

CAN A UK-EU FREE TRADE AREA PRESERVE THE BENEFITS OF THE SINGLE MARKET AND THE CUSTOMS UNION IN SOME SECTORS?

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KEY POINTS

- A narrow sectoral approach to concluding a Free Trade Area (FTA) between the EU and the UK would contravene World Trade Organization (WTO) law.
- However, if the EU and UK agreed a broad tariff-free FTA, WTO rules would not prevent them from maintaining benefits of the Customs Union and the Single Market in a few key sectors.
- Customs Union-like conditions could be achieved by co-ordinating external tariffs in some sectors and agreeing on relaxed Rules of Origin.
- Single Market-like access could be approximated through sectoral Mutual Recognition Agreements.
- An agreement on trade in services would need to liberalise services trade in a broad range of sectors relative to what the UK has listed in its schedules under the WTO, but could then go much deeper in a subset of sectors.
- These approaches to liberalising trade would still fall short of current market access levels even in the selected sectors and would also re-create some of the limits to independent trade policy arising from the UK's Membership of the EU.

INTRODUCTION

The EU Customs Union and Single Market created a significant volume of trade between the UK and the EU and stimulated the development of European value chains – Lydgate and Winters (2017). The UK government has stated its intention to leave the Single Market and Customs Union eventually, and this remains the position of the leadership of both main political parties. But the UK government and European Council, as well as many sectoral bodies, have also indicated the desirability of a very ambitious trade agreement – HM Government (2017b): Part IV, and European Council (2017): Part IV para. 20.

Both the Customs Union and the Single Market enable a degree of integration far exceeding that attainable through any simple tariff-free Free Trade Area (FTA). The Customs Union ensures zero tariffs between members and a common external tariff, which means that intra-EU border posts are not required to levy tariffs or enforce Rules of Origin (RoOs). The Single Market contributes further through regulatory harmonisation. It ensures that goods may be exported without requiring additional certification, that customs procedures are harmonised, and that many services can be traded without hindrance through approaches such as 'passporting' for financial services and mutual recognition of professional qualifications.

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In this briefing paper we examine the possibilities for maintaining some of these benefits in key sectors. Such arrangements would need to be compatible with WTO rules, which require that Regional Trade Agreements (RTAs)¹ be wide (covering many sectors – but not necessarily all) and deep (offering meaningful liberalisation of trade). These requirements rule out selective tariff reductions or special market access granted solely to some companies. However, the rules are drafted and applied in such a way that the UK and the EU27 could design a WTO-consistent trade agreement that goes some way towards preserving current trading conditions in a subset of sectors. We discuss how this might be achieved and also some of the limitations that such an approach entails here and in greater detail in our working paper *'Deep and not comprehensive? What the WTO rules permit for a UK-EU trade agreement'*.²

GOODS: WTO RULES AND PRACTICE

Any FTA concluded between the UK and EU will have to comply with WTO disciplines on RTAs; in the case of FTAs on goods, this means GATT Article XXIV. Although Article XXIV has not been fully enforced, and mostly functions as a transparency and review mechanism (Winters, 2015), it can be thought of as something like a speeding law: even if commonly violated, it reduces the extent of bad behaviour. The EU takes its requirements seriously, and the UK, as a model WTO citizen – Fox (2016) – must as well.

Article XXIV states that the purpose of RTAs is 'increasing freedom of trade' by 'closer integration of the economies of the countries parties to such agreement'. A UK-EU FTA would replace the existing single customs territory with a less liberal arrangement, and so violate this purpose. We argue, however, that as long as the EU and UK met the substantive requirements of Article XXIV, which set out the minimum level of liberalisation that RTA Members must attain, they would be in compliance. However, to achieve such compliance, the FTA would need to be measured against the 'no deal' scenario, in which the EU and UK would trade with one another on a Most

Favoured Nation (MFN) basis, rather than against the current single customs territory.³

Article XXIV contains two key requirements. First, RTA Members must not raise duties and other restrictive regulations to non-RTA Members (paragraph 5b). This precludes either party increasing its bound tariff rates. The UK has indicated that it will 'replicate as far as possible its current position as an EU Member State' - HM Government (2017a): para. 9.18. On past precedent, the EU27 would not seek to raise its tariffs on signing an FTA. Thus this condition is unlikely to cause problems.

