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Inquiry Secretary, Joint Standing Committee on Foreign Affairs, Defence and Trade
Trade Sub-Committee
PO Box 6021, Parliament House
CANBERRA ACT 2600

I thank the Trade Sub-Committee of the Joint Standing Committee on Foreign Affairs, Defence and Trade for its letter of 17 January, 2016, inviting me to make this submission to the Parliamentary Sub-Committee on Australia's trade and investment relationship with the UK.

The views expressed herein represent the author's professional views only as an analyst, researcher and consultant on economic and political affairs. This submission does not represent the views of Monash University, its affiliated institutions, or its officials, employees or representatives in any way.

Sincerely,

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[1] Author biography: Dr. Remy Davison holds the Jean Monnet Chair in Politics and Economics at Monash University, a lifetime Chair awarded by the EU Commission to scholars in the field of European integration. Dr. Davison holds a Ph.D. (Commerce and Political Science) from the University of Melbourne. He is Australia's foremost expert on the EU Single Market. He was appointed a Global Expert by the United Nations in 2011. He has published in the area of EU integration for over 25 years. He is Associate Director and former Acting Director of the Monash European and EU Centre, and a former Vice-President of the Contemporary European Studies Association of Australia (2001–02); Research Fellow at the Contemporary Europe Research Centre, University of Melbourne (1997–2009); and editor of the *Australasian Journal of European Integration*. He has held appointments in International Business, and International Political Economy at the universities of Melbourne, Monash, ANU, Tasmania, La Trobe and Griffith. Dr. Davison is a regular contr butor to both Australian and international media, including *Fortune, Voice of America*, *Courrier International* (Paris) and Bloomberg TV. He is the author of *The Political Economy of Single Market Europe* (2011), *The Political Economy of the Eurozone Crises* (forthcoming 2017) and *The New Global Politics of the Asia-Pacific* (2004, 2012, 2017).

[2] *Disclosure of interests*: Dr. Davison's Jean Monnet Chair is an international Chair appointment funded by the Commission of the European Union. He is also a direct and indirect recipient of research funding from various EU-funded Centres in Europe, the US, Asia, Australia and New Zealand. He is a member of the European Consortium for Political Research (ECPR) and the Council for European Studies (CES), Columbia University, New York.

Submission to the Joint Standing Committee on Foreign Affairs, Defence and Trade, Trade Sub-Committee on Australia's trade and investment relationship with the United Kingdom

The background to Brexit

In July 2016, UK voters in the referendum on Britain's membership of the European Union (EU) voted to 'Leave' by a small majority. However, the vote was fractured and a number of regions and cities, including Scotland, Northern Ireland, Manchester, Liverpool and London voted to 'Remain' in the EU. The British government has announced it will activate Article 50 of the 2009 Treaty on the Functioning of the European Union (TFEU; the 'Lisbon Treaty') in March 2017.[3] TFEU Article 50 provides the means for the legal withdrawal of EU member states from membership of the EU Treaties.[4]

The UK government claimed the royal prerogative in its right to activate Article 50, and this led to a High Court challenge, joined by the Scottish and Welsh governments, to compel the government to hold a parliamentary vote on the executive's right to activate Article 50. Since 2016, there have also been two legal challenges to the UK government by Northern Ireland, and by Scotland and Wales. In January 2017, the UK Supreme Court ruled that neither the Scottish nor the Welsh legislatures need be consulted by UK government in order to activate Article 50. In February 2017, following an appeal in the *Miller* case, the UK Supreme Court ruled that Parliament was compelled to vote on the activation of Article 50.[5] Subsequently, the House of Commons voted by a decisive majority to endorse the UK Cabinet's decision to activate Article 50. Further legal challenges from regional governments, corporations, associations and private individuals are highly likely over the coming years, particularly in relation to the applicability of EU law throughout the period since 1973.

The legal implications of Brexit

Britain is an attractive destination for FDI and FPI; its competitive advantages as an FDI host include access to the City of London's financial markets and services; the regional headquartering of many of the world's major firms in London; English's status as an international language; and the fact that the vast majority of commercial contracts are written in English. Advantages that will be diminished by Brexit include the question of access to the EU Single Market; and Britain's application of the EU's common market legal regime, which ensures harmonized commercial policies, such as competition

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[3] Article 50 states, 'Any member state may decide to withdraw from the union in accordance with its own constitutional requirements.' Article 50 is procedural, not regulatory.
[4] These include the original and amended treaties comprising the original European Communities, which became the European Union in 1993. The original three treaties comprised the European Coal and Steel Community (ECSC) (1951); the European Economic Community (EEC) (1957) and the European Atomic Energy Community (EURATOM) (1957). These three Treaties and their associated institutions were merged under Merger Treaty (1968). The most recent EU treaty that supersedes the previous treaty is the Treaty on European Union (2009), also referred to as the Lisbon Treaty.
[5] See UK Supreme Court (2017) *R (on the application of Miller and Dos Santos) v Secretary of State for Exiting the European Union*, 24 January. Available: https://www.supremecourt.uk/news/article-50-brexit-appeal.html

policy. In response to a number of these issues, the May government in October 2016 announced the 'Great Repeal Bill' (GRB), which will repeal the *European Communities Act 1972* (ECA) and transpose the bulk of EU legislation into UK law. The GRB will not enter into British law until after the UK formally departs the EU.

