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Mrs May's emerging deal on Brexit

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- ★ Theresa May has set out her plan for Brexit: the UK will leave the single market and the customs union, and seek a free trade agreement (FTA) with the EU. But in Brussels key policy-makers worry that she may not succeed – either because the 'Article 50' divorce talks collapse in a row over money, or because the two sides cannot agree on the transitional arrangements that would lead to the FTA.
- ★ EU officials are pessimistic because they observe the pressure May is under from hard-liners to take a very tough approach to the negotiations. They see limited pressure on her for a softer Brexit. But several factors could favour a less-than-very-hard Brexit: a majority of MPs wants to retain close ties with the EU, as do business lobbies; and an economic downturn (if it happens) could steer public opinion away from supporting a clean break.
- ★ In May's government, 10 Downing Street takes all the key decisions. The downside of this centralisation is that decision-taking may be delayed, and particular proposals may be tested on too narrow a circle of experts.
- ★ The outcome of the Brexit talks will be shaped to a large degree by the EU governments. They are mostly united in taking a hard line. Worried about the cohesion and unity of the EU, they do not want populist leaders to be able to point to the British and say, "They are doing fine outside the EU, let us go and join them." Exiting must be seen to carry a price.
- ★ The British government has yet to decide what it wants on some key issues, such as: what sort of immigration controls should it impose? What kind of special deal, if any, should it seek for the City of London? What customs arrangements will it ask for? What sort of court or arbitration mechanism would it tolerate? And what transitional arrangements does it want?
- ★ Britain's strongest card is its contribution to European security. The arrival of Donald Trump could help the UK, by giving continentals an extra reason to keep the UK engaged; but if the British become too chummy with Trump, they will lose the goodwill of EU governments. Britain's other cards are weaker. It regards the City of London as a European asset that should be cherished by all – but that is not how most of the 27 see it. Nor should the UK try to claim that since the 27 have a trade surplus with it, they need a good trade deal more than it does; the reality is that Britain depends more on EU markets than vice versa. Finally, May's threat to respond to a bad deal by transforming Britain into a low-tax, ultra-liberal economy lacks credibility.
- ★ There are only three possible outcomes of the Brexit talks: a separation agreement plus an accord on future relations including an FTA; a separation agreement but no deal on future relations, so that Britain has to rely on WTO rules; and neither a separation agreement nor a deal on future relations, so that Britain faces legal chaos and has to rely on WTO rules.

- ★ Once Britain triggers Article 50, it is in a weak position: it must leave in two years, and if it has not signed a separation agreement before doing so, it risks economic chaos. So if Britain wants a half-decent deal, it needs the goodwill of its partners. That means ministers should be polite, sober and courteous. Grandstanding and smugness will erode goodwill towards the UK. As for the substance of the negotiations, the more that Britain seeks to retain economic and other ties, the more likely are the 27 to offer a favourable deal.
- ★ Whatever happens in the negotiations, Brexit will be hard. That is because both the UK and the 27 are placing politics and principles ahead of economically optimal outcomes. In the very long run, once both the UK and its partners have understood that a hard separation is not in anyone's interests, serious politicians will start thinking about how to engineer closer relations.

Ever since the early 1960s, when Harold Macmillan sought to take Britain into the then European Economic Community, Britain has been locked into a never-ending series of negotiations with its European neighbours – for accession (twice), renegotiating the terms of membership (twice), major changes to the founding treaties (six times) and new laws (thousands of times). The context of all these negotiations was that Britain and the other members would move closer together, stay conjoined once differences had been settled, jointly plan the club's future or work on improving the rules for everyone's benefit. Britain and the others felt a commonality of interest that lubricated the negotiations and encouraged compromise.

But the Brexit talks are about divorce and very different. Rational minds will point out that, even when the British leave the club, they and the 27 will still have common interests – notably in terms of economics and security – and that they should wish each other well. But divorces often involve acrimony and a lot of self-righteous posturing.

Britain has decided that it no longer wishes to share its destiny with the continental nations. At a time of global uncertainty, exacerbated by the arrival of Donald Trump in the White House, Britain's decision baffles its partners. They feel snubbed, hurt and (at least in some cases) insecure. Many of the factors that would have pushed them to satisfy Britain's preferences during previous negotiations no longer apply. The Brexit negotiations will be the most difficult in the EU's history.

Theresa May does not like the term 'hard Brexit'. That is because a hard Brexit – meaning a withdrawal that cuts many of the ties binding Britain and the EU – will inevitably have negative economic consequences. And when considering key decisions on Brexit, the British prime minister has been unwilling to acknowledge the trade-offs between sovereignty and economic well-being. But speaking in Lancaster House in January, May was fairly clear about the kind of Brexit she wants, and she edged towards recognising the trade-offs.

May wants a hard Brexit: freed of the jurisdiction of the European Court of Justice (ECJ) and EU rules on free movement, Britain will leave not only the single market but also the essentials of the customs union – which

means restoring customs checks on the EU-UK border. She wants "a bold and ambitious free trade agreement" (FTA). To govern the future economic relationship, and a "phased process of implementation" to cover the period between leaving and when the new arrangements take full effect.¹

The prime minister does not want the very hard Brexit favoured by some eurosceptics, according to which the UK would leave the EU and simply rely on World Trade Organisation (WTO) rules. Nevertheless some key officials in Brussels and other capitals fear that Britain may face a much harder Brexit than May imagines: exiting to WTO rules, or perhaps even falling out of the EU without any separation agreement, leading to legal chaos for companies and individuals.

This pessimism stems from these officials' reading of UK politics. They note that the domestic political pressures on May are nearly all from one side, the shrill eurosceptic lobbies and newspapers that want a very hard Brexit. The officials worry that these pressures may prevent May from striking the kinds of compromise necessary – for example, over the money Britain supposedly 'owes' the EU – for a deal to be reached.² They also fret that the British government is deluded over the strength of its negotiating hand; the reality, they (correctly) surmise, is that once Article 50 is triggered, determining that the UK must leave in two years, it is in a weak position. They fear that UK politics may drive May to walk away from the Article 50 negotiations and seek a bigger parliamentary majority in a general election.

1: Theresa May, 'A global Britain', speech at Lancaster House, January 17th 2017.

2: Alex Barker, 'The €60 billion Brexit bill: How to disentangle Britain from the EU budget', CER policy brief, February 2017.

Despite such worries, Britain's partners welcomed much of the Lancaster House speech, and the white paper that followed a few days later. They liked the clarity over Britain's intentions, and the warm words about the EU (which contrasted with the many rude things Donald Trump has said). But they did not like the suggestion that Britain's FTA could "take in elements of current single market arrangements" for the car industry and financial services. That sounded like 'cherry-picking' to the 27, who believe that the single market is all-or-nothing. Nor did they like May's comment that if the EU offered a punitive deal, the UK would walk away and turn its economic model into something akin to Singapore, with light-touch regulation and low taxes.

“That May proclaimed all could be done in two years makes Britain's partners worry 10 Downing Street is not in touch with reality.”

The most alarming passage in the speech was the pledge to negotiate not only the Article 50 separation agreement within two years, but also the FTA and everything else required to govern future relations on security, research, migration, energy and so on. Britain's partners think that is bonkers, especially since there will be not much more than a year for real negotiations, between the formation of a new German government towards the end of this year and the need to start the process of European Parliament ratification in late 2018. FTAs normally take at least five years to negotiate and several more to ratify.

UK officials talk confidently of bringing "bold ambition" and "political will" to the negotiations. They say that because EU and UK rules are already aligned, an FTA can be sorted out quickly. Britain's partners beg to differ, pointing out Britain's desire to be able to change the rules, its focus on ensuring good access for service industries, and the need to sort out sensitive issues like state aid and competition policy, will make the negotiations fiendishly complex.

If all goes well, the 27 believe, two years could suffice for the completion of the Article 50 deal and a sketch of the future relationship in a political declaration. That would fit the wording of Article 50, which says the Union should write the withdrawal agreement "taking account of the framework for its future relationship with the Union". The details of the future relationship could then be negotiated during the transitional phase, after Britain leaves the EU. But the fact that May proclaimed that everything could be done in two years makes Britain's partners worry that 10 Downing Street is not fully in touch with reality. They wonder if, following the departure in January of Britain's EU ambassador, Sir Ivan Rogers – who annoyed some in

the government by pointing to the many pitfalls that lie ahead – there remain enough officials willing to speak uncomfortable truths to power.

