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**Research Report**

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# A European “Special Relationship”

Guiding Principles, Interests and Options for the EU-27 in the Brexit Talks

Barbara Lippert and Nicolai von Ondarza

“Brexit means Brexit”, Prime Minister Theresa May promised the British, after a majority voted in June to leave the European Union. But at this point, before formal exit talks have even begun, the shape of future relations between the EU and the UK is still absolutely open. Economic interests on both sides speak for integrating the country as fully as possible into the internal market – if London could agree to accept its conditions. But the thrust of British politics is driving towards a “hard Brexit”. Theresa May categorically rejects partial integration models of the kind enjoyed by Norway and Switzerland. In the process of reshaping the relationship, Germany and the EU should therefore seek a specific solution for the British: a European “special relationship”. This would allow the UK to remain a close partner, but outside the internal market and the EU institutions.

Brussels and London are facing years of complex negotiations over the UK’s departure from the Union (see SWP Comments 35/2016). The legal corridor for the process is laid out in Article 50 of the Treaty on European Union. Politically too, both sides have already put down markers. The EU-27 insist that talks will not begin until London has formally notified the Council of its intention to leave, which Prime Minister May has declared she will do no later than the end of March 2017. Although the timeframe could be prolonged by a court ruling that the British parliament must be consulted, MPs are not expected to block the process if the ruling is upheld by the Supreme Court.

After notification under Article 50, both sides have two years to agree the concrete

modalities for extracting the UK from the EU and its entire legal framework. This includes all claims and obligations relating to the EU budget and the fate of British staff working in EU institutions. Not until the exit agreement comes into force – or the two-year deadline (which can only be extended by unanimous accord) expires – is the UK actually outside the EU and its organs. That is likely to occur in spring 2019.

## Reformatting the EU-UK Relationship

The central political and economic challenges thrown up by Brexit affect not only the arrangements for separation, but also the shape of future cooperation between the EU-27 and the UK. The central question

is the form in which the British will participate in or enjoy preferential access to the internal market. Although the exit agreement is required to take into account the framework for future relations, the concrete details are completely open and will have to be regulated in a subsequent document. These talks will take place during a period that is already critical for the EU, in light of the European poly-crisis, geopolitical developments in the neighbourhood and Donald Trump's election as US President.

In its relations with other European states, the EU has to date insisted on an absolute distinction between members and non-members. While there is no such thing as partial membership, partial integration is an option, above all in the internal market. Two possible models are offered by the European Economic Area (EEA, "Norwegian model") and the bilateral treaties between the EU and Switzerland, which permit preferential market access in individual sectors. However, under these models, Norway and Switzerland both accept the EU's rules (including freedom of movement) and the rulings of the European Court of Justice (ECJ); they also contribute to the EU budget. Turkey enjoys a customs union with the EU, which covers most of the goods traded between them and includes a common external tariff. Despite this partial integration, the states in question continue to be treated as non-members of the EU. They have no representation or voting rights in EU organs, and play no part in creating EU secondary legislation – even in cases where they are obliged to implement it.

Any of these models would allow the British to pursue a "soft Brexit". But they would also require significant concessions on national sovereignty. The looming alternative is the threat of a "hard Brexit", where not only most of the political, but also the economic ties would be cut.

## **The Interests of the EU-27**

Directly after the referendum, the heads of state and government of the EU-27 agreed that there will be "no negotiations before notification". This put the ball in London's court as far as talks about leaving and creating a new relationship are concerned. The British government and parliament will use the time between now and late March 2017 to define the interests it wishes to prioritise in the coming talks. The EU should define its own interests equally dispassionately and thoroughly.

