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Hard Brexit Ahead: Breaking the Deadlock

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In this contribution we sketch how the current deadlock between the EU and the UK could be solved. Negotiations as well as parliamentary debates have shown that the British position (no backstop, no single market, no customs union, no dependence on the ECJ) on the one hand, as well as the Irish position¹ (backstop, no hard border) and that of the EU (backstop, indivisibility of the four freedoms, no cherry-picking) on the other, are mutually exclusive. Holding on to these ‘red lines’, a hard Brexit is the only possible equilibrium. From a game theoretical perspective, the backstop is unacceptable for any British government as it permanently manifests only one sub-game perfect equilibrium, which is the backstop itself. Conversely, a time limitation on the backstop is unacceptable for the EU, as it risks manifesting another sub-game perfect equilibrium, which is hard Brexit. Therefore, neither renegotiation of the backstop nor elections or the extension of the withdrawal period of Article 50 TFEU can break the deadlock. A first-best solution, which from a trade perspective would be the continuation of UK membership in a reformed EU, is beyond the scope of this analysis.² We instead take Brexit as given and discuss terms that limit its political and economic damage. We focus on the contentious issues only; we do not elaborate on the provisions of the Withdrawal Agreement itself, for which a settlement has been reached that appears to be satisfactory for both sides. Because the core debate

¹ For the sake of simplicity, we use the term Ireland for the Republic of Ireland.

² Cf. Hans-Werner Sinn’s lecture „Die Bedeutung des Brexit für Deutschland und Europa“ at the Munich Seminar on December 19, 2018. The lecture can be accessed via <http://mediathek.cesifo-group.de/iptv/player/macros/cesifo/mediathek>.

revolves around the backstop and the issue of a possible border between the Northern Ireland and the Republic of Ireland, we mostly deal with trade policy arrangements.

Why a Backstop Does Not Work

The current negotiations about Brexit have to be seen as a repeated bargaining process between the UK and the European Union, which will end when a definitive arrangement has been found and ratified by both sides.

In the long term, there are only two conceivable outcomes of the negotiations between the EU and UK. Either there are no controls at the border between Northern Ireland and the Republic of Ireland. Then, if the UK as a whole is to remain a unified customs territory with no invisible internal border, deep economic integration of the UK in the European Union is a prerequisite. Or the border to Ireland will be controlled. Then, a free trade agreement is the most likely solution. A third potential outcome – different customs regimes applying to different parts of UK – is highly unlikely given the massive defeat of the Withdrawal Agreement bill in parliament in January.

The current proposals for an exit of the UK from the EU, specifically the Withdrawal Agreement combined with the backstop, have a strong impact on the final bargaining outcome. This is particularly true of the backstop – the insurance device introduced by the EU to keep the Irish land borders open –, which has become the key issue of controversy. Under the Withdrawal Agreement's backstop, the UK de facto falls back into a customs union with the EU and Northern Ireland remains deeply integrated with the EU's single market if negotiations for a permanent solution fail.

Since this backstop directly affects the threat points in subsequent negotiations about a long-term solution, it has a strong impact on the final outcome and, in particular, makes a customs union between the EU and UK the likely long-term equilibrium. In the extreme, the EU could delay negotiations until the transition period has expired and the backstop kicks in. This in turn is a major reason why the Withdrawal Agreement cannot gain the support of a majority in the UK Parliament, despite repeated attempts by EU representatives to deemphasize the importance of the backstop (Letter of 14. of January by the European Council and the European Commission).

Given this stalemate, a temporal limitation to the backstop has been suggested. However, a limited backstop would shift bargaining power to the UK government, and proponents of a long-run equilibrium with a limited free trade agreement would have much improved chance to implement this solution. In the extreme, a time limit could invite the UK government to delay negotiations until the backstop has expired. Hence, a time-limited backstop is unattractive for the EU and for the proponents of deep mutual integration.

