

Brexit and the Future of Trade

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Abstract. International trade and investment are the biggest areas of economic policy that the UK will need to decide on as it prepares to exit the European Union. This chapter explains key developments that determine the economic challenges for UK's future trade policy. These include the rise of new forms of globalisation, the recent slowdown in wage and productivity growth and the current escalation of trade wars. It examines the best possible ways of addressing these challenges through the UK's future trade policy with the EU and the world economy, and its domestic policies for inclusive growth. The UK's best strategy would be to prioritise an ambitious trade deal with the EU and to pioneer a new generation of trade deals that re-balance the rights of different stakeholders.

Keywords. Brexit, trade and investment, trade agreements, tariffs, global value chains, multinationals

The United Kingdom is one of the most open economies in the world. Its exports and imports were over £600 billion (30 per cent of UK GDP) each last year. It is "extremely open" from an investment perspective, both its outward and inward FDI stocks, equivalent to 55% and 46% of GDP in 2015, are higher than the UK share in OECD GDP. Given their importance for the economy and the dependence on EU policy in these areas, international trade and investment are the biggest areas of economic policy that the UK will need to decide on as it prepares to exit the European Union.

Despite all the concerns about the upheaval Brexit will cause, it will nonetheless present a once in a lifetime opportunity to re-define Britain's role in the world economy.¹ New economic and political developments - rising economic marginalization, trade wars, a weak world economy and new forms of globalization – must be taken into account as the UK decides on its post-Brexit policy. This chapter explains key developments that determine the economic challenges that the UK needs to address through its future trading relationships. It examines the best possible ways of addressing these challenges through its future trade policy with the EU and the world economy, and its domestic policies for inclusive growth.

The Brexit vote in June 2016 revealed the extent of political polarization within the country, much of which can be traced back to decades of marginalization faced by economically declining areas of the country. Political developments outside Britain, like the economic policies and trade wars of President Trump, have further revealed the fragility of the existing trading system. Many have understood these events as a backlash against the world trading system and a rejection of policies which have perpetuated years of economic neglect of large sections of society.

This apparent backlash against globalization has come at a time of sluggish income and productivity growth in the world economy. The global financial crisis has deepened the economic hardship faced by many people. Wage growth in almost all advanced economies is much lower than before the crisis. Productivity growth continues to be slow, even negative, after the crisis. The UK has fared worse than many advanced economies. Since the global financial crisis, UK real wages have fallen by more than in other OECD countries and

relative wage growth is just above that of Greece.² The modest real wage recovery that started in 2014 has recently been eroded by higher price inflation from the sterling depreciation that followed the vote to leave the European Union (EU). Productivity has also fallen after the financial crisis and is recovering more slowly than in France and Germany.

A small open economy like the UK has more at stake than most other nations from the backlash against globalization and weakened world economy. Reduced trade and investment can exacerbate the negative trends in wage and productivity growth by reducing the level of economic activity with foreign markets. The UK must therefore seize this difficult yet historic moment to create agency for a modern trade policy that strives to support inclusive growth.

The UK's Relationship with the EU

We need to start with realism. The EU is the UK's largest trade partner. Around a half of the UK's trade is with the EU. As a member of the EU, the UK is in a customs union with member states, and conducts its trade policy collectively with them. A customs union means that all tariff barriers have been removed within the EU and members charge the same tariffs to countries outside the EU. Membership of the single market means eliminating non-tariff barriers that apply across goods and services and accepting common standards and regulations.

The main economic issue generated by Brexit is that the UK is highly integrated with the EU and its separation will increase the costs of doing business with member states. To take just one example, outside of the customs union, all goods sold to the EU would need to satisfy rules of origin checks, which can add between 4 and 15 per cent to the cost of a good.³ In the event of a 'No Deal' Brexit, cars would incur a 10% tariff rate, which the head of European manufacturing at Nissan stated would be a 'disaster' for the UK automotive industry. Furthermore, there may be divergence in regulation between the UK and EU such that regulatory checks will be required for goods, services and investments.