The interests of the EU-27 are shaped by three principal factors. Firstly, the EU states have an undeniable economic interest in maintaining regulated access to the British market. In 2015 about 10 percent of intra-EU trade went to the UK (value €302 billion). But the economic significance of trade with the UK varies between member states. The UK is one of the top five trading partners for Germany, France and Poland, for example (about 7 percent of exports in each case), for Ireland it is the most important (about 14 percent). The UK is a less central trading partner for many Central and Eastern European countries, such as Hungary, Austria and the Baltic states, and for Greece. In intra-EU trade, the UK has the second-largest trade deficit, after France. It originates entirely in visible trade; in services the UK has a trade surplus with the rest of the EU, above all on account of financial services. While Brexit will always involve additional economic restrictions, preserving free movement of goods would serve the central economic interests of the EU-27. The UK, on the other hand, stands more to lose from relinquishing its privileged access to free movement of capital and services than its European partners.

Secondly, the EU has an interest in guarding the Union's cohesion. The uncertain future of transatlantic relations following the US presidential election makes European unity even more crucial. Brussels will therefore insist that full participation in the internal market can only be granted if the EU's legislation and

regulations are implemented in full and its court rulings accepted. At their first informal meeting in June 2016, the twenty-seven heads of state and government reiterated their insistence that the four freedoms of the internal market are indivisible. Indeed, Switzerland and all the EEA states (like Norway) also are required to implement EU legislation in those areas where they participate in the internal market. Within the EU, too, flexibilisation on customs union and internal market is excluded. For the heart of internal market is not just exemption from customs duties, but collective regulation of the market and reciprocal recognition of standards and norms. This is what makes it possible to minimise non-tariff trade barriers. Simply in order to safeguard the functioning of the much more important intra-EU market, the Union has no option but to insist that participation in the internal market means accepting its rules.

Additionally, like monetary union, the internal market is not governed by a purely economic rationale. Instead it is set up as an integration project, based on a political balancing of the preferences and interests of the participating states. This includes mechanisms by which the more powerful economies compensate the benefits they derive from the internal market through EU-funded spending for the weaker members. The EU therefore demands that third states like Norway and Switzerland accept these package solutions and make their own contributions, for example through cohesion payments. On account of their participation in the internal market, these countries are also bound to permit freedom of movement for economically active persons. In purely economic terms, the internal market would also function with restricted freedom of movement, as evidenced by the long transition periods imposed on workers from new member states. So making participation in the internal market conditional on freedom of movement and contributions to the EU budget represents an important precondition

for protecting the EU's cohesion, rather than a punishment for the UK.

Thirdly, specific national interests will play a role in the talks with London. The Republic of Ireland, in particular, is concerned to keep its border with Northern Ireland as open as possible. Although freedom of movement between Ireland and the UK is regulated in a separate bilateral agreement, the openness of the shared border is heavily affected by EU membership. If the UK leaves the customs union with the EU, for example, customs controls would have to be introduced. And any hardening of the border would endanger the Northern Ireland peace process. Spain in turn demands at least shared sovereignty over Gibraltar if the UK leaves the internal market; otherwise, Madrid threatens to close its border with the British enclave. The EU states with most citizens living in the UK will want to protect their rights. In the negotiations, these particular interests will have to be reconciled with the overall interests of the EU-27.

The EU-27's existing position for the Brexit talks can be summarised as follows: British participation in the internal market is desirable and possible, but only under EEA conditions. That means acceptance of all four freedoms (including freedom of movement), contributions to the EU budget, and implementation of EU rules (including interpretation of internal market law, which in the EEA context means the ECJ and the EFTA Court). Notably, all twenty-seven member states are in complete agreement on these points.

### **London Wants the Hard Brexit**

Political developments in the UK since the Brexit referendum, however, show that any kind of partial integration that would effectively turn the UK into a satellite of the EU is out of the question. This is despite the UK having more to lose than the EU from ending privileged access to the internal market. The EU-27 is by far the most important trading partner for the UK, with about

47 percent of goods exports (August 2016); even its trade with Ireland remains larger than with China. But since her defining speech to the Conservative Party conference in October 2016, Prime Minister May has repeatedly excluded the possibility of any kind of cooperation based on existing partial integration models.

