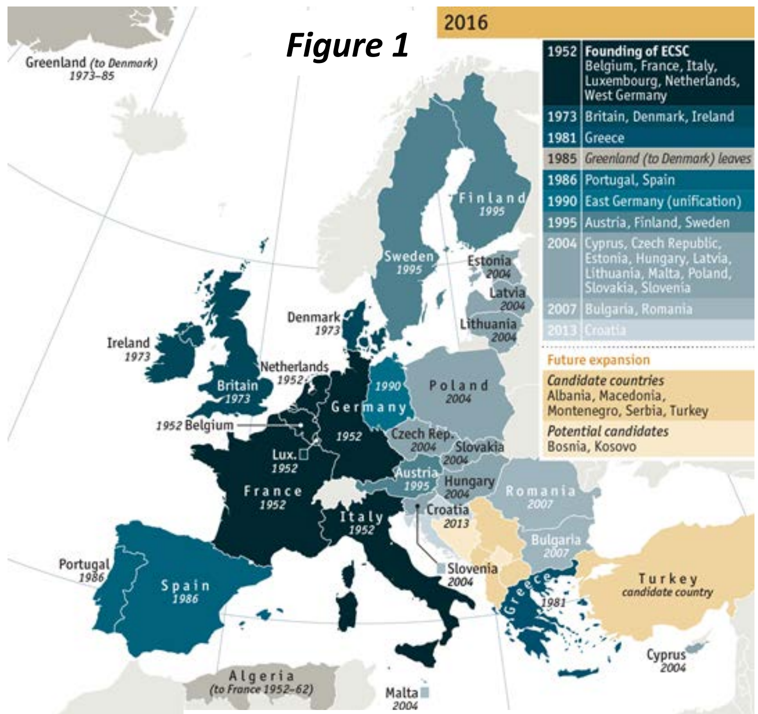
Joint Economic Committee
Representative Pat Tiberi, Chairman
Senator Mike Lee, Vice Chairman
MARCH 31, 2017

‘Brexit’ Can Give Free Trade New Momentum

Figure 1



Source: *The Economist*, June 18-24, 2016.

European integration. In 1957, the Treaty of Rome created the European Common Market, which set Europe on its path toward unification. In 1973, the United Kingdom (U.K.) became one of the Common Market’s first three new member countries.[1] Additional treaties advanced and formalized unification of Europe, but last June, the U.K.—the second-largest economy in the European Union (EU) after Germany—voted to leave the Union in a national referendum. British prime minister Theresa May invoked Article 50 of the Treaty on European Union (as amended by the Lisbon Treaty) on March 29 to commence the formal withdrawal process from the Union, which may take up to two years, unless all EU members agree to an extension. Central topics of the EU-U.K. negotiations going forward will include the U.K.’s remaining fiscal obligation to the EU[2] and the terms of bilateral trade, which the EU favors addressing after the terms of withdrawal are settled and the U.K. wants to negotiate in parallel.

After World War II, European countries recognized that international trade promises large benefits, and therefore reduced trade barriers until they eliminated all tariffs and quotas among them in 1992 when they signed the Treaty on European Union in Maastricht. However, the EU continues to impose tariffs of varying levels on goods and services imports from non-member countries and it is poised to re-impose tariffs on its trade with the U.K. after it leaves.

Brexit. The EU and its member states, including the U.K., are signatories to World Trade Organization (WTO) agreements that limit the ways in which they may curtail trade with a particular country, including that they not raise tariffs above a ceiling they have set.[3] Nevertheless, significant EU tariff and non-tariff barriers could follow Britain’s exit from the Union. The United States and the EU both are WTO members and even though a large portion of U.S.-EU trade is tariff free, some significant tariffs apply given the absence of a free trade agreement.[4]

[1] The original six member countries were France, Germany, and Italy, the continent’s three largest economies, along with three smaller ones, Belgium, Luxemburg, and the Netherlands. Denmark and Ireland also joined in 1973, along with Britain.
[2] Up to about $65 billion is an oft-cited estimate.
[3] In particular, most favored nation treatment applies to trade among WTO members.
[4] See, the WTO’s EU Tariff Profile; http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=E28.

