

UK-EU TRADE RELATIONS POST BREXIT: TOO MANY RED LINES?

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INTRODUCTION

There is considerable discussion in the media and amongst commentators as to what form of Brexit the government will implement and whether the UK should go for a 'hard' or a 'soft' Brexit. The aim of this briefing paper is to provide an evaluation of the feasibility of different options. With the EU accounting for close to 50% of the UK's imports and exports of goods and services, the focus in this paper is on the UK's future trading relations with the EU itself.

It is important to stress that *all* of the options listed in this paper are problematic - either because they run the risk of not meeting certain political constraints domestically or abroad, or because of their economic consequences. It is therefore easy to criticise any given option. The aim here is to examine the limitations of what may be feasible and in so doing to suggest a way, or ways, forward.

Given that the UK's objectives take the form of seeking to impose certain constraints on the post-Brexit outcome we look at the extent to which each option is consistent with these 'red lines'.

WHAT AGREEMENT WOULD RESPECT THE UK'S RED LINES?

The current lack of a clear government position, and the recent High Court ruling on the role of Parliament in triggering Article 50, has unleashed a plethora of views on what form of Brexit would 'respect the will of people' following the referendum result. The wording of the referendum question - "Should the United Kingdom remain a member of the European Union or leave the European Union?" - does not help very much. This is because the question itself does not specify (a) why people voted to leave the EU, and therefore what were the objections to the EU nor (b) what the alternatives to EU membership would be.

KEY POINTS

- Given the pro-Brexit Referendum campaign and post-Referendum statements from the government, four key constraints for post-Brexit negotiations – 'red lines' – are apparent.
- Based on these red lines, five possible options for future trading relations between the UK and the EU-27 are considered, but only the option of an FTA with a variety of special sectoral arrangements (e.g. cars) satisfies all of the UK's red lines. However, such an arrangement could entail costly compliance requirements, documentation for Rules of Origin and agreement on technical regulations. In addition, this option may not be agreed to by the EU-27 and could limit the ability of the UK to negotiate deep FTAs with third countries.
- Applying WTO Most Favoured Nation tariffs would be the easiest option to negotiate, but would lead to significant increases in barriers to UK/EU trade and both sides would lose out significantly.
- Identification of key sectoral strategic interests for both the UK and the EU would help to focus negotiations.
- A five-year transitional period, similar to when the UK joined the EEC, would allow time to agree the form of Brexit.

With regard to (a) it seems reasonably clear from the referendum campaign and subsequently the British Prime Minister's speech to the Conservative Party conference in October 2016 that four key constraints / red lines have emerged:

- No free movement of people / labour;
- Independent trade policy;
- No compulsory budgetary contribution;
- Legal oversight by UK courts only and not by the European Court of Justice.

At the same time the EU-27 seem widely and strongly of the view that if there is no free movement between the UK and the EU-27 then the UK cannot expect access to the Single Market on the same terms as now. This is sometimes expressed as "no cherry picking".¹

The British red lines can be thought of as the UK's defensive objectives. Defining these red lines is inherently problematic. What does control over movement of labour mean for actual arrangements to manage the entry of EU citizens? Similarly, does no compulsory EU budget contributions mean no EU budget contribution under any circumstances? Trade policy involves both tariffs and non-tariff barriers on goods and services (see Box 2, page 6 on 'The Importance of Services in the Negotiations'). Does an independent trade policy require control over all this and for all sectors?

At the same time, the government and most commentators have indicated a desire for trying to maintain as good access as possible to the EU (Single) Market for both goods and services, while meeting the red lines. These represent the UK's principal offensive interests. Once again, defining the offensive interest is not straightforward. Does access to the Single Market in goods mean no tariffs on exports to the EU, or does it mean full access to the EU's regulatory union? What is meant by access to the Single Market in services? What is apparent is that, where the red lines / defensive interests are largely motivated by political considerations, the offensive interest is motivated by economic considerations – i.e. with maximising access to the EU market (our principal destination and supplier for goods and services).

The difficulties in precisely defining the red lines and the offensive interests stem in part from some of the terminology being used loosely and differently by different people, and in part from genuine differences in where

the precise red lines are to be drawn. In order to avoid terminological confusion, and in order to allow the narrative to flow more easily, at the end of this paper we provide a glossary of the key terms and forms of economic integration that may be open to the EU and the UK after Brexit. This enables our discussion to focus on the red lines themselves.

With regards to b) above, Table 1 suggests that future trading relations with the EU are likely to fall into one of five categories, ranging from a full Customs Union with the EU, to Most Favoured Nation (MFN) trading terms. The table then cross-classifies these different options for the UK with the defensive and offensive interests outlined above. Where the objective is fully satisfied this is represented with 😊; where it is only partially satisfied with 😐; and where it is not satisfied with 😞.