In connection with the talks, May has drawn three red lines. After leaving, the UK will neither accept full freedom of movement nor implement EU legislation, and will not be bound by rulings of the ECJ. May's government interprets the referendum above all as a vote against freedom of movement and loss of national sovereignty. The British Conservatives would not accept these aspects of the EU – which they regard as negative – surviving Brexit, even in exchange for participation in the internal market.

The Labour Party has also publicly committed to accepting the outcome of the referendum – especially with 70 percent of Labour MPs representing seats that voted “leave”. The Scottish regional government, on the other hand, is pressing for access to the internal market. But it possesses no formal veto right and has seen Prime Minister's cold shoulder. Even with the parliamentary participation required by the British courts, Britain is heading for a hard Brexit.

### **Building Blocks for a European Special Relationship**

Although the UK and the EU-27 derive great economic benefit from the common market, political interests on both sides thus largely exclude partial integration – unless one side decided to decisively subjugate its political interests for the sake of economic gain. This cannot be entirely excluded, for example if the economic costs of Brexit rise significantly before the talks are completed, or pressure is exercised by the British parliament. But a hard Brexit must be the baseline scenario for Germany and the EU-27.

This makes it even more crucial from the European perspective to define principles and mechanisms to enable cooperation with the British without integration into the internal market. The issue in question is a special relationship between the EU and the UK. The European interests outlined above suggest four elements.

#### **1. Change of status: from member to third country**

Brexit means a change of status from member to third country, requiring a different perspective on the whole relationship. When the UK leaves, this will be the first time that the EU has to establish comprehensive relations (“close partners”) with an ex-member, which for its part will be seeking to cut many of its ties with the Union. In principle the process of severing links should be regulated in the exit agreement.

As described above, London rejects any option that involves replicating the conditions of the internal market. So the question will be not which of the benefits of EU membership can be preserved (membership minus), but which (trade) relations the EU wishes to maintain with the UK over and above simple trade in goods (free trade plus x). The EU should therefore treat talks over future cooperation with the UK primarily as trade talks.

#### **2. Preserving free movement of goods**

In these trade talks the EU should seek at least a basic free trade agreement (FTA), in order to ensure tariff-free movement of goods. Potentially, if the negotiations went well, the corresponding provisions could follow on seamlessly from the transitional arrangements of the exit agreement. This would create legal security for European companies and safeguard a vital export market – especially for German businesses.

In view of the tight timeframe for the Article 50 talks, such a basic FTA should initially be configured purely as a duty-free

arrangement. This would place it far below the level of the EU's recent deep and comprehensive agreements like CETA, which aim primarily to abolish non-tariff trade barriers. As such it should be possible to conclude it within the two-year deadline, in parallel to the exit agreement. One relevant consideration is that a basic FTA could be ratified at EU-level, without involving the member states.

Such an agreement would also be clearly distinct from partial integration into the internal market, even in visible trade. For example there would be no common external tariff, no free movement of services and no "passporting" permitting firms based and regulated in the UK to sell financial services throughout the EEA. Nor would a basic FTA contain harmonisation measures or reciprocal recognition of norms and standards, which work to minimise the non-tariff trade barriers that play a much larger role today.

Initially at least, trade barriers created by differences in regulations will be minimal anyway. London has already announced that there will be a "Great Repeal Bill" to ensure legal security. Despite its name, as well as ending the applicability of European law within the UK, the proposed bill would also adopt the EU's entire *acquis* into British law with effect from the leave date. This will initially ensure close regulatory congruence. But each subsequent legal act and court ruling in the EU and the UK will widen the regulatory gap. In order to enforce European standards after Brexit, it may therefore make sense for the EU-27 to gradually augment the basic FTA with elements pointing towards a deeper and more comprehensive trade agreement. The EU should also prepare itself for any kind of targeted undercutting of EU standards by the UK to enhance its competitiveness, including in taxation.

As its preference for an EEA-type solution indicates, the EU is interested in an evolutionary clause to open a route for expanding relations beyond free trade. But London will attempt to secure access to the EU ser-

vices market by the back door, without shouldering the associated political and financial costs. What London most wants to avoid is concessions on sovereignty and freedom of movement.

