Ottaviano, Thomas Sampson & John Van Reenen, 'The impact of Brexit on foreign investment in the UK', Centre for Economic Performance, London School of Economics and Political Science (2016).

pected an increase in trade costs and coordination costs between headquarters and British located production plants (transfers of key staff within the firm may be harder because of migration controls; different regulatory standards can make engineering, R&D and consultancy services more difficult and expensive).⁶

Financial services have the largest stock of inward FDI in the UK (45%), constitute 8% of its GDP and generates 12% of tax receipts. In this domain, the effects of Brexit are difficult to predict, and they can't hardly be offset by expanding to other markets since there is no evidence that European regulations were a burden that hindered the UK's ability to trade with countries outside the EU. On the contrary, the negative effects of becoming a non-EU Member State seem to be significant as there is a consensus that the City became a financial hub while being in the EU. Europe is actually the world's largest exporter of financial services (making up for a quarter of world financial services exports) and half of the cross-border lending in the world is originated within the EU.⁷

A part of the financial flows – once in London – will shift to other financial centres such as Paris or Frankfurt, but it is safe to say that – probably with less vigour – London's financial services industry will survive Brexit.⁸ Many of the advantages that have made London a financial services hub will remain after Brexit, and the loss of passporting might be partially offset by the creation of subsidiaries or bridgeheads within the EU or by the principle of equivalence.⁹

The internal market for financial services is based on the EU 'passporting' system for banks and financial services companies which allows a

6 Aimin Zhang & Ran An, 'The Impact of Brexit on Motor Industry in UK', *Advances in Economics, Business and Management Research* (AEBMR), Vol. 37 (2017), 643–653. David Bailey & Lisa De Propriis, 'Brexit and the UK Automotive Industry', *NIER* (2017), at

https://research.aston.ac.uk/portal/files/23922060/Bailey_De_Propriis_final_author_copy_NIER_Nov_2017.pdf.

7 On the impact of Brexit on UK financial markets: Welfens, Paul J. J. & Fabian J. Baier (2018), 'Brexit and FDI: Key Issues and New Empirical Findings', Discussion Paper No. 241, Wuppertal: Universitätsbibliothek Wuppertal; Sapir, André; Dirk Schoenmaker & Nicolas Véron (2017), 'Making the Best of Brexit for the EU-27 Financial System', Peterson Institute for International Economics No. 17–8. Bruegel: Bruegel.

8 That will probably determine some changes in UK's growth model, perhaps through a revival of manufacturing, which has experienced decades of decline.

9 A Duillet-Margerit, M. Magnus, B Mesnard & A Xirou, *Third-country equivalence in EU banking legislation*, European Parliament, Directorate General for Internal Policies (2017).

bank based in one member of the EU to set up a branch or provide cross-border financial services in another (or in the European Economic Area (EEA)), while being regulated by authorities in the home country (home state authorization). ‘Passporting’ means that a UK bank can provide services across the EU from its UK home. It also means that a Swiss or an American bank can do the same from a branch or subsidiary established in the UK.

Loosing access to the passporting system is a huge change for Great Britain’s financial firms. As it was explained, EU internal market offers the possibility to provide regulated financial services across borders under simplified conditions: companies can apply only once for a license within the EU and then offer their services in the entire Union without additional national permits (‘EU passport’).¹⁰ Passporting is a tool for a more efficient functioning and integration of financial markets, since it reduces supervisory and compliance burdens, as well as ensure that investors—especially retail investors— all over the EU are protected in the same way.

However, without a special agreement, EU passports like all European legislation cease to apply for business activities between UK and EU jurisdictions after Brexit. In a scenario of no-deal Brexit, the UK becomes a ‘third-country’, regarding its relationship with the EU, and could eventually benefit from a specific regime. These so called third-country regimes give companies from countries that are not Members of the European Economic Area (EEA) uniformly regulated access to EU markets, so that cross-border transactions can be concluded more securely and efficiently. The most common third-country solution are so-called ‘equivalence regimes’.¹¹

10 EU passports can be granted for market participants (e.g., banking permit), products (e.g., securities prospectus) or services (e.g., marketing a fund).

