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LEGATUM INSTITUTE SPECIAL TRADE COMMISSION
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Cost of EEA Membership for UK

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Much work has been done on the cost of not having "access to the single market" even though the terms "access" and "single market" are not particularly meaningful. Proposals are now being discussed which suggest that the UK should pay for access to the single market in financial services. The notion of paying for access is anathema to free trade principles of course, but there is another reason why this proposal is problematic and that relates to the UK's interest in services liberalisation with other markets.

Little has been said about the potential cost to the UK economy of remaining within the European Economic Area (EEA) or otherwise retaining single market membership through an associate membership. The reason why there is a cost associated with EEA membership is that if the UK remains within the EEA, and therefore subject to the laws and regulations governing the single market (EEA Regulation) then it will be unable to negotiate agreements on services with other countries. The reason for this is that every services negotiation is an agreement on domestic regulation, and agreements on domestic regulation require trading partners to be able to put their own domestic regulation on the table for negotiation. If the UK is bound by EEA Regulation, then it will not be able to negotiate its own domestic regulation.

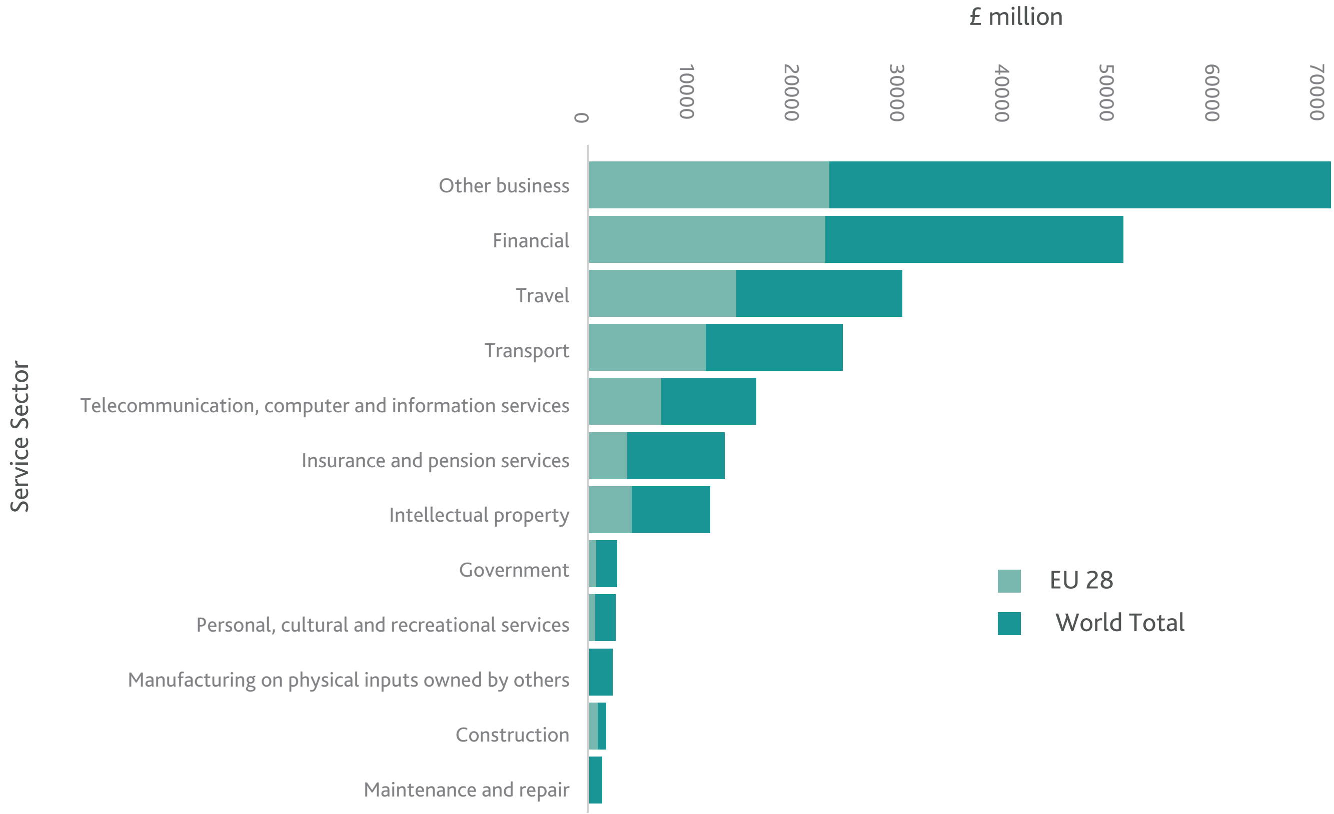
Although it may be technically possible to negotiate the very basic market access and national treatment measures in services with other countries from within the EEA, it is not possible to negotiate on the issue that is the most important in any services negotiation which is on domestic regulatory issues because the UK would be bound by EEA Regulation and therefore would be unable to negotiate.

