

Reflections on Australia-UK Trade Opportunities following Brexit

Written Evidence from

The UK Trade Policy Observatory (UKTPO)

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30 March 2017

Submission to the Trade Sub-Committee of the Australian Parliament's Joint Standing Committee on Foreign Affairs, Defence and Trade for its enquiry into 'Australia's trade and investment relationship with the United Kingdom'.

The United Kingdom (UK) government triggered Article 50 of the Treaty of European Union (EU) on 29th March 2017, to set in motion its exit from the EU. While there is debate about whether such a trigger is revocable, the overwhelming probability is that the UK will leave the EU in March 2019 and that is the basis of this submission.

Australia-UK trade relations will be influenced by Brexit via at least three routes:

1. Brexit will affect the structure and performance of the UK economy - although opinions differ even as to the direction of the effect, let alone its size;
2. The UK needs to settle its position – its rights and obligations – within the World Trade Organisation (WTO); and
3. Once it has left the EU Common Commercial Policy (a stated objective of the UK government), the UK will be in a position to sign its own trade agreements with other countries, and commentators have already identified Australia as one such candidate.

Lacking a crystal ball with which to predict the first of these effect, this note deals with the second and third. ***It concludes that the effects on Australia of the UK regularisation of its position in the WTO will be very small, and that an Australia-UK Free Trade Agreement is perfectly possible but unlikely to be of huge significance.***

The World Trade Organisation (WTO)

The UK is a full – indeed a founding member – of the WTO and the GATT before it – and has a full set of rights and responsibilities stemming from such membership. The responsibilities – the commitments negotiated over the years - are enshrined in Schedules of concessions, and although the UK's schedule has been submitted to the WTO through the agency of the European Union, along with the commitments of other EU Member States, they

are nonetheless the commitments of the UK¹. After Brexit, the EU schedule can clearly no longer apply formally to the UK and so the UK needs to create its own individual schedule.

Given the extraordinary complexity of negotiating Brexit over the two year period allowed for in Article 50 of the Treaty of European Union and the UK's lack of experienced trade officials, and in line with advice from many commentators – e.g. Holmes, Rollo and Winters (2016) - the UK government intends to make the least possible number of changes to its *de facto* trade regime in the course of adopting its own schedule.² From that base it will then be able to negotiate revisions to its schedule to bring it more into line with Britain's and its partners' needs over a lengthier period. Such an approach will also minimise the disruption that Brexit causes to other members of the WTO, making it much easier to enter constructive negotiations shortly after Brexit. The underpinning philosophy of this strategy of minimal change is that neither the UK government nor its partners should see Brexit as an occasion to pursue trade policy objectives, to open old agreements or settle old grievances, but take rather as a dry technical adjustment designed to replicate as far as possible pre-Brexit trading conditions.³

The Rectification of Schedules

The process of making purely technical changes to schedules is known as rectification and was defined by the GATT in 1980.⁴ It is intended for changes that “do not alter the scope of a concession ... are purely formal character”. Crossing out ‘European Union’ and replacing it by ‘United Kingdom’ at the top of the Schedule would seem to fall into this class. A WTO member making such a rectification proposes the changes and notifies them to the WTO Secretariat, which then circulates them to other members, who then have three months in which to lodge objections. If there are no objections, the new schedule is accepted – ‘certified’ in WTO language.

The only grounds for objection to a proposed rectification are that the notified schedule does not correctly reflect the modifications that have been made (not a problem in this case, since no change is proposed), or that the changes are not mere rectifications but modifications which change the nature or substance of the member's commitments. In the latter case the proposed changes cease to be rectifications but become a proposal for modification, which has to be negotiated and agreed with (certain) other WTO members according to Article XXVIII of the GATT. In the case of a re-negotiation the existing schedule continues to apply until the new one is agreed by the WTO membership. The twist in this particular case is that while such a negotiation was underway the UK would continue to apply the tariffs and other

¹ For trade in goods, the UK's commitments are identical to those of other EU Member States as reflected in the Common Commercial Policy, but for trade in services, the commitments differ substantially across Member States despite the fact that they are submitted jointly by the EU.

² See Szyszczak and Lydgate (2016) for details of the process.

³ This strategy was much discussed academically – e.g. Holmes, Rollo and Winters (2016) – but was first laid out officially in a Foreign Office Blog on 17th January 2017, <https://blogs.fco.gov.uk/julianbraithwaite/2017/01/23/ensuring-a-smooth-transition-in-the-wto-as-we-leave-the-eu/>.