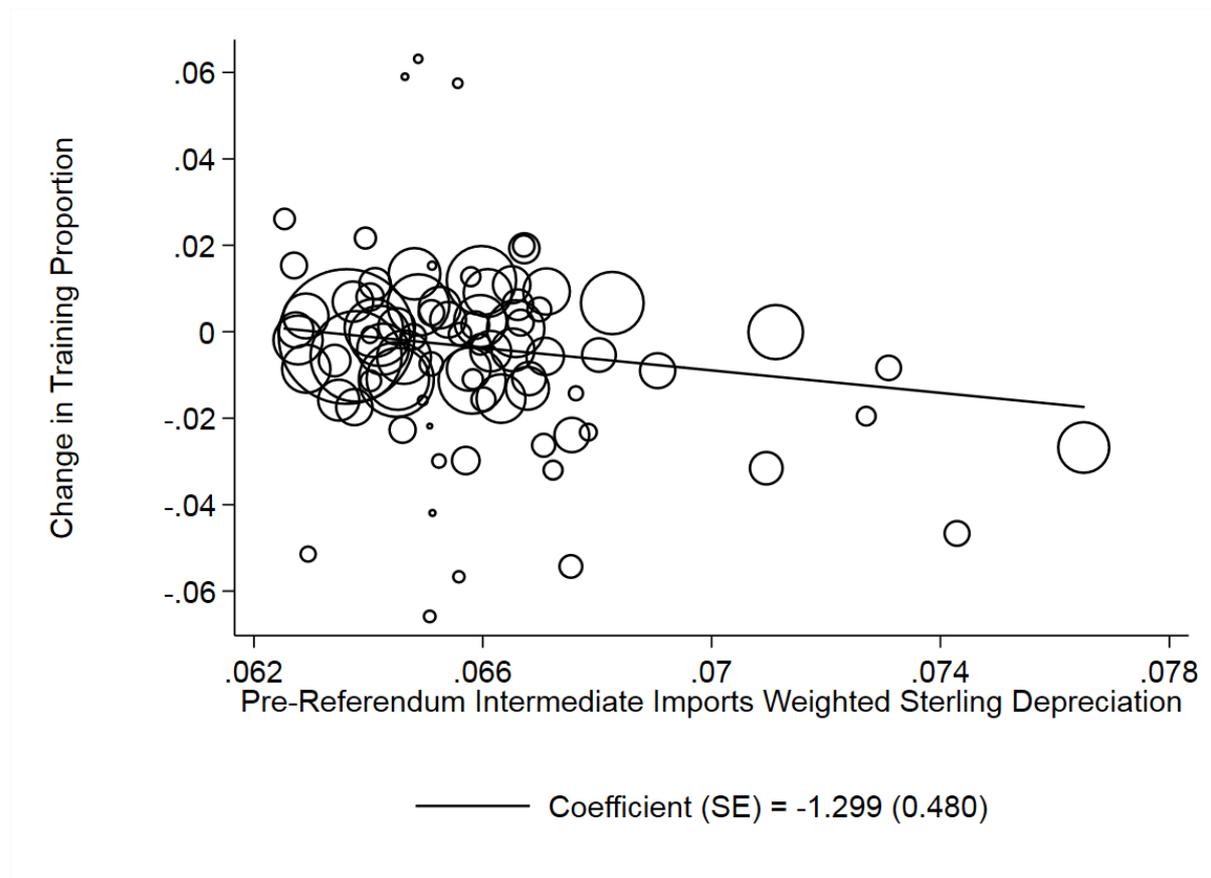
State-of-the-art models of international trade, using comprehensive trade data, estimate that a no-deal option would lead to a large reduction - about 40% - in trade with the EU over the next ten years.⁴ Reduced trade alone would imply a 2.9% reduction in income per capita (or 2.6% net of changes in budget payments to the EU). In a 'No Deal' scenario, a decade of higher trade barriers would translate into a reduction of £1,890 in household income every year after Brexit relative to the UK's existing relationship with the EU. These costs would be halved if the UK followed a Norway-style relationship with the EU (inside the single market but outside the EU customs union). Overall, there is a *consensus* among economists that UK's trade and investment with the EU will fall substantially after Brexit, and the extent of these costs will depend on Britain's post Brexit trade policy (although it should be noted that the UK could stay in a customs union for some time as a consequence of the Northern Ireland 'backstop' provisions of the proposed Withdrawal Agreement between the UK and EU).

