

What would 'trading on WTO terms' mean?



The **UK** in a
Changing Europe

Foreword

The day when the UK is scheduled to leave the EU is drawing closer, and concerns over the fate of the deal negotiated by the Prime Minister are becoming more acute. As a result, the World Trade Organisation (WTO) is being talked about again. As MPs consider the implications of voting down Mrs May's deal, there seems to be renewed interest in the idea of a post-Brexit UK trading with the EU 'on WTO terms'. The phrase is frequently bandied about, but rarely explained.

This is what we aim to do in this short report. It is intended for a non-specialist audience and attempts to spell out in layperson's terms what such an outcome would mean. We have deliberately not attempted any economic modelling – much of this has already been done elsewhere, [including by us](#). Rather, we seek to assess what WTO terms would mean and particularly what it might mean for the ability of the UK to trade both with the European Union and more broadly.

As ever, this report has come from the hard work and collaboration of a number of colleagues. We'd like to record our profound thanks to Katy Hayward, David Henig, Holger Hestermeyer, Emilija Leinarte, Sam Lowe, Steve Peers and Peter Ungphakorn. Their more detailed reflections on this subject can be found in the longer report that they have produced here.

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Introduction

Brexit. The things we never knew about and never thought we'd need to: Article 50, the Good Friday Agreement, the nature of the devolution settlement and complex international supply chains. We should now add the World Trade Organisation (WTO) to this list. The WTO is an institution frequently mentioned in the context of Brexit, yet profoundly misunderstood. The idea that the UK could trade on 'WTO terms' is rarely if ever clearly explained.

There are two parts to the process of the UK's withdrawal from the EU:

- the withdrawal agreement, wrapping up the outstanding issues from the UK's EU membership such as the divorce bill, citizens' rights and the Irish border. This is the legally binding 585-page document that the Prime Minister has brought back from Brussels and which very few in Parliament seem to like; and
- the future relationship between the UK and the EU. The broad form of this is outlined in the political declaration accompanying the Withdrawal Agreement. However, the future relationship itself won't be negotiated in precise terms until the UK has actually left the EU.

So, where does the WTO fit into all of this? Simply put, we could end up trading with the EU on WTO terms in the event that the UK parliament (or indeed the European Parliament or European Council) fail to approve the deal that has been negotiated. Should this happen, the UK will leave on 29 March with no arrangements in place for preferential trade with the EU.

The short-term impact of such a 'no deal' scenario would be severe. It would involve the disappearance of much of the legal framework that governs not only trade but also travel, and security cooperation between the UK and the EU. It would doubtless also imply much ill will and mutual recrimination between the two sides. And, finally, it would mean that WTO rules would be all that governed trade between them.

We've dealt with the short-term impact of no deal [elsewhere](#). Here, we want to focus on what trading on WTO terms might mean.

For some Brexiters, the absence of a trade deal with the EU is nothing to worry about. The WTO, they claim, holds the answers to the myriad questions posed by Brexit. After all, we conduct our trade with the likes of the US on WTO terms, right? (Actually, we don't.) For them, the WTO not only provides all we need to continue trading with the European Union, but also to launch a 'Global Britain,' trading freely with all corners of the globe.

So, what are these fabled WTO terms? And what would trading with the EU solely on the basis of them mean for the UK? These are the questions we seek to address. What follows is a condensed version of a longer and more comprehensive report. It does not, therefore, claim to be exhaustive but to provide an introductory explanation to those interested in the Brexit process and what its various potential end points might imply.



What is the WTO?

The WTO was set up at a meeting in Marrakesh in 1994 as the result of a major overhaul of the system of trade rules set up after the second world war. Its purpose is to make trade between WTO members easier, not only when it comes to buying and selling goods across borders (such as televisions, phones, cars and so on) but also in rapidly growing areas such as services (the likes of banking, insurance and law).

WTO members—of which there are 164—include both individual countries, and the EU and three 'customs territories' of China, and all decisions are taken by them collectively.



Can the UK 'fall back' on the WTO?

In short, yes. The UK is a member of the WTO and [will continue to be](#) after Brexit. However, its commitments—pledges about how much access it gives goods and services from other WTO states—are currently bundled up with those of the EU as a whole. After Brexit, the UK will have to separate its commitments from those that have been agreed for the EU as a whole.

