THE WORLD TRADE ORGANISATION: A SAFETY NET FOR A POST-BREXIT UK TRADE POLICY?

BRIEFING PAPER 1 - JULY 2016

UK TRADE POLICY OBSERVATORY

INTRODUCTION

By electing to leave the European Union, the United Kingdom has chosen, among many other things, to leave the customs union and the single market that includes all member states and reassert its status as an individual member of the World Trade Organisation (WTO). In doing so it will take sole responsibility for the control and governance of its external trade policy with all other WTO members (including the EU) within the framework of WTO rules. This Briefing Paper aims to explore the nature of those WTO commitments and how they might impact the UK from the yet-to-be-set date of the UK's exit from the EU (B(rexit) day).

UK TRADE POLICY PRIOR TO BREXIT

The UK will remain a full member of the EU until it completes the negotiation on the terms of its exit. This could take up to 2 years after the UK first triggers Article 50 of the Treaty on European Union, unless this period is extended with the approval of all EU member states. Until the exit date, legal competence for UK trade policy still rests with the EU and its implementation is in the hands of the EU Commission. All existing EU agreements with other WTO members would still apply and the treatment of UK imports from and exports to EU partners and third countries should receive exactly the same treatment as before the referendum.

WHAT HAPPENS ON B-DAY?

In principle the UK loses its status as an EU member of the WTO and takes up its membership as an individual member of the WTO. As far as UK imports are concerned, what happens is in the hands of the British Government. Theoretically, it could continue to apply the same measures as on B-day-1 which would be consistent with the tariff and services schedules it agreed to in the WTO's Uruguay Round and as subsequently revised to take account of subsequent enlargements of the EU. If it decides not to apply the same measures, and insofar as this results in higher barriers to trade, this will give rise to renegotiations with affected WTO members. What follows assumes that the British Government will not raise barriers above those applied by the EU, but focusses on how other WTO members are going to treat UK exports. There are three classes of trading partners:

- the EU-27
- those countries which had a preferential trading arrangement with the EU-28 on B-day -1 but only with the EU-27 on B-day and
- those countries which have a so-called Most Favoured Nation (MFN) relationship with the EU-28 based on tariffs and services schedules negotiated in the WTO, e.g. the USA.

The post B-day relationship with the EU-27 is complex because it is unclear whether the Treaty on the Functioning of the European Union allows negotiation of the post-Brexit arrangements between the UK and the EU-27 in parallel with the Article 50 mandated negotiations on the terms of the exit. If the reality is that the EU-27 would not allow a new trade relationship to be negotiated until the UK has left the EU the default position will be that both sides treat each other on MFN terms, which is unlikely to be desirable for either side. An alternative is to extend the status quo.

UKTPO
UK TRADE POLICY OBSERVATORY

US
UNIVERSITY OF SUSSEX

But that might be unacceptable in the UK if it includes the free movement of labour (not a WTO subject per se) and unacceptable to the EU-27 if it does not. Other WTO members may complain that MFN is violated by such an extension of the status quo, but any associated WTO dispute proceedings will take a lot of time, so that even if some WTO members bring a case, in practice the UK government and the EU will have time to deal with the issues. Indeed, WTO members might allow both parties transitional periods or temporary waivers to allow the EU-UK negotiations to continue after B-day without pressure from Geneva. Of course that does assume goodwill on all sides which should not be taken for granted. The post B-day relationship with countries that have FTAs with the EU may paradoxically be easier because they may be more relaxed about informally discussing allowing the existing bilateral arrangements to continue beyond B-day while a formal FTA or similar agreement is drawn up. Such goodwill is likely to be a function of political factors as well as of whether or not the partner country involved thinks it will benefit from reverting to MFN. Hence the final outcomes are likely to vary across partners.

Finally for countries with which the EU currently has MFN-based trade relations, a continuation of that after B-day with both the EU and the UK would seem the line of least resistance.

Hence it is possible that relations with all three classes of partner will revert to an MFN-based relationship grounded on the WTO. There are many dimensions to this so-called 'WTO-Option' which the *UK Trade Policy Observatory* will explore in detail in future; this Briefing Paper sketches some preliminary thoughts about the challenges that it raises in three critical areas of trade: goods, services and government procurement.