The biggest worry of Britain's partners is that London does not realise how weak its cards are. The strongest card – repeatedly mentioned by May in Lancaster House – is Britain's contribution to European security, via co-operation on policing, intelligence, defence and foreign policy. Any attempt by Britain to make its help in these areas conditional on a good trade deal would be viewed as cynical and damage its reputation. But handled deftly, Britain's contribution on security could help generate goodwill.

A related card cited by British officials is Donald Trump. His questionable commitment to European security, and the increasingly dangerous nature of the world, could make partnership with Britain more valuable to continental governments. But the Trump card could easily end up hurting the British. The more that British ministers cosy up to Trump, and avoid criticising his worst excesses, the more alien the British appear to other Europeans, and the more the UK's soft power erodes.

The British try to play the City of London as another card, claiming that it adds value to the entire European economy. Therefore, they say, the 27 should give the UK financial services industry a special deal, so that it can continue to do business across the EU. The British are right that the continent would incur an economic cost if it lost access to the City. Few EU governments, however, regard the City as a European jewel whose sparkle should be preserved. While some view it as a cesspit of wicked Anglo-Saxon capitalism, several others are keen to pick up the business that could leave the City post-Brexit.

May's threat in Lancaster House to turn Britain into a lightly-regulated, low-tax economy is a card that lacks credibility, given that in the same speech she spoke in favour of employee rights, workers on boards, industrial strategy and a fairer society. There is no majority in the Conservative Party or the country at large for creating an ultra-liberal economy, and the 27 know this.

Given the weakness of these cards, a half-decent deal will require the goodwill of Britain's partners. And that means that May and her ministers should conduct the talks in a sober, courteous and modest manner. She will help to foster a positive atmosphere if she seeks a relatively soft Brexit in some key domains, such as free movement of people or co-operation on security.

Some of the 27 are sceptical that the state of British politics will permit May to veer in a softer direction. But in fact May's political position is strong: the Labour Party is weak and divided, while hard-line Tory europhobes

have been partially disarmed by her pledges in Lancaster House. However weak May's hand may be in Europe, in the UK she may be in a stronger position than she herself realises.

The focus of this paper is the future economic relationship between the EU and the UK. May's government will also have to negotiate on issues like foreign and defence policy co-operation, counter-terrorism and policing, as well as research, universities, climate and energy.³ Some people will judge Brexit for the impact it makes on migration. But as far as Britain's long-term economic health is concerned, the trade and

investment relationship will be crucial in determining whether Brexit is a success or not.

The paper examines the pressures that may push May and her ministers towards a harder or a softer Brexit; how the centralisation of the British government may affect the negotiations; the priorities of the other member-states, and the EU institutions; the issues on which the British government has yet to make up its mind; the strength of the cards that Britain may be able to play; and the most plausible outcomes of the Brexit talks. The paper concludes by suggesting how the British government can achieve the best possible deal for the UK.

The pressures on Theresa May

One of the reasons why Brussels officials expect a hard Brexit is that they observe Britain's domestic political debate. They may not be engaged in 'pre-negotiations' with their British counterparts, but they do read Britain's newspapers and the speeches of its politicians. Brussels officials see a lot of pressure on May's government for a clean break with the EU and considerably less pressure for maintaining close economic ties.

Britain's eurosceptic lobbies are certainly well-organised, well-funded and noisy, with many allies in the press. If they decide they want something, they can raise the pressure and make it hard for the government to resist. For example, hard-line Leavers wanted the scalp of Ivan Rogers, whom they believed to be insufficiently committed to making a success of Brexit. 10 Downing Street denied Sir Ivan its full support and he resigned.

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The arrival of President Trump has boosted the self-confidence of those who want to cut ties with the EU. They argue that with the UK becoming America's best friend in a renewed special relationship, involving a bilateral trade deal, good access to EU markets is now less important. The performance of the UK economy has also strengthened the hand of the 'clean-breakers': thanks to higher than expected consumption after the referendum, output grew at about 2 per cent in 2016, faster than any other G7 economy.

The way the prime minister has chosen to talk about Brexit reassures those who want it to be hard. Although she was a (reluctant) Remainer, May now presents

3: Charles Grant, 'Theresa May's six-pack of difficult deals', CER insight, July 2016. See also Camino Mortera-Martinez, 'Plugging Britain into EU security is not that simple', CER bulletin 111, December 2016-January 2017.

herself as the voice of the 52 per cent who voted Leave, and of the 'left behind' people who want change. Her government's rhetoric is markedly less sympathetic to big business and the City than that of the Cameron government. The dictionaries of quotations will surely remember the key section of her party conference speech: "Too many people in positions of power behave as though they have more in common with international elites than with the people down the road. ... But if you believe you are a citizen of the world, you are a citizen of nowhere. You don't understand what citizenship means."⁴ The use of such words makes it hard for her to ignore the views of those – whether Brexiteer backbenchers or eurosceptic columnists – who claim to represent ordinary people against global elites.

Yet there are at least five reasons why May and her government may end up pursuing a softer version of Brexit than that desired by the hardest eurosceptics. These reasons, however, are unlikely to push the government towards the sort of Brexit that many businesses would like to see.

First, Britain's courts and Parliament have ended up playing a bigger role than May would have liked. May's starting position was that Parliament should not be involved in triggering Article 50 or in monitoring the negotiations. Then in January 2017 the Supreme Court ruled that the government must pass an act of Parliament before invoking Article 50. However, this ruling has not delayed the Brexit process. Although there is a House of Commons majority for a soft Brexit, a big majority of MPs voted in favour of the Brexit bill in early February. Indeed, many pro-Remain MPs are so scared of their voters – and the organised Brexit lobbies – that they were unwilling to make their support for the bill conditional on the government accepting amendments (one amendment, asking the government to guarantee the right of EU nationals to remain in the UK, came close to passing).

4: Theresa May, speech to the Conservative Party conference in Birmingham, October 5th 2016.

The House of Lords has an even stronger majority for Remain than the Commons, and may pass amendments to the bill. However, most peers are unwilling to be seen to block the popular will. The Commons would probably overturn any amendments passed by the Lords.

Nevertheless Parliament has gradually nudged the government to do things that it was reluctant to do. Most MPs wanted a white paper on the government's Brexit strategy, and they got one soon after the Lancaster House speech (though the white paper added little of substance).⁵ MPs wanted the right to vote on the final deal, so the government ceded the point in order to smooth the passage of the bill through the Commons. It has promised to submit the "final draft agreement" to Parliament, before ratification by the European Parliament. This means that MPs and peers will probably vote on the terms of Brexit in the autumn of 2018.

“If MPs vote down the deal, the government may be obliged to return to the 27 and ask for a softer variant of Brexit.”

It is not clear how much of a concession the government has really made. On the one hand, ministers are adamant that if Parliament rejects the deal, they will not return to the negotiating table, and Britain will simply leave the EU without any agreement – a position which could make it very hard for Parliament to vote no. On the other hand, Labour's Brexit spokesman, Keir Starmer, reckons that a parliamentary defeat would put strong pressure on the government to go back to the EU and seek to improve the terms. The significance of this concession will probably depend on the state of public opinion at the time of the vote. If voters have shifted towards regretting the referendum result, and MPs are emboldened to vote down the deal, the government may be obliged to return to the 27 and ask for a softer variant of Brexit. (It is virtually impossible to imagine circumstances in which Parliament would ask the government to revoke Article 50 and/or hold another referendum.)

The second reason why a softer Brexit is still possible is that business lobbies are getting their act together and speaking out more loudly in defence of their interests. Many businesses that said nothing during the referendum campaign are now trying to influence the government's negotiating stance. For example, pharmaceutical firms are concerned that leaving the single market may endanger their right to sell drugs across the EU. Airlines worry about the consequences of the UK quitting the

5: 'The United Kingdom's exit from and new partnership with the European Union', British government white paper, February 2017.

6: André Sapir, Dirk Schonemaker, Nicolas Veron, 'Making the best of Brexit for the EU-27 financial system', Bruegel policy brief, February 2017.

European Common Aviation Area. Car and aerospace manufacturers, as well as retailers, are worried about the impact of Britain leaving the customs union. Sometimes lobbying appears to work: Nissan demanded 'reassurances' before committing to new investments in Sunderland, and received a (secret) letter that persuaded it to go ahead.

