THE ECONOMY 2030 INQUIRY
SHAPING A DECADE OF CHANGE

Trading Up

The role of the post-Brexit trade approach in the UK's economic strategy

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The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

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Executive Summary

For the first time in half a century Britain needs a trade strategy. EU membership had effectively provided that strategy, determining our trade relationship with the rest of Europe and negotiating it with the rest of the world. Two years after Brexit, the responsibility to design and prosecute such a strategy now resides with the UK government. The stakes are high: such a strategy shapes what families and firms buy from abroad and what gets produced domestically; influences our jobs, productivity levels and, ultimately, living standards; and contributes a major plank of Britain's international policy at a time of heightened geopolitical tensions.

Britain's post-Brexit trade policy has run out of road

Britain has not had a trade strategy post-Brexit, but it has had a trade policy: prioritising the speed and volume of free trade agreements (FTAs) signed. This was understandable and broadly successful, with 'rollover' agreements signed with the vast majority of countries that had pre-existing EU agreements, meaning UK firms retained access to these markets.

In addition, the Government has sought to expand the coverage of FTAs, aiming to secure free trade agreements with countries covering 80 per cent of UK trade by the end of the 2022. In practice, this has meant rapidly negotiated deals with Australia and New Zealand, representing a tactical approach to offset some of the significant reduction in trade openness post-Brexit.

But a trade strategy – which requires well-specified objectives, beyond the simple wish to sign FTAs – this is not. And the tactic has run out of road anyway. The UK has limited scope for further substantial liberalisation through further FTAs, without seeking an agreement with the US or China, which jointly account for 24 per cent of UK trade. Here, the US has signalled the former isn't on the table, while the latter is unimaginable in the current geopolitical climate.

The, largely understandable, emphasis on speed of negotiations during this period necessitated relying on the tools that were readily available – FTAs. But FTAs are focussed on goods and do not cater to Britain's strengths as a service 'superpower' The average long-run increases in goods trade from such deals are estimated to be between 54 and 97 per cent, compared to an increase of just 5 to 17 per cent for financial services.

A new strategy should be defensive on goods and expansive on services

So, a new trade strategy is needed, one with clear objectives grounded in the UK's wider economic strategy, that recognises the context and constraints within which we operate; reflects, rather than ignores, trade-offs; and is highly integrated with domestic policy.

The argument of this paper is that such a strategy should have twin objectives:

- a 'defensive' objective on goods: delivering market access for high value added manufacturing firms struggling to retain their place in European supply chains; and,
- an 'expansive' objective on services: seeking to ensure the UK benefits from the growth in global services trade, which is particularly strong in areas of British specialism.

UK goods trade is where the initial impact of Brexit has been most visible: goods exports were 17 per cent below pre-Trade and Cooperation Agreement (TCA) levels in Q1 2023, significantly below France, the second weakest G7 performer, whose goods are just 6 per cent lower. To make matters worse, the longer-term impact of these goods-trade frictions with the EU could be a reduction of some of the UK's high-productivity manufacturing such as automotive industries, reliant in many cases on being part of European supply chains, while boosting low-productivity manufacturing for the domestic market (e.g. food manufacturing). In this context, the objective for a new UK trade strategy should be defensive – asking us to be clear eyed about what it would take to prevent this structural shift, and the loss of high-quality firms and jobs it implies, taking place.

Further reasons this new strategy on goods is best seen as defensive include the desire to secure resilience of supply in some essential products, and the broader context of the US and EU increasingly seeking, including via significant subsidies, to bolster domestic manufacturing, particularly of green and strategic goods such as microchips.

On the other hand, an expansive strategy for services trade would seek to position trade policy so that the UK can better benefit from growing global trade in services and our broad strengths across service sectors. Indeed, in the decade following the financial crisis, services exports grew by an annual average of 4.0 per cent compared with 1.4 per cent for goods. Moreover, progress here is also less reliant on the EU.

Recognising these objectives is just the start, because delivering against them is hard. Meaningfully protecting Britain's higher-value manufacturing from decline means facing hard choices about the UKs future relationship with the EU – even fairly significant tweaks to the current relationship will not do the job. On services, traditional trade policy tools have far less to offer in delivering meaningful liberalisation, requiring deeper regulatory cooperation that's has proved harder to negotiate. The UK therefore needs to pioneer a new approach.

This report lays out what a trade strategy that is defensive on goods and expansive on services should look like, recognising the challenges of making it a reality as well as the opportunities it seeks to exploit. Throughout, we stress the need to align domestic policy with trade policy – after all, you only have a genuinely strategic approach to trade if it is grounded in a wider economic strategy.

A defensive goods strategy is needed to resist the decline of some of Britain's most successful manufacturing industries

The hit to UK manufacturing trade, which includes 30 per cent of the UK's value added in gross exports, is already clear. At the end of 2022, the high-value manufacturing exports such as cars and chemicals were (respectively) 11 per cent below and just 2 per cent above pre-Brexit levels (compared to Q4 2018). This is underperforming the rest of the G7, where car and chemicals exports were on average 4 per cent below and 25 per cent above the level at the start of that period.

These are worrying developments in two important, high-productivity manufacturing sectors. In our previous work we found that, although the overall level of manufacturing activity in the UK should not change substantially as a result of Brexit, there would be a structural shift, which would see less-productive manufacturing grow as a share of output, while productive exporters shrink. This is one way in which being a less open economy makes Britain poorer: the average productivity of those manufacturing sectors expected to shrink is £47 per hour, compared with £37 per hour for the less-productive sectors that are set to grow.

A key reason for this is the deep supply-chain integration between the UK and the EU: in 2022, 54 per cent of manufacturing imports were from the EU and 47 per cent of exports were to the EU, with most of this trade (52 per cent) being in intermediate inputs rather than final goods. In part, this integration reflects the importance of market size for some high value added manufacturing, given the scale firms are required to operate at if they are to be competitive. While high-productivity manufacturers are relatively less responsive to trade barriers, over time these supply chains will begin to disentangle, shrinking some of the UK's manufacturing successes.

The car industry provides an early case study of the problems such manufacturers may face. This is because the structural transition to electric vehicles has meant a recent period of rapid investment decision-making, putting automotive well ahead of other industries where adaptation to the new trading arrangement will be more gradual. Importantly, cars have clear economies of scale: 8 out of every 10 cars built in the UK are exported, with almost 60 per cent going to the EU. It is also specialised, with the UK making twice as many engines as cars, selling these engines to international plants. While politicians of both main parties are currently almost exclusively focussed on how to respond to US and EU subsidies in this area, the underlying challenge is that EU countries can offer frictionless access to a much larger market. Given that the UK produced half the number of cars in 2022 than in 2018, it is important to recognise that Brexit, not 'Bidenomics', is the structural driver of decline for the UK car industry.

This matters so much because it might be automotive today, but it risks being chemicals or spacecraft and aviation tomorrow, as the structural shifts driven by our new trading arrangements play out. A defensive strategy to prevent the drift away from high value added manufacturing needs to recognise the driver of that drift: there is no alternative to revisiting the EU relationship.

We can make useful tweaks to our relationship with the EU, but halfway houses won't address the fundamental challenges

Politicians are united in their desire to reverse the decline of manufacturing exports since the TCA was implemented. But the proposed changes are small: they would reduce trade costs for specific sectors, but are not material for the economy overall, and do not offer much hope of avoiding the structural shift out of higher-value manufacturing. Welcome areas of focus include the Government's ambition to digitise borders (to enable "the UK border to be the most effective in the world") and Labour's plan to negotiate light touch Sanitary and Phytosanitary (SPS) checks for animal products. While helpful at the margin, neither will make much difference when decisions are being taken about where a multinational will build its next Gigafactory.

There is more to be gained by refreshing the UK's domestic regulatory approach with the goal of reducing overall costs for exporters. This is an important example of where protecting high-value manufacturing in the UK from the reality of not having frictionless access to a large home market is about domestic as well as trade policy. Here, the UK should decide to mirror a subset of EU rules, and update these as changes are made by the EU. This dynamic alignment will support these manufacturers because it reduces the costs of supplying both EU and UK markets. Importantly, this could be achieved unilaterally by the UK and would have material gains for certain sectors, such as chemicals, where the sector currently faces an estimated £1 billion of additional costs due to regulatory divergence. This approach should be pursued only when clearly in the UK's interests, such as aligning minimum product requirements and conformity testing so as to reduce duplication for British manufactures. Lessons can be taken from Canada's relationship with the US and New Zealand's arrangements with Australia where the smaller neighbours have established institutions to align regulation with the specific goal of reducing their producers' costs.

But while dynamic alignment will reduce costs and uncertainty, it doesn't actually improve market access to the EU for British exporters. This is because such halfway houses won't address the fundamental issue faced by British manufacturers – the existence of the UK-EU border for goods. Manufacturing businesses are reporting en masse – and at higher rates than services businesses – that the challenges to exporting are growing: 53 per cent of manufacturers experienced an increase in exporting challenges, compared with 39 per cent of services firms, between June 2022 and March 2023. These challenges include additional paperwork, customs duties, and border checks, all of which result in delays in transporting goods across borders. Failing to move goods seamlessly reduces trade and economic activity: it is estimated that each additional day that a product is delayed before crossing the border leads to a more than 1 per cent decrease in trade on average. Delays have a relatively greater impact on exports of time-sensitive goods, such as just-in-time supply-chain shipping.

These border issues are also why one often-mentioned solution – a customs union –is not the game changer it is often presented as. While it would remove certain border requirements, ultimately the goods border is binary – either it exists or it doesn't. A customs union would remove rules-of-origin requirements, reducing the non-tariff barriers (NTBs) facing firms by an estimated 3 to 5 percentage points. But standards and conformity checks would remain. Their continued presence, and the risk of delays or rejection at the border, are particularly harmful to the UK's position as a mid-supply-chain manufacturer. This is supported by evidence from Turkey which has had a customs union arrangement with the EU since 1995, but research has found that the customs union has had no noticeable impact on trade flows.

Supporting high value added manufacturing means a new trading arrangement with the EU for goods trade

There will always be some outstanding, globally-trading manufacturing firms in Britain. But if politicians really want to avoid the structural shift against high value added manufacturers in the UK economy, then the task is to maintain integrated supply chains over the long term. That requires a deal that delivers the benefits of the EU's customs territory and the single market *for goods* (not services). The combination of the two is greater than the sum of its parts.

The choice for Britain is whether or not to stay part of European supply chains. If we do, then the answer is to deliver a 'UK Protocol', building on the agreement for Northern Ireland. This is the only path to delivering a frictionless flow for goods trade between the UK and EU – the essential condition for being a meaningful part of European supply chains – as well as removing the complicated elements that manage Northern Ireland – Great Britain trade flows

A UK Protocol could boost our GDP by as much as 1 to 2 per cent, according to modelling of similar arrangements undertaken after the referendum. The benefits of such a set up are already emerging for Northern Ireland. In the two years since Brexit, Northern Ireland has shown greater resilience than other UK regions and nations in its trade with the EU: Northern Irish exports to the EU have performed better than the UK average in all but one goods sector.

To say the least, achieving a UK Protocol is thorny – both politically and substantively due to worries about the division of the four freedoms (goods, services, capital and people). Politically, both the

Conservatives and Labour have ruled out a customs union and even partial single market arrangements, and the EU previously ruled out a single market for goods and people. Substantively, the UK would need to align with EU regulations and customs policies, reducing the UK's current freedom on regulation and trading arrangements with third countries, for example by not acceding to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

But a UK Protocol isn't unimaginable. This is not about re-joining the EU, and the British Social Attitudes (BSA) survey suggests the public is substantially less interested in what the Government agrees on regulatory alignment than it is about free movement of people. The impact of lost regulatory freedom is likely to be limited: the UK's existing international commitments, including the TCA, limit the UK's scope to de-liberalise through level-playing-field commitments. And politicians who do not wish to take this path should recognise what that means for the future of some of our most successful manufacturing industries.

Meanwhile, for the EU, a UK Protocol presents significant challenges too. Brussels, as it stands, is not open to such an arrangement. But a UK Protocol aligns with what they have agreed in the Northern Ireland Protocol, and offered the UK during Theresa May's premiership. There are also clear political gains for the EU: the UK Protocol would remove the issue of the Northern Ireland hard border which lingers on. It would also be in the EU's economic interests to regain frictionless access to British goods markets. In any case, a trade strategy is not just about what is on the table right now – it is also about laying the groundwork for future deals that align with the broader needs of the UK economy. The precedent of the Northern Ireland Protocol and the existence of mutual gains for the UK and the EU make a new goods trading arrangement feasible at some point, were a UK Government to prioritise it as a core component of its trade strategy.

The UK needs an expansive strategy to deliver for services

A UK Protocol on goods retains flexibility for the UK's primary growth engine: services.

The UK's services specialisation and size jointly make it the second-largest services exporter in the world. This is about far more than the stereotype of a one-trick – financial services dominated – pony, with the UK's comparative advantages stretching across a broad range of services sectors, from cultural services to information and communications.

Patterns of global trade growth mean those specialisations can and should be harnessed as part of an attempt to turn around the UK's dire growth performance. Services trade as a share of GDP continued to grow even as overall trade growth stalled post financial crisis. Trade in the services in which the UK specialises, such as cultural and recreational services and other business services, have experienced particularly strong growth: global services exports in industries with a UK revealed comparative advantage (RCA) tripled between 2005 and 2021, outpacing goods exports which doubled over the same period. And these sectors generate well-paid jobs, with jobs in tradable services 80 per cent more likely than average to pay in the top 5 per cent of the wage distribution.

An expansive objective for services within the UK's trade strategy also reflects that it is here that the largest opportunities for trade liberalisation beyond the EU lie. The UK is less dependent on the EU market for its services exports relative to goods: 61 per cent of services exports went outside the EU, compared to 50 per cent of goods exports, in 2018. There also remains significant scope for further liberalisation, even with partners the UK already has recently agreed an FTA with (which do little more than lock in existing market access for services exporters). This approach also allows the UK to retain an independent migration system, something which is incompatible with membership of the single market for services.

There is, however, also room for improving arrangements with the EU. In this context, the aligned regulatory regimes of the EU and UK provide a strong basis for going further than the standard FTA we currently have in some sectors. The priority should be improving market access for services exporters. Here the UK should push for achievable improvements, such as allowing

UK professional qualifications to be recognised in the EU and delivering a renewed data adequacy arrangement, to secure the rights for the transfer of personal data.

Given the limitations of traditional FTAs in addressing barriers to services trade, this approach will require innovation in both the content and method of trade policy. So we should not expect it to always be an easy path. Achieving material liberalisation often relies on deeper regulatory arrangements that can prove difficult to agree in the absence of harmonisation, even between countries with similar regulatory regimes.

But there are reasons to be optimistic. While challenging, the UK has had some success in pursuing agreements that liberalise specific services, for example its world class digital agreements and the mutual recognition agreement being negotiated with Switzerland. It is now a matter of systematising these difficult, but to-date, piecemeal accomplishments. And the current politics of international trade, specifically the growing focus on onshoring goods manufacturing, also points to the UK's offensive trade strategy objectives being in the services space. This creates an opportunity for the UK to cement its services leadership role.

The UK should look to secure innovative services trade agreements

Rather than accept the traditional trade tools that do relatively little to liberalise services, the task for the UK is one of innovation. Prosecuting the trade strategy envisaged in this paper requires creating a new framework for trade agreements, both in terms of the components of those agreements and the approach taken to negotiating them. On both fronts it should build on previous successful services liberalisation.

The components required in what we see as new services trade agreements (STAs) would address the ability of services suppliers to move across borders, and ease restrictions by recognising equivalence, where it exists, between regulatory regimes. STAs should include:

- Mutual recognition of professional qualifications (MRPQs) which would enable improved mobility of skilled workers by agreeing sector-specific arrangements as well as developing a simplified process for the recognition of qualifications. These would build on the many examples of sector-specific MRPQs (for example for US and Canadian accountants), as well as the broader arrangements for recognition between Australia and New Zealand.

- Digital agreements which would seek to grow digital trade and provide reassurance against future digital barriers emerging, covering data adequacy as well as provisions on electronic authentication and digital identity approaches. These would build upon the EU-UK data adequacy arrangement and the Singapore Digital Economy Agreement. They would also provide standards and protections in a fast-evolving sector.
- Mutual-recognition agreements (MRAs) for financial services which would enable companies to trade freely in the partner country with minimal additional authorisation. These could be based on the eventual UK-Swiss MRA, which is currently being negotiated, and seeks to agree market access liberalisation on the basis of aligned regulatory outcomes, rather than harmonisation.
- Enhanced-mobility arrangements which would seek to agree ambitious reciprocal improvements in temporary visa-free access, for example by encouraging the Home Office to develop a preferential visa-access regime. This could build on the UK-Swiss Services Mobility Agreement.

The approach, not just content, of this new trade policy has to be different too. The necessary focus on regulatory regimes requires that regulators be at the centre of negotiations and the implementation of these agreements. To do this, the UK can build on the regulatory cooperation approach established in the UK-Australia trade deal, by initiating negotiations with a 24-month dialogue between regulators to agree and present regulatory recommendations. Agreements would then primarily be discussed and agreed by regulatory bodies and professional associations, as is the case for the Swiss-UK MRA on financial services. The Department for Business and Trade would, however, remain critical in managing the negotiations. Joined-up policymaking across government departments and regulatory bodies in an international negotiation is not a new concept, but this has to be centre stage when it comes to the envisaged focus on services trade liberalisation.

Finally, identifying partners suitable for STAs would redirect UK trade policy. The approach would seek to build on the FTAs already negotiated, including with Singapore, Australia, Canada, Switzerland and Japan, and explore negotiating services deals with some of the UKs other largest services trade partners, such as the US. Importantly, these countries, unlike India and China who also represent relatively large shares of UK services trade, have similar regulatory regimes and higher income levels than the UK, so have lower perceived migration risks. Refocussing trade policy on services deals with these countries will also target a large and growing demand for services in which the UK specialises – six priority non-EU markets import 33 per cent of services with UK RCA. This is equal to demand from the EU, and growth in demand by these countries since the financial crisis has outstripped the EU.

Although the current global economic environment is not favourable to delivering traditional liberalisation, key trading partners have demonstrated interest in exploring innovative trade arrangements that avoid traditional tariff reductions, for example the US Indo-Pacific Economic Framework and the US-Taiwan agreement. In the absence of multilateral action by the WTO, countries are looking to set standards and ensure market access is future proofed, for example by pursuing new digital agreements.

The UK is also an attractive partner for seeking services liberalisation opportunities. It is a disproportionately significant services import market for its largest non-EU-trading partners, accounting for between 4 and 7 per cent of partners' services exports, more than double its share of global GDP, and substantially higher than the 1 to 4 per cent of goods exports the UK received from these countries in 2022.

The overall value of agreeing these deals could be worth several billions in exports. For example, ambitious agreements with Canada, Japan, Switzerland and Australia could add up to £6 billion in business services exports. These are all countries the UK has recently concluded or is currently negotiating deals with. If it was feasible to agree similar arrangements with the US, the impact could be more than doubled (to £17 billion additional exports). And as these are just partial assessments: the dynamic gains could be even larger, particularly when combined with an aligned domestic-policy framework supporting these sectors.

Aligned domestic policy is also needed to enhance UK competitiveness in services

Addressing trade barriers must be complemented by domestic policy, which has the advantage of being directly under UK policy makers' control. In this context, the UK has become less internationally competitive in several key services sectors over the past decade. For example, in financial services, the UK has lost 22 per cent of its market share since 2005, while this has grown by 12 per cent for the rest of the G7. A coordinated domestic and trade policy approach is vital to support British firm's international competitiveness, with responsibility going beyond the Department for Business and Trade.

