

**SPECIAL TRADE
COMMISSION**



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The Brexit Inflection Point The Pathway to Prosperity

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ABOUT THE 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.

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Cover image: David Davis (Secretary of State for Exiting the European Union) and Michel Barnier (European Chief Negotiator for Brexit). Brexit negotiations, Brussels, Belgium. 19th June, 2017.

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FOREWORD



During the build-up to the momentous referendum last June, the Legatum Institute was neutral on the issue of Brexit, and our team—from our core staff to the experts on our Special Trade Commission—held a range of views on which outcome would be best for Britain.

During the months after the referendum there was a real need to understand why people had voted the way they had. To bring understanding in this confusion, we focused our energies on reuniting the nation through our document *48:52: Healing a Divided Britain*.

This is not a moment for infighting; the people of the UK have voted to leave the European Union, and we need to unite to achieve the best possible Brexit, one that puts this country on the pathway to greater prosperity and provides a positive future for all young people and for generations to come. Though much of recent debate has been fractious, we believe that in March 2019 we have an opportunity to embark on a prosperous new era in the history of this great nation.

Brexit presents the UK with a once-in-a-generation opportunity to re-imagine Britain's role in the world in the 21st Century; to embrace a global role for Britain, one that is open and inclusive, that creates growth and jobs and encourages innovation and enterprise.

But this future is not inevitable. Delivering this over the coming months and years will be an enormous challenge, but it is essential that our relationship with the EU throughout the negotiations remains what it has always been: one of partnership. And partnership should also be our focus at home. We owe it to all the people of Britain—regardless of how they voted in the referendum—to achieve the best deal possible: one that enables the UK to embrace a new, global vision, inspiring the next generation to fulfil their potential.

Brexit will be a defining moment in the history of our nation. But I believe that if we come together to seize the opportunities it presents, it can become a pathway to greater prosperity—our legacy for future generations.



Baroness Philippa Stroud
CEO of the Legatum Institute

EXECUTIVE SUMMARY

Historically, the British system of free trade made Britain, Europe and the world richer. The EU system that has replaced it—of protectionism and harmonised regulation—has constrained economic growth for Britain and the world. There is now a brief opportunity for Britain to restore her freedom to trade, liberalising the global trading system itself.

But for the UK to be fully independent in its capacity to trade, it must be fully independent politically. This paper outlines what is needed in an interim period and beyond for the UK to be able to make independent trade deals having left the EU, reflecting the will of the British people expressed in the referendum on 23 June 2016.

We describe what is at stake: how the UK and the world will benefit from trade liberalisation, but conversely how failure to secure the right terms in the interim will leave the UK without the leverage needed to secure the right trade deals, placing it in a permanent rule-taking position, only halfway out of the EU.

THE INTERIM

Britain's government has stated that it will implement an interim period, to minimise disruption for businesses, that will follow Britain's formal date of exit from the EU on March 30th 2019.

This paper argues that the nature of this interim arrangement is vital for Britain's ability to resume its place as an independent trading nation. However, many of the options currently being proposed would prevent this.

First, the interim arrangement must make clear what will replace it; it must be an implementation period towards an established destination. Without this, any potential trading partners will assume we will not be in full control of our trade afterwards. Trade leadership requires demonstrating this. It should also last a maximum of two years.

This destination requires control in two areas: we call these customs and regulations.

In the first area, the known end of the interim must be tariff-free trade. The Common External Tariff (CET) can be maintained as a transitional measure so businesses need not prove they meet Rules of Origin during this time; otherwise there should be a zero-for-zero tariff agreement, before a Free Trade Agreement (FTA) is agreed by the end of the interim period. This FTA needs to include liberal Rules of Origin (preferred, or if not a waiver of Rules of Origin based on a temporary alignment of the UK tariff to the Common External Tariff), expedited customs arrangements, and commitment to reduce anti-competitive barriers.

In the second area, future regulatory flexibility must be ensured. Any agreement to maintain harmonised regulations within the interim must allow divergence afterwards—without this we will have only partial freedom to negotiate with other countries. This requires a mutual recognition agreement (MRA) or sector-specific MRAs. However, these MRAs need to be in place by the beginning of the interim period, allowing Britain’s government and business to devise new regulations to be implemented freely after this period. It will take early discussion of these areas for the financial settlement to be achieved.

For an FTA to be possible afterwards, the period must also mean no membership of the Customs Union, EEA or EFTA, and freedom to negotiate all future tariff schedules with third countries.

THE IMMEDIATE ACTION

This requires action now by the UK government, including:

- » Moving to substantive negotiations as soon as possible—leverage is much higher *before* exit.
- » Taking the lead in World Trade Organisation (WTO) membership and explaining why the UK and WTO members now share a trade liberalising agenda.
- » Enhancing domestic regulatory bodies to be capable of MRAs with the EU and others.
- » Instructing UK customs agencies to talk to EU member state counterparts and enhance domestic business awareness.
- » Evaluating and expediting US-UK, NAFTA and TPP agreements and accessions.

Taking the right decisions now will allow the UK to embrace the world as an independently trading sovereign state; the wrong decisions in the name of short-term stability will render the UK a rule-taker, bypassed in trade negotiations. From the low-income consumer who pays unnecessarily high food bills because of tariffs; to the developing world producer whose products these tariffs prevent from entering our market; to the innovative entrepreneur who cannot sell their product because technical standards have been set by incumbents, often abroad: the opportunity to restore our trading independence represents an opportunity to turn poverty into prosperity for all.

INTRODUCTION: OUR TRADING FUTURE IN THE BALANCE

The United Kingdom was once the great free-trading nation. The prosperity that has been bestowed on the United Kingdom as a result of free trade can be reclaimed once more.

The EU system of trade—including tariffs, but also its control of regulation—has presented challenges for trade for Britain and the world. Trade protection has prevented millions in the world’s developing countries exporting to the UK market, and pushed their people deeper into poverty. At home, misconceived EU regulations make British firms less innovative, deciding what they can and cannot produce. Global economic output is slowing, the share of GDP made up by trade is falling, productivity in developed countries is down. Continuing on this path will push more and more people into poverty.

The alternative now awaits. A century ago, Britain was the “free trade nation”, a cause that brought crowds of tens of thousands to the streets in its defence, being vital both to the livelihoods of Britons and to the economic miracle Britain gave the world in the century to 1914. But in the century since, our trade—and the world’s—has been subsumed into a restrictive system that creates poverty. The global economy is essentially stuck.

We argue that the EU system of trade and internal regulation—including tariffs, but also its prescriptive rule-book approach to regulation—has damaged the EU, Britain and the global economy. Global supply chains suffer from regulatory distortions that destroy wealth.

The systematic reduction of trade barriers in the WTO and its predecessor, the GATT, is vital to world prosperity. But no large global trade round has closed for twenty-three years, longer than at any time in GATT history. Non-tariff barriers, especially anti-competitive regulation, are on the rise.

Britain once again has the opportunity to help lift millions out of poverty and unleash the suppressed innovative capacity of its economy, demonstrating global leadership for free trade. The UK should understand that any interim period which removes control of tariff schedules and regulatory flexibility entails a significant risk to the execution of the UK’s independent trade policy.

The right decisions are now urgent: this paper is a guide to what to do.

OUTLINE OF THE PAPER

The aims

A fundamental change of course for Britain and how it trades with the world requires the right decisions now.

We outline that to drive competition, productivity and equality at home, and rejuvenate free trade abroad, a UK-EU FTA needs to mean: zero tariffs on all products (replicating the existing situation), liberal Rules of Origin with cumulation, expedited customs arrangements, a commitment to eliminate anti-competitive regulatory barriers, services liberalisation, and commitments on the mutual recognition of regulation. This will also allow much-needed regulatory divergence from the EU.

At the same time, we must acknowledge that staying within the EU is not conducive to allowing our firms and people to operate in pro-competitive free markets. Increasingly the EU has embraced anti-competitive regulation.

The world has become one of competing global supply chains, and supply chains move quickly to jurisdictions that promote competition and have better regulatory frameworks. This means the UK does not face a binary choice between trade deals with others versus trade deals with the EU: this should be understood in the round, as part of an independent trade policy delivering unilateral, bilateral, plurilateral and multilateral freedom of action. With the UK outside the Customs Union, supply chains will re-orient over time, which is not possible as long as the UK maintains the Custom's Union's Common External Tariff (CET), or agrees to regulatory control.

This capacity of supply chains to move and adjust creates economic benefits. To be made more efficient, more of them will flow through the UK because of its better regulatory environment—if we are able to create it, and have it recognised by the EU.

The immediate actions

The UK's leverage is much higher *before* the exit date. The first priority is to move on to the substantive negotiations as quickly as possible. The UK government then needs to move the discussion to the WTO terrain which is more favourable for them, by requesting joint notification with the EU to the WTO of intent to negotiate an FTA. Early WTO notification means more leverage, as EU resistance would cause difficulty to other WTO members, who will be concerned about their own "cliff edges" with the UK. A financial payment to the EU is also extremely important: this is a card the UK government holds until a deal is done.

Other immediate actions are:

- i. Instruct UK customs to talk to member state customs agencies for inter-operability.
- ii. Have HMRC develop and support trusted trader programmes and other simplifications for UK business to facilitate customs compliance.
- iii. Ensure WTO membership is kept aware of UK steps using the WTO Embassy in Geneva.

The interim

In seeking to execute independent trade policy, we must differentiate between ability to negotiate agreements and the likelihood that countries will actually negotiate: the UK is an interesting prospect for trade if after any interim agreement we can immediately execute independent trade *and* domestic economic and regulatory policy, negotiating with third countries *during* the interim.

The length of the interim period is therefore less important than what is in it. Independent trade policy cannot mean only partial freedom to negotiate with third countries during this period: for example, uncertainty over membership of the Customs Union (where we would not control tariff schedules) or the Single Market or EEA (with limited domestic regulatory control) is not tolerable for countries contemplating negotiations.

Negotiating a UK-EU free trade agreement is not like negotiating *ab initio*: both sides operate without tariff barriers, and erecting tariffs would go against the 2016 commitments at the G20 for tariff “roll-back”. However, while the stated policy of the UK government is to leave the Customs Union and Single Market on day one of Brexit, interim proposals are now being floated to remain in the Customs Union, part of it, or join EFTA and accede to the EEA Agreement. This is very dangerous: the EU will use such uncertainty to maximise its leverage, while other trading partners will re-focus their energies on the EU. The UK will lose its opportunity for trade leadership at the WTO, and the consequences will be serious.