Banks and other financial firms, realising that they have probably lost 'passporting' (the right for UK-regulated financial firms to do business across the EU), are hoping for provisions on 'equivalence' that allow them to retain access to EU markets (equivalence enables the EU to recognise a third country's rules as similar to its own; financial firms based in that country may then do business in the Union). Many large financial firms have made it clear that they will shift jobs out of the UK if they are not given sufficient assurances (one recent study suggested that Brexit would lead to the City losing 10,000 financial jobs, and a further 20,000 in supporting business services).⁶ Their priority, like that of many other businesses, is for the UK to obtain a transitional deal that provides for a few years' continuity while they consider their long-term options.

The third reason is that the economy may start to turn down while the government is enmeshed in the Article 50 talks. If and when that happens, the Treasury and others who want to maximise ties with the EU will try to push 10 Downing Street towards a softer Brexit. Early in 2017, the resilience of the economy was delighting Leavers, although the fall of sterling was beginning to push up prices. In the long term, uncertainty about the future EU-UK relationship is bound to affect levels of investment and thus productivity and growth.⁷ That may influence public opinion.

Fourth, a hard Brexit would increase the chances of Scotland leaving the UK. The Scots voted to stay in the EU by 62 per cent and many in the Scottish National Party (SNP) hope for a second independence referendum, so that a solo Scotland can join the EU. Yet Scottish opinion has not shifted significantly towards independence since June 23rd, mainly because of concerns about the economic consequences: Scotland exports four times as much to England as to the 27, and new barriers on the border between them could endanger some of that trade.⁸

However, the SNP is already making the case that Conservative England – with very little opposition from the Labour Party – is pursuing a hard version of Brexit that will harm Scotland. If in the long term Brexit is seen to damage the Scottish economy – for example through job losses to the financial services industry, or labour

7: Simon Tilford, 'Britain's economy: Enjoy the calm before the storm', CER bulletin 112, February-March 2017.

8: Some Scots also hesitate over going for independence because of the low oil price, and the EU's insistence that Scotland would have to sign up for the euro before acceding.

shortages in tourism – support for independence may rise. And then the need to placate the Scots would be another reason for London to pursue a softer Brexit.

Fifth, senior figures in the British government are gradually learning more about the EU. Many of them are starting from a low level of knowledge, but officials report that ministers are taking home and digesting long briefing notes.

May herself has a track record of being empirical on Europe. In 2013, when the government exercised its right under the Lisbon treaty to opt out of all existing justice

and home affairs laws, the then Home Secretary had to decide which areas Britain would opt back into (even though doing so would mean accepting the jurisdiction of the ECJ). May listened to the advice of the police, the security services and other experts and chose to opt back in to key measures like the European Arrest Warrant, Europol, Eurojust and the Schengen databases – much to the annoyance of hard-line sceptics. The more the prime minister and her aides and ministers understand how the EU works – and the domestic politics of the other member-states – the more likely they are to set objectives that are realistic and economically less harmful for the UK.

The centralisation of the British government

Ever since June 24th, the UK's partners have worried about the capacity of the British government machine to deliver a coherent strategy on Brexit, and to manage the complex negotiations that will unfold after Article 50 is triggered. They have probably been right to worry. These talks may prove to be the most difficult and complex negotiation conducted by a British government since the Congress of Versailles after World War I.

During the autumn of 2016, there was talk in Westminster and Whitehall of the government struggling to get a grip on the Brexit dossier. In November, a leaked memo from the Deloitte consultancy said that the government had no plan for Brexit, that it would take another six months for it to decide on its priorities, that civil servants had had little guidance on what to work on, that an extra 30,000 civil servants would be needed to make Brexit happen, that ministers were divided and that 10 Downing Street took all the key decisions.

“Despite his swashbuckling manner and long-standing euroscepticism, Davis is becoming an increasingly serious figure.”

The surprise resignation of Ivan Rogers, the UK Permanent Representative to the EU, in January, did not help the government's image elsewhere in the EU. In his leaked farewell letter to his staff, Sir Ivan wrote that “the structure of the UK's negotiating team and the allocation of roles and responsibilities to support that team need rapid resolution”, implying that the UK Representation in Brussels – with its in-depth knowledge of the views of the other 27 – was playing a less central role than it should. And Sir Ivan urged his colleagues to “continue to challenge ill-founded argument and muddled thinking [and] to never be afraid to speak the truth to those in power.”

Given the mammoth and unprecedented task of Brexit, and the creation of two new ministries – the Department

for Exiting the EU (DExEU) and the Department for International Trade (DIT) – some delay in formulating objectives, and a certain amount of chaos, was to be expected. By the early months of 2017 the government appeared to be getting its act together. Nevertheless the way that May has organised her government has in some ways added to the confusion.

The most striking feature of the May government, compared with its predecessors, is the centralisation of power in 10 Downing Street. Under Tony Blair, Gordon Brown's Treasury was an important rival centre of power. When Brown became prime minister, his government was more centralised, but senior ministers such as Alistair Darling, Alan Johnson and David Miliband also had clout. Under David Cameron, George Osborne's Treasury was a second, though not necessarily rival, locus of power.

On Brexit, as on most other key issues, the big decisions are taken in No 10 by May and her closest advisers. The most important are Fiona Hill and Nick Timothy, who worked with her in the Home Office. The most influential ministers on Brexit questions are David Davis in DExEU and Philip Hammond in the Treasury. Of the ‘three Brexiteers’ (the others being Foreign Secretary Boris Johnson and DIT Secretary Liam Fox), Davis has the most at stake in the outcome of the negotiations, and seems to have established a good working relationship with 10 Downing Street. Despite his swashbuckling manner and long-standing euroscepticism, Davis is becoming an increasingly serious figure in the government. Hammond is the leading voice for moderation. He has also long been sceptical about the EU, but came out for Remain during the referendum campaign. He is an economic liberal who listens to the voices of business. He has known May since they were at Oxford University and is trusted by her, though he is a weaker chancellor than Brown was to Blair or Osborne was to Cameron.

The views of Boris Johnson also count, because he sits on the cabinet committee that deals with Brexit and

because of his popularity in the Conservative Party and the country. However, his relationship with No 10 is tense at times and, as an institution, the Foreign and Commonwealth Office (FCO) has been marginalised on Brexit. Liam Fox appears to be outside the innermost circles of decision-making.

The most important official working on Brexit is Olly Robbins, who doubles up as permanent secretary in DExEU and the prime minister's personal adviser on Brexit. Sir Tim Barrow, the career diplomat who has replaced Ivan Rogers, is playing a major role (he has worked in the past on Russia and security policy as well as the EU). Sir Jeremy Heywood, the cabinet secretary, is also closely involved in Brexit matters. Peter Storr, a former Home Office official, and Denzil Davidson, a longstanding Conservative special adviser, are part of the Europe Unit in 10 Downing Street that advises May. Chris Wilkins, head of strategy in No 10 and a former Conservative official, plays a big role in the key speeches.

There may be upsides to the centralisation of decision-making in 10 Downing Street. By confining the decision-making on key issues to a small circle of trusted allies, the prime minister can ensure that sensitive discussions do not leak. And when the prime minister decides what she wants, she should be able to execute her wishes quite quickly, with minimal foot-dragging from other Whitehall departments. But there are evidently downsides. People in the inner circle may become over-stretched, so that important decisions are delayed. And centralisation may discourage the tapping of outside expertise. In May's government, there appear to be relatively few people at a very high level with significant expertise in areas such as the EU, diplomacy, economics, financial markets or business (many of her inner circle have a Home Office background). If too small a group of people is involved in decision-making on Brexit strategy, policies may emerge that are not viable. One example is the commitment in the Lancaster House speech to negotiate not only the Article 50 deal but also the future EU-UK arrangements on trade and everything else in just two years.

What the 27 want

The kind of deal that Britain ends up with will depend, to a large extent, on what the EU is prepared to offer. So far, the member-states and the institutions have achieved a unity and strength of purpose that has surprised many of them – as well as British officials. The mainstream view, set by the Germans, the French and the Brussels institutions, is to be tough on the British. There can be no negotiations until Article 50 is invoked. And given that Britain wants to restrict the free movement of EU workers, it cannot remain in the single market. Most governments also insist that they will not deal with the UK bilaterally, and that it must talk to the EU as a whole.

