

BREXIT CHALLENGE #2

WHAT DOES BREXIT MEAN FOR THE UK'S TRADING RELATIONSHIPS?

Introduction

Membership of the EU governs the trading relationships that we have with the rest of the world.

Since long before the evolution of the Single Market in the 1990s, members of the EU have also been members of the European Union Customs Union. The Customs Union has two elements. First, it ensures there are no customs checks on goods crossing internal EU borders. Second, it means that all of its members adopt a 'Common External Tariff', charging the same rates of import duties on goods which are imported from countries outside the EU. This rule is designed to avoid third country goods entering the market and circulating freely having avoided the tariff rules set by the Union as a whole.

The Customs Union also means that EU member states negotiate trade agreements collectively, through the EU institutions, rather than negotiating their own bilateral trade agreements with third countries. The advantage of this arrangement is that the EU negotiates as a bloc of 500 million consumers, and can use access to this vast market as leverage to secure better trading terms than could be delivered by any individual member state.

How is EU trade with the rest of the world organised?

The UK is currently party to more than 50 Free Trade Agreements (FTAs). While the EU itself remains our largest trading partner (accounting for 44% of UK exports in 2014), EU trade deals with third countries cover significant UK trading partners, including Switzerland, South Korea, and Canada (under ratification), as well as several Commonwealth countries and important emerging markets like Vietnam and Colombia. These agreements give British businesses preferential access to foreign markets while allowing reciprocal access to our market (i.e. waiving all or most of the duties normally required under the Common External Tariff and removing some non-tariff barriers).

There are negotiations in progress with a further 67 countries, including the US, Japan and India.

In addition to FTAs, which primarily aim to reduce tariff barriers, the EU has a large number of other trade-related agreements that address specific non-tariff barriers. For example, Mutual Recognition Agreements (MRAs) with third countries allow goods to be inspected and declared in conformity with Single Market rules by approved bodies before they are exported to the EU. This saves time and expense as shipments do not need to be impounded and checked at the EU border. MRAs are in place with many countries which do not have a full FTA with the EU, including China, the US and Australia. Other types of agreement include sector-specific deals (for example covering aviation and airlines' rights to fly between the EU and third countries), and Economic Partnership Agreements (EPAs), which grant preferential access to a number of developing economies - mainly former colonies of EU member states.

When the UK leaves the EU, it will cease to be a party to these agreements. Only 15% of UK total trade is currently with countries that are neither members of the EU nor covered by an EU trade agreement which is either in force or under negotiation.

How is the government likely to proceed?

Our membership of the Customs Union is part and parcel of our membership of the EU; when we leave the EU we will leave the Customs Union. Given the consistency with which the Leave campaign argued for the freedom to strike our own trade deals, it seems unlikely that the government would seek to strike a deal with the EU which preserved our membership of the Customs Union, even if this was politically possible. At the time of writing, however, the government would not confirm one way or the other.

Assuming that we leave the Customs Union when we leave the EU, the government will then presumably seek to strike an FTA with the EU, and to open trade talks with third countries as quickly as possible. Brexit Ministers have presented this as a relatively straightforward process. David Davis has asserted that within 2 years the UK will be able to negotiate a free trade area “massively larger than the EU”, including deals with China and the US.

This scenario is almost certainly impossible. A number of unavoidable steps will need to be taken before the UK is in a position to strike its own trade deals, and these steps will take several years to complete. The reasons for this are explored below.

What needs to happen before the UK can negotiate its own trade deals?

The UK has traded as part of the EU for more than 40 years. As a consequence our laws are completely intertwined with the EU’s, we have virtually no trade negotiators of our own, and any potential trading partners are going to approach talks with a good deal of caution, at least in the short term.

Each of the following steps needs to be completed before any new non-EU trade deal can be struck:

1. Confirmation that the UK will not seek to remain in the Customs Union

Remaining in the Customs Union would avoid the need for an FTA with the EU, but would also prevent the UK from negotiating FTAs with other countries. Future trading partners will want confirmation that we are indeed free to negotiate our own trade deals before they commit to negotiations. To date, **the government has not confirmed its position**, and so prospective trade partners remain in the dark. It should be noted that leaving the Customs Union will impose significant extra burdens on British exporters (see below).

2. Agreement with the EU on opening talks

Members of the EU Customs Union are not able to enter into their own discussions with third countries about bilateral trade agreements. Technically, the other 27 members of the EU will need to agree to the UK opening informal talks. While this is unlikely to be a stumbling block to the opening of discussions, **the UK will not be able to conclude any agreement with a third country while it remains part of the Customs Union.**

3. Clarity about the UK relationship with the EU

Any third country considering whether to enter into a new trade deal with the UK will most likely want to wait until there is clarity about the UK's trading relationship with the EU. If the UK decides to seek to retain its membership of the Single Market (either in total through membership of the European Economic Area (EEA), or through a bespoke agreement for specific sectors), then third countries would most likely want to see the terms of any deal, including arrangements for onward re-export of goods to the EU, before developing their own position.