TRADE IN GOODS

UK exports to the EU were 44% of total UK exports and 54% of total UK imports in 2015. All of this was carried out with zero tariffs and very low non tariff barriers courtesy of the single market. If that trade were carried out on an MFN basis then the average MFN tariff levied by the EU is 5.3%.[1] However, at a more detailed level around 16% of UK exports to the EU-27 would have faced tariffs of more than 7%; of that 16%, half was represented by motor cars which would face a tariff of 10%.

A similar story can be told of trade between the UK and the 51 countries that the EU had an FTA with in 2015. Trade with those countries in 2015 represented 14% of UK exports and 11% of imports; UK exports would have faced average MFN tariffs that varied from under 5% (Israel) to almost 30% (Egypt) and perhaps most notably an average 17% tariff into Korea. At a more detailed level tariffs could be considerably higher.

Overall therefore and based on 2015 statistics, UK exports could face significant MFN tariffs on the 58% of total exports that go to the EU and markets where the UK currently receives tariff free entry. Similarly the UK could end up levying tariffs on the 65% of imports that originate from the EU and other preferential partners that previously attracted no tariffs, with consequent negative impacts on both British consumers and on firms dependent on imported inputs.

APPLYING AN MFN TRADE REGIME ON GOODS

There are potential administrative problems involved in applying EU MFN tariff schedules in the UK. Under the WTO Agreement on Agriculture, some agricultural imports from the rest of the world face tariff rate quotas (TRQs), which allow the entry of a specified quota of imports at a below-normal tariff rate. These quotas are defined at the EU level, and in order to extract itself and claim its share of the TRQ, the UK will need to negotiate with both the EU-27 and the WTO members that take advantage of the TRQs.

A similar problem arises from the cap on expenditure on trade-distorting agricultural subsidies that the EU negotiated in the Uruguay Round (the so-called blue box). The division of this right to subsidise will again require the agreement of both the EU-27 and other WTO members. This is doubly complicated because the EU commitments to the WTO have not yet been updated to take account of the enlargements of 2004 and 2007.

This unpacking process could take time and could lead to resistance among WTO members who feel that the reallocation between the UK and the EU may disadvantage them. Hence even if the division of the TRQs and the blue box formed part of the Article 50 negotiations on UK withdrawal, it would still then in principle have to be negotiated with the WTO membership.

Of course, the UK could unilaterally choose not to operate a TRQ system and apply the low, within-quota, tariff to all imports of the relevant commodities. Similarly the UK, with its new found margin for manoeuvre, could unilaterally abolish trade-distorting agricultural subsidies and reduce blue box expenditure to zero. Such moves would be welcomed by WTO members but would doubtless face resistance from the UK agricultural sector.

1 MFN applied tariff, unweighted average, total trade 2014, source WTO tariff profiles.

SERVICES TRADE

The United Kingdom has a vital interest in trade in services. In 2014 the total value of UK services exports (excluding transportation, travel and financial services) stood at about £120 billion and imports at £55 billion. Approximately half these flows are with European countries (£59bn are exported to Europe,[1] £34 to the Americas, £20bn to Asia). Europe is the single most important trading partner across all major types of services. The most important services exports are in professional, scientific and technical activities, followed by information and communications. Financial and insurance activities are third.

SERVICES TRADE WITH THE EU UNDER THE WTO GENERAL AGREEMENT ON TRADE IN SERVICES (GATS)

There is no uniform EU external trade policy for services. The EU's GATS schedule sets out a framework for market access which is punctuated by individual countries' derogations in particular subsectors and modes of supply. For example, while the conditions for establishing commercial presence (mode 3) in life insurance are similar across most EU members, those pertaining to the legal sector (advice on foreign law) differ widely; e.g. in France non-EU firms are not allowed to establish branches under their own name or to form partnerships with locally licensed lawyers. Thus the UK's "WTO option" in services will require negotiations with all individual EU member states as well as with the Commission.

The extent to which the UK's access to the EU market would deteriorate based upon the EU's GATS schedule is difficult to assess because market access based on currently applied measures is typically better than in the GATS schedules. The GATS schedules thus impart only a lower bound for currently applied (or de facto) market access and national treatment condition; these may be quite favourable but could be removed at any time and thus are afflicted by considerable uncertainty that does not pertain while the UK is within the EU.

