Aperiodic – n°16/065 – March 2, 2016

UNITED KINGDOM – The UK/EU deal vs Brexit alternatives

- **The deal reached between the UK and the European Union (EU) on 19 February is the maximum that David Cameron might have hoped for, in our view. Not only does it legally recognise the special status of the UK within the EU and grant new opt-outs for the UK (crucially from "further political integration into the European Union"), it brushes the limits of the fundamental principles of the EU (such as the non-discrimination between EU citizens).**
- **From an EU perspective, the deal is important because it sets a precedent other member states might be tempted to follow. Significantly, it recognises that the EU integration process of an "ever closer union" is a multi-currency, multi-speed process, which does "not compel all Member States to aim for a common destination".**
- **The deal has allowed the British Prime Minister to call a date for a referendum on EU membership (23 June 2016) and to lead the campaign for the UK to stay in the EU.**
- **In this note, we look at the legal aspects of a Brexit and the various options that might serve as a potential template for the relationship between the UK and the EU in the event of a Brexit. From the UK's perspective, all the alternatives to EU membership are inferior to the February EU/UK deal.**

A good deal for the UK, but risky for the EU

The European Council meeting on 18/19 February ended with a deal on a "new settlement" for the United Kingdom within the European Union, which allowed PM David Cameron to officially start the campaign in favour of remaining in the EU ahead of the referendum on the UK's membership of the EU. The referendum will be held on 23 June, which is good news as it reduces the period of uncertainty ahead of the referendum and avoids any additional increase in the odds of a Brexit during the summer period. As we have discussed previously, the negotiation process between the UK and the EU had been accelerating since November on the back of strong willingness among European state leaders to avoid the calamity of a UK exit and help David Cameron campaign to remain within the EU. The deal was a difficult balancing act whereby member states had to agree on further concessions to the UK which would limit as much as possible the need to make changes to the Treaties, would not breach the 'four freedoms' of the Union (goods, services, capital and people) and would not imply risks to the process of Eurozone integration and the functioning of the banking union.

The deal: what has been agreed?

Below are the main terms of the agreement, which broadly are a reiteration of the Draft decision of the European Council of 2 February. The terms are set to apply immediately after the referendum if the United Kingdom decides to remain a member of the EU:

1. Economic governance: A set of principles which outline that those outside the Eurozone should not be discriminated against, can keep their own financial supervision authorities, will not participate in Eurozone bailouts, will have visibility on Eurozone talks and may individually ask the Council to reconsider a decision without being able to veto it. The text acknowledges the need for "specific provisions within the single rulebook", which opens the door to exceptions to the uniform application of the single rulebook for non-euro member states.

2. Sovereignty: Recognition that the United Kingdom is not committed to further political integration into the EU (to be incorporated into the Treaties at the time of their next revision); a clarification of the interpretation that should be made of "ever closer union", which is seen as "compatible with a different path of integration" and does "not compel all member states to aim for a

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

common destination"; a 'red card' for national parliaments, which would allow 55% of the EU's national parliaments to object to draft legislation when it comes to issues of subsidiarity.

3. Migration and access to welfare: (1) An "alert and safeguard mechanism" that would allow, provided it was authorised by the Council, a member state to restrict access of newly arriving EU workers to non-contributory in-work benefits for a total period of up to four years from the commencement of employment. This 'emergency brake' would apply for a period of seven years. (2) A statement that limits the exportation of child benefits to children living in other EU countries by indexing them to the standard living of the receiving country; this measure would be applicable to existing claims to child benefits starting from 2020.

4. Competitiveness: This was the least contentious issue. It contains commitments to "implement and strengthen the single market", as well as to lower administrative burdens and compliance costs on economic operators, especially small and medium-sized enterprises. However, these statements lack objectively measureable targets.

We think that David Cameron secured the maximum concessions he could, given the strong opposition from a couple of countries to key pillars of his demands in the area of sovereignty, economic governance and migration. The most contentious reform proposals were: (1) the set of measures that is likely to imply some degree of discrimination from European citizens in terms of access to welfare (Poland, Hungary, Czech Republic and Slovakia were the most vocal opponents); (2) the 'red card' for national parliaments (initially rejected by Belgium); (3) the measures relative to the effective management of the banking union (with France seeking assurances against any measure that might equate to a veto for the UK 'via the back door' and special treatment for the City of London); and (4) any measure which might be seen as contrary to the principle of "ever closer union" (eg, the position of Belgium and Luxembourg, both very attached to the idea of federal union).

Despite all the sticking points, the European partners of the UK finally agreed with David Cameron on most of the reforms he outlined in his November letter. This highlights the political will among other member states to help David Cameron lead the campaign in favour of continued EU membership.