The Global Britain campaign is banking on the prospect of new Economic Partnership Agreements (EPAs) with China, India and the USA to cushion this fall. But evidence suggests that the UK stands to lose more by diverging from the EU than it is likely to gain from new deals. Throughout history - and even in this new age of services, complex supply chains and the "death of distance"- countries trade the most with their biggest, closest neighbours. This is by far the most robust fact about international trade - it is true across a

range of countries, time periods and sectors (goods, services, e-commerce and foreign investments). Estimates of economic models that replace EU membership with a free trade agreement with the United States or with unilateral zero tariffs in the UK estimate that these will barely make up for a fraction of the losses from reduced economic ties with the EU after Brexit.

The so-called 'Chequers' statement of UK government policy recognizes this economic reality, and proposes a single market for goods between the UK and EU, and a customs arrangement that allows the UK freedom to decide its own external tariffs. The proposal tries to minimize trade frictions in goods, but it contains limited details on how to implement a customs arrangement that has not been tried before on this scale by any country. Importantly, it remains vague on services, which make up 80% of the UK economy and where single market membership provides greater market access than even the most ambitious EPAs of the EU (such as with South Korea and Canada). Over the long term, Brexit is clearly expected to reduce economic activity and living standards in the UK relative to the status quo.

Early indicators provide worrying evidence that this has already started happening since the Brexit vote. Immediately following the referendum, sterling suffered its biggest one-day loss since the introduction of free floating exchange rates in the 1970s - a bigger drop than Black Wednesday and the height of the financial crisis. In fact, the Brexit sterling fall is the biggest drop that has ever occurred in any of the world's four major currencies since the collapse of Bretton Woods. The sterling depreciation from the Brexit vote was expected to benefit UK exporters and improve the earning potential of domestic workers. But new research from the Centre for Economic Performance shows that wages and training of workers have fallen since the referendum. The rise in the costs of imported inputs have led to lower wages and fewer training opportunities for workers in the UK, which could reinforce the trends of anemic wage and productivity growth.



The UK is deeply integrated in global value chains and access to the EU market is a key driver of its position in the world economy. Given the EU is the UK's closest trade partner in terms of geographical proximity and is a large market with a GDP of almost \$20 trillion (double that of China), finding any equivalent size replacement is effectively impossible. Importantly, what makes this relationship unique is that when one compares the EU's standards on goods, services and labour these seem far more aligned to those of the British people than those in the US, China and India. This is why securing deep trade deals that reduce non-tariff barriers without compromising domestic standards would be far harder with these countries. The next section discusses how this might be best approached.

A new generation of trade deals

Early trade agreements, until the 1990s, focused on easing trade and investment by reducing tariffs. Today tariffs are low in most industries and the services sector - which has no tariffs - dominates economic activity in many countries. Modern trade agreements have therefore moved beyond tariff reductions: the bulk of modern trade policy is about reducing the costs of doing business across borders. This includes streamlining customs procedures and port inspections, rules of origin checks, cross-country differences in regulations over things like product standards and safety, easing eligibility requirements for foreign service providers and investors, and settling disputes that might arise with foreign partners. Deep trade deals increase trade volumes by reducing these non-tariff barriers (NTBs), creating an integrated market where domestic and foreign businesses play by the same rulebook.

While deep trade deals raise economic activity and competition by granting market access to each others' businesses, they come with an inevitable trade-off between integration and national sovereignty. Countries involved in deep trade deals or EPAs, need to agree similar rules, standards and oversight policies so that businesses compete on a level playing field. If partner countries have similar preferences, it's easy to agree on these rules without giving up much sovereignty. For instance, the UK gives up some sovereignty when it applies the EU's Toy Safety directive on its businesses. But the loss in sovereignty is small because the safety concerns of UK consumers are similar to those of EU consumers. Many non-tariff barriers though reflect a clear difference in preferences between countries rather than an unnecessary impediment to be shaken off. For example, UK consumers differ from US consumers in their tastes for hormone fed beef and chlorine washed chicken, so harmonizing safety standards for these products would be undesirable for some consumers. EPAs aim to balance market access for businesses with the need to maintain high standards in products, services, environmental, labour and consumer rights. But they have not always been successful in getting the balance right, and this has culminated in strong anti-globalization sentiments.

