Overview of Article 50 Negotiations and Current State of Play

Current levels of uncertainty around the Brexit talks are high. There is uncertainty around whether, when and what sort of deal may be done. A deal including both the withdrawal agreement and the political declaration could be agreed at a mid-November summit, but if there is insufficient progress, that could be delayed until the EU’s December summit. If there is a deal, it has to be either accepted or rejected at Westminster. There might also be an amendment to call for a further referendum on the deal – which may or not pass.

If there is no deal or any deal is rejected at Westminster, uncertainty will deepen and the UK will probably face a major political crisis with serious knock-on economic impacts. How such a situation would be resolved, whether with a further EU referendum (including a ‘remain’ option), a general election or further negotiations with the EU (hard to envisage at this stage) is entirely unclear. If Westminster couldn’t agree on a way forward, the political crisis would deepen. If there were a general election or further public vote, there would be a need to request an extension to Article 50. The EU27 might be open to such an extension in the face of either of these two possibilities, but it cannot be guaranteed at this stage. Moreover, the outcome of any election might or might not change the political context of the Brexit talks.

This degree of uncertainty inevitably has substantial economic and political impacts. UK growth has already slowed considerably in the last two years with the IMF now predicting only 1.4% growth for 2018. FDI inflows into the UK in 2017 were 90% lower than in 2016.

A new British Chambers of Commerce survey also shows that 67% of Scottish firms in their sample (about 200 businesses) have not done any risk assessments on the impacts of Brexit compared to 62% of firms across the rest of the UK. Uncertainty over Brexit also comes out as the most important factor for these Scottish firms when considering whether or how much to export and import. These results are troubling and suggest businesses are struggling to plan ahead given levels of Brexit uncertainty.

If a deal is struck, and passes at Westminster, the European Council and European Parliament, it will include both a withdrawal agreement and a political declaration on the future relationship. Michel Barnier, the EU chief negotiator, has suggested trade talks on the future relationship should then start in April next year under 10 different strands. Even so, considerably uncertainty will remain about what sort of trade deal will be struck, when and whether it will be ratified and whether any general election during the time of trade talks could result in a substantial change of direction in the type of deal being negotiated.

Any deal between the EU and UK will include a backstop for Northern Ireland so that the Irish border remains open. This may involve Northern Ireland remaining effectively in the EU single market for goods and agriculture; and it may involve the whole UK remaining in an indefinite customs union. Depending on the progress of trade talks – and whether such talks can lead to a frictionless EU-UK border (which seems unlikely) – then the Irish backstop could kick in
at the end of December 2020. However, it is also possible that the final withdrawal agreement might include the possibility of extending the transition period that should begin next April – which would then put back the time when the backstop would kick in.

Impact and Implications for Scotland

Uncertainty: The levels of uncertainty that will remain, even with a Brexit deal that does pass at Westminster, do not bode well for future trade and foreign direct investment (FDI) options and outlook for Scotland or the rest of the UK. It is also the case that any trade negotiations with other third countries are unlikely to proceed quickly unless and until the shape of the future UK-EU relationship is clear.

If the Irish backstop includes an indefinite period where the UK stays within a customs union with the EU, this will also impact directly onto whether and when the UK can agree any future trade relationships with third countries.

Scotland’s options for promoting trade and FDI after Brexit (if it goes ahead) all depend, therefore, on the nature of the deal, and the degree and range of uncertainty that it and the rest of the UK faces. This means planning for a range of uncertain scenarios which in itself consumes resources and makes adjustments by the range of government departments, businesses, organisations and individuals that are all impacted by Brexit extremely difficult.

Impact: There have been many studies done of the likely impact of Brexit on GDP and on trade and FDI depending on the nature of the future UK-EU relationship. Most of these predict negative impacts\(^3\). Both Scottish government and UK government estimates are very similar in terms of overall impact on GDP growth. The Scottish government estimates\(^4\) staying in the EU single market would reduce future growth, in 2030, by 2.7%; a Canada-style free trade deal would lower growth by 6.1%; and in a WTO scenario growth would be 8.5% lower (UK government figures respectively are 2.5%, 5.5% and 9%).

Estimates by the National Institute of Economic and Social Research, focusing on trade flows, suggest that in a Canada-style free trade deal, UK-EU goods trade could fall by 35% and services by 61% – and in a WTO outcome, goods could fall 58%\(^5\). The NIESR study assesses whether new trade deals elsewhere in the world could counter this fall in trade, and finds that it only has a very modest impact. Overall, the study finds a fall of 30% in total UK world trade if it moves to a WTO relationship with the EU and a fall of 22% if it moves to a free trade agreement with the EU.

Recent economic research has found that services trade, like goods, is strongly impacted by distance (as well as by non-tariff barriers)\(^6\) suggesting the goal of increasing services trade beyond the EU will not be an easy one to fulfil (even before considering the greater difficulties in negotiating trade deals in services, and the interconnections between goods and services trade). In research for a report by the Institute for Global Change Institute, the NIESR also found that compared to a ‘soft’ Brexit, in a Brexit on WTO terms, GDP would be 4.9% lower by 2030 – with services accounting for 2.1 percentage points of that lower growth and goods only 1.1 percentage points (and migration and other factors also lowering future growth)\(^7\). For a Chequers’ style deal, they find GDP growth 4.1% lower.

