

## With or without EU?

### MAPPING UK TRADE POLICY AFTER BREXIT



The new Prime Minister's delphic pronouncement that "Brexit means Brexit" leaves open a range of options. Under a "hard" scenario, the UK would depend, initially at least, for access to overseas markets on membership of the World Trade Organization (WTO). This bulletin in our post-referendum series explores the possibilities – and limitations – provided by such an outcome, including the impact on different sectors of the economy. While various options open the possibility of bilateral deals with non-EU countries, we explain why the UK must give priority to preserving as much as possible of the deep integration it has secured with its biggest trading partner.

The UK is a WTO member in its own right, and signatory to the agreements the European Union has made on its behalf. Consequently, in the absence of any other arrangement following "Brexit", both the UK and the EU would apply to each other the same trade arrangements that they apply on a "most favoured nation" (MFN) basis to other WTO members.

From the perspective of UK exporters, MFN means that the members of the EU could not treat the UK worse than they do other countries with which they do not have a preferential trade agreement. By definition, EU members give each other preferential treatment, but they have also struck agreements with other trading partners such as Korea and Turkey. They have recently concluded one with Canada, and are negotiating agreements with the US and Japan. The EU also unilaterally accords extensive duty-free access to a range of developing countries. Taken as a whole, this means that the UK would have more restricted access to the EU than many other trading partners within and outside the EU.

The WTO was created over 20 years ago as part of the last substantial and successful effort at global trade liberalisation (see box below). This major push was based on the well-evidenced expectation that free trade boosts economic growth. As well as stimulating trade between its members, the WTO helped to bring China into the global trading framework, thus supercharging its contribution to world economic expansion.

The same understanding that free trade boosts growth lay behind the efforts to create a "single market" within the EU. The UK Treasury estimates that the dismantling of barriers to trade in goods and services has boosted UK global trade in net terms (i.e., after offsetting any effects EU membership might have had on diverting trade between the UK and non-EU countries) by around 76%. The baseline for this calculation was an estimate of what would have happened had the UK remained outside the EU, and traded with it and the rest of the world on WTO terms.



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**The dismantling of barriers to trade that resulted from the creation of the EU single market is estimated to have boosted UK global trade in net terms by around 76%.**

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This illustrates the fact that the removal of EU internal trade barriers, though still not complete, has gone far farther within the EU than has proved possible to negotiate at the global level. That has notably been the case with non-tariff measures affecting goods, and in services trade.

So the UK must strive to safeguard as much as possible of the benefits that have been generated by close European economic integration over the years. Since, however, this will involve difficult political trade-offs between access to markets and access for people (a key tenet of the single market regime), and since uniformity of regulation has also been key to single market progress, particularly in services, renegotiation risks backlash from Brexiters as the necessary compromises are made.

### Far away, so close

As the chart below shows, exports to other EU countries continue to account for half of UK goods exports, despite faster growth in other regions. They dwarf the UK's sales to the US and China, combined.

Without the EU, of course, the balance might have been different. But quantitative models of trade attest to a powerful “gravity” effect – proximity, whether physical, cultural or institutional, is extremely important. Reinstating trade barriers dismantled through decades of progressive liberalisation would artificially increase the distance between the UK and the EU, without bringing other markets any closer. This is a vital point since an implicit assumption underpinning some arguments in favour of leaving was that it would simply be a question of substituting existing EU trade partners with other, non-EU ones, once agreements were signed with these. Even setting aside the complications associated with getting such agreements in place, what these modelling results tell us is that trade policy post-Brexit will be far more complicated than a simple rearrangement of the deck-chairs. Substantial effects on UK trade can be expected.