In many cases this is about building on UK characteristics that support its services comparative advantage, for example the UK's highly-skilled workforce which rests on domestic skills development and the ability to attract the best international talent. Migration policy is disproportionately important for the UK's education and R&D exports, and should be set with that in mind.

Coordinating domestic and trade strategies also means ensuring regulatory decisions positively impact the competitiveness of tradeable services. This will include offering certainty and confidence about the UK's future regulatory environment to encourage domestic investment, foreign firms to locate in the UK and trading partners to commit to mutual recognition arrangements. It will also be about ensuring the regulatory approach builds on UK strengths, including by protecting the UK's reputation for high regulatory standards, a source of competitive advantage for several services sectors. Lower regulation per se is not a route to lasting services trade success. But this is not just about enhancing our long-demonstrated strengths: our approach must also be designed to help the UK develop capabilities in emerging sectors – specifically those that can help us achieve our domestic ambitions, for example developing green technology.

Finally, ensuring sufficient regulatory capacity will be a prerequisite for successful negotiations, and grant-in-aid funding arrangements could be reviewed to ensure the upfront investments needed to engage in intense regulatory dialogues and negotiations can be delivered.

Moving to a growth-boosting trade strategy means making hard choices

After half a century of the EU setting trade policy for the UK, the UK needs a new trade strategy. Coming after 15 years marked by relative economic decline, it is all the more important that it is the right one – grounded in a wider economic strategy for how the UK succeeds in the 21st Century. The current debate, framed all too often as a choice between re-entering the EU or doing nothing, has not risen to that challenge.

This paper argues that the nature of the UK economy, developments in global trade patterns and rising geopolitical tensions regarding goods trade all point to twin objectives for that strategy: a defensive objective on goods and an expansionary one for services, both underpinned by supportive domestic policy decisions.

On the former, our analysis indicates that the choice for policy makers is a stark one: a significant change to our relationship with the EU is required to prevent some of our most productive manufacturing sectors declining as their integration with European supply chains unravels over time.

But our trade strategy should be innovative as well as defensive. That is what will be required to prosecute a new expansive services-oriented approach to maximising opportunities beyond the EU. STAs are a new approach, but one built on elements of progress seen elsewhere.

Achieving these strategic objectives requires looking beyond what is on the table now. A trade strategy is about setting out clearly what you are aiming for, so it can be built up to over the months and years ahead.

Global services exports are expected to grow from 25 per cent to 28 per cent of total exports by 2035, and the UK is well placed to take advantage of this. The difference between maintaining the UK's current market share compared to the modelled post-TCA hit to exports is worth £200 billion in services exports in 2035– so while the road ahead is challenging, the rewards are potentially huge.

Introduction

A post-Brexit trade policy should be a central part of the UK's economic strategy

When the UK voted to the leave the EU in 2016, this initiated the largest shift in the UK's trade policy debate in half a century.

As a member of the EU, the UK did not have an independent trade policy. The trade strategy, both between member states and with third countries, was set by EU Commission and EU institutions, who together "make laws on trade matters, and negotiate and conclude international trade agreements".[1] While the EU must set a trade agenda accounting for the varying interests of member states, the UK is now empowered to set out and deliver an independent trade strategy that is fully adapted to the strengths and needs of the economy and aligned to its domestic objectives.

This is about much more than trade flows. Our approach to global trade drives what we buy from abroad, but that also implies it sets what gets produced domestically. This means it influences the jobs available to British workers, the productivity of the economy and, ultimately, our living standards. It also contributes a major plank of Britain's international policy at a time of heightened geopolitical tensions. In an interconnected global economy, with dynamic, competing markets, trade policy is a critical tool for the Government to support productive UK firms to grow and to deliver economic dynamism.

As trade will play a pivotal role in our wider economic performance, taking a strategic approach to trade policy is critical. Yet, much of the UK trade policy debate remains muted by the politics surrounding the Brexit debate. Trade policy has been used to signal individual stances on Brexit: advocates hold up the many deals signed as evidence of the dividends of Brexit, while opponents compare the estimated gains to the losses of Brexit. However, in doing so, both sides fail to focus on the important roles trade policy can take

1 European Commission, Making trade policy, accessed 13th June 2023.

in supporting a broader economic agenda. In this report we set out how the UK should approach developing a trade strategy that can deliver growth.

This report is organised as follows:

- Section 1 sets out the limitations of the current trade policy approach and outlines the necessary components of a trade strategy.
- Section 2 sets out a defensive objective to support high-productivity manufacturers, which will mean reviewing the EU-UK trading relationship.
- Section 3 outlines an expansive strategy to address services liberalisation.
- Section 4 sets out our conclusions.

Section 1

A new approach to UK trade is needed

Britain's trade policy post-Brexit has prioritised the speed and volume of free trade agreements (FTAs), both 'rolled-over' agreements and new agreements, rapidly negotiated to offset some of the significant reduction in trade openness post Brexit.

But this approach, while largely understandable and successful for the most part, has run out of road. This is because the UK faces limited scope for further substantial liberalisation through FTAs, without seeking unlikely agreements with the US or China, which jointly account for 24 per cent of UK trade in 2022. On top of that, the emphasis on speed of negotiation during this period, necessitated relying on the tools that were readily available – FTAs. But FTAs that are focused on goods, and so are ill-fitted to benefit Britain's strengths as a service's 'superpower'.

A new trade strategy is therefore needed. Here, we need clear objectives, grounded in the UK's wider economic strategy, that recognises the context and constraints within which we operate, reflects rather than ignores trade offs, and is highly integrated with domestic policy.

Such a strategy would have twin objectives. First, a defensive objective on goods: seeking to protect higher value added manufacturing firms struggling to retain their place in European supply chains. Second, an expansive objective on services: seeking to ensure the UK benefits from the growth in global services trade, that is particularly strong in areas of British specialism.

The UK's current trade approach has run out of road

After the 2016 Brexit referendum, the UK Government pursued a policy of signing trade agreements as quickly as possible. Indeed, the trade department worked quickly to ensure UK firms retained the access to third-country markets, by successfully signing 'rolled-over' agreements with more than 90 countries, covering the vast majority of pre-existing EU agreements and representing more than 60 per cent of UK's trade in 2022.

The Government signalled its intention to expand FTA coverage and to "secure free trade agreements with countries covering 80 per cent of UK trade" by the end of the 2022.[2] Upon leaving the EU, negotiations with Australia, New Zealand, the US and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) were launched in quick succession as the Government set about putting its trade policy into action.

This represented a tactical approach to offset some of the UK's expected lost trade openness post Brexit. The UK is a very open economy, with total trade – that is, both imports and exports – of £1,700 billion in 2022, equivalent to 64 per cent of GDP. Firms reported that they had exported £382 billion of goods and £401 billion of services in 2022.[3] But, in the same year £9 in every £20 (46 per cent) of trade was with the EU, as shown in Figure 1. This trade is the subject of new trade barriers, estimated to reduce trade by more than 20 per cent in the long run.[4]

FIGURE 1: **In 2022, the EU accounted for more than half of goods trade and around 40 per cent of services trade**

EU share of goods and services trade: UK

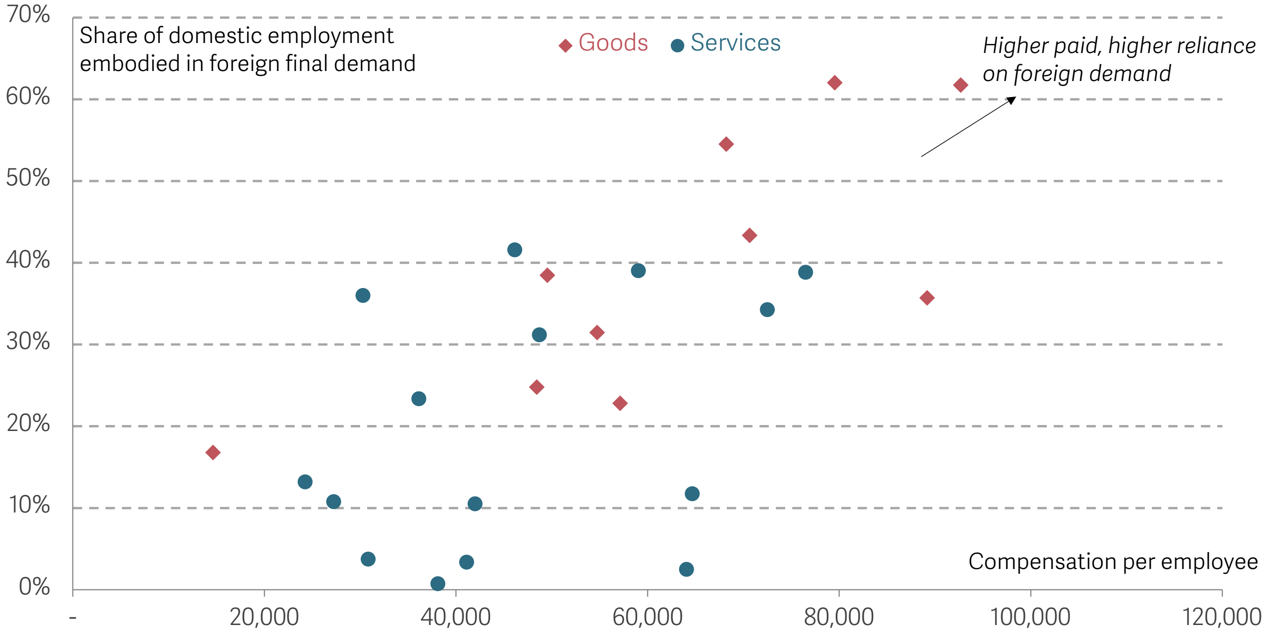
NOTES: EU goods trade is adjusted to account for measurement changes in line with ONS estimates – increasing EU exports 5 per cent and imports 6 per cent for all periods before 2021.
SOURCE: ONS, March 2023 monthly trade statistics and Q4 2022 quarterly services trade statistics.

2 UK Parliament, Free Trade Agreements with the Rest of the World, Written statement made by Liz Truss, February 2020.
3 Analysis of ONS, Bureau of Economic Analysis.
4 S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, Resolution Foundation, June 2022.

The UK's trade openness in both goods and services has historically supported highly-skilled, well-paid jobs in the UK. As shown in Figure 2, a larger share of jobs in higher-paying UK sectors rely on foreign demand – with 20 per cent of overall UK domestic employment embodied in foreign demand in 2018, compared to 41 per cent for the highest-paying sectors.[5] While certain non-tradable industries tend to be less well compensated, specialisation has enabled a larger share of the British workforce to work in particularly well-paid tradeable services, in place of less-productive roles elsewhere in the economy.

FIGURE 2: **Sectors with higher pay, particularly in high paid service sectors, are more reliant on foreign demand**

Share of domestic employment embodied in foreign final demand and compensation per employee across sectors: UK



SOURCE: OECD, Trade in employment, 2021 edition.

The focus of Britain's high-volume approach, once the UK-US FTA negotiations had broken down, was to target agreements with the high-growth partners in the Indo-Pacific region, to unlock new markets for British exporters. This approach was in line with the Government's "Indo-Pacific tilt", set out in the Governments 2021 Integrated Review, and included launching a negotiation with India as well as seeking to be the first European country to accede to the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP).[6] These two targets are relatively large trade partners for the UK, accounting for 2 and 8 per cent of UK trade respectively, and the UK's successful accession to the CPTPP

5 The highest-paying sectors which jointly account for 10 per cent of employment.
6 Cabinet Office, Integrated Review Refresh 2023: Responding to a more contested and volatile world, Policy Paper, May 2023.

was announced in March 2023.[7] Although CPTPP represents a larger total market, import growth of the bloc is low and the UK's existing bilateral deals with nine of the eleven CPTPP members mean the economic gains were likely to be small.[8]

The UK is continuing its approach to sign new FTAs as well as sensibly seeking to modernise existing deals. The Government has recently launched negotiations with the Gulf Cooperation Council which represents 4 per cent of UK exports.[9] The UK has launched talks with countries such as Mexico, to modernise and improve the existing trade agreements, and will need to renegotiate deals that were rolled over with review clauses, for example with Canada.

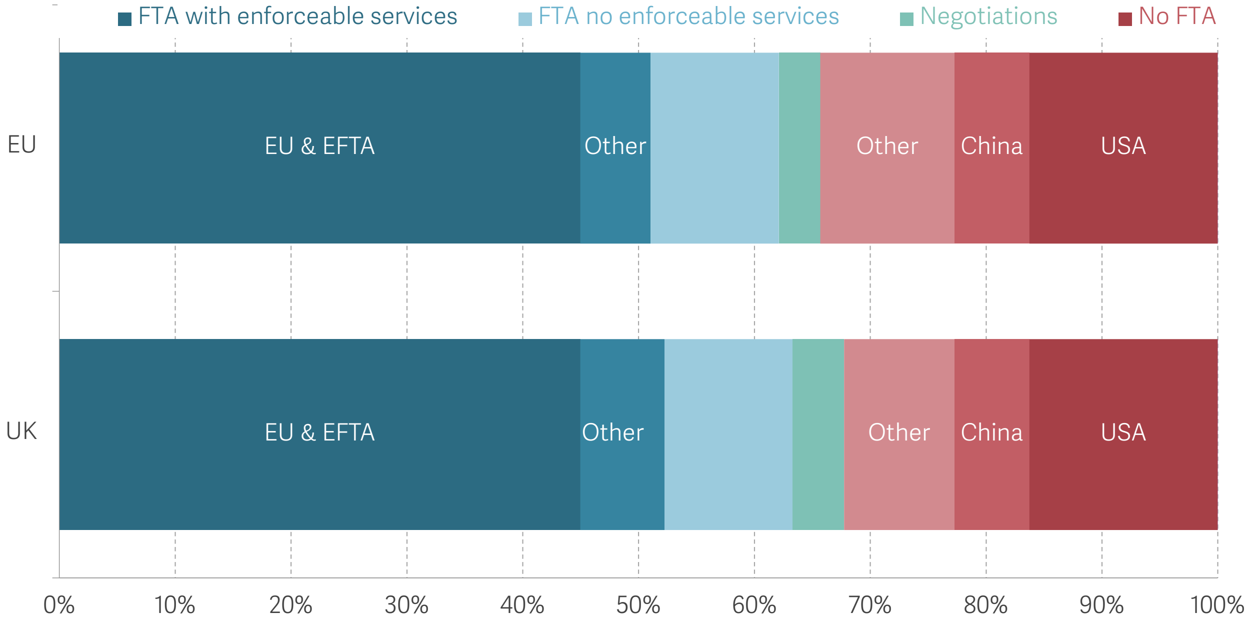
But this approach comes up short of a trade strategy, failing to offer clear objectives beyond the goal of signing as many FTAs as possible, and has now reached the end of the road. The UK now has agreements covering countries accounting for more than 60 per cent of its trade. The two notable exceptions, where big liberalisation opportunities are available, are China and the US, which jointly account for 24 per cent of UK trade. After initially engaging in negotiations, the US signalled that an FTA is no longer on the table. And political challenges with China make this an equally unpromising avenue. Without securing deals with China or the US the UK has little chance of achieving its 80 per cent objective, as shown by Figure 3.

Although the UK managed to cover more than 60 per cent of trade under FTAs in rapid succession, this approach to trade policy has largely failed to deliver for services, which account for 79 per cent of total UK economic output and which Britain has broad-based comparative advantages.[10] These FTAs were often negotiated quickly based on templates from existing agreements that, while having relatively broad coverage, were not best suited to UK strengths. The desire to quickly secure agreements with both Australia and New Zealand left the UK agreeing to substantial agricultural liberalisation, without meaningfully addressing barriers to facing UK services exporters.

7 Department for Business and Trade, Conclusion of Negotiations on the Accession of the United Kingdom of Great Britain and Northern Ireland to the Comprehensive and Progressive Trans-Pacific Partnership , Policy Paper, March 2023.
8 S Hale, A presage to India: Assessing the UK's new Indo-Pacific trade focus, Resolution Foundation, January 2022.
9 However, stakeholders including the Trades Union Congress (TUC), have raised concerns about the GCC's human rights records. For example, see: E Wragg, UK brushes off human rights concerns to start trade talks with GCC Global Trade Review, June 2022.
10 J De Lyon et al, Enduring Strengths: Analysing the UK's current and potential economic strengths, and what they mean for its economic strategy, at the start of the decisive decade, Resolution Foundation, April 2022.

FIGURE 3: **The UK has little scope for further liberalisation through signing new free trade agreements**

Share of UK trade by type of agreement based on existing FTA coverage of the EU and the UK: 2022



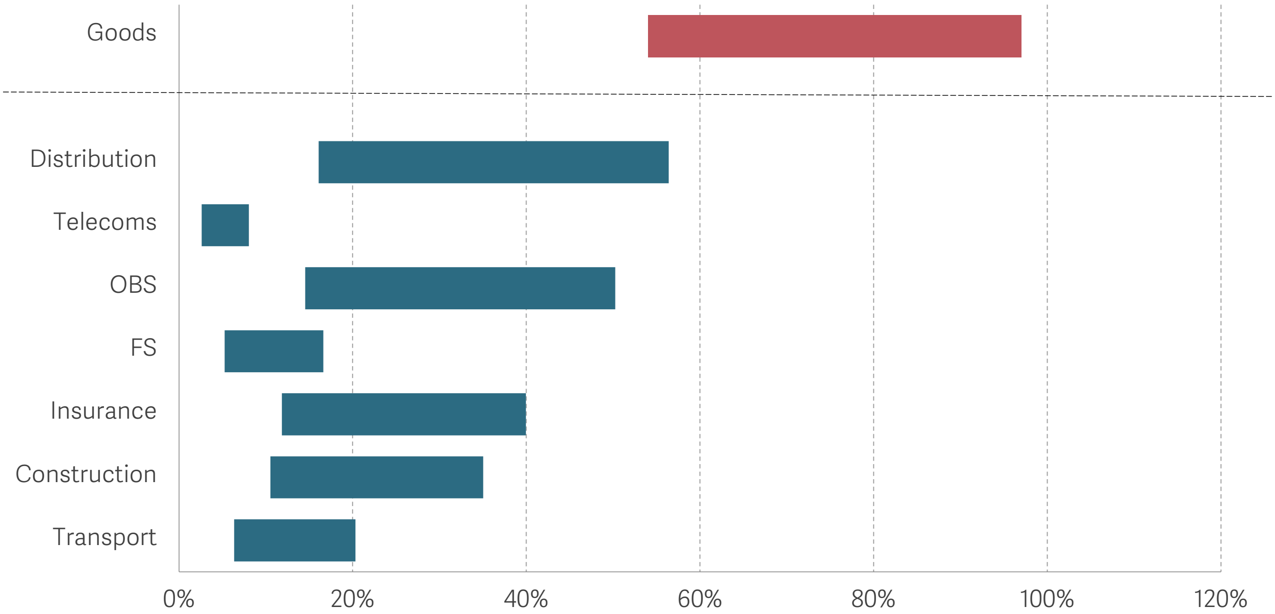
NOTES: Negotiations include Gulf Cooperation Council for the UK, Mercosur, Australia for the EU and India for both. Agreements where negotiations have concluded but the agreements have not yet been implemented are included under FTAs with enforceable services, for example CPTPP for the UK and the New Zealand with the EU.
SOURCE: Analysis based on ONS, Total Trade by Country Annual and the Department for International Trade Collection: The UK's trade agreements collection.