The conclusion is that a backstop is not a suitable instrument for reaching an agreement today, as the design of the backstop preconfigures the long-run solution. Moreover, insisting on a backstop now risks a hard Brexit without an agreement by March 29, 2019. In such a situation, the UK and the EU would incur additional economic losses and Ireland and the UK would enter into a game of conflict about whether and when to start to control borders along the Irish land border.

The preceding line of argument suggests that new approaches must be considered which do not rely on the backstop. A quick fix would be to drop the backstop and lift the time limit on the provisional arrangements of the Withdrawal Agreement. However, we believe that a better outcome than that exists and is politically feasible.

Dropping ‘red lines’

We propose a model for the relationship between the United Kingdom and the European Union for the post-Brexit era that ensures close economic ties and avoids a hard Irish border. Our aim is not to define a first-best solution but rather a politically feasible approach that minimizes economic costs. Political feasibility means that for both parties, accepting the proposed model strictly dominates a no deal scenario. The core of our proposal foresees a permanent participation of the UK in a newly created European Customs Association (ECA). This is an agreement which links the European Customs Union (as it currently exists) to the customs territory of the UK, creating a space with a common external trade policy and giving the UK full and active participation instead of merely being a rule-taker. This minimizes the risk of a hard border between Northern Ireland and the Republic of Ireland and is economically advantageous for both the EU and the UK.

Issues beyond those covered by the ECA, i.e. policy areas other than trade in goods, should be dealt with in the Withdrawal Agreement as already agreed. The ECA should

cover areas related to trade in goods that are currently falling under the exclusive competence of the EU in Brussels.

The permanent nature of the ECA does away with the need for a backstop. However, our solution requires compromises on both sides. The UK would need to yield on some of its red lines: it must, at least partially, forego trade policy autonomy, and accept a dispute settlement mechanism related to the ECA. In return, the UK would have full voting rights in the ECA. Moreover, it would keep the option of running independent trade policies in all areas not covered by the ECA, in particular in services where the British economy has its strongest comparative advantage. Details of the future cooperation with the EU would be negotiated during a transition period of, say, two years, in which the Withdrawal Agreement still applies.

The EU in turn must abandon its indivisibility dogma by which the four freedoms are inseparable, offering the UK to participate in product market integration but allowing it to make its own choices in other areas. Most importantly, this concerns the mobility of people. Building on the Withdrawal Agreement, these issues should be clarified in bilateral agreements between the EU and the UK with the objective of minimizing frictions at the Irish border. We believe that this is feasible; thanks also to the existing Common Travel Area between the two parts of Ireland. The process, however, requires the EU to make concessions with regard to its model of labour market integration. We still view this as highly preferable to the consequences of an uncontrolled Brexit. The following section describes in more detail the scope of an agreement that we believe could be more acceptable for the UK than passive membership in the existing customs union.

A European Customs Association

“The Government believes this new relationship needs to be broader in scope than any other that exists between the EU and a third country.”

– Chequers Plan³

³ The future relationship between the United Kingdom and the European Union, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725288/The_future_relationship_between_the_United_Kingdom_and_the_European_Union.pdf, accessed on January 17, 2019.

The British negotiation position has been to rule out future participation in the EU Customs Union (EUCU). This is not surprising given the relatively poor experience Turkey has had (cf. Yalcin, 2016).⁴ To be fully precise, Turkey is not a member of the EUCU. Instead, in 1996 Turkey and the EUCU created a common customs union, the EU-Turkey Customs Union. However, this is a quite asymmetric relationship: Turkey is obliged to align its trade policies to EU trade policies, as a customs union of course requires a common external tariff (CET). Specifically, whenever the EU signs a free trade agreement with any third country, Turkey is required to adopt all tariff reductions against this third country as well. In short, Turkey is a rule-taker. However, it does not benefit from preferential access to this third country because it is no legal party of the treaty. Hence, the customs union generates non-reciprocal outcomes for Turkey. In trade negotiations, the EU can offer a third country access to the Turkish market on top of the EU's single market, without requesting equivalent concessions for the Turkish economy in return. This obviously leverages EU bargaining power but puts Turkey in a disadvantageous situation. In addition, Turkey cannot engage into talks about its own free trade agreements (FTAs) for practical reasons: its tariffs are bound by the respective EUCU CET. This way of economic integration was chosen in times when an EU accession of Turkey was still considered likely. In extremis, one could argue that this agreement downgrades Turkey to a trade colony of the EU.⁵