EPAs have not grappled with the profound pressures that new forms of globalization have placed on the rules-based trading system, such as the dominance of multinationals, the centrality of supply chains, and the growing importance of intermediate inputs and services. Nor have they generally upheld the spirit of equitable rights across stakeholders, which is the purpose of a rules-based trading system. Dani Rodrik of Harvard Kennedy School argues that the regulatory standards in EPAs - covering health and safety rules, investment, banking and finance, intellectual property, labour, the environment – tend to empower politically well-connected firms, including international banks, pharmaceutical companies, and multinational firms.⁵ Many who are left behind by recent waves of globalization share this view. They feel that they have little say in the rules governing globalization and seldom have access to notional protections enshrined in EPAs to balance the rights of different stakeholders.

The UK has an opportunity to help shape a model trade policy that recognizes the new realities of the rise in global value chains, services and multinationals and that takes on board the concerns of those who have been left behind by the growth of the last few decades. Despite the fact that the UK hasn't been running its own trade policy over recent decades if we cast back further we see it has historical experience to draw on. Along with the United States, the UK was a key actor in laying down the rules for a trading system to prevent countries from engaging in mutually damaging trade wars which arose in response to the Great Depression. Building on this legacy, the UK could seek first mover advantage by drafting a new generation of EPAs that promotes inclusive growth.

This will be necessary if the UK chooses to pursue an independent trade policy, especially under the existing challenges of a weak world economy. But if the UK opts to conduct its trade policy in a customs arrangement with the EU, it will still have influence over the content of deep provisions in EPAs. The European Court of Justice has already ruled that EU member governments have a vote on deep provisions in EPAs, such as investment clauses, so the UK is unlikely to be bound by EU rules on these under a customs arrangement.⁶

Whichever post-Brexit course it takes, the UK should be pushing for a generation of EPAs that reflects public concerns. Many citizen groups are concerned that the existing imbalances in EPAs will exacerbate the race to the bottom on domestic standards, especially when the UK embarks on new trade deals with large countries that have very different standards. The UK can alleviate these concerns by drafting a modern EPA, which ensures that the same rules

and rights apply to all stakeholders - domestic or multinational businesses and workers, consumers or investors.

Non-discrimination across stakeholders has always been the fundamental principle underlying EPAs, but it has been eroded by the fragmentation of production across borders. For example, Rodrik argues global disciplines on tax-and-subsidy competition have not been addressed in EPAs because they serve the interests of foreign investors, and ultimately rob taxpayers by enriching corporations in a harmful race to the bottom. The rise of new forms of globalization has created violations of the spirit of equitable rights across stakeholders, which is the essence of a rules-based trading system. The litmus test of the success of a post-Brexit policy will therefore be the extent to which it reinstates the principles of National Treatment for all businesses and Non-Discrimination across all stakeholders, which are now discussed in turn.

Reinstating National Treatment for All Firms

National treatment is a fundamental principle of most EPAs, which ensures that countries do not discriminate against foreign companies. The underlying motivation is that businesses must compete on a level playing field to ensure the greatest economic benefits are realized from EPAs. The UK could take a leadership role in advocating national treatment by applying the same rules on the opposite side – multinational enterprises (MNEs) should be accorded the same treatment as smaller businesses and domestic firms.

MNEs directly account for half of global exports, a third of world GDP and a fourth of all employment. They have the ability to source inputs and credit from different countries and to shift profits across different tax jurisdictions. This amounts to MNEs facing different business conditions than firms that might be smaller or purely domestically oriented. Tax shifting is the most striking example of this. About 40% of multinational profits are shifted to tax havens globally, and non-tax haven EU countries, like the UK, are estimated to suffer the greatest revenue losses as a result.⁷ The ratio of taxable profits to total assets of foreign multinational subsidiaries in the UK is 12.8 percentage points lower than similar domestic firms (that belong to the same industry and have a similar asset size).⁸

Parliament and government have been at the forefront of plugging loopholes that enable MNEs to shop around for tax benefits and other cost reductions. For example, the UK has previously negotiated tax treaties and data sharing with a number of countries, including with Liechtenstein after the 2008 tax scandal. One approach for reinstating national treatment is through multilateral bodies, such as the OECD and the G20, that are proposing international tax reform. This enables coordinated action, but many would argue that their multilateral provisions are weak because they are non-binding guidelines. They also argue that it does not tackle the fundamental issue that individual governments engage in a race to the bottom by offering attractive tax breaks to MNEs at the expense of other countries. The UK can continue supporting these multilateral efforts. But it would set an exemplary precedent if it followed up with unilateral action if it has the opportunity to do so.