This means that in the interim (as per the WTO notification that we recommend) the UK will need:

- » An FTA with zero for zero tariffs—on all product lines.
- » A Rules of Origin arrangement; customs arrangement including electronic system inter-operability and trusted trader programmes mutual recognition agreements (MRAs) for regulation and an agreed mechanism for monitoring and managing divergence while maintaining recognition.

The economic context

To understand the importance of these actions, we should understand the economic context as the UK embarks on the Brexit process.

Growth in measures of economic output and wealth creation has fallen significantly since even before the Global Financial Crisis. As Figure 1 illustrates, there was relatively strong growth in the IMF’s index of industrial production for advanced economies in the mid to late 1990s. Output fell in the wake of the 2001 recession, since when rates of growth have been subdued. This situation has worsened since the financial crisis, with little or no growth in industrial output (a strong measure of real wealth creation). In the five years preceding the crisis, the average annual growth rate for advanced economies was 2.4%,¹ compared to an average of 0.9% after 2010.²

In this context, with the right decisions Brexit can mean a fundamental change of course, both for Britain and the system of trade in the world. If Britain follows this path, it can execute an

¹ In the IMF’s Index of Industrial Production.

² IMF (2017), “Prices, Production, Labor and Population”, available at <http://data.imf.org/?sk=6AC22EA7-E792-4687-B7F8-C2DF114D9FDC&slid=1439776194766>, accessed March 30, 2017.

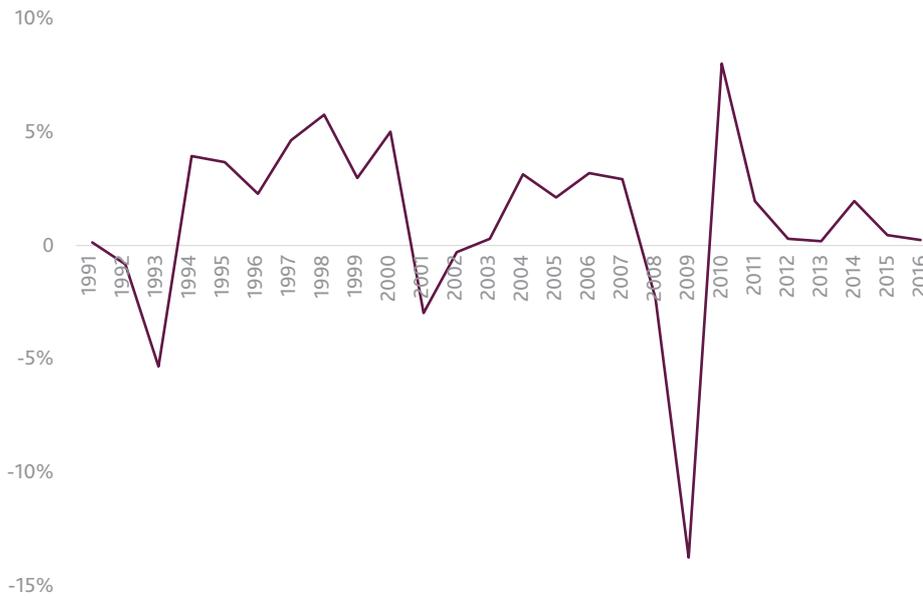


Figure 1: Index of Industrial Production: Growth Rate of Advanced Economies

Source: IMF (2017)

independent trade policy as laid out in our trade policy blue print,³ beginning a new free-trading era of global economic growth.

An FTA with the EU, while doing away with the inflated prices that tariffs create, as well as reducing behind the border barriers and regulatory restrictions, means Britain can drive competition and productivity at home, reduce inequality, and rejuvenate free trade abroad, including for the poorest. A good UK-EU agreement will also allow regulatory divergence from the EU: rather than a race to the bottom, this will allow a more competitive environment with better regulation, maintaining consumer safeguards and improving consumer welfare.

We will now outline in more detail what the UK government needs to do urgently; we then describe our Key Findings, the elements that we suggest are the central goals of negotiation, including how we progress through Phase One to Phase Two negotiation, and the requirements and risks of an interim solution.

³ Shanker A Singham *A Blueprint for UK Trade Policy* April 2017 (available at www.li.com/activities/publications/a-blueprint-for-uk-trade-policy)

1. WHAT TO DO NOW

- The UK should notify WTO members (preferably jointly with the EU) of its intention to negotiate an FTA.
- Resistance to this by the EU would cause difficulty for all other WTO members, who will be concerned about their own “cliff edges” with the UK and will note the UK’s proactive stance.

Beginning at the WTO, the UK needs to frame its case by explaining that making the global economy more prosperous over the long-term requires the urgent liberalisation of world trade.

To begin, UK notification of WTO members will make it necessary for the EU to cooperate in this sphere, then produce a joint document spelling out the interim measures which both parties seek, and for which business can plan. Notification at the WTO at the earliest possible moment will create more leverage for the UK, and present business with actual choices they can analyse (also giving them the chance to provide useful input). It allows a quicker understanding among businesses that a lengthier interim period after Brexit could mean being rule-takers with no benefits from the execution of an independent trade and domestic regulatory policy, but with profound risks and consequences.

The goal must be to make meaningful progress on a trade deal by March 2019. The UK’s negotiating leverage will be much higher before exit: although it may pay a relatively large sum to secure the deal we need, being able to do so is an important card the UK holds.

Assuming the UK and EU are substantially on the way to a trade deal by March 2019, they will need (as per the WTO notification) interim measures agreed as follows:

- a. FTA with zero for zero tariffs—on all product lines.
- b. Mutual recognition arrangements.
- c. Rules of Origin based on change in tariff classification (the EU standard) with cumulation (a standard position for the EU in its FTAs).
- d. Customs arrangement including electronic systems inter-operability, trusted trader programmes, and trade facilitation measures.
- e. Regulatory recognition and dual regulatory coordination (DRC) mechanisms for key sectors like financial and digital services (including adequacy determinations for data protection).⁴ These measures will be critical for the eventual comprehensive trade agreement in any event.

⁴ 'A new UK/EU relationship in financial services—A bilateral regulatory partnership' at <https://lif.blob.core.windows.net/lif/docs/default-source/publications/1702-0036-broc-legendum-financial-report.pdf>

To secure agreement on the above in London and Brussels, and ensure the prosperity that can be unlocked if the UK is able to act as a trade leader, it must do the following:

1. Explain why WTO members and the UK now share a trade liberalising agenda.
2. Not allow itself to be bound by the EU's negotiating mandate. This is structured such that neither party will get what it wants: in particular, the EU won't get its cash, because the financial settlement won't work if the framework for the future trade and financial relationship is not known. If the UK puts constructive proposals on the table (even if it needs to do so through the issues of the Irish border and financial settlement), and the EU continuously rejects them, other countries will raise the pressure on the EU.
3. Demonstrate the costs to key EU businesses of no trade deal or no interim measures.
4. Use that data to ensure lobbying of regional leaders and other politicians in the EU who are likely to see unemployment effects in their districts; encourage lobbying by local businesses, and direct lobbying of Brussels by major businesses; and continue to work with member states to influence Brussels.
5. Work with supply chain managers in third countries like Japan and the US to encourage Brussels to work with UK proposals; help shift their lobbying from London to Brussels.

Immediate action items domestically to create momentum on trade

As an urgent matter, the UK government must:

1. Instruct UK customs to talk to member state customs agencies and work on customs declaration services (CDS) implementation and inter-operability with the EU-27. Despite some EU member states' customs agencies being unable to discuss these, the UK government must ensure this happens.
2. HMRC should develop and support trusted trader and self-assessment programmes with UK business around the country with a well-resourced communications strategy, online and on the ground.
3. Develop suitable customs arrangement to be presented in the interim to the EU to avoid requirement for customs declarations at all as an opening position.
4. Ensure that WTO members are kept aware of steps the UK is taking, using the WTO Embassy in Geneva as lead communicator.
5. Enhance domestic regulatory bodies so that they are capable of MRAs with EU and others.

Immediate action items externally

Externally, we should:

1. Expedite and evaluate the possibility of US-UK bilateral FTA and/or NAFTA accession (on the basis that existing EU agreements with Canada and Mexico will have to be discussed in any event).
2. Evaluate TPP accession (assuming it is a live agreement in April, 2019) or, if not, P4+1 accession, plus drafting of new investment and financial status chapters.
3. Exchange notes with EU's external trading partners for the continuation of existing FTAs, prioritising major trading partners, including EFTA members.
4. Ensure that the UK, and not the EU, now presents to WTO partners on tariff-rate quotas (TRQs), and aggregate measurement of support (AMS) proposals.

2. KEY FINDINGS

The Key Findings (A-D) explain the proposed central goals of negotiations with the EU, and how to get there. The following sections then outline how these Key Findings can be achieved, and give more detail on the UK's approach. These Key Findings are:

- A. The End State—what the FTA should look like.**
- B. Navigating the journey from here to the End State—what the interim state should look like.**
- C. Ensuring the End State discussions are initiated via the three Phase One issues:**
 - a) Bridging the gap on financial settlement.
 - b) Bridging the gap on the Ireland & Northern Ireland issues.
 - c) Bridging the gap on citizens' rights.
- D. Creating the leverage that allows the End State negotiations to start.**

A. THE END STATE—WHAT THE FTA SHOULD LOOK LIKE

1. Zero tariffs on all products (replication of existing situation).
2. A customs chapter including expedited arrangements, business facilitation measures, risk management and inter-agency cooperation/information sharing.
3. Deeper liberalisation in services across market access and national treatment.
4. Deeper liberalisation on conditions of competition. A commitment on both sides to eliminate regulatory barriers that are anti-competitive must be a demand of the FTA.
5. Deeper services liberalisation, especially in newer areas like digital trade.
6. Deeper liberalisation in the form of regulatory cooperation based on the principle of dual regulatory coordination to manage divergence; these measures would be more comprehensive than any FTA currently in existence.
7. Extensive commitments to recognition (MRAs) in the areas of technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS).
8. High standards of intellectual property rights protection.
9. Investment protection.