11 ‘Equivalence’ refers to a process whereby the European Commission assesses and determines that a third country’s regulatory, supervisory and enforcement regime is equivalent to the corresponding EU framework. That recognition makes it possible for the competent authorities in the EU to rely on third country entities’ compliance with the third country framework which has been deemed ‘equivalent’ by the Commission. Equivalence decisions can include conditions or limitations, to better cater for the objectives of granting equivalence (...). Equivalence is primarily used to reduce overlaps in terms of regulatory and supervisory compliance in the interest of EU financial institution or market participants”: J Deslandes, C Dias & M Magnus, ‘Third Country Equivalence in EU Banking and Financial Regulation’, European Parliament (2019), p. 1. [http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614495/IPOL_IDA\(2018\)614495_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614495/IPOL_IDA(2018)614495_EN.pdf).

Equivalence is a condition that allows third-country firms to access the EU markets, if the third-country regulation meets the essential requirements of the EU regime:

‘equivalence is not a vehicle for liberalizing international trade in financial services, but a key instrument to effectively manage cross-border activity of market players in a sound and secure prudential environment with third-country jurisdictions that adhere to, implement, and enforce rigorously the same high standards of prudential rules as the EU’.¹²

Equivalence aims at reducing the risks of contagion from non-EU jurisdictions or protecting the domestic market against financial crises outside the EU. But this system involves a process of recognizing ‘equivalence’ by the European Commission and such decisions on equivalence may be revoked at short notice, that is to say, ‘equivalence’ regimes for third countries may be discretionarily activated or revoked by the Commission. This, indeed, does not offer a good amount of certainty and legal continuity for market participants.

Due to the political uncertainty concerning the Brexit process, some temporary measures have been taken in order to minimize the chaotic outcomes from a no-deal exit. In this context, the UK Government announced a temporary permissions regime (TPR) for inbound passporting EEA firms and funds that will come into effect in the event of a hard Brexit.¹³ The TPR is only relevant for firms that passport into the UK and the European Commission has so far not reciprocated with a similar regime.¹⁴

Additionally, some EU countries have taken their own measures in this area. One of the most relevant transitory regimes was created by Germany. German Parliament has adopted a bill which, *inter alia*, sets out a national

12 Commission Staff Working Document, ‘EU equivalence decisions in financial services policy: an assessment’ SWD (2017) 102 final, 5.

13 In order to take advantage of the TPR firms and funds need to make a notification to the UK Financial Conduct Authority (FCA) or UK Prudential Regulation Authority (PRA).

14 Instead the EU continues to push for UK firms to submit an application for authorisation in the relevant Member State where they wish to conduct business. In particular, the “no-deal” Contingency Action Plan of the European Commission deliberately provides for a limited number of contingency measures only (including temporary and conditional equivalence regimes for UK central counterparties and UK central depositories): Bank of England, “Temporary permissions regime”, at <https://www.bankofengland.co.uk/eu-withdrawal/temporary-permissions-regime>.

transition regime for regulated market participants from the UK in case of a hard Brexit.¹⁵ The German regulator (Federal Financial Supervisory Authority, 'BaFin') is empowered to allow the UK entities¹⁶ covered by the transitional regime, that have operated in Germany under the European passport regime so far, to continue providing certain services without a German license, for a period up to 21 months following a hard Brexit. In synthesis, the bill empowers 'BaFin' to treat UK banks and investment firms currently providing banking and investment services under the European passport regime as if they continued to hold an EU passport post-Brexit.

III. Legal Framework for UK'S 'Access to the EU Single Market'

Brexit also means uncertainty, which has always a negative impact. The British Government is planning to conclude a free trade agreement with the EU, but such an agreement can take several years and as a result, companies in the UK and Europe will lack certainty about the conditions under which they will be able to trade with and invest in the future.

The degree of co-operation with the EU27 can range from two extreme scenarios: (i) the UK would accede to the European Economic Area (EEA), or (ii) the UK would have no preferential trade relationship with the EU, with only their common membership of the World Trade Organization (WTO). In the middle ground, that relation can be similar to other bilateral agreements that exist between the EU and third countries: customs unions, free trade agreements, association agreements, stabilization and association agreements, partnership and cooperation agreements, etc.¹⁷

15 It seeks to avoid market distortions and risks to financial stability and will enter into force only in the event that the EU and the UK do not enter into a Withdrawal Agreement. Given the tax-related provisions also included, the bill is entitled "Tax Act relating to Brexit" (*Brexit-Steuerbegleitgesetz – Brexit-StBG*) <http://dip21.bundestag.de/dip21/btd/19/073/1907377.pdf>.