“The mainstream view, set by the Germans, the French and the Brussels institutions, is to be tough on the British.”

Then there are some specific issues on which the EU will be very tough. The 27 are demanding that Britain hand over a large sum – perhaps as much as €60 billion – before it leaves. The greater part of that figure stems from Britain having committed to support many EU projects on which the money has not yet been spent. The 27 also want Britain to pay towards future pension payments to EU staff, and any contingent liabilities that may turn sour (for example, EU loans to Ukraine or Ireland).⁹ The Commission, and some of the 27, are adamant that unless Britain agrees to hand over most of this money –

allowing progress to be made on the Article 50 separation talks – they will be unwilling to start talks on the future relationship. The European Parliament supports this hard line. However, many EU governments reckon that in practice the Article 50 talks will have to run in parallel to those on the future.

The EU will be tough on the transitional arrangements that Britain will ask for. If Britain wants to remain in aspects of the single market after it leaves, it will be asked to accept both free movement and the rulings of the European Court of Justice – and perhaps also to pay into the budget.

The 27 will also be obdurate on financial services. They have no desire to give the British a deal that would allow the City of London to emerge unscathed from Brexit. Few of the 27 view it as a European asset that should be preserved. Some see it as a malignant entity that has the potential to destabilise the eurozone.

Wolfgang Schäuble, the German finance minister, talks with a softer tone: “London offers financial services of a quality that one doesn't find on the continent.... That would indeed change a bit after a separation, but we must find reasonable rules here with Britain.”¹⁰ Such views, however, are not common among EU leaders, or even in Germany.

A hard EU line on such issues could provoke a crisis in the Brexit talks. Europe's leaders, however, are not very scared by the prospect of an acrimonious Brexit. They believe

⁹: Alex Barker, 'The €60 billion Brexit bill: How to disentangle Britain from the EU budget', CER policy brief, February 2017.

¹⁰: Interview with *Tagesspiegel*, February 5th 2017.

that though the severing of economic ties would cause the 27 some harm, the UK would suffer much more, given its greater dependency on EU markets than vice versa.

In any case, for Angela Merkel and for most other leaders, politics matters more than economics. They do not want populist eurosceptics in countries like France, Italy or the Netherlands to be able to profit from Brexit, by saying to voters “Look at the Brits, they are doing fine outside the EU, let us go and join them!” EU leaders also worry about some parties in power. For example, in France one hears concerns that Poland’s nationalist government could use the example of a successful Brexit to argue that the Poles would also be better off out.

“Merkel’s key concern is to maintain the strength and stability of the EU, and to keep the 27 together.”

Thus most of the 27 do not want the British, in the words of Boris Johnson, to be able to “have their cake and eat it”. The French say this more directly than the Germans, as when President François Hollande said of the Brexit talks last October: “There must be a threat, there must be a risk, there must be a price.”¹¹ But Berlin, too, thinks that the British have to be seen to be worse off out.

Most EU governments want to prevent not only contagion to other member-states but also the institutional unravelling of the EU. If the British were given a special deal that allowed them to stay in the single market without having to accept all the rules, other countries – inside or outside the EU – might demand similar provisions, and then the institutional strength and the coherence of the Union would be undermined. The governments claim an economic rationale for this political point: once the British are allowed to pick holes in the single market, it will be harder to stop others erecting barriers.

The Brussels institutions are particularly sensitive to innovations that could weaken their role. There is a profound institutional conservatism in the thinking of many EU leaders and officials, which is one reason why David Cameron found it so hard to engineer serious reforms during his renegotiation. Although the ‘indivisibility’ of the four freedoms – of goods, services, capital and people – is a dogma in Brussels, there are sound arguments behind it. Economically, free movement makes the single market fairer and more efficient (many services cannot cross frontiers unless people are free to move), while politically, it is widely viewed as a great achievement rather than a problem to be managed.¹²

11: Speech at the Hotel de Lassay, Paris, October 6th 2016.

12: Camino Mortera-Martinez and Christian Odendahl, ‘What free movement means to Europe and why it matters to Britain’, CER policy brief, January 2017.

13: Agata Gostyńska-Jakubowska ‘Parliamentarians in Brexit talks: Bulls in a china shop?’, CER policy brief, February 2017.

What matters most is not what the institutions think, but rather the views of France and (especially) Germany. They will want to ensure that they keep a close eye on the Commission as it leads the negotiations. In December, the European Council decided that a representative of Donald Tusk, its president, should take part in the negotiations – and also that the rotating presidency of the Council of Ministers should send an official to join the Commission team. The European Parliament has so far failed to win the right to take part in the Brexit talks, though it will have to approve the final deals.¹³

Merkel’s key concern is to maintain the strength and stability of the EU, and to keep the 27 together. That means considering the interests of the entire Union as much as what is good for the German economy. Britain’s departure leaves Germany more dependent on France; Germany must therefore respect and to some degree go along with France’s desire for a hard line on Brexit. Merkel often repeats that the four freedoms are indivisible. Many British eurosceptics wrongly imagine that Germany will allow its narrow economic interest in close ties with the UK to determine its strategy.¹⁴

Once the negotiations begin, it may be harder for the 27 to remain united. A disparate collection of countries may be tempted to cut bilateral deals with the British: Poland and Hungary, which share some of their euroscepticism and hostility to Brussels institutions; Ireland, which is particularly worried about the impact of Brexit on its economy and the Northern Irish peace process; and perhaps Sweden, whose leaders think like the British on economic issues such as free trade and the single market. But as one German diplomat points out: “The British should be careful what they wish for; the more disunited the 27 become, the more that will delay negotiations, and increase the risk of Britain crashing out with no deal.”

In any case, the views of Dublin or Warsaw are unlikely to push the EU’s centre of gravity far from the line established by Berlin, Paris and Brussels. Nor should the British expect this year’s French and German elections to lead to more UK-friendly policies.

Unless Marine Le Pen wins in France (which appears unlikely at the time of writing), the next French president is likely to maintain Hollande’s tough line, because that is what the French establishment considers to be in the French national interest. The independent candidate and current favourite, Emmanuel Macron, says he will be “pretty tough” on the UK because the EU must “convey the message that you cannot leave without consequences”.¹⁵

14: Charles Grant, ‘Why the 27 are taking a hard line on Brexit’, CER insight, October 2016; and ‘Brussels prepares for a hard Brexit’, CER insight, November 2016.

15: Interview with the UK’s Channel 4 News, February 13th 2017.

If Merkel remains Chancellor after the general election in Germany, its policy on Brexit will not change. And if Martin Schulz caused an upset by stealing her crown, a

government led by the Social Democratic Party, which is keener on EU integration than the Christian Democrats, would be tougher on the British.

The key decisions that Mrs May still has to make

May's Lancaster House speech, and the white paper that followed, left several crucial issues open. What sort of migration regime will she seek? What will she propose for EU citizens living in the UK? Will she try to stay in parts of the EU's customs union? Will she prioritise a special deal for the City of London? What kind of judicial or arbitration mechanisms will resolve disputes between Britain and the EU? And, perhaps the most difficult of all, what kind of transitional arrangements will she ask for?

The most contentious issue for many Britons will be how May restricts migration from EU countries. This need not be negotiated with the EU – it is a sovereign decision for the UK to make. Nevertheless the model that Britain chooses will influence the stance of the 27 in the Brexit talks.

“Officials suggested that limits on migration must be tough enough to bring about a significant fall in the number of EU migrants.”

Neither May nor her ministers have said much in public on the scheme they want to adopt. However, key officials have suggested that the limits must be tough enough to bring about a significant fall in the number of EU migrants. (Ironically, some of the most senior Leave ministers, such as Brexit Secretary Davis, and Foreign Secretary Johnson, probably favour a more liberal regime than the prime minister, who voted Remain.)

Some system of work permits, with numerical quotas set for particular sectors, is likely. The government has yet to decide whether to have similar or different systems for skilled and unskilled labour, and whether to distinguish between EU and non-EU nationals. But some ministers have hinted that both skilled workers and EU nationals will be treated more leniently. The white paper suggested that it may take several years to introduce the new rules.

One issue that will feature prominently in the Article 50 talks is the 'acquired rights' of the nearly three million EU citizens living in the UK, and of the roughly one million British citizens living in the 27. This subject need not be controversial in terms of British domestic politics. Not only Remain politicians, but also virtually all those who led the Leave campaign want EU citizens in Britain to be

allowed to stay – irrespective of what reciprocal rights are offered.