Second, RTA members must eliminate duties and other restrictive regulations of commerce on 'substantially all the trade' between them (paragraph 8b). The parties currently trade with no tariffs. If co-operation was sufficient to negotiate an FTA in the first place, we might assume that there would not be any serious pressure to introduce tariffs. No FTA has the depth of regulatory integration that the Single Market provides, and few make efforts to reduce other restrictive regulations at all – Epps (2014). Thus it seems that even after a substantial retreat from the Single Market, a UK-EU FTA would more than satisfy WTO practice to date, as long as the retreat was not spread too unequally across the sectors, a point to which we next turn. Again WTO MFN status, rather than the Single Market, must act as a comparative baseline.

Neither WTO Members nor its dispute settlement bodies have agreed a definition of 'substantially all the trade', but in its FTAs with developed countries, the EU requires 90 per cent of its trade to be tariff-free (Woolcock, 2007: 5). Given a starting point of zero tariffs on all mutual trade and the EU's low MFN tariffs, a UK-EU FTA seems likely to be able to achieve this threshold quite easily.

However paragraph 8(b) *clearly rules out* deals whereby UK-EU reduce tariffs below MFN rates in a few sectors. The arrangement which the UK government reached with the car producer Nissan in order to persuade them to continue investing in the UK would not be WTO-consistent if it included any tariff concessions.⁴ Also, a UK-EU FTA cannot be constructed piece-meal, starting with narrow coverage and adding sectors as

1 The WTO utilises RTA as an umbrella term including 'all bilateral, regional and plurilateral trade agreements of preferential nature' – WTO (1996).

2 Lydgate, E., and Winters, L.A., (2017) 'Deep and not comprehensive? What the WTO rules permit for a UK-EU trade agreement, University of Sussex Economics Working Paper No. 12-2017. Available at: <https://www.sussex.ac.uk/webteam/gateway/file.php?name=wps-12-2017.pdf&site=24>

3 The adoption of such a baseline could be purely notional (imagining, say, that one second had elapsed between the dissolution of EU Membership and the conclusion of the FTA).

4 Holmes (2016) discusses possible arrangements for the vehicle sector.

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they are negotiated.

In the subsequent analysis we assume that a substantial tariff-free FTA can be achieved, and consider how much further the EU and UK could go in maintaining benefits of the Customs Union and Single Market.

CUSTOMS-UNION-LIKE ACCESS?

The critical difference between a customs union and an FTA is that members of the former impose the same tariff as each other on any good imported from third countries. Hence, once inside a customs union such a good can circulate without facing any additional tariffs. In an FTA, on the other hand, these external tariffs can vary and so goods might be directed to the member with the lowest tariff and then circulate tariff-free from there. To assist this, FTA members must determine whether a good has been produced largely within a member country, in which case it is exempt from tariffs, or elsewhere, in which case it has to pay the tariff of the country of destination. Enforcing such Rules of Origin means customs checks between the EU and the UK.

There is no WTO regulation that precludes two countries from having the same external tariff on a specific good, nor from co-ordinating to achieve that end. Moreover, since preferential RoOs within an FTA are essentially a matter between the partners, there seems to be no barrier to their agreeing to operate those rules in a way that imposes rather little cost. Thus, it is, in principle, possible to create customs union-like conditions for specific sectors within an FTA.

There are caveats, however. Inputs may have uses in several end products - imagine tomatoes used for tomato paste, frozen pizzas, fresh consumption, etc. The tariff on any good needs to balance the interests of the sector seeking customs-union-like access with those of other sectors. The more open two markets are to each other, the more businesses in the two markets agitate to ensure that they face reasonably equivalent market conditions for non-traded inputs. Thus governments might make very open borders conditional on some form of co-ordination in other areas of policy.⁵ Finally, if the RoOs are to be very light-touch, the equality of tariffs has to refer not just

to the good itself (e.g. a car), but to all significant inputs into it, for otherwise countries with low tariffs on inputs would be deemed to have an unfair competitive advantage.