B. NAVIGATING THE JOURNEY FROM HERE TO THE END STATE —WHAT THE INTERIM STATE SHOULD LOOK LIKE

In the interim state there may also be a series of separate agreements (on, for example, nuclear material, aviation, etc.) which would apply from day one, and could extend well beyond the end of the interim period. More generally, interim key elements include:

1. Interim measures will also be necessary if there is no FTA by March, 2019.
2. Zero for zero tariff deal under GATT Article XXIV.
3. MRAs for conformity assessment and market surveillance.
4. Customs arrangement under GATT Article XXIV.
5. Rules of Origin arrangement or waiver of Rules of Origin assuming an alignment of the CET for a period.
6. Interim arrangements should avoid EEA or EFTA membership.

C. ENSURING THE END STATE DISCUSSIONS ARE INITIATED VIA THE THREE PHASE ONE ISSUES:

According to the EU's negotiating mandate, the three Phase One issues are the issues where the Council must find sufficient progress has been made to proceed.⁵

a) Bridging the gap on financial settlement

The first step on the journey from here to the End State requires us to explain that, although the UK has no legal obligation to pay anything, the solution to the financial settlement discussions must include elements of payments which the UK will agree to make to the EU (but from which the UK taxpayer will ultimately gain), and which allow the EU to maintain that leaving the EU will cause the member state leaving to pay for doing so.

The payment methodology could consist of the following trade-related areas:

1. **The WTO rectification process.** The EU is at risk in the negotiation of the import quotas (Tariff Rate Quotas (TRQ)) in agriculture. As part of the separation between the UK and the EU, both parties will have to agree with other WTO members what their import quotas should be. To the extent that the UK leaving the EU will present the EU with WTO cases brought by TRQ partners, the UK could offer to partially indemnify it for those losses.
2. **The interim period: regulatory recognition.** To the extent that both the UK and EU need to use each other's infrastructure to operate regulatory recognition mechanisms, the UK could pay towards the costs of those mechanisms, potentially at a premium to reflect inconvenience to other member states and EU institutions.

⁵ See also the Council guidelines: <http://www.consilium.europa.eu/en/press/press-releases/2017/04/29-euco-brexite-guidelines/>

3. **The interim period: upgrading facilities by the UK and EU.** If, for example, member state customs agencies must re-tool and upgrade, it is reasonable for the UK to pay for this for a limited period.
4. **The interim period: continued sectoral regulation.** If certain UK sectors wish to remain within the remit of a specific EU regulatory body, the UK could pay a premium amount for this privilege, and may levy these payments to the industries that wish to maintain these regulatory relationships, to avoid the UK taxpayer being required to pay for this element. Affected UK industries can evaluate whether this makes sense for them, with regard to a) cost; b) direction of travel of EU regulation for which the UK will be a temporary rule-taker in the interim period; and c) the interest of the industry in being in a better global regulatory environment which may be forestalled by these measures.

b) Bridging the gap on the Republic of Ireland/Northern Ireland issues

Our recently released paper on the Irish border⁶ includes proposals for solving the border-related questions posed by Brexit, in particular the movement of goods and people. These questions can only be answered in the context of the End State discussion.

c) Bridging the gap on citizens' rights

The Government has now made a reasonable and detailed offer on EEA citizens exercising treaty rights in the UK. The EU reaction has been to require the rights of EU citizens under UK immigration law to be adjudicated by the European Court of Justice, which no other country in the world allows, and which would effectively imply two legal classes of citizens. This means the UK now needs to proceed unilaterally to make relevant offers on immigration on a case by case basis, and not conditional on reciprocity from the EU.

The UK should now make an offer that all EU citizens currently exercising Treaty rights will have the right to remain in the UK and be treated just as UK citizens are, with no more and no fewer rights. It will be challenging for member states not to do the same for UK citizens in their states.

D. Creating the leverage that allows the End State negotiations to start

The UK should:

1. Start negotiating with other countries and evaluate the potential for accession to other larger plurilateral arrangements such as TPP and NAFTA.

Such an action does not violate the duty of sincere cooperation; indeed, there is a strong argument that were the European Commission to object to the UK taking steps to negotiate and conclude FTAs with non-member states which come into force *after* the UK's exit from the EU, it would be going beyond the boundaries of the duty of co-operation expounded in the judgments of the European Court of Justice to date. It is also hard to justify any policy

⁶ *Mutual Interest: How the UK and EU can resolve the Irish border issue after Brexit.* Shanker Singham, Austen Morgan, Victoria Hewson and Alice Brooks. Legatum Institute, September 2017, available at https://lif.blob.core.windows.net/lif/docs/default-source/default-library/irishborder_brexitwebc1a552ff15736886a8b2ff00001f4427.pdf?sfvrsn=0

reason for wider application of the co-operation duty. Steps taken to provide for the future prosperity of a withdrawing member state after exit do not damage the economic interests of the Union and are neither insincere nor un-co-operative. In fact, there is a strong reason to regard them as positively supportive of the EU treaty objective under Article 8.1 to promote an area of “prosperity and good neighbourliness”. The EU’s objectives are to promote not merely economic cohesion benefiting from external trade treaties within its territories, but an area of prosperity extending outside the EU to its neighbours. As much as member states have a duty to co-operate and to respect the Union’s competences, the Union and other member states have an equal duty of co-operation with members going through the process of withdrawal; each must expect to be treated with sincere co-operation before withdrawal, and neighbourliness and friendship afterwards.⁷

2. Jointly notify with the EU to WTO members in some form the parties’ intent to negotiate an FTA with agreed WTO-compatible interim measures (this could be informal notification to the membership instead of full notification under Article 24). These could also form the basis of “early harvest” measures which business could rely on (assuming also that negotiation in good faith is agreed to by the EU and will be committed to in the Withdrawal Agreement). This commitment and a timetable for full terms to be implemented is required under GATT Article XXIV. Failure by the EU to comply could be a violation of the duty of sincere cooperation.

The following sections outline how the Key Findings can be achieved.

⁷ See Francis Hoar, *The United Kingdom’s Right to Negotiate Free Trade Agreements Before Leaving the European Union*, October 2016 (available at www.lawyersforbritain.org/files/uk-right-to-negotiate-free-trade-agreements-before-leaving-eu.pdf)

3. THE BREXIT PRIZE

SUPPORTING KEY FINDING A: The End State—what the FTA should look like.

The UK has a tremendous opportunity before it to restart global trade negotiations: these have been stalled for over two decades, holding back prosperity for Britain, the British consumer, and for our trading partners and their people. In doing so, it can markedly improve its own position as the world's second biggest exporter of services, and the world's fifth largest economy. In order to do this however, the UK must be free as quickly as possible to be able to execute its own independent trade policy and its own domestic economic and regulatory policy. While it does so, it must seek to minimise any disruptions that arise from leaving the EU.

- » In seeking to execute an independent trade policy, we must differentiate between having the ability to negotiate agreements, and the likelihood that countries will actually negotiate with the UK.

If the UK is locked into the European regulatory system too deeply, then it will find that other countries will experience the same difficulties negotiating with it as they find negotiating with the EU, even if they can officially enter into trade agreements as a matter of law.

3.1 THE UK-EU RELATIONSHIP: WHAT IS THE GOAL?

- The goal is a comprehensive end state agreement to which any interim measures must lead.

As both sides have made clear, it is their joint intention to have an End State where there is a comprehensive free trade agreement between the UK and EU.

Although the average time for negotiating a free trade agreement is twenty-eight months (eighteen months for the US),⁸ there are many reasons why the UK and EU could negotiate more quickly than this, given that the starting point is UK membership of the EU in its Customs Union and Single Market arrangements. The negotiating mandate which the EU has put forward, however, does not allow meaningful negotiation of the future trade relationship until sufficient progress has been made on the financial settlement, Ireland and citizens' rights. This will leave a much shorter timeframe, which increases the likelihood that by March, 2019, there will be no free trade agreement in place. In this event, there will have to be some interim measures in place to make sure that trade is not disrupted upon leaving the Customs Union and the EU.

⁸ Peterson Institute for International Economics, 2016. <https://piie.com/blogs/trade-investment-policy-watch/how-long-does-it-take-conclude-trade-agreement-us>

However, it is vital that we consider the End State first, to make serious progress towards it before determining the interim measures that might be necessary in the period between exit and the conclusion of the ultimate free trade agreement.

3.2 STARTING POINT FOR UK-EU NEGOTIATIONS

- The current environment is without tariff barriers.
- Domestic regulations imposed by the EU could thwart trade.
- Our regulatory system will be identical on Day 1 of Brexit.

It is the stated policy of the government that the UK will be leaving the Customs Union and the Single Market, and EEA, on the day of Brexit.⁹ The challenge that the UK and EU both face is to make sure that on the day of Brexit, they minimise the disruptions that they will cause, and to ensure that their people are able to seize the opportunities for increased prosperity that Brexit offers.

» Given that the starting point is that the UK is within the Customs Union and Single Market, negotiating a free trade agreement should not be unusually difficult: the process will not be like negotiating a free trade agreement with another country *ab initio*, as both sides currently operate in an environment with no tariff barriers, and face limited regulatory restrictions as a result of the European Economic Area. It must be the aim of government to continue a zero-tariff trade agreement with the EU, and to ensure that regulatory barriers are minimised.

Typically in trade negotiations, vested interests need to be overcome in order for one country to convince another to reduce tariffs, remove regulatory protection or lower other forms of behind the border market distortions. The existing tariff-free and harmonised regulatory environment means that such interest groups are fewer, and in fact businesses are more likely to argue for zero tariffs and lower regulatory barriers.

The oft-stated view is that this cannot happen smoothly because the EU cannot afford to have a successful former member state: but such a goal would obviously be short-sighted, and in Prime Minister Theresa May's words, an act of self-harm. The momentum for services trade is towards making sure that domestic regulations on either side do not thwart the flow of services trade that already occurs.

Brexit means we must take advantage of opportunities while minimising disruptions; since it is inevitable that there will be some disruptions as the UK leaves the EU, it is critical for the future of the country that we take full advantage of the opportunities.

⁹ See the Prime Minister's speeches, inc.: <https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech>; and the Article 50 Notification Bill

3.3 ENSURING THE UK CAN HAVE AN EFFECTIVE INDEPENDENT TRADE POLICY: DUAL-FACING REGULATION AND INTER-OPERABILITY

- In order to be able to inter-operate with the world, the UK must have domestic regulatory control.