The largely understandable emphasis on speed of negotiations necessitated relying on the tools that were readily available – FTAs. But these have typically been less effective at liberalising services than goods. An FTA is estimated to increase goods trade by between 54 and 97 per cent, but the impact is more modest for services, increasing other business services by 15 to 50 per cent and financial services trade by just 5 to 17 per cent as shown by Figure 4 (both sectors are areas of comparative advantage for the UK).[11]

11 J De Lyon et al, Enduring Strengths: Analysing the UK's current and potential economic strengths, and what they mean for its economic strategy, at the start of the decisive decade, The Resolution Foundation, April 2022.

FIGURE 4: **Traditional FTAs have been more effective liberalisation tools for goods than services**

Estimated percentage increase in trade from a typical free trade agreement



NOTES: Goods impact range represents ECB estimated long-run increase in trade for a typical FTA and a modern FTA. The services estimates use the DIT elasticities for changes in the STRI with OECD estimates that on average, FTAs have removed between 10 per cent and 30 per cent of services restrictions present.
SOURCE: Analysis of DBT, Services trade modelling working paper; OECD, STRI, Measuring services liberalisation and commitments in the GATS and RTAs; and ECB Working Paper Series, Global trade in final goods and intermediate inputs: impact of FTAs and reduced 'Border Effects'.

There are examples where the Government has sought to go further on services, by successfully innovating and modernising some of the UK's trade deals, with provisions that support services. The modernised deals include agreeing enhanced digital provisions within existing agreements, including the UK-Japan Economic Partnership Agreement and the Singapore Digital Economy Agreement. And HMT and the Bank of England are currently negotiating a mutual recognition agreement (MRA) on financial services with Switzerland, which would provide deep access to financial services trade based on mutual trust and assurance of our regulatory systems.

But the big picture is that the reliance on FTAs has meant failing to prioritise the UK's strengths as a services 'superpower' and risks missing the opportunity to use trade policy to harness the tailwinds from growing global demand for services.

A strategic UK trade policy is required

The nature of a trade strategy is that it needs to have clear objectives, recognise the constraints, reflect the current context and be highly integrated with domestic policy.

The UK's trade strategy needs to be clear about the problem it is trying to solve. Here the priority should be to harness trade as an engine for UK growth and international competitiveness. The UK's ambition need not be limited by the status quo, settling for ill-fitting traditional bilateral trade policy tools, and nor should it be restricted by fear of revisiting the EU relationship.

In this report we set out twin objectives for the UK's trade strategy:

- a 'defensive' objective on goods: delivering market access for higher value added manufacturing firms struggling to retain their place in European supply chains; and,
- an 'expansive' objective on services: seeking to ensure the UK benefits from the growth in global services trade, that is particularly strong in areas of British specialism.

The strategy should be defensive on goods to prevent further damage to highly productive manufacturing.

The UK's goods trade is where the initial impact of Brexit has been most visible, with goods exports 17 per cent below pre-TCA levels in Q1 2023, the worst in the G7.[12] Our previous work suggests the longer-term risks of new barriers with the EU fall greatest on Britain's high-productivity manufacturing, reliant in many cases on being part of European supply chains, which would shrink relative to lower-productivity manufacturing. A defensive strategy on goods means securing resilience of supply in some essential products, understanding the systemic risks facing the UK's food supply for example.

On top of this, the longer-term result of significant goods-trade frictions with the EU risks being to shrink high-productivity manufacturing such as automotive industries, reliant in many cases on being part of European supply chains. Meanwhile, our previous modelling suggests that low-productivity manufacturing (e.g. food manufacturing) for the domestic market will be boosted as a share of output.[13] In this context, the objective is defensive – asking us to be clear eyed about what it would take to prevent this structural shift, and the loss of high-quality firms and jobs it implies, taking place.

But delivering on this strategy means that Britain will need a hard-headed assessment of the trade-offs and facing down the political challenges. Britain faces a choice for our goods manufacturers, whether we should revisit our relationship with the EU or accept consequences for high-value-added manufacturers of weakening our role in EU supply chains. Revisiting the EU relationship will be both politically and substantively hard to do, but, as we discuss below, the halfway-house options currently being discussed won't do enough to prevent lost UK high value added manufacturing.

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12 Analysis of ONS, UK Trade in Goods, and OECD International Trade and Balance of Payments. UK figures excludes precious metals; See also: S Hale & E Fry, Open for Business?, Resolution Foundation, February 2023.

13 S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, Resolution Foundation, June 2022.

Meanwhile, an expansive strategy for services trade is about positioning trade policy to better benefit from growing global trade in services and the UK's broad strengths across service sectors. Moreover, progress here is also less reliant on the EU. As UK services exports are less reliant on the EU market than our goods trade, there is value in exploring an approach that that looks beyond the EU.

An expansive strategy for services also requires facing hard realities. Traditional trade policy tools have far less to offer in delivering meaningful liberalisation, requiring deeper regulatory cooperation that's has proved harder to negotiate.[14] The UK needs to pioneer a new approach.

But the strategy for both goods and services will need to be rooted in the reality of rising global trade tensions. Since the UK chose to leave the EU, global trade tensions have risen between the US and China resulting in a trade war between 2018 and 2020 that has left higher tariffs on US and China goods trade and a more fractured global trading system, where partners talk excitedly about 'friendshoring'.[15] The Trump administration refused to agree to the appointment of any World Trade Organisation (WTO) Appellate Body members as members' terms expired, and this has not been resolved under the Biden administration, leaving nobody to hear appeals at the WTO.[16] Progress in multilateralism had already slowed, suggesting it would be wildly unrealistic for the UK to expect broad, multi-country deals to ride to the rescue.

In the past year, the global context has become even more challenging as the US and EU are both pursuing policies to onshore certain advanced manufacturing, as part of their green industrial policies. This includes the US Inflation Reduction Act and the European Green Deal which both seek to bolster domestic manufacturing of green and strategic goods such as chips, batteries, and renewables, with the US announcing almost $400 billion of subsidies towards this goal.[17] This signals their intention to reduce their reliance on imports – particularly in growing green industries – and to approach international trade viewed through the lens of trade being a zero-sum game. This global context makes it even more challenging to deliver benefits by continuing to pursue goods-oriented FTAs, but suggests that there might be opportunities to pursue growth in services trade, where Britain has deep comparative advantages and trade growth is stronger. In the decade following the financial crisis, services exports grew 4.0 per cent annually compared with 1.4 per cent for goods.[18]

14 B Hoekman, A Mattoo and A Sapir, The political economy of services trade liberalization: a case for international regulatory cooperation?, Oxford Review of Economic Policy, Vol. 23 (3), Autumn 2007; WTO, World Trade Report 2019: The future of services trade, 2019.
15 C Bown, US-China Trade War Tariffs: An Up-to-Date Chart, Peterson Institute for International Economics, April 2023.
16 S Lester, Ending the WTO Dispute Settlement Crisis: Where to from here?, International Institute for Sustainable Development, March 2022.
17 The White House, Building a clean energy economy: A guidebook to the Inflation Reduction Act's investments in clean energy and climate action, Version 2, January 2023.
18 Analysis of OECD Balanced Trade in Services (BATIS) and UN Comtrade.

For open, medium-sized economies like the UK, unilateral domestic policy decisions are major tools where the Government has complete control to establish on what terms it interacts with the rest of the world. And so, the trade strategy must look beyond what can be achieved through negotiated deals with trading partners. This means ensuring the UK's approach to regulation and migration are highly aligned with these trade objectives, as a truly strategic approach to trade policy must be grounded in a wider economic strategy.

Importantly, setting a strategy for trade is about setting a direction for UK policy, rather than letting it simply be guided by the deals that are readily available now. Achieving these objectives will require ambition and planning over a longer-time horizon, to allow the UK over the months and years ahead to take the steps required to realise the strategic aims.

Having set out the big picture for the approach that is needed, in the next section, we start by setting out why the approach on goods should be defensive and what this would look like. And in subsequent sections we discuss the approach for an expansive services trade strategy.

Section 2

The UK's approach to goods trade should be defensive

Brexit's effect on UK manufacturing trade is already clear. Just two years after the TCA was implemented, high-value manufacturing exports such as cars and chemicals are 11 per cent below and just 2 per cent above pre-TCA levels respectively (Q4 2022 compared to Q4 2018). This is underperforming the G7, where cars and chemicals exports are on average 4 per cent below, and 25 per cent above during the same period (excluding the UK).

This matters not least because, as shown in our previous work, new EU trade barriers are likely to put pressure on high-productivity manufacturing, and increase the incidence of lower-productivity manufacturing. This is largely due to the disruption of the deep supply-chain integration between the UK and the EU on which high-productivity manufacturing relies. Indeed, in 2022, 54 per cent of manufacturing imports were from the EU and 47 per cent of exports were to the EU, with most of these (52 per cent) as intermediate inputs rather than final goods. Although these supply chains will take time to disentangle, they will shrink the UK's high productivity manufacturing – from chemicals to spacecraft – as they do.

Consensus is building that Britain should seek to reverse the decline of manufacturing exports. But politicians are currently only proposing tweaks to the relationship with the EU such as digitising the border. These might reduce trade costs for specific sectors but they offer little hope of avoiding the structural shift out of higher-value manufacturing.

Instead, a new approach to the UK's regulatory regime could reduce overall costs for exporters forced to comply with similar but slightly different standards and conformity checks of goods in both UK and EU. Dynamic alignment with the EU highlights where the UK's domestic policies can be leveraged in support of trade policy, where providing frictionless access to a large home market isn't just about signing new trade deals. Lessons on the structure of this arrangement can be taken from Canada's relationship with the US and New Zealand's arrangements with Australia where the smaller neighbours have established institutions to align regulation with the specific goal of reducing their producers' costs.

Although dynamic alignment will reduce costs and uncertainty, these halfway houses won't increase market access to the EU. UK businesses continue to face the UK-EU border for goods causing manufacturing businesses to report that the challenges to exporting are growing: 53 per cent of manufacturers experienced an increase in exporting challenges compared with 39 per cent of services firms in June 2022-March 2023. Even a customs union wouldn't remove these border requirements as it continues to require conformity checks causing risk of delay at the border for goods crossing. An evaluation of Turkey's customs union arrangement with the EU since 1995, found that it has had no noticeable impact on trade flows.

Britain will always have some highly-productive, globally-celebrated manufacturing firms, but to avoid the structural shift away from high value added manufacturing the UK needs to maintain integrated supply chains over the long term. That requires delivering the benefits of the combination of the EU's customs territory and the single market for goods (not services): a 'UK Protocol', building on the template of the agreement for Northern Ireland. A UK Protocol could boost our GDP by as much as 1 to 2 per cent, according to modelling of similar arrangements undertaken after the referendum. The benefits of such an arrangement are already emerging for Northern Ireland whose goods exports to the EU have typically outperformed other UK regions since Brexit.

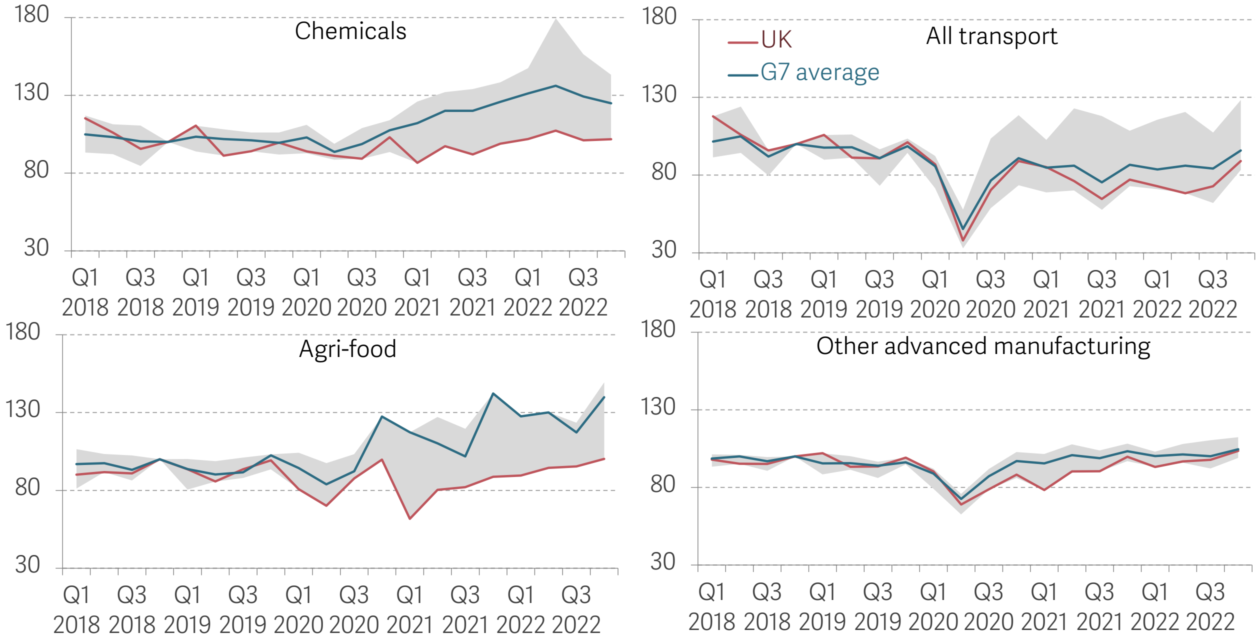
This would be hard but not inconceivable. Substantively, the UK would need to align with the EU both on regulations and customs rules. The UK's lost regulatory freedom is likely limited in practise due to level playing field commitments included in international agreements such as the TCA , and the alternative would further harm highly-productive manufacturing sectors. Furthermore, a UK Protocol aligns with (and simplifies) what has been agreed with the EU under the Norther Ireland Protocol, and what the EU offered to the UK during Theresa May's time in office.

Some of Britain's most successful manufacturing industries are in decline

The hit to manufacturing trade is already clear. UK goods exports have performed the worst in the G7 overall since the TCA was implemented, and at the outset of 2023 were 17 per cent below pre-Brexit levels, significantly worse than France, the second weakest G7 performer, whose goods are just 6 per cent lower.[19] High-value manufacturing exports such as cars and chemicals are 11 per cent below and just 2 per cent above pre-TCA levels as of Q4 2022 (compared to Q4 2018). Meanwhile, G7 cars and chemicals exports are on average 4 per cent below, and 25 per cent above, their Q4 2018 level (excluding the UK), as shown in Figure 5.

FIGURE 5: **High value added manufacturing has taken a hit post Brexit**

Index of goods exports value (Q4 2018=100): G7 countries



NOTES: Chemicals includes HS codes 28-38. All transport includes railway, vehicles, aircraft and ships manufacturing (HS 86 to 89). Agri-food includes HS 1 to 24. Other manufacturing includes machinery and electrical equipment (HS 84 and 85). Swathe shows G7 countries.
SOURCE: Analysis of ITC Trademap.

Manufacturing is more reliant on foreign supply and demand than services. In 2022 exports comprised 32 per cent of manufacturing turnover, with exports in pharmaceuticals and computer, electronic and optical equipment accounting for as much as 69 per cent and 58 per cent of turnover respectively. Exports were just 15 per cent of turnover for services industries.[20] Imports are also essential for manufacturing, supporting choice and productivity growth. A lack of import competition harmed the

19 S Hale & E Fry, Open for Business?, The Resolution Foundation, February 2023.
20 Analysis of the Monthly Business Survey (MBS) turnover of services industries, and the MBS turnover of production industries, and the ONS Trade Time Series.

UK's manufacturing competitiveness in the 1950s, causing low productivity growth in the sector.[21]

There are a number of industries for which the UK has a revealed comparative advantage. These include several high value added manufacturing sectors, such as the production of enzymes and pharmaceutical goods, medical devices, vehicles and spacecraft.[22] Another example is cinematographic cameras where, although the global market is small, the UK is the second biggest exporter. It is also the sixth largest exporter of instruments for chemical analysis (e.g. spectrometers), compared with tenth overall for goods exports.[23] Manufacturing sectors also offer 'good' job opportunities. Workers in tradable goods industries were 20 per cent more likely than average to work in jobs which paid wages in the upper-middle part (50th to 90th percentiles) of the wage distribution – which are able to support decent living standards and offer progression for lower earners.[24]

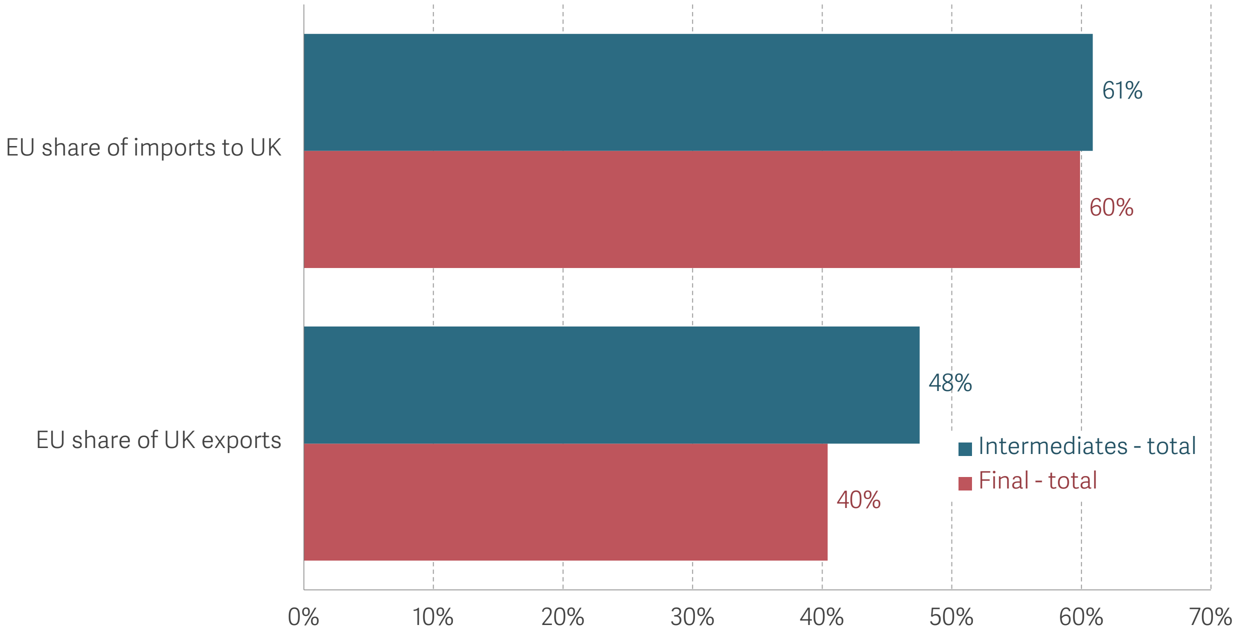
But as Brexit progresses, we are likely to see a shift to lower-productivity manufacturing, reinforcing weak economy-wide productivity. In our previous work we found that, although the overall level of manufacturing activity in the UK may not change substantially post-Brexit, there would be a compositional shift favouring less productive manufacturing as productive exporters are hit the hardest – the average productivity of shrinking manufacturing sectors is £47 per hour, compared with just £37 per hour for growing sectors.[25]

A key reason for this shift is the deep supply-chain integration between the UK and the EU: in 2022, 54 per cent of manufacturing imports were from the EU and 47 per cent of exports were to the EU, with most of this trade (52 per cent) being in intermediate rather than final goods. Figure 6 shows the importance of integration in EU supply chains for UK exports, given the EU accounts for 48 per cent of intermediates exports, but only 40 per cent of final goods exports.

