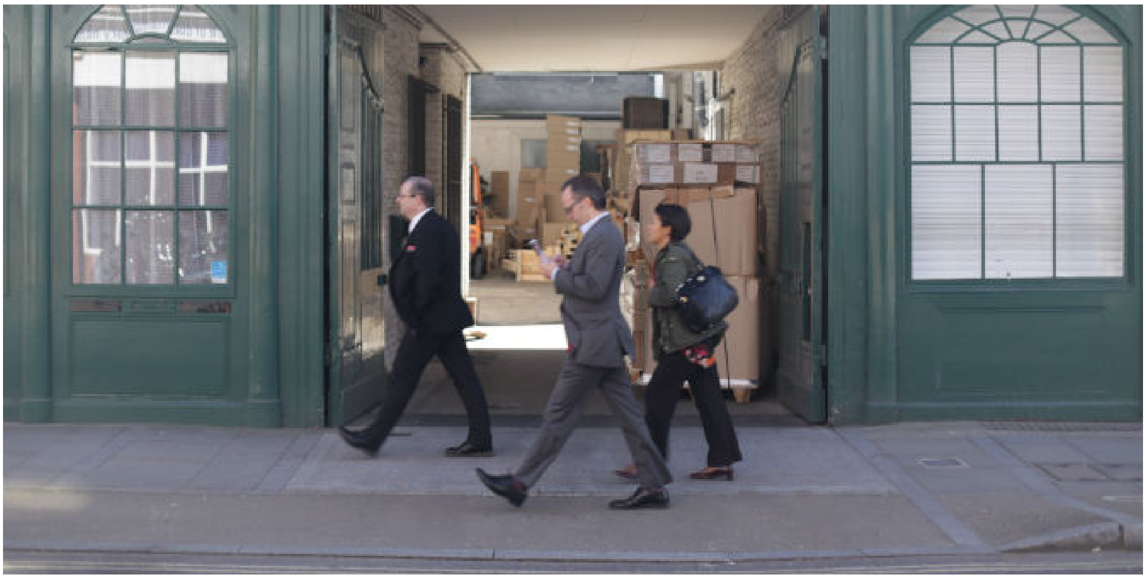
# Outside the Single Market, what kind of deal can Britain's services sector hope for?


*Professional and business services account for more than a tenth of the UK economy. Leaving the single market means it will no longer enjoy the passporting rights that give the financial sector smooth access to EU markets.* ***John Catalfamo*** *and* ***Laura Arts (LSE)*** *look at the limited options available to Theresa May as she tries to reconcile Brexiters' demands for regulatory autonomy with the need to negotiate access to the Single Market.*

One of the most economically significant and complex aspects of the post-Brexit EU-UK free trade agreement (FTA) negotiations is that of services. While negotiations over trade in goods can vary in complexity from simple tariff rates to full regulatory convergence, services negotiations are invariably complicated, requiring sector-by-sector negotiations over the specific "behind the border" regulations and requirements that affect the provision of services. The future of EU-UK trade in services is not only an intricate endeavour, but cuts to the heart of one of the central political issues of the Brexit referendum and the debate currently happening inside Theresa May's government: how much regulatory autonomy should the UK be willing to defer to the EU in return for market access to the European Single Market?

## Services in the UK economy and in EU-UK trade

As a services-oriented economy, the UK runs a large trade surplus in services with the rest of the world (4.7% of GDP in 2016). With financial services, the country is the world's leading financial exporter in terms of net flows, with $95bn in financial exports in 2014 and UK financial institutions can currently do business elsewhere in the EU without setting up a subsidiary by way of EU "passporting rights" that give them access to EU markets. Over 5,400 British firms rely on passporting rights to bring in £9bn in revenue every year.



Lunch hour in London SE1, 2014. Photo: Henry Hemming via a CC BY 2.0 licence

The professional and business services (PBS) sector is another major part of the UK services sector. It accounts for over 11% of the British economy, employing almost four million people, and 36 of the top 50 UK law firms have offices in 25 of the 27 EU Member States. In 2015, over £20bn (32%) of the UK's PBS exports went to the EU, and it imported over £15bn. Given the size of these cross-border flows, access to both the EU and third markets for services is critical for the British economy.

## Services and the Single Market

The intra-EU provision of services is a critical component of the Single Market (SM). Given that the EU and its SM is as much a political project as an economic one, and that part of its resilience is the preservation of benefits for its members, the EU has established that it will not let the UK “cherry pick” the parts of the SM to which it wants access, and those from which it will diverge. At the same time, Theresa May announced in January 2017 that the UK would leave the SM, ensuring a “clean” Brexit, while maintaining the “freest possible trade” with EU countries.

Given the logic of a single regional hub for most of Europe’s financial transactions, financial services and PBS providers in both the EU and the UK stand to lose significantly if the UK’s access to the EU markets is revoked or obstructed, as this would lead to substantial transaction costs and other inefficiencies.