To use the jargon, the UK's goods and services 'schedules'—tariffs charged on goods, quotas, agricultural subsidies and commitments to open markets on services, amongst other things—will have to be amended. Most of these commitments can be copied from those of the EU, particularly tariffs on products such as oranges and coffee. Others, such as arrangements for services, may require technical adjustments to make them more suitable for the British economy.

Negotiations will also be needed on what are called 'tariff quotas'. These allow limited quantities of a product to be imported at a low or even zero tariff, while anything above the quota is charged a much higher duty. Sorting out the 100 or so of these is already proving [extremely complicated](#).

Take one example. The current tariff quota for New Zealand lamb coming into the EU is around 230,000 tonnes, meaning everything up to this amount can be imported duty free. For any imports above that, a significant tariff is charged. The UK and EU have proposed that their quotas should be divided to maintain the same total of 230,000 tonnes. Going on the estimated percentages that ended up in the UK and EU between 2013 and 2015, that basically amounts to a 50-50 split. However, New Zealand and others have objected, arguing that this deprives exporters of the choice of which of 28 national European markets to choose for their product (based on profitability).





What would WTO terms mean?

Without some kind of free trade agreement, trade between the UK and the EU will be based on WTO terms. Put simply, this means import duties and various controls will be imposed on trade between them. In addition, the UK would lose the benefit of the free trade agreements the EU has with a number of countries, unless those countries agree replacement treaties with the UK. Trade in services, currently relatively free in the EU's single market, would be much more restricted under WTO rules.

At the heart of the WTO system is the principle of non-discrimination, known as the [most-favoured nation principle](#) (MFN). This means that, in general, countries cannot discriminate between their trading partners. If country A grants country B a favour (such as a reduced tariff), that same favour must be granted to all other WTO members. If the UK wanted to remove all tariffs and checks on goods arriving from the EU, it would have to do the same for every other WTO member. The same would apply to the EU.

However, one way a group of WTO members can offer favourable terms to one country and not another is to conclude a free trade agreement. The EU itself is, in fact, a very developed free trade agreement. The EU (and by extension currently the UK) also has a number of free trade agreements with other states such as Singapore, Canada and South Korea. In total, there are 35 agreements in place, 48 partly in place and 22 pending.

The UK will lose the benefits from these deals unless it can reach agreement with each of the countries to maintain them. If this isn't possible, more British imports and exports will face tariffs under WTO terms. And agreeing these deals might prove difficult if the other state insists on renegotiating parts of the agreement.

There are also some non-WTO members with which the UK has relatively significant trade, including Azerbaijan (£800 million trade in 2016) and Serbia (£400 million). The EU has agreements with both countries to cover the same areas as the WTO agreements and via which the UK currently trades with them. Without these EU deals, this trade would in fact be on terms worse than those laid down by the WTO.

Trading on WTO terms alone is the default position for WTO members, but in practice none does it without additional agreements. Although many trade barriers have been lowered through WTO membership, all countries seek even less friction. All 164 WTO members have better access to at least one market either through a free trade agreement or duty-free preferences, which are often offered to developing countries.

In fact, most have several deals. For example, the US, Brazil, China and India all have trade agreements with their closest neighbours. Even as it stands, the UK does not trade merely on WTO terms with countries outside the EU. With the US, for instance—the UK's biggest non-EU trade partner—trade is regulated by over 100 sectoral agreements that go well beyond WTO provisions.



Can the UK become the Singapore of the North Atlantic?

It has been argued that extricating the UK from the EU would not prevent us from continuing to trade effectively. The UK could simply decide not to charge import duties on goods coming into the UK, nor do border checks. They also argue that the EU would be prevented from checking imports from the UK because of the [Trade Facilitation Agreement](#)—a WTO pact on streamlining border procedures. Cutting tariffs, it is argued, would reduce the cost of imports, particularly for food. Singapore and Hong Kong are examples of places with low to zero import duties on most or all products. So let's consider what trade on 'WTO terms' might actually look like.