These options are discussed in more detail below, but what emerges very clearly from this table is that there are only two options that could meet the government's red lines. Broadly defined these options are some form of FTA arrangement (but not EEA or Swiss variants), or MFN status. Neither of these options give the UK automatic access to the Single Market, as from the side of the EU the free movement of labour appears to be a key condition for Single Market access.

HOW DO THE OPTIONS STACK UP?

Option 1: Full Customs Union with the EU-27

Even though this option does not appear to have been ruled out yet by the government, it is very hard to see how this could be possible as a long-term outcome because it fails on at least two of the UK red lines: Parties to a CU cannot negotiate separate trade agreements and a proportion of tariff revenue must be handed over to the European Commission. Free movement of labour is not a necessary condition for a CU but as shown in Table 1 the consequence of retaining control of migration is that Britain gets no access to the Single Market. A full Customs Union with the EU may, however, form the basis for a possible transitional arrangement. It also has the advantage that as long as the UK is part of a full CU with the EU, then the UK might be able to retain membership of the 50+ countries the EU has signed free trade agreements with. Strictly speaking the EU's Customs Union is defined in terms of goods only, while the Rome Treaty and the EU's Single Market require market opening in services as well.

¹, See speech by Angela Merkel on the 28th June to the Bundestag (<https://www.theguardian.com/world/2016/jun/28/brussels-eu-summit-leaders-push-quick-divorce-germany-brexit>), and more recently by Donald Tusk at the European Policy Centre Conference, October 13th 2016, <http://www.consilium.europa.eu/en/press/press-releases/2016/10/13-tusk-speech-epc/>

Table 1: The red lines and the UK-EU options

One strike and you are out	UK Defensive Objectives				UK Offensive Objectives	
	Control over labour mobility	Independent trade policy	Control over budget	not subject to ECJ*	Access to SM in goods	Access to SM in services
1. Full CU with EU			/			
2. Partial CU with EU (E.g. Turkey)						
3. FTA with Single Market (based on EEA)						
4. FTA					/	/
5. MFN						

*ECJ = European Court of Justice

Option 2: Partial CU with EU (based on EU-Turkey CU)

It is conceivable that the CU option the government has in mind, and which has not yet been ruled out, is something that is akin to the EU-Turkey arrangement. This is an example of a Customs Union with the EU customs union but one which has several sectoral carve-outs. The EU-Turkey CU excludes agriculture and services, and gives some access to the Single Market in goods - but not services - with procedures on harmonisation and mutual recognition for goods while allowing for restrictions on labour mobility, to keep Turkish workers out of the EU.

However, for the UK such an agreement would eliminate the UK's unconstrained ability to set its own trade policy with third countries, primarily in regards to tariffs. This is one of the key red lines. It also seems unlikely that the EU would agree to mutual recognition of standards.

Option 3: FTA with Single Market (EEA)

An FTA with access to the Single Market and with the condition of free movement of labour is the type of arrangement the European Economic Area (EEA) countries have. This also comes with some carve-outs as the EEA countries are not covered by EU rules on agriculture, fisheries, justice and home affairs. The EEA countries make annual contributions to the EU budget, and are subject to the EFTA court, whose job is to ensure that non-EU states in the EEA comply with the Single Market

norms. Because the EEA countries have a Free Trade Area (FTA) with the EU they are free to sign trade agreements with third countries (so long as they do not cover technical barriers). As this is an FTA it requires the application of Rules of Origin in order to determine which goods qualify for duty-free access. An EEA type of agreement breaches several of the UK's red lines – oversight by a supra-national court, unrestricted labour mobility and compliance with EU norms.

A somewhat similar option is the arrangement between Switzerland and the EU, which is an FTA and includes 120 other bilateral agreements with the EU, which give Switzerland access to the Single Market, except for some service sectors including financial services. Because of the FTA, Switzerland can sign trade agreements with third countries. However it makes an annual payment to the EU Budget, and allows free movement for EU citizens: all UK red lines. Once again Rules of Origin are required in order to determine which goods qualify for duty-free access. It is worth remembering that the EEA covers services in the same way as does the EU's Single Market, but the arrangements with Switzerland do not.

So: A strict (hard) interpretation of options 1-3 would suggest that they can be ruled out – either because they would be unacceptable to the EU, or unacceptable to the UK.