21 N Crafts, Adapting well to new circumstances: UK Experience in Changing Times The Resolution Foundation, November 2022.
22 J De Lyon et al., Enduring Strengths: Analysing the UK's current and potential economic strengths, and what they mean for its economic strategy, at the start of the decisive decade, The Resolution Foundation, April 2022.
23 Analysis of UN Comtrade.
24 J De Lyon et al., Enduring Strengths: Analysing the UK's current and potential economic strengths, and what they mean for its economic strategy, at the start of the decisive decade, The Resolution Foundation, April 2022. Manufacturing jobs comprise 8 per cent of total UK employment.
25 S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, The Resolution Foundation, June 2022. For example, lower productivity sectors include food and wood manufacturing, while higher productivity sectors include chemicals, computers and electronics manufacturing.

FIGURE 6: **UK manufacturing is integrated in EU supply chains**

Share of intermediate and final goods trade with the EU: UK, 2018



SOURCE: Analysis of OECD Trade in Value Added (TIVA).

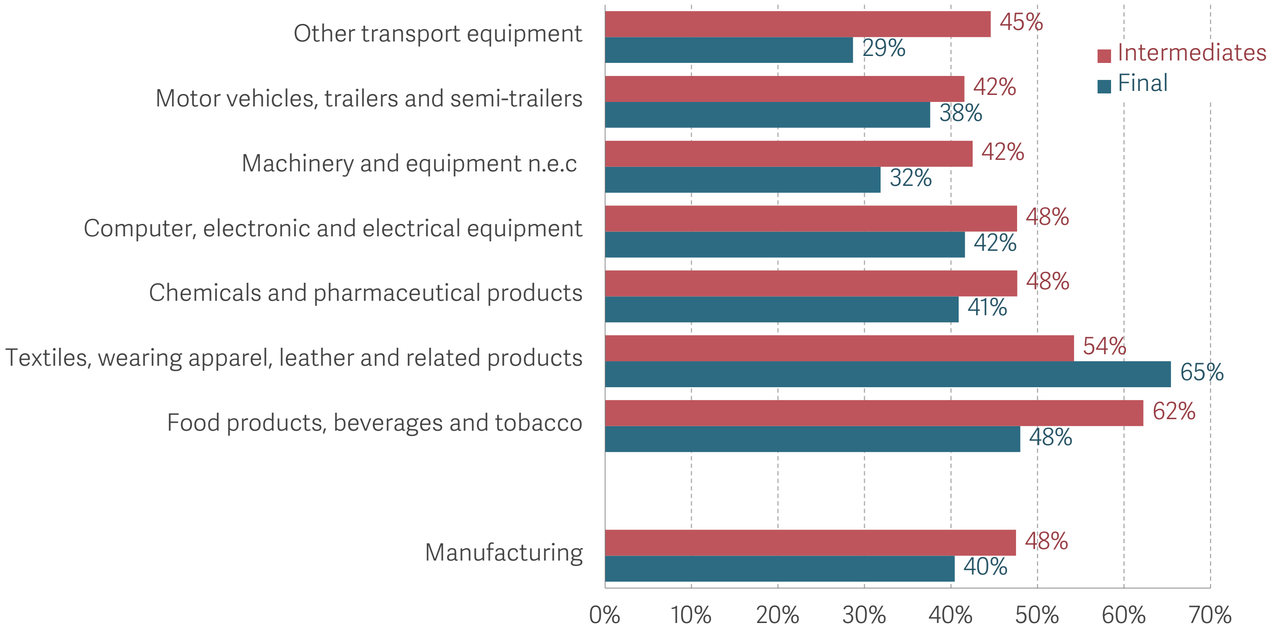
High value added manufacturing sectors including cars, machinery and equipment, chemicals, and computer, electronic and electrical equipment are part of these deeply integrated supply chains, as shown in Figure 7. The EU share of intermediate exports of chemicals and motor vehicles, for example, is 48 per cent and 42 per cent respectively compared with the EU share of final goods exports of 41 and 38 per cent.

Market scale also matters for some high value added manufacturers – in particular access into the larger EU market – so they can produce at scale. And although high-productivity manufacturing is relatively less responsive to trade barriers, and face lower non-tariff barriers with the EU than other goods sectors (such as agricultural products) over time these supply chains will begin to disentangle as EU businesses seek to sign new contracts with other EU businesses, rather than renew with UK businesses.[26]

26 For NTBs, see: S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, The Resolution Foundation, June 2022. For trade elasticities, see: L Caliendo & F Parro, Estimates of the Trade and Welfare Effects of NAFTA, Review of Economic Studies, 2015, & C Boehm, A Levchenko & N Pandalai-Nayar, The Long and Short (Run) of Trade Elasticities, American Economic Review Vol 113, April 2023.

FIGURE 7: **High value added manufacturing is highly integrated with EU supply chains**

Share of intermediate and final goods trade with the EU for manufacturing sectors: UK, 2018



SOURCE: Analysis of OECD Trade in Value Added (TIVA).

Car manufacturers highlight the issues other manufacturers may face

The car industry can provide an accelerated insight into the problems other manufacturers will face. This is because the structural transition to electric vehicles has turbocharged investment decisions in the car industry, putting it well ahead of other industries, when it comes to adapting to the new trading arrangements. Just three years ago, the UK's automotive sector had a revealed comparative advantage, but by 2022, its share of global exports had fallen such that it was no longer considered a sector of comparative advantage by the UK Government.[27]

Importantly, cars have clear economies of scale: 8-out-of-10 cars built in the UK are exported, with almost 60 per cent going to the EU.[28] A single Nissan car plant in Sunderland can produce 500,000 cars in just one year.[29] Furthermore, the UK is specialised within the supply-chain process, with the UK making twice as many engines as cars, relying on its ability to sell these engines to international plants and into international supply chains.[30]

27 UK Government, Global Trade Outlook, February 2023.
28 SMMT, Motor Industry Facts, May 2023.
29 Nissan Press Release, Ten millionth vehicle built at Nissan Sunderland Plant, June 2019.
30 For more on economies of scale in the car manufacturing see: D Rhys, Economies of scale in the motor industry, November 1972.; D Bailey et al., Global restructuring and the auto industry, Cambridge Journal of Regions, Economy and Society, November 2010.

While many are focussed on how the Government will respond to the subsidies in the EU and US green industrial strategies, the UK faces unique challenges in attracting investment, where it must compete directly with EU countries that can offer frictionless access to a much larger market.[31] Because of this, demand will be lower, forcing plants to respond by reducing the scale at which they operate. This will also make imports more attractive, ultimately putting further downward pressure on UK production. Car production halved between 2018 and 2022, with the outlook for the UK car industry a bleak one and its Brexit – and not 'Bidenomics' – that is the structural driver of this decline.[32]

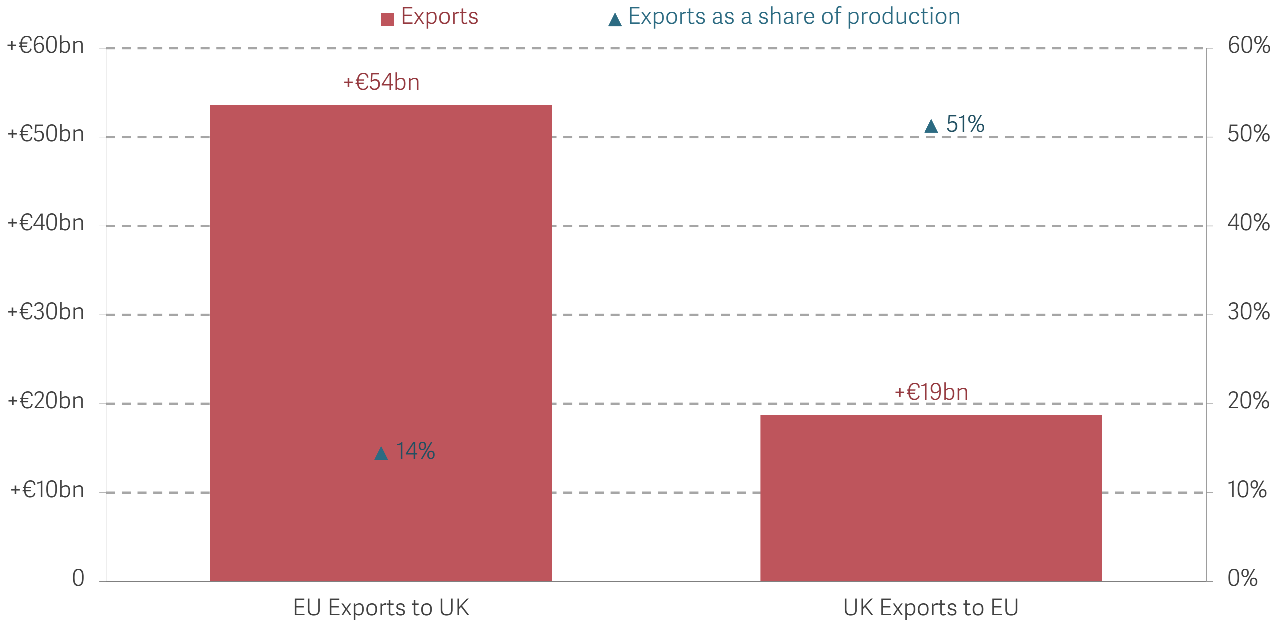
The UK car industry has historically been important for the EU, but that is starting to change. In 2019, the UK exported €19 billion in cars and automotive parts to the EU, and imported over €54 billion from the EU. However, as a proportion of sold production, the UK's exports to the EU are far higher than the EU's exports to the UK: these exports represent 51 per cent of the UK's car output compared with just 14 per cent of the EU's output in 2019 as shown in Figure 8. In addition, the amount exported by the UK to the EU has been declining since 2016: by value, the EU imported 42 per cent fewer cars from the UK in 2022, while importing 12 per cent more from Germany.[33]

Because change is happening quickly in the car market, it is a harbinger of the structural shifts that will occur more gradually in other industries. Sectors such as chemicals and spacecraft and aviation are susceptible to these headwinds going forward as they adapt gradually to the new relationship. Preventing further supply-chain damage and allowing manufacturers to take advantage of the of the of a larger market means revisiting the relationship with the EU.

31 European Commission, The Green Deal Industrial Plan: putting Europe's net-zero industry in the lead , February 2023.
32 SMMT, Motor Industry Facts, May 2023.
33 Analysis of ACEA Driving Mobility For Europe, EU passenger car imports, main countries of origin (by value), May 2023, and Eurostat COMEXT database.

FIGURE 8: **While the UK runs a large deficit in car trade with the EU, our production is much more reliant on the EU market**

Car and car parts exports and exports as a share of production: UK & EU, 2019



NOTES: Cars exports include the divisions 781 motor cars and other motor vehicles for transporting persons; 782 Motor vehicles for the transport of goods and special-purpose motor vehicles; 783 Road motor vehicles, not elsewhere specified (tractors, etc); 784 Parts and accessories of motor vehicles. Car production includes sold production of products related to motor vehicles, parts and accessories.
SOURCE: Analysis of Eurostat ProdCom database, Eurostat COMEXT database.

As set out in Section 1, the scope for the UK to use FTAs to reorient manufacturing trade away from the EU is limited. Britain already has preferential access to most of our largest markets, with the exception of the US and China which are unlikely to materialise. Instead, to make British manufacturing internationally competitive, the UK needs to lean on our strengths, and support firms to export. Gains can be made by reducing the costs faced by goods traders. For UK firms exporting to the EU, this means reducing export trade barriers and the costs of possible or actual dual regulatory regimes that emerge with regulatory divergence. While for firms importing EU intermediate goods, this means reducing import trade barriers. Therefore, there is no alternative but to revisit EU relationship to stop the drift towards low-productivity manufacturing.

Tweaks can help at the margin but will not be enough to fix the fundamental problem

Politicians are united in their desire to protect existing, or even reverse, the decline of manufacturing exports since the TCA was implemented. Chancellor, Jeremy Hunt, recently said that "I want the world's tech entrepreneurs, life science innovators, and clean energy companies to come to the UK because it offers the best possible place to make their vision happen" [34]. Shadow Chancellor, Rachel Reeves, meanwhile told a

34 Jeremy Hunt, Chancellor sets out long-term vision to grow the economy, HM Treasury, January 2023.

Washington DC audience that Labours approach "would see us rebuild our industrial strength. But it would have trade and partnership at its heart too". [35]

But neither party is willing to acknowledge the major trade-offs involved, focusing on making easier but more inconsequential tweaks. Small changes can reduce trade costs for specific sectors, but won't make much difference to the economy overall. For example, the Government is leaning into its ambition to digitise borders to enable "the UK border to be the most effective in the world", building on an already efficient border[36], with plans to make border documentation digital by default by 2025.[37] Import checks on EU goods (for example health certification and physical Sanitary and Phytosanitary, or SPS, checks on agri-food products) that were due to be introduced in 2022 have been delayed by the Government over fears of the impact on the cost of living crisis.[38] The Government plans on replacing these with a risk based model for checks, aiming to alleviate the costs of importing these goods.[39]

Labour has outlined some improvements too, such as negotiating light touch SPS checks for animal products such as those found in the EU-New Zealand veterinary agreement, with the goal of reducing the number of health checks on animal and plant products.[40] This would reduce the high level of random physical checks for SPS products imported to the EU which under the current agreement is set between 30 per cent (for most meat, fish and dairy products) and 1 per cent for a small number of products including hay and straw.[41]

Labour also committed to regain access to the EU's Horizon programme which funds research and innovation, which the EU has also indicated would be on the table.[42] The UK does disproportionately well from the European Research Council (ERC); winning more than 1,800 ERC grants under Horizon 2020. Russell Group universities received 1,400 of those grants, worth €1.8bn and more than were awarded to all universities in France.[43]

While helpful at the margin, such policies won't stop the decline in our high-productivity manufacturing.

Some gains can be made by refreshing the UK's regulatory approach

Even without committing to negotiations with the EU, the UK has the power to make unilateral decisions that could support manufacturers, by refreshing the UK's regulatory approach. Dynamic alignment (or 'Beneficial Alignment' as termed by the Trade and

35 Rachel Reeves, Speech on Securonomics, Peterson Institute, May 2023.
36 The World Bank, Trading across Borders, 2019.
37 Cabinet Office, 2025 UK Border Strategy, December 2020.
38 Cabinet Office, New approach to import controls to help ease cost of living, April 2022.
39 A Burghart, Launch of the draft Border Target Operating Model, UK Parliament, April 2023.
40 K Starmer, Keir Starmer sets out Labour's 5-point plan to Make Brexit Work, Labour, July 2022.
41 UK Parliament, Chapter 5: Sanitary and phytosanitary measures, Beyond Brexit: trade in goods, 2020.
42 S Lister, 'Our future is outside EU': Keir Starmer rules out return of free movement, The Express, May 2023.
43 Russell Group, Horizon Europe: Maintaining UK leadership in global R&D collaboration

Business Commission) with the EU can support high value added manufacturers for which EU supply chains are an essential part of their business. Here, the UK can mirror a subset of EU rules, and update these as changes are made by the EU, reducing overall costs for exporters and the risk that future divergence would further increase the costs of supplying for both the EU and UK markets.[44] This is an example of how the UK can use domestic policy to protect high value manufacturers as well as trade policy.

Dynamic alignment would acknowledge that regulatory alignment is often in the interests of the UK, and bring big benefits for certain sectors. For example, the chemicals sector is estimated to be facing £1 billion in additional costs annually due to regulatory divergence. Some British exporters now face dual conformity assessments: the new UK Conformity Assessed (UKCA) marking, as well as the existing European Union's (EU) Conformité Européenne (CE) marking, both of which define the minimum product requirements and testing required for particular products.[45] Dynamically aligning with the EU's conformity process would remove needless duplications for UK manufacturers exporting to EU, and could provide confidence that conformity assessments can take place in the UK again (something that has been stopped post Brexit).[46] Crucially such dynamic alignment can be achieved unilaterally by the UK.

Another emerging area, where regulatory alignment could reduce costs for UK exporters is the EU's Carbon Border Adjustment Mechanism (CBAM) which would require formal linkage with the EU's Emissions Trading Scheme (ETS). The CBAM is being phased-in gradually by the EU from October 2023 to address emissions imported through products from overseas which face a lower carbon price than is applied in the EU.

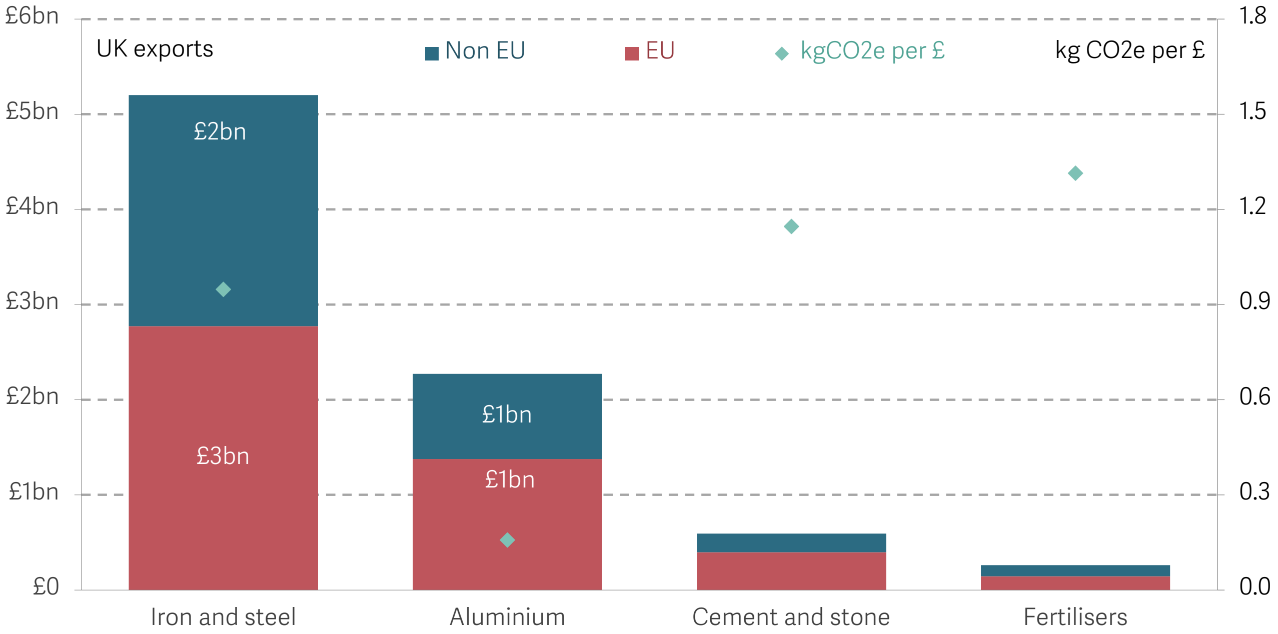
The UK and EU have similar approaches to carbon pricing and both have ambitious net-zero targets. This is reflected by the two ETS schemes which are currently broadly aligned and the prices typically track each other.[47] However, over time, divergence in the scope and price of the UK and EU ETS could make linkage of these, and therefore alignment on a CBAM, more challenging. Although the initial sectors to be covered by the EU's CBAM: steel, cement, aluminium and fertilisers comprise just 2.2 per cent of the UK's total exports, sector coverage is likely to expand over time. If UK decides to implement a carbon border tax, then formal linkage of the ETS, as Switzerland has agreed with the EU, would avoid duplicative reporting for businesses whose exports are EU focussed.[48] As shown in Figure 9, more than half of UK exports covered by the EU CBAM are to the EU (67 per cent for cement; 55 per cent fertilisers; 53 per cent iron and steel; 61 per

44 Trade and Business Commission, Trading our way to prosperity: A blueprint for policymakers, June 2023.
45 UK Parliament, Chemical Business Association written evidence, Sub-Committee on the UK-EU Trade and Co-operation Agreement.
46 Trade and Business Commission, Trading our way to prosperity: A blueprint for policymakers, June 2023.
47 S&P Global, UK carbon prices swing back to premium as EUA rally halts, February 2023.
48 Linking of Switzerland to the EU emissions trading system - entry into force on 1 January 2020, December 2019.

cent aluminium) and without linkage these firms will face potentially costly additional reporting requirements. Even in the absence of full linkage, if the UK chooses to adopt a CBAM, then it will likely want to align the process, including reporting standards, to reduce the costs for firms having to report to both the EU and UK.