### Rules of the global trade game

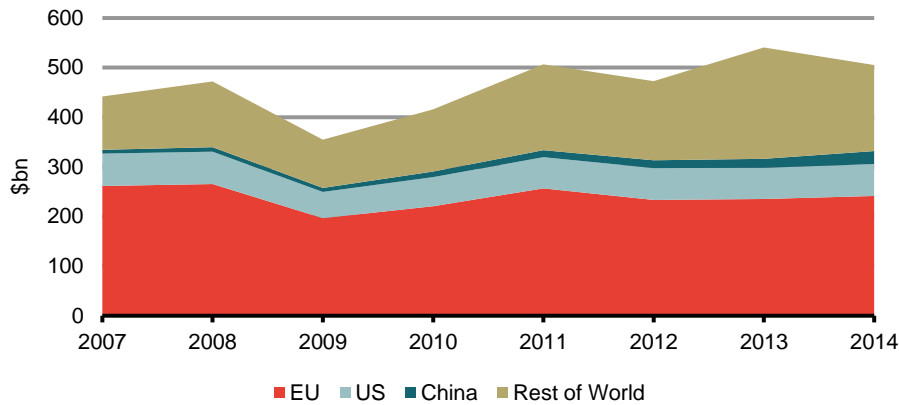
The WTO, which came into being in 1995, was the result of eight years of trade negotiations known as the “Uruguay Round”. The latter was the last and most ambitious of eight multilateral efforts to free up international trade through agreements covering goods and, for the first time, services. Rules on intellectual property were also agreed. The WTO replaced the General Agreement on Tariffs and Trade (GATT) that had been in operation since 1947, and had been established by a group of countries to dismantle protectionist barriers erected in the 1930s. The GATT had been a treaty with provisional application, and the inception of the WTO gave permanency to a multilateral trading system based on rules. It also put in place an enforceable dispute resolution mechanism, which is one of the three central functions of the Organization, along with trade negotiations and the monitoring of members’ trade policies.

The UK played a major part in completing this round, exploiting its unique combination of EU membership and a close relationship with the US to break a succession of deadlocks. Its role was enhanced by the fact that the EU's Trade Commissioner was British (the late Lord Brittan), and at the critical time the UK Government of Sir John Major held in quick succession the Presidency of the G7 major economic powers and the Presidency of the Council of Ministers of the European Union.

The WTO had early success in establishing its authority, through rulings against a wide range of powerful economies, including the US, and its membership has increased to 164 countries. Most notable was the entry of China in 2001, an achievement in which another EU Trade Commissioner, the Frenchman Pascal Lamy, played a critical role.

Despite this success, the WTO's efforts to continue trade liberalisation have faltered. The so-called “Doha round” of talks ran into severe difficulty, with green groups protesting that free trade was damaging the planet and developing countries complaining global trade policy was conducted in the interests of the developed world only. The round was finally declared dead at the end of 2015. While progress has been made with sector-and subject-specific negotiations, bilateral trade deals and regional trade agreements have become much more common.