The UK's primary interest is passporting rights for financial services. These presently permit banks and insurance companies operating in the UK – most notably the City of London – to offer their services across the EU, while operating under British regulations. Despite her statements on a hard Brexit, Theresa May has already promised international firms that their access to the EU market will be preserved. Here the EU-27 needs to preserve its existing consensus that full access to the internal market is contingent on all four freedoms. This should continue to apply if the basic FTA is gradually expanded.

### **3. Multidimensional cooperation**

Beyond the basic FTA, the EU has an interest in comprehensive cooperation with the future non-member; the form and level of commitment are initially open. Fundamentally the entire spectrum of existing EU policy fields, including foreign and security policy, needs to be reviewed to ascertain in how far and in which form cooperation with the third country UK should be organised. Donald Trump's election as US President will force Europe to adopt more responsibility for its own defence, and heightens the EU's interest in cooperating closely with the UK on internal and external security. The EU's broad range of forms of cooperation with other third states supplies a good illustration of the possibilities for bilateral cooperation.

In justice and home affairs Brussels and London will continue to share an interest in working together to tackle transnational challenges. Theresa May has already said that she intends to continue to work with the EU on policing, above all the fight against terrorism and organised crime. Here the British – despite their opt-outs – have long played a leading role in the EU.

Even after the Brexit vote, the UK has made use of its opt-in rights to continue its voluntary participation in Europol and the Eurodac database. Complete isolation from police and judicial cooperation in the EU would hit the British themselves hard, but also tear a hole in international crime-fighting.

Through Europol the EU and the United States have concluded an operational agreement on exchanging data for fighting terrorism and organised crime. In the case of Norway cooperation is even deeper. In justice and home affairs, the EU has numerous agreements with Oslo supplementing the EEA, ranging from data exchange to cooperation with Europol's Cybercrime Centre. Following Norway's example of joining Schengen is out of the question for the UK; not even for the forms of cooperation it provides, for example in EU asylum policy and the European border and coast guard Frontex. Even as a member of the EU, the UK rejected Schengen membership. The association agreement with Ukraine represents a middle path for collaboration with Brussels, with cooperation on border protection and counter-terrorism joining the long-term goal of visa-free travel. The principle in all three cases is that the respective countries are not involved in the EU's decision-making processes, but enhanced cooperation is enabled through bilateral agreements.

Parallels to this are found in the EU's Common Foreign and Security Policy (CFSP) and Common Security and Defence Policy (CSDP). As a NATO member with a permanent seat on the UN Security Council, the UK will remain an important partner for most EU states in this field. If it wished, the UK could contribute considerable military capacities and a wide-ranging diplomatic network. The UK also maintains close bilateral and multilateral relations with certain EU states, such as France and the Netherlands.

The EU has always kept NATO member Norway closely integrated into its defence policy, above and beyond the EEA. Norway

has a cooperation agreement with the European Defence Agency (EDA), and participates in an EU battlegroup as well as in EU military and civilian operations. Oslo also regularly supports joint EU positions at the United Nations and has joined EU sanctions against Iran, Syria and Russia. But Norway is excluded from the decision-making processes and consultation bodies of the CFSP/CSDP. Cooperation with NATO member Turkey is considerably less extensive because of the Cyprus conflict, but Ankara has also participated in EU military operations. In a similar fashion, the association agreement with Ukraine provides for political dialogue on foreign and security policy, as well as cooperation with the EDA and participation in EU exercises and operations. EDA cooperation is already active and there is political dialogue, but not to full extent envisioned in the agreement, on account of the ongoing Ukraine conflict.

There are, however, two significant reservations concerning future European-British cooperation on foreign and security policy. Firstly there is a question of how far London would even be willing to participate in the CFSP/CSDP. Even as a member of the EU, the UK was always very reserved in this context, sometimes even obstructive, for example with respect to a joint headquarters or the EDA budget. Secondly, as a non-member of the EU the UK would not have a say in CFSP/CSDP decisions; instead there would have to be bilateral dialogue between Brussels and London.