Option 4: FTA

This is the only preferential option that satisfies all the UK's red lines, and might also meet some of the UK's offensive interests in the EU market. The EU has signed various FTA agreements with third countries (which the UK will become after Brexit), such as those with Korea, Moldova, or Canada, that also contain elements of deep integration measures. Hence, Option 4 is not clearly defined and covers a variety of more or less deep and comprehensive FTAs. The key differences between this and Option 3 are that an FTA arrangement comes with a lesser degree of sectoral coverage (notably in services) and does not give automatic access to the Single Market. These FTAs typically come with no obligations on free movement of people, budget contributions or legal oversight by the European Court of Justice. Essentially each FTA has some elements of free trade in goods and different coverage of Single Market access.

With an FTA, the UK would have complete freedom to negotiate trade agreements with other countries with respect to tariffs, but not necessarily with respect to regulatory issues. The UK may have the possibility of customising an FTA with the EU that had free trade in goods, which could potentially match the UK's pattern of competitiveness and Single Market integration, including mutual recognition of testing and certification of standards for goods. Note also that these options may give the UK some flexibility in the sectoral coverage, and like Norway or Switzerland, it could try to exclude some sectors from free trade.

There are however several caveats with regard to this option.

First, Option 4 would entail the need for Rules of Origin, and possibly tests to demonstrate compliance with EU norms. Each of these barriers could be as costly as the tariffs that are abolished. An FTA arrangement would also allow the introduction of anti-dumping, countervailing duties and safeguard actions (collectively known as Trade Defence Instruments (TDI)) into UK-EU trade. It follows from this that, despite their name, FTA variants are likely to result in higher barriers and lower trade than current arrangements (Customs Union plus the maximum available Single Market freedoms). Indeed, it is the potential for these new and higher barriers that raise the fears, notably expressed by the Japanese Government and companies², that their production facilities in the UK intended to serve the EU market as a whole may become unprofitable and may have to be moved to EU member states.

Second, and as discussed earlier, the EU has insisted that the UK cannot engage in cherry picking the bits of free trade it would like with the EU. The clearest expression of this is with regard to access to the Single Market, where

the EU's position is that this can only come with the free mobility of labour. By extension, the EU may be unwilling to agree to a deep and comprehensive FTA (DCFTA) with the UK that would grant close to full Single Market access, as this is likely to be seen as cherry picking through the back door. Indeed Mr. Tusk's statement that the options are 'hard Brexit or no Brexit' could be interpreted as saying that that negotiating a DCFTA may not be possible or, if nothing else, will be difficult and time-consuming. It is unclear how easy it would be to include those services sectors the UK would wish to include in an FTA. Recent EU FTAs have included some services, especially EU-Korea.

Nevertheless the UK seems to have hopes for an FTA arrangement with sectoral sub-deals as part of a broader FTA deal, where certain sectors are given more favourable treatment. For example, the UK has hinted that it would like to secure Customs Union status for the car sector (see Box 1 opposite on the "Nissan deal"). This raises the question of whether one could have an agreement that was partly FTA and part CU, perhaps by signing an FTA in which certain sectors' external tariffs were harmonised and where it was agreed that compliance with Rules of Origin would be assumed.

Third, if the UK signs an FTA with the EU that includes mutual recognition of standards and conformity assessment in certain sectors, it could not then sign deep free trade agreements with third countries affecting these sectors, except where the EU chose to do so also.

Fourth, any deep(er) and more comprehensive free trade agreement is likely to cover areas of national (as opposed to EU Commission) competence and would then require approval by all EU national parliaments. As we have seen with the EU-Canada agreement and EU-Ukraine this is far from straightforward and, once again, it is likely to limit what the EU may agree to. The deeper the agreement the more likely this is to be both time-consuming and problematic.

Each of the above caveats point to the fact that any FTA option is likely to be largely concerned with shallow integration i.e. the removal of tariffs on trade in goods, and it will be difficult for such an agreement to contain much of substance with regard to deeper integration – investment, trade in services, standards etc. This does not mean it is impossible, and it is conceivable that agreements such as EU-Korea or EU-Canada could be used as a starting point for a bespoke EU-UK agreement.

² Japan's Message to the United Kingdom and the European Union: <http://www.mofa.go.jp/files/000185466.pdf>

Box 1

CAN WE DO SECTORAL DEALS: WHAT DOES THE NISSAN CASE TELL US?

For the car industry, leaving the EU brings several problems:

- In the case of MFN/WTO-only relations UK exports to the EU would pay 10% tariffs – and be subject to risk of other non-tariff barriers.
- If the UK signed a FTA with the EU to make cars duty free, this would only cover cars “originating in” the UK and they must produce proof of satisfying EU Rules of Origin.
- If, somehow, the car industry could have a special Customs Union deal whereby UK-made cars were treated as if they originated in the EU, the UK would still face the problem of technical barriers.
- In all of the scenarios, UK-made cars would have to prove that they complied with all EU mandatory technical standards. For decades the whole of Europe has used car standards set by the UNECE in Geneva but the EU car market was totally segmented because countries had their own testing arrangements and did not recognise each other’s arrangements. Hence, having common standards is not enough to eliminate technical barriers to trade. Within the EU and the wider EEA (EU + Norway, Iceland and Liechtenstein) there is now a system of mandatory standards and an EU accredited system to enforce, as well as Mutual Recognition of testing and certification. Countries not in the EU cannot rely on such “Mutual recognition”.