The UK must not allow an independent trade policy that provides only partial freedom of negotiation with third countries. For example, Turkey, with its partial customs arrangement with the EU, has an independent trade policy to the extent that it can negotiate with other countries. However, because it is in a partial customs union, it must accept the outcomes of the EU's negotiations with other countries for access to the Turkish market, then negotiate separately with these countries for access to theirs—with a major loss of leverage. If the UK was in any comparable position, it would find itself attempting to negotiate services liberalisation and regulatory changes (the most difficult areas for agreement with other countries), with nothing to trade off. This means it would be unlikely to obtain any agreement that lowers regulatory barriers in other countries, which is critical for UK services exporters.

As a major services provider, the great global challenge facing the UK is to create a more competitive legal and regulatory context, to allow service providers more success globally. Success here can also improve consumer welfare, expanding economies and lifting people out of poverty.

The world now has two broad regulatory systems. The first is the principles- and effects-based system generally applied in common law countries; the second the prescriptive rules-based system found in civil law jurisdictions such as continental Europe (although such rules-based systems are by no means limited to Europe, with a more opaque version in China, for example).

- » Trading without barriers with both systems means that the UK must be able to “inter-operate” with them, by having dual-facing regulation. This will also be required for standards, where Mutual Recognition Agreements (MRAs) will be vital—as they are for regulations.

The challenge is therefore to agree regulatory recognition between the UK and EU on the basis that the regulatory systems meet the same objectives, even if the detail of technical regulation diverges. The WTO Agreement on Sanitary and Phytosanitary Measures (the “SPS Agreement”, which covers measures relating to animal and plant health and risks arising from diseases carried by animals, plants or products derived from them) compels recognition of other members’ SPS regulations even if they are different, as long as it can be objectively demonstrated that they meet the appropriate level of SPS protection.¹⁰ The WTO agreement on Technical Barriers to Trade (the “TBT Agreement”, which covers technical regulations in relation to all goods) also requires that members “give positive consideration to accepting as equivalent technical regulations of other Members, even if these regulations differ from their own, provided they are satisfied that these regulations adequately fulfil the objectives of their own regulations”.¹¹ Under the General Agreement on Trade in Services (GATS), where a WTO member has accepted a commitment in a service (and many members, including

¹⁰ SPS Agreement article IV and see also SPS Committee's Decision on Equivalence

¹¹ TBT Agreement article II

the EU, have accepted broad commitments including in financial services) there are a number of disciplines on how regulations are administered and requirements on licensing and qualification requirements and technical standards.¹² The GATS provides for WTO members to be able to recognise the regulations of other countries (including specifically prudential measures in financial services)¹³ without violating the MFN principle. Where recognition is given to one country it must be made available to other countries that meet the same criteria.

The GATS, the TBT Agreement and the SPS Agreement, require and encourage reference to, and development of, international standards to inform decisions as to equivalence and appropriateness of the relevant regulations,¹⁴ so there is a firm footing in existing WTO rules to make further progress in these areas.

However, there are two approaches to reaching an agreement on regulatory recognition between the UK and the EU. The first is to seek recognition at the point of departure when the EU and UK systems are identical. The form of the relationship would then be governed by the WTO framework, or, preferably, an agreement that builds on the WTO disciplines to manage the divergence and continue coordination and cooperation. The second is to continuously seek recognition through a system of consultation, similar to the EU/Switzerland bi-lateral framework. The latter would effectively prevent the UK from having its own truly independent trade and regulatory policy.

If the UK and EU are able to create the former mechanism, this will create a leading example for trade agreements worldwide, and for meaningful future services disciplines that cover the issue.¹⁵ This would be a major contribution to the global economic architecture.

3.4 WHY OTHER COUNTRIES FIND IT DIFFICULT TO NEGOTIATE WITH THE EU

- The EU's prescriptive approach is at variance with a principles-based regulatory system.

For most countries, negotiating trade agreements with the EU presents special challenges. The principal difficulties that other countries face are in agriculture, where the EU is highly protectionist, and in standards and regulatory issues, where the EU applies a restrictive version of the precautionary principle.

This prescriptive rule-book approach is fundamentally at variance with the principles-based approach used by many countries with the common law tradition. The prescriptive approach delineates which activities are legal, but often operates on the assumption that if it is not described in the regulation then it is illegal. Principles-based regulation meanwhile is interested in the ultimate effects of a regulatory framework on the market but is agnostic about how parties achieve the objective.

Principles-based regulation is generally favoured by international trade rules. For example, WTO rules on technical barriers to trade and sanitary and phytosanitary measures broadly require mutual recognition of different regulatory systems, as long as the end goal of regulation is the same—even where there are technical differences in the regulation itself.

¹² GATS Article VI

¹³ GATS Article VII and paragraph 3 of the Annex on Financial Services

¹⁴ See for example GATS article VII (5), TBT Agreement article II and SPS Agreement article III.

¹⁵ Regulatory cooperation chapters are becoming key provisions in modern trade agreements. For example, Canada has requested that the NAFTA re-negotiation with the US and Mexico include a deeper regulatory cooperation mechanism so that domestic regulatory systems do not act as trade barriers.

There is no binary choice between trade with others versus trade with the EU. Outside the Customs Union, supply chains will re-orient, which is not possible as long as the CET is maintained. This capacity of supply chains to move is what creates the economic benefits: to be made more efficient, more of them will flow through the UK because of its better regulatory environment—if we can create it and have it recognised by trading partners. New Zealand’s former trade minister Sir Lockwood Smith has described how the re-orientation of New Zealand’s dairy supply chain is a classic example—even though New Zealand lacks an EU FTA, it controls its tariffs and domestic regulation.

When the UK joined the EEC, over half of New Zealand’s dairy exports were destined for British shores. To compensate for reduced exports, *“We thought you had to protect emerging industries, so we ended up in a vicious cycle of tariffs and import licencing... and within a decade we had done huge damage to the New Zealand economy [which became] so dislocated from the marketplace that we started turning frozen sheep-meat into fertiliser—thousands of tonnes of it. We had a wine lake in New Zealand.*

“In 1985, a new Government simply eliminated those subsidies and started opening up our economy to the international marketplace [using] a global trade strategy based on the four pillars”, despite predictions it would drive down wages and regulatory standards.

“The New Zealand sheep industry [was] once so protected [that] the subsidies got up to 90%. Those subsidies were wiped that same year, in 1985. Today we produce a similar weight of lamb from less than half the number of sheep. It requires 23% less land and has led to a 19% reduction in greenhouse-gas emissions... 33 years later a lamb is now cut into 42 different cuts, plus by-products, and marketed across 100 different countries around the world. The productivity has improved 107%”. This has been possible because New Zealand has had control over its regulations: “That is the value of unilateral liberalisation.”

Meanwhile, producing just 3% of the world’s milk, New Zealand cannot grow its economy with its own milk alone, so must add value to other countries’. For example, one New Zealand-Netherlands joint venture exports lactose, a by-product of Dutch cheese production; another joint venture in the UK turns this into galacto-oligosaccharide and produces whey, two vital ingredients of infant milk formula and other milk products; these are shipped to New Zealand and sold in products around the world. *“We produce only 3% of the world’s milk, yet we control over a third of all international trade in dairy products”.* The most important pillar of all is therefore the multilateral pillar at the WTO.



The UK must therefore be able to regulate differently from the EU in areas like standards and regulatory issues. If it is locked into the EU regulatory model, it will not be able to make the adjustments necessary in order to sign comprehensive free trade deals with other countries, nor will it be able to lead in the WTO and other multilateral fora.

We now analyse the necessary interim measures—as well as the opportunities each interim arrangement takes off the table and how these may be kept for us—to understand how they affect the End State with the EU.

4. INTERIM ARRANGEMENTS: THE REQUIREMENTS

SUPPORTING KEY FINDING B: Navigating the journey from here to the End State—what the interim state should look like.

4.1 IF NO FTA IS COMPLETED BY THE TIME OF BREXIT, WHAT IS IN THE INTERIM IS MORE IMPORTANT THAN ITS DURATION

- No measure in the interim period should take an opportunity for the UK off the table; though the focus is rightly on leaving the EU, the question of whether the UK can create the new trading relationships it requires to generate future prosperity is also of fundamental importance.
- Delay or lack of clarity will reduce UK leverage.
- EU refusal to recognise an independent UK regulatory system could violate WTO rules if that system is designed to achieve the same end goals as the EU's.

If no agreement is concluded on leaving the EU in March 2019, the disruptions caused by leaving the Customs Union and Single Market could be significant, and have a detrimental impact on prosperity, unless the UK can unilaterally find ways to minimise them.

One of the major arguments made by third countries is that they cannot seriously engage in negotiations unless they know what the UK will 'be' on 30th March 2019. The government's settled policy has so far been clear. The UK will be out of the Single Market and Customs Union, negotiating an FTA with the EU (with interim measures to minimise the disruptions caused by leaving the EU Customs Union and Single Market). EU law will have been carried into domestic law, so the regulatory baseline at the exit date will also be broadly known. This is a level of certainty that most countries do not have as they negotiate trade deals, and so they cannot use uncertainty about what the UK will be in two years as a reason not to start a serious negotiation. This also applies to the processes the UK is currently engaged in at the WTO to rectify our schedules.

However, any uncertainty in connection with membership of a customs union (in which the UK would not have control of its tariff schedules), or the Single Market, EEA-, or EFTA-type arrangements (which would limit the UK's regulatory authority) will not be tolerable for countries contemplating negotiations with the UK.

There is an additional danger that the EU will sense an opportunity to maximise its leverage in the face of such uncertainty. Our other trading partners will re-focus their energies on the EU and not on the UK, and our opportunity will be missed.

If the interim arrangements are such that the UK may continue to be locked into European regulatory systems, then when it is time to negotiate with others the UK will find that it does not have the requisite flexibility to do so. The UK will also find that it is unable to be a meaningful participant in the WTO, and trade leadership in global institutions will be imperilled, while the government will have lost any leverage with the EU to secure a deal that is in UK interests. There is a genuine danger that the only avenue at that point will be to request a return to EU membership, but this will be on negative terms (for example the budget rebate would likely be lost, and we would be in a rule-taking position). This would also create the appearance that once countries join the EU, they can never leave.