⁴ ‘PROCEDURES FOR MODIFICATION AND RECTIFICATION OF SCHEDULES OF TARIFF CONCESSIONS’, L4962, 28 March 1980

restrictions on trade notified in the existing (EU-submitted) schedule – that is, the set of tariffs and other restrictions that the UK wanted to apply anyway!⁵

There are three sets of reasons why the UK's trading partners might object to its continuing its pre-Brexit trade policies. First, opportunism: partners may see this as an opportunity to redress perceived unfairness in previous trade agreements or merely to exploit a moment of weakness. There is little to be done about this, but one might expect the UK government to be slow to address such extraneous disruptions and merely continue to apply its existing schedule.

Market Segmentation

Second, market segmentation: when a market of 743 million people is divided into two of 679 and 64 million respectively with increased paperwork (or worse) impeding trade between the two, the value of access to that market is reduced. Hence a concession offered to the EU in the Uruguay Round to get access to the whole market might be felt to be excessive for getting access to its two parts, so the EU and the UK may be pressed to reduce the tariffs they currently have to restore the balance. There are three responses: first, since the Uruguay Round closed in 1994 the EU has enlarged significantly, increasing the value of the access negotiated in the Round: that is, Brexit merely offsets some of those (unforeseen) gains. Second, while Brexit may disrupt the UK economy – and possibly the EU economy – reducing demand for partners' exports relative to 'no Brexit', the WTO exists to protect the negotiated conditions of access to markets not the health of those markets *per se*. Third, we do not have an accurate measure of the extent to which goods are currently landed in the continental EU and transhipped to the UK or vice versa, but in most cases it is not likely to be very large. The extra paperwork pertaining to such transhipment after Brexit may add costs of perhaps a few percent of the value of the transaction; that is, the costs of disrupting transhipment seem likely to be very small in most cases.⁶ Where such costs can be demonstrated to be significant, the UK and the EU may have to consider offering corresponding concessions, but they will almost always be very minor.

Agriculture: Subsidies and Tariff Rate Quotas

The third ground for objection concerns two cases where the EU's concessions in the Uruguay Round were made on an EU-wide basis and hence have to be disaggregated. First, the Uruguay Round agreed caps on expenditure on certain agricultural subsidies (the so-called Amber Box) and the figure negotiated for the EU pertained to the whole of the EU. The current figure for the EU is €72.4 billion.⁷ But this is far in excess of its annual declarations of Amber Box support to the WTO of €5.9 billion – see Swinbank (2017) – and so there really is no reason why the division between the UK and the rest of the EU should cause any problems at all.

⁵ The details of this set of processes are laid out in an excellent paper .

⁶ The lack of knowledge reflects the fact that trade between the UK and the rest of the EU is currently trade internal to the common customs territory and hence not well documented.

⁷ This number is a self-declaration on the part of the EU, following enlargements in the 2000s, which has not yet been formally accepted by the WTO's membership

The other necessary disaggregation is altogether more sensitive. As part of the (rather limited) liberalisation of agricultural trade in the Uruguay Round and number of countries and the EU agreed to import specified quantities of certain agricultural goods at low or zero tariffs, even though their most favoured nation tariff (the ‘regular’ tariff) was much higher – so-called Tariff Rate Quotas (TRQs). These quantities also pertained to the EU as a whole and need to be broken up on Brexit. TRQs are exceptionally complex administratively and vary across products, but in some cases the TRQ has been allocated to specific importers.

One case on which we can conduct some preliminary analysis is the TRQ on sheep meat. In 1994 (the conclusion of the Uruguay Round) the EU had fifteen members and although the EU has proposed to expand the TRQ somewhat in response to its subsequent enlargements, the WTO membership has not yet accepted and certified such increases. Thus this analysis pertains to the EU15 – the UK and the remaining EU14.⁸ The negotiated TRQ was 284,000 tonnes, of which 225,000 were allocated to New Zealand, 18,500 tonnes to Australia and smaller amounts to other exporters. Table 1 reports the average volumes of trade 2012-15

Table 1: Imports of Sheep Meat (HS 0204) into UK and EU14

Thousand tonnes, Mean of 2012-2015

| Source | EU14 | UK | Non-EU14: | of which | |
|----------|-------|------|-----------|---------------|-------------------|
| Importer | | | | TRQ countries | Non-TRQ countries |
| EU14 | 104.7 | 69.5 | 82.6 | 81.8 | 0.8 |
| UK | 10.4 | .. | 81.5 | 81.0 | 0.5 |

Source: Comext (EU trade statistics)