In December 2016 the British government sought a provisional accord on this point, speaking to many member-states individually. The EU rebuffed the British, because their initiative raised fears of a divide-and-rule strategy, and because they seemed to be attempting a 'pre-negotiation' before triggering Article 50. This rebuff was unfortunate, since it made the EU appear dogmatic and indifferent to the real insecurities of continentals living in the UK (but to many of those EU citizens, May's government also appears indifferent, in resisting the pleas of British politicians to guarantee unilaterally their right to stay).

In any case May and her ministers will prioritise the issue of EU citizens in the UK when substantive talks commence, and the EU will probably do the same. But it remains far from clear how the rights of EU nationals in the UK will be guaranteed. Presumably they will need to register and provide proof that they have lived in the UK for a certain period of time. But will the cut-off point be the date of the referendum, or of Article 50's triggering or of Brexit – or some other day? The EU will surely say that people who move to the UK before the day of Brexit are exercising their legal right to do so and should be allowed to stay.¹⁶

EU officials fear that, even with goodwill on all sides, the technicalities involved will make this a difficult negotiation. For example, the definition of a 'resident' is different in Britain and in France. What kinds of family member would an EU citizen living in Britain be able to bring into the country? And what kinds of welfare and healthcare would residents be entitled to (these issues are largely the responsibility of national governments, which may encourage the UK to seek bilateral deals with particular capitals)?

The only substantially new announcement in the Lancaster House speech was the decision to leave the essentials of the EU customs union, namely the Common Commercial Policy and the Common External Tariff. Britain's manufacturers, retailers and farmers – as well as the Treasury – had been hoping Britain would stay in, so that UK-EU trade could remain free of tariffs, bothersome rules of origin and customs procedures. The recent House of Lords report on trade criticised the government for not having done enough work to quantify the cost of leaving the customs union.¹⁷

¹⁶: Camino Mortera-Martinez and John Springford, 'Britain will struggle to make EU migrants 'go home'', CER insight, August 2016.

¹⁷: House of Lords, European Union committee, 'Brexit: the options for trade', December 2016.

But staying in the customs union would prevent Liam Fox from striking trade deals with other countries. It would also require some mutual recognition of things like product standards and safety requirements (and this could, arguably, give the ECJ an indirect role). The British would have to adopt not only European tariffs without having a vote on them, but also some European regulations.¹⁸

Yet there was some ambiguity over the customs union in the Lancaster House speech. May said she wanted a customs agreement with the EU and asked whether Britain could “become an associate member of the customs union in some way, or remain a signatory to some elements of it ... I have an open mind on how we do it”.

The prime minister has said that the issue of the customs union is not a binary decision, which might be taken to imply that certain industries could stay in the union and others leave it. But that would breach WTO rules, which state that a customs union, like an FTA, must apply to substantially all trade in goods between two entities. Nevertheless in the speech she singled out the car industry for special treatment in the FTA that she will seek with the EU.

“The British and Irish governments may be obliged to restore customs posts between Northern Ireland and the republic.”

She may have meant that if Britain and its partners agreed to recognise each other’s regulations on cars and their components, customs controls could be minimal. The more that the UK and the 27 can strike mutual recognition agreements, the less there is a need for customs checks. But with Britain outside the common commercial policy and external tariff there would still have to be checks for tariffs (when tariffs apply) and rules of origin (lest goods made in the UK with a high proportion of non-EU components ‘escape’ the EU’s external tariff).

That is a particular problem for the Irish. With Britain out of the customs union, the British and Irish governments may be obliged to restore customs posts between Northern Ireland and the republic (passport controls will probably not be needed, since the UK is unlikely to require EU citizens to obtain a visa before visiting). The appearance of customs posts could be a provocation to terrorists. There is a strong desire in Dublin, Belfast and London to find some clever system which would obviate the need for customs controls on the border. The good news is that Michel Barnier, the Commission’s chief Brexit negotiator, is very keen to help. The less good news is that nobody has yet found the clever system that will solve the problem.

¹⁸: John Springford, ‘Customs union membership is no way out of the Brexit trap’, CER insight, December 2016.

The Lancaster House speech also singled out the freedom to provide financial services across borders as another objective for the FTA. The British government is resigned to losing ‘passporting’, since the 27 consider it part of the single market. ‘Equivalence’ could be another way of enabling UK-based firms to access European financial markets from outside the EU. But equivalence is very much a poor man’s substitute for passporting; it does not operate in some financial sectors, like commercial banking and certain sorts of insurance; the Commission decides whether to grant it; and the Commission may revoke equivalence at 30 days’ notice.

The big financial firms in London are not sure how much May really cares about their fate. Of the 78 pages in the white paper on Brexit, only one covers financial services, one of Britain’s strongest economic sectors. Philip Hammond and the Treasury have certainly listened to the City’s concerns. But to judge from her public comments, May is less of an enthusiast for the City than her predecessors Tony Blair, Gordon Brown and David Cameron. Paying particular attention to the fortunes of over-paid foreign financiers would hardly fit with her narrative that the government is focused on the ‘just about managing’ classes.

Nevertheless the government will surely not ignore this industry in the Brexit talks; it contributed £70 billion in taxes last year, and ran a trade surplus of £63 billion. The Treasury hopes for an FTA that will provide something better than the current system of equivalence. It would be happy if the UK and EU both undertook to abide by globally-agreed standards; if each of them started out by recognising the other’s rules as equivalent; and if and when either wanted to change its rules, a joint committee decided whether they remained equivalent. It would also hope for equivalence to become a legally watertight concept, rather than one which can be revoked at the whim of the Commission. However, the EU is unlikely to agree to a deal that implies equality of status in rule-making between the 27 and the UK, and it will want the ECJ to play a role in arbitrating disagreements.

Indeed, dispute settlement may well cast a long shadow over much of the negotiations. The government appears to recognise this, having added a four-page annex covering various types of dispute resolution mechanism to the white paper. Ever since her party conference speech in October, May has singled out the avoidance of ECJ rulings – alongside restrictions on free movement – as her top priority for the Brexit deal. But some British officials wish she had been less categorical and that she had left herself some space for an ECJ role in arbitration.

It is true that the EU’s FTAs with other countries include arbitration mechanisms that do not involve the ECJ, and

the UK will presumably ask for similar provisions in its own FTA. But when the UK requests special arrangements that resemble single market membership, or other sorts of very close relationship – as it may do on financial services, or data transfers, or aviation, or the European Arrest Warrant – the EU will insist that its court be the arbitration body.

The British are thinking about other models of arbitration that could be adapted, such as the EFTA court, which polices the rules of the European Economic Area for its three non-EU members – Liechtenstein, Norway and Iceland. The court is based in Luxembourg and its judges are nominated by those three countries. The court follows ECJ jurisprudence where it exists, but has more latitude in cases where there is no relevant ECJ ruling.¹⁹ But if the UK were to ask for something similar, it would have to contend with the strong belief in Brussels and many member-states that the authority of the ECJ should not be diluted.

“The most difficult part of the negotiation may be over the transitional arrangements that the British will request.”

The most difficult part of the negotiation may be over the transitional arrangements that the British will request. May said in her Lancaster House speech that the entire future relationship could be worked out in two years, alongside the Article 50 negotiation. But the view of nearly all officials, in London, Brussels and the member-states, is that an FTA between the UK and the EU will take much longer than two years to sort out. All the experts giving evidence to the House of Lords’ EU committee, for its recent report on trade, said that two years would be impossible.²⁰ The Canada-EU FTA took seven years to negotiate and a further three to ratify.

Businesses want a transitional deal to provide regulatory stability during the period between when the UK leaves the EU, probably in spring 2019, and whenever the FTA enters into force. Without a transition, they would face a ‘cliff-edge’, falling out of the single market with only the

rules of the World Trade Organisation to protect them – meaning tariffs on many goods, very high tariffs on some farm exports and sharply reduced market access for many service industries.

After taking some time to acknowledge that it will need transitional arrangements, the government has come round to the idea. The white paper says that after leaving the EU, a “phased process of implementation” could cover “immigration controls, customs systems or the way in which we co-operate on criminal and civil justice matters. Or it might be about the future legal and regulatory framework for business.” The white paper then says that some of these interim arrangements will need to last longer than others.²¹

Both what Britain will ask for on the transition, and how the 27 will respond, remain uncertain. It seems unlikely Britain will want to stay in the single market during this phase – and if it did, the EU would insist on free movement, payments into the budget and the ECJ, which May could probably not accept. A transition that retained the customs union for a period would be easier to agree upon, but by no means easy; the EU could still insist on a role for the ECJ.