Brexit generally evokes questions of what it means for U.S.-U.K. trade and what it means for the U.K.[5] The U.K. share of U.S. trade with the world is relatively small, 3.75 percent of exports and 2.55 percent of imports.[6] Any likely change in the U.K. economy or gain in trade with the U.K. after it leaves the EU is too small to have a substantial impact on the U.S. economy. However, the U.K. is the world's fifth-largest economy and the United States is its largest export destination (see Figure 3). Further, it is unclear how Brexit will affect London's role as a leading financial center. In any case, a trade deal with the U.K. could advance the cause of free trade generally, in addition to the direct benefits of further liberalizing trade with the U.K.

Trade liberalization. Since World War II, the United States advanced free trade around the world through international trade organizations. Many countries participated in the trade liberalization—despite varying national objectives—because they were too small individually to affect demand, supply, and prices on the world market and because other national markets might have closed to them if they did not open their own. Participating in the General Agreement on Trade and Tariffs (GATT) and subsequent WTO negotiations gives them a vote on policy.

Some countries are too small to dictate special terms to foreign firms for access to their markets as ample alternative market opportunities exist. Some countries may be large enough to influence the terms of trade but since they can only control one side of foreign trade, trading partners can take countermeasures that will reduce consumer welfare for everyone. Presumed near-term gains from trade intervention by individual governments in the past (notably during the Great Depression) led to escalating trade barriers that reduced trade volume to the detriment of all trading nations. Box 1 shows common reasons for government trade intervention (besides those motivated by market efficiency considerations).

Control over market access. The formation of the EU and the industrialization of China have created large economies comparable in size to the U.S. that give their governments control over access to very large internal markets. To some extent, the European Commission and China's national government can affect international terms of trade, and when they try to do so it is not necessarily for the exclusive benefit of advancing trade liberalization. If a country's or trading bloc's internal market represents a large share of the world market, the government may be able to extract special concessions from trading partners, such as to demand technology transfers.

EU objectives. In the case of the EU, an important goal is to induce additional countries in Europe (and possibly outside of Europe) to join the Union or at least to make contributions to

BOX 1: Why Governments Intervene in Trade

Government Revenue. Imports are a potential source of tax revenue for the state. Import tariffs raise prices to domestic consumers, but foreign suppliers typically absorb part of the tariff, which transfers a benefit if the tariff is not set too high.

Protectionism. Governments may intervene to help domestic firms maintain or increase market share and profitability, and, importantly, maintain or increase domestic employment.

"Infant" industries. Temporary protection may be afforded to specific industries or technologies that the government seeks to develop from a nascent to an internationally competitive level. (Typically this turns into ongoing protectionism.)

National Security. National governments may override free trade outcomes to secure weapons technology and weapons production capability or to secure vital inputs to the military and the national economy.