These data report the country of entry into the EU15, not the final destination, but in the absence of information to the contrary we will assume that they are not seriously misleading. Several features deserve note. First, the TRQ is not binding overall – with imports of only 161,800 tonnes out of a possible 284,000. Second, there are effectively no imports from Non-TRQ countries: if the TRQ were expanded and imports increased, it would be at the expense of EU or UK production. Third, there is significant trade in sheep meat between the UK and EU. This will become ‘unrelated-country’ trade after Brexit, and if it were not accommodated in some new arrangement, it would potentially disrupt imports under the TRQ significantly. For example, if the UK could not export to the EU (mainly France), UK production would either decline strongly or re-orient to the domestic market thus eliminating a substantial volume of imports under the TRQ. On the other hand, the resulting scarcity of sheep meat in the EU would expand the demand for imports. If sheep meat were perfectly homogeneous this re-shuffling of demand could potentially leave current suppliers to the EU quite unaffected, but since UK imports and EU imports are at least somewhat different, there would be some disruption.

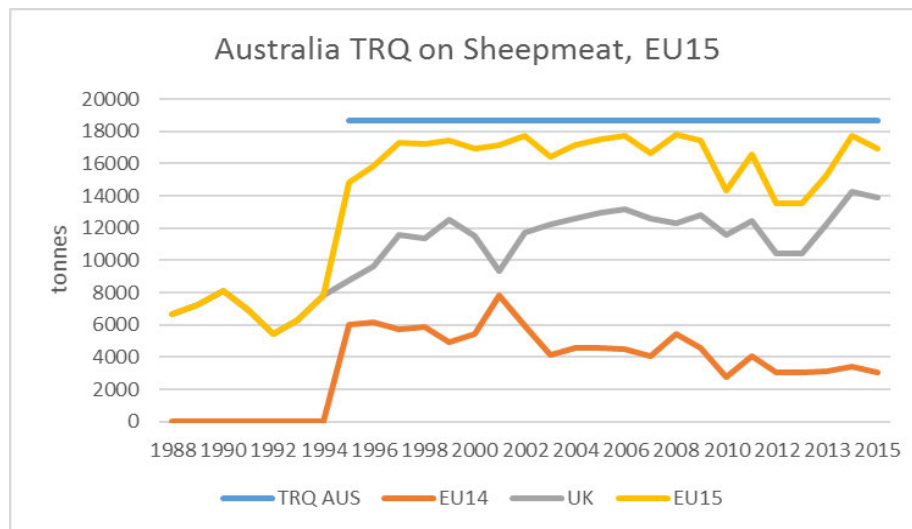
Although the TRQ does not bind overall, the quota for Australia does so in nearly every year. Figure 1 illustrates the position.

⁸ The EU14 comprises: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden

Prior to the conclusion of the Uruguay Round Australia exported sheep meat only to the UK among the EU15 countries. Following the institution of the TRQ, exports occurred to the EU14 and exports as a whole approached the TRQ limit of 18,500 tonnes. From 1996, and excepting 2008-2014 when the exchange rate was very high, Australia has effectively exhausted its TRQ; moreover exports to the UK and to the EU14 show a marked negative correlation (even excluding the blip in 2001). Both observations suggest strongly that the quota is binding.

When the TRQ is divided between the UK and the EU14, Australia will lose the flexibility that it currently has to switch exports between the UK and the EU14 according to market conditions.⁹ It will become more difficult to fill the quota and so the quota will become less valuable. In fact, examination of the flows in Figure 1 shows that there is no fixed division of

Figure 1 EU15 Imports of Sheep Meat from Australia (tonnes)



Source: Comext

the 18,500 tonnes which would have permitted exactly the pattern observed for actual trade. Overall, therefore Australia might claim that any division of the sheep meat TRQ disadvantages them and thus cannot be legitimately regarded as a rectification of the UK's WTO schedule.

On the other hand, the amounts of trade at stake are small and the cost of any disruption would be just a small percentage of them – in 2015, Australian exports to the UK and EU14 amounted to \$US79 million and \$US23 million respectively. The amounts are so small, in fact, that it seems inappropriate to disrupt Brexit, which will certainly generate many other headaches, over them. A reasonable request of the EU and the UK (and recall that it is a joint problem) might be to increase the TRQ by, say, 10% and propose a division based on the last few years' data.

⁹ That is, if demand in the UK is low one year, exports can be diverted to the EU14.