There has never been any serious doubt that: 1) the UK government is seeking an exit agreement; and 2) with or without a full trade deal having been agreed at the exit date, the government will seek interim (or implementation) arrangements to minimise trade disruptions caused by leaving the Customs Union and the Single Market. These interim measures would include a zero tariff agreement (plus requisite Rules of Origin) which is WTO compliant.¹⁶ On the basis that laws and regulations will be harmonised on the day of Brexit, interim measures should include maximum regulatory recognition. WTO rules on TBT and SPS measures¹⁷ mean that it could be a violation for the EU to cease recognising UK product and SPS regulation and conformity assessment requirements (which will be identical to those in the EU at the point of Brexit). Similar controls also apply (to a lesser extent) in services.¹⁸

These interim measures, however, are considerably different from some of the proposals now being floated to remain in the EU Customs Union, or part of it (which is legally unfeasible from the perspective of WTO rules¹⁹ and EU law²⁰) or join EFTA and accede to the EEA Agreement for a limited time.

Apart from the problem that such arrangements would have to be negotiated with EU and EFTA partners and cannot simply be expected as a *fait accompli*, there are fundamental problems within the EEA Agreement (as there are with EFTA membership without acceding to the EEA), which may have been overlooked (discussed below).

4.2 WHAT INTERIM ARRANGEMENTS WOULD BE NEEDED?

- Any interim arrangements must allow for the immediate implementation of an independent trade policy.
- The alternative is a rule-taking position, with the UK trapped half-in and half-out of the EU.

¹⁶ GATT Article XXIV (4 & 5)

¹⁷ WTO Agreement on Technical Barriers to Trade Articles 2.7 and Article 6 (*inter alia*) and WTO Agreement on the Application of Sanitary and Phytosanitary Measures Article 4

¹⁸ For example, GATS Article VII

¹⁹ GATT article XXIV requires customs unions to cover "substantially all trade"

²⁰ The Customs Union is established by the treaty on the Functioning of the EU and covers EU member states only. At best, it would be necessary to negotiate a separate customs union, as the EU has done with Turkey.

The central features of any interim arrangement are to minimise disruption, and that the UK should be able immediately upon exit to execute an independent trade, and domestic economic and regulatory policy. If the UK is unable to do this from day one, it risks becoming locked into the EU regulatory system, such that it cannot negotiate meaningfully with the rest of the world on a bilateral, plurilateral or multilateral basis. It thus risks being unable to improve its own domestic regulatory system to be more pro-competitive, and miss the opportunity to allow our businesses to increase the UK's national prosperity through more innovation, meaning better products and more successful exports.

The UK is an interesting prospect for trade with other countries to the extent that it is able to diverge from the European approach to regulation—the prescriptive rule-book approach—and pursue a more open, liberal system of regulation. This would be in line with its common law tradition. It is also what other countries expect.

Trade negotiations are like triage. The way to proceed is to determine what action will not do harm, and to ensure that no steps are taken that would cause irreparable damage to the process. Therefore, this paper focuses next on what the UK government should not do (to ensure it does not take opportunities off the table), then looks at concrete and immediate recommendations. Time is vital, and the government must regain the initiative, rather than being subservient to an EU calendar which, in our opinion, does not fit either the UK or the EU's objectives.

5. INTERIM ARRANGEMENTS: THE RISKS OF EEA, EFTA & CUSTOMS UNION

SUPPORTING KEY FINDING B: Navigating the journey from here to the End State—what the interim state should look like. and **KEY FINDING C:** Ensuring the End State discussions are initiated via the three Phase One issues

The fundamental logic has not changed: to maximise the opportunities of Brexit, the UK must have control over tariff and services schedules, and full regulatory control. The opportunities also allow improvement in the domestic regulatory environment, and for the UK to lead global trade and its institutions in a pro-competitive direction, agreeing deals with other countries both bilaterally and by acceding to existing large trading arrangements. We have described this elsewhere as a four-pillared independent trade strategy: this means pro-competitive freedom unilaterally, and the capacity to sign bilateral, plurilateral, and multilateral trade agreements: all interdependent elements of a trade policy that creates rather than constrains prosperity (see below, and Shanker A. Singham, *A Blueprint for UK Trade Policy*).²¹

The tests of a good interim solution, to be in operation either before an FTA with the EU is implemented or pending completion of trade negotiations, are:

1. How much it mitigates disruptions.
2. How much it impacts opportunities.

We also set out at the end of this section a range of scenarios, from no deal to membership of the EEA and a customs union, indicating their mitigating qualities and their threat level with a 'Red/Amber/Green' analysis.

5.1 HOW TEMPORARY EFTA MEMBERSHIP TAKES OPPORTUNITIES OFF THE TABLE

- EFTA prevents regulatory divergence and does not solve the market disruption issues.
- It therefore renders the UK unable to negotiate properly on trade.

Since the EEA Agreement itself was signed in 1994 by the EU and three EFTA states (Norway, Iceland and Liechtenstein), either remaining in the EEA or a customs union (or both) means removing control over tariff schedules and regulations. Inability to remove tariffs or make regulations more

²¹ Shanker A Singham *A Blueprint for UK Trade Policy* April 2017 (available at www.li.com/activities/publications/a-blueprint-for-uk-trade-policy)

competitive means the inability to create a better environment for trade, and is likely to mean that no trading partner will want to negotiate with the UK.

The EFTA Convention also requires the members to take on all EU technical barriers to trade (as noted elsewhere). Even temporary EFTA membership however limits the UK's ability to execute an independent trade or domestic regulatory policy. This is because the EFTA Convention (the 1960 founding document of EFTA) was revised into a new form at Vaduz, Liechtenstein, in 2001 (now "the Vaduz Convention"), to include the following provisions:

- » Annex H, Article 2 provides for a complex mechanism of notifications wherever an EFTA member intends to regulate in ways that diverge from either European standards or international standards.
- » For Switzerland, under Annex I, Article 4, Swiss equivalence to EEA regulation is accepted only *after* the EU and Switzerland agree that Swiss law is equivalent (which has to be done on a case by case basis).

In practice, for the UK this would require the government to revert to the EU every time it wished to signal to a trading partner that it could change a regulation, rendering the UK unable to carry out genuinely independent trade negotiations. This is the reason Switzerland's agreements with other countries are focused on tariffs where it has complete authority, but present it with little opportunity in technical regulation or services, where the UK is the second biggest exporter in the world.

Furthermore, EFTA membership does not by itself solve any of the market disruption issues related to leaving the Customs Union or the EEA. These can only be solved by agreement (the Swiss for example have Single Market access through a series of agreements where they agree to be part of the EU rule-book, and have also committed to the four freedoms as well as membership of the Schengen system). The gains of EFTA membership are the relationships the UK would then automatically have with EFTA members. A better approach would be to agree an interim zero tariff and mutual recognition arrangement with EFTA (similar in scope to what will be required with the EU) with a view to a full FTA as soon as possible. Since the UK is a major trading partner with the EFTA countries, there is strong mutual incentive to achieve this, and it has been endorsed by the president of Switzerland.²²

5.2 HOW EEA MEMBERSHIP OR BEING A PARTY TO THE EEA AGREEMENT TAKES OPPORTUNITIES OFF THE TABLE

- EEA mandates all EU technical regulations.
- This leads to a rule-taking scenario without delivering an independent negotiating capacity.

We have discussed in various reports²³ why remaining in a customs union with the EU, or in the EEA, is not consistent with an independent trade policy, and therefore prevents the UK capturing the opportunities of Brexit. Even on a temporary basis, remaining in either of these arrangements (even assuming the EU and the EFTA states would allow it), would effectively send a signal to other

²² www.swissinfo.ch/eng/post-brex-it_switzerland-is--open-to--britain-rejoining-efta/42609748

²³ For example Shanker A Singham and Victoria Hewson, *Brexit, Movement of Goods and the Supply Chain*, February 2017 (available at www.li.com/activities/publications/special-trade-commission-brexit-movement-of-goods-and-the-supply-chain) and Singham A *Blueprint for UK Trade Policy*

countries that the UK is not available for bilateral or multilateral trade agreements or unilateral actions. While countries can justify a two-year wait for preliminary negotiating exercises before concluding an FTA, signalling a lack of serious intent to begin negotiating in earnest risks changing the calculus dramatically.

The EEA Agreement (which EFTA members signed with the EU and its member states in order to be members of the European Economic Area) essentially means membership of the Single Market and commitment to the four freedoms—free movement of goods, services, capital and workers. The EEA Agreement has been proposed as a transition stage for the UK after exit, but while joining the EEA Agreement could minimise disruption in the context of the UK's relationship with the EU, it would profoundly curtail the freedom that would be required in order to be a credible partner in trade negotiations with other countries.

In particular, like the EFTA Convention, the EEA Agreement incorporates all EU measures on technical barriers to trade, but goes further than EFTA, also incorporating SPS measures. Given that the EEA Agreement applies to all EU and EFTA states except Switzerland, and any others which in theory could join the Agreement, as the EFTA secretariat describes, this means:

"The EEA Agreement extends the Union's internal market rules to the three EEA EFTA States. This comprises the entire body of technical regulations determining the requirements products need to fulfil concerning safety, consumer protection, health and the environment, as well as the procedures for testing conformity with such requirements. The Convention incorporates the rules established under the bilateral agreement between Switzerland and the EU in this area, as well as the corresponding provisions of the EEA Agreement."²⁴

Of course, the EFTA states are not part of the Customs Union or subject to the common commercial policy and enter into FTAs with other countries either in their own right or as a bloc. However, once again, the FTAs are very limited in scope and focus mainly on goods and tariffs. With respect to non-tariff barriers and services, they generally do not go beyond affirming the parties' existing WTO commitments and some hortatory language on co-operation. Compare, for example, EFTA's agreement with Canada²⁵ and the EU's comprehensive FTA with Canada (the Comprehensive Economic and Trade Agreement "CETA"²⁶). CETA covers services, investment and goods, and includes provisions on technical barriers to trade and SPS measures, which EFTA states would not be able to agree to as they are not in control of their regulations in these areas, which are passed to them from the EU. There is little or no flexibility for the EFTA states under the EEA Agreement. The four freedoms are indivisible and regulations that implement them must be complied with.