Possible solutions?

1. To eliminate border bureaucracy *entirely* there would need to be both a **Customs Union arrangement** (to avoid Rules of Origin) **and a Mutual Recognition agreement** (for conformity assessment). However a comprehensive arrangement crosses too many red lines.
 2. Joining the EEA would only solve the problem of technical inspections. The car industry would still have to comply with and prove compliance with origin rules to get duty-free access for cars. Full EEA membership is also not compatible with the UK’s red lines. A partial agreement by sector is imaginable (and easy) where both partners apply global standards.
 3. Could there be a **special deal** in which cars were in a Customs Union and Single Market “regulatory union” arrangement and other sectors weren’t? A trade agreement covering a single sector would be WTO incompatible and is therefore undesirable. An alternative, therefore, would be to have an FTA with the EU, but with a specific deal for cars which maintains existing access to the EU market. This might be possible if the UK agrees to keep the same external tariff as it has now (the EU’s Common External Tariff), both on cars but also on the key intermediates that are used in the production of cars. This would eliminate the need for strict monitoring of Rules of Origin.
- In the event that the UK signs FTAs with third countries, “cumulation” arrangements on origin would need to be in place to prevent value chains being disrupted, since on average a high share of UK cars are made up of imported components from the EU.
 - If there were separate deals on the mutual enforcement of standards, the UK could not sign any trade deals with third countries covering cars, or any other sector this carve-out applied to.

The preceding is possible, but difficult even for one sector. It could however be generalised. For example, both the UK and the EU could agree that in all industries where the UK keeps the same external tariffs as it has now, Rules of Origin would not be checked, and/or that where standards and enforcement was maintained as it had been within the EU, Mutual Recognition could be assumed at least temporarily.

And if we can’t get such a deal? It has been suggested that the UK has offered eventual financial compensation in the event their promised outcome doesn’t happen. This is highly problematic. If car producers receive subsidies to compensate for tariffs the EU could impose “countervailing duties”, or the member states could give its producers matching subsidies too. It is likely that any FTA signed with the EU would preclude the giving of such state aids by the UK, and in any case the UK would be subject to the WTO subsidy code.

Option 5: MFN

This option is where the UK and the EU in their bilateral trade revert to WTO Most Favoured Nation (MFN) terms (this is one interpretation of ‘hard Brexit’). That is, each side re-introduces tariffs at the maximum level allowed by their commitments agreed under the Uruguay round of trade negotiations that was completed in 1995. Compliance costs on testing and certification would be higher than now and there would be the threat of Trade Defence Instruments but no need for Rules of Origin. Since compliance costs and Trade Defence Instruments are the same in both Options 4 and 5, overall (on goods) the MFN arrangement could be better or worse than option 4, depending on whether MFN tariffs are more or less costly than the costs associated with Rules of Origin. Note also that the EU’s WTO commitments on services are in general less liberal than intra-EU terms, even though the Single Market for services is incomplete. Access to the EU market in services would therefore be more restricted than the alternative option.

Box 2

THE IMPORTANCE OF SERVICES IN THE NEGOTIATIONS

- In 2014 services generated 78.3% of UK GDP. In the same year, UK exports of cross border services to the world amounted to £220bn (almost 43% of total UK exports of goods and services). Of the total services exports £81bn (37%) went to the EU. For imports the equivalent figures were: total imports of £131bn (24% of total goods and services imports) of which £64bn (49%) came from the EU.
- On a sectoral basis, almost a quarter of UK exports of services to the EU in 2014 were financial services and a further 22% were Other Business services. On the imports side almost a third of UK imports were from the Travel sector followed by Other Business (24 %) and Transport (16%).
- The UK runs a sizable trade surplus in cross-border services trade with the world and the EU.
- The UK is an attractive location for foreign investment (important for services trade in part because of EU membership and access to the single market).

SO WHAT IS REALLY FEASIBLE?

The overall assessment here is that the UK, by holding on to its four red lines, rejects any possibility of having a Customs Union or an FTA plus access to the Single Market/regulatory area. Similarly, the EU-27, if they hold strictly to their mantra of no cherry picking, are saying that if the UK rejects free movement of people it is opting out of the benefits of the Single Market, which in turn restricts the extent to which the simple FTA option (Option 4) can include significant deep integration.