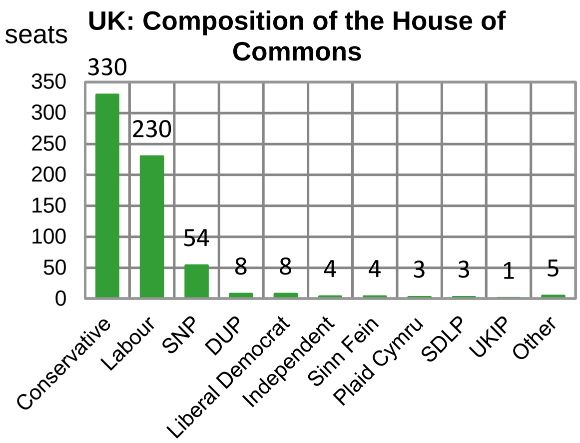
In brief, the agreement confirms the existing opt-outs of the UK (euro, Schengen, area of freedom, security and justice), establishes an opt-out by the UK from any further political integration of the EU and reinforces the special status of the City of London (right to keep its own authorities within the banking union, a differentiated treatment within the single rulebook). From the perspective of the rest of the EU, in our view the most important agreement, though often seen as rather symbolic, is the one which formally allows for several levels and speeds of integration within the EU, by stipulating that "the references to an ever closer union among the peoples are therefore compatible with different paths of integration being available for different member states and do not compel all member states to aim for a common destination".

The UK reaction to the deal

Key political figures have joined the pro-Brexit campaign

The deal on the new settlement of the UK within the EU has allowed the British Prime Minister to reassert his pro-European stance, arguing that a Brexit would be "a step into the dark", with no certainty over the trading arrangements the UK would ultimately enjoy. Crucially, the Conservative Party is highly divided: according to press reports, 150 Tory MPs – about half the parliamentary party of 331 MPs – are now expected to back the Brexit. On 22 February it emerged that 18 mainstream MPs are to join the Brexit campaign, including the energy minister Andrea Leadsom, the defence minister Penny Mordaunt, the justice minister Dominic Raab, the environment minister George Eustice and the employment minister Priti Patel.

Two very popular political figures, Michael Gove, justice secretary, and Boris Johnson, mayor of London, have officially declared they would campaign against the Prime Minister. Additionally, Nicola Sturgeon, First Minister of Scotland, has reaffirmed her commitment to another referendum on independence for Scotland if the English vote to withdraw from the EU.



Source: UK Parliament, Crédit Agricole S.A.

Businesses in favour of EU membership

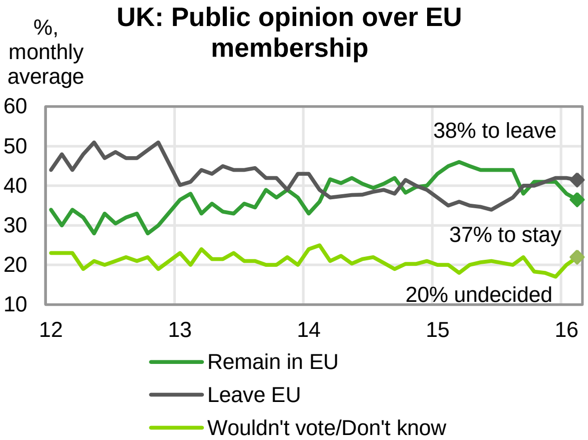
The heads of 36 FTSE 100 companies – and 162 other businesses – have signed an anti-Brexit

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

letter, including Royal Dutch Shell, Asda, Marks & Spencer and BT. At the same time, this implies that about two-thirds of the FTSE 100 have not signed the letter. However, this does not necessarily mean that their heads are pro-Brexit, they might simply not wish to "make any form of political statement", according to Cameron.

Polls remain close

Several polls showed a sizeable swing towards 'leave' after the draft UK-EU deal was published. The YouGov poll had shown a rise of 5 points in the lead of the 'leave' camp, but this was reversed in the days following the 19 February deal; according to the latest YouGov poll (23 February) the 'remain' and 'leave' camps are neck and neck, with the percentage of 'undecideds' having climbed to 25%, which is the highest in two years.



Source: YouGov, Crédit Agricole S.A.

As the campaign evolves in the coming days and weeks, polls are likely to continue to move considerably, but we see little chance of a major shift in favour of the 'remain 'camp, meaning that the uncertainty of the outcome would remain elevated until the referendum.

The probability of a Brexit

We continue to think that the probability of a Brexit is less than 50%. First, we believe that the undecideds have a high level of propensity to vote for the status quo at the time of the crucial vote. Polls overestimated the probability of Scottish independence ahead of the Scotland's 2014 referendum and also failed to predict the majority gained by the Conservatives at the May 2015 general election. Both were cases where the polls had underestimated the willingness of the British people to vote for the status quo.

