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Brexit: No deal is still not credible

The Conservative Party manifesto for the general election restates the position on Brexit that "no deal is better than a bad deal". Secretary of State for Brexit, David Davis, has restated that the UK does not accept the EU's premise that withdrawal issues should be settled before discussion of a future trade arrangement, and has continued to argue that the UK walking away from the discussions is a realistic (if unlikely) prospect. Meanwhile, minutes of meetings at the Commission note that reaching an agreement on the financial issues will be difficult, and that public opinion in the UK is becoming acclimatized to the possibility of a 'disorderly' Brexit.

We have sought to explain previously why we do not believe the 'no deal' option is a credible one for the UK (see Brexit: Beyond "deal or no deal", 20 January 2017). The key to this is to understand that UK-based activity has adapted to the framework for trade facilitation that the EU has provided, and that the sudden removal of that framework without provision of a functioning replacement would be enormously disruptive to activity in the short run. It is extremely difficult to put numbers on this effect because, as we explain below, there are no meaningful precedents for such an abrupt change. Our expectation is that, as time passes and greater numbers of UK-based firms move into contingency planning for a 'no deal' Brexit, awareness of these issues will rise, and so will the pressure from businesses for the administration to seek a deal.

In the near term, however, we are surprised by how often in discussion with clients the implications of 'no deal' on Brexit are misunderstood. It is common in such discussions for clients to raise the issue of tariffs as soon as the potential for 'no deal' is raised. Certainly the imposition of tariffs creates its own issues which matter for the medium term. But, in our view, tariffs are barely the tip of the regulatory iceberg with which the UK would collide in a 'no deal' Brexit. At the risk of repetition of our prior work, we want to explain in detail why this is the case. We apologize in advance for the length of what follows.

Understanding goods trade with the EU

Under EU Treaties, EU nations are required to follow the Union Customs Code, which establishes the procedures by which goods enter the EU. In order to be made available on EU markets, goods have to go through a process which establishes them as "Union goods" cleared for circulation, as opposed to "non-Union goods", which may not be sold in the EU. To be established as "Union goods", customs officials have to be satisfied, given a risk-based assessment, that the goods conform to relevant EU safety, labelling and environmental standards. This establishment of conformity with relevant EU product regulations can be interwoven with the procedures for paying relevant tariffs upon import goods, but is conceptually distinct from it. For example, Turkey has an association agreement with the EU which means its goods exports are not subject to tariffs, but it is routine for trucks at the Turkish-Bulgarian border to be stopped for hours while other aspects of documentation are checked.

For EU nations, one of the fundamental freedoms is the free movement of goods between borders. Beyond a minimal check of documentation to verify goods have been produced within the EU, it is illegal to hold goods up at internal EU borders. Producers of goods within the EU are subject to the EU-wide regulatory regime and have to be able to demonstrate their compliance with it for all the goods they produce, independently of whether they export their products across borders or not. That compliance is typically established and monitored through national bodies authorized to ensure EU requirements are being met. With alignment with EU regulations established elsewhere, goods then pass unhindered through borders.

With this framework in mind, the issues associated with the UK leaving the EU become clearer. As the UK leaves the EU, the establishment of regulations around goods production and monitoring compliance with them shift from being an EU competence to a UK competence. Simultaneously, UK-produced goods move from the classification of being "Union goods" to being "non-union" goods. As a result, the goods are now subject to the regime for establishing conformity with EU regulations as it applies to non-EU countries. The responsibility for ensuring that UK-produced goods imported into the EU meet EU standards thus shifts from regulatory agencies in the UK to EU customs officials as UK goods enter the EU.

In order to ease the passage of non-EU goods into the EU, ***all*** of the developed countries with which the EU trades have entered into agreements on trade facilitation. These include mutual recognition agreements, so that where goods have been assessed to meet certain international standards by a non-EU regulatory body, the EU recognizes that assessment. It includes the ability of some non EU-based firms to explicitly mark their products as meeting EU standards, with conformity established via other means. And it will often include agreements to exchange data and documentation to facilitate rapid processing through the customs system. Data exchange is particularly important given that physical checking of goods at EU customs is expected to be 'risk-based' rather than a requirement for every consignment of goods. It should be emphasized that there is ***no*** instance of any of the EU's major trading partners acting on the basis of "WTO terms" alone – there are always trade facilitation arrangements in place, even when a formal 'trade deal' as recognized by the WTO is not.