Following the July 2016 referendum on EU membership, the British government faced the insuperable task of replacing the commercial legal regime that has had application in the UK since 1 January, 1973. The repeal of more than 40 years of EU legislation was not considered practical. Consequently, the British government in October 2016 announced it would introduce the GRB, which would repeal the ECA, while transposing all extant EU legislation into British law. Specific pieces of primary legislation, such as the *European Union Act 2011,* which ratified the 2009 TFEU, may need to be repealed entirely. The House of Commons Library's report on the GRB notes that over 13% of all UK legislation between 1993 and 2004 was EU-related and that the transposition will be the 'largest legislative task ever undertaken in the UK.'[6]

The House of Commons Library's report also notes that the GRB proposes the use of delegated powers in order to adapt or amend transposed EU legislation to ensure that laws are 'fit for purpose' under the commercial regimes established by the British parliament following Brexit. It is anticipated that the GRB's provisions will be applicable in UK law 'the day following Brexit'. However, it is likely there will be a transitional period in the UK commercial legal regime that will take considerable time; for example, it is unknown how UK courts will refer to EU legal precedents or rely upon post-Brexit regulatory interpretation.

The implications of the uncertainly surrounding the post-Brexit legal regime are very likely to result in a period of commercial uncertainty as it becomes clear how the new legal regime will operate. This is particularly applicable to legislation that relates to cross-border or international transactions. The law firm Herbert Smith Freehills identifies the challenges of transposition as follows:

> In the case of legislation that is cross-border or international in nature, it will not be possible for the UK unilaterally to preserve the effects of these frameworks without the cooperation and consent of other Member States and the EU (for example the Treaty provisions on free movement). The extent to which such frameworks will remain relevant, and the way they will operate, depends on the final deal negotiated between the UK and the EU.[7]

The government has attempted to eliminate uncertainty and instability via the transposition of EU law via the GRB. However, very little is currently known about the composition of the GRB, and the transition will be affected significantly by the degree to which the UK commercial legal regime remains harmonized with that of the common market law regime administered within the EU by the ECJ and the General Court.[8]

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[6] House of Commons Library (2016) 'Legislating for Brexit: the Great Repeal Bill', 21 November. Available: http://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-7793

[7] Herbert Smith Freehills (2017) 'The Great Repeal Bill: fit for purpose?', 26 January. Available: https://www.herbertsmithfreehills.com/latest-thinking/the-great-repeal-bill-fit-for-purpose

[8] EU law has 'direct effect' (i.e., primacy, direct applicability and enforceability) within EU and EEA member states, and is superior to national law within the jurisdictional competences of the EU. EU law will no longer apply to the UK following its formal withdrawal, and UK courts will not implement the rulings of the ECJ or refer cases to rulings to the Luxembourg court. Broadly speaking, within the common market legal regime, the ECJ's role is analogous to that of the High Court of Australia, while the EU General Court's rough equivalent is the Federal Court of Australia.

The financial costs of Brexit

The potential economic consequences of Brexit were modelled extensively by both private and public sector entities, including Treasury, Price Waterhouse Coopers (PwC), Oxford Economics, the OECD and the National Institute of Economic and Social Research (NIESR). Modelling scenarios envisaged three possible outcomes; these were:

(i) UK withdrawal to the European Economic Area (EEA);[9]
(ii) negotiation of a free trade agreement (FTA) between the EU and the UK; or,
(iii) employing most-favoured nation (MFN) tariff schedules under extant World Trade Organization (WTO) arrangements.

There are several issues in relation to each scenario. Scenario (i) envisages Britain adopting the 'least-worst' or 'Norway' option of withdrawing to the EEA, but retaining full access to the EU Single Market. Legally and politically, this option is unlikely. First, Britain would not simply be legally permitted to 'withdraw' to the EEA; it would need to apply for membership. Second, given that EEA membership uncategorically specifies freedom of movement of intra-EU labour,[10] this would pose considerable domestic political challenges, given that Brexit campaigners devoted significant resources to the development of policies that would introduce much more restrictive immigration policies. A further alternative would be that the UK applies for membership of the European Free Trade Association (EFTA),[11] which was co-founded by Britain in 1959–60.

Scenario (ii) modelling is based upon a bilateral FTA between the UK and the EU, replicating most of the features of the EU Single Market, with the exception of freedom of movement of labour. This would include FTA access to services, as well as freedom of capital movement.

Once Brexit formally takes place, the UK will automatically lose all of the privileges associated with the bilateral and plurilateral FTAs to which it has current access, as these are EU-based agreements. These include the EU's FTAs with Canada, Mexico, South Korea, India, the ACP and Switzerland, as well as the EU-Turkey Customs Union (CU).