The realistic choices are likely therefore to reduce to a simpler goods and tariffs-only FTA versus MFN trade. As we have seen, on the face of it there may not be much to choose between these. The balance of advantage lies on whether the average level of tariffs abolished is higher or lower than the costs of complying with Rules of Origin, and on the extent to which non-tariff measures and services liberalisation can be included.

Feasibility is also related to the desire of each negotiating party to reach an agreement, which in turn is related to how important it is for each party to strike a deal. Clearly complex political calculations come into play here, not just in the UK, but also in the EU and between the EU member states – each of which may need to ratify the deal. Economic objectives are also important. On average in 2015, 44% of UK exports went to the EU; and 7% of EU exports to the world (including intra-EU trade) went to the UK.

REFLECTIONS ON THE POLITICAL ECONOMY OF A UK/EU-27 AGREEMENT

For individual EU countries the share of trade with the UK clearly varies. Hence the countries for whom the UK is a more important destination market are: Ireland (13%); Cyprus (10%); Netherlands (9%); Belgium (9%), and the countries who export comparatively little with the UK are: Slovenia; Bulgaria and Estonia for whom the UK accounts for less than 3% of their exports.

However, aggregate trade figures may mask differing possible sectoral interests. The top panel of Table 2 is based on a subdivision of total UK trade into 96 sectors (using the HS2002 2-digit classification). For each sector we calculate the share of UK exports going to the EU. For example, we know that, of the total UK exports in vehicles (HS 87), 57% of those exports go to the EU. We then count the number of sectors that fall within each share of exports range, and subsequently the share of those sectors in total UK exports to the EU. The bottom panel of the table repeats the analysis for the EU.

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Hence the first row of the table indicates that there are three sectors for which UK exports to the EU accounted for less than 20% of those sectors' world exports. Those three sectors accounted for 2.2% of total UK exports to the EU. From rows 3-5 we see that the EU constitutes more than 40% of sectoral exports, for nearly 80% of the UK's trade with the EU. This highlights that the importance of the EU as a destination market is not simply concentrated in a narrow range of sectors, but is true of 85 out of the 96 sectors, and for 10 of these sectors the EU accounts for more than 80% of UK exports. These are the sectors that are most likely to have a larger negative impact if the UK does not manage to negotiate a satisfactory Brexit deal. The final column of the table also gives the average EU tariff on the sectors included in each range. Interesting here is that tariffs are on average higher, for those sectors for whom the EU markets is a more significant destination. Should the UK revert to MFN status with the EU, the

impact of tariffs will therefore be greater precisely in those sectors.

The share ranges in the bottom panel of the table where we focus on the EU are unsurprisingly much lower. As given earlier in aggregate, 7% of EU exports in 2015 went to the UK. When we consider this by sector we see that the UK constitutes more than 10% of EU exports, for nearly 30% of the total of the EU's exports to the UK. Again, this will mask considerable differences between countries. Once again the EU tariffs are positively correlated with the importance of the UK as a destination market, and reimposition of MFN tariffs between the UK and the EU would therefore have a bigger impact.

Table 2: Sectoral shares in trade with the UK and the EU

UK	Sector trade share ranges	No. of sectors	Share of total UK exports to EU	Average EU tariff
% of UK exports in each sector going to the EU	0% - 20%	3	2.20	0.2%
	20% - 40%	8	19.60	2.4%
	40% - 60%	29	40.80	3.4%
	60% - 80%	46	34.70	6.0%
	80% - 100%	10	2.70	5.7%

EU	Sector trade share ranges	No. of sectors	Share of total EU exports to UK	Average EU tariff
% of UK exports in each sector going to the EU	0% - 5%	31	7.3	4.4%
	5% - 10%	54	63.30	4.0%
	10 - 15%	9	28.70	8.3%
	15% - 20%	2	1.00	12.7%

Note: Source: UN Comtrade, calculations undertaken using TradeSift (www.tradesift.com)

Table 3 takes the 11 sectors identified in the last two rows of Table 2, for which the UK constitutes more than 10% of EU exports for each sector. The second column of the table gives the share of that product in total EU exports to the UK. Here we see that most of these sectors are not significant in terms of their overall share of EU trade with the UK. The one exception is vehicles, which accounts for more than 20% of EU trade with the UK. The third column gives the share of the UK in each sector's exports by the EU. Hence 10.7% of EU Cocoa exports go to the UK. The fourth column gives the number of EU countries for whom the UK market in that sector accounts for more than 10% of their total sectoral exports, and the fifth column gives

the countries for whom that share is greater than 15%. These are therefore the countries that have the biggest stake in agreeing free trade with the UK in those sectors.