The precise timing of the talks on the transition will be particularly contentious. The UK will want interim arrangements to be fixed as soon as possible in the separation talks, to dissuade footloose companies from quitting the UK. But the EU may well exploit this British requirement by demanding concessions in other parts of the negotiation. In any case, EU officials see strong reasons to leave the transition talks until near the end of the two-year Article 50 process: it would not make sense to talk of a transition without knowing the outlines of the future FTA. Yet there will not be time to grapple with the FTA, they say, until difficult Article 50 issues are sorted out (such as budget contributions, the rights of EU citizens in the UK, giving certainty to legal contracts, and so on).

It is because the negotiation of the transition is likely to be so fraught that a smooth Brexit, leading to an FTA, cannot be taken for granted.

How strong are Britain’s cards?

Once Article 50 is triggered, Britain has just two years to strike a deal. Technically, that period can be extended, but only by unanimity, and given that most of the 27 are firm on the two-year period, an extension is unlikely. The clock will be ticking and if there is no deal at the end of

the period, companies and individuals would face great uncertainty and there would be legal chaos. As far as many EU governments are concerned, this puts the British in a weak position: the pressure of time running out may force May’s government to accept a deal on the EU’s terms.

19: Alan Dashwood, ‘EEA could be good model for dispute resolution post Brexit’, InFacts, February 2017.

20: House of Lords, European Union committee, ‘Brexit: the options for trade’, December 2016.

21: ‘The United Kingdom’s exit from and new partnership with the European Union’, British government white paper, February 2017.

The response of many Britons is: “But that would damage our and your economies, which is not in your interests.” However, as this paper has argued, the 27, like the British, are not being driven primarily by economics. The best-informed British officials understand that the UK will be in a weak position during the Brexit talks. But there is a risk that those who are brave enough to explain this fact will be attacked by newspaper columnists or in social media as “remoaners”, “defeatists” or “people who talk their country down”.

“Because of the patchy expertise in London on EU matters, there is a risk that the British will overplay their hand in the negotiations.”

Because of the patchy expertise in London on EU matters, there is a real risk that the British will overplay their hand in the forthcoming negotiations. Many British eurosceptics are convinced that May can achieve a good deal because, they believe, she has many strong cards to play. They mention Britain’s contribution to European security; the arrival of Donald Trump in the White House; the strength of the City of London; the UK’s large trade deficit with rest of the EU; and the threat to turn the UK into a low-tax, deregulated Singapore-style economy. Some of these cards could help Britain in the forthcoming talks, but only if handled deftly, and none of them gives it a great deal of clout.

The strongest card is Britain’s contribution to European security, a point mentioned several times in the Lancaster House speech. It has a permanent seat on the UN Security Council, skilled diplomats, capable armed forces, effective intelligence services and considerable expertise on fighting terrorism and organised crime. A leading member of NATO, Britain is one of the few countries to meet that alliance’s 2 per cent of GDP target for defence spending. It recently sent about 1,000 troops to Estonia and Poland. Given this contribution to European security, some government advisers have suggested, EU member-states – and especially those in Central Europe – should go the extra mile to give the UK a generous exit settlement.

However, this argument, if handled unsubtly, could backfire on Britain. Some Baltic and Polish politicians who heard it last summer were miffed, saying they had thought the UK was sending troops because it cared about their security; but it now appeared to be a cynical move to ensure better terms on a trade deal.

So the British should not seek a trade-off between security and trade. Rather, they should appreciate that the more they contribute to European security, the more that

generates goodwill, and – in the long run – that should help them secure a favourable trade deal. May got the tone right in Lancaster House, saying that she wanted “practical arrangements on matters of law enforcement and the sharing of intelligence material with our EU allies” and “to work closely with our European allies in foreign and defence policy”.

Some Britons believe that the election of Donald Trump strengthens Britain’s security card. Given Trump’s ambiguous attitude to NATO and his softness towards Russia, many Central Europeans and others are fearful. Therefore, the thinking in London goes, the continentals need the UK’s contribution to their security more than ever. There is some merit in this argument, but the British need to be careful about the way they play the Trump card. If the UK is seen as too friendly to the new president – a point discussed in the penultimate section – its attractiveness as a partner diminishes.

A third card, often cited by eurosceptics and those more favourable to the EU, is the strength of the City of London. They argue that since the City benefits Europe as a whole, the EU would be silly to harm it – for example, by preventing London-based firms from serving EU clients, or by forcing the clearing of euro derivatives into the eurozone.

The Bank of England’s governor, Mark Carney, has argued that a bad deal for the City would lead to a greater risk of financial instability on the continent than in the UK.²² That assertion is over-the-top, but the fragmentation of Europe’s financial markets would raise the cost of capital for many continental companies. They depend on the City to raise money, trade currencies, hedge risk and provide financial expertise. Some 8,000 continental financial firms benefit from passporting into British markets, compared to the roughly 5,000 which passport out of the UK into other EU countries (though the latter do a lot more business than the former). The Bank of England is probably right to argue that if business left the City, as much of it would relocate to non-European centres (such as New York or Hong Kong) as to rival European cities.

But that is not how it looks to a lot of top EU politicians and officials. They do not want to give the City special treatment. Indeed, some of them laugh when they hear the argument that hurting the City could rebound on the 27. Some European politicians blame the City for the financial crisis of 2008, viewing it as a haven of crooked Anglo-Saxon finance capitalism; others are intent on attracting City business to their own financial centres. The 27 are firm that the UK should lose passporting, and as for equivalence, the Commission recently launched plans to make the rules more onerous, so that the UK would find it harder to meet standards set by the EU. France, Germany and the European Central Bank are strongly committed to

22: Evidence to the House of Commons Treasury select committee, January 11th 2017.

shifting the clearing of euro derivatives from London into the eurozone. It will be very difficult for the UK to achieve any kind of special deal for the City.

A fourth card, often cited by eurosceptics, is Britain's trade deficit with the EU. In 2015, the last year for which full figures are available, the UK exported goods and services worth £222 billion to the EU, and imported £290 billion worth from it, leaving a trade deficit of £68.5 billion. Therefore, eurosceptics have said again and again, the EU has much more to lose than the UK in any trade war.

“The UK is much more dependent on trade with the 27 than vice versa, and will therefore be hurt more in any trade war.”

Trade deficits are not particularly problematic, so long as the country concerned can finance them sustainably. From an economic perspective, the benefits of free trade accrue mostly to consumers, who get better and cheaper products thanks to imports. But if one wishes to focus simply on the relative dependency of the British and EU economies, the 27's exports to the UK account for 3 percent of their GDP, while British exports to the 27 make up 13 percent of its GDP.²³

The UK is much more dependent on trade with the 27 than vice versa, and will therefore be hurt more in any trade war. It is true that the Germans will not want to endanger their car exports to the UK. But a UK-EU free trade agreement is likely to eliminate tariffs on goods, which will make life easy for German manufacturers. The problem for Britain is that its greatest strength is in services, which are not covered by traditional FTAs; zero tariffs on goods do nothing to help the City of London.

The final card comes in the form of a threat. The British know that their partners are worried that they might steal business by cutting social and environmental standards, or tax rates. The government therefore keeps threatening to turn the economy into something resembling Singapore in the North Atlantic. Philip Hammond has hinted at this in several speeches and the prime minister repeated

the threat at Lancaster House. She said that in the event of being offered “a punitive deal that punishes Britain” she would consider no deal to be better than a bad deal. “We would be free to set the competitive tax rates and embrace the policies that would attract the world's best companies and biggest investors. And, if we were excluded from accessing the single market, we would be free to change the basis of Britain's economic model.”²⁴

There are three problems with this threat. First, it undid some of the good that May's positive and courteous tone had achieved in the first three quarters of the speech. Second, threats that lack credibility sound hollow. And given that May, earlier in her speech, had praised employee rights, workers on boards, industrial strategy and a fairer society, her brand of Conservatism is clearly distant from the kind of libertarian Thatcherism that she was threatening to establish.

