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**IoD Policy Paper August 2017**

# **Bridging the Brexit Gap**

## Options for transition



## Executive summary

There is an urgent need for Government to engage properly on the most imminent risk to business from Brexit – what happens (or doesn't) on Brexit day. Given the unprecedented and comprehensive nature of trade negotiations to come, mitigating this risk early on is essential to a smooth exit. Regardless of whether they are called transitional, interim or bridging arrangements, making this a clear policy objective will send a significant signal of confidence to companies that the UK is committed to minimising the need for disruption.

The Institute of Directors has always been clear that engaging in discussion about objectives is not tantamount to revealing our negotiating hand – how we get there is a different exercise. “Minding the gap” however is first and foremost on the minds of businesses, and resolving this issue allows for a fuller engagement on the details of how to arrive at our final destination.

However, interim arrangements are not and should not be a single straightjacket. To be taken seriously, they warrant a greater level of detail on practicalities of what is needed. There are multiple ways in which these could be agreed, and the IoD sees its role as providing a range of options in order to allow for a wide-ranging discussion with Government and other stakeholders. The following

paper sets these out in greater detail, outlining as well the various trade-offs between them. In summary, some of these proposals include:

- The UK and EU agreeing to extend the Article 50 negotiating window in the next 6-12 months
- The UK entering into the EEA (agreement) as an independent contracting party
- Prolonging the application of the EU acquis
- Maintaining alignment with the EU's Common External Tariff (in particular to avoid sudden introduction of rules of origin for cross-border trade)
- Using Brexit-related legislative bills to incorporate ongoing alignment to EU rules, after responsibility for these functions have been transferred to the UK
- Signing up to the Common Transit Convention
- Establishing a joint EU-UK customs cooperation committee and Trade Contact Group to expedite discussion of trade facilitation issues between customs authorities and related bodies
- Undertaking a “parallel sources” agreement before the UK leaves the EU to bind a transitional deal into both parties' respective legal systems

## Overview

Much has been made in recent weeks over the desirability and shape of potential transitional arrangements as the UK leaves the EU. This has followed increased scepticism about the Government's intention to conclude a final agreement with the EU about its future relationship before the two-year Article 50 window expires in March 2019. While the objective is laudable and also one shared by the EU, the business community has learned from experience that Brussels and hard deadlines do not always mix well. Therefore – if both parties are serious about achieving an orderly Brexit – it is essential to discuss interim arrangements alongside our final destination rather than wait until the end of negotiations.

To date the Government has rigidly adhered to the idea of a "phased implementation" in referencing transition, if at all, but has put no flesh on the bones of what this might mean. As the IoD outlined in its Navigating Brexit report early in 2017, this discussion is ostensibly separate from interim arrangements, as 'implementation' denotes having concrete textual changes to put into place. Article 50 calls for the withdrawal agreement to "take account of a new framework" for future relations between the EU and a departing member state. If this is indeed a broad

framework, rather than the text of a new free trade agreement, businesses will have little to actually implement.

Interim arrangements would therefore deal with the bridging period during which the UK and EU would negotiate the technical detail of new regulatory cooperation outlined in the withdrawal agreement's framework for future relations. Over the past few weeks, members of the Cabinet have engaged in a range of speculative arguments over transition. The Chancellor has discussed the putative length of such a transition, and argued in his Mansion House speech that current customs border arrangements would be maintained for this period, even if the UK is outside the EU's Customs Union<sup>1</sup>. In contrast, the Transport Secretary told *BBC Newsnight* that it was "perfectly plausible that we could leave without a transitional arrangement".

While the latter may have been providing a reminder that the UK could still exit the EU without a deal, it is clear there is a need for Government to engage with the business community on the practicalities of what transition could mean. Instead of dancing around the edges, this issue must become a policy discussion for the Cabinet. This could minimise the growing level of

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<sup>1</sup> <https://www.gov.uk/government/speeches/mansion-house-2017-speech-by-the-chancellor-of-the-exchequer>

## The Single Market outside the EU

confusion and uncertainty in this area. Clearly, the details will be subject to negotiation with Brussels, but as the IoD has urged before, discussing objectives is not tantamount to giving away the negotiating strategy of how to get there. This is the reason that position papers are published, which both sides have committed to doing.