**Exhibit 1. Breakdown of UK goods exports, 2007-2014**



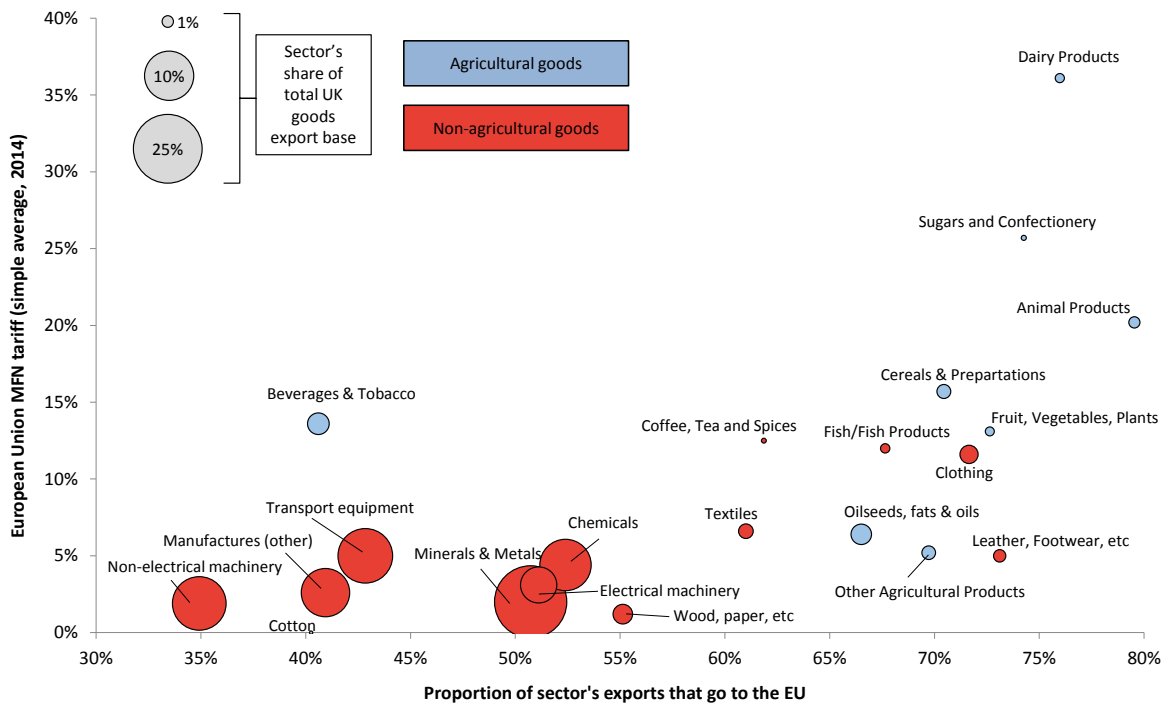
Source: WTO

The effect of a “hard” Brexit involving a reversion to WTO rules would likely be felt particularly strongly in sectors for which:

- the WTO has not succeeded in grinding down “tariff peaks” – i.e., tariffs significantly in excess of the average MFN rate of duty; and
- a significant proportion of UK exports currently go to EU Member States.

The chart below provides an overview of the potential exposure of different sectors on the basis of these two measures (with sectors towards the top-right hand corner of the chart being potentially most exposed in this sense).

**Exhibit 2. Exposure map for different UK goods sectors for a “hard” Brexit scenario**



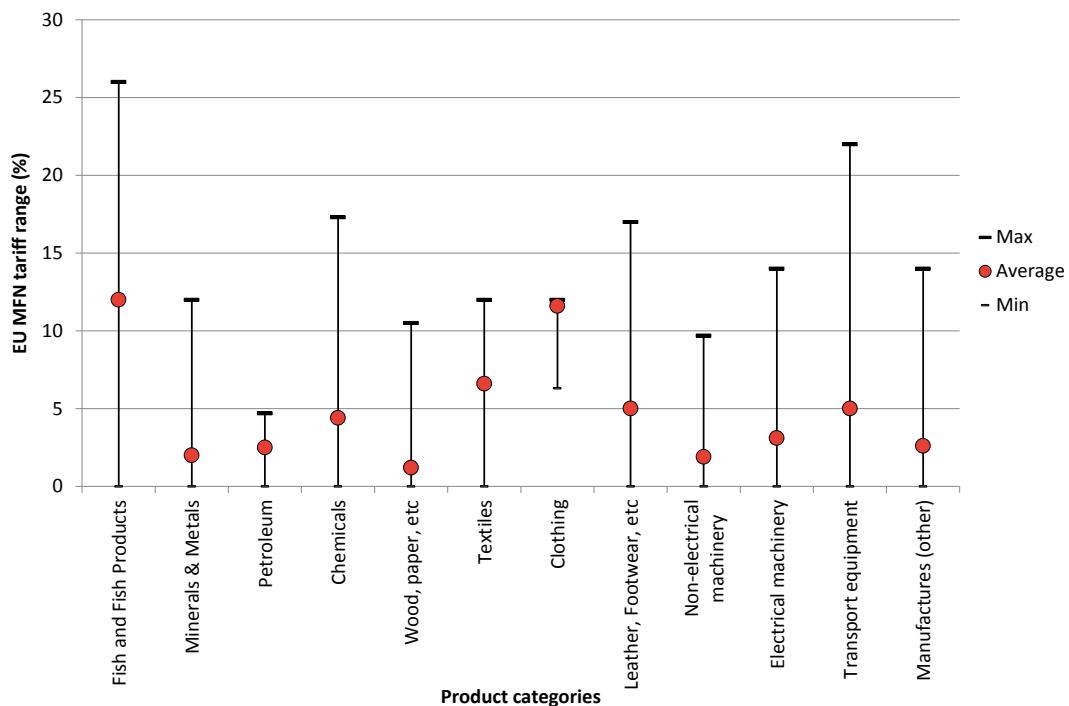
Source: Frontier Economics analysis of average MFN tariffs reported by the WTO (Trade Policy Review – Report by the Secretariat, 18 May 2015, page 43) and HM Revenue & Customs data on UK historical export volumes for 2012-2015.