The history of the EEA Agreement has shown that the EFTA states that are parties to the agreement are rule-takers, and must take on the Single Market acquis, but they have no vote on the legislation and only consultative input on its formulation. The potential for EFTA countries to use the EEA Agreement's provisions to block regulation has never been carried out, for good reason: the EFTA parties to the EEA Agreement have no formal access to the Council or Commission, and only limited access to the Commission's relevant groups and committees.²⁷

²⁴ Short Overview of the EFTA Convention www.efta.int/legal-texts/efta-convention/detailed-overview-of-the-efta-convention#tbt

²⁵ Free Trade Agreement Between Canada and the States of the European Free Trade Association (Iceland, Liechtenstein, Norway And Switzerland), signed January 2008 available at www.efta.int/free-trade/free-trade-agreements/canada

²⁶ Available at ec.europa.eu/trade/policy/in-focus/ceta/index_en.htm

²⁷ See for example the testimony of Dr Johanna Jonsdottir, Policy Officer in the EFTA Secretariat, on 25th April, 2012 the House of Commons Foreign Affairs Committee, available at www.publications.parliament.uk/pa/cm201314/cmselect/cmfa/87/87we02.htm

What happened to Norway when it attempted to refuse to adopt the third Postal Services Directive is instructive. After initially declining to implement the directive under Article 102, Norway was threatened with sanctions under the EEA framework which included loss of cooperation on mobile roaming, harm to Norway's fishing industry, or ejection from the EEA altogether. Eventually, in November 2013, Norway agreed to adopt the directive and signal that it would accept future directives and regulations.



Many have claimed that Section 102 of the EEA Agreement allows an EFTA member to avoid taking on EEA rules it does not like. However, since the EEA Agreement is the agreement providing preferential access to the Single Market, and since market access issues are linked, triggering Article 102 gives the EU the right to take retaliatory measures to reflect the non-compliance of an EFTA member who declines a measure. This is in practice why the EFTA countries have never used this power. For the UK it would mean that every time it wanted to change its baseline legislation, as in place at Brexit, for domestic policy reasons or as part of a trade agreement, the consent of the EEA Joint Committee would need to be sought, and if it did not agree to the amendment (which, if it meant a divergence from the *acquis*, seems inevitable) the EU would be in a position to trigger retaliatory measures against UK trade.

The EU itself has recommended that in cases where there are disagreements on the incorporation of the new EU *acquis* into the EEA Agreement (such as when EFTA members are not implementing it sufficiently quickly), the EU should ensure that the part of the EEA Annex which would be ultimately suspended is done in such a way that it would be to the detriment of the partner's interests.²⁸ The Commission has also recommended strengthening the EFTA Surveillance Authority and Court so that they function as a mirror to the EU authorities. The EFTA Surveillance Authority was established through the EEA Agreement with the EU, and the EFTA Secretariat itself states: "the EFTA Surveillance Authority and the EFTA Court [respectively] mirror the surveillance functions of the European Commission and the Competences of the Court of Justice of the European Union".²⁹ This means harmonisation of regulation, not management of divergence.

If the UK finds itself a rule-taker, the EU would be in a position to enact a host of regulations that the UK had blocked in the past. In this event, the UK would be disadvantaged by the new regulations, but still dependent on the EU, having been locked out of agreements with other countries.

²⁸ Commission Staff Working Document: A Review of the functioning of the European Economic Area, 12 December, 2012, SWD (2012) 425 final available at [www.europarl.europa.eu/RegData/docs_autres_institutions/commission_europeenne/swd/2012/0425/COM_SWD\(2012\)0425_EN.pdf](http://www.europarl.europa.eu/RegData/docs_autres_institutions/commission_europeenne/swd/2012/0425/COM_SWD(2012)0425_EN.pdf)

²⁹ EFTA Secretariat. <http://www.efta.int>

5.3 HOW REMAINING IN THE CUSTOMS UNION TAKES OPPORTUNITIES OFF THE TABLE

- Without control over tariff schedules, time in the Customs Union prevents UK leadership within the WTO.
- Without control over tariff schedules, the UK cannot negotiate with other countries. But, seeking a special customs arrangement with the EU is WTO-permissible.
- The UK must present tariff-rate quotas (TRQs) to partners, as the first step in FTA discussions.

Many have recently suggested that free circulation of goods around the EU-28, including the UK, is the paramount concern. Despite the fact that we have noted how WTO-compatible customs arrangements between the EU and UK are possible in the interim period, some have suggested this means the UK should remain in the Customs Union. The EU has reacted to the UK proposals on customs arrangements by saying that:

- a) We are not at that stage of the negotiations.
- b) Only the Customs Union preserves full free circulation.

However, if the UK remains in the Customs Union, it will be unable to make any progress on agreements with other countries; nor will it be able to be active in the WTO through taking control of schedules or by taking the lead in arguing for a reduction of the many trade barriers which remain in the services sector and have been largely untouched by WTO liberalisation in services.

The UK and EU are in the midst of the WTO rectification process now, on which serious progress must be achieved quickly because other WTO members are concerned about their own “cliff edges”. In any interim period, this requires the UK to have control over its tariff schedules, and therefore not be bound to a customs union with the EU (although maintaining harmonised external tariffs for a short interim period may be necessary to ensure systems are in place for a functioning customs border between the UK and EU). Seeking a customs arrangement³⁰ with the EU in this period is also WTO-permissible and should certainly be pursued.

The agricultural share of European import quotas (the tariff-rate quotas, or TRQ, negotiations) will require the UK to commit to TRQ partners that it will be able to offer liberalisation (across the trading relationship with them more widely, i.e. covering non-tariff barriers and regulations as well as tariffs and quotas) in a phased way over time, in order to make sure that the UK will get a better deal on TRQs.³¹

As part of the TRQ discussions, the government will also need to explain to TRQ partners the roadmap for agricultural liberalisation in the context of FTAs. If the UK does not have authority over its own tariff schedule, this will not be possible. Following the unsuccessful joint presentation, it is

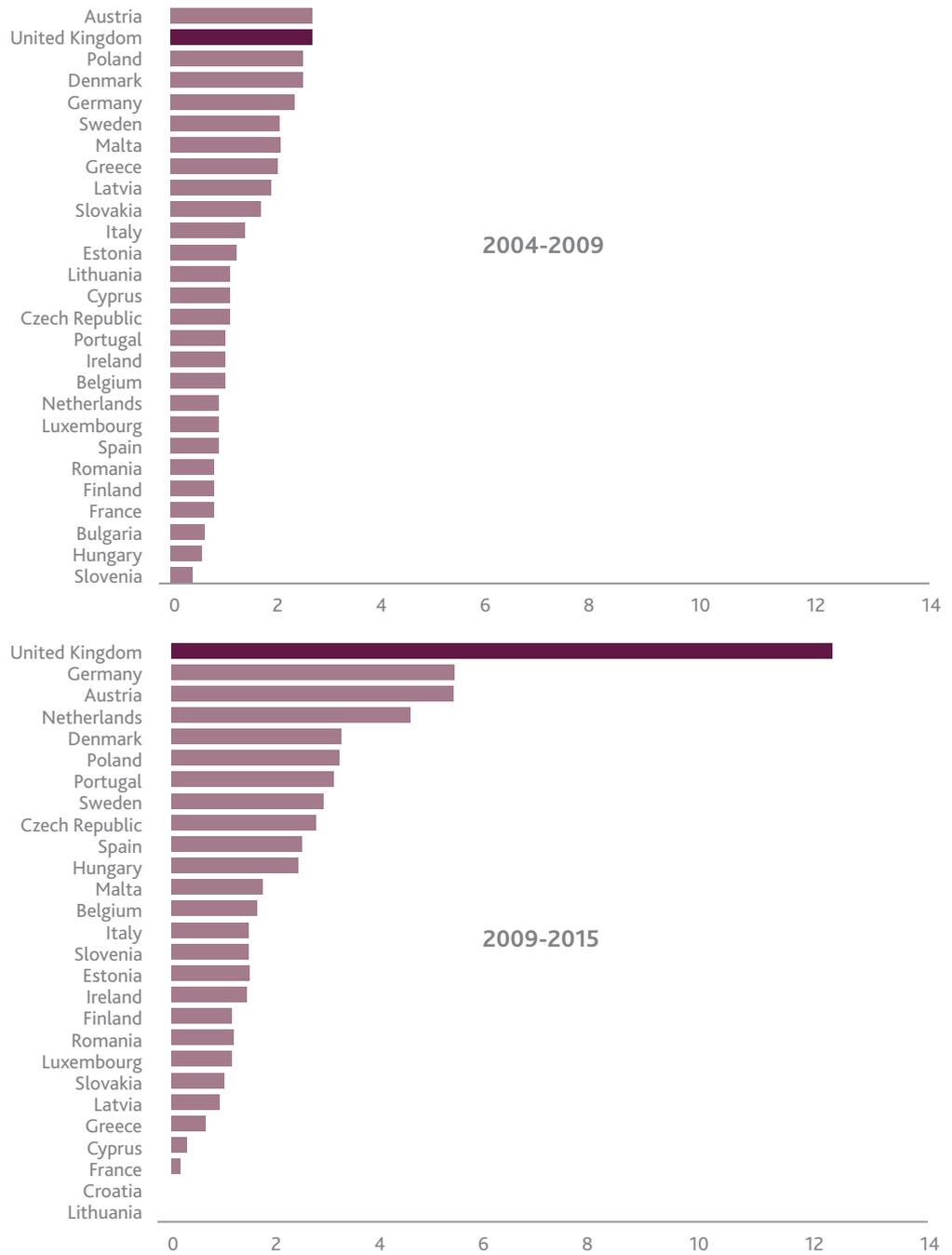
³⁰ This should be distinguished from remaining in, or attempting to create, a new Customs Union.

³¹ See Appendix 2 for some key considerations for the rectification of TRQs between the UK and the EU in the WTO.

³² The EU's TRQ system currently is country by country, whereas most countries apply a global quota where all countries compete to fill the quota on a first come first served basis.

Figure 2:
Percentage of times each
EU government has been
in a losing “minority”
in Council votes, as a
proportion of all votes it
took part in during the
2004-2009 and
2009-2015 periods

Source: Hix and Hageman³⁴



now very important that it is the UK and not the EU that presents its TRQ ideas to TRQ partners. (Beyond a share of the EU's current TRQ or simple replication of that TRQ, the UK may also consider using a global quota,³² which would include the EU-27, in which case some mechanism will be required to deal with imports from markets that are highly distorted, such as the EU-27. Alternatively, the UK may have to unilaterally lower its agricultural tariffs to zero to avoid food price inflation, in which case a mechanism needs to be put in place to protect British farmers from competition from distorting countries.) The UK must also present its aggregate measurement of support (AMS) numbers independently, not as a share of the EU AMS.

