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Brexit and Outlook for U.S.-UK Free Trade Agreement

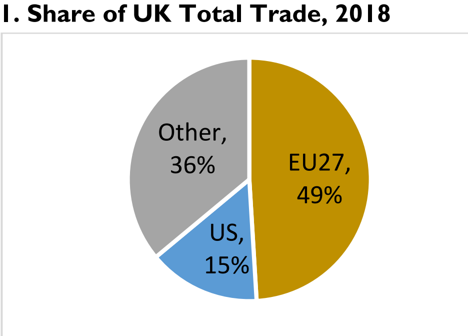
Introduction

Brexit—the withdrawal of the United Kingdom (UK) from the European Union (EU)—occurred on January 31, 2020. During the transition period, currently expected to last until the end of the 2020, the UK remains a member of the EU single market and customs union, and therefore subject to EU rules. The UK and EU aim to negotiate an agreement on their future trade and economic relationship. The outcome of the negotiations directly shapes prospects for a potential bilateral U.S.-UK free trade agreement (FTA), which is supported by the Trump Administration and many Members of Congress.

Post-Brexit UK-EU Trade Relationship

In 2018, the UK was the world's fifth-largest economy, and the second largest economy of the EU28, comprising 15.2% of the bloc's gross domestic product (GDP) after Germany (21.0%). The EU bloc is the UK's largest trading partner; by country, the United States is its largest (see **Figure 1**). UK-EU trade is tightly integrated through supply chains, trade in services, and foreign affiliate activity.

Figure 1. Share of UK Total Trade, 2018



Source: CRS, based on UK House of Commons Library data.
Notes: Total trade for exports and imports of goods and services.

Several possibilities exist for the future UK-EU trade relationship. Most of the analyses predict lower growth for the UK economy in all scenarios, but a "no deal" scenario in which the UK and EU are unable to conclude a trade agreement and return to World Trade Organization (WTO) terms of trade at the end of the transition period likely would constrain growth rates the most.

Trade Agreement? The political declaration attached to the UK-EU withdrawal agreement envisions "an ambitious, broad, deep, and flexible partnership across trade and economic cooperation with a comprehensive and balanced Free Trade Agreement at its core." The UK government, led by Prime Minister Boris Johnson, seeks to negotiate a "best in class" trade deal with the EU. Existing EU FTAs vary in their scope of trade liberalization and rules-setting.

Draft EU negotiating directives for a trade agreement with the UK include tariff- and quota-free trade on goods and cover a range of sectors, including services trade, digital trade, intellectual property rights (IPR), government procurement, and regulatory cooperation. The EU offer is conditional on commitments to ensure a "level playing field" in relation to state aid, labor and environmental protections, and taxation agreements. The UK may seek to diverge from EU rules and regulations, which would afford it more flexibility in its other trade negotiations.

The Johnson government aims to conclude a deal by the end of the transition period. EU officials have warned that the "extremely challenging" time frame will constrain the scope of the talks. Some past EU trade agreement negotiations have been lengthy; EU negotiations with Canada and Japan took, respectively, seven and four years.

Customs Union? The prospect of the UK remaining a member of the EU customs union is unlikely in light of the decisive victory of Johnson's Conservative Party in the December 2019 UK election and recent UK official statements. A customs union would allow the UK closer economic ties with the EU, but limit the UK's control over its trade policy. The UK potentially could negotiate with other countries on issues outside of the customs union (e.g., services, government procurement, or IPR), but would have limited negotiating scope since alignment with the EU would be a condition of being in the customs union—which includes a common external that customs union members apply to trade with countries outside of the arrangement. A customs union also could limit UK trade policy on trade remedies or developing country preference programs.

If the UK is no longer part of the EU customs union, it would regain control over its national trade policy and be free to negotiate its own trade agreements with other countries, a key rationale for many Brexit supporters.

WTO Terms? If the transition period ends without an UK-EU trade agreement or customs union arrangement, the UK would no longer have preferential access to the EU market. WTO terms would govern UK-EU trade, which would no longer be tariff-free. EU tariffs are low (5.2% on average), but WTO trade terms could significantly affect certain industries; for instance, the EU imposes tariffs of 10% on passenger cars and tariffs of up to 6.5% on chemicals. Nontariff barriers such as new customs procedures would add delays and costs to doing business.

UK regulatory frameworks are currently aligned with those of the EU on data protection and data flows, but after the transition period, the EU will have to make determinations on UK compliance with the EU regulatory frameworks. For financial services, absent an equivalence decision, after the transition period, the UK will not be able to use financial passporting (which allows banks to use their UK bases to access EU markets without establishing legally separate subsidiaries). Even with a positive determination, the EU would retain the ability to revoke equivalence at any time.

Continued trade in financial services may require firms in the UK and EU to restructure operations; some financial institutions already have shifted or are planning to shift some jobs and assets from London to EU cities.

Global Britain

The UK is acting on multiple fronts to retain and strengthen its trade linkages around the world after the transition period ends. It is negotiating its own WTO schedule of commitments on goods, services, and agriculture. Treatment of agricultural products is especially complex as it requires reallocation of EU and UK tariff-rate quotas. In the interim, the UK continues to apply the EU schedule. The UK's continued participation in the WTO Government Procurement Agreement (GPA) was approved in principle; the UK has not submitted its instrument of accession yet.