Secondly, Euroscepticism does not necessarily mean being pro-withdrawal. This view has been corroborated recently by new research led by NatCen Social Research. It found that two-thirds of the public can be regarded as Eurosceptics – nearly the highest level since the survey started in 1992 – but less than one in three voters (22%) are 'inflexible' Eurosceptics, i.e. who believe that Britain should 'withdraw' from the EU "even when presented with the option of backing a less powerful EU". Instead, the majority of Britons merely want the EU's powers to be reduced. Overall, the research found that 60% of Britons favoured remaining in the EU, with 30% wanting to withdraw. The research suggests that the key determinant of the voters' preferences (to stay or to leave) is the economic prospects of a Brexit, which overwhelms considerations about any impact on UK identity or cultural consequences for about half of the people that declare themselves concerned about those issues.

The legal framework of a Brexit

The mechanics of a Brexit

Article 50 of the Lisbon Treaty, which came into force in December 2009, introduced the possibility for an EU Member state to exit the EU. According to its provisions (see **box**), the UK could decide to trigger the exit procedure unilaterally, i.e., without the need for an agreement from other member states. Upon UK notification to the European Council of its intention to leave, negotiations would begin between the UK and the EU in order to establish a withdrawal agreement. The latter would be concluded by the Council, acting by a qualified majority, after obtaining consent from the European Parliament.

The date of the UK's withdrawal from the EU would be the date of entry into force of the withdrawal agreement or, if negotiations failed, two years after the notification of the UK's decision to the European Council. If a withdrawal agreement could not be concluded during this period of two years, which is highly likely, the Treaty allows for an extension of the negotiations, but this requires unanimity from the European Council.

During the negotiations for the withdrawal agreement, the UK would legally remain a full member state of the EU. The EU Treaties would continue to apply to it. However, the UK would not be allowed to participate in the discussions concerning its future withdrawal agreement.

Article 50 of the Lisbon Treaty

"1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority[1], after obtaining the consent of the European Parliament.

3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it. A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.

5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49."

The UK Prime Minister has confirmed that if the British people vote to 'leave' he would plan on triggering legal exit procedures immediately. This helps to rule out a case whereby David Cameron would try to renegotiate the deal after a 'leave' vote at the referendum and propose a second referendum.

It is in the EU's interests to find an agreement which limits as far as possible the disruption to economic activity resulting from a Brexit, given the high level of integration of many European countries with the UK in various aspects of activity (trade, production chains, foreign direct investment, mobility of people), but also due to shared policy objectives with the UK. To be sure, an agreement which provides the same degree of access to the EU market as the current one is highly unlikely. This is especially true for the services sectors, and even more so for the financial sector where regulation is extremely complex and where the EU registers a trade deficit with the UK.

Jean Claude Piris from the Robert Schuman foundation[2] has argued that the capacity of the UK to secure large access to the single market shall not be exaggerated because the trade surplus of the EU with the UK is concentrated in two countries (Germany and the Netherlands), which make up more than half of the EU trade surplus with the UK, whilst a qualified majority is required at the European Council in order for the withdrawal agreement to be signed.

Source: IMF, Crédit Agricole S.A.

However, trade is obviously not the sole channel through which a Brexit would impact EU member states. A broad spectrum of metrics needs to be taken into account when assessing the exposure of EU countries to the UK including investment, financial and migration links, but also the degree of alignment with UK policy objectives and the level of dissatisfaction of the local population towards the EU. Take the Austrian example. For economic and financial purposes, breaking the ties with the UK would not be a crucial event. However, considering the high percentage of EU negative perception by Austrian people (41% according to EU Barometer December 2015) a Brexit might be politically significant.

The legal options of a Brexit

Below we discuss the pros and cons of the various existing options that could be used as a template for the potential withdrawal agreement for the UK. It appears that none of these options would be satisfactory for the UK and each of them comes with major drawbacks when compared to the EU/UK deal on which the UK will vote.

- ✓ **European Economic Area (EEA) membership**[3] (the case of Norway, Lichtenstein and Iceland)

If the EU proposes to the UK to join the EEA agreement, this would give the UK tariff-free access to the single market (goods, services, capital and persons). The UK would not be committed to EU policies such as agriculture,

[1] According to Article 238(3)(b) of the Lisbon Treaty, a qualified majority shall be defined as at least 55% of the members of the Council representing the participating Member States, comprising at least 65% of the population of these States.
[2] For a more detailed analysis see, "Should the UK withdraw from the EU: legal aspects and effects of possible options", Robert Schuman Foundation, 5 May 2015

[3] The European Economic Area comprises the 28 EU Member states and three of the four Member States of the European Free Trade Association (EFTA): Iceland Norway and Lichtenstein.