For the European financial system, retail banking is less likely to be affected by Brexit than wholesale banking, as it is less cross-border in nature. Within wholesale banking, over the counter (OTC) products and corporate lending and deposits are most likely to be affected, as they depend on recognition of equivalence under MiFID II or access to single passporting rights. Other products – such as payments, advisory services, and exchange traded products – are less vulnerable.

The key tension May’s government must balance is between regulatory autonomy and market access. On one side of the debate are those who benefit greatly from market access to the services SM. On the other side are the “hard” Brexit supporters who emphasise the importance of British regulatory autonomy and trade negotiation authority. Yet these two options are mutually exclusive. Full access to the SM necessitates a degree of regulatory convergence. Likewise, prioritising regulatory autonomy would mean foregoing the single market in services.

## Possible post-Brexit frameworks

For financial services and PBS, the UK’s future trade relationship with the EU depends on whether it will remain in the SM or not. If it decides to leave, it will have potential options. It can either secure a mutual recognition agreement with the EU, in which specific services sectors would be reviewed by a committee set up through the agreement to determine the commonalities of the parties’ regulatory regimes. Another option is equivalence, which is a unilateral determination by the EU that a third party’s regulatory regime is equivalent to EU regulations. The EU retains the authority to revoke equivalence at its own discretion with only 30 days’ notice. If the EU and UK fail to reach any sort of agreement for services, trade in services would revert to WTO rules, in which the UK’s access to the single market would be that of any other third (non-EU) country that does not have a free trade agreement with the EU that covers services.

## WTO rules

An outcome in which WTO rules dictate the EU-UK trade relationship would be the most extreme example of regulatory autonomy with limited market access. The UK would be completely unburdened from the EU’s regulatory authority, but it would lack any preferred access to the SM. No major stakeholder has advocated this position.

## CETA

The Comprehensive Economic and Trade Agreement (CETA) substantially integrated the Canadian and EU markets, but it would represent a significant downgrading from the access that the UK currently enjoys. While CETA liberalised some trade in services, it contained a wide array of carve-outs and exceptions, and while the UK could potentially trade in PBS under the auspices of equivalence, the Commission could rescind equivalence at its own discretion. For financial services, a CETA-style agreement would not give the UK single passporting rights – meaning that it would lose its ability to do business in all EU member states without establishing subsidiaries or proving equivalence.

## CETA+

A CETA+ agreement would likely fall somewhere between EEA membership and a CETA-style agreement. The 'plus' could imply improved coverage of services, particularly financial services. Under such an agreement, the UK could try to secure mutual recognition that covered professional qualifications and licensing for various sectors from its inception. But any deepening of services commitments under a CETA-Plus agreement would trigger unconditional Most Favoured Nation (MFN) clauses in the EU's other FTAs covering the market access aspects of cross border services and investment (such as CETA). However, this unconditional MFN may not apply to any EU-UK mutual recognition agreements.

## Customs Union membership

Customs union membership has been discussed as a post-Brexit option for goods, but without an FTA covering services it would revert trade in services to WTO rules. The customs union provides for a common external tariff and no internal barriers to trade in goods, but nothing for services. Given how important PBS and financial services are to the British economy, UK negotiators are unlikely to favour this option.

## EU Association Agreement

The association agreement between the EU and post-communist Eastern European countries like Ukraine offers the latter an opportunity to begin the regulatory convergence process with the EU, as the first steps to membership. As such, the nature of the EU-UK relationship is fundamentally different: while an association agreement aims towards regulatory convergence, the UK aims for managed divergence away from EU regulations. However, unlike European Economic Area (EEA) membership, an association agreement not only demands applying EU rules, but also depends on the EU granting equivalence for them. In addition, the party must agree to adopt any future SM services regulations immediately – which would likely defer more regulatory power to the EU than the hard Brexit supporters could stomach.

## EEA membership

An EEA agreement would be the most minimal shift from the UK's current position as a member of the EU, and it is the framework under which Norway, Liechtenstein and Iceland operate. EEA countries have access to the SM for services but are outside the customs union and have the opportunity to negotiate their own FTAs. However, these countries must adopt all SM regulations into their national laws and are not given a seat at the table when the regulations are devised, acting as 'rule takers' rather than 'rule makers.' May's January 2017 speech probably ruled out EEA membership for the UK, as it clashes with her aim of a "clean" Brexit.

## Conclusion

Options like EEA membership, WTO rules, and standalone customs union membership are unlikely to garner much support from relevant stakeholders. Either they give too little market access for services (WTO rules or a customs union) or they defer too much regulatory authority to the EU (EEA membership). A CETA, CETA+, or an association agreement might placate the different factions within the UK while offering a palatable option for the EU. However, MFN clauses in the EU's existing FTAs mean that concessions to the UK would translate into matching concessions to all the EU's FTA partners. While both sides are now seriously considering the merits of CETA or CETA+, equivalence and mutual recognition are still major stumbling blocks.

*This post represents the views of the authors and not those of the Brexit blog, nor the LSE.*

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