5.4 THE REGULATORY OPPORTUNITY

■ Pro-competitive, pro-consumer legislation requires divergence.

Much EU regulation, across sectors, has been damaging to trade and competition and needs to be reviewed by the UK outside the constraints of the EEA. However this does not mean advocating deregulation—the UK would still look to regulate these policy areas, in most cases with the same overall objectives and regulatory goals, but with less distortion, in a more pro-competition, pro-consumer manner, and in ways that better suit the UK market.

The recent trend however shows that the UK is being outvoted more frequently in the European Council and being compelled to accept regulation that the government does not consider to be in Britain's best interests but is unable to amend or reverse.³³ This trend has been caused by the expansion of the EU's competences and the extension of qualified majority voting (QMV) after the Lisbon Treaty. This is illustrated by the chart on page 29, which shows the percentage of times each EU government has been in a losing "minority" in Council votes, as a proportion of all votes it took part in during the 2004-2009 and 2009-2015 periods.³⁴

The regulatory opportunity therefore requires the UK to be able to adopt a regulatory system based on outcome- and effects-based regulation, not the prescriptive rule-book approach of the EU. The former approach to regulation is more in line with common law jurisdictions, allowing economic forces to prevail and for markets to find their consumer welfare-increasing equilibrium. A prescriptive rule book approach however is agnostic about economic effects and is more likely to lead to anti-competitive outcomes. The task will be to find the space where the UK can mutually recognise both systems (the subject of a forthcoming Legatum Institute paper). But such a result is needed both for UK firms and for UK consumer welfare.

The following RAG analysis sets out the respective advantages and disadvantages of the different possible interim measures.

³³ Of 20 measures (2000-15) examined in wholesale financial services by Business For Britain, only 6 would have been enacted by the UK acting alone, 4 would have been enacted but with less substantial EU goldplating, and the remaining 12 would not have been enacted at all for various reasons (e.g. promotion of Single Market or Eurozone, or outright opposition, such as FTT, clearing house location policy and AIFMD). See How EU wholesale financial regulation differs from what the UK would choose for itself, December, 2014, Europe Economics.

³⁴ *Does the UK win or lose in the Council of Ministers?* Hix and Hageman, UK in a Changing Europe, available at ukandeu.ac.uk/explainers/does-the-uk-win-or-lose-in-the-council-of-ministers/

RAG ANALYSIS: INTERIM MEASURES

References are to flexibility with respect to EU, not global standards. RAG rating comparison is relative to different options, not against current state or optimal state. For options related to MIRAs, there is a spectrum, and outcomes will depend on the flexibility within the MIRAs.

	COSTS								OPPORTUNITIES							
	Having to maintain harmonised standards	Disruptions from customs checks	Application of tariffs	Application of non-tariff barriers (subject to WTO SPS/TBT agreements)	No capability for regulatory divergence	Subject to multiple regulatory authorities	Rule-taker with no say	No ability to control EEA immigration	Domestic regulatory reform	Ability to set own standards	Ability to negotiate tariff deals with third countries	Ability to negotiate non-tariff barriers / services regulation with third countries	Ability to control borders	Commercial attractiveness for business to operate in UK	Commercial attractiveness for trade deals / investment with third countries	Improvements in consumer welfare (lower prices / higher standards)
POTENTIAL INTERIM STATES																
Zero for zero tariff deal for a reasonable, limited time period, with MIRAs and regulatory co-operation on single market acquis	Orange	Green	Green	Green	Orange	Red	Green	Green	Orange	Green	Green	Orange	Green	Green	Green	Green
Zero for zero tariff deal for a reasonable, limited time period (no MIRAs)	Green	Red	Green	Red	Green	Red	Green	Green	Green	Green	Green	Green	Green	Orange	Red	Orange
Agreement on mutual recognition, but no tariff deal	Orange	Red	Red	Green	Orange	Orange	Orange	Green	Orange	Orange	Green	Green	Green	Green	Green	Orange
Customs union (assuming acquis adopted for goods—Turkey model)	Red	Green	Green	Green	Red	Orange	Green	Green	Orange	Red	Red	Red	Green	Orange	Red	Orange
EEA	Red	Green	Orange	Green	Red	Green	Red	Red	Red	Red	Orange	Red	Red	Red	Orange	Orange
No interim agreement	Green	Red	Red	Red	Green	Red	Green	Green	Green	Green	Green	Green	Green	Red	Red	Orange

■ = does not deliver an advantage to UK position;

■ = could deliver advantages to UK position depending on how formulated;

■ = delivers advantage to UK position.

6. THE GLOBAL REGULATORY AGENDA

SUPPORTING KEY FINDING C: Ensuring the End State discussions are initiated via the three Phase One issues

- Trade requires not just bilateral deals—also multilateral and plurilateral deals, and regulatory choice.

The global trading opportunity being presented to Britain through Brexit is not solely about doing bilateral trade deals. Many of these opportunities relate to what the UK can do unilaterally (thus attracting investment and trade globally), such as reducing food prices by cutting tariffs. Others relate to the UK's potential trade leadership through leading multilaterally (in other words in reaping the gains of an improved global system), by demonstrating to others the benefits to prosperity through improved productivity. But it also affects how the UK can connect to regional partnerships and plurilateral agreements.

The challenge is in how other countries look at the UK—and the likelihood that it is sufficiently in control of its regulatory choices to be a proper partner, capable of agreeing and implementing its own measures on technical barriers to trade and services regulation. For example, because the EEA Agreement restricts members' regulatory freedom, many of the things that other countries would need from the UK to agree comprehensive and meaningful FTAs would be impossible. In areas like industrial policy and agriculture, this must mean a much more open, liberal economic environment than the EU. This is good for Britain, and will make the country a better trading partner for others.

For example, in services, the EU is moving in a negative direction, especially in the WTO Trade in Services plurilateral negotiations, where it recently suggested new services should not be covered by the agreement. It also adopted the General Data Protection Regulation, in the knowledge that this constituted a violation of WTO rules on cross-border data flows.

7. MOVEMENT OF WORKERS & CITIZENS' RIGHTS

SUPPORTING KEY FINDING C: Ensuring the End State discussions are initiated via the three Phase One issue

- UK should now make non-conditional, case by case offers.

As we have described, the Government has made a detailed offer on EEA citizens exercising treaty rights in the UK. The reaction from the EU has been to require the rights of EU citizens in the UK to be adjudicated by the European Court of Justice, which no other country in the world allows, and which would imply two legal classes of citizens. Therefore the UK must now proceed unilaterally to make offers on immigration on a case by case basis, not conditional on reciprocity from the EU.

In a transition period and beyond, the UK needs to have an immigration policy based not on the concept of "free movement" but on targeted programmes to attract people where they are demonstrably needed in the British economy. We would seek to attract the best and the brightest, and to bring in needed workers sector by sector, using tools like a Seasonal Agricultural Workers Programme, and allowing sponsoring entities to demonstrate that they need these workers.

8. THE OPPORTUNITIES AND HOW WE TAKE ADVANTAGE OF THEM

SUPPORTING KEY FINDING D: Creating the leverage that allows the End State negotiations to start

- UK requires freedom of action in four areas during negotiation.

We have outlined in our trade policy blueprint a four-pillared approach to trade policy. This constitutes an End State which we propose is favourable to the UK economy (we will provide a more detailed outline of the economic impact of that four-pillared approach). In that paper, we note that the benefits of Brexit to Britain come from four pillars in which the government must preserve and reinstate its capacity to act:

1. Unilateral action—both on trade (reducing tariffs unilaterally where possible), and improving the domestic regulatory environment and making sure it maximises competition.
2. Bilaterally through trade deals.
3. Plurilaterally through seeking to accede to major trading arrangements with open accession rules such as NAFTA and the Trans-Pacific Partnership (TPP).
4. Multilaterally through increased participation and leadership in the WTO and global standard-setting bodies.

It will thus be critical for the UK to have freedom of action in all four areas as it negotiates a final FTA with the EU, so that the UK can trade freely between the EU and the rest of the world. This is a challenge that other countries have already faced (Canada has an FTA with the EU and US, as does Mexico). If the UK is constrained such that it approaches other trading partners as the EU does, this will be difficult to achieve. How the UK exits the EU and re-engages with it will determine whether it can achieve this objective.

CONCLUSION

The opportunity now before the British government is rare: to rejuvenate Britain as an independent trading nation, capable of creating a framework that provides prosperity for all.

For the UK to be fully independent politically, it is required to be fully independent in its capacity to execute independent trade and domestic regulatory policy. To be able to make trade deals requires control over commercial and technical regulations and standards. Only when businesses are free to innovate, and consumers can buy cheaper imports, can we sustainably increase productivity, creating prosperity.

The economic benefits we have described are created by the capacity of supply chains to move and adjust. When we create a better regulatory environment, supply chains will re-route through the UK in order to become more efficient—but only if the UK is able to create this environment.

As we have seen, remaining in any relationship with the EU that limits capacity to regulate in these areas, or to control tariff schedules, would render this impossible. Inability to negotiate these in an interim period would also prevent other countries engaging in serious trade negotiations with the UK. The opportunity to liberalise trade for the UK, and liberalise the stalled system of world trade, reaping the huge economic benefits that come with it, would largely be lost.

The government must represent all of the British people in its negotiations with the EU. This means not only incumbent large businesses represented by established trade associations, but small businesses and entrepreneurs, the businesses of the future—many of which will be created only if pro-competitive regulatory frameworks can be established—as well as consumers, the largest group of all. It is imperative that we do not extinguish the opportunities ahead of us by committing to unnecessary restraints in the name of minimising disruption. The UK has an opportunity before it to greatly expand its own economy and global wealth, but it must be taken now.

The UK and EU are not negotiating in a vacuum. Their negotiations will have a huge impact on the rest of the world. A successful Brexit will be good for the UK, the EU and the rest of the world, and one that risks wasting the opportunity of Brexit will have a profound and lasting impact on prosperity for all.

The time in which the UK government can act is shortening rapidly: urgent action needs to be taken now.