There aren't readymade solutions to do this, but some of the possibilities include taxing all MNEs that *sell* in the country and enforcing equal treatment of all domestic firms and MNEs in terms of profits. Treating MNEs that sell in the UK at par with MNEs that locate in the UK would avoid penalizing firms that create jobs here. This is one of the motivations for the US proposal to tax incomes based on the country where the income is generated. Taxes based on sales destination prevent the flight of footloose capital, but not profit shifting to exploit the

best tax concessions globally. This can be contained if the UK takes the stance of benchmarking MNEs with purely domestic firms or by extending similar benefits to domestic firms. Any action would need to carefully weigh the potentially conflicting commitments in previous tax or investment treaties with the objective of maintaining real competition. A post-Brexit reset in trade policy is an opportune political moment to have this overdue discussion.

Reinstating Non-Discrimination for All Stakeholders

A second fundamental principle that the UK needs to reinstate is non-discrimination, which has been eroded because many EPAs give greater rights to investors over other stakeholders. Since 1975, the UK has negotiated over ninety bilateral investment treaties, almost all of which include provisions to enforce investors' rights. Until now, the bulk of these treaties have been with countries that are net recipients of investments from the UK, so the investment agreements were largely designed to protect UK investors from expropriation of assets in developing countries with politically unstable conditions.

With the fragmentation of supply chains, most EPAs today contain provisions regarding settlement of disputes brought by investors against host governments. These are often referred to as Investor State Dispute Settlement (ISDS) clauses. They give foreign firms the right to bring claims against the host country if they have not been given fair and equitable treatment. ISDS clauses are increasingly being used by investors to challenge developed country governments. Many challenges have been in sensitive policy areas like public health and environmental safety, and include cases such as the plain packaging of tobacco and the withdrawal of operating licenses for nuclear power plants.

The main contention with ISDS clauses is that the language of what constitutes a violation of investor rights is too vague. This constrains governments from changing laws and can lead to a regulatory chill due to the fear of expensive litigation from foreign investors. Furthermore, the settlement procedure is typically opaque and costly. And there is a growing recognition that ISDS confers rights to foreign companies that are not available to domestic companies. There still isn't a standard solution to balancing the rights of foreign investors for fair compensation and the right to regulate for host governments. In fact, ISDS clauses have been contentious even between developed countries with advanced legal systems, like Germany and Sweden. These problems are expected to become more acute as developed countries get into EPAs, like a transatlantic partnership between the EU, UK and USA. Typically, the US insists on an ISDS mechanism to settle disputes between foreign firms and host governments – indeed, cases brought under US-style ISDS procedures have been some of the most controversial.

New solutions for balancing investor rights with regulatory discretion are being proposed, and the UK can join these efforts to develop workable proposals. For example, New Zealand has signed side letters with several countries in the newly revived Comprehensive and Progressive Trans-Pacific Partnership to opt out of compulsory ISDS. It has also instituted a review of all foreign investments in sensitive areas and proposed safeguards for areas, like public health, education and social services, where investors cannot challenge governments.

The UK could go further in ensuring that its public services and domestic standards are not compromised through ISDS procedures. One way that many EPAs do this is by including chapters on social clauses - environment, health and labour rights. Typically, these have been motivated by concerns that developing countries are likely to have lower standards in these

areas, and including social clauses in EPAs would induce them to comply with higher standards. But this has meant that the language of these social provisions is weak and they often have limited legal enforceability or compensation for damages. In contrast, investor rights are legally enforceable and the areas that can be challenged under these provisions is much wider.