FIGURE 9: **UK is more exposed to EU than non-EU in industries that will initially be covered by the CBAM**

Exports to the EU and greenhouse gas emissions by selected goods: UK, 2019



NOTES: CO2e means CO2 equivalent and includes all greenhouse gases. Aluminium CO2 figure uses other basic metals.
SOURCE: Analysis of UK trade data and Defra UK Footprint Results (1990-2020).

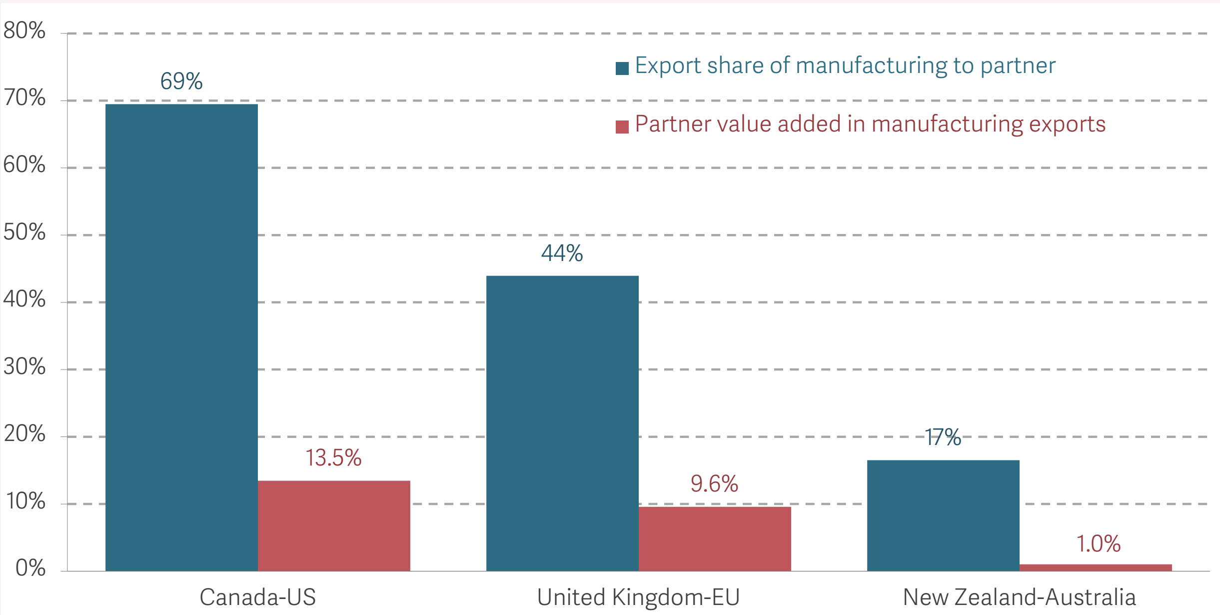
The challenges of regulatory divergence facing the manufacturing sector are not unique to the UK. Lessons can be taken from Canada-US and New Zealand-Australia arrangements that likewise manage their independent regulatory regimes while considering the costs associated with divergence from their largest trading partners (Box 1). In both instances these partners have established institutions to support improved regulatory cooperation, which can provide a blueprint for the types of institutions and structures that might suit the UK.

BOX 1: **Trading with your larger neighbour: lessons from Canada and the US, and New Zealand and Australia**

Like the UK, Canada is a country situated next to a large single market of which it is not part, though it has a free trade agreement with it. Some 69 per cent of Canadian manufacturing exports go to the US, and 13.5 per cent of Canadian manufacturing exports originates in the US as shown in Figure 10. Trade between Australia and New Zealand is less intensive than between Canada and the US, but Australia is still NZ's most important economic relationship accounting for 17 per cent of manufacturing exports. The UK's relationship with the EU sits between the two, with 44 per cent of manufacturing exports going to the EU, and 10 per cent of the UK's exports comprised of EU value added. These countries illustrate how close neighbours can balance the need to develop an integrated market whilst maintaining regulatory autonomy.

FIGURE 10: **The UK's relationship with the EU is comparable to Canada's with the US and New Zealand's with Australia**

Proportion of industry supply chain and goods exports with partner countries compared with total: 2018



SOURCE: OECD International Merchandise Trade Statistics; ONS Trade, OECD TIVA.

Everyone would recognise Canada as a sovereign state, yet in many respects it gears its regulatory systems to reflect the economic reality of its strong trade links with the US. Under the Canadian Directive on Regulation, Canada expects its regulations to align or seek cooperation with key trading partners, specifically the US, with whom a Regulatory Cooperation Council (RCC) was launched in February 2011. The RCC involves 16 Canadian and US agencies with health, safety and environmental protection mandates, together with stakeholders, and covers a wide range of sectors, for instance pharmaceuticals, medical devices, food, dangerous goods, energy efficiency and transport safety.

The approach works well where supply chains and markets are integrated (the same product is on sale in both territories) and similar health and safety outcomes are sought. For cars, Canada has introduced 'ambulatory incorporation by reference', whereby for certain products (for example, rear-view mirrors), Canadian legislation provides that Canadian requirements will automatically follow US requirements as they change. Each jurisdiction maintains its own decision-making authority. But if regulators synchronise work, use common data sets, conduct risk assessments together and examine options together, then the likelihood of the same decisions rises. This reduces costs to exporters who avoid duplicated testing and inspection certification.

Its arrangements with the US do not prevent Canada from looking to strengthen regulatory cooperation with other markets such as the EU, and the Canada-EU trade agreement makes provision for work between regulators, and includes some areas where requirements have been judged to be equivalent. Inevitably, however, Canada prioritises its trade with the US, as its largest trading partner.

Likewise, New Zealand and Australia have committed to Closer Economic Relations and Single Economic Market agreements that mean the default position is that goods put on the market in one country can automatically be sold in the other. Similarly, individuals with professional qualifications in New Zealand in most instances have an automatic right to practise in Australia and vice versa, with very limited grounds for refusal. This mutual recognition approach works on the basis that both countries are confident that they take a similar approach to protecting the public without insisting that regulatory requirements are exactly the same. It also provides some carve outs in a limited number of areas, for instance medicines where each country retains its national licensing system and the mutual recognition arrangement (the Trans-Tasman Mutual Recognition Arrangement) does not apply.

These Mutual Recognition Agreements are bolstered by regulatory collaborations and links. For instance, food standards are set by a joint Australia and New Zealand body and have legislative effect in both countries. In other areas, arrangements have been made to deliver similar outcomes without complete integration. For example, the two countries maintain their own competition systems, but look to ensure that businesses operating in both jurisdictions have confidence in similar outcomes through cross representation on their respective competition authorities as well as considerable information sharing. In accounting, there are cross appointments on standards bodies, and "concerted unilateral" decisions are taken by regulators: in other words, regulators hold discussions about a set of risks and how they should be regulated. National decisions are then taken, but informed by a shared analysis.

Both Canada-US and New Zealand-Australia show what can be achieved by closely integrated but legally separate jurisdictions when there is a strong political commitment to avoid duplication and achieve convergence in regulatory approaches, resulting in cost savings and reductions in complexity for business. Mechanisms can vary: overarching legal frameworks binding national discretion are generally avoided, but strong forums for regulatory collaboration at both the political and technical level can deliver substantial alignment through mutual recognition principles, joint standard setting and 'concerted unilateralism'. Whilst historical context, legal order and culture are important and mean that experiences elsewhere cannot automatically be replicated, these models are worth drawing on in developing the future UK-EU economic relationship.

Borders will be the key issue facing manufacturers even in a customs union

While dynamic alignment eases uncertainty by reducing the risk that trade costs rise sharply in future, it doesn't actually improve market access to the EU for British exporters. This is because such halfway houses won't address the fundamental issue faced by British manufacturers – the existence of a new UK-EU border for goods trade.

Crossing an international border while carrying goods is complicated: according to the World Customs Organisation, an average cross-border transaction involves up to 30 different parties and around 40 documents with about 200 data elements, most of which need to be re-entered to several systems. These might include customs declarations as well as regulatory approvals and documentation. There is additional time required behind the border to prepare and provide this data, and even if this becomes digitised issues remain as the data still needs to be collated.[49]

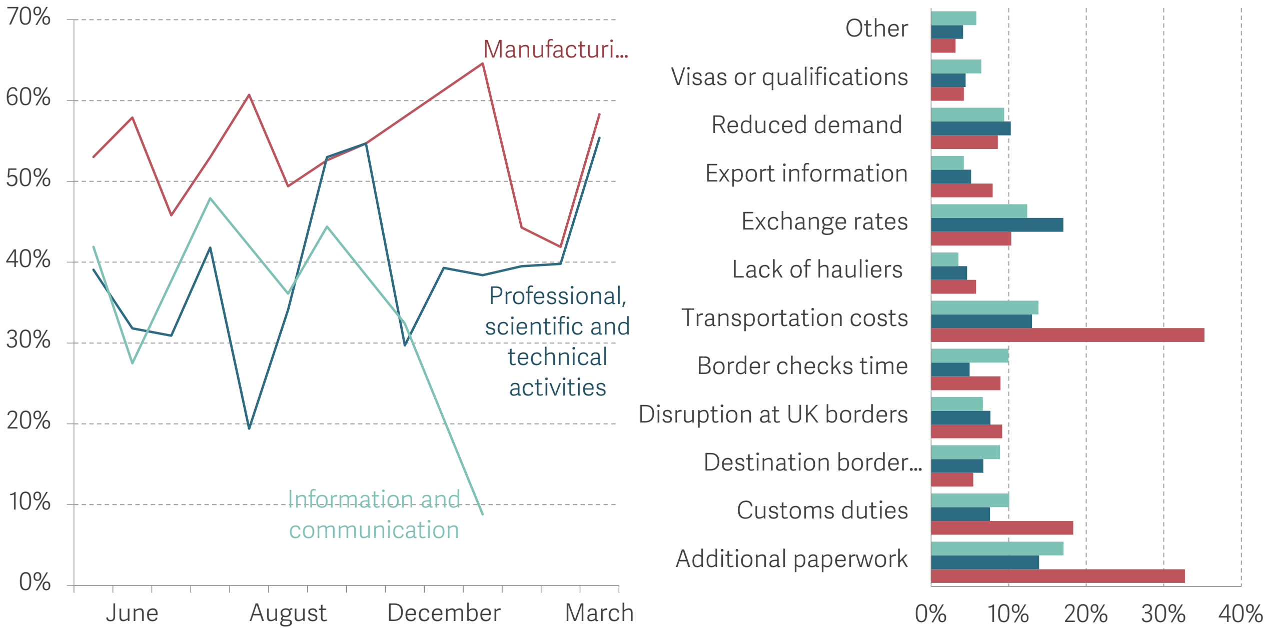
Manufacturing businesses are reporting en masse – and at higher rates than services businesses – that the challenges to exporting are growing: 53 per cent of manufacturers experienced an increase in exporting challenges compared with 39 per cent of services

49 World Customs Organisation, Procedures and Facilitation.

firms in June 2022-March 2023 as shown in Figure 11. Manufacturers are also consistently reporting that additional paperwork, customs duties, and border checks have increased exporting challenges for UK firms.

FIGURE 11: **New border requirements are challenging for manufacturers**

Share of firms that reported experiencing an increase in exporting challenges (left panel) and reported export challenges (right panel): UK



NOTES: Export challenges average of waves 61 to 81 (only waves where export questions were asked), June 2022 to March 2023.
SOURCE: Analysis of ONS, Business insights and impact on the UK economy.

These challenges result in delays which in turn harm trade. FourKites, a logistics visibility platform, found that shipments crossing the Schengen boundary averaged 3.9 miles per hour two years after Brexit, compared with 4.9 mph for goods that moved within Schengen.[50] Failing to move goods seamlessly hampers trade: each additional day that a product is delayed before crossing the border leads to more than 1 per cent decrease in trade on average. Delays also have a larger impact on exports of time-sensitive goods (such as agriculture or just in time supply chain shipping).[51]

The outcome of these border frictions is that firms are reporting losing contracts to EU competitors, even before substantial regulatory divergence from the EU has occurred.

These border issues are also why one often-mentioned solution – a customs union – on its own is not enough. While it would remove certain border requirements, ultimately the border to a large extent is binary – either it exists or it doesn't.

50 B Murray, Brexit Costs, Delays Still Weigh on UK Companies Trying to Trade, Bloomberg, January 2023.
51 S Djankov, C Freund & C Pham, Trading on Time, World Bank Policy Research Working Paper, May 2006.

FIGURE 12: **A UK Protocol removes issues for manufacturers at the EU border**

	Documents pre-travel					Other regulations and/or customs requirements				
	Pre-notification declaration	Transportation and commercial documentation	International conventions documentation	Customs declarations	Preferential origin certificate	MFN tariffs	Excise duties and VAT	Pre-travel assessment	Document, identity or physical checks	
Free Trade Agreement	required	required	required	required	required	required	required	required	required	Destination
Customs Union	required	required	required	required	light touch	not required	required	required	required	Destination
Northern Ireland Protocol	not required	required	not required	not required	not required	not required	not required	light touch	not required	Destination

= required
= light touch
= not required

- A customs pre-notification needs to be submitted to the first place of entry into the customs territory of the EU, and are known as an Entry Summary Declaration and Exit Summary Declaration.
- Transportation, shipping and commercial details include details of what is being transported including bill of lading and invoices.
- Documentations related to international conventions include for example anti – smuggling checks (e.g. CITES documentation for transport of wild fauna and flora).

- A full customs declaration typically has over 50 data elements which indicate the customs procedure for each good, although this can be simplified in certain circumstances.
- Together these will determine the origin of goods (ROO), classification and customs value of goods, ensure exporter pays duties under relevant tariff, and traders must be registered in relevant countries for import VAT.

- Conformity assessment and marking stamp which must be done by an independent assessment body (UK conformity assessment bodies can no longer carry out mandatory conformity assessment for products placed on the EU market).
- Strategic or controlled goods, e.g. chemicals where the exporter must be registered under EU REACH and comply with these standards, or the Sanitary and Phytosanitary standards and controls for trade in animal related products.

NOTES: Preferential origin certificate are in the case of an FTA (e.g. EUR), or movement certificates (e.g. A.TR) in the case of a customs union. There are opportunities to simplify these border procedures, for example applying a simplified customs declaration at the border which can enable goods to be released faster upon entry, although a full customs declaration will still need to be completed.

SOURCES: A Jerzewska, There is no such thing as completely frictionless trade across a border, February 2019; HM Government, The Windsor Framework, February 2023; J Owen, Theresa May's Brexit deal: Chequers plan, Institute for Government, July 2018.

A customs union would remove rules-of-origin (ROO) requirements – reducing the non-tariff barriers (NTBs) facing firms by an estimated 3 to 5 percentage points depending on the sector.[52] But even removing the ROO requirements through a customs union, standards and conformity assessment procedures would remain, as shown by Figure 12. The continued presence of checks on the border and risks of delays or rejection are particularly harmful to the UK's position as a highly integrated trading partner with the EU (we are often referred to as a 'mid-supply-chain manufacturer'). This will deter EU firms from choosing UK suppliers over those within the single market.

BOX 2: **Rules of origin**

While the UK was a member of the EU, goods could flow between UK and EU without considering where the component parts had originated from. But under the TCA, the UK and the EU must prove a certain share of the value added originates in either the UK or the EU (including labour, materials, and product design) to benefit from preferential tariffs (which remove tariffs across all goods) in the trading agreement. These conditions are called rules of origin (ROO) and form part of the customs declaration process.[53]

The rules of origin are particularly an issue for goods that trade back and forth across borders multiple times – i.e. those within supply chains. Changes in rules of origin are already hurting producers. This is can be because: goods don't meet the requirements under the TCA (for example they contain a high share of foreign value added from inputs sourced outside the EU); or because it is difficult and complicated in long supply chains to prove that the ROO are met (for example the regulatory burden to meet them is perceived to exceed the cost of paying the tariffs); or because –the ROO content requirements ramp up rapidly over the 2020s - as in the case of electric vehicles (EVs) for which ROO requirements increase first in 2024 and again in 2027 and 2028 as the EU aims to ensure EVs, EV batteries, and EV battery parts are sourced locally.

There are opportunities for the UK to resolve rules requirements without a customs union. One option is joining the pan-Euro-Mediterranean cumulation (PEM) convention.[54]

52 S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, The Resolution Foundation, June 2022.
53 Treasury Committee, Oral Evidence: UK's Future Economic Relationship with the European Union, February 2017.
54 PEM members include the EU, the EFTA States (Switzerland, Norway, Iceland and Liechtenstein), the Faroe Islands, the participants in the Barcelona Process (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia and Turkey), the participants in the EU's Stabilisation and Association Process (Albania, Bosnia and Herzegovina, the Republic of North Macedonia, Montenegro, Serbia and Kosovo, and the Republic of Moldova).

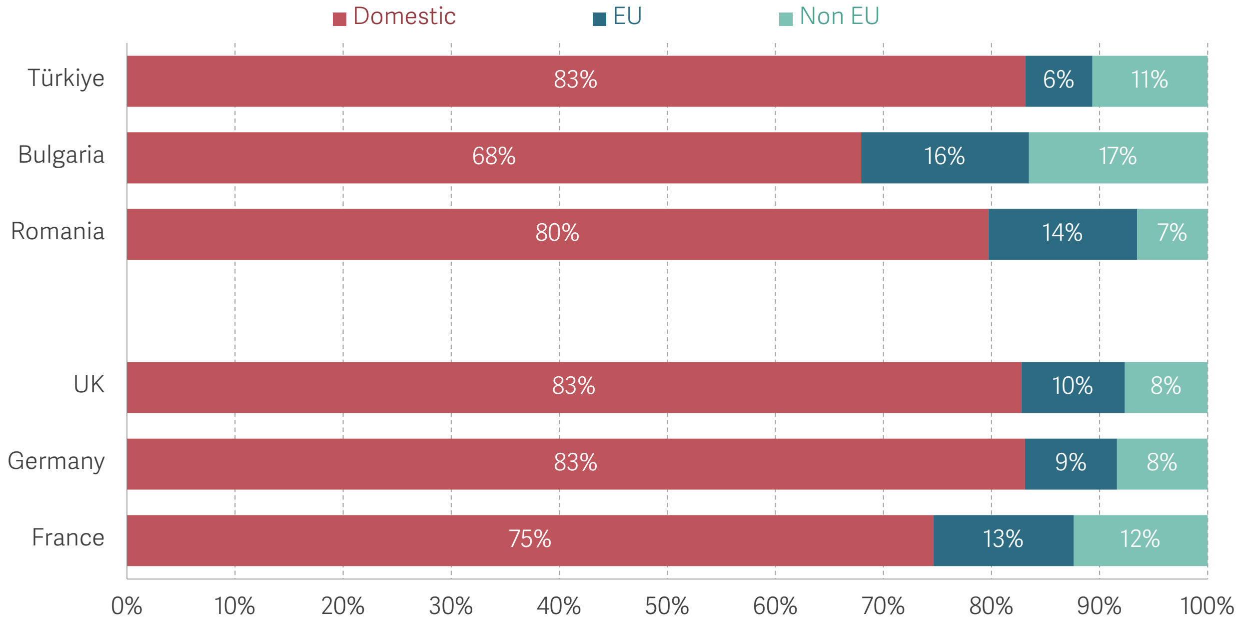
Crucially, the PEM convention offers only diagonal cumulation – this means that one additional PEM member's inputs can be counted under the ROO (where all three countries have FTAs). It could support UK exporters in meeting ROO requirements to the EU market in some cases. But the additional PEM members accounted for just 10 per cent of UK imports in 2019; and the largest single partner, Norway, accounted for just 3 per cent. It would also likely require the UK to use to the PEM ROOs with the EU rather than the more favourable ones agreed in the TCA, (although the UK could negotiate that PEM ROO runs in parallel with existing ROO arrangements, such as is the case for CPTPP and the UK-Australia FTA where exporters can choose which agreement they are using).[55] However, for immediate issues – such as those facing electric vehicles – PEM is unlikely to help in the short term, with negotiating an extension of the current arrangement likely to be preferable. [56]

This is supported by evidence from Turkey which has a customs union arrangement with the EU since 1995, but which research has found has had no noticeable impact on trade flows.[57] Turkey remains far less integrated in EU markets than neighbours (and EU members) Bulgaria and Romania, as well as the UK, with just 6 per cent of Turkish manufacturing exports comprised of EU value added compared with 16 per cent and 14 per cent for Bulgaria and Romania, and 10 per cent for the UK as shown in Figure 13.