GLOSSARY

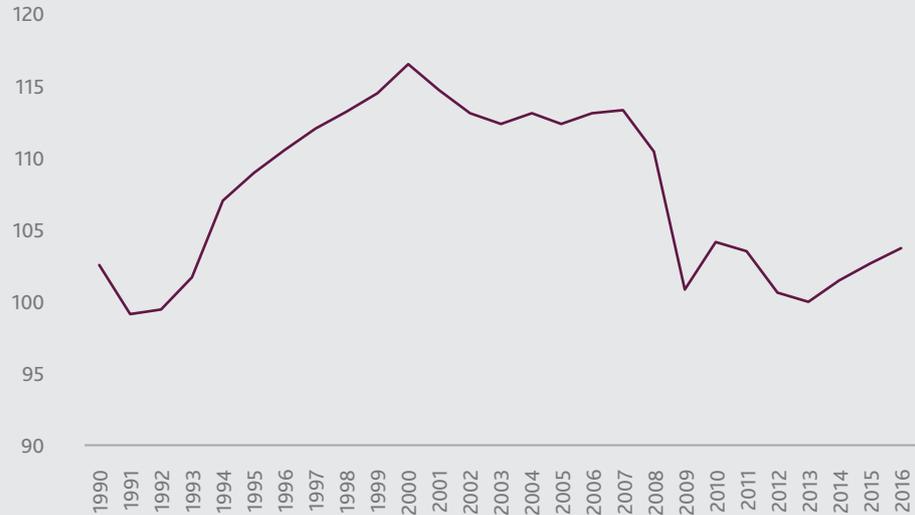
AMS	Aggregate Measurement of Support
CDS	Customs Declaration Services
CET	Common External Tariff
CETA	Comprehensive Economic and Trade Agreement (EU-Canada)
DRC	Dual Regulatory Coordination
ECJ	European Court of Justice
EEA	European Economic Area
EFTA	European Free Trade Association
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDPR	General Data Protection Regulation
HMRC	Her Majesty's Revenue and Customs
MRA	Mutual Recognition Agreement
NAFTA	North American Free Trade Agreement
P4+1	Pacific 4 + 1 (Brunei, Chile, New Zealand and Singapore, plus Australia)
RoO	Rules of Origin
SPS	Sanitary and Phytosanitary Measures
TBT	Technical Barriers to Trade
TPP	Trans-Pacific Partnership
TRQs	Tariff-Rate Quotas
WTO	World Trade Organisation

APPENDIX 1: THE ECONOMIC CONTEXT: PRODUCTION AND EXPORTS

1. UK production has not yet recovered from the financial crisis and remains well below pre-crisis levels

Figure 3: UK Index of total production of manufacturing, mining and quarrying, and energy supply industries

Source: ONS (2013 = 100)



2. While the level of UK trade with the EU remains significant, the share of EU exports and imports is declining

Figure 4: UK export shares in goods and services

Source: ONS Pink Book

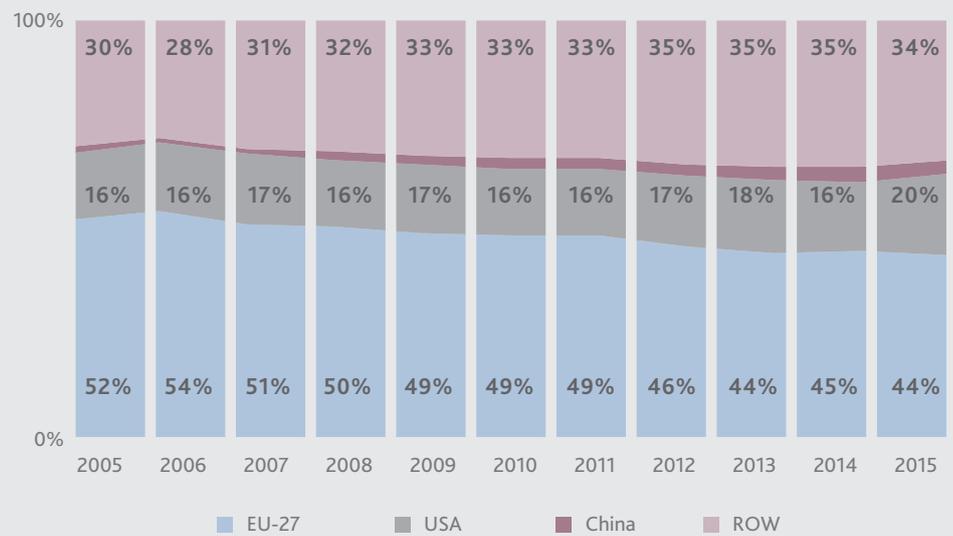
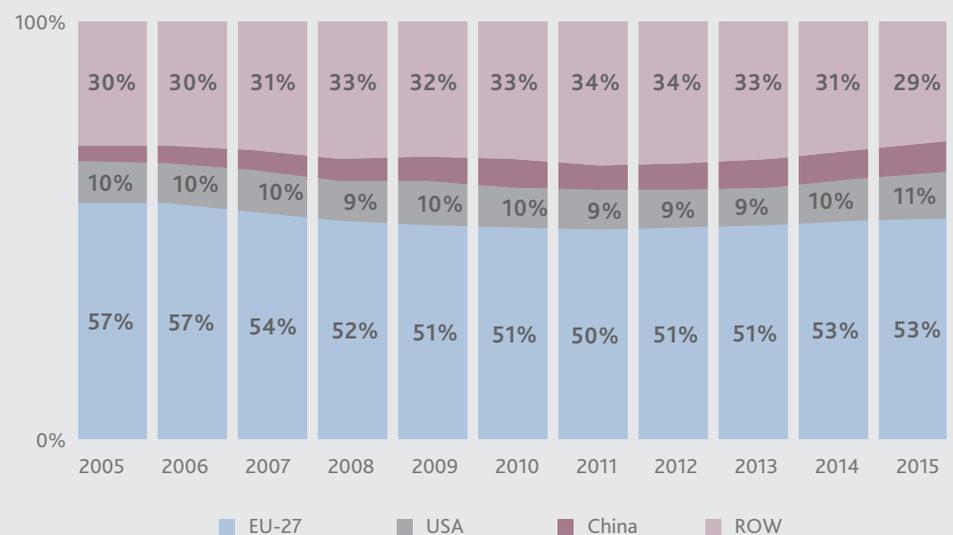


Figure 5: UK import shares in goods and services³⁵

Source: ONS Pink Book



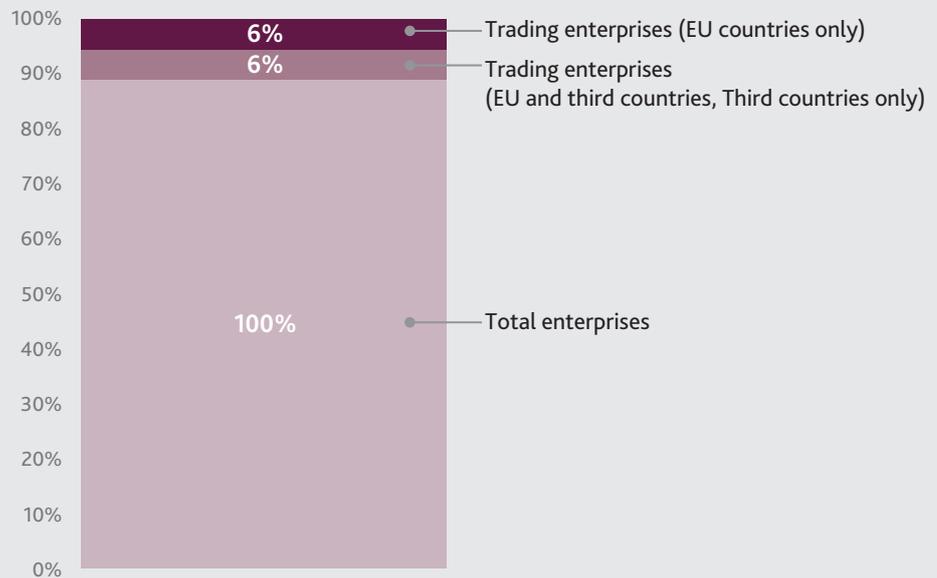
³⁵ The existence of the Rotterdam and Antwerp effects mean that these shares overstate the volume of UK trade with EU and understates the volume of UK trade with RoW.

3. 52% of trading enterprises trade only with the EU, but this amounts to overall 6% of enterprises

- Of the 1.8m enterprises recorded by Eurostat and used to establish the OECD figures set out below, only 226k trade at all (12%).
- Of those that trade, 82% are engaged in trade with the EU and 48% are engaged in trade with third countries.
- Overall, 52% of businesses that trade, only trade with the EU, which amounts to only 6% of businesses.
- Note, however, that these numbers do not align with the ONS estimates, which are higher, but this focus on the percentages is still illustrative.

Figure 6:
Enterprises and trade

Source: OECD



APPENDIX 2: AUTONOMY IN TRQ/AMS NEGOTIATIONS

We understand informally that the UK has been under pressure from the EU side to agree tariff rate quotas (TRQ) on agricultural products with the EU, to be jointly presented to the WTO membership for ratification.³⁶ This approach would limit the UK's ability to secure beneficial TRQs that would lay the ground for future bilateral and plurilateral trade deals.

The UK should be negotiating its TRQs directly with TRQ partners, while being transparent in communicating the process with the EU.

The EU is more vulnerable on TRQs than the UK, as it will be less willing and able to accept larger quotas from suppliers and may therefore be exposed to claims from members who consider that they have lost some of the benefits that they had bargained for when TRQs were agreed. To the extent that the UK leaving the EU causes the EU loss in this respect, it would be possible for the UK to compensate these losses, and there is WTO precedent for such a settlement.

This approach would be a point of principle that the EU and UK could agree in the context of the overall financial settlement arising out of the Article 50 process, as a methodological component rather than a fixed amount, as it would only crystallise once the trading relationships have been settled.

Meanwhile, on AMS, the UK should not simply agree a share, because the split will lead to a very high UK AMS that others will object to. AMS should be presented separately; the first signal to trading partners is very important.

³⁶ For further details on this process see Shanker A Singham *World Trade Organisation Process and Negotiation of Free Trade Agreements* February 2017 available at www.li.com/activities/publications/brexit-world-trade-organisation-process-and-negotiation-of-free-trade-agreements

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 use its expertise to advocate a successful Brexit 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 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.

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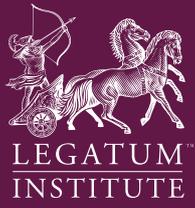
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