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

fisheries, judicial affairs, foreign policy, etc. The 'four freedoms' of the EU would continue to apply as if the UK was a member of the UK.

The main drawback of this option is the obligation to comply with all EU legislation relative to the single market without having the right to influence its content, because EEA countries do not participate in the EU legislative process. For instance, Norway has no representatives at the European Council, the European Parliament, the European Court of Justice and its 'right of refusal to implement EU legislation' is quite difficult to put into practice. Those countries also have to implement social, employment and environmental policies, and contribute to the EU budget.

Consequently, EEA membership is not an attractive solution for the UK. It is difficult to imagine the UK accepting to commit to new EU legislation concerning the single market, including financial sector rules, free movement of people, etc, without having any say on it. Furthermore, an obligation to comply with EU rules on social and employment policies would not be accepted by the UK people, for whom immigration is the principal source of concern.

- ✓ **Follow the Swiss example and conclude bilateral agreements with the EU**

This option would allow the UK to participate in specific sectors of the single market via bilateral agreements with the EU. However, it would be impossible to conclude a comprehensive framework in such a short timeframe of two years. Switzerland, a member of EFTA since 1972, has concluded more than 120 agreements with the EU throughout two rounds of negotiations, which took around ten years to be established and applied.

The major drawback of this option from the UK's point of view would be the partial access to the single market. Crucially, Switzerland has no agreement with the EU on financial services, except on non-life insurance. This obliges Swiss banks to establish subsidiaries in an EU member state, which implies higher costs for the banks. EU financial services regulations add significant barriers to accessing the single market.

The complexity of the legal framework governing the relationship between the EU and Switzerland, the limited access to the single market of financial services while having to accept the free movement of persons suggest that that the UK is unlikely to follow the Swiss example.

- ✓ Negotiate **a Free Trade Agreement with the EU**

This option comes with major hurdles, which substantially limit its attractiveness for the UK. It has been demonstrated that none of the existing EU agreements with third countries is as comprehensive as the UK would wish. Additionally, even if such an agreement were concluded, the UK would still have to apply EU legislation at least relative to the sectors of the single market to which it has access, without having any say on it. Last but not least, the UK would have to re-establish its own trade agreements with the rest of the world, while having a much weaker negotiating position than the EU (currently the EU has around 200 free trade agreements with third countries and associations).

- ✓ Negotiate **a Customs Union** with the EU (follow the example of Turkey)

This option would only give access to the single market of goods, not services. The UK would have to apply the customs tariffs concluded by the EU with third countries, without any ability to influence them.

- ✓ A hard exit from the EU (the UK becoming a third country to the EU under the rules of **the World Trade Organisation (WTO)**)

The UK would regain full sovereignty under this option in the areas of internal and foreign affairs. In terms of trade, some sectors (eg, automobile, chemistry, food and tobacco) would see significant customs tariffs applied to their exports to the EU. While the UK would lose its tariff-free access to the single market, its exports to EU member states would still have to conform to EU standards. Vis-à-vis the rest of the world, the UK would also cease to benefit from the preferential EU tariffs with third countries, and would benefit from the clause of the "most favoured nation".

There is no better alternative to the UK's "new settlement" within the EU

The deal that was reached between the UK and the EU on 19 February offers the maximum David Cameron might have hoped for, in our view. Also, in terms of the trade-off 'sovereignty/access to the single market', the deal is superior to any plausible solutions that might be open to the UK in the event it votes to leave the EU. It is extremely difficult to imagine the EU granting full access to the single market without imposing its common rules and surveillance from the European authorities. A UK-tailored withdrawal agreement, whereby the UK keeps similar access to the free market to currently while choosing only the EU policies which are in its interests, would be very difficult, not to say impossible to negotiate.

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

As the UK would remain a full member of the EU during the negotiation period of the withdrawal agreement, this provision of the Treaties would limit the initial disruption of activity as businesses would continue to operate as usual. Nevertheless, a Brexit would initiate a long period of uncertainty regarding the long-term relationship between the EU and the UK, which would badly hurt the economy. A comprehensive withdrawal agreement would likely take more than two years to be established.

We believe that, as the campaign gets underway in the coming weeks, more emphasis would be put on the superiority of the February EU/UK deal to the alternatives to a Brexit. Our best-case scenario remains consistent with the UK voting to remain a member of the EU at the referendum scheduled for 23 June 2016. ■

Crédit Agricole S.A. — Group Economic Research
12 place des Etats Unis – 92127 Montrouge Cedex

Publication Manager: Isabelle Job-Bazille - **Chief Editor:** Armelle Sarda
Information center: Dominique Petit - **Statistics:** Robin Mourier
Sub-editor: Véronique Champion
Contact: *publication.eco@credit-agricole-sa.fr*

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