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A HITCH-HIKER'S GUIDE TO POST-BREXIT TRADE NEGOTIATIONS: QUESTIONS, OPTIONS AND PRINCIPLES[1]

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Introduction

The United Kingdom (UK) has voted to leave the European Union (EU). But what comes next is unknown. The referendum rejected the status quo, but did not endorse any alternative vision of the UK's relations with the EU. This article discusses the future of UK trade policy following the referendum vote. We begin with a brief review of the main options for future UK-EU trade relations. We then discuss the purpose of trade negotiations and what principles the UK government should adopt to guide its negotiating strategy.

In earlier work we have analysed the economic consequences of Brexit (Dhingra et al. 2016a,b) and discussed what policies the UK should adopt if it leaves the EU (Dhingra and Sampson 2016a). This article focuses on a different question. What strategy should the UK government adopt to secure the best possible outcome for the UK in future trade negotiations? We do not attempt to suggest specific policy goals for the UK. Instead, we outline principles the UK can follow to best achieve whatever objectives it chooses.

Three options for future UK-EU trade relations

Leaving the EU will not allow the UK to wash its hands of dealing with the rest of Europe. Post-Brexit, the EU will continue to be the world's largest market and the UK's biggest trading partner. Dhingra and Sampson (2016b) outline three main alternatives for the UK following Brexit: remain part of the Single Market like Norway; negotiate bilateral trade deals with the EU like Switzerland and Canada have; or trade with the EU under World Trade Organization (WTO) rules like the United States and many other

[1] We are grateful to Amartya Menon for excellent research assistance.

non-European countries do. These options capture a trade-off between economic integration and political sovereignty. Greater economic integration requires agreement on international coordination of decision making in some areas of economic policy. Inside or outside the EU, this trade-off is inescapable.

Remaining in the Single Market would lead to the fewest changes in UK economic policy. Norway, Iceland and Liechtenstein belong to the Single Market by virtue of their membership of the European Economic Area (EEA). There is free movement of goods, services, people and capital within the EEA. Since EEA members are part of the Single Market, they must implement EU rules concerning the Single Market, including legislation regarding employment, consumer protection, environmental and competition policy.

EEA membership does not oblige countries to participate in monetary union, the EU's common foreign and security policy or the EU's justice and home affairs policies. EEA members also do not participate in the CAP. While there is free trade within the EEA, EEA members are not part of the EU's Customs Union, which means that they can set their own external tariff and conduct their own trade negotiations with countries outside the EU. However, it also means exports between EEA members and the EU are subject to rules of origin requirements.[2]

EEA members effectively pay a fee to be part of the Single Market. They do this by contributing to the EU's regional development funds and contributing to the costs of the EU programmes in which they participate. In 2011, Norway's contribution to the EU budget was £106 per capita, only 17% lower than the UK's net contribution of £128 per capita (House of Commons 2013). Becoming part of the EEA would not generate substantial fiscal savings for the UK government.

The second option available to the UK is to negotiate a free trade agreement (FTA) with the EU. There are many types of FTA offering differing degrees of economic integration. A simple FTA would merely remove tariffs on goods trade between the UK and the EU. But most modern FTAs, such as the Canada-EU FTA, also include provisions to increase market access in services and to reduce non-tariff barriers to

[2] 'Rules of origin' are used to determine whether a product originated in a free trade area is eligible to enter a market duty-free. The precise specifications of rules of origin are complex and variable, but typically to benefit from free trade a product must undergo a certain level of processing within a country that belongs to the free trade area, or a certain proportion of its value-added must come from within the free trade area.

trade.[3] However, a FTA would not provide the same level of market access as membership of the Single Market. Most FTAs do not include free movement of labour, although Switzerland's bilateral treaties with the EU are an exception.