If we take a "no deal" Brexit to mean no agreement on any of the issues to be discussed, including customs and trade facilitation arrangements, there would be an abrupt change to the trade relationships at the point where the EU exit becomes effective. UK goods exports would no longer be classified as "union goods" and hence would be subject to the regime for non-EU goods as they enter the EU. In the absence of agreement otherwise, UK-based bodies which have established conformity with EU standards in the past would not be recognized by EU officials. Moreover, the exchange of data required to allow 'risk-based' sampling of goods upon entry to the EU would not continue in the absence of explicit agreement to do so. The likely result is that a large quantity of goods would need to be stopped at the border as customs formalities were completed, and in many cases samples would need to be sent to labs for testing before the goods could be released for sale on the EU market.

A key difficulty is that the EU ports to which UK exports are destined will often not have the facilities in place for processing and storage of large amounts of UK exports. For example, roll-on roll-off traffic through the port of Dover accounts for almost 25% of UK exports to the EU by value, with in excess of 10,000 trucks crossing the English Channel on a daily basis. The majority of that is bound for Calais, where facilities for processing of non-EU imports are very limited. Rotterdam is the EU's largest port for non-EU imports, but is adapted primarily for containerized trade from large ocean-going vessels - there would be significant logistical disruption in attempting to route UK exports there, where they would be competing for customs processing capacity with goods from the rest of the world.

In addition to these broad issues associated with the logistics of goods trade, the EU's regulatory framework has specific provisions in a number of sectors which will become relevant under a "no deal" scenario. Non-EU plant, food and food products are subject to specific requirements for testing (under sanitary and phytosanitary regulations) which require them to be imported via ports with specific facilities. Problems of lack of capacity for this sector would be particularly acute. For chemicals and medicines, responsibility for demonstrating conformity with EU rules must be taken by an individual located within an EU member state: hence UK manufacturers will need to establish an agent in the EU before goods can be exported.

Taking the above together, the potential for sustained interruption to flows of goods from the UK to the EU is enormous. Given the lack of processing capacity described above, large backlogs of goods are likely to occur at the points where UK goods enter the EU, unless an agreement that attempts to facilitate smooth trade flows largely via existing routes is reached.

The border with Ireland

Both the UK and the EU have an interest is avoiding the reimposition of a 'hard border' between Northern Ireland the Irish Republic. Extensive use of vehicle registration plate technology and ability to implement customs procedures away from the border may allow that to happen. But the logistical challenge is large. And it is clear that any 'borderless' solution will require (a) significant information exchange between the UK authorities and the Republic, and (b) an unprecedented degree of flexibility in the legal regime as it applies to EU borders. Note that the European Council has already agreed that its appointed negotiators will act as a centralized point of contact between the EU and the UK, which will constrain the ability of Ireland and the UK to reach any agreement independently of the EU. And the ability of Ireland to implement any agreement is constrained by the fact it is a signatory to treaties which establish arrangements around borders and customs processes on a common basis across the EU. It is difficult to imagine the goal of the 'soft border' being met in the absence of a broader agreement between the EU and the UK on the conditions of withdrawal.

Transport services and leaving the EU

Further complications to the picture on goods trade arise from issues in the transport sector. A shared regime for the licensing and regulation of road haulage companies has facilitated movement of goods within the EU. The "great repeal bill" passing EU law into UK law means that the UK will likely continue to recognize community-issued driving licences for HGVs, certificates of professional competence, certificates of roadworthiness, and the like. But in individual countries within the EU, the legislation will typically apply to EEA member states, without the UK being specifically named. As a result, UK HGV drivers and companies will lose the legal basis of their ability to operate in many EU states, and many may choose not to operate or will find it difficult to have guaranteed insurance coverage if they do. The combination of (a) trucks awaiting clearance to enter the EU because of customs processes relating to the goods they are carrying, and (b) limitations on the ability of UK trucks to operate in the EU is likely to create challenges for moving goods both within the UK and in the EU.