The Turkish case explains why the British government is resisting the idea of staying in the customs union à la Turquie, potentially forever – that is, if negotiations with the EU fail and the backstop kicks in. We do believe that a customs union between the EU and that UK could be economically advantageous for both sides, and also helps softening the consequences of an internal Irish border. But the Turkish model is not good enough; it needs to be amended.

⁴ In a recent interview with the Guardian, ex EU commissioner and ex WTO director general Pascal Lamy makes interesting comments on the Turkish model in line with our argument: <https://www.theguardian.com/politics/2019/jan/21/no-say-on-trade-deals-for-uk-in-eu-customs-union-says-ex-wto-chief>, accessed on January 22, 2019.

⁵ The EU-Turkey Customs Union does not apply to all goods; for example, agri-food products are excluded. Also note that Turkey can engage in negotiations with third parties in areas not covered by the Customs Union so that it can trade-off tariff concessions against, say, better access to its services markets. However, the asymmetric agreement with the EU drastically lowers Turkey's bargaining power and limits its degrees of freedom.

Our model stipulates that both parties create a new European Customs Association (ECA), which is constructed similarly (and could well be identical) to the EUCU. This has the following consequences:

- (1) The Backstop provision in the Withdrawal Agreement is dropped.
- (2) The United Kingdom permanently delegates all trade policy matters in goods to a newly created European Customs Association (ECA) in which the EU (and, why not, Turkey) is also a member. Neither the EU nor the UK pursue independent trade policies, and the ECA represents them the World Trade Organization (WTO) in the same way as the EU has done until now for all 28 EU members.
- (3) The UK has voting rights in the ECA, as do all other member states. Together with the other members of the ECA it mandates the EU Commission to negotiate trade agreements with third parties.
- (4) Decisions are taken with double majority as defined in the Lisbon Treaty, and the European Court of Justice (in extended form including all participating countries) continues to supervise all law- and policy making in the field of trade.
- (5) The ECA covers all “classical” areas of trade policy, such as tariffs, quotas, rules of origin, trade defense, et cetera. On these issues, the EU has exclusive competence.
- (6) Areas in which the EU has no exclusive competence and in which countries have veto rights (trade in services, intellectual property, direct foreign investment, audiovisual and cultural services, and social, educational and health services), should not fall under the ECA. During a transition period, the pertinent provisions in the EU treaties continue to apply. For the future, arrangements in these areas are made by means of one or several supplementary bilateral agreements.
- (7) In existing trade agreements with third parties, provisions pertaining to “classical” areas or areas covered by bilateral agreements continue to apply to the UK, as well as those currently or in future negotiated.

Our proposal has significant advantages over an FTA between the EU and the UK. These are:

- **No Rules of Origin:** FTAs require so called rules of origin to avoid that tariff concessions that one party grants the other in an FTA are taken advantage of

by a third party that has a preferential trade agreement with one of the partners in the FTA. These procedures are costly and reduce the gains from trade. In many cases, when documentation requirements are demanding and MFN⁶ tariffs are low, companies decide to not make use of preferential tariffs at all (cf. Felbermayr et al, 2018a). In a customs union, there is no need for Rules of Origin as external tariff differentials do not exist.