Moreover, the equality of tariffs refers not only to MFN rates but also to preferential rates; thus if customs-union-like conditions are to prevail, the UK and the EU would need to have FTAs with the same set of third countries. Many goods have a large number of inputs and tariffs on all of these would need to be harmonised, including preferential rates offered as part of FTAs with other countries or unilaterally to developing countries. This starts to undermine the notion of an independent UK trade policy.

Finally, the extent to which this arrangement would manage to circumvent border delays is uncertain. Even if a given product doesn't require RoO certification, it may still be subject to queues while other products are checked and verification that they actually qualify for customs-union-like treatment.

SINGLE MARKET-LIKE ACCESS?

Meeting regulatory conditions and proving that you have done so are in many cases greater barriers to trade than tariffs - World Economic Forum (2013). Addressing these was one purpose of the European Single Market, which has harmonised the majority of its Members' product regulations. For non-harmonised regulations, unless a Member can prove that a product imported from another Member does not meet its standards, it is assumed that the standards are equivalent. This ensures that products moving within the Single Market (the EU plus the EEA) are automatically exempted from national technical regulation. This recognition of each others' standards and testing regimes is referred to as the principle of mutual recognition.⁶

In the absence of this principle, the EU and UK could agree to mutually-recognise regulation in one or several sectors by negotiating mutual recognition agreements ('MRAs') for technical regulation. EU past practice suggests that this would require the UK to adopt the *acquis*, or the body of EU law, in these sectors - Correia de Brito et al., (2016) 19. Furthermore, a technical regulation MRA that either side could rescind on short notice offers a lot less

⁵ For example, paragraph 20 of the EU's Negotiating Brief of Article 50 states that outcomes should 'encompass safeguards against unfair competitive advantages through, inter alia, tax, social, environmental and regulatory measures and practices'.

⁶ 'Mutual Recognition', European Commission website at: ec.europa.eu/growth/single-market/goods/free-movement-sectors/mutual-recognition_en

long-term assurance than a legal requirement of recognition enforced by the Court of Justice of the European Union (CJEU), and so co-operative outcomes that were achievable under the Single Market may no longer be so.

An option that better accommodates the unwinding of existing regulatory harmonisation is to negotiate MRAs on Conformity Assessment Procedures (CAPs). Such MRAs have the more modest effect of avoiding duplication by establishing that EU product inspection, testing and certification can be done in the third country and vice versa. They require the Conformity Assessment Body in country A to be knowledgeable of the regulatory requirements of country B, and capable of fulfilling them, and vice versa. But the UK and EU have established trust in one another's CAPs already, which gives them a major advantage.

WOULD UK-EU MRAS ON GOODS BE COMPATIBLE WITH WTO OBLIGATIONS?

There have been no WTO disputes on MRAs. It seems likely that the exclusion of a petitioning third country from an MRA would in many cases contravene MFN obligations to provide equal treatment to goods from all WTO Members, as established in GATT Article I:1, the Agreement on Technical Barriers to Trade (TBT Agreement) – see Zell (2016) – as well as the Agreement on Sanitary and Phytosanitary Measures (SPS Agreement). However the obligation is procedural; to engage in talks towards concluding MRAs. There is scope to exclude third parties on the basis that they cannot establish the equivalence of their regulation or CAPs.

Past disputes focusing on regulatory equivalence and conditionality, such as *US – Shrimp* (1998), *EC – Tariff Preferences* (2004) and the *GATT EEC – Beef from Canada* (1981), suggest that the Appellate Body would require objective and transparent criteria to establish equivalence and would place the burden on complaining countries to establish that they can provide the same level of regulatory protection (a requirement made explicit in the TBT and SPS Agreements). In fact, negotiated sectoral MRAs between the UK and EU that are in principle open to other WTO Members may actually be more likely to comply with MFN obligations than the existing closed comprehensive automatic mutual recognition within the EU.

