

To achieve its post-Brexit objectives, whatever they turn out to be, the UK government needs a trade negotiating strategy based on a clear-eyed understanding of how trade agreements work.

Thomas Sampson sets out four principles that should guide the UK's approach to future negotiations, most immediately with the European Union.

Four principles for the UK's Brexit trade negotiations

The meaning of Brexit is yet to become clear. But if Brexit means leaving the customs union of the European Union (EU), it would allow the UK to pursue its own trade policy for the first time since joining the EU in 1973.

An independent trade policy presents both challenges and opportunities. The most important challenge would be to reach a new trade agreement with the EU. The UK has yet to decide what relationship with the EU it wants following Brexit. But whatever it chooses, whether the government achieves its objectives will depend on the success of its negotiating strategy.

Previous work by CEP researchers has analysed the economic consequences of Brexit (Dhingra et al, 2016a; 2016b) and discussed what policies the UK should adopt if it leaves the EU (Dhingra and Sampson, 2016). The latest report in our series on Brexit asks a different question: what strategy should the UK adopt to

secure its objectives in future trade negotiations?

A successful strategy must be grounded in a clear understanding of why countries negotiate trade agreements and how negotiations are conducted.

When a country sets trade policy unilaterally, it does not account for how

The first priority should be to agree a transitional deal to cover UK-EU relations until a long-term agreement is reached

its choices affect the rest of the world. However, because countries are interdependent, the effects of trade policy do not stop at national borders. In the language of economics, trade policy generates international 'externalities'. And frequently these externalities lead to 'beggar-my-neighbour' effects, which make other countries worse off by lowering their terms of trade or reducing inward investment (see Grossman, 2016).

By negotiating trade agreements, countries can internalise the externalities resulting from international interdependencies, avoid damaging trade wars and improve welfare. Importantly, this is true regardless of whether governments' policy goals are motivated by the desire to maximise economic output, the wish to protect particular groups of workers and firms, or the pursuit of other social objectives (see Bagwell and Staiger, 1999, 2001).

To reap the gains from international

coordination, trade agreements require governments to give up unilateral control over some policies. For example, members of the World Trade Organisation (WTO) give up the right to use import quotas and production subsidies, and they agree limits on the tariffs that each country can charge on imports from other members.

The fact that trade agreements place limits on countries' policy options shapes how trade negotiations are conducted. Trade negotiations are not about countries identifying a common objective and working together to achieve it. They are not a cooperative endeavour.

Instead, trade negotiations are a bargain between countries with competing objectives. Each country must give up something it values in order to obtain concessions from other countries. This realisation suggests four principles that the UK should adopt to guide its trade negotiation strategy.

1: You get what you give

To reap the benefits of trade agreements, the UK must be willing to give its trading partners something they value. In general, the more countries are willing to concede and the more policy control they give up, the bigger are the potential gains from reaching an agreement.

An important question that the UK faces is what it is willing to give up in return for the EU allowing UK services firms to participate in the Single Market. Unless the UK makes a sufficiently attractive offer, the EU will take the opportunity that Brexit presents to impose new barriers on UK services exports.

The fact that free trade agreements are based on mutual concessions also makes unilateral tariff liberalisation a less attractive policy because it would mean the UK giving away a potentially important bargaining chip.

2: Where negotiations start from matters

The outcome of any bargaining game depends on where negotiations start from. Trade agreements are no exception. The policies each country will adopt if no agreement is reached provide a reference point – or 'threat

Triggering Article 50 by March 2017 would be a mistake and should be avoided

point' – for the negotiations. Countries make concessions starting from this reference point.

It is unclear whether the reference point for UK-EU negotiations would be trade under WTO rules or the status quo in which the UK is a member of the Single Market. Starting from the status quo, the UK would have to negotiate the right to impose restrictions on immigration from the EU. Starting from WTO rules, the UK would not need to negotiate immigration restrictions, but would need to negotiate access to the Single Market.

Before any trade negotiations between the UK and the EU take place, there will have to be an agreement on what the reference point is. The UK government should seek a reference point that helps it to achieve its post-Brexit objectives.