If we take vehicles as an example, we see that this sector accounts for more than 20% of total EU exports to the UK, and that out of total EU exports to the world 11.5% of these go to the UK. There are 8 countries for whom the exports to the UK account for more than 10% of their exports in that sector, and there are three countries (Belgium, Ireland and Malta) for whom the UK accounts for more than 15% of their exports in that sector.

Table 3: Sectors where the UK accounts for more than 10% of EU exports

Sectors	Share of total exports to UK	UK share of in EU exports to world	EU tariff	Count ¹	Countries for which the sectoral share going to the UK exceeds 15%
Cocoa and cocoa preparations	0.73	10.71	6.1%	7	Greece, Ireland, Poland
Live trees and other plants	0.42	10.79	6.7%	4	Ireland
Preparations of cereals, flour...	1.10	10.87	10.7%	9	Cyprus, Ireland, Lithuania
Beverages, spirits and vinegar	1.84	11.15	3.9%	8	Cyprus, Ireland, Sweden
Miscellaneous edible preparations	0.86	11.21	9.5%	8	Denmark, Ireland
Vehicles other than...	20.12	11.50	5.8%	8	Belgium, Ireland, Malta
Meat and edible meat offal	1.59	11.54	5.2%	6	Ireland, Netherlands, Romania
Preparations of veg, fruit or nuts	0.88	12.12	17.7%	7	Belgium, Ireland, Netherlands
Edible veg & certain roots & tubers	0.85	2.20	8.6%	5	Cyprus, Ireland, Spain
Preparations of meat, fish..	0.76	17.22	18.13%	11	Denmark, France, Germany, Ireland, Portugal, Poland
Carpets and other textile floor coverings	0.29	19.72	7.3%	6	Belgium, Denmark, France, Ireland, Netherlands, Portugal

Note: Source: UN Comtrade, calculations undertaken using TradeSift (www.tradesift.com)

¹: This gives the number of countries for whom the sectoral share going to the UK exceeds 10%

This table contains several interesting features. First, other than vehicles, and carpets etc, all the sectors where the UK is a relatively important destination are in agriculture and food processing. This may help to identify some of the EU's sectoral strategic interests in their negotiations with the UK. Second, for each of these industries Ireland appears as a country where the UK accounts for more than 15% of their exports. Third, there are sixteen EU countries for whom at least one of these industries accounts for more than 15% of their exports. On the one hand this might suggest that there could be a coalition of countries with an incentive to agree on maintaining good access in these sectors. On the other hand the diversity of countries may complicate the negotiations.

TIMING AND TRANSITION ARRANGEMENTS

There are also important issues of timing. The more complex the deal being sought, the more difficult and time-consuming one would expect negotiations to be. However, even 'simple' deals may hit stumbling blocks that complicate the negotiations, and which might be easier to resolve via the greater opportunity for trade-offs in a more complex deal. There is then a trade-off between complexity, timing and satisfying the red lines.

Out of the realistic options, the easiest to 'negotiate' is the MFN option, as this requires regularisation of the UK's schedules in the WTO which needs to happen anyway, and no negotiation with the EU itself. However, this would lead to significant increases in barriers to UK-EU trade.

If it is impossible to negotiate any part of the future EU-UK agreement as part of the Article 50 negotiations it seems that the UK and the EU will find themselves on day one of Britain's exit with no arrangements to govern trade between them except the WTO schedules negotiated

by the EU in the Uruguay Round. That would be a drastic change. There is a lesson from the British accession. When the UK joined the then EEC it had a five-year transition period to adopt the *Acquis Communautaire* including the common external tariff. Now that the UK is about to embark on replacing the Customs Union adopted in 1973, perhaps an equivalent transition period to replace that Customs Union is necessary.

The difference is that, on accession, the UK negotiated the destination and then transited gradually towards it. This seems to be the sort of transition period envisaged in Article XXIV of the GATT. Now however the UK and the EU need a transition period to agree the destination (for example, an FTA) and prevent us falling off a cliff to a de facto 'hard' Brexit. Such an outcome and consequent economic damage – while it might concentrate the mind of negotiators – would result in unnecessary declines in trade, profits and employment that would have to be recovered once a more trade-friendly regime is negotiated, ratified and implemented.

Both the situation and the EU ideally need a grandfathering of existing trade arrangements to a certain date (say 5 years after Brexit). If that deadline is passed without agreement then 'hard' Brexit could be triggered. That would provide an incentive to seek an agreement on both sides. It is worth observing that once we have finally left the EU, and the treaties no longer apply, we can no longer be subject to the jurisdiction of the ECJ. Hence unless there is some alternative binding ad hoc dispute settlement arrangement (which would risk crossing the red line of infringing UK sovereignty), the only way the EU can have a guarantee of our compliance is to allow for the possibility of contingent protection. This is ruled out for the EU and the wider EEA because of the direct effect of EU law there and the jurisdiction of the ECJ and EFTA Court.