And third, the 27 have been warned and are preparing counter-measures. Lodewijk Asscher, the Dutch deputy prime minister, has written to fellow Socialist leaders, warning of the dangers of May's government creating an ultra-liberal economy: “Let's fight the race to the bottom for profits taxation [which harms] our support for our social security systems.” He wrote that they should not sign an FTA with the UK unless “we can agree firmly on tackling tax avoidance and stopping the fiscal race to the bottom.”²⁵

Several governments say they would veto any trade agreement that permitted the UK to engage in excessively competitive tax cuts. Commission officials claim that they are already preparing mechanisms that would allow the EU to curb access to European markets or raise tariffs, if the British went for social or fiscal ‘dumping’. But the EU could find that difficult: Ireland already has corporation tax of 12.5 per cent (on trading income), while Britain's main rate of 20 per cent is due to fall to 17 per cent by 2020. The EU could insist that the FTA commit all parties to respecting international rules on unfair tax competition, and the provisions on state aid and competition policy could seek to prevent the British behaving in ways that distorted the single market. But the EU can hardly punish Britain for setting a rate of corporation tax that is higher than Ireland's. So perhaps the counter-measures are not much more credible than the threat.

What kind of Brexit deal is likely?

Only three possible options remain for Britain's future relationship with the EU: an Article 50 agreement, including transitional arrangements that lead to an FTA

and other deals covering future relations; an Article 50 agreement that merely leads to reliance on WTO rules; and no Article 50 agreement, plus reliance on WTO rules.

23: Crude trade balance figures include exports that contain inputs imported from elsewhere, so a more accurate measure is the share of total domestic value added (the basic ingredient of GDP) that is exported to the other side. The latest OECD figures, for 2011, put the domestic added value contained in the EU's exports to the UK at 2 per cent of the total; meanwhile for the UK the equivalent figure is 11.7 per cent of its total domestic value added.

24: Theresa May, speech at Lancaster House, January 17th 2017.

25: Cited in Dan Boffey, ‘Netherlands will block EU-UK deal without tax avoidance measures’, *Guardian*, January 14th 2017.

Of the three options, an FTA would be by far the best for the UK economy.²⁶ With luck, an FTA would provide for low or zero tariffs on industrial goods, and remove some farm tariffs. A conventional FTA would not require the UK to accept free movement or the authority of the ECJ (though all FTAs establish dispute settlement procedures or special arbitration courts). The problem with FTAs is that, traditionally, they do not do a great deal to open up services markets (a British strength) or remove non-tariff barriers to trade.

The deepest FTA that the EU has hitherto negotiated, with Canada, takes some tentative steps to open up telecom, postal and shipping services, and parts of public procurement, but leaves out financial services, aviation, audio-visual media and many other services. If Britain does request an FTA, it will certainly hope for a better deal than Canada. But it should not assume that it will succeed, given that several UK industries are stronger and more threatening to their EU competitors than are Canada's (for example, finance, consulting, law, accounting, airlines and outsourcing). Furthermore, Canada needed the deal far less than the UK will need its FTA. In negotiating the deal, the EU may demand greater budgetary contributions – and fewer restrictions on free movement – in return for market access in particular sectors.

“Those talks could collapse over, for example, the EU's insistence that Britain pay the €60 billion it claims is owed.”

As already explained, an FTA will require a transitional deal, given the time that the former will take to negotiate. If the UK and the EU find the difficulties of negotiating a transitional deal too great to overcome, Britain will face an abrupt exit from the EU, falling back on WTO rules. Those rules set maximum tariff levels for goods. Britain would face the EU's common external tariffs on its exports. While quite low for many products, they are high for others – 10 per cent on cars, 12 per cent on clothing, 20 per cent for beverages and confectionery, and more than 40 per cent for many kinds of meat. Moreover, WTO rules do virtually nothing for services: the General Agreement on Trade in Services (GATS) is a WTO treaty that sets general principles and provides some transparency and legal predictability, but it does not open markets.

26: John Springford et al, 'The economic consequences of leaving the EU', CER report, April 2016.

27: Monique Abell estimates that an FTA with the EU would in the long term cut the UK's total trade by 22 per cent. Meanwhile new trade deals with the five BRICS countries, as well as the US, Canada, Australia and New Zealand, would boost British trade by 5 per cent. See her 'Will new trade deals soften the blow of hard Brexit?', National Institute for Economic and Social Research, January 27th 2017. See also John Springford et al, 'The economic consequences of leaving the EU', CER report, April 2016.

Some hard-line British eurosceptics favour the WTO option, on the grounds that it would be quick and simple, and obviate the need for years of complex FTA talks with the EU bureaucracy. They are confident that new FTAs with emerging powers and English-speaking countries will soon make up for lost EU commerce. But some recent economic research suggests that new trade deals will do little to compensate for the loss of EU trade that will stem from Brexit.²⁷ Furthermore, some eurosceptics oppose the principle of a transitional deal per se, because they worry that interim arrangements could drag on for many years, or perhaps forever, with the result that the UK would never properly leave the EU. They also fear that the EU may extract a high price for the transition, such as free movement and the jurisdiction of the ECJ.

One particular group of libertarian Brexit economists, led by Patrick Minford, a professor at Cardiff Business School, argues that once it has left the EU, Britain should unilaterally remove all tariffs (as well as scrapping many taxes, and social and environmental rules).²⁸ That policy would take away the UK's bargaining chips in future negotiations on FTAs; but these libertarians are not particularly bothered whether Britain achieves FTAs with other countries. Turning the UK into an Asian tiger in the North Atlantic would, they argue, generate a massive boom in economic activity, with or without trade deals. Minford admitted during the referendum campaign that such a course would eliminate much of Britain's manufacturing industry. It would also finish off many British farmers. However, May's government is unlikely to go down such a controversial path. There is no majority in the Conservative Party for Minford's ultra-Thatcherite medicine.

One outcome that would cause even more economic damage than the WTO option remains possible. That would be a breakdown of the Article 50 talks followed by WTO rules.

Those talks could collapse over, for example, the EU's insistence that Britain pay the €60 billion it claims is owed. If May stormed out of the negotiations, perhaps to fight a general election on a eurosceptic platform, Britain might then leave the EU without any agreement at all. This would create great legal uncertainty for companies and people who have invested, traded or moved across borders. There would be arguments over which law applied to contracts. Maritime commerce and aviation between the UK and the EU might be disrupted, at least in the short term. An enormous number of lengthy and complex legal cases

28: Patrick Minford, 'Unilateral free trade is far more attractive than membership of the single market', BrexitCentral, September 21st 2016.

would clog up international courts, covering issues like budget payments, pensions and residency rights, as well as regulatory and trade questions. It is highly unlikely that financial markets would react calmly.

Such an outcome would cause huge damage to the British economy and some damage to the rest of the EU.

How to get a good deal

Given the weakness of May's hand, a half-decent agreement will require the goodwill of Britain's partners. Some of the government's conduct has eroded that goodwill. To generate goodwill, May and her ministers need to think carefully about their style and tactics, and then come up with requests on the substance of the negotiations that generate a relatively warm response.

Ministers should be serious and courteous, while avoiding anti-EU rhetoric. To quote a senior official in one northern capital, "if you want a good deal, keep the negotiations boring and technical. The more your ministers grandstand, the more we become defensive and unhelpful."

“Ministers should be serious and courteous, while avoiding anti-EU rhetoric ... smugness and bravura should be avoided.”

To be fair to May's government, many of its senior figures are gradually getting the message. But not all of them. When Boris Johnson said in November that the idea of free movement being a founding principle of the EU was "a total myth" and "bollocks", he was not only factually wrong but also offensive. The Foreign Secretary was at it again in January, when President François Hollande said that Britain's Brexit deal would have to be worse than membership. Johnson quipped that Hollande wanted "to administer punishment beatings to anyone who wishes to escape, rather in the manner of some World War Two movie" – humour that did not travel well.

Smugness and bravura should be avoided. Speaking to the Corporation of London in November, David Davis said that he was "not really interested" in a transitional deal, but that since the UK's sudden departure could harm the EU's financial stability, he would "be kind" and agree if the EU asked for a transition.²⁹

Ministers should also consider how their chumminess with certain governments may affect attitudes in Berlin, Paris, Brussels and other key EU capitals. Theresa May's welcome of the Polish and Hungarian prime ministers

But that does not mean it cannot happen. Some of the most senior EU officials think it possible, because – in their view – the British over-estimate the strength of their cards, and are being driven more by eurosceptic emotion than economic self-interest. Ivan Rogers shared some of these concerns and thought that a breakdown of the talks was possible.

to 10 Downing Street was frowned upon, since their governments' track record on the independence of state media and the judiciary has made them the black sheep of the European family (it is unusual for a British prime minister to pick up a visitor from the airport, as May did for Poland's Beata Szydło).