16 The Brexit-StBG introduces transitional rules for regulated market participants and trading venues that target the German market from the UK, namely, credit institutions, investment firms, insurance undertakings, payment institutions and electronic money institutions, regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs).

17 Michael Emerson, Matthias Busse; Mattia Di Salvo, Daniel Gros & Jacques Pelkmans, *An Assessment of the Economic Impact of Brexit on the EU27*, European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy (2017).

The shape of the agreement between the EU and the UK is still to be defined but the 12-point plan for the UK's exit, presented by British Prime Minister,¹⁸ has established some boundaries and features for future relations. Theresa May established as an objective for Brexit: '8. *Free trade with the EU: The United Kingdom is seeking the greatest possible access to the EU single market for goods and services. It is willing to make financial contributions to the EU.*' But according to the same speech, the relation with the EU is also determined by other objectives: '2. *Control over legislation: The laws applicable in the United Kingdom will be made in the UK and interpreted only by UK courts, no longer by the European Court of Justice*' and '5. *Control of immigration: The United Kingdom intends to control the number of immigrants from the EU.*'

As the internal market represents a 50 per cent share of British trade (the other 50 per cent is divided up between various trading partners such as China, India, Japan, Canada and USA), it's in the UK best interest to establish a free trade agreement guaranteeing the 'greatest possible access' to the European markets.

The internal market for *goods* is far less significant for the UK today than it was in the mid 1990s, not only because since then British economic development model shifted towards a specialization in services, but also because of a rise in Britain's non-EU exports (especially to Asia). Regarding goods, the fact that UK relies more heavily on access to world markets than on access to the EU's internal market it's accompanied by the conviction that the country can secure privileged access to those markets on its own rather than as part of the EU, because trade deals will be much easier to negotiate¹⁹. However, the UK will have less leverage in negotiations than the EU does, especially in dealing with large emerging economies.

As for the internal market for *services* things can be different, because services exported to the EU account for about 40% of the UK total²⁰. If the UK adopted a relation as the one covered by the *Treaty on the European Eco-*

18 Theresa May's speech delivered on 17 January 2017 at <https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech>.

19 Nevertheless, some political declarations state that Brexit is the opportunity for the UK to be the global leader in free trade, to build a new Prosperity Zone (with countries such as New Zealand, Singapore and Australia, who are all committed to free trade), to engage in a US-UK trade deal or in a Continental partnership.

20 Regarding financial services, the effects of Brexit can be significant, as they account for about one-third of Britain's total services exports and two-thirds of the overall services surplus that the UK needs to pay for its deficit on goods. David Blake, *Brexit and the City*, Cass Business School (2017) at

conomic Area (EEA)²¹ it would have an extensive access to the EU internal market. Companies based in the EEA can export goods to the EU, duty free or at reduced rates of duty, and offer services, including financial services, throughout the EU without having to set up an EU subsidiary ('EU passporting'). As there is no obligation of complying with a common economic policy, British Government could conclude its own free trade agreements. But this model of economic relation is incompatible with the UK's claims for full control over legislation and over immigration. Actually, EEA countries are obliged to accept all EU rules relating to the internal market (without any involvement in drafting them) and are subject to the jurisdiction of the EFTA (European Free Trade Association) Court that in turn has to base its decisions on the case law of the European Court of Justice (ECJ) (Article 3 of the Treaty establishing an EEA Court). Conversely, by accepting all the *acquis* related to the internal market EEA countries have to respect all four freedoms of the EU, including the freedom of movement.

Another way of designing the economic relationship between Europe and the UK could be based in the 'Swiss model' or EFTA model, in which the access to the EU internal market only applies to certain sectors. Considering that financial services have been almost completely excluded from market opening,²² this will not be a good solution for the UK.

A *Comprehensive Economic and Trade Agreement* (CETA), such the one EU has concluded with Canada, would provide free trade without free movement, but it doesn't provide the necessary framework for a close cooperation with the EU on foreign and defence policy as well as on combating crime and terrorism.

<https://static1.squarespace.com/static/58a0b77fe58c624794f29287/t/58ca91f8e58c62741806e682/1489670684557/Brexit-and-the-City.pdf>.

