

October 2016

Hard Brexit and UK Trade: A bold step?



“...Noe Forreigne Prince, Person, Prelate, State or Potentate hath or ought to have any Jurisdiction, Power, Superiority, Preeminence or Authoritie, Ecclesiasticall or Spirituall, within this Realme...”

(English Bill of Rights, 1689)

The Great Repeal Bill

At the Conservative Party Conference on 2 October, Prime Minister Theresa May announced a “Great Repeal Bill” which – perhaps confusingly – will preserve the effect of EU law post-Brexit, pending its later repeal on a piecemeal basis. Perhaps the title was designed to recall the so-called “Great Reform Act” (Representation of the People Act 1832), which modernised the UK’s electoral system and abolished rotten boroughs maintained under patronage. The chosen title may therefore have been intended as a parting swipe at the European Parliament, and other EU institutions; we do not know. Despite its grandiose title, the Great Repeal Bill will simply be part of a legislative process that will be necessary to give effect to Brexit.

The much more substantive policy announcement related to the Government’s formal departure notice under the now well-known provisions of Article 50 of the Lisbon Treaty. This notice will now be given by the end of March 2017. There may be several reasons for this announcement at the present juncture. First of all, “out” campaigners within Mrs May’s own party might have become restive in the face of a continuing delay. Secondly, other EU Member States had been pressing the UK Government to get on with the process, in order to mitigate any damage to the EU itself as a result of continuing uncertainty. Finally, Mrs May might have hoped that the announcement of a deadline would incentivise the other Member States to engage in pre-negotiations around a post-Brexit relationship – a step that they have thus far steadfastly refused to countenance. We would expect that they will maintain that position until the Article 50

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letter drops onto the doormat. Indeed, this position was confirmed by the German Chancellor, Angela Merkel, and other prominent figures immediately following Mrs May's speech.

As we have noted in our previous publications on Brexit, it is difficult to comment on the future UK-EU relationship when negotiations have not even yet begun. But, even at this early stage, some of the key areas of difference are beginning to emerge. For example, Mrs May dismissed the templates offered by the "Norway model" and the "Switzerland model", discussed in our earlier briefings. The new arrangements will be "...an agreement between an independent, sovereign United Kingdom and the European Union..." So the negotiations will start from a blank sheet of paper without the guiding hand of history or precedent. The sovereignty card was played on a number of occasions. Mrs May noted that "...Our laws will be made not in Brussels but in Westminster. The judges interpreting those laws will sit not in Luxembourg but in the courts of this country. The authority of EU law in Britain will end..." Finally, on the single market, Mrs May said "...I want [the agreement] to give British companies maximum freedom to trade with and operate in the single market – and let European businesses do the same here..." On the other hand, in relation to immigration, she noted that "...we will do what independent, sovereign countries do. We will decide for ourselves how we control immigration. And we will be free to pass our own laws..."

Hard Brexit

To the ears of the Brussels establishment and to the major EU Member States, these objectives will be irreconcilable. Again, in the aftermath of Mrs May's speech, Mrs Merkel repeated that the single market is indivisible, and that the UK cannot simply opt for those aspects that meet its tastes. They see single market participation and free movement of people as indissolubly linked—in other words, the single market is a set menu, not an a la carte selection. As matters stand at present, therefore, it would appear that the UK is heading for a "hard Brexit" – if the UK wishes to control immigration from other EU Member States, then its access to the single market will necessarily be restricted. Without wishing to revisit the merits of the Brexit vote or to rehearse the referendum arguments, it may be noted as an aside that many politicians in the "out" camp confidently asserted that Germany would assist the UK to obtain a favourable exit deal because of the depth of the trading relationship between the two countries. To the present writer, this view always appeared both simplistic and naïve. Germany's history and its place at Europe's top table always meant that its primary concern would be the preservation of the remaining fabric of the EU and its single market. That political objective would always outweigh the depth of the economic and trading relationships between the UK and individual EU Member States. Whilst some had hoped for a "soft Brexit", it was always difficult to see how that could be achieved in the face of a referendum result that specifically rejected EU membership and principles.