Tariffs

The [average import duty](#) that the EU (and, for now, the UK) charges on goods is 3.2%. However, this is higher for agricultural goods (8.7%). Duties exceed 25% for more than one in ten agricultural products, sometimes by a large amount, whereas almost no products in any other sector have duties above 25%. The highest tariffs are in fact way above 25%—the equivalent of 189% for some dairy products and 116% for some animal products. Those rates do not apply to imports under free trade agreements or preferences for developing countries, but they would have to apply to trade between the UK and the EU, unless they were reduced for all WTO members.

Clearly, trade in food and other agricultural products would be hit hardest. Both importers and exporters would be affected. That said, a 10% import duty might not mean a 10% increase in what we pay for those goods in the shops. The exporter might lower their price to offset some of the impact, and the price rise in shops would be even less because the effect of the tariff would be diluted by transport costs and other overheads. And, of course, it is also affected by the value of the pound. We should also note that the UK's [National Farmers Union \(NFU\)](#) seems [more alarmed](#) about a lack of agreement, in the event of a no-deal Brexit, on regulations and standards (so-called 'non-tariff barriers') than on tariffs. This is an indication that the delays resulting from things other than tariffs may be even more serious than tariff barriers.

So what might happen if tariffs were cut to zero? First, almost half of imports into the EU already enter duty free because the normal tariff is zero, because of free trade agreements or because the EU already scraps the import duty on many products from developing countries (and on everything but arms from the poorest among them). Around a further 10-20% are charged a duty of no more than 5%. Less than half of imports are charged a duty above 5%. Therefore, the gains from a zero-duty policy would be nil or limited for more than half of the goods the UK imports.

Slashing import duties would have the biggest impact on sectors that are the most protected. These are generally agriculture and food and drink. The reasons for protecting agriculture through tariffs include ensuring some local production is kept alive. We do this partly so we don't rely totally on imported food, partly to keep farmers in business, and partly to preserve rural communities and protect the environment. Singapore and Hong Kong are both cities, and neither has agriculture of any significance. They both rely almost entirely on food imports, so imposing duties would



be counter-productive for them. That makes them a strange comparison with the UK, however.

The model and assumptions used recently by a group of economists called [Economists for Free Trade](#) has been challenged by most mainstream economists. Criticisms include the fact that Economists for Free Trade make some bold assumptions about how costs can be cut if some regulations are removed. The numbers they produced to estimate how much the British economy would benefit are also challenged by most economists, including this group from [the London School of Economics](#).

Border checks

Any product crossing from, say, Somerset into Devon is assumed to be safe because the transaction takes place within the UK's own internal market. Similarly, goods entering the UK from the rest of the EU are not normally inspected and are assumed to be safe because of common standards and checks in the EU's internal market.

This will no longer be the case once the UK is outside this market. Of course, the UK could scrap checks, making it easier for EU goods to enter the UK. But the WTO non-discrimination principle would still apply. This would mean imports from all other WTO members would have to be treated in [the same way](#). Doing away entirely with inspections and paperwork would mean losing control over imports, including of dangerous products such as contaminated food, animal and plant products carrying pests and diseases, dangerous electrical goods, unsafe cars and so on.

Moreover, the WTO's Trade Facilitation Agreement would have no effect on how and whether the UK and EU check each other's goods. The UK and EU already comply with most, if not all, of its provisions. And those provisions dealing specifically with streamlining at the border—such as electronic paperwork—generally ask countries [no more than to do their best](#), so non-compliance is hardly easy to prove!

UK goods and agricultural exports entering the EU will face new barriers to entry and friction at the border. You only have to look at the long list of barriers facing imports from, say, [the US](#) to know that this is true. Some commentators have [downplayed](#) the negative impact of trading with the EU without a preferential trade arrangement. Others have [argued](#) that new non-tariff barriers to trade, such as different regulatory standards, ['would be illegal under WTO rules'](#). This is misleading. The WTO would not prevent the EU from imposing new checks on imports from the UK. In practice, we already know how the EU will treat UK exports at the border in the event of a no deal Brexit: the same as for any other non-EU country with which it doesn't have a preferential relationship.

This would mean, for example, that all products of animal origin must enter the EU via a [veterinary border inspection post](#) where document, identity and physical checks would be carried out. A full 100 per cent of consignments of milk for human consumption would also be subject to document and identity checks, with no fewer than 50 per cent of consignments subject to additional physical checks. Currently, two of the UK agriculture's main routes to market—the Port of Calais and the Eurotunnel—are not veterinary border inspection posts.