However, for the business community to be taken seriously in this regard and to build confidence in its argument that transition is about practical need and not remaining indefinitely within the EU's main strictures, it must come forward with its own detailed proposals. Some of the terminology employed so far in debate about transition has triggered a degree of scepticism. Simply "remaining in the Single Market and Customs Union" can appear to be a vague statement of intent, even if there are still many parts of the EU we would be out of under this type of 'arrangement'.

In truth – certainly to countries outside of the EU – there is no Single Market to be part of as such, but rather its Internal Market, which the likes of Norway, Iceland and Liechtenstein participate in through the EEA agreement. The European Economic Area, created in 1994, extends the Internal Market to members of the European Free Trade Association (EFTA). The UK, while originally a member of EFTA, left it in order to join the EU's predecessor, the European Economic Community (EEC). Our participation in the Internal Market, and by extension, the EEA, is therefore contingent upon our EU membership.

Consequently, "staying in the Single Market" is not a simple matter for the UK, as its current full participation in the Internal Market would cease upon EU exit. The consensus amongst most European legal and policy experts is that the UK would first need to rejoin EFTA and negotiate its way (back) into the EEA agreement as a new contracting party. As the next section sets out, this is not an insurmountable challenge, but very limited timing constraints could pose significant challenges.

## The Customs Union

The Customs Union, as per the European Commission<sup>2</sup>, marks out the external borders of the EU. While Brexit has created an unprecedented situation in which political goals will test the bounds of legal flexibility, it is difficult to see how a non-EU country could still formally be in its Customs Union. While this presents an important legal question, it has to some degree obscured the larger debate about whether the UK should be in any new customs union with the EU. Turkey and several microstates such as Andorra and San Marino are in separate customs unions with the EU. However, they are partial in scope and still require extra paperwork as well as some border checks to move goods between one other.

The EU's Customs Union long predates the advent of its Internal Market, being an original enterprise in 1968 to eliminate customs duties and adopt a common external tariff between the contracting parties in pursuit of a European common market. In addition, the Customs Union means there are no rules of origin applied to intra-EU trade and a common rules of origin system for products from outside the EU, as well as a common definition of customs value. While the Customs Union is defined by Article 28 of the Treaty on the Functions of the European Union, much of its practical content is underpinned by EU

customs legislation. As explained later, the legislative aspect may help the UK in its aim of maintaining "frictionless trade" even if formally outside the EU's Customs Union – at least in the interim.

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<sup>2</sup> [http://ec.europa.eu/taxation\\_customs/general-information-customs/eu-customs-strategy\\_en#about](http://ec.europa.eu/taxation_customs/general-information-customs/eu-customs-strategy_en#about)

## Options for Transition

The IoD agrees with the Government that on a long-term basis, membership of its Customs Union and the EEA agreement as currently constituted – outside the EU – is neither practical nor desirable. Our *Navigating Brexit* report goes into more detail on why this is the case, working on the established precedent of non-EU countries participating in both<sup>3</sup>. However, this does not prejudice the possibility that some of the asymmetries attached to those precedents could be renegotiated longer term.

We are also clear that there will eventually be some increase in transactional costs to trading with and doing business in the EU, and that pretending otherwise is denying the inevitable logic of trade-offs associated with Brexit. However, the business community's focus on interim arrangements is primarily aimed at keeping those to a minimum and allowing both companies and government infrastructure the necessary time to move towards our longer term objectives.

While the Government may have priced in the inevitability of some businesses relocating jobs and operations outside of the UK to ensure continued frictionless trade with the EU, IoD research shows this remains at a very low level to date. Only 11% of our members have activated

any contingency plans yet, and while some may see this as a lack of active preparation, it can also be viewed as an opportunity to steady the ship on our way out<sup>4</sup>. The Chancellor is right to worry about business investment stalling. This is among the most frequently considered changes to deal with Brexit, alongside relocation of operations to the EU. The latter is especially true for IoD members in Northern Ireland are currently considering co-location/relocation<sup>5</sup>. Government engagement on types of transition would send a significant confidence-boosting signal to industry and enterprise that an orderly exit is not just sound-bite but an active policy objective. It is not about delaying the inevitable, but rather allowing sufficient time to get to the end destination to minimise the need for disruption.