Whilst lengthy and difficult negotiations lie ahead, and many compromises no doubt remain to be forged, is it possible to divine the outlines of the future UK-EU relationship from this preliminary examination of the proverbial tea leaves?

A "hard Brexit" trade relationship

In view of the above discussion, it seems that "hard Brexit" means that the UK will not be able to retain access to the EU's single market on anything like the current terms. Whilst Mrs May hopes for "maximum freedom" for trade and business operations between the UK and the EU, the extent to which this objective can be achieved will be severely curtailed as a result of the government's determination to control immigration from other EU Member States.



Given that position, what are the possible options for the UK?

EU customs union

Apart from its many other features, the European Union currently amounts to a customs union because (i) there are no tariffs on trade among EU Member States and (ii) EU Member States impose a common tariff on external trade with third countries. There has been some political discussion in the UK as to whether this country should leave the EU customs union. In truth, however, the UK will cease to be part of that customs union as a result of its withdrawal from the EU. The true question is whether the UK should seek to negotiate a new customs union arrangement with the remainder of the EU (e.g. as Turkey has already done).



It might be possible for the UK to negotiate a separate customs union arrangement but in reality, this seems unlikely. The UK would be required to impose tariffs on trade with third countries at rates determined by the EU and over which the UK would have no influence. This would be inconsistent with the UK's desire to reassert control over its own trade policy.

Free trade area

In contrast, a free trade area involves liberalisation of trade as between the members, but does not include a common external tariff. As a result, members of the area retain the right to set external tariffs on trade with third countries. Whilst the EU currently has a number of free trade agreements with third countries, it is not immediately obvious why the EU would wish to negotiate a favourable agreement with a departing Member State. Nevertheless, it may be anticipated that both the EU and the UK will think it better to reach some form of trade agreement rather than none. The best guess may be that the UK will be offered restricted access to the single market in return for reciprocal rights for EU businesses in the UK. In addition, the UK will be required to make a significant financial contribution to the single market. The latter aspect will inevitably be controversial in the UK but some form of package deal will clearly be necessary if a deal is to be struck.

In relation to third countries, it may be added that the UK currently has the benefit of a network of free trade agreements negotiated by the EU (e.g., with Norway and other countries via the European Free Trade Agreement). However, the UK's participation in these arrangements will fall away on Brexit. It will be open to the UK to negotiate new agreements with all of those countries once it has ceased to be an EU Member State. But experience shows that agreements of this type can take many years to negotiate, and an extended period of uncertainty in this area would clearly cause significant difficulties for UK businesses.

World Trade Organisation

Overview

Whilst this scenario is thought to be unlikely, it may at some point become apparent that the UK will be unable to negotiate a mutually acceptable trade agreement with the EU. At this juncture, "hard Brexit" may involve reliance on the agreements operated under the supervision of the World Trade Organisation. The primary such agreements are (i) the General Agreement on Tariffs and Trade (GATT) and (ii) the General Agreement on Trade in Services (GATS). Over 160 countries are currently members of the WTO and a significant amount of world trade flows solely on the basis of the WTO agreements. At first sight, therefore, the use of these arrangements has a certain attraction.

There are, however, a number of practical difficulties. Although the UK is itself a member of the WTO, its position is effectively aligned with that of the EU itself, which holds competences in relation to EU external trade and is itself a member of the WTO as a customs union. Post-Brexit, the UK would have to determine the basis of its tariff arrangements with all other WTO countries. This would be a daunting task even under the best of circumstances. Other countries may seek to exploit the UK's position to seek better terms, and negotiations may therefore be protracted.

It is therefore necessary to consider whether there are any other avenues offered by the WTO agreements that the UK could invoke under these circumstances.