The UK's participation in the agreements and regulatory mechanisms for civil aviation has also been intimately bound up with membership of the EU. Membership of Eurocontrol (which implements air traffic control on a day to day basis), the European Common Aviation Area, and the Single European Sky initiative is not limited to EU or EEA states alone. Terms of membership for non-EU members have typically been negotiated on a case by case basis. In the absence of a broader agreement encompassing the aviation sector, it is unclear how the regime governing UK and EU airspace will operate.

The broader impact on services trade

Financial sector activities that derive their regulatory basis from passporting would lose authorization immediately at the point of EU exit. According to estimates from a report by Oliver Wyman, activities dependent on "passporting" account directly for some 7%-10% of financial sector value-added, while the spillover impact from the loss of passporting to the rest of the system could account for a further 7% loss of output. With financial sector output accounting for near 8% of value-added, that impact would be around 1.4% of GDP based on these estimates. The abrupt loss of regulatory authorization could also generate systemic stability issues by creating a sudden loss of liquidity in some financial instruments. These effects will, however, be mitigated to a large extent by contingency planning within the sector itself; a significant portion of the activity dependent on explicit regulatory authorization may relocate ahead of when EU exit occurs.

UK exports of non-financial services to the EU are larger than the financial services sector. Aside from the financial and transport sectors, an EU-wide regime also covers sectors including broadcasting, postal services, professional services, private security services and cross-border provision of health services. Arrangements vary country to country, but in a number of instances the regime distinguishes between EEA/EU members and others. Hence, for example, in five EU member states, EEA/EU nationality or admission to the Bar in a member state is required for lawyers to advise on foreign law. The World Bank measures services trade restrictiveness in an index registering between zero (most liberalized) to 30 (most regulated). For services trade between EU members, the index is rated 18. For non-EU countries attempting to access EU services markets, the index scores 26 (Figure 1). In prior work, we have estimated that a full reversion to non-EU status would cause a 28% drop in UK services exports to the EU in the longer term (see Brexit and the UK services sector: How much will it hurt?, 17 March 2017). A significant portion of that drop could be expected to occur abruptly at the point of Brexit as the regulatory regime changes.

The impact on UK imports

Should the UK leave the EU without a withdrawal agreement and the effects above become apparent, what happens to EU exports to the UK? To some extent, the UK's "Great Repeal Bill" will replicate aspects of the status quo in terms of recognition of EU standards setting bodies. The UK could, however, take 'retaliatory' action against the EU in a number of respects, changing its own legislation and processes for EU imports. Provided whatever changes are made apply equally to EU and non-EU imports, they would not fall foul of WTO rules. Independently of such action, however, there are a couple of reasons to think EU imports to the UK may be disrupted as a 'disorderly' Brexit occurs.

First, the issues around congestion at the ports and broader problems of logistics may impede the ability of both EU and non-EU imports to enter the UK smoothly. Second, there is an open question about whether the UK's IT system for customs processing will work smoothly as the number of import declarations it needs to handle rises approximately five-fold upon EU exit. The existing IT system (known by the acronym CHIEF) is due to be replaced by a new system (known by the acronym CDS). This project is already seven years behind its initial schedule, and the status of the project has recently been changed to "amber-red", suggesting it is subject to "major risks" and in need of "urgent" action.

Approximately a quarter of the UK's food consumption is made of up of imports from the EU, which raises the importance of ensuring that the logistics of the sector is able to operate.

The impact of a simultaneous regulatory shock across sectors

It is extremely difficult to try and put numbers on the size of the shock to output that could occur in the case of no agreement as Brexit occurs. There are basically no precedents we can identify for a shock of this sort acting across sectors simultaneously.

The nearest we can get is research on the potential and actual impact of port closures. Strike action and the potential for disruption via terrorist and other events have generated some research on this issue for the US. Research commissioned by the CBO published in 2006 suggested that a 3-year shutdown of ports on the West Coast and a one-week shutdown of all ports would generate a near 0.45% drop in GDP. A more recent (2014) analysis of the impact of a 20-day closure of West Coast ports put the impact at 0.3% of GDP.

In our view, the impact of Brexit without an agreement would be orders of magnitude larger than these estimates. In addition to the issues created around movement of goods through customs procedures, there would be a broader regulatory shock extending across sectors. Given the breadth of the EU's regulatory reach, it is very likely there would be important impacts which we have missed in the account above. In addition, the share of trade in GDP for the UK is significantly higher than for the US.

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