The challenge for Scotland and the whole UK, for goods and services trade and FDI, is therefore one of damage limitation. Trade will also be affected by what happens to existing EU trade deals with countries around the world. Even if these trade deals are successfully
rolled over during transition, they will eventually need full renegotiation. The UK, as a much smaller trade partner than the EU, will have much less bargaining clout than the EU and so may not anticipate getting equally good deals.

What Sort of Future UK-EU Trade Relationship?

A ‘Soft’ Brexit: The Scottish government has made clear, that if Brexit goes ahead, it would want to see a ‘soft’ Brexit of the UK staying in the EU’s single market and customs union. Economically, this would be the least damaging option. It would mean that the UK faced neither tariff nor non-tariff barriers to trade and FDI with the EU. However, over time, with the UK no longer having a full voice and vote and participation in EU institutions, it would seem inevitable that UK and Scottish interests will not always match with those of the EU27 and decisions on regulation and trade will be taken that will in some areas not be beneficial to the UK and Scotland.

This democratic deficit will impact on the economy but will also have political impacts – the UK will be a rule-taker and will have given up sovereignty rather than sharing it. If the UK is to stay in the single market and customs union, then it would clearly be politically and democratically preferable to stay in the EU.

A Free Trade Deal: Under the UK government’s current Brexit policies and red lines, any future trade deal, however deep and special, between the UK and EU is likely to mean new barriers to trade – especially non-tariff barriers between the UK and EU. This will make it particularly challenging to attract FDI to Scotland and the UK, as the UK will no longer be an attractive location for companies wishing to be within the EU’s single market; the UK will no longer be a gateway to the EU. It will also act as a brake on trade.

Customs Union and an Irish Backstop: If, as part of an Irish backstop, there is provision for an indefinite customs union between the UK and EU, this will reduce frictions due to absence of tariffs and absence of checks on rules of origin. This will help the goods but not services sector. However, the Chequers proposal of the UK remaining in the single market for goods, with full regulatory alignment and hence no checks on regulatory compliance, has been rejected by the EU for a range of reasons (whether some version of close alignment resurfaces in the deal is an open question). If the UK was allowed to be in something close to the single market for goods, there would again be a substantial democratic deficit, and a major hit for services in being excluded.

For that period where the Irish backstop kicks in (if it does), there will, even with a customs union, be major negative economic impacts on both Scottish and UK goods and services sectors due to non-tariff barriers. The extent to which Northern Ireland will gain economically by remaining in the EU’s customs territory and single market for goods (if that is what transpires) is an open question but the Scottish government is right to be concerned that any such deal, while strongly desirable in terms of protecting the Good Friday Agreement, could divert FDI away from Scotland to some degree. However, any special deal for Scotland whereby it could have a differentiated deal, staying in the EU’s single market and customs union, looks impossible at this late stage in the talks.

Consultation: Current structures for consultation between the UK government and devolved administrations do not look adequate in terms of Scottish interests in both the future UK-EU relationship and other trade negotiations. New provisions for participation and consultation are clearly needed, as proposed by the Scottish government and others. However, if EU-UK
talks do begin next April, then there needs to be rapid discussion of, and agreement on, new structures. How any such structures relate to processes and structures for agreeing UK common frameworks will also be a key question. There may be a clear risk that UK government decisions on trade deals will pre-empt the functioning of processes to agree common frameworks and pre-empt devolved decision-making.

Labour as the main UK opposition party has said that it would aim to agree a permanent customs union with the EU. If Labour came to power at a general election while trade talks were under way, it would be anticipated these talks would then change substantially. A very different approach to the future UK-EU relationship may also need a different approach to consultation and participation structures for the devolved administrations. Hence uncertainty – both political and economic – will continue to impact on all preparations and policy options.

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1 “The UK’s Chronic Brexit Crisis”, Kirsty Hughes, September 2018, SCER website [www.scer.scot](http://www.scer.scot)
2 OECD ‘FDI in Figures’ April 2018
3 For an overview, see, for example, “An Assessment of the Economic Impact of Brexit on the EU27”, Michael Emerson, Matthias Busse, Mattia Di Salvo, Daniel Gros, Jacques Pelkmans, Centre for European Policy Studies (CEPS), paper for the European Parliament’s Committee on Internal Market and Consumer Protection, March 2017
4 “Scotland’s Place in Europe: People, Jobs, Investment”, Scottish government, 15 Jan 2018
6 “Why Brexeters’ confidence in services trade may be misplaced” Financial Times 24 September 2018, Chris Giles – reporting on research by Professors Jonathan Eaton and Samuel Kortum
7 A. Tarrant and S. Tilford “Brexit and the UK’s Services Trade”, report, Institute for Global Change, October 2018
8 “Brexit: Heading to a Deal or No Deal While UK Politics Implodes?” Kirsty Hughes, July 2018, Federal Trust Policy Paper, London