More problematic has been London's attitude to the election of Donald Trump. Johnson's enthusiastic response in November, telling EU leaders to "snap out of the general doom and gloom about the result [and the] collective whinge-o-rama", and his boycotting of an EU dinner to discuss the president-elect did not enhance his already shaky relations with fellow EU foreign ministers. Then in January, shortly before Trump's inauguration, Johnson shunned a conference of 70 nations in Paris that reaffirmed support for the two-state solution to the Palestine problem. He subsequently vetoed a motion in the EU's foreign affairs council that backed the conference. The Foreign Office pointed out that it had not changed its policy on Palestine and that the timing of the Paris event had been provocative to the incoming US administration. Nevertheless the British moves reinforced the impression that Britain was more concerned to curry favour with Trumpians than stand by its European allies.

Of course, for the UK to court the incoming US administration, and potential friends in Budapest and Warsaw, is legitimate and rational; it needs all the allies it can find. But British ministers should be aware that there are potential costs, particularly if they mishandle the theatre of diplomacy. With the Trump administration, in particular, some British politicians seem unaware of the potential downsides of cosying up.

During May's trip to the US, at the end of January 2017, she generally got the balance right. Speaking to Republicans in Philadelphia, she said there was "nothing inevitable" about an eclipse of the West, and that its values must be upheld. The European project was vitally important: "It remains overwhelmingly in our interests – and in those of the wider world – that the EU should succeed."³⁰ And when she went on to Washington she persuaded Trump to agree with the statement that he was 100 per cent behind a strong NATO. But then when

29: Alex Barker, 'David Davis rebuffs City hopes for a transition deal', *Financial Times*, December 9th 2016.

30: Theresa May, 'Speech to the Republican Party', Philadelphia, January 26th 2017.

she came home to the news that Trump had banned visitors from seven Muslim countries, she was slow to say she disapproved.

Trump's behaviour will present the British with constant challenges. If the way May handles Trump implies that Britain shares significant parts of his worldview – despite his line on Russia, Palestine, Iran, climate and trade being radically different from British (and European mainstream) policy – she will do great damage to Britain's reputation. There is a real risk that, as the British government attempts to straddle the widening gap between the two sides of Atlantic, it may fall down the middle.

“May and Merkel have reacted to the election of Trump in different ways, which has not made their relationship easier.”

Britain's image in the EU would benefit from the prime minister making a big speech somewhere on the continent, setting out a positive vision for what the UK could contribute to Europe post-Brexit. For example, she could build on her Lancaster House and Philadelphia speeches by offering to make Britain's expertise on foreign policy, defence, counter-terrorism and policing available to the EU, in pursuit of common policies and objectives. She could offer ships and border guards for policing and strengthening the EU's external frontier – goals which would evidently benefit Britain. She could aspire to make Britain a closer partner of the EU on security policy than any other non-member – and come up with some concrete proposals on how to achieve that.

On the future economic relationship, May would impress the 27 if she aimed for a high level of integration, within the parameters set out in Lancaster House and in the white paper. She might signal a willingness to accept the authority of some judicial body that was similar to but not the ECJ, in a dispute settlement mechanism.

She could offer money for the funds that support the development of poorer EU members. The Central Europeans will probably lose out from Brexit, since richer states will be reluctant to replace Britain's contribution to EU regional funds. Such a financial offer could reduce the scale of the 'Brexit bill' (consisting mainly of unspent budgetary commitments) that the 27 expect Britain to pay upfront. It could also spur the 27 to offer Britain a more generous FTA.

As for free movement, if May proposes less stringent controls on EU citizens than those from other continents, she will earn some goodwill. But if the new regime cuts the numbers of EU migrants sharply, goodwill will be lost.

In addition to reinforcing British soft power, May and her ministers need to think hard about how best to use the Whitehall machine. Lord Kerr, a former permanent representative to the EU (and the current chairman of the CER), had some trenchant advice in a recent article. “The first rule of good policy-making is rigorous pre-launch testing”, he wrote. He suggested that ministers should convene a wide circle of experts to consider the practicalities of, and possible objections to, each policy proposal. “Keeping the circle too small leads to disasters like Mrs Thatcher's poll tax”. He emphasised the importance of understanding how the 27 would react to British ideas. “To dismiss realism as defeatism, and damn dissent as disloyalty, is to court disaster”.³¹ It is perhaps surprising that as the government has prepared its strategy for Brexit, it has seldom sought the advice of Lord Kerr or other former permanent representatives to the EU.

The EU will get annoyed if the UK regularly seeks to bypass the official negotiations by talking informally to particular governments. But there will be occasions when the British need to do this. They should certainly nurture informal channels with Berlin – a capital where May and her ministers probably need to invest more. There is a view in May's government that David Cameron over-emphasised the importance of Germany: in the end Merkel failed to stop the appointment of Jean-Claude Juncker as Commission president, or to give Cameron as much as he wanted in the renegotiation of February 2016. Cameron may have counted too much on the German relationship, but May – to the alarm of some British officials – seems to have under-invested in Berlin.³²

May and Merkel have reacted to the election of Trump in different ways, which has not made their relationship easier. But even though Germany does not control the EU, it remains more influential than any other country and will be crucial in corraling support for a final deal with the UK. London needs to focus not only on Merkel but also on Martin Schulz and other leading Social Democrats. Schulz rose to prominence as president of the European Parliament. That should remind May's government not to ignore that powerful institution, which can veto all the Brexit agreements. Ministers should be in Strasbourg as well as Berlin.

31: John Kerr, 'Honest advice is a tradition worth preserving', *Financial Times*, January 7th 2017.

32: Peter Foster, 'Exclusive: Brexit alarm in Whitehall over Theresa May's 'almost non-existent' relationship with Angela Merkel', *The Telegraph*, January 4th 2017.

Conclusion

Although an acrimonious divorce that damages all parties is possible, the UK and the 27 may in the end agree on some kind of FTA, with transitional provisions. One of May's strengths is that at least some of the time she believes in evidence-based policy-making. If she concludes that the national interest requires it, she may find the courage to break with the hard right and go for a not-so-hard Brexit.

But even in the most optimistic scenarios, the Brexit deal will be fairly hard. One reason is that the British government's strategy is not about achieving economically optimal outcomes. The prime minister will prioritise restricting free movement and excluding the European Court of Justice, whatever the economic price. For the British government to pursue such a strategy is perfectly legitimate, though it has – unsurprisingly – been shy of admitting the likely economic costs.

The second reason is that the 27, too, are being driven more by politics than economics. Many EU leaders are rather franker than the British government on this point. They say that the cohesion, unity and strength of the EU count for much more than the loss of some trade with the UK.

Neither side seems particularly bothered that even the best possible deal that is feasible will harm the economic well-being of all concerned. Such views are unlikely to shift in the next year or two, especially since the atmosphere in the divorce talks will probably be fraught.

In the very long run, however, a better deal, giving Britain many though not all the benefits of membership, could become more plausible. A group of eminent analysts

outlined such a model in a paper published by the think-tank Bruegel in August 2016 – suggesting that Britain and other non-members could participate in the single market, be consulted on its rules and be excused freedom of movement, so long as they accepted the ECJ.³³

Such a model is not politically acceptable in either the UK or the EU at present. In the longer term, however, when Britain has experienced the chill winds of solitude; when its erstwhile partners see the potential economic benefits of drawing the British closer; and when the EU itself is more open to reform and new ideas, then schemes such as those promoted by Bruegel may return to the agenda.

Thinking about issues other than economics could help to bring about a reconciliation between the British and the EU. Given the unstable neighbourhood surrounding the EU, and the many threats to the continent's security, the 27 could benefit from the UK providing resources and expertise. That is why Theresa May was right to talk about security in her Lancaster House speech. Her government should come up with concrete proposals for the role that Britain could play in European foreign, defence and security policy. Working together in these areas could help to establish a climate in which closer economic relations become imaginable.

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33: Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker and Guntram Wolff, 'Europe after Brexit: a proposal for a continental partnership', Bruegel, August 2016.