The IoD is proposing a range – but by no means exhaustive list – of options for interim arrangements in order to move the debate on transition from desirability to practicality. These are not a substitute for discussion on priorities for a longer term trade agreement but rather a complementary exercise. A holding arrangement will allow both business and the machinery of government to map out concrete details of our new relationship with the EU in a systematic and organised manner, thus allowing for a phased

<sup>3</sup> pg. 18-23, [https://www.iod.com/Portals/0/PDFs/Campaigns%20and%20Reports/Europe%20and%20trade/Navigating\\_Brexit\\_Priorities\\_for\\_business\\_options\\_for\\_government.pdf?ver=2017-02-20-174338-027](https://www.iod.com/Portals/0/PDFs/Campaigns%20and%20Reports/Europe%20and%20trade/Navigating_Brexit_Priorities_for_business_options_for_government.pdf?ver=2017-02-20-174338-027)

<sup>4</sup> <https://www.iod.com/news-campaigns/press-office/details/Government-has-window-of-opportunity-before-firms-trigger-Brexit-contingency-plans->

<sup>5</sup> <https://www.iod.com/news-campaigns/press-office/details/Government-has-window-of-opportunity-before-firms-trigger-Brexit-contingency-plans->

implementation of specific changes as they are agreed.

### Extending Article 50 Period

- This is the simplest way of allowing sufficient time for full negotiations to include a comprehensive free trade agreement, and ensuring one single period of adjustment/implementation for business, negotiators and government machinery to grapple with
- It is also the most WTO-compliant option, as we would still be in an existing and clearly-defined preferential trade arrangement
- However, it is politically very contentious. While the UK is no longer likely to have a General Election to deal with before 2022, European elections in 2019 are just one reason many in the EU would want the UK formally out of the EU by March of that year
- In order for this to substantially ameliorate business uncertainty, both sides would need to agree within the next 6-12 months to extend this if necessary, rather than leave any extension until the last minute in negotiations

- It also implies continuing EU Free Movement beyond March 2019 which HMG have already ruled out. However, this does not necessarily mean we will no longer have another 'UK' form of Free Movement<sup>6</sup>, which is also relevant for the other options below

### EEA option

- This would likely require re-entry into EFTA (although this is broadly desirable in its own right for the UK, unless a separate trade negotiation with EFTA is concluded) and a subsequent negotiation into the EEA agreement for the UK as a new contracting party outside of the EU
- It provides a tailor-made option for both continuity of trade (particularly in respect of preventing new non-tariff barriers) and input into decision-making to replace the UK's formal voting power on EU rules
- It could provide more autonomous control over sovereignty than simply prolonging the application of the EU's acquis. The EEA's Joint Committee (and Consultative Committee), its dispute settlement mechanisms and method of incorporating Internal Market legislation would

<sup>6</sup> <http://www.politics.co.uk/blogs/2017/07/31/no-10-announcement-on-free-movement-completely-without-meani>



allow for a more cooperative and consultative approach in transition, rather than pure imposition by Brussels once the UK has left the EU

- Accordingly, as a European Parliament briefing sets out, "In contrast with EU law, EEA law does not benefit from direct effect and primacy" – thereby necessitating an Act of Parliament to incorporate this option for transition<sup>7</sup>
- However, becoming a newly independent contracting party to the EEA agreement would not be a completely comprehensive transition for trade or for leaving the EU altogether. Exiting the Common Agricultural Policy, Common Fisheries Policy and the entirety of the Common Commercial Policy (i.e. full control over trade and related external relations) would also need to be negotiated
- Moreover, a transitional agreement to tie off other customs related issues would be needed, with the EEA agreement as one of several pillars, particularly to make this option WTO-compliant. **The additional requirements for this are outlined in the next section:**

- The EEA agreement currently has its own set of rules of origin and a diagonal cumulation system for simplifying this in Protocol 4. Without an exemption for the UK, this would introduce costly new requirements for goods trade with the EU and make some kind of customs border between the two immediately inevitable

- However, the EEA agreement would go a substantial part of the way towards halting the need for new customs control on animal and food standards issues<sup>8</sup>, and the EEA agreement itself does also contain a chapter on trade facilitation and customs cooperation between all the contracting parties

<sup>7</sup> p.3, [http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602053/IPOL\\_BRI\(2017\)602053\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602053/IPOL_BRI(2017)602053_EN.pdf)

<sup>8</sup> The EEA agreement and Internal Market rules govern large swathes of food/animal welfare and product standards. Regulatory divergence in this field –even the possibility thereof– increases the scope for compliance checks and documentation requirements



## Customs Duties and Cooperation in a Transitional Agreement

On the presumption that the UK could not formally stay part of the EU's Customs Union upon exit, several alternatives would be needed to replicate current customs border arrangements to maintain its benefits