Similarly, if we leave the Single Market and negotiate an FTA with the EU, then the nature of this FTA will materially change the calculations that any third country makes about signing a bilateral deal with the UK. **Potential trading partners are therefore likely to choose to wait and see what emerges from these talks before committing to negotiations.**

This question is also vital for foreign investors because onward access to the rest of the European market is one of the central attractions for any business looking to invest in the UK. If we are going to be outside the Single Market, the value of preferential access to the UK's market to a prospective investor will be diminished.

4. UK 'schedules of commitments' to be agreed at the World Trade Organisation

The last step which the UK will need to take before it can open meaningful negotiations with third countries is to establish 'schedules of commitments' at the World Trade Organisation (WTO). These set out the default duties that will apply to imports into the UK of goods and services.

The UK is a WTO member, but as a member of the EU we have been part of the EU's Common External Tariff for 40 years. In order to trade independently we will need to notify the rest of the world of our maximum import tariffs for merchandise, and other commitments for services, for every category of goods and services. These 'most favoured nation' (MFN) terms apply to any country with which we don't have a bespoke trade agreement of a kind permitted under WTO rules.

Until the point at which the UK leaves the EU Customs Union it will be bound by the Common External Tariff and cannot establish its own commitments at the WTO. Once we are free to do so at the end of the article 50 talks, the UK may attempt to expedite the WTO process by simply replicating the existing EU schedule of commitments, rather than starting with a blank sheet of paper.

However, this is unlikely to be plain sailing. The UK's schedule of commitments has to be adopted by consensus among the 164 members of the WTO. **Some WTO members may try to secure better access to the UK market than they were able to secure when the UK was part of the much larger EU bloc.** Or they may choose to block on wholly unrelated grounds as a means to exert political or economic pressure on the UK.

Even if the UK can agree its terms with the other WTO members, there may be **domestic roadblocks** to overcome. Freed from the Common External Tariff, various UK interest groups may want to challenge the UK's existing MFN rates. For example, there may be sectors where the EU currently charges a zero tariff on imports where protectionist interests in the UK may want to increase the tariff. Or there may be sectors where the EU currently applies relatively high tariffs, for example on food products, where businesses

and consumer groups in the UK may want to make imports cheaper. For example, Tate and Lyle have made it clear that they want to see lower import duties on cane sugar.

The whole question of **tariffs on agricultural imports** will be connected to decisions on the new agricultural policy which the UK government will have to take in partnership with the Scottish, Northern Irish and Welsh administrations. Tariffs on beef, for example, which are currently very high, will both be highly contentious domestically and of significant interest to many EU and third countries who will want to see them lowered.

Agreeing an FTA with the EU

If the UK leaves the Customs Union and does not attempt to re-join the EEA, then a UK-EU FTA is the next logical step.

An FTA would seek to abolish or minimise tariff barriers, ease non-tariff barriers, and provide whatever preferential access proved negotiable to some areas of the Single Market. It should be noted that it is not possible to pick off individual member states and sign FTAs (for example with Germany, our biggest trading partner). As members of the EU Customs Union they are prohibited from signing bilateral deals.

Some MPs who favour a quick unilateral Brexit have suggested that we could avoid the need to sign an FTA by simply dropping our own tariffs on imports from the EU to zero, and challenge the EU to reciprocate. This would not work, for three reasons:

- First, in the absence of a comprehensive FTA the EU is legally obliged under WTO rules to apply the Common External Tariff to the UK, resulting in immediate tariffs on goods ranging from 10% in the case of cars, to 12% for clothes, 21% for beer and spirits, and 29% for chocolate and other confectionary.
- Secondly, WTO 'most favoured nation' rules dictate that if we drop tariffs on EU imports to zero we will be obliged to do the same for every other country in the world. That would at a stroke undermine any prospect of securing favourable FTAs with third countries, as we would already have unilaterally removed our tariffs and would find countries unwilling to offer reciprocal tariff reductions - we would have squandered our negotiating capital.
- Finally, such a move would do nothing to address the non-tariff barriers which are harmonised for countries inside the Single Market, or the right to provide services, which will become a far more significant concern for British businesses once we leave the EU.