Under Scenario (iii), the UK's position in relation to the WTO is uncertain. WTO Director-General, Roberto Azevedo, noted in June 2016 that the UK's WTO tariffs are integrated with the EU's Single Market under the rubric of the Common External Tariff (CET), which is concomitant with the Single Market's CU. Consequently, the UK would need to re-negotiate its market access regimes with both developed and developing economies within the WTO. In addition, all of the WTO's 161 members' and the EU's current WTO

[9] The EEA Agreement was ratified in 1994 in order to extend the EU's 'Four Freedoms' (goods, services, labour and capital) to its close EU trade partners. The EEA's member states comprise Iceland, Liechtenstein and Norway. Switzerland did not ratify the EEA agreement and has instead signed over 100 bilateral treaties with the EU in order to maintain preferential access to the EU's goods, services and capital markets. EEA members are subject to regulatory oversight by the EU Commission and judicial oversight by the European Court of Justice (ECJ). However, although EEA members contribute to the EU General Budget, they possess no EU-level decision-making authority and hold observer status only in terms of policy making. Britain was a signatory to the EEA as a EU member state in 1994. However, the current legal consensus is that the UK does not hold EEA membership in isolation of, or in addition to, its EU membership.
[10] The EU's 'Four Freedoms' are enshrined in the 1957 Rome (EEC) Treaty. The Four Freedoms refer to freedom of movement of goods, services, capital and labour. They are applicable throughout the EU-28 and the three EEA countries, plus Switzerland.
[11] EFTA members comprise Iceland, Liechtenstein, Norway and Switzerland.

commitments are unknown, since the Millennium Round of the WTO was abandoned at the 2003 Cancun Ministerial, and the EU has expanded from 15 to 28 member states since 2004.

Table 1: Quantitative economic estimates of the 2030 impact of Brexit

Scenario	Organisation	Estimate (% of GDP)	Range (% of GDP)
EEA	CEP (2016a) static	−1.3	N/A
	HM Treasury	−3.8	(−3.4 to −4.3)
	NIESR	−1.8	(−1.5 to −2.1)
FTA	CEP (2016a) dynamic[a]	−7.9	(−6.3 to −9.5)
	HM Treasury	−6.2	(−4.6 to −7.8)
	NIESR	−2.1	(−1.9 to −2.3)
	PwC (2016a)	−1.2	N/A
	Oxford Economics[b]	−2.0	(−0.1 to −3.1)
	Open Europe[a]	−0.1	(−0.8 to +0.6)
	OECD	−5.1	(−2.7 to −7.7)
WTO	CEP (2016a) static	−2.6	N/A
	HM Treasury	−7.5	(−5.4 to −9.5)
	NIESR	−3.2	(−2.7 to −3.7)
	NIESR with productivity	−7.8	N/A
	PwC (2016a)	−3.5	N/A
	Oxford Economics[c]	−2.7	(−1.5 to −3.9)
	Open Europe	−2.2	N/A
	Economists for Brexit	+4.0	N/A

[a] Estimate is mid-point of FTA range.

[b] FTA with moderate policy scenario used as central estimate; range includes 'liberal customs union' (−0.1) to 'populist FTA' (−3.1).

[c] Central estimate is mid-point of the range. Range includes 'populist MFN' (−3.9) to 'liberal MFN' (−1.5).

Note: Estimates are for the impact on GDP in 2030 relative to EU membership.

Source: Estimates from organisations above. Emmerson et al. (2016)'s assessment of impacts modelled.

Source: Emmerson et al (2016: 42).

At time of writing, the EU's WTO agreements comprise over 9,000 individual goods attached to tariff schedules. It is unlikely that the UK would simply retain the EU tariff schedules for its own product lines when Britain commences trade negotiations with third countries or regions following Brexit, as the schedules may be inappropriate to the commercial requirements of UK firms. The Treasury modelling of the impact of Brexit with WTO tariffs (Table 1) and no successor arrangements has a central estimate of UK GDP at 7.5% (£66 billion) lower after 15 years.[12]

As Table 1 illustrates, it is noteworthy that virtually all of the Brexit economic modelling results show a diminution of UK GDP through 2030 of between

[12] *The Telegraph* (2016) ''Hard Brexit' will cost Britain £66 billion per year, claims controversial leaked Treasury report', 11 October. Available: http://www.telegraph.co.uk/news/2016/10/11/revealed-hard-brexit-will-cost-britain-66billion-per-year/

–0.1% GDP and –7.9% GDP. The levels of divergence and the ranges of GDP vary considerably across the studies, indicating the different assumptions in the modeling. For example, reports varied in terms of the scope of their sectoral studies. Only one study, prepared by 'Economists for Brexit', forecast an increase of GDP of 4.0% through 2030.[13]

In the short term, the administrative costs of Brexit are estimated at £5 billion. In November 2017, the Chancellor of the Exchequer, Mr. Hammond, in his Autumn Statement, stated that Treasury modeling forecast GDP at 2.4% lower in 2020, due to the impact of Brexit. The Chancellor also revealed that UK Treasury would need to borrow an additional £122 billion through 2016–22, of which £58.7 billion would due to problems created by Brexit, including lower immigration and a weaker sterling exchange rate. In addition, Mr. Hammond noted that the government was no longer forecasting a surplus for 2019–20.[14]

Passporting and financial services

There have yet to be any comprehensive studies on the impact of Brexit upon inward and outward FDI and FPI in the UK. At time of writing, this is due to the uncertainty surrounding the investment, banking and financial regimes (the 'rules of the game') that the British government will negotiate with the EU and third countries. Of critical importance to the UK banking and financial services sector will be the maintenance of 'passporting'.[15] Under the bank 'passport',, EU-28 banks plus EEA banks are not required to obtain local licensing. However, Swiss banks under the EU-Switzerland bilateral agreements do not possess passporting rights; thus, Swiss banks, such as UBS operate investment banking services via subsidiaries in the City of London. If the UK faces the withdrawal of passporting rights, third country banks could shift to other EU financial centres, such as Frankfurt, Paris, Amsterdam or Dublin.