- At a minimum, the UK would need to commit to maintaining the EU's Common External Tariff (CET) and/or aligning its harmonised tariff schedule (and code classification) to the EU's TARIC system
- While a new customs union to manage this and the below would be the simplest umbrella method of coordination, this is likely more of an option for negotiating a longer term agreement
- Since much of the EU's Customs Union is underpinned by customs legislation, the UK would need to agree to port over and continue transposing the Union Customs Code (UCC) as it develops for the transitional period. The forthcoming Customs Bill, rather than simply the Repeal/Withdrawal Bill, provides the opportunity to do so
- Customs transit is an extremely important method of facilitating the movement of goods with different customs territories and/or within a single one. To help facilitate our departure from the Customs Union, the UK should prioritise acceding to the Common Transit Convention in its own right -or through EFTA membership
  - This will allow the UK to continue benefitting from the New Computerised Transit System (NCTS) – a simplified electronic transit declaration system<sup>9</sup>. It would also mean that goods moving between the UK, EU and other contracting parties to the agreement will still be considered as being in "free circulation" throughout these multiple customs territories
- Remaining part of the EU's VAT union for a transitional period should be a priority, and can be supported through a similar commitment to continue transposing its VAT legislation during this time
  - This would help ensure that new onerous reporting requirements (changing from Intrastat/EC Sales List to

<sup>9</sup> <https://www.gov.uk/guidance/using-the-new-computerised-transit-system-to-move-goods-across-the-eu-and-efta-countries>

import/export declarations) are not immediately introduced, and that VAT treatment for UK-EU goods trade as well as access to the EU's one-stop-shop mechanisms for VAT compliance are maintained in the interim

- To manage all of the above, it is imperative that a joint customs cooperation committee between the UK and EU be established as soon as possible, regardless of whether the UK has left yet. The EU has these in place with many countries with whom it does not yet have a comprehensive free trade agreement
- This, alongside a dedicated Brexit trade contact group, would create platforms for our customs authorities, the Commission and related stakeholders to discuss trade facilitation issues
- The UK should also aim to continue participation in the EU's Customs Policy Group, an informal expert group consisting of the heads of customs administrations set up by the Commission. This does much of the policy coordination for the Customs Union - and counts countries like Norway as associate/observer members

### **Prolongation of the EU acquis**

- An arrangement whereby the UK agrees to continue to applying the body of EU law known as the acquis for a transitional period after it formally leaves is also another option which would draw together all of the issues covered by and absent from the EEA agreement
- This would be far more comprehensive and likely simpler to negotiate with the EU, and has been explicitly floated in the Council's original negotiating guidelines
- It would also likely be easier to apply time limitations to, and potentially allow for the phased implementation (or phased reduction in application) that the Government has spoken of
- However, it is unlikely to afford the UK much say in the development of – or flexibility in application – of EU laws during the transitional period. It would also make the EU more likely to dictate the terms of how the acquis prolongation would work compared to the EEA agreement mechanisms

- It would mean full and direct application of ECJ jurisdiction rather than the EFTA Court (although outcomes in rulings usually converge)
- It would likely mean less opportunity for "cherry-picking" the parts of the *acquis* that the UK would continue to automatically follow during the transition
- Questions remain over how to make this a WTO-compliant transition option in the absence of a formal customs union or free trade agreement (in order to comply with the WTO's non-discriminatory Most Favoured Nations rules - although few third countries are likely to object to such an in-principle extension of current arrangements)
  - EU and UK could opt for what some have described as a "parallel sources" agreement for transition to encapsulate the above<sup>10</sup>. This would need two separate legal mechanisms, created through an Act of Parliament (or amendment to the 1972 ECA which would be retained in domestic law after the Withdrawal Bill is complete) and EU regulation that would bind the both parties into the above

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<sup>10</sup> <https://www.law.ox.ac.uk/business-law-blog/blog/2017/02/how-make-transitional-brexit-arrangement>

## Summary

These collective proposals for interim arrangements are not a comprehensive list for mitigating against all Brexit-related uncertainty for business. Some are mutually exclusive and others would need to be done in tandem to achieve a transitional period resulting in “frictionless” trade between the UK and EU. They are instead a starter for ten, and the sooner both the UK Government and EU accept the need to engage on this area, the easier it becomes to achieve a smooth and orderly exit.

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