The only examples of non-EU countries which can export to the EU without the need to send their products via such inspection posts are Switzerland and the EEA/EFTA nations (Norway, Iceland and Liechtenstein). However, all have harmonised their so-called 'Sanitary and Phyto-Sanitary' (SPS) regimes with the EU via deep preferential partnership agreements, which means their food, animal and plant



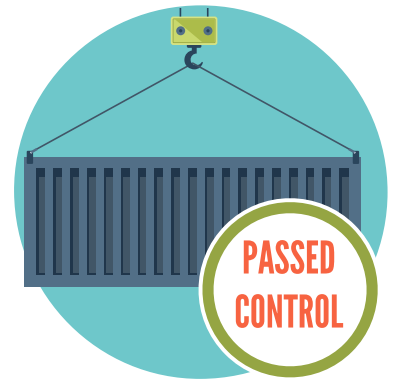
safety standards are aligned. If the EU changes its SPS rules, these countries have to follow if they want to maintain this ease of access.

WTO agreements on so-called Technical Barriers to Trade (TBTs), such as technical regulations and standards, are even weaker. In practice, UK exporters to the EU will continue to be able to self-certify that products produced to European standards are eligible to be sold in the EU. However, it would then be the responsibility of the EU importer to place the UK goods on the EU market, and they would be liable if something were to go wrong.

For products that require approval by testing bodies, such as medicines, declarations by UK-based bodies that goods comply with EU standards would no longer be recognised in the EU. However, the UK and EU could sign an agreement allowing assessment bodies based in the UK to certify that products produced in the UK to comply with an EU standard. This would reduce some of the administrative burden for UK exporters and potentially remove the need for double testing of goods to allow them to be sold in both UK and EU markets. However, this is obviously not something the UK can do on its own and requires the agreement of the EU. At the very least, there would be substantial short-term disruption while such arrangements were worked out.

And there would still be the need for risk-based inspections at the border, new import and export declarations, and associated red tape that comes with being a non-EU country exporting to the EU. There is little reason to think that the EU will allow bodies located outside its territory to authorise highly regulated products such as pharmaceuticals, cars and chemicals.

All of this would constitute new barriers facing British companies looking to sell into the EU. Friction, in other words. WTO arrangements do provide some ways to reduce non-tariff barriers to trade. However, in the event of the UK trading solely on WTO terms, they offer little in the way of solace for British exporters. New barriers to trade between the two parties would be both inevitable and highly disruptive.



Services

More than 80% of UK economic output (and 45% of exports) come from services. They are everywhere you look: from finance to law, catering to tourism, and transport to telecommunications. Even the manufacturing sector depends heavily on services. Just think of aeroplanes, which are often sold alongside long-term and highly lucrative maintenance service contracts.

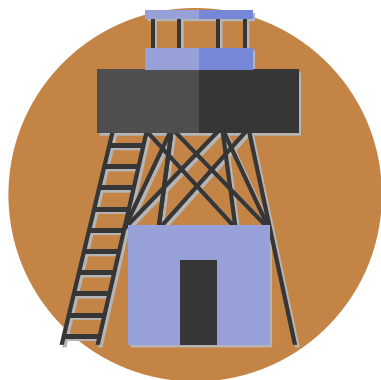
Trade in services is also regulated by the WTO agreements. Yet despite the importance of services in modern economies, these arrangements are far less developed than they are for goods. For one thing, goods trade involves tangible products physically moving across a border. Services are more complicated.

Tariffs and quotas imposed at the border play a large role in goods trade. However, the main barrier for trade in services has always been differing national regulations. Immigration law is also an important factor

that affects a service exporter's ability to supply and a consumer's ability to consume services abroad.

Moreover, the various requirements states put in place to control the creation of corporations make establishing a so-called 'commercial presence' more difficult. The requirement to hold the qualifications of the host state (for lawyers, to take one example) make it harder to offer services abroad. Attempts to reduce barriers to services trade often means limiting the ability of countries to pass such regulation, which can often be politically difficult.