Irrespective of the final structure of any UK-EU deal, the City of London will remain a global financial services hub, as well as an important clearing house for euro-denominated bonds and over-the-counter derivatives. However, its position in relation to euro trading will depend heavily upon the extent to which the EU is prepared to allow a significant proportion of euro-denominated trades outside the euro area.

There have been several attempts since 2001 by the European Central Bank (ECB) to control and authorize euro-derivatives clearing houses, with a clear preference to locate such houses within the euro area. In 2009, the Governor of the Bank of France, Christian Noyer, stated, ''Most of the euro business should be done inside the euro area. It's linked to the capacity of the central bank to provide liquidity and ensure oversight of its own currency.' In 2011, the ECB called for the regulation of euro derivatives to be placed into legislation, which led to the European Council and the European Parliament

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[13] This study, led by the pro-Brexit economist, Professor Patrick Minford, was based upon the UK defaulting to WTO tariff schedules only.
[14] HM Treasury (2016) 'Autumn Statement 2016: documents', 23 November. Available: https://www.gov.uk/government/publications/autumn-statement-2016-documents
[15] Passporting refers to the right of bank and non-bank financial services providers to offer financial products and services throughout the EU unrestricted by borders or technical, physical or fiscal barriers. The free movement of capital and financial services are two of the critical pillars in the architecture of the Single European Market (SEM) that may be at risk, or potentially subject to limitation, depending upon the outcomes of the UK-EU Brexit negotiations. Passporting falls under the rubric of the EU Single Market in Financial Services.

(EP) ratifying the European Markets Infrastructure Regulation in 2012.[16] In response, the UK government launched two legal challenges to the ECB in the European Court of Justice (ECJ) in 2011 and 2012. The 2011 challenge was based upon the principle of non-discrimination in the Single Market in Financial Services; lawyers acting for the UK government argued that restrictions upon derivatives trading violated the Single Market's freedom of capital movement provisions. In the second case, a technical, challenge to Regulation 648/2012, the ECJ established in its 2015 ruling that the ECB had exceeded its competence by attempt to restrict trade in euro-denominated derivatives. However self-evident it may be, it is worthwhile noting that, following Brexit, the UK will no longer be able to challenge EU institutional decisions in the ECJ.[17]

In February 2016, the then-Prime Minister, Mr. Cameron, secured commitments from the EU, which included the right of the Bank of England (BoE) to maintain its own national banking supervisory mechanism to ensure financial stability, in an assertion of independence from the Single Supervisory Mechanism (SSM), applicable within the euro area from November 2014. The Chairman of the BoE in his remarks to the Treasury Select Committee in March 2016, noted that the February 2016 agreement between Mr. Cameron and European Council President, Mr. Tusk, included 'a legally binding commitment to ensure non-discrimination in the single market on the basis of currency'.[18] However, the February 2016 EU-UK agreements will be rendered null and void by the UK's withdrawal from the EU.

The UK is Australia's second-largest source of both FDI and FPI. Together with the US, the UK is systemically important in terms of FPI to the stability of its equities and the liquidity of Australia's capital market pool. There is no literature or systematic empirical data on the value of FDI or FPI sourced from the EU Single Market, and cleared via City of London bank and non-bank financial intermediaries. Despite Brexit, the integration of European equity markets with London appears likely to continue. The *de facto* integration of EU stock exchanges may also take place even in the face of Brexit, given the pending £22 billion merger of the London Stock Exchange (LSE) and Germany's Deutsche Börse. However, a financial probe currently being conducted into Deutsche Börse is likely to delay or defer the merger. Furthermore, at present, the EU Commission is considering the merger on anti-trust grounds;[19] in 2012, the Commission blocked the Deutsche Börse-EuroNext[20] merger on the grounds that the combined entity would dominate the euro derivatives trade. The Brexit vote in June 2016 led to significant losses for Australian Stock Exchange (ASX) listed companies that had exposure to the UK market; for example, BT Investment Management, Iress and Westfield experienced sharp falls.[21]

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[16] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. Text with EEA relevance. Available: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32012R0648
[17] However, UK firms or their subsidiaries will have access the ECJ.
[18] House of Commons Select Committee (Treasury Committee) (2016) 'Bank of England questioned on UK's EU membership', 3 March. Available: http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/uks-eu-evidence-15-16/
[19] Bloomberg (2017) 'EU Said to Warn Deutsche Boerse-LSE Merger May Crush Rivals', 20 January. Available: https://www.bloomberg.com/news/articles/2017-01-20/eu-said-to-warn-deutsche-boerse-lse-merger-may-crush-rivals-iy5ooq12
[20] EuroNext previously operated in the euro derivatives trade in New York. LSE offloaded the French arm of EuroNext recently in order to clear the ground for the Deutsche Börse merger.
[21] Business Insider (2016) 'Stocks with exposure to Britain are getting hammered on the ASX', 24 June. Available: http://www.businessinsider.com.au/stocks-with-exposure-to-britain-are-getting-hammered-on-the-asx-2016-6

It appears reasonable to assume that, even in the absence of a sub-optimal UK-EU trade in financial services agreement, that the capital and investment (FPI and FDI) pools in London will experience at least some short-to-medium term impact from a reduction in euro business, currently estimated at approximately $US1.4 trillion per annum. It is well known in the trade and investment literature that trade restrictions and increased trade costs routinely cause reductions in FDI and FPI flows.