- **No hard Irish Border:** A different status for Northern Ireland and for Great Britain, and hence a de facto border within the UK, can be largely avoided as the Customs Union and a series of bilateral agreements make border checks redundant. For the EU, an open border between Ireland and Northern Ireland has priority. This is particularly in the overriding interest of the Republic of Ireland, which according to various quantitative studies would lose most from a hard Brexit (cf. Felbermayr et al., 2018b and the references listed there). Our proposal acknowledges the territorial integrity of the UK and the objective of no hard Irish border. The ECA forms the core of the relationship between UK and the EU, this alone already reduces border frictions substantially. Depending on how far the bilateral agreements go, the UK de facto remains in the single market for goods and perhaps services, so that border controls are minimized. Membership of Ireland and the UK in their Common Travel Area (CAT) ensures frictionless mobility of people.
- **Leveraging Market Size:** in international trade talks, market size determines bargaining power. This is the reason why EU member states have delegated trade policy to the EU; and this is the reason why the UK and the EU should join forces also in the future. The UK as the EU's second largest economy with 65m people is an undeniable asset for the ECA. Together, the EU and the UK account for a quarter of global GDP; this is the basis for negotiations on an equal footing with giants such as China and the United States. Close cooperation is in our common long-term interest.
- **Transferability:** Such a model might also be attractive for other European countries who do not fully join the EU but where there is strong interest in the closest economic integration possible.

From our point of view, the proposed European Customs Association between UK and the member states of the EU is theoretically convincing. There remains the critical issue of political feasibility.

⁶ Most favoured nation tariffs according to WTO law.

At the time when both sides drew their red lines, neither the UK nor the EU seemed to embrace the idea of a full, permanent customs union. This led to the sunset clause for the withdrawal agreement, which in turn resulted in the EU insistence on a backstop. The UK had major reservations about the passive rule-taking this would imply and the lack of options for pursuing an independent trade policy. On the EU side, misgivings were expressed about breaking up the unity of the four freedoms. The compromise found in the Withdrawal Agreement remains very close to a customs union while not ruling out future UK trade deals with third countries. Lacking an ambitious long-term arrangement like the ECA we propose, the provisional arrangements of the Withdrawal Arrangement are perhaps the closest thing to a compromise that is acceptable to both sides. Given the controversy surrounding the backstop, a second-best solution would be to throw out the backstop and remove the sunset clause on the Withdrawal Agreement.

However, the political ground has shifted on both sides. The EU has recently made repeated offers of a permanent customs union. After some hesitation, the opposition Labour party in the UK has committed itself to a customs union as well. The governing Conservative Party is perhaps split on the issue. The UK Prime Minister has excluded a customs union so far, and in any case would have to find a cross-bench majority for a customs union against considerable internal opposition. We believe that a decisive new element could be brought into the debate if a customs arrangement would be offered in which the UK is not a passive rule-taker anymore.

On the Four Freedoms

In public debates, free movement of people is often confused with the elimination of border controls for individuals meaning passport free travel. The latter was initiated by the Schengen Agreement in 1995 and established by the majority of EU member states; it has recently been suspended at some borders, where controls were re-introduced due to the ongoing influx of refugees. However, the UK as well as Ireland never joined the Schengen Agreement as they form the Common Travel Area⁷ (CTA), an Anglo-Irish version of Schengen that has existed for decades. Thus, they still conduct passport controls for EU citizens entering and leaving their territories. In case

⁷ <https://www.gov.uk/government/publications/travelling-in-the-common-travel-area-if-theres-no-brexite-deal/travelling-within-the-common-travel-area-and-the-associated-rights-of-british-and-irish-citizens-if-there-is-no-brexite-deal>, accessed on January 18, 2019.

of a hard Brexit, customs declarations at the Irish border make border controls unavoidable; in this case the CTA will play a key role in keeping borders open for people and securing the fragile situation at the Irish border.

It is often claimed that the four freedoms of the European single market – freedom of mobility for goods, services, capital and labor – are indivisible. From an economic perspective, this is a somewhat dogmatic view. Kohler and Müller (2017) argue it is not grounded in economic theory. For example, in the standard Heckscher-Ohlin model of international trade, the economic consequences for wages or rental rates of capital, of free trade of goods and services and free factor mobility (capital and labour) are identical: goods and services crossing international borders embody their factors of production, such as capital and labour. Consequently, to achieve efficient allocation of resources, the most productive use of capital and labour across all participating countries, free trade in goods is sufficient. Thus, the functioning of the single market does not require all four freedoms being applied at the same time and therefore, giving up one of them causes no severe economic harm. And even if trade and factor mobility are not perfectly substitutable, which is the empirically relevant case, it makes little sense to deny three freedoms if the fourth is not achievable. There is no theoretical basis for believing that the four freedoms are so strongly complementary to each other that not having all four of them is equivalent to not enjoying any of them. This is the logic that has informed the implementation of long transition periods for the free movement of labour in the context of the EU eastern enlargement.

