CITY OF LONDON

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BARRIERS TO TRADE AND THE EFFECTIVENESS OF POTENTIAL TRADE ARRANGEMENTS AFTER BREXIT

ANALYTICALLY DRIVEN

Report for the City of London

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EXECUTIVE SUMMARY

The purpose of the report is twofold: firstly to promote a clear understanding of the potential issues around trade and trade barriers to inform discussions; and secondly to provide suggestions about how to address the challenges facing the UK as it looks to renegotiate its trade relationships both with the EU and elsewhere, including suggestions on where additional evidence would add value. The aim is to identify not only the risks, but also how the alternative options can be made to work most effectively. Given the importance of financial and professional services for the City of London, the report also includes an explicit assessment of the issues facing those sectors.

In general the analysis shows that barriers to trade in services are considerably higher than barriers to trade in goods and that reducing trade barriers can be extremely beneficial.

Looking to the future, the report assesses three different types of approach that could help address the challenges facing the UK, focusing on:

- the interdependencies in trade negotiations;
- the need to define and prioritise the goals for trade negotiations; and
- the way in which different trade arrangement with the EU will influence the barriers to trade.

CREATING A NEW TRADE REGIME FOR THE UK – KEY POLICY ISSUES

Issue	Implications
The need to address the interdependencies associated with negotiating trade deals.	The terms of the UK's WTO membership will be the starting point for trade deals with third countries, as they represent the baseline against which potential partners will judge deals. Therefore the ability to reach an agreement on the renegotiated terms of the UK's WTO membership (to reflect the fact that it has left the EU) will play an important role in the country's ability to agree trade deals with third countries.
	Agriculture is typically a contentious issue in trade negotiations. Having an agreed approach to the issue of trade in agricultural and food products, including any support for UK farmers, will therefore be important.
	Effective dispute resolution mechanisms will be important for any trade deals, but particularly deals that look to create a deep trade agreement, for example through harmonising regulations.
	Trade deals can include clauses that, if one of the signatories offers a better deal to a third country, give the signatories the right to have the terms of the deal upgraded so that the terms of the new deal are available to existing partners. This is a potentially powerful mechanism to ensure that trade deals remain advantageous and an example of a trade agreement with this type of provision is the EU-South Korean deal. However, the existence of clauses of this type in existing trade deals held by potential partners will complicate negotiations. This is because potential partners will need to be confident that any proposed deal will also work for their trade with existing partners covered by this type of clause.
The importance of having clearly defined goals for trade negotiations.	Trade negotiations are very resource intensive and some issues, such as removing barriers to trade in services, can be more complicated to negotiate than others, because of the need to tackle behind the border barriers to trade such as differing regulatory standards. It will therefore be important that the UK has clear priorities on the breadth (number of countries covered) versus depth (number of trade barriers removed for trade with a single country) of potential deals, in order to allow it to prioritise resources effectively. This is an issue where the City of London could potentially play an important role, by identifying the preferences of service sector firms within the City as to whether the UK government should prioritise achieving a few deep deals, or a lot of simpler trade deals.
	It will be helpful to ensure that the level of detail used in any agreements is appropriate, including the extent to which sectors need to be separately identified and addressed specifically within trade regulations. For example, current EU WTO commitments differentiate between over 10,000 different tariff lines and the rule of origin regulations used for key EU trade deals differentiate between bicycles produced with and without ball bearings. While increased detail helps tailor deals to local circumstances, it also acts as a potential trade barrier, by increasing the administrative and regulatory burdens on firms. This means that it will be important for the UK government to have a clear view on how much detail is

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	necessary, and where the balance of cost versus benefit lies in differentiating between the regulations applying to different sectors.
	It will be important to understand the situations where regulatory harmonisation is likely to be helpful, as it typically brings the greatest benefits when trade barriers are already low. In addition, outside formal trade negotiations, it may be beneficial for professional bodies in individual sectors to explore whether mutual recognition of qualifications could help reduce barriers.
	Given the complexities of service sector trade, it would be helpful to have a clear mapping of the different ways in which trade can take place in key service sectors, in order to help define the priorities for negotiations. For example, the aviation sector already has a mapping of this type, in the form of the nine freedoms of the air, which help define which individual business models will be allowed under different deals. Such a mapping will need to address issues such as: where the customer is based; where the activity is based; whether trade is dependent on someone crossing a border; the impact of different ownership structures, including the need to set up branches or subsidiaries; the front versus back office requirements; access to the necessary infrastructure; and where data needs to be held.
	It will be important not to neglect the role of connectivity in promoting trade. For example, the trade regulations covering the road and maritime service sectors can have an important impact on the time it takes for both imports and exports to arrive and therefore their competitiveness.
The implications of alternative approaches to trade arrangements with the EU.	Typical trade deals only tackle a small proportion of the potential barriers to trade, particularly in the case of non-tariff barriers. Therefore the UK will need to make some important decisions about how ambitious it wants any potential trade agreements to be, both with the EU and with other countries. This is particularly true with respect to the trade-offs needed to eliminate non-tariff barriers, as significant reductions in non-tariff barriers often depend on the ability to harmonise regulations, which can be difficult without effective mechanisms to ensure regulations remain in sync.
	WTO rules allow for considerable differences in the approaches taken by countries to both tariff and non-tariff barriers (such as the regulations governing access to service sector markets) and the rules can be complex. Furthermore, from the perspective of trade with the EU, it is important to recognise that under WTO rules, the rules of access for service sectors firms differ in different EU countries. For example, under their WTO commitments the legal services markets in Luxembourg and Poland are closed to foreign (non-EEA) entrants, but this is not the case for all EU countries. This means that the UK service sector will potentially face a much more fragmented EU market once the UK leaves the EU, with exporters needing to assess the rules of access on a country-by-country basis, rather than for the EU as a whole. Furthermore, this issue will not automatically be resolved under a free trade agreement. Therefore, the UK will need to consider the priority that it places on harmonising rules for accessing the EU.
	Although under a trade deal with the EU regulatory equivalency could theoretically