SERVICES - WTO RULES AND PRACTICE

Services trade agreements are governed by GATS Article V, which describes them as 'Economic Integration Agreements' (EIAs). Paragraph 1 describes an EIA as 'an agreement liberalising trade in services.' As it is more or less inevitable that a UK-EU EIA would eliminate some of the services liberalisation currently available, it would not meet this definition. As above for goods, however, we believe that using WTO GATS schedules rather than the status quo as a baseline should suffice to overcome this problem in practice.

The requirements imposed by the WTO in negotiating a sectoral deal for trade in services are similar to those for goods, although they have not been codified precisely by Members nor yet interpreted by the Appellate Body. Article V requires 'substantial sectoral coverage', constituted by the number of sectors and volume of trade affected, and that there should not be *a priori* exclusion of any of the four modes of supply.⁷ In most EIAs there is greater ambition within modes 1 and 2 than in mode 3, and mode 4 commitments are often only marginal - Cottier and Molinuevo (2008) 133-4.

Within the sectors that are included in the 'substantial sectoral coverage', EIA members must eliminate 'substantially all discrimination' by providing national treatment as described in GATS Article XVII; namely, treating 'like' services of EIA members no less favourably than domestic ones. Paragraph 1(b) offers two very different requirements: 'eliminating current discriminatory measures', which suggests near total merging of the domestic market with the foreign market(s), 'and/or prohibiting new or more discriminatory measures', which suggests that a standstill will suffice. One interpretation is that the first obligation should apply to sectors in which there are many discriminatory measures and the latter to sectors where there is little discrimination – Cottier and Molinuevo (2008) 136-137. There is no requirement to eliminate all discriminatory barriers in all sectors.

⁷ The modes are 1) cross-border supply; 2) consumption abroad; 3) commercial presence; and 4) presence of natural persons.

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GATS AND MUTUAL RECOGNITION

GATS Article VII addresses MRAs in services with the tentatively-worded obligation that a party to an MRA ‘shall afford adequate opportunity for other interested Members to negotiate their accession to such an agreement or arrangement or to negotiate comparable ones with it’. It also provides for non-discrimination ‘in the application of ... standards or criteria for the authorisation, licensing or certification of services suppliers.’ It has been speculated that the lack of disputes is because the ‘burden of persuasion’ for third countries to establish that they should receive better-than-MFN treatment is perceived to be too high - Marchetti and Mavroidis (2010), 423.

ASSESSING THE GATS COMPLIANCE OF A UK-EU EIA

Given the uncertainty about how to interpret the GATS’ legal provisions on EIAs and the absence of any rulings from the Appellate Body, we turn to the practice of members and Secretariat for guidance. We base this analysis on the Secretariat’s *Factual Presentation of the EU-Korea FTA* (WTO, 2012); the *EU-Peru FTA* (WTO, 2013) suggests similar criteria.

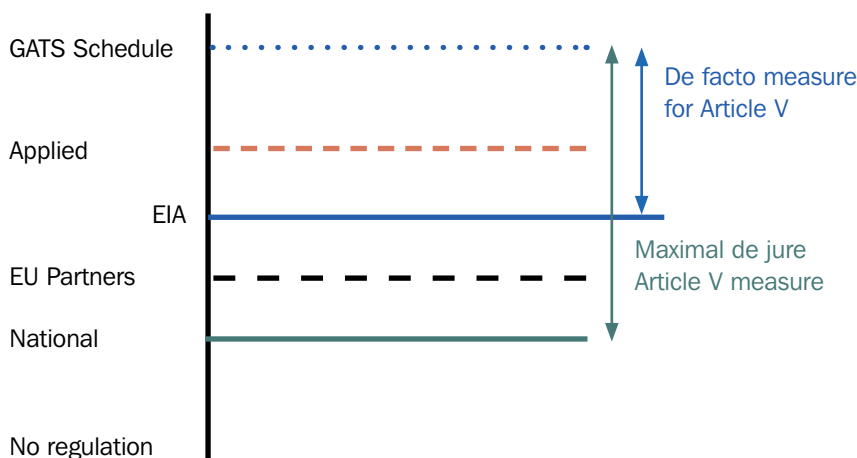
In presenting the EU-Korea FTA, the Secretariat notes that ‘The specific commitments by the Parties in the Agreement are based on their GATS commitments.... For certain sectors (and sub-sectors) coverage is enlarged, while, for a number of sectors (sub-sectors)