This has implications for the liquidity of Australian capital markets, from which the major Australian banks obtain most of their wholesale funds for borrowing. Moreover, there is also likelihood of some measure of instability and unpredictability in London's (and global) financial markets once the terms of the UK's Article 50 withdrawal are known. In the event of a 'soft' Brexit, where the UK's trade and capital mobility provisions within the EU Single Market remain largely intact, this 'least-worst' scenario would minimize market disruption.

Existing and prospective trade negotiations

The Transatlantic Trade and Investment Partnership (TTIP) between the US and EU commenced negotiations under the Obama administration. Despite considerable opposition from EU publics and the European Parliament (EP), together with some 'red line' issues under dispute, decision makers on both sides were close to achieving a far-reaching transatlantic liberalization of goods, services and public procurement, as well as cooperation in other sectors such as agriculture, intellectual property and information technology.[22] However, the election of Mr. Trump as President of the United States in November 2016, has cast considerable doubt upon the promulgation of any new bilateral or plurilateral trade agreements. In early 2017, the Trump administration withdrew from Trans-Pacific Partnership (TPP), in which Australia had invested considerable diplomatic capital. However, the new US administration has signalled it would consider a US-UK FTA following Brexit.

The Australian Trade Minister, Mr. Ciobo, and the UK Secretary of State, Mr. Fox, have stated that Australia and the UK will establish a bilateral Trade Working Group to fast track an Australia-UK FTA, once Britain exits the EU. Under existing treaty law with the EU, the UK is not permitted to engage in bilateral, plurilateral or multilateral trade negotiations until it formally departs the EU. As a contributor to the Free Enterprise Group report, *Reconnecting with the Commonwealth,* the former prime minister, Mr. Abbott, has called for an Australia-UK FTA where, '[t]he movement of goods between our two countries should be absolutely free of tariffs or quotas.' In addition, the UK Secretary of State for Foreign and Commonwealth Affairs, Mr. Johnson, previously argued in 2013[23] in favour of a free movement of labour agreement (a 'migration block') between the UK, Australia, Canada and New Zealand. However, it appears unlikely, in view of the internal politics of Brexit, that the UK will increase migrant intakes from third countries. Once Britain exits the EU, it is likely to join the Trade in Services Agreement (TiSA), which is currently under negotiation between 23 OECD state and regional parties, including Australia, the US and the EU-28. TiSA members are heavily services-oriented economies and the promulgation of TiSA will expand high value-added services trade. A study published by the UK Institute for Fiscal Studies estimates that the financial

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[22] See European Commission (2016), 'EU negotiating texts in TTIP', 14 July. Available: http://trade.ec.europa.eu/doclib/press/index.cfm?id=1230
[23] Mr. Johnson was Lord Mayor of London at the time he made these comments.

services sector contributes 8% of Britain's GDP and employs over 1.15 million persons.[24] Services as a whole constituted 80% of UK GDP in 2015;[25] consequently, it is critical for the UK to secure a trade in services agreement with the EU.

Agricultural trade

Britain is Australia's largest investor in agricultural land. The 2016 Australian Land Registry Report shows that of the 13% of foreign-owned agricultural land, 52% is owned by UK interests.[26]

The 1932–72 Imperial Preference system that operated within the Commonwealth until 1 January, 1973, gave Australian agricultural products preferential access to the UK market. However, with UK accession to the (then) European Community in 1973, Britain was integrated into the EU Customs Union and its agricultural imports from third countries were significantly restricted by the Common Agricultural Policy (CAP). The CAP was formally instituted in 1968, replacing interim agricultural tariff and quota arrangements that had been in place since 1962.

The CAP comprises three core elements:

(1) Direct 'whole farm' payments.
(2) Producer price guarantees.
(3) Export subsidies.

Despite considerable reform attempts throughout the last 25 years, the CAP still consumes at least 50% of the EU General Budget. Since its accession in 1973, the UK has been a net financial contributor to the CAP, as Britain's farm sector is small, contributing less than 0.5% of UK GDP. After Brexit, the UK government will no longer contribute to the CAP.

The CAP has also produced negative externalities, such as successive US Farm Bills since the first 'omnibus' Farm Bill under the Nixon administration in 1973. Both EU and US farm policies have damaged Australia's agricultural production and trade via the extensive employment of subsidies. By the mid-1990s, the EU farm Producer Subsidy Equivalent (PSE) was, on average, 500% higher than that for Australian farmers, and 140% higher than US farmers. Production subsidy distortions are compounded by export subsidies. Despite pressure wrought by the Australia-led Cairns Group, the 1994 GATT agreement did not produce substantial reform of the CAP, following the 1993 Blair House II agreement. In addition, the collapse of the 2003 WTO Cancun Ministerial has meant that US-Australian proposals for the progressive (100%) elimination of all agricultural production subsidies among WTO members has been 'left on the table'. Consequently, endogenous pressures within the EU for CAP reform have been slow, with only incremental programs implemented in 2005 and 2013.[27] It was estimated in