An Australian-UK Free Trade Agreement (AUK-FTA)

The UK is likely to be very keen to sign a Free Trade Agreement (FTA) with Australia. One of the main claims made for Brexit is that it would allow the UK to sign its own trade agreements, and the UK government will be anxious to prove that it can actually do so, and do so within a 'reasonable' period of time. Australia is an ideal partner to start with, sharing a language and many deep cultural and institutional links. Moreover, as I shall show, the stakes in an AUK-FTA are not large and so it would be a good place to start building the capacity and experience for trade negotiation that the UK currently lacks.¹⁰

For Australia, on the other hand, there is less urgency. First, until the UK has worked out its relationships with the WTO and the EU, it is very difficult to assess the value of an FTA with the UK. An FTA exempts partners from each other's most favoured nation (MFN) trade policies; hence defining the latter the necessary precursor to working out what to offer in order to avoid it. And given that around half of UK trade is with the EU, the UK-EU relationship will be critical to both the UK's economic fortunes and the nature of the UK's post-Brexit regulatory regime.¹¹ Second, Australia is already some way towards concluding an FTA with the EU, a larger market than the UK and arguably one with more international 'clout'. Third, the UK cannot formally start trade negotiations until after formal Brexit two years from now, and the EU is, by some accounts, keen to remind its partners of that fact.

Australia-UK Goods Trade

Turning to the substance of a possible AUK-FTA, the two sides are not large traders of goods – a natural consequence of the distance between them. The UK is Australia's 9th largest partner for both imports and exports, while Australia is the UK's 20th largest for exports and 36th for imports.¹² The principal products flowing northwards in 2015-16 were, in order, gold (54% of the total), lead, wine, and pearls and gems, only the third of which attracts significant tariffs in the current EU schedule.¹³ The UK's main exports to Australia are vehicles, medicines, alcoholic beverages (whisky) and printed matter, of which the first, accounting for 20% of total trade faces tariffs of 40% or more. In short, outside UK exports of vehicles, tariff reductions on goods offer very little prospect for significant gains. There are potentially regulatory gains for wines and for vehicles, but these would be highly complex to negotiate even if the parties were willing.

Trade in Services

Australian-UK trade is relatively stronger in services. The UK is Australia's second largest supplier of cross-border service imports and its third largest market for exports. Australia is the UK's 11th largest provider of cross-border service for exports and 12th largest for imports (UK Pink Book, 2016). But again, the major flows are largely impervious to the effects of an FTA. The largest flow in each direction is Personal Travel (58% of Australian service exports

¹⁰ See Gasiorek (2016) for these arguments.

¹¹ Relatedly the existence and nature of any UK-USA trading agreement would also influence the value of an AUK-FTA to Australia.

¹² The data are taken from DFAT's online Factsheet on the UK, consulted last on 27th March 2017.

¹³ The tariffs are mostly specific so the ad valorem equivalent varies with the quality (cost) of the wine; at the cheapest end it may be as high as 50% but on higher quality wines it is much lower.

and 27% of her imports from the UK), and the second largest Professional, Technical and Business services (28% of exports and 11% of imports). The latter obviously do offer scope for mutual trade liberalisation but the Australian government has already said that it sees improved visa provisions for business travellers as part of this, which, at least in the short term, is a difficult concession for the UK government to deliver. According to UK data, the third largest service flow in each direction (14% of Australian exports and 20% of imports) is transportation, which is basically a derived demand from goods trade and so not likely to respond to an FTA.¹⁴

Finally, consider flows of investment. The UK has a significant share of Australian stocks of foreign direct investment – 10% of foreign-owned assets in Australia and 15% of Australia's assets abroad (International Investment Australia 2015, DFAT). For the UK the figures are much smaller – Australia accounts for 1.7% of the stock of foreign direct investment in the UK and hosts 1.2% of the stock of UK FDI abroad. These flows obviously open up scope for regulatory cooperation whereby the AUK-FTA encourages cross-ownership by facilitating the operation of companies from one party in the other. Possible interests in Australia might be to expand the Australian model of care provision into the UK. However, as noted above, negotiating such cooperation is a time-consuming and sensitive exercise, especially in any area impinging on the UK's health provision.

Overall, the nature of current Australian-UK trade does not offer very much scope for improvement by means on an AUK-FTA. The major flows from Australia are already largely unimpeded and although the UK could benefit by seeking the reduction of certain Australian barriers, even here the amounts concerned are small by comparison with UK trade overall. Moreover, those gains lie in awkward places which require regulatory co-operation, not merely a change in a simple policy, so that reaping them is likely to be a complex task.

Conclusion

Overall, therefore, I conclude that an Australia-UK Free Trade Agreement is likely to be some way off and of only minor significance economically. It would be worth having – notably for the UK, which will need all the encouragement it can get to restore trading volumes after Brexit and as a sign of deeper cooperation in other dimensions – but is unlikely to do much for employment or income in either partner.

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¹⁴ The UK and Australian data are clearly not perfectly compatible.

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