No country would negotiate on services in this context. Thus all the gains from deeper services liberalisation for an economy with 80% services exports would be lost. The UK exports about £230bn of which about £50bn is financial services.

Interestingly business services exports by themselves amount to £70bn (greater than financial services exports). The UK imports £138bn in services of which £9bn is financial services.[1] Clearly the UK is a country which is therefore much afflicted by barriers to its services exports in markets all over the world, and financial services is only one part of the UK's overall services offering (about 25%).

Without the UK as a key demandeur for services liberalisation, the global record on services liberalisation has been very, very weak. The WTO services agreement positive schedule is full of exemptions and limitations on the market access and national treatment requirements. By way of example, there are 28 financial services exemptions to MFN disciplines among the countries that have made any commitments in financial services at all (which is only around 30 of all the members—counting the EU as one).

The record in free trade agreements is similarly weak. In financial services, regional trade agreements have a number of reservations across all modes of supply except where the agreement is between two countries that genuinely do not compete in the provision of financial services so commitments given are not actually evidence of a real commitment to open trade. At the multilateral level improvements to the GATS are so thin that a group



Above: UK Service Exports 2015 (£ million)

(Source: ONS, The UK Pink Book 2016, Chapter 9.11, 'Trade in services by type of service 2015'.)

of countries have a launched a plurilateral agreement, the Trade in Services Agreement (TiSA). But this agreement is at its Domestic regulation is in many ways the final frontier of international trade.

Anti-competitive regulation which increases the level of anti-competitive market distortions ("ACMDs") in countries thwarts the gains of the border liberalisation measures of tariff reduction/elimination. Merely having access (for example lawyers being given the right to supply cross border services) is nothing if not accompanied by market contestability (and this right for lawyers can easily be trumped by domestic rules that make it hard to practice law or increase the cost of the practice of law). This is the heart of a negotiation on domestic regulatory issues.

Services is not the only area where there would be a loss if the UK is not able to put its own regulatory system on the agenda in a negotiation. This would include areas like government procurement. However, in government procurement given that the EU's government procurement regime is more liberalising than the WTO's Government Procurement Agreement (GPA), there is probably not much else the UK would want to negotiate on its own.

REDUCTION OF REGULATORY BARRIERS AND ANTI-COMPETITIVE MARKET DISTORTIONS

As noted above, the track record on a reduction of barriers and distortions that affect the services sector has not been very strong. Many ACMDs remain—so much so that our productivity simulator that measures global distortions notes that a further 1000% Global World Product growth is still possible if all distortions are reduced to zero.[2] While this is obviously an aspirational goal and could only be achieved over a significant period of time, it does represent the inefficiencies that still plague the international economic system.

To put this in context, it should be noted that the reduction of border barriers (tariffs) resulting from the succession of GATT negotiating rounds between 1947 and 2000 led to an increase in global world product of about 1000% as compared to an approximately 100% increase in GWP in the roughly two thousand years preceding the GATT. In other words, this type of exponential and transformative growth is available again, and the notion that we are in the new normal is not actually true, although it will become so if we do not make progress reducing ACMDs.

Inside the EEA, the UK is bound by EEA Regulation. This means that a lot of European regulation that is distortive of competition also cannot be changed. Outside of the EEA, the UK would be able to remove the agricultural regulatory barriers that have plagued the EU's trade relationships with other countries. Many of these are in the realm of Sanitary and Phytosanitary measures such as bans on beef treated with hormones, poultry, and Genetically Modified Organisms to name a few. If the UK adopted a science and innovation based approach to regulation in these areas, and not the precautionary principle relied on by the EU, the UK would be much more open to agricultural trade and would be able to lower its own distortions. The gains from elimination of these kinds of barriers far outweigh the tariff and border measure gains which in agriculture would themselves be significant.[3]

GAINS TO PRODUCTIVITY OF A REDUCTION OF ACMDS

We can evaluate the gains to productivity of a reduction of ACMDs. The most likely scenario for a serious reduction of global ACMDs is to gather like-minded countries whose economic systems are broadly based on open trade, competition on the merits as an organising economic principle, and property rights protection. Such countries are more likely to agree the kind of liberalisation that reaches inside the border and deals with distortions. We have modelled these countries in the form of the platform agreement that we have discussed among a like-minded group of countries. These countries include New Zealand, Australia, Singapore, the UK, Canada, the US and Mexico—largely as a result of the fact that the NAFTA was a powerful reform document for Mexico. We have found that even if these countries merely lower their distortion by one third, this will result in a 1.5% year on year increase in overall Global World Product such that the global economy is 50% bigger in fifteen years than it would be if we remain on the same glide path as we have been on since the early 2000s.[4]