21 Since 1992, with Norway, Iceland and Liechtenstein.

22 "The main argument against the 'Swiss Model' though is the fact that the United Kingdom wants to restrict free movement. Since 2002, an agreement on free movement has been in place between the EU and Switzerland. This states that free movement can only be restricted in exceptional cases by mutual agreement. If Switzerland were to terminate the agreement on free movement in order to implement the popular initiative 'against mass immigration', this would result in the automatic termination of all bilateral agreements between Switzerland and the EU ("Guillotine Clause)": Urs Pötzsch & Bert Van Roosebeke, "Ukraine Plus" as a model for Brexit', *cep Adhoc*, (2017) p 4, at http://www.cep.eu/fileadmin/user_upload/cep.eu/Studien/cepAdhoc_Brexit/cepAdhoc_Ukraine_Plus_as_a_model_for_Brexit.pdf.

The Association and Free Trade Agreement that the EU concluded with the Ukraine (*Deep and Comprehensive Free Trade Area* (DCFTA)) seems to correspond to the British objectives: it guarantees a substantial market access without requiring the application of EU law or the compliance with the ECJ case law; it doesn't provide for free movement and allows free trade agreements with third countries. It also provides for collaboration on foreign and defence policy, as well as in combating crime and terrorism. Nevertheless, the 'Ukraine Model' contains numerous restrictions on market access particularly for cross-border services, incompatible with interests of the British finance industry.

IV. Financial Contribution

The United Kingdom has been the third largest net payer into the EU, behind Germany but almost equal to France, and it is pointed by some British politicians that one of the "advantages" of Brexit is that, being no longer a member of the single market, the UK will not be required to contribute with huge sums to the EU.

With the UK's withdrawal, the EU is likely to face a € 9 billion 'hole' in its annual budget, but at the same time, the UK declared that in exchange for the access to the EU single market it is willing to make financial contributions.

All Member States are interested in keeping the gap, caused by Brexit in the EU-finances, as small as possible because otherwise national contributions would have to increase or European expenditures be reduced. Receiving a financial contribution in connection with a trade agreement is particularly relevant for Germany and France, the two biggest net payers into the EU budget but also the countries that have a significant trade surplus *visà vis* the UK. Therefore, British willingness to pay is an additional very interesting incentive especially for those countries as they "have an interest, both fiscal and trade related in a comprehensive free trade agreement paid for with a substantial financial contribution from the United Kingdom"²³.

The amount of that contribution as a condition for a comprehensive free trade agreement can also be estimated: taking as reference amount the

23 Urs Pöttsch & Bert Van Roosebeke, "'Ukraine Plus" as a model for Brexit', cep Adhoc (2017), p 7, at http://www.cep.eu/fileadmin/user_upload/cep.eu/Studien/cepAdhoc_Brexit/cepAdhoc_Ukraine_Plus_as_a_model_for_Brexit.pdf.

contribution that Norway makes, scaled up for the size of the UK economy, this gives about € 3.5 billion. On the other hand, if the UK has simply a WTO-based relationship with the EU, then the European budget would receive additional tariff revenues, estimated at € 4.5 billion. Either way the EU will recuperate around a third to half of its loss of UK contributions.²⁴

Conclusive Remarks

Any agreement must reasonably balance the interests of all sides, and the scenario of a close economic cooperation is of course the one with larger mutual benefits.

The UK needs to preserve its relationship with the EU; but it is also very important for companies in the EU to retain the greatest possible access to the British market, as in 2015, the EU's trade surplus with the UK amounted to almost 80 billion euros.

Although the advantages of economic cooperation are huge, it cannot be ignored the UK's will to terminate being a participant in the most developed economic integration project in the world. A project of free trade and free movement, based on non-discrimination, characterized by its coherence, which justifies the EU Heads of State and Government, repeated emphasis that 'access to the single market' after Brexit will be linked to the continuation of 'free movement'.

In our view, this is the correct perspective as internal market is a 'global reality' that cannot be fragmented, and the European project is not compatible with a kind of 'differentiated integration' outside the EU legal and institutional framework.

24 Additionally, there also the issue of 'legacy costs' of the divorce with figures in the range of € 20–40 billion; there has been so far no listing of the EU's assets and liabilities, including contingent liabilities such as loan guarantees, nor explanation of the legal basis for this claim.

Michael Emerson, Matthias Busse, Mattia Di Salvo, Daniel Gros & Jacques Pelkmans, *An Assessment of the Economic Impact of Brexit on the EU27*, European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy (2017).