3: Bargain from a position of power

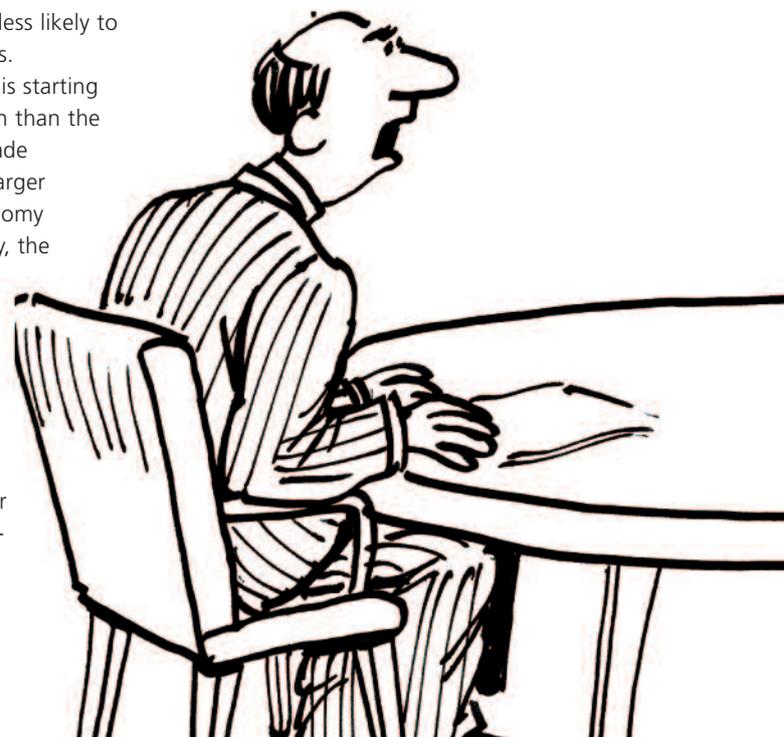
Bargaining power affects the outcome of trade negotiations. Countries that have little bargaining power are less likely to achieve their objectives. Unfortunately, the UK is starting from a weaker position than the EU. Because UK-EU trade accounts for a much larger share of the UK's economy than the EU's economy, the UK needs a deal more than the EU does.

The weakness of the UK's position is exacerbated by the two-year time limit on exit negotiations under Article 50. As the two-year limit approaches,

the UK will become increasingly desperate to obtain an agreement.

There are two steps that the UK should take to improve its bargaining position. First, delay triggering Article 50 until the government has decided its post-Brexit objectives and EU leaders are ready to start negotiations. Theresa May's commitment to invoke Article 50 in early 2017, before the French and German elections, weakens the UK's position because the EU will not be able to participate in meaningful negotiations until after these elections.

Second, the UK's immediate objective after invoking Article 50 should be to neutralise the two-year time limit by agreeing a transition arrangement to govern UK-EU trade relations during the period between when the UK leaves the EU and when a longer-term agreement is concluded. Returning to the principle that you only get what you give, the UK needs to decide what it is willing to offer the EU in return for a transition agreement.



4: Invest in negotiating capacity

Trade agreements involve many simultaneous policy changes, which makes it difficult to analyse their economic consequences. Smart negotiators use this uncertainty to their advantage by ensuring that they are better informed than their counterparts on the other side about who stands to gain and who stands to lose from any policy proposal.

Having not participated in trade negotiations for the past 40 years, the UK currently has very little negotiating capacity. To become a smart negotiator, the UK needs to invest heavily in four areas of expertise: trade lawyers to conduct negotiations; diplomats to provide information on the objectives and strategies of its negotiating partners; business intelligence to understand how firms will be affected by different policies; and trade economists to quantify the welfare effects of proposed trade agreements.

The UK has a weak hand because it needs a deal more than the EU

Conclusion

Since the UK joined the EU in 1973, trade policy has played a minor role in UK politics. Now it's back. Much has and will continue to be written about what the objectives of post-Brexit UK trade policy should be. But whether the UK is able to achieve the objectives it eventually chooses will depend on the success of its negotiating strategy.

The government has a responsibility to ensure it obtains the best possible outcome for the people of the UK. By adopting these four principles, it can have a better chance of making the best out of a bad hand.

This article summarises 'Four Principles for the UK's Brexit Trade Negotiations', CEP Brexit Analysis No. 9 by Thomas Sampson (<http://cep.lse.ac.uk/pubs/download/brexit09.pdf>).

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Further reading

Kyle Bagwell and Robert Staiger (1999) 'An Economic Theory of GATT', *American Economic Review* 89(1): 215-48.

Kyle Bagwell and Robert Staiger (2001) 'Domestic Policies, National Sovereignty and International Economic Institutions', *Quarterly Journal of Economics* 116(2): 519-62.

Swati Dhingra and Thomas Sampson (2016) 'UK-EU Relations After Brexit: What is Best for the UK Economy?', in *Brexit Beckons: Thinking Ahead by Leading Economists* edited by Richard Baldwin, VoxEU.

Swati Dhingra, Gianmarco Ottaviano, Thomas Sampson and John Van Reenen (2016a) 'The Consequences of Brexit for UK Trade and Living Standards', CEP Brexit Analysis No. 2, March (<http://cep.lse.ac.uk/pubs/download/brexit02.pdf>).

Swati Dhingra, Gianmarco Ottaviano, Thomas Sampson and John Van Reenen (2016b) 'The Impact of Brexit on Foreign Investment in the UK', CEP Brexit Analysis No. 3, April (<http://cep.lse.ac.uk/pubs/download/brexit03.pdf>).

Gene Grossman (2016) 'The Purpose of Trade Agreements', National Bureau of Economic Research Working Paper No. 22070.