SERVICES IN EU FTA: THE CASE OF KOREA

The EU has a flagship trade deal with Korea which is deeper than any of its other agreements. If the deal does not apply to the UK after Brexit, the UK would lose the considerably greater access it provides (compared with Korea's GATS schedules). It is not easy to compare the FTA and the GATS schedule because they differ in structure: for example, the FTA incorporates rules about the establishment of foreign firms into its investment conditions rather than as an element of services trade. Nonetheless, in many specific areas the EU-Korea agreement goes well beyond Korea's GATS commitments. For example, in financial services it opens up the Korean market in several respects, and in particular allows EU firms the right to offer new financial services as they develop. It also opens telecommunications markets by reducing local ownership requirements, as well as the legal services and shipping services markets. The Korea-EU FTA is similar to the Korea-US FTA, so that if the UK could no longer trade under the FTA, it would suffer disadvantages relative to both the rest of the EU and to the USA.

Article 7.14 of the Korea-EU FTA includes a clause that requires each party to extend to the other any liberalisation that it may grant in any future FTA that it signs with another party. Hence if a future Korea-UK FTA offered the UK very favourable terms, these would have to be extended to the whole of EU. Thus even if the UK were prepared to offer a very deep relationship to Korea, this clause makes it unlikely that Korea would be prepared to improve significantly on what it has already offered under Korea-EU.

THE UK'S PUBLIC PROCUREMENT AND THE WTO GOVERNMENT PROCUREMENT AGREEMENT (GPA)

The world market in government procurement is reported to represent the equivalent of 15-20% of GDP by the European Commission (EC), but because of the various restrictions on coverage, less than half of that is actually contestable under the GPA. The EC also reports the EU procurement market at 14% of GDP and the annual value of procurement activities opened up to international competition by the 43 GPA parties amounts to US$ 1.3 trillion.

The GPA opens up certain government procurement in member countries to suppliers from other GPA-members. However those suppliers must also be able to get their goods and services into the country in the first place, which is conditioned by the country's import polices which, in turn, are bound by its GATT and GATS schedules. Thus unlocking the huge procurement market will typically require the negotiation of both the GPA and the WTO schedules.

An under-appreciated issue is that the UK is covered by the GPA only through its membership of the EU: the EU ratified the GPA on behalf of its members but the UK has not, so far, done so individually. If the UK does not ratify/accede the interim, its exit from the EU will undermine its rights of access to all GPA members' procurement markets. It will also remove any obligation on the UK to allow foreign suppliers to tender for its procurement contracts, which would severely reduce competition and create serious value-for-money challenges. Yet, until it has left the EU, the UK will not formally have the standing to deal with the GPA.

1 Switzerland is included in these figures and is an important export destination for UK services.

CONCLUSIONS

The WTO provides the UK with a useful framework for re-negotiating its trade relationships both with and outside the EU, but the analysis above suggests that:

- For goods, the UK should adopt existing EU tariff schedules for imports with the aim of maintaining stability and facilitating swift negotiations with the EU and the other members of the WTO.
- If the EU does not wish to begin formal negotiations until after the Article 50 process is complete the WTO option will govern UK-EU trade relations. This will be costly for both parties relative to the status quo.
- With respect to preferential trade agreements between the EU and third countries, the UK should push to initiate informal discussions immediately to maintain these preferential trade relationships post-Brexit. If that is not possible, WTO MFN terms will again come into play.
- Reverting to WTO terms of trade under the Agreement on Agriculture poses complexities, as negotiation within and beyond the EU is unavoidable. The UK must make it a priority to initiate these negotiations, as concluding them is in the best interest of both the UK and the EU.
- Basing services trade with the EU and Korea on GATS schedules after B-day will result in a significant deterioration in access for British services compared with the single market or the Korea-EU FTA. As a priority, the UK should aim to maintain as close to current levels of access to the EU-27 and the Korean markets and to extend Korean style access terms in any new FTA it negotiates.
- The GPA delivers important access for British exports to government procurement markets in many other countries and increases competition in the British market. If the UK does not ratify/accede to the GPA in advance, B-day threatens to reduce exports and create serious value-for-money challenges in the UK.

The UK will undertake an unprecedented redesign/reboot of its trade policy over the coming months and years. This Briefing Paper is a first foray by UKPTO into the mass of issues that will arise from that redesign. Over the next six months we will provide a series of Briefing Papers and meetings in London and around the UK to generate informed scrutiny of the process and the substance of making Britain's new trade policy.

FURTHER INFORMATION

This document was written by by Jim Rollo, Ingo Borchert, Kamala Dawar, Peter Holmes and Alan Winters 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.

For further information on this theme or the work of the UK Trade Observatory, please contact:

Professor L Alan Winters
Director of the UK Trade Policy Observatory

Email: uktpo@sussex.ac.uk