As consequence, participation in the single market need not be linked to the four freedoms. Things are fundamentally different in currency unions: according to Mundell's (1961) theory of optimum currency areas, the free movement of both capital and labour plays an essential role in the internal adjustment of interest rates, wages, and prices. For this very reason, participation in the Euro area must be linked to these two freedoms. But as Britain is not a member of the Euro area, future economic ties between the EU and the UK can feasibly be designed as a de facto participation of the United Kingdom in the EU single market for goods (and services).

Evidently, pragmatic solutions need to be found for migration, and the rights of about 3m⁸ EU citizens living in the UK as well as upwards of 900K, perhaps twice as many

⁸ <https://migrationobservatory.ox.ac.uk/resources/briefings/eu-migration-to-and-from-the-uk/>, accessed on January 18, 2019.

British nationals⁹ residing abroad in the EU must be protected. However, in the negotiations leading to the Withdrawal Agreements there was very little disagreement about mutually granted residence permits and associated rights.

We want to be very clear that we favour free mobility of labour as a factor of production. However, it is widely acknowledged that dissatisfaction with migration to the UK has played a major role for the outcome of the 2016 referendum.¹⁰ When the former British Prime Minister David Cameron asked for EU reforms¹¹, his concerns with respect to free mobility of labour did not refer to the proverbial Polish plumber. Mr. Cameron aimed to “end the ability of EU jobseekers to claim any job-seeking benefits at all”, adding that “if jobseekers have not found a job within six months, they will be required to leave”. Additionally, he insisted “that EU migrants who want to claim tax credits and child benefits must live here and contribute to our country for a minimum of four years”.¹² To put it pointedly: Cameron did not mean to give up free movement of labour but wanted an end to the free movement of unemployed; his objective was to restrict migration incentivized by social benefits. Differentiating between what free movement of people was meant for and what consequences it brought, may help reaching an agreement. Sigmar Gabriel, a former German Minister for Foreign Affairs and leader of the German Social-Democrats (SPD), called for a rethink of free movement of people for the same reason, “which would also be in the interest of many German mayors”.¹³

Cherry-Picking

The EU is deeply worried about centrifugal forces if it allows countries EU membership à la carte, i.e. an individual mix-and-match of partial integration for everyone. There is doubt as to whether Brexit will invite imitation, given that not even a large economy can apparently divorce itself from the Union without major damage (cf. Springford, 2018). First, it should be clear that any solution apart from full membership does

⁹ <https://www.independent.co.uk/travel/british-citizens-europe-residents-eu-brexite-a8332986.html>, accessed on January 18, 2019.

¹⁰ <http://blogs.lse.ac.uk/brexit/2018/05/04/leavers-have-a-better-understanding-of-remainers-motivations-than-vice-versa/>, accessed on January 21, 2019. For a district-level analysis, cf. Becker et al. (2017).

¹¹ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/475679/Donald_Tusk_letter.pdf, accessed on January 24, 2010.

¹² <https://www.bbc.com/news/uk-politics-eu-referendum-35622105>, accessed on January 22, 2019.