Any agreement on the UK's future relationship with the EU will take time to negotiate. Trade Commissioner Cecilia Malmström has said that trade negotiations will be treated as separate from the article 50 process. The logic of this is that we will have to wait for 2 years for the end of the article 50 process and actually leave the EU before there can be a formal FTA negotiation; though in practice, and with EU goodwill, these discussions may be able to run in parallel to some degree.

Once talks do begin we can expect them to last for several years.

It is sometimes suggested that the EU's Comprehensive Economic and Trade Agreement with Canada (CETA) offers a model that the UK might follow. There are at least four reasons to question this:

- First, the sheer time it would take. The Canada-EU negotiation was launched in 2007. Nine years later, the agreement has still to take effect.
- Second, CETA grants only limited freedom of services, with hundreds of pages devoted to Canadian and EU 'carve outs' from general liberalisation commitments. Yet the UK is heavily dependent on service exports – and especially financial services.
- Third, it would introduce all sorts of new red tape on British businesses, from 'rules of origin' requirements to intrusive customs checks (see below).
- Fourth, the tariff reductions it achieves are limited. Under CETA, Canadian exporters will face tariffs and other restrictions on scores of food and farm products. It will still face EU quotas on beef, for example, the elimination of which had been Canada's single biggest negotiating objective.

An FTA would have to be agreed by all 27 member states, and it is extremely unlikely that every single country will give the UK an easy ride in the negotiations. While Leave campaigners have claimed that the UK is in a commanding position due to its overall trade deficit with the EU (in other words "they need us more than we need them"), in reality much of this trade deficit is accounted for by Germany. Many other member states buy more from the UK than they sell to us. The balance of negotiating leverage would be dictated by the fact that we represent only some 17% of total EU trade, while they represent about 44% of ours.

Another time-consuming aspect of an FTA is the negotiations that will have to take place with **domestic UK stakeholders**, who will have diverse and often conflicting views and needs.

Finally, it is important to note that **an EU FTA has to be ratified by the Westminster parliament, and more significantly by the parliaments of all 27 EU member states and by the European Parliament**. This introduces further significant scope for delay.

For all of these reasons it is probable that **an EU FTA will take several years to put in place post-Brexit**, stretching the time horizon for a new deal well into the 2020s, and introducing a protracted period of uncertainty for business.

In the meantime, unless there is some interim arrangement for tariff-free access, **the UK will need to impose tariffs on imports from the EU**, for the reasons set out above. To do otherwise would squander any chance of negotiating meaningful FTAs with other countries, and would hamstring our own talks with the EU. This will raise the cost of imports from the EU, which will be borne by British consumers. According to some studies, the impact on UK food prices alone could be as much as 8%.

It may be tempting to imagine that there is a way around these problems by putting in place a simple, 'quick and dirty' FTA covering essential sectors and leaving others for future negotiations. But this is not possible: the WTO rules require any FTA to be 'comprehensive', covering "substantially all" the trade between the transacting parties. If the deal failed to meet this threshold it would be ruled illegal and both EU and UK would revert to their MFN tariffs.

What are the pros and cons of leaving the EU Customs Union and signing an FTA with the EU?

Once the various obstacles explored here are overcome, the UK would have the ability to negotiate new trade deals with third countries which would not otherwise have been available as a member of the EU, and without having to balance our negotiating asks with those of other EU countries. However, the freedom which this implies is less than it might seem:

- **On leaving the Customs Union, we will immediately lose access to FTAs which give UK business preferential access to more than 50 markets.** Open Europe estimate that these trade deals mean that an additional 14% of UK trade on top of our trade with the EU takes place on preferential terms.
- We will also lose MRAs with 3rd countries (including major trading partners like the US) which allow products to be imported having been certified as being in conformity with EU rules and regulations. Assuming we leave the Single Market and continue to maintain similar regulatory frameworks, these agreements will need to be renegotiated in order to avoid the creation of non-tariff barriers for importers.
- **Outside the Customs Union, all goods exported to and imported from the EU will need to be declared to the customs authorities. This will introduce delays, extra paperwork and costs for British businesses, including customs checks, value declarations, inspection certification, and advance cargo declarations.** It will also make continental businesses less willing to include UK-produced goods in their supply chains.
- If we sign an FTA with the EU, or seek to adopt a Norway-style relationship, then **British exporters will also have to comply with complex ‘rules of origin’.** These rules require UK exporters to obtain proof of origin certificates from their national customs authorities to guarantee that the product (or an agreed percentage of the product) originates in the UK. Under an FTA, goods have to be shown to come from the country in question in order to benefit from the preferential tariffs agreed under the FTA, and to prevent third country imports from being passed off as domestic products. These rules are not applied to countries inside the EU Customs Union. **The economic impact of rules of origin has been estimated to increase trade costs by between 4% and 15%.** The impact would be particularly pronounced on companies with highly integrated cross-border supply chains like the British aerospace and automobile industries.
- Leaving the EU Customs Union will require the introduction of **new customs controls (a “hard border”) between Northern Ireland and the Republic,** in order to prevent goods from crossing the border in contravention of customs checks.
- Perhaps most importantly, the FTAs that the UK manages to negotiate once outside the EU will lack an advantage that the UK had as a member of the EU. Negotiating as part of a market of 500 million consumers gave us far greater leverage than we will ever have as a market of 65 million consumers. This is simply matter of arithmetic: third countries will find our market relatively less appealing and so will make fewer concessions in negotiations than they would do if we offered a larger market for their products. **It is highly unlikely that we would be able to negotiate equivalent access to that which we currently enjoy as a member of the EU, let alone to improve on it.**

