What trading outside the Single Market looks like

blogs.lse.ac.uk/brexit/2017/03/01/what-trading-outside-the-single-market-looks-like/

01/03/2017

Once the UK has left the Single Market – and assuming it does not join EFTA or negotiate a bespoke deal with the EU – it will have to revert to World Trade Organisation membership. In this extract from its latest report, the ***LSE Growth Commission*** *explains that in the absence of bilateral deals this will mean determining a universal set of tariff rates. Keeping nontariff barriers low will also be important. Given the UK's dependence on trade with the EU and US, these deals must take priority over other countries.*

The political and legal landscape surrounding Brexit is evolving at a fast pace and there is still a high degree of uncertainty over its likely form. A number of options appear to have been largely ruled out (these are shaded in grey in Table 1 which shows the key attributes of different Brexit models). In its recent White Paper on the UK's exit from the EU, Government has stated that border control will be a priority and that therefore, the UK cannot remain in the EU's Single Market. (Norway, Liechtenstein and Iceland are not EU members, but have access to the Single Market via membership of the European Economic Area (EEA)). Moreover, staying in the Customs Union appears unlikely as this limits the UK's capacity to negotiate its own trade deals which is another of the government's key objectives.

This implies that the UK will need to find a bespoke trade agreement with the EU. One option – which may be difficult politically – is re-joining EFTA, which would provide tariff-free trade in goods. The other option is to negotiate a bespoke deal of the type recently agreed with Canada. Neither would guarantee free trade in services, and would still result in significant non-tariff barriers in goods markets such as complying with rules of origin. The UK must therefore aim for a better deal than either of these options, in particular with respect to the services sectors where the UK has comparative advantage, acknowledging that there is likely to be some cost or concession to achieve it.

In order to revert to World Trade Organisation (WTO) membership, the UK would first have to become an independent member of WTO. If this did happen and became the default, then under WTO rules, each member must grant the same 'most favoured nation' (MFN) market access, including charging the same tariffs, to all other WTO members. The UK would then have the same trading relationship with the EU as any other country. In the absence of any bilateral trade agreements with the EU (or any other countries) the UK would have to determine a universal set of tariff rates to apply with all trading partners. If tariffs are too high, imports will be more expensive, harming UK consumers and businesses which use significant imported inputs. While lowering tariffs would make imports cheaper, there is no guarantee that this would be reciprocated, and the UK will lose bargaining power: once duty-free access to the UK market has been offered, other countries will have no incentive to give the UK preferential access to their own markets.

A German cargo ship on the Thames at Gravesend. Photo: Glen via a CC-BY 2.0 licence

It is crucial that the system replacing EU membership is able to maintain low tariffs with the EU. But equally crucial is the need to constrain nontariff barriers to trade which add substantially to trade costs. Adherence to EU rules and regulations have been an essential component of reduced non-tariff barriers. So even outside the EU, it is likely that harmonised rules will be required in any deal that preserves high levels of market access.

There are some areas that could be particularly problematic. For firms participating in global value chains, with high shares of imported inputs, the bureaucratic cost of complying with EU rules of origin are high and may reduce the UK's attractiveness as a location for production processes. Moreover, the financial costs associated with expediting tax (VAT) and customs clearance are especially important for small exporters. As previously discussed, small and medium enterprises do not typically export and those that do currently focus on the EU market. (9% of SMEs export and a further 15% are in the supply chains of other businesses that export. Most of this relates to the EU.) It has been argued that leaving the EU provides the UK with more freedom in designing domestic policies and regulatory frameworks aimed at increasing firms' profitability, which may compensate for the rise in administrative costs implied by Brexit. The UK would have the freedom to redesign all areas currently under the authority of the EU, including competition policy, international trade regulations, and areas that rely on EU funding like regional development and research. However, any new subsidies or regulations that do not comply with EU or WTO normative standards may result in the imposition of further market restrictions from global trading partners. More generally, a lack of coordination in competition policies with the EU will provide more freedom for domestic policy design, but will leave UK firms vulnerable to antidumping measures and less able to export. Moreover, it is worth noting that any country that exports goods to the EU has to comply with EU product standards.

Table 1: Brexit options

	Current UK	EFTA plus EEA: Norway	EFTA plus EEA: Liechtenstein	EFTA plus bilateral agreements: Switzerland	EFTA only	Trade deal: Canada	WTO
Free trade in goods?	yes	yes	yes	yes	yes	mostly	MFN tariffs, non tariff barriers WTO compliant
Free trade in services?	yes	yes	yes	limited access	limited access	limited access	limited access
Ability to negotiate own trade deals with rest of world?	no	yes	yes	subject to EU consent	yes	yes	yes
Immigration control?	no	no	subject to EU consent	no	yes	yes	yes
Subject to EU rules and regulations?	yes	yes	some	some	EU product standards on exports	EU product standards on exports	EU product standards on exports
Subject to EU policies and programmes?	opt out from some EU programmes	opt out from some EU programmes	opt out from some EU programmes	opt out from some EU programmes	no	no	no
Payments to EU?	Budget contribution	Budget contribution	Budget contribution	Budget contribution	no	no	no

New relationships with the rest of the world

By exiting the EU, the UK will be allowed control over trade deals with non-EU countries. While the UK will now be able to seek trade agreements tailored to UK interests, it will have reduced bargaining power with large trade partners like the US and China once it is outside the largest trading bloc in the world. There is a risk, therefore, that the UK will have less power to negotiate deals that are in its longterm interest.

Exploratory talks have already taken place with a number of countries, most recently the US, but also New Zealand, Australia and Gulf nations. Our analysis of UK trade shows that while all such deals are positive developments, the UK must prioritise deals with the US and EU.

Currently the UK and the US trade under WTO terms. Tariffs are already relatively low, and the largest gains would be from reducing non-tariff barriers, for example through regulatory harmonisation. This may now be more difficult. Under the previous US government, a wide-ranging deal was being negotiated with the EU (the TTIP) , but the general consensus so far is that President Trump will be more protectionist than his predecessor.

In the coming years there are opportunities to increase exports to China and India. Both have rapidly growing middle classes with a preferences for goods and services where the UK has comparative advantage.

It is important to note that deepening international integration with non-EU countries – in particular emerging markets – implies different challenges than those faced in current partnership with the EU. European economies are relatively similar to the UK in terms of education, labour costs, and environment regulations. As a result, much of the gains from trade within the EU are based on economies of scale and access to broader varieties of goods and inputs. The gains from trade with labour-abundant economies such as China or India are based on complementary patterns of factor abundance.

This post represents the views of the authors and not those of the Brexit blog. It is an extract from the LSE Growth Commission's UK Growth: A New Chapter report, in partnership with the LSE's Centre for Economic Performance. Find out more about the Growth Commission.

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