¹³ <https://www.tagesspiegel.de/politik/vor-dem-eu-austritt-grossbritanniens-haltet-die-uhr-an/23856656.html>, accessed on January 14, 2018.

involve an element of cherry-picking. For the EU to exclude any cherry-picking at all, it would be consistent to reconsider its partnerships with Iceland, Liechtenstein, Norway, Turkey, and Switzerland as well. Second, the question is whether the EU's internal stability would be even more threatened by a one-size-fits-all EU. In the long run, the current model may be inherently unstable if member states do not agree on the direction it takes. Hence, our proposal concretizes what is called 'multi-speed Europe'. On the one hand, there is a European core which in the long run wants to form a union in the dimensions of politics, trade, currency, defense and maybe even more. Considerations with respect to a 'core Europe' can be traced back to the so-called Schäuble-Lamers Paper (1994), which first used this term. On the other hand, there are peripheral countries, which are interested in the economic part of the union but want to remain autonomous in all other dimensions. It is not a question of cherry-picking if the EU allows them to participate economically; it is a question of economic self-interest. Thus, putting obstacles to an economic integration of such countries is irrational and strategically unwise – as they may look for other allies. The EU has found different types of partnerships with peripheral neighbours: customs union (Turkey), EFTA + single market (Iceland, Norway, Liechtenstein), and EFTA + bilateral agreements (Switzerland). Why not placing ECA + bilateral agreements (United Kingdom) in this row? In the very long run, the EU will potentially have to discuss the integration with Serbia and Ukraine, which are both closely linked to Russia, which itself is part of the Eurasian Customs Union. Some degree of flexibility may solve problems there, too. Ideas for the flexibility of EU governance that combine the approaches of a 'Europe of concentric circles' and a 'Europe of Clubs', are outlined by Demertzis et al. (2018).

Avoiding Disaster

Some of the direst consequences of a hard Brexit would be that the Irish border is no longer open, that millions of people lose their residence permits overnight, that the EU has to write off British financial obligations worth 42bn Euro¹⁴, and that bilateral trade deteriorates for logistic and bureaucratic reasons. With respect to customs declarations, it is likely that the EU faces higher obstacles, as the UK would probably reduce its MFN tariffs to zero in order to avoid chaos at the border and ensure supply reliability. Moreover, in case of a hard Brexit the UK could simply refrain from any

¹⁴ <https://fullfact.org/europe/eu-divorce-bill/>, accessed on January 22, 2019.

border controls as product standards will then still be the same in the single market and the UK. Together with the CTA, even in a hard Brexit scenario it is unlikely that the UK would enforce a hard Irish border. Thus, it depends on Brussels and Dublin whether the other side of the border remains open. It is not clear if Ireland wants to unilaterally enforce the EU's new external border. Sub-game perfection tells a different story: Ireland may be blamed for doing so both by Irish nationalists in Northern Ireland and the UK government. And it would suffer high economic costs, for which it may ask compensation from Brussels. In a standard game of chicken, the actor who loses the most will dodge first. That is perhaps why the EU leans back and plays for time. Can the EU really be sure that losses are sufficiently asymmetrically distributed that it 'wins' this game?

We do realize that the British parliamentary factions are probably playing for time: the stronger the threat of an impending hard Brexit, the faster their voters will forgive their elected politicians for accepting compromises they vigorously rejected in the past. The nearer the deadline, the better the chances for a last-minute compromise. Yet, this is a very dangerous game, both for the UK and for EU. It is wiser to take the threat of a hard Brexit at face value and react accordingly. Recognizing that a hard Brexit is in no one's interest and that it would cause irreparable political as well as economic damage, we call both on the UK government and the EU Commission to rethink their 'red lines' and return to the negotiation table. Since 2000, the United Kingdom paid a net contribution to the EU budget of 76bn Euro. One may argue that this fact alone merits a fair treatment of the second largest European economy. We have outlined an arrangement that should be politically feasible and acceptable for both parties. An evolution of the customs union in the direction of a European Customs Association with active UK membership and voting rights can serve as an economic anchor according to our proposal. The United Kingdom would need to accept economic realities and seek close trade cooperation with the EU. The European Union would need to accept UK autonomy in fields others than goods trade and respect its territorial integrity. Most important of all, under the proposed new arrangement there would be no passive rule-taking but instead a continuing active involvement of the United Kingdom in European trade policy, with high mutual benefits.

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