55 S Lowe, Most Favoured Nation: PEM to the Rescue?, Most Favoured Nation, June 2023.
56 M Gasiorek, P Holmes, & M Tong Koecklin, Driving round the bend: Rules of origin and cars, UK TPO June 2023.
57 G Dursun, The impact of the customs union on the EU – Turkey trade, International Economics, May 2023.

FIGURE 13: **Turkey is less integrated in EU supply chains than either Romania or the UK**

Domestic, EU and Non-EU value added as a share of gross manufacturing exports: selected countries, 2018



NOTES: Manufacturing value added in manufacturing exports of domestic country.
SOURCE: Analysis of OECD Trade in Value Added (TIVA).

Supporting high value-added manufacturing means revisiting the goods trading relationship with the EU

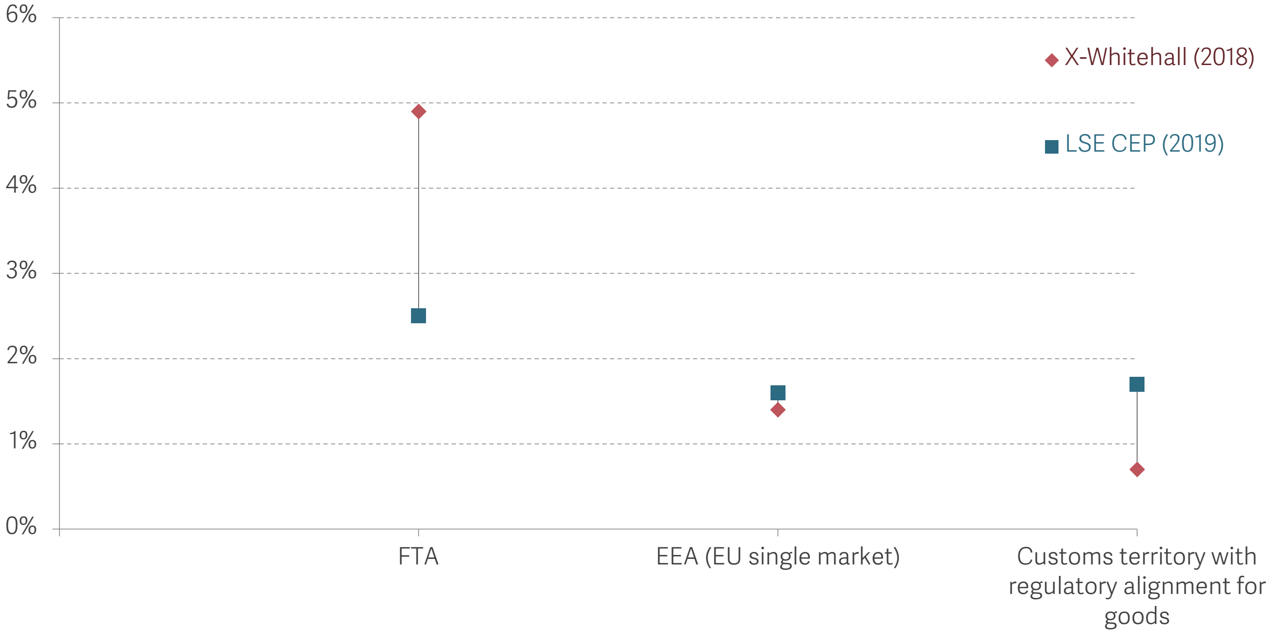
Britain will always have some globally competitive manufacturers. But to avoid the structural shift away from highly-productive manufacturing, the objective for a UK trade strategy must be to maintain integrated supply chains over the long term. That requires revisiting the UK's relationship with the EU to deliver the benefits of the EU's customs territory and the single market for *goods* (not services). The combination of the two is greater than the sum of its parts, removing almost all frictions for goods crossing the border.

The choice, therefore, for Britain is whether or not to stay part of EU supply chains. Should we choose to remain a part of these supply chains, then the answer is to deliver a 'UK Protocol', building on the foundations established by the Northern Ireland agreement. Such an arrangement would extend, the Northern Ireland Protocol to the rest of the UK, enabling the UK to take part in both the EU's customs territory and the single market for goods, while removing the complicated elements that manage Northern Ireland – Great Britain trade flows.

This arrangement would create a free trade area for goods crossing the channel and the Irish Sea, removing both customs requirements and the need for duplicated regulatory approvals, delivering virtually frictionless access for goods trade from both EU and UK. UK high value-added manufacturing exports would no longer be associated with a risk premium for potential delay and the risk of rejection at the border nor face additional border costs, preventing further decline in the UK's role in EU supply chains. According to modelling of similar arrangements undertaken after the referendum, a UK Protocol could boost our GDP by as much as 1 to 2 per cent as show in Figure 14.[58]

FIGURE 14: **A UK Protocol can boost GDP by as much as 1 to 2 per cent**

Estimates of long-run UK GDP losses from different Brexit scenarios from ex-ante assessments: UK



NOTES: Customs territory and regulatory alignment for goods modelled on Theresa May's EU proposal which includes the component parts of a UK Protocol. The X-Whitehall model includes deeper services liberalisation than would be sought under the proposed UK Protocol so is likely to overestimate a UK Protocol, whereas the LSE CEP model assumes a customs union but not a single market for goods, so may underestimate the impact of the UK Protocol on goods liberalisation. The EEA includes the four freedoms of the EU Single Market in line with the EU's relationship with Norway, Liechtenstein and Iceland. FTA models a similar deal to the TCA.
SOURCE: Analysis of HM Government, EU Exit: Long term economic analysis, November 2018; and S Dhingra & T Sampson., Brexit Economics, November 2019.

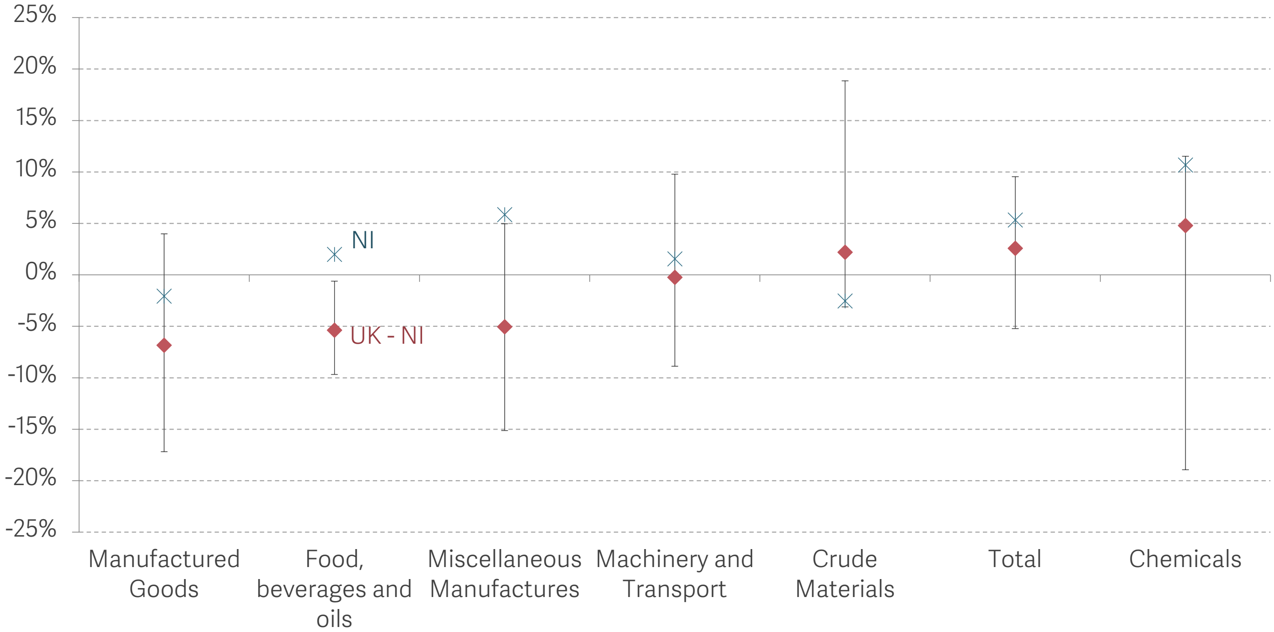
The benefits of a UK Protocol are already emerging for Northern Ireland. In the two years since Brexit, Northern Ireland has shown greater resilience than other UK regions in

58 These assessments model similar arrangements, specifically the arrangement set out in HM Government, The future relationship between the United Kingdom and the European Union White Paper, July 2018. This included GB remaining within the EU customs territory with deep regulatory alignment, required to maintain frictionless trade between the UK, EU and Northern Ireland. This would be similar, in effect, to the arrangement set under a UK Protocol. The two papers modelling this arrangement are: HM Government, EU Exit: Long term economic analysis, November 2018 and S Dhingra & T Sampson, Brexit Economics, November 2019. These reductions are applied to the OBR, The latest evidence on the impact of Brexit on UK trade, March 2022. Under the Whitehall paper, the estimated impact of an FTA compared to this deal is 4.9 per cent hit to GDP versus 0.7 per cent under the May deal. This is an 86 per cent reduction in impact. However, assumes deeper services liberalisation is delivered than is proposed under a UK Protocol. Under the LSE CEP paper, the impact of an FTA to GDP is a reduction of 2.5 per cent, which falls to 1.7 per cent under the May deal, equivalent to a 32 per cent reduction in impact. However, this modelling underestimates goods liberalisation, as it assumes a customs union but not a single market for goods (i.e. no customs-related border procedures but trade still subject to new regulatory requirements and checks).

its trade with the EU. Despite political challenges, Northern Ireland exports to the EU have performed better than average in all goods sectors apart from crude materials, suggesting Northern Irish manufacturers may be finding it easier to maintain their position in EU supply chains as part of a free trade area with the EU as shown in Figure 15. Although not conclusive – Northern Ireland's overall trade performance including non-EU has not been better than other UK regions, perhaps in part due a lack of first ministers since February 2022 – this points to benefits to manufacturers being part of a free trade area with the EU.[59]

FIGURE 15: **Northern Ireland goods exports to the EU have outperformed other UK regions following Brexit**

Change in EU share by SITC group and region between 2019 and 2022: UK



NOTES: Food, beverages and oils groups SITC codes 0, 1 and 4. Chart does not show SITC 9 and 3 which were distorted by abnormal precious metals and fuels trade in 2022.
SOURCE: ONS, Regional Trade Statistics Q4 2022.

A UK Protocol is not straightforward to say the least– either substantively or politically. The UK would need to align with EU regulations for goods, reducing the UK's ability to set regulation, as well as with the EU's trading arrangements with third countries. Politically, Conservatives are looking only to tweak the existing deal and Labour has previously ruled out a customs union and single market arrangements.[60] Meanwhile in Brussels, the EU has previously insisted on maintaining the indivisibility of the four freedoms: people, goods, capital, and services.[61]

59 J Sargeant, Northern Ireland: Functioning of government without ministers, Institute for Government, November 2022.
60 K Starmer, Keir Starmer sets out Labour's 5-point plan to Make Brexit Work, Labour, July 2022.
61 W Kohler & G Müller, Brexit, the four freedoms and the indivisibility dogma, November 2017.

But a UK Protocol isn't inconceivable. The impact of lost regulatory freedom is likely to be more limited in practice than is often framed in the public debate: the current international obligations, particularly those outlined in the Trade and Cooperation Agreement (TCA), impose constraints on the UK's ability to rollback regulations through level playing field commitments. If replicated in full, Great Britain, like Northern Ireland, would retain a higher degree of regulatory autonomy surrounding agricultural subsidies, one area where the UK has undertaken substantial regulatory reforms post-Brexit. Furthermore, the British public is considerably less focussed on what the Government agrees on regulatory alignment than it is about the free of movement of people. The British Social Attitudes (BSA) survey found no evidence that the British public wished to rollback EU regulations. For example, the EU rules on flight compensation and regulation aligning the cost of mobile phone calls across the EU are both relatively popular.[62] But the BSA survey found that there was widespread support for the decision to end freedom of movement, with nearly two-thirds of people (64 per cent) supporting requirements for EU migrants to apply to live and work in Britain post Brexit.[63] This independent migration policy would be maintained under the UK Protocol.

An independent goods-trade policy also might not be as much of a loss as it first appears: the EU has FTAs with almost all the same countries as the UK. Here again, the broad coverage of deals negotiated by the EU, and since rolled-over in most cases fully aligned with original EU deals, would allow the UK to maintain preferential access to most markets. It should also be relatively straightforward to construct agreements with Australia and New Zealand that would revert the UK's deals to align with the EU. The only potential losses would involve the UK needing to withdraw from CPTPP and if the UK had to forgo deals with India, the US or China (of which only India is currently on the table). On the other hand, the British public care about preventing the decline in manufacturing jobs. According to research by MakeUK, almost 90 per cent of the public believe Britain needs a strong manufacturing base and 74 per cent recognise that manufacturing generates jobs across the country.[64]

That said, a mechanism would be needed to ensure the UK has input into regulatory decision-making and a safeguarding procedure to object to changes to EU rules. The Northern Ireland Protocol has the 'Stormont break' in place, or in the case of the EEA if the parties disagree as to whether new EU rules should be incorporated into the agreement, part of the agreement can be suspended. The overall institutional framework under a UK Protocol might include a forum that can set the direction for the future relationship, and a joint committee to manage the technical aspects of implementation, similar to that under the EEA and going beyond what is currently set up in the TCA.[65]

62 British Social Attitudes, Wave 37, Post Brexit Public Policy, October 2020.
63 British Social Attitudes, Wave 38, Immigration, October 2021.
64 Make UK, Brexit - Making it work for manufacturing, 2019.
65 M Thimont Jack & J Rutter, Managing the UK's relationship with the European Union, Institute for Government, February 2021.

A UK Protocol presents considerable challenges for the EU too: Brussels, as it stands, is not open to such an arrangement. But the proposal aligns with the Northern Ireland Protocol and has been previously offered to the UK during Theresa May's premiership. There are also clear political gains for the EU. First the UK Protocol would address the persistent issue of the Northern Ireland hard border, and it would serve the EU's economic interests by restoring seamless access to the British goods market. These mutual benefits suggest that a goods trading arrangement is potentially feasible in the future, should the Government choose to prioritise it as a key element of a UK trade strategy. In any case a trade strategy is not just about what is on the table right now – it is also about laying the groundwork for future deals that align with the broader needs of the UK economy.

Critically, a UK Protocol retains flexibility for the UK's primary growth engine: services. An expansive trade strategy for services will be explored in Section 3.

Section 3

The strategy for services should be expansive

A defensive strategy for goods still means there's leeway for taking advantage of the UK's status as a services 'superpower'. Indeed, the UK is the second-largest services exporter in the world, with comparative advantages stretching across a broad range of services sectors. Given rapid growth in the sectors where the UK has a comparative advantage, there is a clear case for harnessing this to address our relative decline. This would also reflect the opportunities for trade liberalisation that lie beyond the EU – UK services exporters are less dependent on the EU market than their goods-exporting counterparts, with 61 per cent of services exports sent outside the EU, relative to 50 per cent of goods exports in 2018.

Although liberalisation with the EU won't be the central focus, the aligned regulatory regimes of the EU and UK provide a strong basis for going further than the standard FTA currently in place. While some of the most impactful elements of lost single market access will also be the hardest to replace, for example mobility arrangements and passporting for financial services, the UK should look to secure achievable improvements, such as allowing UK professional qualifications to be recognised in the EU and delivering a renewed data adequacy arrangement.

Boosting services trade is challenging, but there are reasons to think that it is far from impossible. Standard agreements do relatively little to liberalise services trade, so the task for the UK is one of innovation in both the content and method of trade policy. In addition, achieving material liberalisation of services often relies on deeper regulatory arrangements, that can prove difficult to agree. There are reasons for optimism, though: the UK has had some success in delivering agreements that have liberalised specific services, for example its digital agreements and the mutual-recognition agreements being negotiated with Switzerland. The task now is to systematise these piecemeal accomplishments. The current politics of international trade, specifically the growing focus on onshoring goods manufacturing, also points to focusing on an expansive services trade objective.

To deliver on an expansive services trade objective the UK should seek to deliver what we see as new services trade agreements (STAs), addressing the ability of services suppliers to move across borders, and ease restrictions by recognising equivalence, where it exists, between regulatory regimes. The approach, not just content, of this new trade policy needs to be different too. The necessary focus on regulatory regimes requires that regulators be at the centre of negotiations and implementation of these agreements – with agreements scoped and primarily discussed and agreed by regulatory bodies and professional associations, as has been the process for the Swiss-UK MRA on financial services.

The approach would seek to build on the FTAs already negotiated, including with Singapore, Australia, Canada, Switzerland and Japan, and explore negotiating services deals with some of the UK's largest services trade partners, such as the US.

There are reasons to believe the UK would find willing partners. In the absence of multilateral action by the WTO, countries are looking to set standards and ensure market access is future proofed, for example by pursuing new digital agreements. The UK is an attractive partner for countries seeking services liberalisation opportunities thanks to its disproportionately large services import market, which accounts for between 4 and 7 per cent of its largest non-EU trading partners' services exports.

Addressing trade barriers must be complemented by domestic policy, which has the advantage of being directly under UK policy makers' control. Not doing so risks making it harder for services firms to trade, meaning they lose competitiveness. In this context, the UK has actually been losing ground, becoming less internationally competitive in several key services sectors over the past decade. For example in financial services, where the UK has lost 22 per cent of its market share since 2005, while this has grown by 12 per cent for the rest of the G7.

In many cases this is about building on the factors that underpin the UK's services comparative advantage. For example, the UK's highly-skilled workforce which rests on domestic skills development and the ability to attract the best international talent. But coordinating domestic and trade strategies also means ensuring regulatory decisions positively impact the competitiveness of tradeable services. This will include offering certainty and confidence about the UK's future regulatory environment to encourage domestic investment, foreign firms' to locate in the UK and trading partners to commit to mutual recognition arrangements. It will also be about ensuring the regulatory approach builds on UK strengths while helping the UK develop capabilities in emerging sectors.