Sequencing issues and the 'WTO Option'

The process of arriving at an FTA with the EU is, as we have set out above, not straightforward. The 2-year time window provide by the Article 50 process is completely inadequate for the scale of the task, and unless the deadline can be extended or an interim arrangement can be put in place **it seems inevitable that there will be a hiatus between the point at which we formally leave the EU and the point at which an EU FTA comes into force.**

It may be that a temporary interim arrangement which prolongs our membership of the Single Market and/or Customs Union could be sought, pending the conclusion of a comprehensive FTA. It is not clear whether such a deal would be politically achievable or legally compatible with article 50. Even if it was, there is still the danger that talks would collapse, or that the terms of any agreement would fail to be agreed by the EU-27. **Any of these scenarios would see the UK leave the EU without any form of agreement in place.**

In these circumstances the UK would have to rely solely on to its basic schedule of commitments as agreed in the WTO (see above). This is fraught with dangers: we would face immediate tariffs on our exports to the EU, bureaucratic customs checks, loss of passporting rights for services, and substantial non-tariff barriers on goods and services, including the prospect of trying to certify our exports as being in conformity with EU rules without any recognised approved UK certification authority.

It is, for example, hard to see how any significant animal and animal product exports to the continent could continue given that imports to the EU have to pass through designated Border Inspection Posts, of which there are precisely none on the other side of the Channel. This is a £1.5bn export trade which would disappear overnight. And the wider £18bn food and drink export industry would be hit by significant tariffs which would inevitably damage sales on the continent.

For these reasons, the Treasury estimated the cost to UK economy of the 'WTO option' as 7.5% of GDP after 15 years.

The conclusion is that there is no viable 'WTO only' solution. An interim trade deal therefore has to be in place at the point at which the 2-year Article 50 time limit expires. For the reasons set out above and in Brexit Challenge #1, we believe that an interim deal based on the EEA / Norway approach, which would preserve our membership of the Single Market while allowing us to strike our own trade deals outside the EU Customs Union, would be the least bad option.

Even the 'Norway option' carries serious downsides though: a major loss of sovereignty as we are cut out of the setting of Single Market rules, coupled with the introduction of new bureaucratic burdens for British exporters who will have to comply with complex 'rules of origin' to show where every element of their products was manufactured. However, there are no obviously better choices on offer.

The questions that need to be answered

1. Is it government policy that the UK will leave the EU Customs Union?
2. Is it the government's intention to seek membership of the Single Market?

3. Will the government come clean about the increase in red tape which awaits exporters who want to continue selling their goods into the EU post-Brexit?
4. How will the UK negotiate new WTO schedules of commitments in a reasonable timescale, given that this will require consensus of all WTO members, some of whom are likely to object?
5. How long does the government expect it will take to negotiate a Free Trade Agreement with the EU? Does it believe it can be achieved in the 2-year time frame of the article 50 negotiations?
6. What is the government's plan to prevent a highly damaging hiatus between the end of the article 50 process and the commencement of an EU FTA?
7. What will the government do to protect UK interests against the risk that ratification of the EU FTA is blocked by EU Member States?
8. Will the government confirm its determination to avoid the so-called 'WTO option', given its unworkability and the Treasury's estimate that it would reduce GDP by some 7.5%?
9. How will the government address the fact that third countries cannot enter into meaningful negotiations with the UK until the UK's future relationship with the EU is clear and its WTO schedule of concessions agreed? What will happen to UK export markets during the hiatus in between?
10. What is the government's estimate of the increase in food prices that would result from applying EU tariff levels to imports from the EU and losing access to preferential food imports under EU agreements with third countries?
11. Does the government intend to pursue an interim agreement which preserves the UK's access to the Single Market while a comprehensive FTA is negotiated?
12. How many external trade negotiators and consultants does the government intend to recruit over the next two years, and at what projected cost?

September 2016