Issue	Implications
	act as an alternative to passporting for some types of financial service trade, in practice as the UK and EU adjust their regulatory regimes the ability for regulations to remain equivalent could potentially come under threat, leading to equivalency being withdrawn, potentially at short notice. This means that even if a deal involving equivalency is initially in place after BREXIT, firms will face on-going uncertainty about its durability, in light of the evolving regulatory landscape. Therefore, it might be beneficial to investigate whether alternative approaches to equivalency might yield a more robust equivalency regime, even if the benefits are initially lower. For example, if only having to deal with a single regulator helps to reduce costs for firms, could an approach to equivalency be developed that depended on the equivalency of supervisory quality, rather than rules, with the home country regulator also regulating activity abroad, but on the basis of foreign rules? While the rules themselves would be different, this would allow firms to have a single point of contact for dealing with regulation. Whether this will be beneficial will depend on issues such as which markets and types of transaction are covered.

KEY FACTS ON TRADE AND TRADE BARRIERS

Issue	Key facts
Trade with the EU	In 2015 the EU accounted for 46.9% of UK goods exports and 39.4% of UK services exports, as well as 54.2% of UK goods imports and 49.4% of UK services imports. Over 80% of UK exporters do business with the EU.
	OECD estimates suggest that trade in services between EU members is 70% more than it would otherwise be, because of the Single Market.
	Passporting plays an important role in reducing trade barriers in the EU, by allowing financial services firms to operate elsewhere in the EU under the supervision of their domestic regulators. Between March 2014 and February 2015 almost 50% of authorisation requests for firms' activities received by the UK's Prudential Regulation Authority related to passporting. In insurance, over 60% of firms operating in the UK's general insurance market are headquartered in another EU country and passport in under the EU Third Non-Life Directive and almost 50% of those operating in the UK's life insurance market do the same under the EU Third Life Directive.
Trading under EU trade agreements	All 5 EU legal firms to take advantage of the EU's trade deal with South Korea are from the UK.
	Rules of origin regulations determine whether a good qualifies for tariff free access under a trade deal. Under the EU's deal with South Korea, EU produced cars only qualify for tariff free entry into South Korea if the local content is above 55%. At the moment local content is defined as coming from the EU, meaning UK cars qualify while it is part of the EU. However, only 41% of the components in cars produced from the UK currently come from the UK itself, creating potential problems once the UK leaves the EU, if it replaces the deal with South Korea on the same terms.
Exports and the UK economy	Only 11% of firms in the UK export, but they tend to be the most productive firms operating in the economy.
	Even firms that do not export directly can benefit from trade through global value chains. Around 22% of UK employment is embodied in UK gross exports, of which about half reflects indirect jobs amongst firms and industries that support UK exporters.
	In total, taking into account both direct and indirect jobs, more than 70% of the jobs linked to UK exports are found in service industries.
	The UK accounted for 7.2% of world services exports in 2014 and 17.4% of G8 services exports. UK services imports in 2014 accounted for 4.4% of world services imports and 12.0% of G8 services imports.
Service sector trade	Excluding trade where a company does business through a branch or subsidiary it has set up in a country (which is known as commercial presence), around 55-60% of UK services exports are in the form of cross-border supply, around 30-35% in the form of consumption abroad, and around 10% in the form of presence of natural persons.
	Trade through commercial presence is very important in the service sector, accounting for 69% of trade in services in EU countries. However, this type of trade does not usually appear in trade statistics, which may help explain why measured trade in services is so low compared to the share of services in output.
	It is not just the existence of a trade barrier that will influence trade flows – the

Issue	Key facts
	extent to which countries use the same approach to regulating trade is also important. OECD estimates suggest that for service sector trade around 60% of variations in trade regulations across countries can be accounted for by regulations covering restrictions on foreign entry and restrictions on the movement of people.
	In terms of market potential, in 2014 the G8 accounted for over one third of world services imports, with France, Germany and Italy together accounting for 14.3% of world services imports, and the US and Canada accounting for 11.8% of world services imports.
The impact of barriers to trade in services	Barriers to trade, including non-tariff barriers, are significant, particularly in the services sector. For example, estimates suggest that trade in services between the US and Canada is only 2.4% of the level it would be without a border as a result of barriers to trade.
	In service sectors increasing competition at home through lower trade barriers acts to strengthen international competitiveness. For example, a five basis point reduction in the OECD's measure of services trade restriction for commercial banking results in an increase of 5.3% in imports of commercial banking services and 9% in commercial banking exports. (The OECD has created the Services Trade Restrictiveness Index to identify trade barriers, based on countries' WTO most favoured nation commitments. The index covers 22 sectors and 44 countries and assesses barriers across five different types of barrier.)
	High service sectors trade restrictions at home, including for financial services, can reduce manufactured exports.
	At low levels of trade restrictions, reducing the OECD's measure of regulatory differences by five basis points can increase exports by 13%.
Combating tariff evasion	Outside customs unions, reducing tariff barriers through free trade deals creates the possibility of tariff evasion. Rule of origin regulations are used to prevent this, but these are often complex. For example, EU rules for trade with Switzerland and Norway are 140 pages and have different rules for bicycles produced with and without ball bearings. Estimates suggest that the rule of origin regulations for EU trade deals increase compliance costs by 8% and general administrative costs by 6.8%.

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