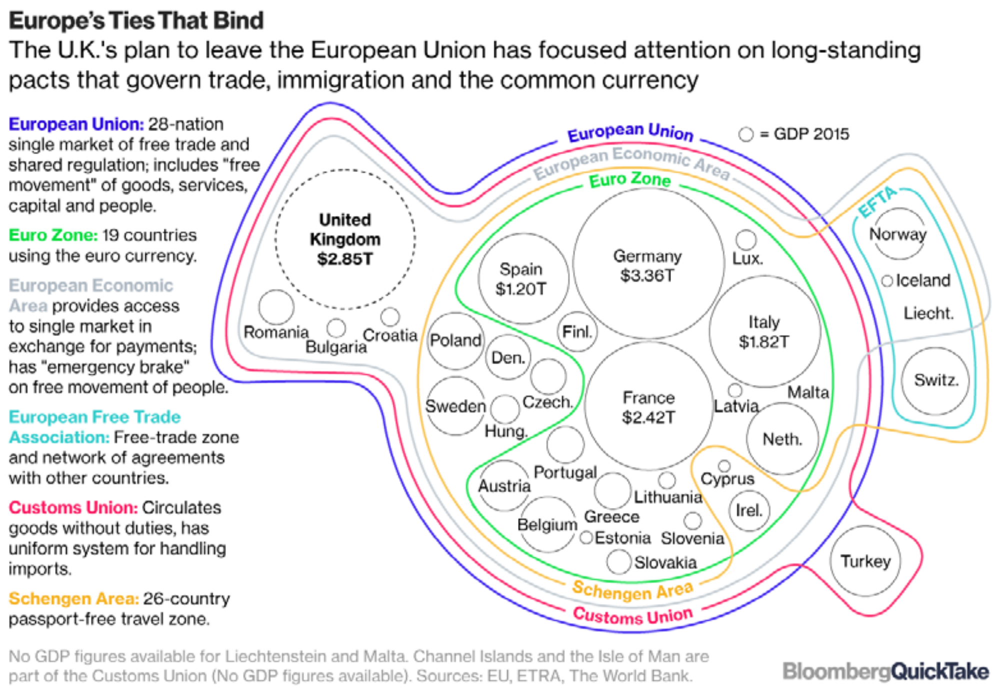
[5] Britain includes England, Scotland, and Wales. The United Kingdom includes Northern Ireland in addition to Britain. Scotland and Ireland may hold their own referendums to determine whether to remain part of the U.K. or apply to become part of the EU.

[6] WITS; http://wits.worldbank.org/CountryProfile/en/Country/USA/Year/2015/TradeFlow/Import.

the EU's budget and adopt its laws and regulations, including acceptance of the European Court of Justice's jurisdiction, automatic adoption into national law of EU legislation, and unfettered intra-bloc migration. Rather than simply include the small non-EU countries of Europe in its customs union and waive its tariffs, the EU imposes a highly structured and varied array of conditions on their exporters' EU market access, as Figure 2 shows.

Setting requirements for observance of private property rights and the rule of law, and setting limits on government market manipulation is appropriate for a country's inclusion in a free trade zone. However, the EU is imposing trade conditions on countries whose established standards in these respects are at least as high as those within the EU.

Figure 2



The European Commission issues an enormous amount of commercial rules.[7] Switzerland, which is part of the European Free Trade Area (EFTA), has negotiated in the order of 120 bilateral trans-border agreements with the EU. Iceland, Liechtenstein, and Norway are the other EFTA members, but they are also part of the European Economic Area (EEA) that commits them to adopt EU legislation, although with certain carve-outs such as for agriculture and fishing. None of the EFTA countries is in the European customs union, which means that their exports to the EU are subject to tariffs if they have too much non-EU, non-EFTA content.

The countries of Europe outside the EU face the choice of trade barriers to the 28 custom union member countries or relinquishing some degree of their independence. Partial EU integration can mean diminished national sovereignty with virtually no ability to influence the trading bloc's central decision-making. The EFTA countries, for example, have no vote in the European Parliament or the Council of the EU.

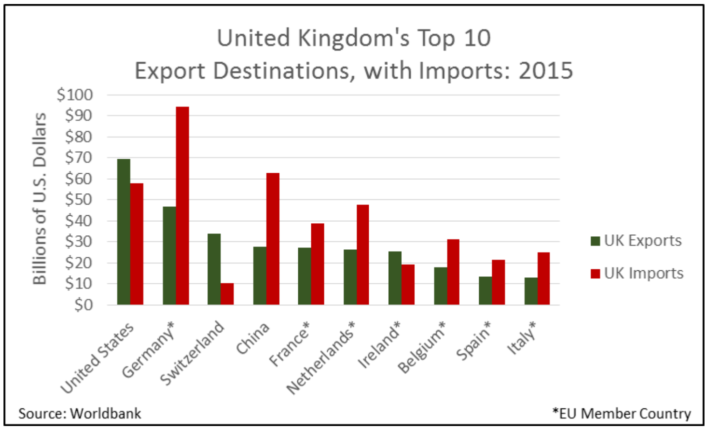
<u>Bilateral deals and non-tariff barriers</u>. National product standards, certifications or licensing requirements, and laws governing intellectual property rights, such as patents, can enhance commerce through transactional and informational efficiencies, or by addressing market externalities, such as the cost of harmful emissions that may not be reflected in market prices. Differences among trading nations in these respects can be an unintended hinderance to trade; and harmonizing them, in turn, can facilitate trade. Negotiations toward that end may be easier