Instead of negotiating a FTA, the UK could seek to remain part of the EU's Customs Union. In this case there would be no tariffs, customs procedures or rules of origin to restrict UK-EU trade, but the UK would be bound by the EU's common trade policy meaning it would not be able to negotiate its own free trade agreements with non-EU countries. In addition, Customs Union membership would not guarantee market access for services trade or necessarily ensure low behind the border non-tariff barriers.

The final option available to the UK is to revert back to trading with the EU under WTO 'most favoured nation' (MFN) rules. As a WTO member, the UK's exports to the EU and other WTO members would be subject to the importing countries' MFN tariffs. Compared with EU or EFTA membership, this would raise the cost of exporting to the EU for UK firms due to increased tariffs and non-tariff barriers. The UK's services trade would also be subject to WTO rules. Since the WTO has made far less progress than the EU in liberalising trade in services, this would mean reduced access to EU markets for UK service producers.

The WTO has no provisions for free movement of labour, so under this scenario, free labour mobility between the UK and the EU would cease. But free movement of capital between the UK and EU would probably continue, as the EU prohibits restrictions on capital mobility not only within the EU, but also with countries outside the EU.

[3] 'Non-tariff barriers' is a catch-all term referring to any measure that raises the costs of trade but does not take the form of a tariff. It covers everything from quantitative trade restrictions such as import licensing to border costs of complying with customs procedures and behind the border costs caused by regulatory or product standard differences across countries. The EU Single Market has reduced non-tariff barriers between member states by removing customs procedures and harmonising regulations and product standards.

The purpose of trade agreements

Unless the UK chooses the WTO option, Brexit will require negotiating a new trade relationship with the EU. These negotiations will take many years and play an important role in shaping the UK's economic future. A successful strategy for trade negotiations must be grounded in a clear understanding of why countries negotiate trade agreements and how agreements are reached. Drawing upon Sampson (2016) we next review the purpose of trade agreements and why international agreements lead to better outcomes than if each country makes unilateral policy decisions. Then, we show how understanding the purpose of trade agreements helps explain the way countries conduct trade negotiations. Finally, we use this analysis to identify four principles to guide the UK government's approach to its post-Brexit trade negotiations.

When a country sets trade policy unilaterally it does not account for how its choices affect the rest of the world. But because countries are interdependent, the effects of trade policy do not stop at national borders. In the language of economics, trade policy generates international externalities. And frequently these externalities lead to beggar-my-neighbour effects which make other countries worse off.[4]

Trade policy externalities operate through three main channels. First, terms of trade effects. Each country can use trade policy to improve its terms of trade by raising the price of its exports relative to its imports. For example, OPEC countries improve their terms of trade by restricting the supply of oil to drive up its price. But one country's exports are another country's imports. Consequently, a country can only improve its terms of trade by making imports relatively more expensive for the rest of the world. A high price of oil benefits oil exporters, but hurts oil importers. Voting to leave the EU has already reduced the UK's terms of trade by causing the pound to depreciate. A cheaper pound makes UK exports more competitive, but also raises the cost of imports leaving UK consumers worse off.

Second, production location effects. Countries compete to attract investment from internationally mobile firms. Policies designed to attract foreign investment include reducing tariffs on intermediate inputs and providing production subsidies through tax breaks or loan guarantees. Ireland has been very successful in using investment incentives to attract multinational firms. But while Ireland benefits from

[4] Grossman (2016) provides a detailed overview of the reasons for pursuing trade agreements.

increased investment and employment and from obtaining access to new technologies, other countries lose out. Location decisions are a zero sum game.

Third, even when firms are immobile, trade policy can be used to raise the profits of domestic firms at the expense of their foreign competitors. This profit shifting effect lies at the heart of the decades long battle between the US and the EU to capture a greater share of aircraft industry profits by subsidising Boeing and Airbus, respectively.