#### **4. Institutional framework for cooperation**

Even in the event of a hard Brexit the EU should build an institutional framework that enables it to discuss with London on a regular basis. This applies above all to cooperation in non-economic fields. In association agreements the EU has already created sometimes elaborate institutional means for dialogue with third states. The association article of the Treaty on the Functioning of the European Union re-

quires that such agreements define shared procedures and specific processes, as well as reciprocal rights and responsibilities. In practice this means regular meetings at senior official, ministerial or even summit level to discuss the state of relations and progress made. To this end there is usually also an ongoing dialogue between MEPs and the respective national parliaments. The setting often reflects the partner countries' strong desire for dynamic relations and ever closer association. As a rule representatives of the EU – Council President, Commission President or High Representative – meet directly with the third state; consultations between third states and the representatives of all EU members tend to be the exception.

The EU will face particular challenges in seeking to institutionalise its relations with the UK. Firstly, all forms of partial integration – and not just the hard Brexit – exclude British participation in EU decision-making processes. Leaving aside the political imperative to preserve the Union's cohesion. In the context of the founding of the EEA the ECJ explicitly ruled that decision-making and enforcement systems located outside the EU must not be binding on the EU organs. Secondly, even a basic FTA may require a basic institutional framework with working groups, a cooperation committee at senior official level and a ministerial cooperation council. But this rather technical cooperation would not be adequate for developing relations in non-economic fields. For example in the field of security a new institutional arrangement could be developed for cooperation on internal and external security.

All in all, the specific solution for the UK is likely to lie somewhere between the EU's loosely institutionalised relations with the United States and its over-institutionalised arrangements with Russia. Both versions involve summits. Like Washington and Moscow, London can also be expected to test whether it can divide the EU-27 through strong bilateral relationships (for example London-Berlin, London-Paris etc.).

There are various options for an appropriate institutional arrangement. Either the EU pursues a bundling of treaties and agreements – which could end up being as confusing as the package of more than 120 bilateral agreements with Switzerland. Or Brussels seeks a framework agreement, eventually building on the FTA, and embeds this further. It would also be conceivable to create a joint organisation with its own organs, modelled on the EEA. But that would presuppose shared interests in substantive areas. In all this it must be remembered that the EU is a community of law that requires a dependable framework for properly regulated relationships, and cannot be directed primarily by British pragmatism.

### **After the Divorce – a Special Relationship**

Negotiating the UK's departure and future relations will be an extremely complex operation even for the EU, both legally and politically. In the light of the three red lines London has already drawn, the EU's answer can only be to seek partnership rather than partial integration. In view of the shared interests and geographical proximity, this should be a special partnership, a European special relationship. In the two years of leave talks it will only be possible to build the base of this partnership, which should have four cornerstones: (1) the UK will be a third country outside the internal market, with (2) trade in goods is governed by a basic FTA; (3) arrangements for cooperation in external and internal security and (4) institutionalised forums for regular exchange.

Both the exit agreement and the special relationship will be new territory for the Union. So the talks are likely to be strongly characterised by insecurity, speculation and perhaps also experiments. Mitigating harm will not suffice as the EU's objective. At the same time the EU side is unlikely to find it easy to maintain a thoroughly consistent and unified negotiating stance



towards the UK. Strong conflicts of goals can already be seen emerging – between market interests and freedom of movement, between hard Brexit on economic questions and cooperation in foreign and security policy, and between the national interests of individual member states.

It is therefore central for the Brexit negotiators to communicate quickly and clearly which procedures are being applied and which goals the EU and its member states are pursuing. A European special relationship is a realisable project that also gives the EU space to pursue its internal reforms. This is necessary if the EU is to assert its foreign policy and security interests in a world in geopolitical turmoil. Despite Brexit the Union has the chance to renew itself as a political and economic powerhouse of the West.

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