GATT and GATS

Whilst there are significant differences of detail between GATT and GATS, the essential principles of the two agreements include the following:

- national treatment. A WTO member cannot take measures designed to distort competition between domestic goods and comparable goods of foreign origin;
- most favoured nation. Subject to defined exceptions that are not relevant here, a WTO member must not discriminate against or between other WTO members. Thus, if the UK agrees to allow tariff-free import of specific goods from another WTO member, then it must extend the same treatment to the same goods originating in all other WTO member countries;
- limitation of tariffs. The objective of GATT and GATS is to reduce tariffs over time. With the exception of some special cases (e.g., agricultural products and cars), tariff levels on goods are now relatively low; and
- quantitative restrictions. Quantitative restrictions on imports – e.g. such as quotas – are generally prohibited (but this rule does not apply to services).

Whilst the underlying principles of GATT and GATS are similar, the rules in relation to goods are significantly more advanced than those in relation to services. This is especially unfortunate for the UK, given that its economy is heavily biased towards the provision of services.

Free trade – a bold move?

If it were minded to do so, the UK could take the bold step of declaring itself a “free trade zone” – i.e., it would not impose tariffs on goods or services imported into the UK. This would clearly be a high-risk strategy, both in terms of revenue and balance of payments, and in competitive terms. Of necessity, this would be a unilateral measure on the part of the UK and would only apply to imports into the UK. In view of the “most favoured nation” clause discussed above, the offer would have to be extended on equal terms to all WTO member countries. Exporters from the UK would remain subject to the EU's external tariff and to the tariff rules of third countries with which they do business.



Depending upon one's point of view, such a move would be either laudably bold or exceedingly foolhardy. Some of the obvious disadvantages have already been noted. But possible attractions include the following:

- first of all, this move would be in harmony with the UK's reputation as a free-trading nation (and, to use a favoured politician's expression, to demonstrate that the UK is “open for business”);
- secondly, it would of necessity be a worldwide measure that would portray an outward-looking UK confident in its own future;

- thirdly, it would provide to the UK a strong political basis to negotiate improved trade arrangements with other WTO members;
- fourthly, the UK would no longer be applying the EU's common external tariff. Third country exporters would therefore be able to compete for business in the UK more vigorously than has been the case to date (although, of course, similar tariff-free access would have to be extended to the remaining EU Member States); and
- fifthly, as noted, the declaration of the UK as a free trade zone could be made by a post-Brexit UK unilaterally and without negotiation with, or the consent of any other country or organisation. It would, therefore, serve as something of a trump card and would represent an unequivocal demonstration of the UK's (repatriated) sovereignty in the sphere of international trade. Such a move might also play well with those who believe the EU's single market to be a protectionist (as opposed to a competitive) construct.

Of course, the above proposal would not solve all of the UK's potential difficulties. For example, it may be necessary to take other measures to ensure that foreign investors remain confident of their position in the UK and continue to view this country as a natural destination for their activities. But a unilateral decision to opt for free trade would send a clear message to both actual and potential trading partners, within the EU and beyond.

Conclusions

As noted above, the abolition of tariffs by the UK would represent a high-risk strategy on its part. Yet there are attractions to this route. The "out" vote necessarily means that the UK has to chart a new course, so it may be that radical solutions are to be preferred to interminable negotiations in Brussels.

More fundamentally, negotiations with other EU Member States will be difficult and protracted, leading to a period of uncertainty. The current EU climate suggests that goodwill towards the UK may be starting to evaporate, so that an acceptable agreement may be impossible to reach in any event. A unilateral declaration of free trade would deal with these problems at a stroke.

It remains to be seen whether the UK Government is sufficiently bold (or foolhardy?) to reach for such a radical solution.

This briefing has been prepared by Charles Proctor, a member of our banking and finance team. It does not necessarily reflect the views of the firm as a whole.

Further information?



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