Brexit: Preserving the UK's Future Success as a Service Economy

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EXECUTIVE SUMMARY

Apart from ensuring tariff-free trade in goods, the UK's EU membership removes regulatory barriers to trade and investment. If Brexit results in the UK losing full access to the Single Market, financial transactions, business activity, and investment will be seriously affected. UK companies, especially banks, will have difficulty expanding and offering their services across the Channel, which could motivate firms to relocate. The London Stock Exchange will be less attractive for European companies and investors, and fewer multinational companies will locate their European headquarters in London. This brief examines three policy options to mitigate these risks.

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POLICY BRIEF #1

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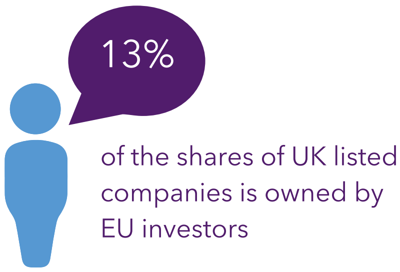
The decision of the British people in June 2016 to exit the European Union (EU) could lead to far-reaching consequences, beyond tariff barriers affecting trade in goods. EU membership since 1973 has benefited the UK financially in many ways thanks to EU law's four fundamental freedoms. These major benefits, four of which are explored below, are at risk of being lost unless the current negotiations lead to a 'soft Brexit'.

1) Dominance of the LSE

Over the last 20 years, companies on the London Stock Exchange (LSE) have been attracting large amounts of investment from European investors. When issuing new shares, UK companies can offer them to investors from across the EU thanks to the passporting of prospectuses. Moreover, the LSE has been an attractive destination for European companies wishing to raise investment in shares or bonds.

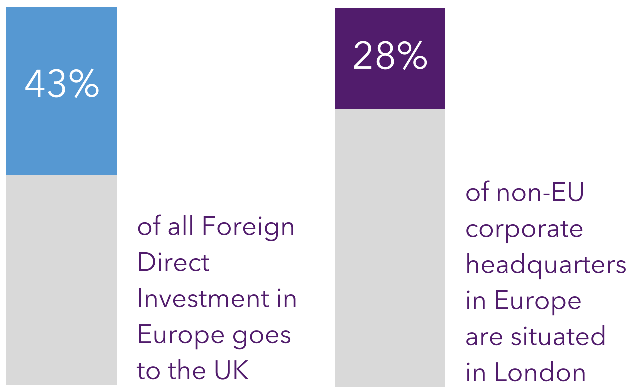


2) Exporting services across the EU

UK companies can offer their products and services directly to EU customers. More importantly, UK banks and other financial institutions can offer their services to EU customers with no need for regulatory approval. This has enabled UK banks to expand their business in Europe, with banks such as HSBC and Barclays now having a major presence on the Continent. This is possible because regulatory rules and supervision by national authorities are harmonised across the EU.

3) Reciprocal corporate expansion

UK companies can operate and expand in the rest of the EU. To do so, they do not need to set up a subsidiary company under the law of another EU country but can simply set up a branch, which entails less legal compliance cost. Reciprocity in this area allows the UK to attract large amounts of Foreign Direct Investment from other EU and non-EU countries. Moreover, due to its sophisticated legal and professional services, the English language and English law, and because it provides access to the Single Market of half a billion customers, London has been the most popular city for foreign multinational companies seeking to establish European headquarters.



4) Popularity of English legal structures

The English private limited company has been a popular business form for entrepreneurs from other EU countries where setting up a company with limited liability is costly or requires a minimum amount of capital.

Moreover, English contract law is the preferred chosen law for financial contracts in Europe because it provides maximum certainty to the parties. This makes the UK's legal profession and other relevant professions more lucrative.

These benefits have been possible thanks to a large-scale programme of harmonising national laws in areas such as financial regulation, securities regulation, corporate law and conflict of laws.

Leaving the EU without maintaining these arrangements jeopardises the UK's position as a successful export-oriented service economy. This is because regulatory barriers can be more problematic for firms than tariffs as they can totally prevent a firm from offering its services abroad or attracting international investment.

All these benefits rest on continued access to the Single Market after Brexit, which will depend on which of the following three policy options is pursued.

- First, **the UK can choose to join the European Economic Area (EEA)** which consists of Norway, Lichtenstein and Iceland. This would require the UK to continue to abide by the free movement of people.
- Second, **the UK can follow the 'Swiss model' of replicating the Single Market** through a series of bilateral treaties with the EU. The Swiss model is a partial solution because it covers the freedom of establishment of companies, but does not provide for the passporting of prospectuses and financial services. Again, free movement of people would apply, but perhaps with a limited possibility to prioritise UK candidates in jobs.
- The final option of a **UK-EU free trade agreement** is extremely unlikely to confer any of the benefits explored in this brief because such agreements focus only on removing tariffs for goods.

	EU membership	EEA membership	Swiss model	Free trade agreement
Tariff-free trade in goods	✓	✓	✓	✓
Tariff-free trade in services	✓	✓	✓	?
Freedom of establishment	✓	✓	✓	✗
Passporting of prospectuses	✓	✓	✗	✗
Passporting of financial services	✓	✓	✗	✗
Customs union - no borders?	✓	?	?	✗
Common Agricultural Policy	✓	✗	✗	✗

References: Hornuf, L. (2012) Regulatory Competition in European Corporate and Capital Market Law: An Empirical Analysis. Cambridge: Intersentia; Breitenmoser, S. (2003) Sectoral Agreements between the EC and Switzerland: Contents and Context, *Common Market Law Review*, 40 (5), pp. 1137-1186.

POLICY RECOMMENDATIONS

1. The four major financial benefits that the UK currently derives from the EU, i.e. the dominance of the LSE, vibrant exports of financial and other services to the EU, reciprocal corporate expansion and the popularity of English legal structures, must be prioritised in Brexit negotiations to preserve the UK's future success as a service economy.

2. Access to the Single Market by joining the EEA should be prioritised on the Brexit agenda if it proves to be the only way to maintain these financial benefits.

3. If this is not politically possible, the second best option is to work towards achieving an extended version of the Swiss model.

4. If no Brexit agreement is reached, it will be necessary to ensure the continued alignment of UK financial and securities regulation with EU standards, as a vital aspect for the success of the UK economy.

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