already covered, new commitments are made or certain GATS-limitations are withdrawn’ (paragraph 104). The criterion that the Secretariat uses for defining a sector as covered is that the EIA improves upon the GATS scheduled degree of restriction.

In most sectors, EU- and UK-applied MFN policies are already more liberal than scheduled policies, such that even an EIA that merely committed to current applied levels would seem to satisfy the *de facto* standard. As nearly all sectors should meet this standard, there is ample cover for a few – or perhaps more than a few – to offer mutual access at the EU Partner (Single Market) level without violating the ‘substantially all sectors’ criterion.

To illustrate the point, consider a single notional service sector, such as health provision, banking or telecoms. Imagine, also, that the degree of restriction can be collapsed into a single scalar measure, which we represent on the vertical axis of Figure 1. Even national suppliers have to obey some restrictions, and we denote this as ‘National’ in the figure. At the other end of the scale, a WTO member must record in its GATS schedule the maximal amount of regulation that it will impose on services and, as we just observed, most applied policies towards services imports are more liberal than this. In addition, the Single Market usually implies less regulation for trade between EU partners than with non-Members. This may be the same as is required of nationals or more, but it would never exceed the restrictions offered at the MFN applied level.

FIGURE 1: LEVELS OF REGULATION IN A NOTIONAL SERVICE SECTOR



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Now suppose that the EU signs an EIA with the UK, which introduces regulation at the level labelled 'EIA'. GATS Article V (1) requires the absence of discrimination 'in the sense of Article XVII'. At its strictest, this requires the application of the 'national' level of regulation. If this criterion were applied, our notional sector would not be sufficiently liberalised to count as 'covered' in the WTO interpretation of an EIA; the liberalisation required by this interpretation is labelled 'maximal *de jure* Article V measure'. Most scholars would argue, however, that 'the sense of Article XVII' covers only a subset of the regulations that apply to nationals or in the Single Market, in which case the EIA may be able to meet the *de jure*

requirement. In fact, however, the actual practice of the WTO and its members is to measure liberalisation downwards from the 'WTO Schedule' level – labelled '*de facto* measure for Article V' - which, in this case, the EIA would meet easily.

An actual EIA between the UK and the EU would comprise many sectors but, on the *de facto* standard, almost every one of them would meet the liberalisation requirement and so the EIA would be fully acceptable under the 'substantial sectoral coverage' rule.

CONCLUSION

The agreement we have outlined in this paper is intended to preserve as much as possible of the mutual access that the UK and the EU27 currently offer each other. The first step is to agree the simple tariff-free FTA. If tariff co-ordination did seem desirable, work would then pass on to co-ordinating regulations and designing rules of origin and their administration in a way that minimises the customs burden. The latter can occur only once the UK has worked out its general customs regulations and procedures. The UK government recently laid out its aspirations in this regard, although with very little concrete detail – HM Government (2017c).

Regarding regulation for goods, conformity assessments and services, it is relatively straightforward to convert existing harmonisation into MRAs, as compared to the usual situation in which trade partners have to build trust in divergent regulatory systems. The issue is how to enforce the agreed rules in the UK independently of the CJEU, and how to modify MRAs to reflect changing regulation. The UK as the smaller party would have to accept EU leadership in most standards - a voluntary reduction in regulatory self-determination in exchange for market access.

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FURTHER INFORMATION

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