Note: not all agricultural products have straight tariffs – instead, some have tariff-rate quotas, the effects of which will not be captured by the average MFN rates reported in the chart.

The chart above suggests that:

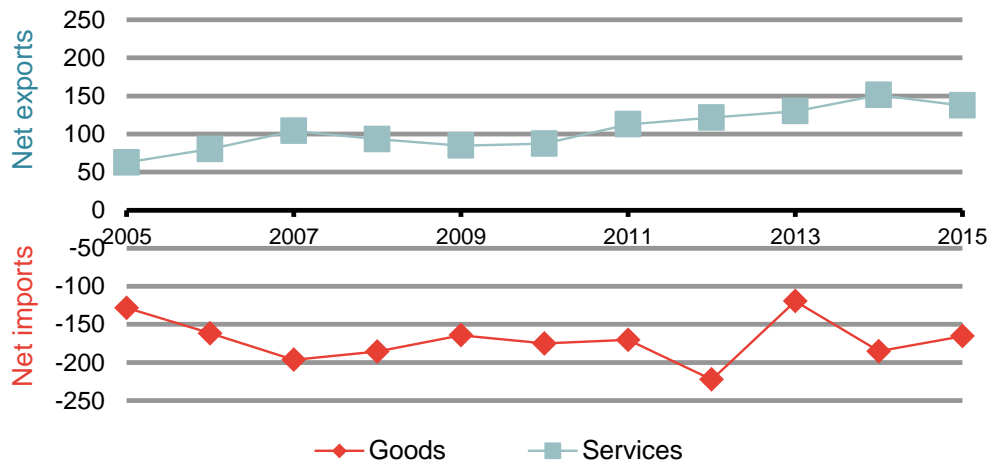
- **Agricultural and fish products** could be particularly hard-hit due to high average MFN tariffs (animal products and dairy products, for example, are subject to European Union MFN duties averaging around 20% and 36% respectively) and a relatively high dependence on the EU as a destination for exports (well over 50% for many agricultural products). Leave campaigners argued that French, Dutch and Italian farmers would be anxious to avoid similar barriers to UK markets, which could give the UK some leverage, but negotiations will not be easy.
- The UK would also face notably high average MFN tariffs for **clothing** and **textiles** – and again the impact of these high tariffs would be compounded by the fact, the EU accounts for more than half of UK exports for each of these product categories.
- At face value, average tariffs would appear to be lower for those non-agricultural products that make up the bulk of the UK's goods export base – **manufactures, transport equipment minerals, metals** and **chemicals**. However the UK cannot afford to be complacent. All of these sectors send a significant proportion of their exports to the EU (ranging from 35% to 55%). Average tariffs – though generally lower than those for agricultural products – could still deter exports and discourage future investment (for example, during the referendum campaign multinational car makers such as Toyota pointed to single market access as an important consideration behind their decision to locate European manufacturing plants in the UK). Moreover, as the chart below shows, the average tariffs reported in the chart above mask significant variation within each category. EU MFN duties on some types of transport equipment, for example, exceed 20%. As with so much of the challenge of managing the fallout from Brexit, the devil will be in the detail.

**Exhibit 3. European Union MFN tariff ranges for non-agricultural goods**



Source: WTO Trade Policy Review – Report by the Secretariat, 18 May 2015, page 43.

Negotiations with respect to **services** could be even more highly-charged than those for goods, since they account for such a substantial share of the UK's overseas earnings. As the chart below shows, the service sector has made a strong and consistently positive contribution to the UK's balance of payments over the last decade, a time when the UK has been running a serious deficit on its trade in goods. For all the talk of “rebalancing” the economy back towards manufacturing, robust exports in services will be critical to the UK's ability to pay its way in the world for the foreseeable future.

**Exhibit 4. Net imports/exports in UK goods/services (\$bn), 2005-2015**

Source: Frontier Economics analysis of WTO data.