The UK also is working to replicate existing EU deals with non-EU countries. The EU has more than 40 trade agreements with around 70 countries. During the transition period, EU trade agreements continue to apply to the UK. As of December 4, 2019, the UK had signed continuity deals covering 8.3% of total UK trade with around 50 countries or territories, including Switzerland, Liechtenstein, Iceland, Norway, and South Korea.

In addition, the UK is negotiating mutual recognition agreements (MRAs) to assure continued acceptance by UK and partner country regulators of each other's product testing and inspections in specific sectors. The UK has signed MRAs with Australia, New Zealand, and the United States; MRA discussions with Japan are ongoing.

Finally, as part of the UK government's "Global Britain" strategy, the UK is taking steps to pursue new trade deals, such as with the United States, Australia, China, India, and New Zealand. During the transition period, the UK can negotiate, but not implement, trade agreements with other countries. Rather than rolling over the EU-Japan FTA, Japan seeks to negotiate new terms with the UK.

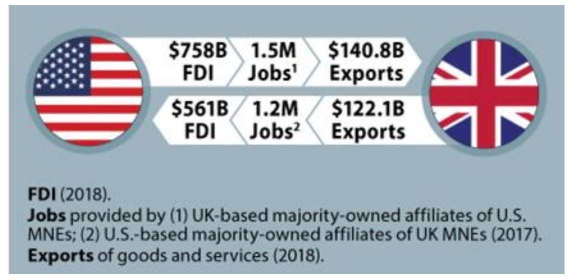
U.S.-UK Trade Agreement Outlook

The UK is a major U.S. trade and economic partner, and foreign direct investment (FDI) and affiliate activity are key aspects of bilateral ties (see **Figure 2**). In January 2017, President Trump and then-Prime Minister Theresa May discussed the potential for a future U.S.-UK trade agreement, and a bilateral working group was subsequently formed to explore ways to strengthen trade and investment ties. On October 16, 2018, the Administration formally notified Congress, under Trade Promotion Authority (TPA), of its intent to enter into trade agreement negotiations with the UK to address tariff and nontariff barriers to trade in goods, services, and agriculture, investment, and government procurement, as well as trade-related rules.

U.S. Trade Representative Robert Lighthizer has said that trade negotiations with the UK are a "priority" and will start as soon as the UK is in a position to negotiate, but he cautioned that the negotiations may take time. Whether the Administration ultimately takes a comprehensive approach to the negotiations, as with the U.S.-Mexico-Canada Trade Agreement (USMCA), or a more limited approach, as with the U.S.-Japan trade deal, remains to be seen.

Some analysts question the priority that will be afforded to U.S.-UK trade agreement negotiations, in light of the UK-EU and U.S.-EU trade agreement negotiations. Some analysts also question the sequencing, to the extent that the United States may face difficulty negotiating with the UK without knowing what the final UK-EU relationship looks like; others counter that the UK-EU trade and economic relationship is becoming clearer. Some experts are optimistic about a U.S.-UK FTA in light of the U.S.-UK "special relationship" and historical similarities in trade approaches. The UK has been a leading voice on trade liberalization in the EU. Others are skeptical about the likelihood of a "quick win," particularly for a comprehensive trade deal, as negotiations would need to overcome a number of obstacles and concerns.

Figure 2. U.S.-UK Trade and Direct Investment



Source: CRS, data from U.S. Bureau of Economic Analysis.
Notes: Foreign direct investment (FDI) on stock basis.

Many U.S. and UK businesses and other groups see an FTA as an opportunity to enhance market access and align UK regulations more closely with those of the United States than of the EU. Other stakeholders oppose perceived efforts to weaken UK regulations. Some in UK civil society have voiced concerns about the implications of U.S. demands for greater access to the UK market, and potential changes to UK food safety regulations and prices for pharmaceutical drugs. Bilateral issues also could include financial services, investment, and e-commerce. To the extent that the UK remains aligned with the EU, difficulties in past U.S.-EU trade negotiations could resurface in the U.S.-UK context.

Other complexities for the U.S.-UK trade talks include frictions over tariffs and other policy issues. For instance, the Trump Administration has threatened the UK with tariffs over its plan to apply a new digital services taxes (DST), and strongly opposes the UK's recent decision to open its 5G network development to participation by Huawei, a Chinese telecommunications firm. Other issues, such as the U.S. Section 232 national security-based steel and aluminum tariffs, and potential auto tariffs, could see pushback from the UK side.

Many Members of Congress support a U.S.-UK FTA. However, some Members have cautioned that they would oppose a deal if Brexit undermines the Northern Ireland peace process, whereas others support a trade agreement without such conditions. Whether a potential final agreement would meet congressional expectations or TPA requirements, or be concluded as an executive agreement is unclear. Congress may continue to hold consultations with the Administration over the scope of the negotiations, and engage in oversight as the negotiations progress. For more information, see CRS Report R45944, *Brexit: Status and Outlook*, coordinated by Derek E. Mix.

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