The UK could seek to redress this imbalance by tightening the language of investor protections and by granting to stakeholders, like workers and consumers, similar rights and dispute settlement procedures as are given to investors. For example, since 2007, the US upgraded labour disputes from a separate sanction to the status of dispute settlement procedures that apply to other commercial disputes.⁹ Enforceability of stakeholder rights would also promote the spirit of sustainable development that the UK has championed for the developing world when they have negotiated with developing country trade partners.

Reinstating National Treatment and non-discrimination would be big steps towards redressing imbalances in EPAs. But ultimately, trade policy can only do so much in fostering inclusive growth. As Barry Eichengreen of University of California-Berkeley highlights, there is no easy solution to long-term economic problems.¹⁰ To undo the years of economic stagnation faced by many, a post-Brexit economic policy would need to commit to investing in skills so that people face lower risks of being left behind in the future.

Conclusion: Instituting A New Social Compact

Wages have decoupled from productivity and many working families in the UK have never really shared in the prosperity that globalization has brought to many global firms and their workers in the last few decades.¹¹ While redistribution of economic gains can provide compensation to workers who are hurt by economic changes, it is difficult to achieve when the gains are concentrated on one side of the border. There are no good worldwide redistribution systems and these are highly unlikely to arise in the current context of trade wars. Domestic policy will have to continue to fill this gap.

As a starting point, what's needed is an adjustment assistance fund that compensates people who are displaced by economic changes. A post-Brexit UK would be more inclusive of ordinary working families if they had access to an enforceable mechanism to compensate them for job losses induced by broad economic changes. The evidence on the effectiveness of such programmes, like the trade adjustment assistance in the US and EU, has been mixed. For example, these programmes often have stringent eligibility criteria and are heavily under-used, leaving workers exposed to hardship from changes in their economic environment. The UK will therefore need to learn from the improved provisions that countries are putting in to make these programmes more effective. These include higher levels of funding, systematic monitoring and evaluation mechanisms, less stringent eligibility criteria and streamlined application procedures.

But compensation alone will not solve the problems of the constant churn to which workers are exposed. Ultimately, wage and productivity growth requires re-training and upskilling of the workforce. High productivity, low inequality economies like Denmark and Sweden commit over 1% of GDP to investments in skills, while countries with greater inequality, like the US and the UK, invest substantially less than that. Going forward, if private investments in skills fall, as is happening already in the UK, public investments would need to step up further to protect workers from permanent income losses.

The UK can ensure these policies are supported along with market access provisions in EPAs. For example, the US brought about companion treaties on labour rights and standards under NAFTA and has subsequently included labour rights in other EPAs. The UK can follow a similar approach of linking labour rights, compensation and rehabilitation policies to EPAs, and by learning the lessons from the inadequacies that plague existing provisions. For example, the NAFTA labour side agreement pledges to enforce effectively national labour laws, but it does not provide for effective sanctions. On the positive side, it has a complaints and arbitration procedure that has led to developments, like reforming Quebec's anti-union laws and enforcing health and safety standards in Mexican maquiladoras. But sanctions to remedy non-compliance apply to just a few of the labour standards set out in the accord. The UK should take on board the relevant suggestions: specifying rules for accepting or rejecting cases, following up on issues raised by petitioners, deciding what constitutes an appropriate government response to violations and creating oversight bodies to pursue violations.

Anticipating exactly who will be hurt from a particular policy is always difficult - it can take years before the link between job displacements and economic policies becomes apparent. Worryingly, the Brexit vote is already de-skilling UK workers and reinforcing the trends of anaemic wage and productivity growth. Whether the UK operates its post-Brexit trade policy independently or via a customs union with the EU it should be pushing for EPAs that deliver market access without compromising the UK's high standards on labour, products, services and safety.

It will be exceedingly hard to replace any loss of access to the EU market and to find trade partners that share the high quality standards that the UK has always maintained. Any new EPAs with China, India or the US need to respect these high quality standards. If it ends up outside of the EU customs union the UK's best strategy would be to pioneer a new generation of trade deals that balances the rights of different stakeholders and addresses the new economic reality of global value chains and multinationals. The three rebalancing provisions - national treatment, non-discrimination and a new social compact - would be the first steps towards an inclusive economic model. In the current era of strong anti-globalisation sentiments, a post-Brexit trade policy must be re-gearred to truly serve British society, not just free trade.¹²

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