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[24] Emmerson, C., Johnson, P. and Mitchell, I. (2016), 'The EU Single Market: The Value of Membership versus Access to the UK', Institute for Fiscal Studies, August. Available: https://www.ifs.org.uk/uploads/publications/comms/R119%20-%20The%20EU%20Single%20market%20-%20Final.pdf
[25] World Bank (2016), 'World Development Indicators: Structure of output', table 4.2 Available: http://wdi.worldbank.org/table/4.2
[26] Australian Taxation Office (2016) 'Register of Foreign Ownership of Agricultural Land', Report of registrations as at 30 June 2016. Available: http://firb.gov.au/files/2016/08/Register_of_foreign_ownership_of_agricultural_land.pdf
[27] EU Commission (2013) 'Overview of CAP Reform 2014-2020', *Agricultural Policy Perspectives Brief*, no. 5, December. Available: http://ec.europa.eu/agriculture/sites/agriculture/files/policy-perspectives/policy-briefs/05_en.pdf

2001 that the CAP accounted for 38% of all world agricultural price distortions and 90% of global agricultural export subsidy payments.[28]

Sugar exporters were afforded improved access to EU markets in 2006, following Australia's successful litigation in the WTO, compelling the Commission to reform EU sugar quotas.[29] Britain has been a net food importer since the mid-19th century, and the UK's withdrawal from the EU provides considerable opportunities for Australian food exporters to the UK. Currently, 70% of the UK's food imports are sourced from the EU, with Australia only supplying 1.0% of the British food market.[30] Australian farm exports to Britain, comprising principally wine, lamb and beef, total 1.5% of Australia's agricultural and food exports.[31]

Australian producers can expect to make some inroads into the British dairy sector, although they will continue to face considerable competition from subsidized EU and US producers, as well as New Zealand dairy exporters. The largest British food group imports are dairy and eggs; cereals; beverages; meat, and fruit and vegetables. In the latter category, the EU is the dominant supplier, and EU fruit and vegetable supplies have become highly competitive, as EU producers, due to sanctions, cannot currently export to Russia, one of the EU fruit and vegetable sector's largest export destinations.

A 2016 Rabobank *Agribusiness Monthly* report assesses the likely impact of the elimination of the CAP quotas and subsidies and the potential outcomes for UK and EU agribusinesses.[32] Under current CAP farm payments, the UK receives approximately £3 billion in subsidies per annum (as at 2015).[33] For example, beet sugar is heavily subsidized in the EU, rendering cane sugar imports expensive and uncompetitive. However, it is possible the UK government will develop at least interim subsidy arrangements to support beet farmer throughout the Brexit transition.

There are a number of intervening variables that will affect Britain's post-Brexit agricultural trade. First, the relative strength or weakness of sterling and the euro will play a role in determining the UK's sources of imported foods. For example, a weaker euro in the medium term would advantage EU dairy producers over Australian farmers exporting to the UK market. Second, a review of the Australian agricultural industry peak groups' commentary on Brexit indicates a broader consensus forming around increased export opportunities for the farm sector. However, Rabobank, Australian Grain and the Federal Government's Grains Research and Development Corporation (GRDC) are generally of the view that any gains by Australian farm exporters in the UK market

[28] Zunckel, H. (2004) 'The rationale behind agricultural reform negotiations', *Tralac Working Paper*, no. 5, July, p. 2.
[29] See WTO (2005) 'European Communities – Export subsidies on sugar', AB-2005-2, Report of the Appellate Body, 28 April. Available: https://www.wto.org/english/tratop_e/dispu_e/265_266_283abr_e.doc; and DFAT (2005) 'WTO dispute settlement: European Communities - Export Subsidies on Sugar', 5 December. Available: http://dfat.gov.au/international-relations/international-organisations/wto/wto-dispute-settlement/Pages/european-communities-export-subsidies-on-sugar-3.aspx
[30] Department for Environment, Food and Rural Affairs (2016) 'Food statistics pocketbook 2016', table 3.1, p. 22. Available: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/553390/foodpocketbook-2016report-rev-15sep16.pdf
[31] Keogh, M. (2016) 'The impact on Australian agriculture as Britain exits the EU', *Australian Grain*, September-October, p. 36. Available: http://ausgrain.com.au/Back%20Issues/263sogrn16/Brexit.pdf
[32] Medianet (2016) 'Direct Brexit impacts for Australia's agricultural trade relatively limited – Rabobank', 30 June. Available: http://www.medianet.com.au/releases/99080/
[33] *Raconteur* (2016) 'Uncertain times for the UK sugar industry', 13 October. Available: http://www.raconteur.net/current-affairs/uncertain-times-for-the-uk-sugar-industry