Importantly, none of these gains will be achievable if the UK remains in the EEA as in this case, no agreement can be reached on services, although agreements on the reduction of tariffs on goods could be reached. The fact that the UK is primarily a services economy puts the EEA option out of court, and means that the best pathway forward is a reduction of distortions through a series of Free Trade Agreements with a Prosperity Zone including Australia, New Zealand, Singapore, Canada, US and possibly Mexico and Switzerland as well as a comprehensive FTA with the EU. If such negotiations can be accompanied by Economic Partnership Agreements with less developed countries where the partnerships consist of the UK providing these countries with agricultural access, and no tariff escalation in exchange for regulatory reform in the developing country, which is in their interests anyway, then the gains to global growth would be magnified. If as a result of this process—which the UK is able to catalyse—there is a reduction in overall levels of distortions by one third, this would lead to an injection of 1.5% into Global World Product year on year, and a global economy that would be 50% larger than it would otherwise be in fifteen years without these gains. This growth rate is more in line with growth rates in the 1950s and 1960s. This injection of growth is highly dependent on the current impasse in international trade negotiations being unblocked so that structural reforms can be delivered, and requires other countries to liberalise, especially in their services sectors.

As the demandeur for regulatory and structural reform around the world, it is the British economy that would reap a substantial part of these significant gains.

There are also gains to be had in the UK's domestic policy. Our productivity simulator measures the delta between the current domestic environment with respect to open trade, competition and property rights protection, and identifies what the impact of distortion is on a measure of productivity, GDP per capita. In the case of the UK, the impact of distortions is around 286% which is better than most countries, but still shows that there are efficiencies to be had through a reduction of these distortions. Assuming a fifteen-year window to put in place the domestic regulatory changes that would eliminate at least one third of UK distortions, some of which would be achieved through the trade agreements proposed above, some through domestic legislation which would be possible outside the EEA, this results in an additional growth rate of around 4-5% p.a.

CAN THE CURRENT TRADE NEGOTIATING MACHINERY DELIVER THESE GAINS?

The current trade negotiating machinery is unlikely to be able to deliver the gains which we refer to here. The WTO agenda is stalled, and the higher standards trade agreements such as TPP and TTIP are in trouble. The EU has objected to the inclusion of new services in the new Trade in Services Agreement negotiations at a WTO level (TiSA). The EU has also raised issues on data protection that threaten to derail the agreement and for which reason the US has suggested that the EU should not be a participant. As a result of the difficulty of passing the CETA agreement, and the objections of local governments over the services and investment provisions, it is difficult how the EU can proceed with these. The Australian government has just withdrawn its investment suggestions from the EU-Australia negotiations. If the UK remains within the EEA, then it will be entirely reliant on the EU to negotiate agreements, and progress on those issues of importance to the UK, such as services liberalisation will be much harder to realise.

Given this, the only way that these gains can be unlocked will be for the UK to negotiate its own services deals and these are much less likely from behind the walls of the EEA.

REFERENCES

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ABOUT THE LEGATUM INSTITUTE SPECIAL TRADE COMMISSION

The Legatum Institute Special Trade Commission (STC) was created in the wake of the British vote to leave the European Union. At this critical historical juncture, the STC aims to present a roadmap for the many trade negotiations which the UK will need to undertake now. It seeks to re-focus the public discussion on Brexit to a positive conversation on opportunities, rather than challenges, while presenting empirical evidence of the dangers of not following an expansive trade negotiating path.

The STC draws upon the talent of experienced former trade negotiators from the US, Canada, Mexico, Australia, New Zealand, and Singapore, among other nations.

In the coming few months, the STC will host a number of public briefings that offer advice to key stakeholders on EU negotiations.

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All commissioners will serve the Commission in an individual capacity.

MISSION STATEMENT

The purpose of the Legatum Institute Special Trade Commission (STC) is to understand and guide the process that the UK and other governments are engaged in as a result of the Brexit referendum.

The Commission will provide the academic firepower to enable a successful process that includes

1. The UK's relationship with Europe;
2. The relationship with the countries that more holistically embrace open trade, competition on the merits as an organising economic principle, and property rights protection;
3. The bilaterals with other key trading partners;
4. The relationship with the Commonwealth and developing countries; and
5. The underpinning WTO relationship.

The STC's combined expertise and experience, spread over two hundred years and hundreds of trade agreements puts it in a unique position to be a trusted and independent advisor to the series of post-Brexit processes that could and should lead to the creation of a global economic engine.

This realises the Legatum Institute's theory of change which is ultimately driven by the need to lift the global poor out of poverty and to create jobs, hope and opportunity for the world's people through the application of property rights protection and open trade systems that are characterised by competition on the merits as the organising economic principle.

The STC's role is to help shepherd governments, stakeholders and others towards increased global prosperity which is available if the inflection point in history that the Brexit vote represents is capitalised on.