Terms of trade effects, production location effects and profit shifting effects all provide reasons for governments to adopt trade policies that benefit the domestic economy while hurting other countries. But if all countries act in this way the benefits cancel out and the world as a whole ends up worse-off because of the distortions the policies create. For example, suppose the EU tries to improve its terms of trade by charging tariffs on imports from the US. Rather than accepting a deterioration in its terms of trade, the US could ensure the terms of trade remain unchanged by imposing its own tariffs on imports from the EU. In this case both countries end up losing because the higher tariffs will distort production and consumption decisions and increase the price producers pay for intermediate inputs.

Put another way, unilateral trade policy is beneficial only if other countries do not respond by changing their policies. In trade wars everyone losses. This is why trade agreements are needed.

By negotiating trade agreements countries can internalize the externalities resulting from international interdependencies, avoid damaging trade wars and make all countries better off (Bagwell and Staiger 1999, 2002). Importantly, this is true regardless of whether governments' policy choices are motivated by the desire to maximize economic output, the wish to protect particular groups of workers and firms or the pursuit of other social objectives. Whenever policies have international spillovers that governments fail to internalize there is scope for international agreements to make all countries better off.

Trade negotiations

To reap the gains from international coordination, trade agreements require governments to give up unilateral control over some policies. Members of the World Trade Organisation (WTO) give up the right to use import quotas and production subsidies and agree limits on the tariffs each country can charge on imports from other members. More recently, the scope of trade agreements has expanded to cover new areas such as intellectual property rights, health and safety standards, foreign investment and rules for trade in services.

In all these areas, the nature of trade agreements is that governments give up some control over their own policies in exchange for other countries doing the same. The goal of negotiations is to prevent countries from following beggar-thy-neighbour policies, while not restricting the ability of governments to achieve their domestic policy objectives. The WTO's ban on import quotas satisfies this goal since it prevents countries from using quotas to manipulate the terms of trade, affect firms' location decisions or shift profits between countries, but import quotas are not needed for domestic policy purposes.
Understanding the purpose of trade agreements has immediate implications for how trade negotiations are conducted. Trade negotiations are not about countries identifying a common objective and working together to achieve it. They are not a cooperative endeavour.

Instead, trade negotiations are a bargain between countries with competing objectives. Each country must give up something it values in order to obtain concessions from other countries. This idea is embodied in the 'principle of reciprocity' which guides WTO negotiations. The principle of reciprocity requires all countries to make equivalent concessions during negotiations. Equivalence is usually interpreted to mean the outcome of the negotiations should not affect countries' trade balances.

Four principles for Brexit negotiations

Leaving the EU's Customs Union would be the start of many years of trade negotiations for the UK. The outcome of these negotiations will determine the UK's place in the global community and the future well-being of UK citizens. To achieve its post-Brexit objectives, the government needs a negotiating strategy based upon a clear-eyed understanding of how trade agreements work. The preceding discussion of the purpose of trade agreements and the realisation that negotiations are a bargaining process between countries with conflicting goals suggests four principles the UK should use to guide its trade negotiation strategy.

1. You Get What You Give

To reap the benefits of trade agreements, the UK must be willing to give its trading partners something they value. Making concessions provides a reason for other countries to give the UK what it wants. In general, the more countries are willing to concede and the more policy control they give up, the bigger are the potential gains from reaching an agreement.

The government must enter negotiations knowing not only what it is (and what it is not) willing to concede, but also what concessions it wants to obtain from other countries. An important question the UK is likely to face is how much it is willing to give the EU in return for the EU allowing UK services firms to participate in the Single Market. Unless the UK makes a sufficiently attractive offer, the EU will take the opportunity Brexit presents to impose new barriers on UK services exports. This will lead some companies to move their production location out of the UK.