[7] See, EUR-Lex for EU laws, regulations, directives, decisions; http://eur-lex.europa.eu/statistics/legislative-acts-statistics.html.

between two countries—or among a small group of countries—than attempting to establish worldwide standards through the WTO.

Yet whatever benefit arises from harmonizing non-tariff barriers through bilateral negotiation, adding back tariffs certainly does not help. Moreover, the sheer volume of EU commercial regulation does not suggest that its rules only address information, transaction, or externality problems. Instead, it suggests that the European Commission is managing rather than facilitating commerce. The multitude of bilateral agreements suggests an effort by the EU to extract varying concessions from individual trading partners depending on the resistance they can muster, in essence, to discriminate among them. Similar treatment now may await the U.K., even though it is well aligned with EU practices as a longstanding member state. In 2015, 44 percent of U.K. exports and 53 percent of U.K. imports were with the EU.[8] Figure 3 shows the U.K.'s top trading partners, seven of which are EU member states.

Figure 3



<u>Why trade?</u> International trade provides more consumer choice, allocates resources more efficiently, aligns prices with costs, and furthers economic growth, all of which will improve living conditions for trading partners. These benefits of trade stand on their own. Economic integration can bring further efficiencies, but there is no economic model of trade that sets conditions of the kind the EU imposes on trading partners for realizing the gains from trade.[9]

Economic and political integration can bring other benefits, and these should stand on their own as well, meaning that countries should choose more integration for the advantages it brings them, not for trade benefits the EU may withhold otherwise.

U.S. influence on the way trade is conducted around much of the world has been transmitted via the WTO. The size of the U.S. economy and its role in international finance also positions the United States well to negotiate trade matters with the EU or China, but the United States has no direct influence over trade negotiations between and among third countries.[10] There is little the United States can do to discourage large countries and trading blocs from using their power over market access to extract concessions from smaller countries other than to engage in free trade with them itself.

<u>A U.S.-U.K. trade agreement</u>. Brexit presents an opportunity for the United States to demonstrate its commitment to free trade for the inherent benefits and not as a means to achieve other ends. Trade sanctions may be appropriate in particular circumstances, but certainly not with a democratically governed country that is a partner in trade and national defense such as the U.K. *The United Kingdom Trade Continuity Act* introduced in the U.S. Senate last year by JEC Vice Chairman Senator Mike Lee, would urge the President to initiate negotiations expeditiously with the United Kingdom to reach a final comprehensive bilateral trade agreement (S.3123 from the 114th Congress). A U.S.-U.K. agreement could serve as a model and make it easier to negotiate truly *free* trade agreements with the EU and other economies, large or small.

---

[8] "Statistics on UK-EU trade," Briefing Paper, No. 7851, January 6, 2017, House of Commons Library.

[9] The classic illustration of comparative advantage from trading British cloth for Portuguese wine did not assume that the countries had to accept each other's national laws and court decisions or change their immigration policy, for instance.

[10] The Transatlantic Trade and Investment Partnership (TTIP) negotiations with the EU have been suspended. Asian countries fear China's commercial and military dominance, which motivated many of them to try to join an alternative bloc with the United States, the Trans-Pacific Partnership (TPP), whose fate is now uncertain.