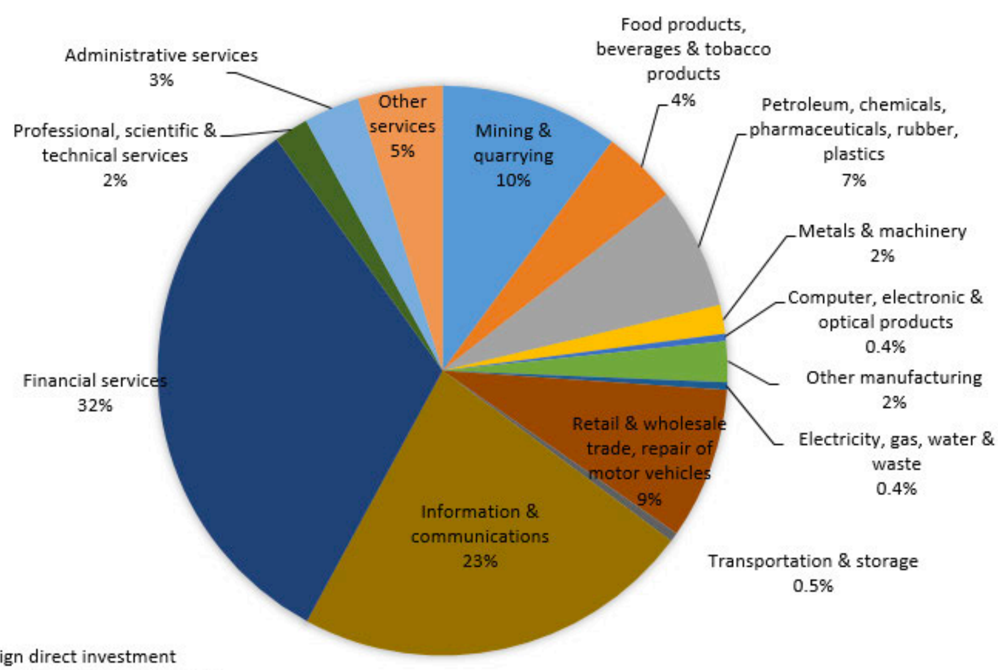
will be modest and largely dependent upon the sterling exchange rate.[34] Since the Brexit vote, sterling has depreciated to some of its lowest levels in 30 years, and one can reasonably expect short-to-medium terms weakness, thus rendering imported foodstuffs relatively expensive on the UK domestic market.

Foreign investment

As of 2014, the EU accounted for almost half the stock of FDI in the UK ($US774 billion). Australia is Britain's eighth-largest source of FDI, with 23 projects in 2013 and 29 in 2014. The UK directs approximately 22% of its outward FDI to Australia.

The UK is the EU's largest recipient of FDI in four of the ten most important EU industry sectors: software, business services, automotive assembly and financial intermediation.[35]

Figure 1 UK outward FDI stock to EU, 2014



FDI = foreign direct investment
Source: Office for National Statistics.

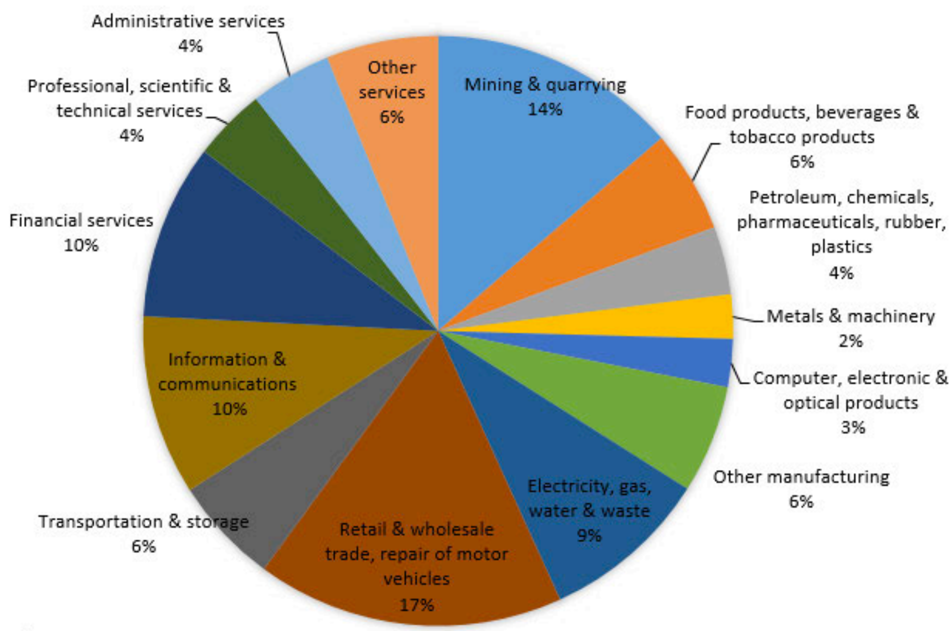
The UK ranked highly on measures of investment openness, institutions, labour market flexibility, incentives and low exchange-rare risk.[36] One of the most attractive features of the UK market for third-country investors has been its tariff-free access to the 500-million strong EU market, as well as freedom of movement of services, capital and labour. From

[34] GRDC (2016) 'The impact on Australian agriculture of Britain leaving the European Union', 10 August. Available: https://grdc.com.au/Research-and-Development/GRDC-Update-Papers/2016/08/The-impact-on-Australian-agriculture-of-Britain-leaving-the-European-Union
[35] Ernst & Young (2016) 'Attractiveness survey – UK 2015', pp. 15–16.
[36] See Driffield, N. et al (2013) 'How attractive is the UK for future manufacturing foreign direct investment?', Foresight, Government Office for Science. Available: Available: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/277171/ep7-foreign-direct-investment-trends-manufacturing.pdf

1973, but particularly from 1987, with the establishment of the Single Market project, transplanted industries from third countries employed the UK as their EU base in order to access the Single Market, making Britain an attractive export base. Noteworthy firms establishing operations in Britain included Nissan and Toyota. More recently, BHP Billiton has shifted its treasury operations to London, a move that has become more commonplace among global corporations, due to a less restrictive regulatory regime and reduced taxation.[37]

Figures 1–2 demonstrate the composition of UK inward and outward FDI (2014). Outward investment shows a high concentration in sectors such as financial services information and communications technology, and retail and wholesale trade. Financial services capture the largest proportion of FDI, accounting for 32%, demonstrating the UK's competitive advantage in this sector. Conversely, inward FDI is concentrated in retail and wholesale trade, ICT and financial services. Table 3, which ranks the main FDI source countries, illustrates the high level of dependence the UK has upon US outward investment flows, which account for almost one third of all inward FDIs.