The fact that trade agreements are based on mutual concessions also has important implications for the desirability of unilaterally removing import tariffs. Unilateral tariff liberalisation is an attractive policy for many reasons. It reduces consumer prices, lowers the cost firms pay for imported inputs and capital goods, removes price distortions and makes trade policy less subject to capture by lobbyists. But a major disadvantage of unilateral liberalisation is it involves giving up an important bargaining chip. If the UK chooses a zero tariff policy, there is no need for the EU to seek a free trade agreement to obtain tariff free access to the UK market. And without a free trade agreement WTO rules mean tariffs will be imposed on the UK's exports to the EU.

2. Where Negotiations Start from Matters

The outcome of any bargaining game depends upon where negotiations start from. Trade agreements are no exception. The policies each country will adopt if no agreement is reached provide a reference point, or threat point, for the negotiations. Countries make concessions starting from this reference point. Consequently, trade negotiations are path dependent and the final outcome depends upon the starting point.

For most trade negotiations the reference point is the status quo. For example, the ongoing negotiations between the US and the EU over the proposed Transatlantic Trade and Investment Partnership (TTIP) start from the understanding that if no agreement is reached US-EU trade relations will remain unchanged. However, it is unclear what the reference point for negotiations between the UK and the EU would be, since it is not known what the UK's trade relations with the EU would be if negotiations failed.

Consider two alternatives. First, suppose the reference point is the current status quo in which the UK is a member of the Single Market. In this case, allowing the UK to impose restrictions on immigration would represent a concession from the EU and, in accordance with the principle of reciprocity, the UK would need to make an equivalent concession in return.

Second, suppose the reference point is trade under WTO rules. In this case, there would be no presumption of free movement for labour meaning the UK would not need to negotiate restrictions on immigration. Instead, the negotiations would start from a position where UK based financial institutions did not have passporting rights to operate in EU countries. Consequently, the UK would need to offer concessions to the EU in exchange for passporting rights.

These examples illustrate how the reference point for negotiations determines what countries bargain over and, consequently, the outcome of negotiations. Before any trade negotiations between the UK and the EU take place, there will have to be an agreement on what the reference point is. Deciding the reference point is no less important than the negotiations themselves and the UK government should seek a reference point that ensures it can achieve its post-Brexit objectives.

In principle, trade negotiations are supposed to involve countries making reciprocal concessions of equivalent value. In practice, this is not always the case. It is often difficult to determine the value of a concession and countries that bargain poorly will get a worse deal. This realisation leads to the final two principles that should guide the UK government's approach to negotiations.

3. Bargain from a Position of Power

Bargaining power affects the outcome of trade negotiations. Countries that are desperate to obtain a deal at any cost have little bargaining power and are less likely to achieve their objectives. As in any negotiation, being willing to walk away risks failure, but also strengthens a country's bargaining power by signalling the country will not accept a bad deal. Unfortunately, the UK is starting from a weaker position than the EU. Even though the UK has a trade deficit with the EU, UK-EU trade accounts for a much larger share of the UK's economy than the EU's economy.[5] Consequently, the UK needs a deal more than the EU does. This puts the UK at a disadvantage.

The weakness of the UK's position is exacerbated by the two year time limit on exit negotiations imposed by Article 50, which can only be extended with the consent of both the UK and the EU. Suppose that if no trade agreement is reached before the UK leaves the EU, UK-EU trade reverts to WTO rules with tariffs on goods trade and no access to EU markets for most UK services producers. Then as the two year limit approaches, the UK will become increasingly desperate to obtain an agreement making it more likely the UK accepts a poor deal. In this scenario, the EU has an incentive to slow down the pace of negotiations knowing that as time passes its bargaining position becomes stronger. This explains why EU leaders are currently refusing to conduct informal negotiations before the UK triggers Article 50. Reducing the time available for negotiations benefits the EU.

There are two obvious steps the UK can take to increase its bargaining power. First, delay triggering Article 50 until the government has decided its post-Brexit objectives and EU leaders are ready to start negotiations. Theresa May's commitment to invoke Article 50 in early 2017 before the French and German elections weakens the UK's position because the EU will not be able to participate in meaningful negotiations until after these elections. By triggering Article 50 too early the UK would unnecessarily start the two year clock ticking.