The limits of WTO obligations on services become much clearer when compared with those relating to trade in goods. Once a good has been imported, it cannot be treated any worse than a domestic good. For services, however, national treatment is optional. Members remain free to discriminate against foreign services and bar them from accessing their domestic market. The only limitation is that they must discriminate against all other members equally. The EU's regime is vastly more far-reaching than the WTO's in this respect. In the EU, equal treatment is the norm and there is an extensive programme of mutual recognition of qualifications, making it much easier to provide services across borders.



The Ireland/Northern Ireland border and the WTO

Ireland has figured prominently in the Brexit debate. The whole purpose of the controversial 'backstop' has been to avoid a hard border, including infrastructure and checks, between Northern Ireland and the Republic. There is no doubt that, should the UK end up trading with the EU on WTO terms, this would mean a hard border on the island of Ireland.

The consequences of such a scenario will be severely felt in a region that has only recently begun to recover from the experience of violent conflict and related under-development. Economically, WTO terms would have a direct impact across a range of areas vital to protecting the quality of everyday life in the region, including broadcasting, telecommunications and the single electricity market on the island.

But the key issue, of course, relates to the border itself. WTO rules would necessitate a hard border because tariffs and quotas would have to be applied. Checks and controls on the movement of goods across the border will therefore be required. Moreover, such checks and controls typically require the use of physical infrastructure. To operate a customs border, for example, there tend to be designated entry points for goods, where paperwork (even electronic versions) can be checked, exit and entry can be recorded, and inspections can be performed where necessary. To avoid restricting the number of roads that goods can legally cross the border, companies would have to be registered as trusted traders. The practical problem here relates to the current lack of capacity in the UK's customs authority to register sufficient numbers of operators. And so businesses trading across the Irish border will have to comply with the requirements for trading into a third country. Given that three-quarters of businesses in Northern Ireland trading across the border are small or micro businesses, they simply lack the resources to manage this change.

Under WTO terms, the EU's most-favoured nation (MFN) tariffs and other checks would also apply to all consignments moving between Northern Ireland and Ireland. All goods going from Northern Ireland to the Republic would have the EU's tariff rates applied, and those going from Ireland into Northern Ireland would



have the UK's trade tariffs applied. Reductions in trade from Northern Ireland to Ireland would no doubt arise from the effect of tariffs and non-tariff barriers arising from WTO rules, especially in the dairy sector.

As Irish cross-border trade involves a lot of agricultural produce, trade in Northern Ireland would face higher tariffs compared to estimates for the UK as a whole. Although a substantial fraction of products would face no tariff, the small percentage of products that would incur tariffs of over 35% make up a significant share of cross-border trade.

The nature of co-operation and trade across the Irish border reflects its context: it is a rural, underdeveloped, close-knit region. There are complex supply chains in agri-food and myriad micro-traders. WTO rules will not preserve this situation but introduce a significant level of friction in a place where border controls represent a potentially dangerous step backwards in politics as well as economics.



Enforcing trade law

Just as the WTO is unlike the EU in terms of the substance of the systems in place to prevent friction at borders, its procedures are also very different. The WTO is an organisation of governments, and citizens and companies can only access its dispute settlement procedures via their governments. This means that companies and businesses must persuade their governments to bring a claim on their behalf. Given how expensive, complex and political WTO litigation is, governments filter complaints and only a very small number of them are brought before the WTO panels.

Furthermore, because claims can only be brought against states, if a breach of trade rules is committed by a competitor company, the WTO dispute resolution system is generally of no help.

Conclusion

WTO terms provide a basic floor for world trade. Most obviously, there are the schedules describing the market access all members receive in terms of the tariffs they pay on goods, the conditions under which they can provide services in other territories, along with measures to limit barriers at borders. Taken together, these provide a basic level of predictability and non-discrimination. Members cannot discriminate against others by charging them higher tariffs or putting in place specific measures, for example discriminating against UK foodstuffs, without specific grounds to justify this behaviour.

However, the inadequacies of these arrangements provide incentives for countries to go further and seek preferential access to tackle issues inadequately covered through WTO rules. The UK will, as other members do, want to seek the closest relationship possible with the EU given political constraints. The WTO option alone would have a significantly disruptive impact on trade between the UK and the EU, and even on some UK trade with other parts of the world. Falling back on WTO terms would be, to say the least, suboptimal politically, economically and socially.



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