The UK is well placed to benefit from an expansive services strategy

As discussed in Section 1, a trade strategy must be built on a hard-headed assessment of the country's strengths and weaknesses and reflect the global context. The UK's strengths clearly lie in exporting services and the UK has comparative advantages across a broad range of services sectors, from cultural services to information and communications. The services specialisation of the economy, combined with its overall size, make the UK the second-largest services exporter in the world, and the natural place to innovate traditional trade policy to better deliver for services.

Not only is the UK competitive in these sectors, but expanding them further can generate well-paid jobs. Jobs in tradable services are 80 per cent more likely than average to pay in the top 5 per cent of the wage distribution.[66] And there is evidence that liberalising services can have spillover benefits to manufacturing productivity.[67]

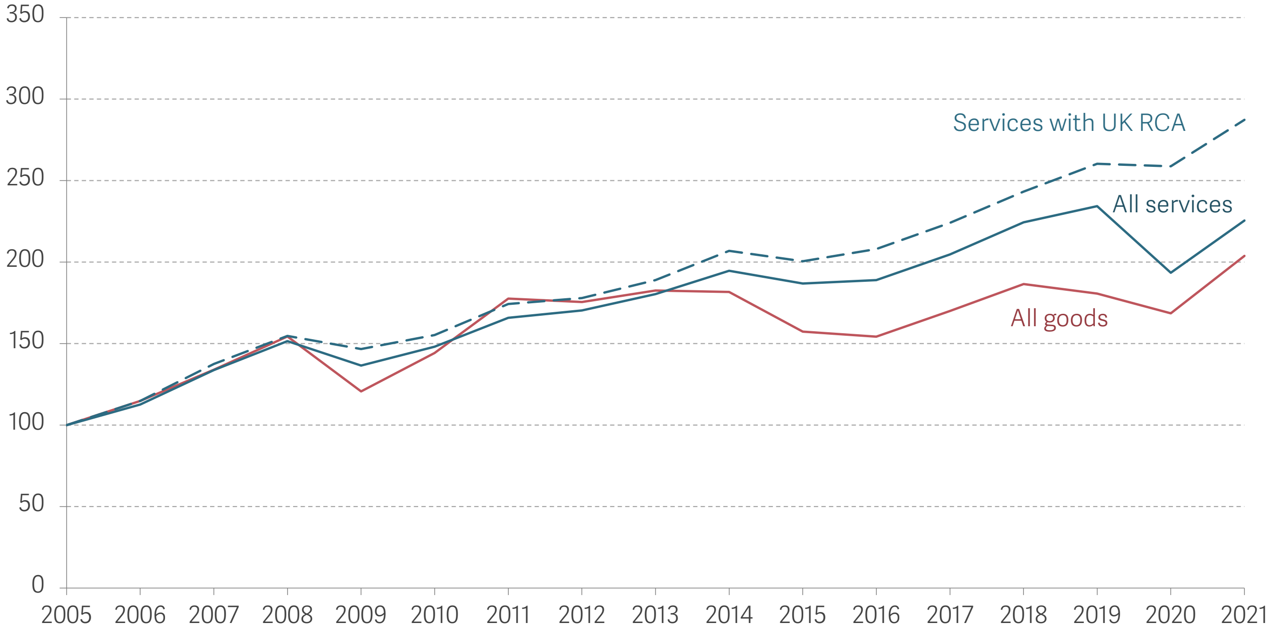
The combination of rapid growth in services trade globally and the trend towards on-shoring goods trade among major advanced economies also supports pursuing a services-oriented policy. Although global trade growth has slowed since the global financial crisis, growth in services trade has outperformed goods: services trade as a share of GDP continued to grow from 12 to 14 per cent between 2008 and 2019.[68] By contrast, world trade in goods as a share of GDP peaked at 50 per cent in 2008, and had fallen by 7 percentage points (to 43 per cent) by 2019. This may be reinforcing the growing view of some countries that trade has become a zero-sum game – if the demand for trade isn't growing, expanding exports (as a share of GDP) in one country means less for another.

The UK has persistent, revealed comparative advantages in service sectors which are about far more than the stereotype of financial services dominated trade. Indeed, the UK has comparative advantages in cultural services, information and communications and other business services, all of which have grown particularly fast, almost trebling since 2005. Over the same period, goods trade 'only' doubled, as shown in Figure 16. While global competition for manufacturing becomes ever fiercer, the UK should look to harness these global tailwinds by focussing on opportunities to expand market access for the sectors where demand is growing fastest.

66 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.
67 C Beverelli, M Fiorini & B Hoekman, Services trade policy and manufacturing productivity: The role of institutions, Journal of International Economics Volume 104, January 2017.
68 R Baldwin, The peak globalisation myth: Part 4 – Services trade did not peak, CEPR, September 2022.

FIGURE 16: **Global trade in sectors which the UK specialises in have trebled over the last 15 years**

Index of global exports of goods, services, and services with UK RCA (2005 = 100)



NOTES: Services with UK RCA includes the sectors where the UK has a revealed comparative advantage in 2019 which includes Government goods and services, Charges for the use of intellectual property, Personal, cultural, and recreational services, Other business services, Financial services, Insurance and pension services.
SOURCE: Analysis of Harvard Growth Lab, Atlas of Economic Complexity (HS version) and OECD-WTO, Balanced Trade in Services.

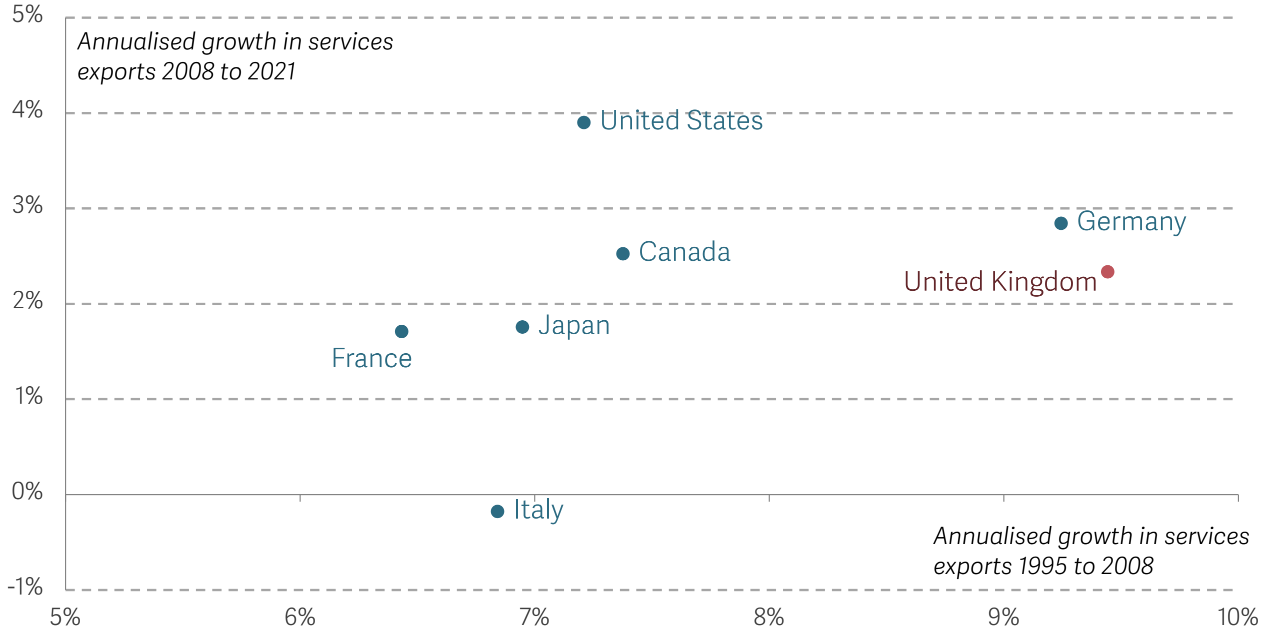
This strategy also builds on where the UK has realistic opportunities to pursue further liberalisation and importantly is less reliant on the EU than the strategy for goods. Services integration with the EU is tied up with the issue of free movement of people, which was central to the debate in the lead up to referendum and has remained politically salient since. Retaining control of the UK's immigration system is a red line for both parties. For the EU, this limits what is in scope for further services liberalisation with the UK. However, trade beyond the EU typically accounts for around a 10 percentage points larger share of UK services exports than goods exports – representing 61 per cent of services exports relative to 50 per cent of goods exports in 2018. As such, a services trade strategy can seek to improve access beyond the EU while avoiding the political issues around a single market for services, which would be incompatible with an independent migration system.

While the route for agreeing more FTAs is running out of road, there is scope for deeper services liberalisation with partners outside the EU. Even those partners where the UK has existing FTAs could go much further on services, since existing agreements have typically done little more than locking in existing market access for services exporters.

But, as with goods, it is important to act now to cement the UK's comparative advantages and to avoid losing further ground. Despite strong growth in services exports in 2022, UK performance has deteriorated in recent years. Having been one of the fastest growing services exporters before the financial crisis, the UK is now below the G7 average in the period since (Figure 17).[69]

FIGURE 17: **The UK is no longer the fastest growing services exporter in the G7**

Annualised growth in services exports between 1995 to 2008 and 2008 to 2021: G7



NOTES: Annualised growth between 1995 and 2008 and 2008 and 2021 of balanced total services exports.
SOURCE: Analysis of OECD, International Balanced International Trade in Services.

Despite these clear arguments for pursuing services liberalisation, implementing a services strategy will not be easy.

The constraint here is the non-standard approach that will be required in designing and delivering a services strategy. Such an approach will inevitably stray from the template of traditional FTAs widely used and understood.

This is not a UK-specific challenge. Even during the heyday of globalisation, where world trade costs in goods fell by around 15 per cent between 1995 and 2007, trade costs in services remained stable.[70] FTAs have provided the comfort of a clear template for pursuing liberalisation – and larger trading partners replicate existing deals almost word-for-word with different partners. The adoption of new provisions and expanded coverage in FTAs over time has been a gradual evolution. The WTO General Agreement on Trade in Services (GATS) established a multilateral framework of rules and principles for trade in

69 E Fry and S Hale, Open for business? UK trade performance since leaving the EU, Resolution Foundation, February 2023.
70 S Miroudot, J Sauvage and M Sudreau, Multilateralising Regionalism: How Preferential Are Services Commitments in Regional Trade Agreements?, OECD Trade Policy Papers (Number 106), December 2010.

services, but progress stalled and the more ambitious Trade in Services Agreement (TiSA) was never agreed. So there's no 'off-the-shelf' policy template for services trade – and so this requires developing a new product necessitating innovation in both the content and method of trade policy.

The barriers that face services exporters differ from goods, with the former unaffected by tariffs or other customs barriers addressed by traditional trade policy. This means achieving deeper liberalisation for services requires the emphasis to be shifted to improving the ability of services suppliers to move across borders and easing regulatory restrictions by recognising equivalence, where it exists, between regulatory regimes.

Without pre-existing harmonisation of regulations, improved market access has proved difficult to agree, even between countries with similar regulatory regimes. The long-term nature of trade agreements – which by design are infrequently renegotiated – along with the perceived potential to limit future regulatory decisions, mean partners tend to be conservative and cautious in what they agree. And this makes innovation in trade policy hard, where deals must be agreed by both partners to be successful.

Yet there is reason to believe these difficulties may be surmountable. Despite slow progress, both multilateral policy and FTAs have evolved over time to become deeper and cover broader aspects of trade, including services. Mutual recognition deals on manufacturing sectors have increasingly become common in bilateral deals, and the UK is naturally placed to push the frontier by normalising equivalent arrangements for services sectors too.[71]

There are also existing arrangements that can form the building blocks for a more coordinated and comprehensive services trade approach. Alongside the Government's FTA programme, it has already had some success in delivering agreements focussed on addressing services trade barriers. The challenge to replicate the much deeper services access the UK had with Switzerland, as well as other EEA members, created the impetus for the UK to explore innovative and enhanced trading arrangements. The UK has been able to negotiate a Services Mobility Agreement and launched negotiations on an MRA on financial services with Switzerland. In addition, it has effectively delivered digital agreements with both EU and non-EU markets, including securing data adequacy equivalence with the EU, signing the UK-Singapore Digital Economy Agreement and enhancing the digital provisions in the EU-Japan FTA. Although it will not be as easy as simply replicating these arrangements across partners, these agreements indicate there an alternative path to FTAs available.

71 S Dhingra, R Freeman, H Huang, The impact of non-tariff barriers on trade and welfare. CEP Discussion Papers (1741), LSE, March 2021.

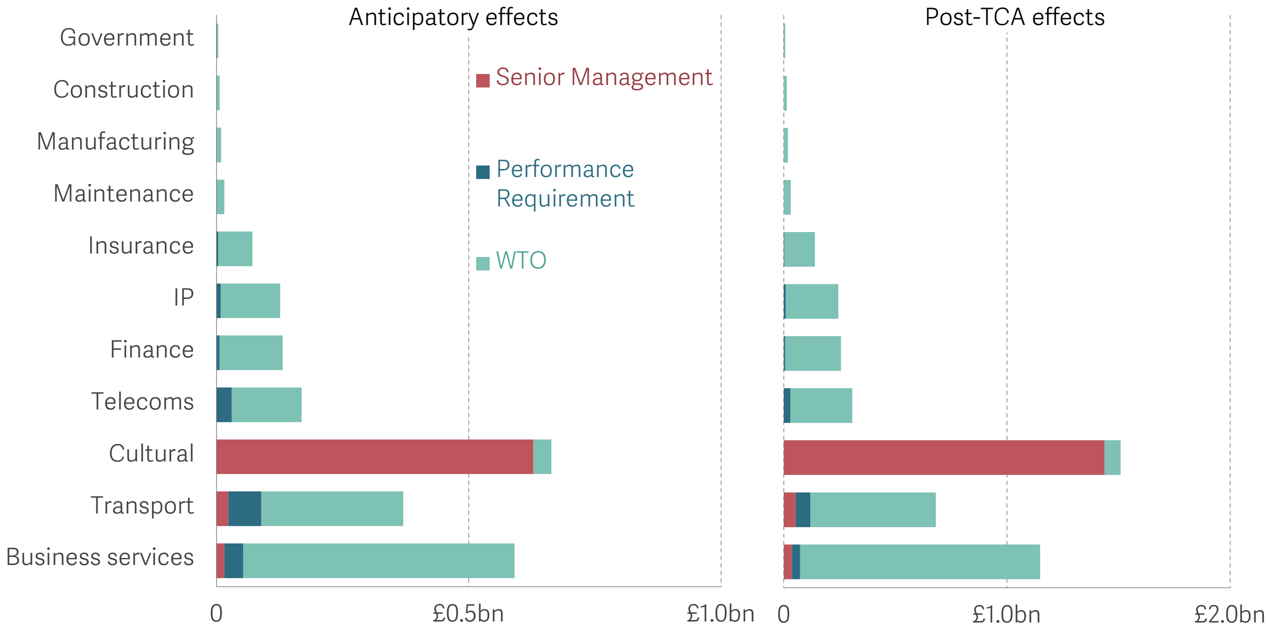
Finally, while global tensions have made the landscape more challenging to pursue traditional trade policy, the recent green industrial policy focus in both the US and EU has been almost entirely goods focussed. The services inputs feeding into the green industrial sector's supply chains, such a R&D, finance and legal services, have not been the target of onshoring in the same way goods inputs have.

Although the EU won't be the focus, the UK should still seek to improve the UK-EU services deal

Although the services strategy should look beyond the EU, there are areas where the UK should seek to improve the TCA with the EU. The TCA does not go much further than a typical FTA in liberalising services and there will be an opportunity to review the arrangement in 2025. The EU still accounts for more than a third of UK services exports, and the aligned regulatory regimes of the EU and UK provide a strong basis for going further in certain sectors. Renegotiating TCA coverage and improving implementation is likely to have only a marginal impact.

FIGURE 18: **Wider coverage of the TCA provisions would only have a small impact**

Change in exports from removing all reservations, by sector: UK



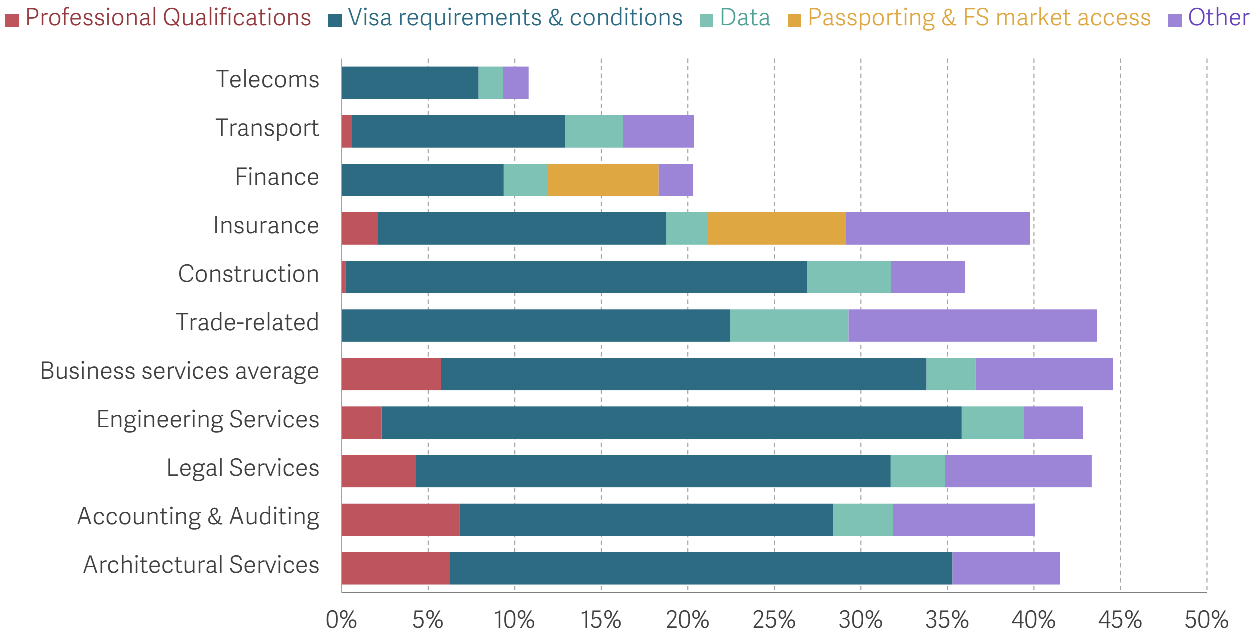
NOTES: Estimates uplift based on elasticities from regression results and trade flows in 2022 – more details on the regression approach is available in Annex 1. WTO includes articles on MFN, National Treatment and Market Access (Articles 128-130 and Articles 135, 137 and 138). Local presence (Article 136) is excluded from chart as results were not statistically significant. Anticipatory effects represent the impact to services trade between Q3 2016 and Q4 2020 and post-TCA effects represent Q1 2021 to Q4 2022.
SOURCE: Analysis based on ONS, Quarterly Services Trade data Q4 2022; Trade and Cooperation Agreement Annex 1 reservations and PPML regression of the impact of reservations on UK trade flows.

Our novel approach to assessing the early impacts of the TCA is based on the so-called 'reservations' taken out by countries against services provisions. The reservations effectively switch off particular TCA obligations for particular countries and sectors.[72] This approach uses the variation (across sectors and countries) in these reservations to assess the impact the barriers these provisions seek to remove have on services trade using a gravity model approach with fixed effects (see Annex 1 for more details). We find that there are only marginal benefits to securing the removal of reservations, suggesting the inherent value of these provisions is relatively small, as shown in Figure 18.[73] The priority should be to look beyond narrowly tweaking the coverage of the TCA, and instead seek to expand the market access offer for services exporters in other ways.