CAN THE RED LINES BE RELAXED? IF SO, WHICH?

The easiest red line to relax would be the EU one on no cherry picking, at least in the context of Option 4, since in each case the EU has already granted non-member states some aspects of Single Market freedoms - whether it is mutual recognition of testing and certification for autos (in the Korea agreement) or access for some services sectors (in each of the Korea and Canada agreements). Admittedly, allowing mutual recognition of testing and certification for goods (or selected sectors) could have a bearing on plant location decisions, making it easier for e.g. Nissan to remain in the UK. It remains hard to see why the EU would want to completely reject such options when it has included them for smaller and more distant markets.

The UK seems to be more wedded to its red lines, but also risks losing more by not modifying them. The Prime Minister's speech to the Conservative conference is widely interpreted as being a commitment to a restrictive interpretation of the red lines. Taking the easier options first: it seems possible that the government could agree to budgetary subscriptions e.g. to R&D or other programmes (regional funds) perhaps, if that came with some form of quid pro quo, such as a reduction in the opposition to restrictions on free movement by the post-2004 member states. Similarly, on the question of ECJ oversight perhaps any EU-UK agreement could have its own dispute settlement or mutual recognition body that eased the continuation of existing standard setting procedures for food and other products.

On the face of it, taking back control of British borders for people and trade seems harder to finesse. Taking people first, it seems that control is tied to the labour market with the reintroduction of work permits for citizens of the EU, EEA and Switzerland which would put them on a par with migrants from third countries. Such an approach likely puts a premium on admitting skilled rather than unskilled workers. Perhaps an EU annual quota for unskilled (e.g. seasonal agricultural workers) could make this more palatable to the EU-27 but perhaps not – a consideration which only underlines that the UK may have control of its red lines but not of the EU's.

Independence of trade policy seems, however, binary. It is hard to see how any Customs Union arrangement could be consistent with a British FTA with third countries where the UK does not already have the exact same terms as a pre-existing EU FTA – which hardly constitutes independence.

The key uncertainty is that, as with all red lines, these are political and not always susceptible to economically rational bargaining. If nothing is binary, as the British prime minister has said, then all is to play for. The sooner both sides put their objectives for these negotiations on the table the better, but if the EU were to insist that Article 50 does not permit discussions of trade issues before UK exit, which is doubtful (see the UKTPO Briefing Paper no.4³) that could be anything up to 28 months away.

3, "Triggering Article 50 TEU: A Legal Analysis", <http://www.sussex.ac.uk/bmec/research/uktpo>

CONCLUSION: IS 'HARD BREXIT' INEVITABLE?

Perhaps Mr Tusk and the Brexiters are correct in saying 'hard' MFN-based Brexit is inevitable. But if such an option is chosen, both Britain and the EU will lose. Trade will inevitably fall, because new barriers will have gone up (Rules of Origin and/or standards compliance plus Trade Defence Instruments). Of course trade will not disappear. Economic gravity will ensure that. However, to leave each other with the choice of the worst possible trade policy outcomes is surely perverse: a barbed wire divorce indeed, not least because the EU has already given better terms to Canada, Ukraine and Korea without any conditionality around the four freedoms being indivisible.

It is easy to be lost in pessimism given the four British red lines and EU equivalent on cherry picking on the EU-27 side. In this briefing, we have demonstrated that the most attractive outcome, from the UK government's point of view and given its red lines, would be an FTA with a variety of special sectoral arrangements. If that reduced or abolished non-tariff barriers on a wide range of goods and services, much trade would be saved. Whether this is acceptable to the EU side is unclear, but the alternative of going from the most integrated bilateral/regional trade relations on the planet to MFN terms ought to be deeply unpalatable to all concerned, and an incentive to find an FTA-based least-cost alternative. The debate, however, is heated on both sides, and mistakes and accidents are all too possible. MFN may be the only answer unless both sides shift from megaphone diplomacy and start explaining to their own constituencies that the cost of the most extreme versions of the red lines is unnecessarily high. Moreover, such extreme versions of Brexit do not exclude trade and investment subsidy wars as governments try to compensate footloose multinationals for the consequences of policy failure.

GLOSSARY

Customs Union (CU)

No tariffs on goods trade (free trade) between the member states; with a common external tariff (CET) on imports from all third countries. Hence, for example, in the EU the CET on imports of vehicles is 5.8%, and on imports of fertilisers is 4.7%.