Second, the UK's immediate objective after invoking Article 50 should be to neutralise the two year time limit by agreeing a transition arrangement to govern UK-EU trade relations for as long as necessary between when the UK leaves the EU and when a longer term agreement is concluded. The UK should

[5] In 2014 the UK's trade deficit with the EU was £62 billion. However, the UK's exports to the EU accounted for 13% of UK GDP, whereas the EU's exports to the UK accounted for 3% of EU GDP.

seek a transition agreement that minimises the economic cost of Brexit and leaves unresolved contentious issues that may slow down the negotiating process. Returning to the principle that you only get what you give, the UK needs to decide what it is willing to offer the EU in return for a transition agreement.

The UK could also seek to improve its bargaining position by maintaining secrecy around its negotiating objectives and bargaining tactics. There is a difficult balance to be struck between the bargaining advantage the government could gain by keeping its cards hidden and the need for democratic accountability in formulating the UK's negotiating objectives and choosing between alternative trade policies. A reasonable solution could be to combine public debate on broad policy objectives with secrecy over the exact trade-offs the UK would be willing to make to achieve its objectives.

4. Invest in Negotiating Capacity

Trade agreements involve many simultaneous policy changes making it difficult to analyse their economic consequences. Smart negotiators use this uncertainty to their advantage by ensuring they are better informed than their opponents about who stands to gain and who stands to lose from any policy proposal. This enables them to secure the deal that best meets their objectives.

Having not participated in trade negotiations for the past forty years, the UK currently has very little negotiating capacity. To become a smart negotiator, the UK needs to invest heavily in four areas of expertise. First, it should hire the best available trade negotiators to negotiate on its behalf. Trade lawyers are needed to understand and write the text of trade agreements.

Second, it needs diplomatic expertise to provide information on the objectives and strategies of its negotiating partners. Successful negotiators outmanoeuvre their partners by anticipating what they want and what they're willing to concede. The UK's diplomats are well-placed to provide advice on what European leaders are thinking.

Third, the government should strengthen existing links and develop new links with UK businesses to obtain feedback on how they will be affected by different policies. Without speaking to businesses it is not possible to understand exactly how firms will respond to alternative market access arrangements. The government should seek to ensure ongoing communication throughout the negotiation process.

Finally, the government needs to invest in the expertise needed to analyse the economic consequences of alternative possible trade agreements and identify which proposals are best for the UK's economy. Economic considerations should not be the only factor that affects the UK's policy choices and economic analysis is a necessarily imperfect art, but without quantitative estimates of the effects of proposed trade agreements the government will not be able to evaluate the costs and benefits of different options. Moreover, high quality analysis will be necessary to understand whether the concessions other countries offer the UK during negotiations will indeed benefit the UK. The UK government does not currently have the capacity to undertake state-of-the-art quantitative analysis of trade policy. Building this capacity should be a priority if the UK chooses to leave the EU's Customs Union and develop its own independent trade policy.

Conclusions

Since the UK joined the EU in 1973 trade policy has played a minor role in UK politics. Now it's back. Much has and will continue to be written about what the objectives of post-Brexit UK trade policy should be. But whether the UK is able to achieve the objectives it eventually chooses, will depend upon the success of its negotiating strategy.

Trade negotiations are a bargaining game between countries seeking to reap the gains from international coordination while giving up as little as possible to their negotiating partners. This suggests four principles that should guide the UK's approach to trade negotiations: (1) You get what you give; (2) Where negotiations start from matters; (3) Bargain from a position of power; and (4) Invest in negotiating capacity.

With its limited existing capacity to undertake trade negotiations and its need to reach some kind of deal with the EU before Brexit occurs, the UK is starting from a weak bargaining position. But by adopting these four principles the government can ensure it makes the best of a bad hand.

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