Many of the barriers to trade in services are regulatory in nature. Our [previous bulletin](#) explored the issues with respect to the largest category, financial services. But there would also be pronounced effects on other sectors, notably professional services, such as law or accountancy. A conservative estimate, based on research carried out by Frontier for London First of the effects of increasing restrictions on services trade following Brexit, is that it could reduce the UK's total trade by around £67 billion per year<sup>1</sup>. This figure relates to both exports and imports of services and goods, so the effect on net output would be less – but it is a measure of the extent to which the UK would become less competitive and efficient, and of the interdependence of goods and services. Crucially, the loss of free movement of labour would drive increased restrictions on trade in services. It would be more difficult or costly to supply services via two modes of supply: (i) the movement of natural persons, and (ii) commercial presence, since firms wishing to hire personnel from the EU (or from the UK, if the firm is in the EU), could face limitations on the length of stay, EU residence requirements or economic needs.

### Even better than the real thing?

One of the propositions underpinning some post-Brexit thinking is that the UK would have greater latitude to pursue its own trade and industrial policy objectives, once freed from the shackles of the EU. This is true to the extent that the UK would be able to phase out all protectionist elements that it inherited from the EU, including subsidies in agriculture. There is economic merit in such an approach. But whether it would be feasible politically is unclear, especially in light of the clear evidence that fear of global import competition in specific sectors was a driver behind the Leave vote.

In any event, policy proposals floated recently seem to favour a more activist industrial policy, including the use of subsidies to support local industries such as car manufacturing. But such approaches would run into WTO disciplines on subsidies, and are no more plausible than when the UK was a fully-fledged EU member.

As far as the apparatus of EU trade policy is concerned, the internal disciplines negotiated collectively by EU members have their advantages in providing reliability of access. The reliability of trade rules depends on the authority of the body that polices them. European rules are buttressed by the European Commission and the European Court of Justice. Breaches of WTO rules can only be dealt with through its Dispute Settlement Mechanism. Though powerful by multilateral standards, it is significantly more limited than a court in terms of its jurisdiction (it hears state-state disputes only)

<sup>1</sup> Frontier research for London First, May 2016. This represents 7-8% of UK trade (exports and imports of services).

and powers. It can only order compliance from the date of a finding, and (apart from peer pressure) relies heavily on the threat of trade sanctions by the plaintiff for enforcement; a feeble weapon when wielded by the smaller trading party. It cannot, for instance, offer remedies such as compensation for historical damages, nor can it grant interlocutory injunctions.

These differences in enforcement mechanisms are compounded by the fact that the WTO agreements themselves are now more than two decades old. This is particularly evident in the area of services. Recent work by the OECD documents the extent of “water” in services commitments, that is to say the difference between legal commitments and actual practice. The more water, the greater the uncertainty for investors in the sector concerned.<sup>2</sup>

### Sometimes you can't make it on your own

In view of the dis-advantages of keeping the EU at arms-length, various alternative models for the future relationship with the UK have been canvassed, usually based on the example of jurisdictions that have recognised the benefits of closer economic integration while, for political reasons, being also unable to countenance full membership.

The most frequently touted bilateral arrangement between the UK and the EU is some variant of the European Economic Area model, adopted by Norway for example. Realistically, if the UK is to achieve conditions for trade in goods and services, and investment, that are even comparable to what is currently on offer, this is the only approach available. While the “Swiss model” is sometimes put forward, this is really a significantly more limited version of the Norway model. It consists of a series of bilateral agreements, including a commitment to the free movement of labour, but falls short of achieving a single market since there is no overarching agreement on services trade and restrictions on trade in agricultural products.

Other options are also limited: a Canada style free trade agreement does not provide the same conditions of access, notably on services, and Turkey's free trade arrangements are limited to goods.

The most sensitive elements of negotiations with the EU, politically, will concern the interaction with immigration rules and subjection to “Brussels red tape”. Both are often seen as a “price” of access, but in reality are part of its value. Free movement of people facilitates trade, in services in particular, and trade in services facilitates trade in goods. Equally, as tariff barriers have declined, non-tariff measures (stemming from domestic regulation) have become a significant in determining trade costs. In particular, firms that operate along geographically unbundled supply chains are sensitive to the costs of divergent standards. While Brexit offers the opportunity to develop standards tailor-made to domestic needs, with the potential to create new business opportunities, divergence may end up imposing more red tape on exporters than it saves, and some are already raising concerns about this.