- Under the GATT Art XXIV all members of the CU have to levy the agreed tariff and this applies both to the MFN tariff and to any preferences that the CU may grant to third countries, or any trade agreements the CU may sign with third countries. In order to be WTO compatible the intra CU free trade should cover substantially all trade, which typically means around 90% of tariff lines.
- A complete CU entails agreeing to either using the customs revenues collectively, or to share the customs revenues among the member states.
- The EU Customs Union formally provides for the removal of customs duties on trade in goods. In itself it does not address wider single market issues such as mutual recognition of testing and certification of goods, and barriers to trade in services which generally takes the form of domestic regulations with real or ostensible aims such as consumer protection, which have the effect of obstructing access to foreign service providers. Aided by the ECJ's jurisprudence, the EU Single (Internal) Market programme provides for an ambitious but less than complete opening of intra-EU services trade.
- At the WTO, trade in services is covered by GATS rules on modes of liberalisation. Service trade barriers normally take the form of domestic regulations. Countries can decide sector by sector to open for full Market Access or to apply their rules on a non-discriminatory basis.
- It is possible for a country to sign a Customs Union with another Customs Union. The EU-Turkey Customs Union is an arrangement of this type. (Technically the EU also has customs unions with Andorra and San Marino). However, the EU-Turkey CU is incomplete as it excludes agriculture and fish, has not harmonised external trading relations and allows for the use of anti-dumping duties.

Free Trade Area (FTA)

In an FTA each member country is free to set its own tariffs vis-à-vis third countries, but there is free trade between the member states for their own goods. Hence the EU has an FTA with Korea, which means that for most goods the tariffs on intra EU-Korean trade are zero. However, the EU still levies its MFN tariffs of 5.8% and 4.7% on vehicles and fertilisers, while Korea levies tariffs of 5.8% and 7.5% respectively.

- With regard to non-tariff provisions the content of a free trade area can vary considerably. This applies, for example, to the liberalisation of investment and services, to the treatment of standards, and to issues of dispute settlement. For example, the EU has negotiated free trade areas with EFTA minus Switzerland (EEA), Korea, Canada and Moldova inter alia – and each of these are different with regard to the non-tariff provisions.
- In order to be WTO compatible the FTA should cover substantially all trade, which typically means around 90% of tariff lines. Hence in a FTA it is still possible to protect

certain industries.

- An FTA requires Rules of Origin (see below) to establish which goods are eligible for duty free treatment.

Regulatory Integration

i.e. the extent to which regulations and standards are either harmonised or there is mutual recognition of conformity assessment. In principle this could be with respect to goods and/or services.

- **“Regulatory Union” / Single Market** In the EU Single Market all regulations governing goods and (in principle) services, and the rules for assessing compliance, are harmonised or mutually recognised so that any item lawfully sold in one can be sold in any other and border controls are not needed to check this. Such an arrangement is independent of agreements about tariffs. The European Economic Area (EU+ EFTA3) is a regulatory union but not a Customs Union.
- DCFTA: In a ‘deep and comprehensive’ free trade area there is typically some element of regulatory integration, either with respect to goods and/or services. A Customs Union agreement may also contain provisions for NTBs that entail their partial abolition only.

Common Market

A common market allows for free movement of factors of production (capital and labour).

- **Labour mobility** is typically a feature of a common market which allows for the free movement of goods, services, labour and capital. One can distinguish between free labour mobility and restricted labour mobility, where the latter covers various options. This is because various restrictions on labour mobility are possible, such as allowing for mobility only in certain sectors, or for certain skill types, or only for those in possession of a job offer. It does not necessarily imply free movement of people other than for employment.

Rules of Origin

The critical difference between a CU and an FTA is that whereas the former allows goods, once inside the area, to circulate without facing any additional tariffs (because they will have faced the same tariff wherever they entered the area) the latter cannot do this. If one member of an FTA has a zero tariff on e.g. oranges, while others have positive tariffs, exporters would seek to send their oranges to the first country and serve the others from there, thus avoiding the other members' tariffs. To avoid this trade deflection, FTAs have Rules of Origin (RoOs) to determine whether a good has been produced within a member country (in which case it is exempt from tariffs under the FTA agreement) or whether it has been produced outside (in which case it has to pay the tariff of the country of destination).

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FURTHER INFORMATION

This document was written by Michael Gasiorek, Peter Holmes and Jim Rollo, with inputs from other members of the UKTPO. The UK Trade Policy observatory (UKTPO), a partnership between the University of Sussex and Chatham House, is an independent expert group that:

- 1) initiates, comments on and analyses trade policy proposals for the UK; and
- 2) trains British policy makers, negotiators and other interested parties through tailored training packages.

The UKTPO is committed to engaging with a wide variety of stakeholders to ensure that the UK's international trading environment is reconstructed in a manner that benefits all in Britain and is fair to Britain, the EU and the world. The Observatory offers a wide range of expertise and services to help support government departments, international organisations and businesses to strategise and develop new trade policies in the post-Brexit era.

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