Figure 2 UK inward FDI stock from EU, 2014



FDI = foreign direct investment
Source: Office for National Statistics.

The various findings of Bruno et al, based upon OECD statistics in 34 countries between 1985–2014, demonstrate a statistically significant link between EU membership and inward FDI flows.[38] Similarly, Straathof et al found that inward FDI from third countries increased by approximately 14%, while intra-EU FDI inflows were boosted by as much as 28% as a result of EU membership.[39]

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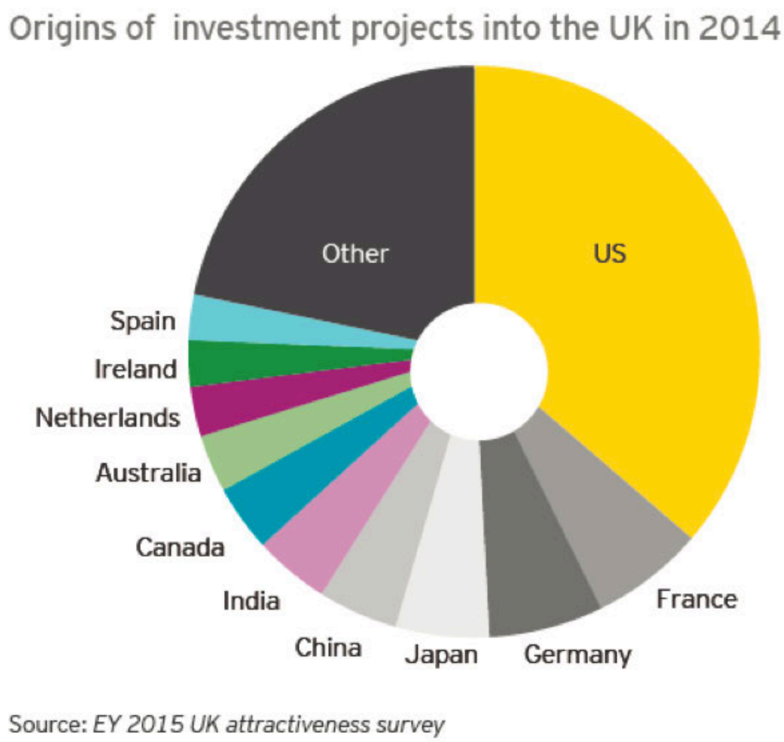
[37] Fiat Industrial moved its tax headquarters to London in 2013, followed by Fiat Chrysler's decisions to shift its treasury operations to London in 2014.
[38] Bruno, R., N. Campos, S. Estrin and M. Tian (2016) 'Gravitating towards Europe: An Econometric Analysis of the FDI Effects of EU Membership', Centre for Economic Policy, LSE, Technical paper. Available: http://cep.lse.ac.uk/pubs/download/brexit03_technical_paper.pdf
[39] Straathof, S., G-J. Linders, A. Lejour and J. Mohlmann (2008) 'The Internal Market and the Dutch Economy: Implications for Trade and Economic Growth', CPG Netherlands Document No. 168.

The view of this submission is that an Australia-UK FTA or bilateral investment treaty (BIT) would be advantageous, given Britain's important investment position within the Australian economy. Previous FTAs with the US and China have sought successfully to raise the FDI threshold without automatic referral to the Foreign Investment Review Board (FIRB), with a view to incentivizing investments of significant monetary value and strategic importance to the Australian economy. This submission recommends that a similar approach be adopted when considering the investment framework of a prospective Australia-UK FTA.

Figure 3



Summary

This submission endorses the now long-held bipartisan precept that Australia should practice open and non-discriminatory trade and investment policies. The Federal government is in the process of considering commencing negotiations on an Australia-EU FTA. In my 2016 submission on the prospective Australia-EU FTA negotiations, I argued that Australia should seek a comprehensive FTA with the EU.[40] Despite the challenges posed by Brexit, logically, the Australian government should seek to extend its global network of FTAs by pursuing FTAs with both the EU and the UK. Counterfactually, had Britain opted to remain within the EU, Australia would have pursued negotiations with the EU-28 in any case. Indeed, Britain's prospective departure

[40] Davison, R. (2016) 'Submission to the Department of Foreign Affairs and Trade on the negotiation of the Australia-European Union Free Trade Agreement, 26 February. Available: http://dfat.gov.au/trade/agreements/aeufta/submissions/Documents/dr-remy-davison-monash-university-eufta-submission.PDF

from the EU makes the case for an Australia-EU FTA even more pressing, as the UK will no longer be able to be employed as a European market base for Australian trade, investment and services delivery into the EU Single Market. Equally, as noted above, Australian capital markets are less likely to obtain investment from euro area markets via London, as has been typically the case since the establishment of the Eurodollar markets in 1963.

Given that Britain is likely to retain a close, albeit less integrated, banking, investment and trade relationship with the EU, it would make little sense for Australia to integrate with one European partner and not the other. Moreover, Australia already has very strong trade and investment ties with Germany, France and the Netherlands, and the major EU economies will still be tightly integrated with the UK economy, particularly under a Single Market access agreement or if UK-EU relations approximate those of the EEA states or Switzerland.