**Free movement of labour and “Brussels red tape” are often seen as a “price” of access to the single market, but in reality they are part of its value.**

Because of the size of the EU market, and the interdependencies between the EU and the UK, it will therefore be in the UK's interest to align itself to EU standards as much as possible. But doing so passively by “updating” EU regulation is not likely to an optimal approach. The UK would need to see whether it could negotiate a specific mechanism on standards. Specific chapters can be found in regional trade agreements, such as those concluded between the EU and, respectively, Canada and Korea. But these are less developed than intra-EU cooperation mechanisms, and the challenge for the UK will be to see whether it can develop its own arrangements that can replicate, at least in part, the voice it currently has.

<sup>2</sup> OECD (2015), Water in the GATS: Methodology and Results, Working Party of the Trade Committee.

Free movement is likely to prove more of a stumbling-block, with Brexit Ministers proclaiming their own “solutions”, however poorly aligned with EU principles. Once proper negotiation starts, however, it may be possible to agree some bounds on free movement by negotiating an enhanced safeguards mechanism. This could be modelled on proposals currently being developed in Switzerland. They involve mechanisms that would control movement into regions and/or sectors that are deemed vulnerable according to certain objective criteria, without setting an overall cap.

Under any model that does not involve a customs union with the EU, the UK will be free to apply its own tariffs to the rest of the world. These tariffs cannot exceed what the EU has committed to at the WTO, since the UK, as explained above, inherits these commitments. The UK could, however, reduce or eliminate these tariffs, which would have the potential to stimulate productivity and growth, by removing distortions caused by the EU’s pattern of protection.

But as already observed, there may be significant political constraints in pursuing such an agenda. The problem could be addressed in part at least if the UK were to create market access opportunities for its own exporters by negotiating its own free trade agreements, as this might create constituencies in favour of free trade that offset those that favour protectionism. But while the UK might be able to “warm-up” potential trading partners, there is little or no scope for formal negotiations as long as the UK hasn’t finalised its arrangements for leaving the EU. Moreover, the UK would have considerably less leverage than if it negotiated as part of a larger coalition of countries. And because it inherits a generally liberal tariff structure from the EU, the commitments it would be able to offer trade partners will probably involve changes in regulation and measures “behind-the border”, which are both economically and politically challenging.

### Running to stand still?

Over thirty years ago, the trade economist C. Fred Bergsten coined the expression “the bicycle theory of trade”. In essence, this says that unless policy-makers continuously strive for liberalisation, the trading system will topple under the weight of protectionist pressure. The empirical evidence suggests that intra-European trade liberalisation has, together with multilateral initiatives, served to keep the wheels spinning, to the benefit of its Member States, including the UK.

The potential costs, to the UK and also the EU, of Brexit lie in the reversal of this progress, at a time when trade policy globally is in poor shape. The WTO provides protection against discriminatory tariffs, and bilateral deals can be negotiated to improve on this baseline. So options do exist to minimise the costs of exit. But those that provide most access to the EU are likely to require significant back-tracking on political promises made during the campaign. And they will require actively pedaling against the protectionist sentiments that lay behind at least part of the Leave vote. This in turn will require a concerted effort in explaining the benefits of trade, and more importantly, ensuring that there are redistributive mechanisms and safety nets to ensure that the overall gains from trade are shared, and that any losers from liberalisation are compensated.

It is hard to avoid the conclusion that the UK will be negotiating from an internationally-weakened and domestically-constrained position, and that the opportunity costs of seeking to replicate the advantages of its current arrangements, let alone achieving any advance on them, will be substantial. But as reality begins to dawn, it may begin to open up options for a pragmatic approach leading to sensible outcomes and even some gains through bilateral deals – despite the risk of backlash against the simultaneous European negotiations, from those whose expectations of their country’s ability to have its cake and eat it were raised dangerously high during the campaign.



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