Some of the most impactful elements of lost single market access will also be the hardest to replace, specifically expanded mobility arrangements and passporting for financial services, as shown in Figure 19.

FIGURE 19: **The biggest losses come from lost mobility and financial services**

Estimated long-run partial trade impact of lost services liberalisation with EU partners by type of barrier on exports: UK



NOTES: Matching of STRI sectors to trade data uses the mapping set out in the DIT, Services trade modelling. The impact of removing measures related to the categories above are applied to the elasticities (the increase in trade for a given change in the STRI) estimated in the paper. Estimates are based on the difference between intra-EEA STRI and applied STRI scores across EU partners.
SOURCE: Analysis of DIT, Services trade modelling, DIT Analysis Working Paper; OECD STRI, ONS, quarterly services trade data Q4 2022.

72 As set out in Annex 19 of the UK-EU TCA.
73 However, these are short-term impacts, only up to two years since the agreement, and this should be kept under review.

However, the UK should push for improvements where they can be delivered. Although many UK-based financial firms have largely adapted to the loss of passporting rights to the EU, the new trade barriers facing UK firms are estimated to reduce UK exports in the long-term by over £1 billion a year.[74] The UK will be unlikely to be able to go as far as it would want on financial services access given the EU's desire to reduce reliance on external partners in this sector as part of its open, strategic-autonomy agenda. However, it should push to expand and extend existing equivalence arrangements with EU. The current financial equivalence offered to the UK is below even that offered to the US, which is considerably less aligned with, yet also accounts for a large share of, EU financial services. The EU has also indicated it will not extend the limited equivalence offered for euro-denominated clearing, saying this proposal was vital to the bloc's "financial resilience".[75] Given the high value of improved access, it is worth the UK regularly revisiting this with the EU, including by using regulatory cooperation arrangements to demonstrate that the regulation and supervision of the financial systems are delivering equivalent outcomes and are moving in broadly the same direction.[76]

Reclaiming full control of the UK's migration regime necessarily meant substantial new barriers related to lost mobility between the EU and UK, making it difficult to go further on mobility. Nonetheless, several improvements to the system could be sought, for example aligning employed and self-employed visa-free access and expanding the business activities covered when travelling from the UK, for example to include legal services. In addition to improving mobility through direct improvements to visa-free access, supporting measures could also be taken to help mobility of workers in specific sectors. One of the areas that has been most vocal about sector-specific challenges, is performers – who have had challenges with shipping their own equipment (e.g. instruments and installations) due to the additional border requirements, specifically the requirement to buy ATA Carnets (also known as the passport for goods) to avoid paying customs charges. Collaboration on cultural services is important, especially since this sector is a UK RCA. As set out in the recent UK Trade and Business Commission's recommendations, agreeing bilateral cultural agreements for work permits, a visa-waiver agreement for cultural services and a cultural exemption for ATA Carnets which would all help to improve access.[77]

There are several other areas the UK should look to expand access. The UK already has a four-year data adequacy arrangement with the EU, securing rights for the transfer of personal data. However, the UK should seek to secure a renewed data adequacy arrangement without the current four-year sunset clause, as this creates uncertainty for

74 Based on estimated increases shown in Figure 18 applied to 2022 ONS services trade data.
75 S Fleming and J Pickard, EU sticks with post-Brexit clearing trade deadline despite objections, Financial Times, May 2023.
76 House of Lords Library, UK-EU relationship in financial services, March 2023.
77 Trade and Business Commission, Trading our way to prosperity: A blueprint for policymakers, June 2023.

businesses (both goods and services exporters) who may fear its renewal may be affected by other political issues at the time, as was the case for Horizon access. Replicating the digital market in the single market access through a broader digital agreement could also deliver meaningful liberalisation, expanding EU exports by 3 per cent for business services. While this may seem small, digital trade is growing and so too is the importance of addressing digital market access barriers. The UK should also seek to restore the mutual recognition of professional qualifications, that previously allowed professionals to have UK qualifications recognised in the EU. Many EU nationals still study in the UK, and improved recognition would support UK higher education exports to EU students who can more easily use their new qualifications back home. Improving this for individual professions and reviewing the process for transferring professional qualifications could also expand services exports in key business services sectors, for example for architects and accountants by 6 and 7 per cent respectively, as shown in Figure 18.

The UK should look beyond the EU to secure innovative Services Trade Agreements

Rather than accept the current framework for FTAs, which are less well suited to deliver for UK trade, the UK should be ambitious in designing a new model for trade agreements that prioritises addressing the challenging, but valuable, services barriers. These would look different from FTAs, and would also demand a different approach along a number of key dimensions, including the components of the agreement, the negotiation approach, and the partners it would target.

The content of an STA would build on existing successful services deals

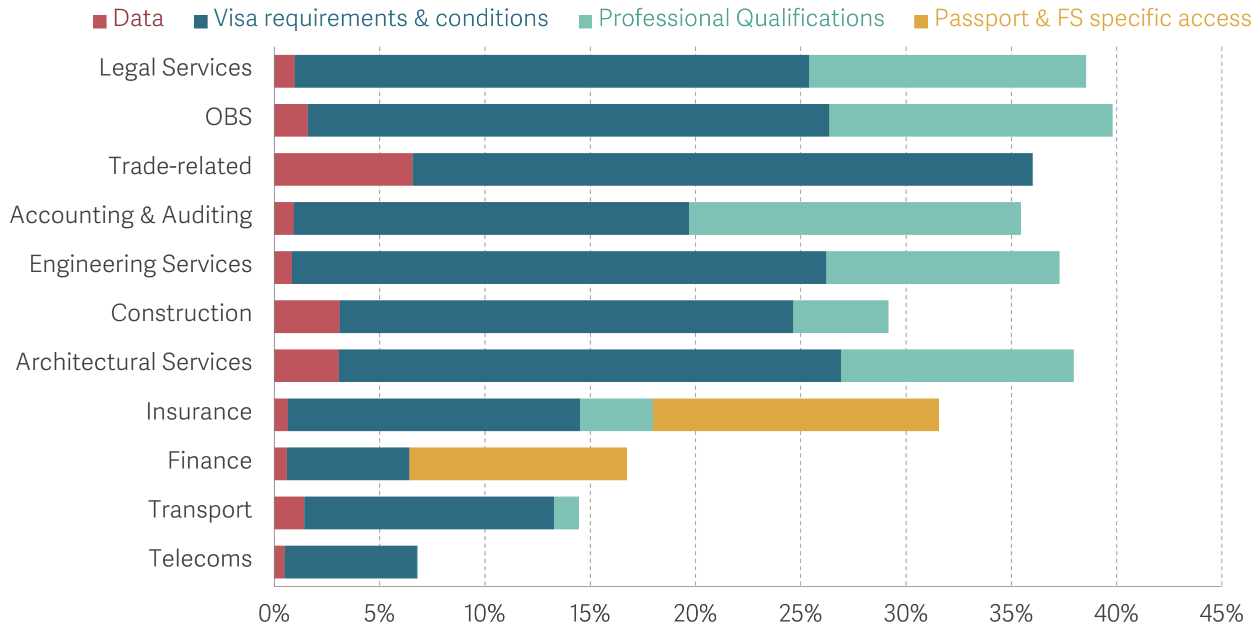
STAs would seek to target the barriers that are most restrictive to UK trade. Figure 19 shows the scale of potential trade gains from fully removing some of the biggest barriers to services trade. This uses DBT research that estimates the impact of reducing services barriers, as measured by the OECD services trade restrictiveness index (STRI) and assesses the impact of removing groups of measures relating to data, visas, professional qualifications and financial-services-specific market access barriers.[78] Visa requirements and labour-market conditionality are estimated to account for the largest share of barriers, and, although removing these entirely is unlikely, removing these could increase trade by between 6 and 30 per cent across sectors. Digital barriers are also cross-cutting, impacting all sectors, and removing these restrictions could increase trade by a further 7 per cent in trade-related services and 2 per cent for business services, although the importance of these addressing these barriers will grow as digital trade grows. The restrictions on financial services are sector specific, but addressing these could boost

78 B Fraser, Services trade modelling, Department for Business and Trade, August 2021.

trade in financial services and insurance by 10 to 14 per cent respectively. Finally, exports of regulated business services, in particular, are restricted by the lack of recognition of professional qualifications: removing these restrictions could boost business service exports by a further 13 per cent. This shows the importance of creating a package of liberalising measures that seeks to address as many barriers as possible across the strengths of UK services. A package that could successfully address all these barriers could boost the UK's service-sector exports by as much as 40 per cent, equivalent to an additional £6 billion in business services exports if achieved with Canada, Japan, Australia and Switzerland, rising to £17 billion if an agreement with the US could also be reached.

FIGURE 20: **Substantial gains could be made by liberalising services**

Long-run partial trade impact of removing services barriers on exports: UK



NOTES: Matching of STRI sectors to trade data uses the mapping set out in the DIT, Services trade modelling. The impact of removing measures related to the categories above are applied to the elasticities (the increase in trade for a given change in the STRI) estimated in the paper. Estimates are based on the average impact of removing trade barriers with Japan, Switzerland, Canada, Australia and the US.
SOURCE: Analysis of DIT, Services trade modelling, DIT Analysis Working Paper; OECD STRI, ONS, quarterly services trade data Q4 2022.

The agreements would prioritise delivering equivalence and mutual recognitions agreements, that would improve, rather than simply lock in, market access for UK services exports. These agreements would use the trade tools that have already been used, to varying degrees of success, to address these barriers (more details on some of the existing arrangements are set out in Box 3). These agreements would prioritise making progress across the three broad areas below:

1. Mutual Recognition of Professional Qualifications (MRPQs). This would cover both sector-specific deals as well as an improved and simplified process for the recognition of qualifications, aiming to enable professionals to get their existing qualifications recognised without having to do more testing or examinations. Such deals would could create benefits to the UK education sector, by making it easier for foreign students to have their UK qualifications recognised at home. It would also promote the exchange of skills and knowledge across borders by, for example, supporting multinationals to move professionals between offices. Delivering these would require engagement between professional associations and regulatory bodies to establish where there is equivalence in professional standard. But the Government should push for broad coverage of regulated professional business service providers, ranging from engineers and architects to accountants and legal professionals. Many sector-specific arrangements have already been agreed by other countries, including a recently concluded Mutual Recognition Agreement (MRA) between Canada and the EU on the professional qualifications of architects. The Trans-Tasman Mutual Recognition Agreement also provides a template for a broader framework for recognising qualifications (See Box 3).

2. Digital agreements would aim to cover data adequacy to facilitate the transfer of data, as well as provisions on electronic authentication and digital identity approaches. These arrangements would seek to reduce administrative burdens that slow data flows by limiting the need to use costly and time-consuming transfer tools, such as international data transfer agreements. A recent OECD paper found digital trade has been growing faster than non-digital trade such that, by 2018, 24 per cent of global trade could be considered digital.[79] As digital trade grows, reducing these barriers becomes even more important to exporters. The UK-Singapore Digital Economy Agreement and EU and UK data adequacy arrangements provide templates for what expansive digital agreements could deliver (see Box 3). As in the data adequacy agreement with the EU, safeguards and non-regression measures should be included to ensure that, if standards deviate over time, the UK has recourse to address these, including the option to terminate the agreement.

3. MRAs for financial services would seek to enable banks and financial services companies to trade freely in the partner country with minimal additional authorisation. These require deep regulatory cooperation to ensure equivalence of regulatory outcomes, without requiring the regulatory harmonisation required in the single market. These novel agreements would represent "a new paradigm in

79 J López González, S Sorescu & P Kaynak, Of bytes and trade: Quantifying the impact of digitalisation on trade, OECD Trade Policy Papers (Number 273), May 2023.

international services trade" built on the basis of "deference".[80] Financial services is an important export sector for the UK, but the risks to macroeconomic stability mean that carefully managed and bespoke arrangements are needed. But the benefits could be significant – the Government's EU exit analysis estimated that the modelled White Paper arrangement – which would include positive equivalence decisions under existing equivalence frameworks and close and structured cooperation – would halve the impact of barriers from lost single market access relative to an FTA.[81] The Swiss-EU MRA in financial services is currently being negotiated and could provide a template for future negotiations with third countries once concluded (see Box 3).

BOX 3: **Existing mutual recognition agreements**

Several pre-existing arrangements provide templates which UK trade policy could build upon in each of the priority areas. We give more details below.

1. MRPQ for architects between Canada and the EU

This sector-specific deal was negotiated through the Joint Committee on Mutual Recognition of Professional Qualifications established under the Comprehensive Economic and Trade Agreement (CETA). This agreement enables architects that meet certain qualification- and experience-based criteria to have their qualifications recognised by the European and Canadian authorities, reducing the requirements for further burdensome examinations to be undertaken.[82] The UK already has a framework with Canada for agreeing this type of sectoral deal through the rolled-over UK-Canada agreement, and could push to advance similar deals in its current negotiations to update the UK Canada FTA.

2. Trans-Tasman Mutual Recognition Agreement

Under the much broader Trans-Tasman Mutual Recognition Agreement, professionals from Australia and New Zealand can have certain qualifications recognised across borders without having to do more testing or examinations. This broad agreement covers not only qualifications, such as university degrees, but also certain

80 City of London, Supporting UK-Switzerland: Seizing the opportunity to develop a trailblazing cross-border relationship, November 2022.
81 HM Government, EU Exit: Long-term economic analysis, November 2018.
82 European Commission, EU and Canada lay the foundations for free movement of architects, March 2022.

occupations that require registration or licensing, such as plumbers and electricians.[83] Australia and New Zealand have close regulatory cooperation framework, as set out in Box 1, that may not be possible to replicate, but the agreement can provide a framework.

3. Singapore Digital Economy Agreements

The Singapore Digital Economy Agreement was agreed as an amending treaty to the existing UK-Singapore FTA. The agreement covers cooperation, digital trading systems, data flows, safeguards, financial services and electronic payments. The Professional and Business Services Council has indicated that "the DEA contains a number of provisions which may be regarded as 'best in class'".[84]

4. EU-UK Data Adequacy

The EU decision granting data adequacy to the UK, reciprocated by the UK, formally recognises equivalence of the UK's high data protection standards to those guaranteed under EU law, enabling personal data to flow freely from the EU and UK. The UK has also sought a similar arrangement with the US. The adequacy decisions include a 'sunset clause', which limit its duration to four years after their entry into force. The agreement can be renewed if the UK continues to be found to have adequate level of data protection. The agreement also contains other safeguards for the EU, which can intervene if the UK deviates from the level of protection currently in place.

5. UK-Swiss MRA for financial services

The on-going negotiations are aimed at facilitating or improving cross-border market access in the banking, insurance, asset management and capital market infrastructure sectors. Although not yet agreed, if this agreement delivers on the ambition promised, then it could create a framework for deep-market access for financial services, allowing financial services firms unparalleled access to third countries' markets while the UK remains outside the single market.

In addition to MRAs, the services trade agreements would seek to enhance mobility arrangements with trading partners. This would include ambitious visa reform that would expand existing offers of visa-free work-related travel, as well as offering a preferential visa access regime implemented by the Home Office, in exchange for reciprocal

83 New Zealand Foreign Affairs & Trade, Recognising New Zealand qualifications.
84 International Agreements Committee, Scrutiny of international agreements: Digital Economy Agreement with Singapore, and Sixth Protocol to the Convention on a Very High Neutron Flux Reactor, April 2022.

improved access. Enhanced mobility agreements would seek to improve reciprocal access through improvements in several areas:

- Extend access to youth mobility schemes to a broader range of partners.[85] These can enable UK businesses to more simply recruit and train young talent, without requiring possession of a Home Office Sponsor License. This could be aligned with broader objectives to bring in high-skilled labour.
- Improve the business visitor rules to support businesses to bring in highly-skilled talent from overseas for short-term projects. This would include extending the maximum length of stay and broadening scope of business activities covered to enhance mode 4 services trade (that requires professionals to travel to the destination they are supplying the service export).
- An improved student visa offer, offering family visas and extended stay after higher education courses are completed.[86]

The UK-Switzerland Services Mobility Agreement demonstrates that reciprocal access can be delivered to enhance access for UK professionals, but the UK could go further in expanding access across the different visa routes to support services professionals and businesses.

Although these elements take time to negotiate, they are unlikely to fall foul of the WTO commitments that trade agreements must cover substantially all trade. First, all of the potential partners mentioned above other than the US already have a traditional trade agreement with the UK, so these measures would simply enhance the existing coverage. Second, these agreements would be similar to others that have been made in the absence of an FTA (for example, negotiations for data adequacy between the UK and US, and wider bilateral visa agreements). Importantly none of these would raise new barriers with other trading partners.

The approach to negotiating an STA also has to be different

This shift towards a much more intense focus on delivering market access through mutual recognition will naturally require a different negotiation approach to one that puts regulatory dialogues at the centre and regulators behind the steering wheel of agreeing the scope of services trade agreements.

But here too the UK does not need to start completely from scratch. Regulatory dialogues in various forms have been key components of the various countries' FTA

85 The UK's regime currently covers Australia, Iceland, India, Canada, Japan, Monaco, New Zealand, Republic of Korea, Hong Kong and Taiwan.
86 This would mean reversing recent restrictions designed to cut net migration, see: GOV.UK, Changes to student visa route will reduce net migration, May 2023.

negotiations and ongoing trade and regulatory cooperation. Box 1 discusses the processes that New Zealand and Canada put in place for on-going regulatory dialogues with their largest trading partners, and the TCA and other recently signed UK FTAs also set up a number of Trade Committees. For example, the UK-Australia FTA established a Professional Services Working Group to support "relevant bodies in the development of systems for recognition of professional qualifications", with a commitment to meet annually for three years.[87]

The negotiation of Services Trade Agreements would adapt these regulatory cooperation approaches. They could be initiated with a 24-month intensive regulatory dialogue where the regulators would agree on the areas to be taken forward, and then agreements would be negotiated between regulators, as was the process for the Swiss-UK MRA on financial services. The trade department should continue to play a lead role, coordinating regulators through intense negotiations, efficiently managing input, and ending unproductive engagements. It is also critical to ensure that dialogues have the right membership, and to establish ambition at the outset, especially when this approach is less established; however, if the UK's ambition is not reciprocated, or where regulatory differences mean progress is not being delivered, then resources should be reallocated.

With this model, DBT would retain responsibility for initiating the negotiation, setting the priorities (such as which sectors and arrangements to prioritise with each partner), agreeing the agenda with partners, and coordinating and supporting a deal through all parliamentary and scrutiny processes. But this will also require joined-up policy making between government departments, which, although not a new concept in international negotiations, needs to become centre stage when it comes to the envisaged focus on services trade liberalisation.

Mutual recognition deals, even more so than FTAs, will require on-going cooperation with partners to support the implementation of these deals. As with FTAs, these will be important forums to build trust between regulators, flag any risks and promote future alignment, as well as supporting staged implementation. As with FTAs, sensible safeguards and non-regression measures should be built in. But these groups should help reduce the chance that agreements need to be terminated, due to perceived (or actual) regulatory divergence resulting in the scenario where either regulator no longer perceives regulations as equivalent.

Alongside the negotiation of these deals, implementation, review and evaluation are key to success. Agreements should be clearly communicated to businesses, with support from trade promotion authorities to make connections in target markets so as to ensure a high utilisation of the eventual agreements.

87 Department for Business and Trade, International treaty: Chapter 10: Professional Services and Recognition of Professional Qualifications, December 2021.

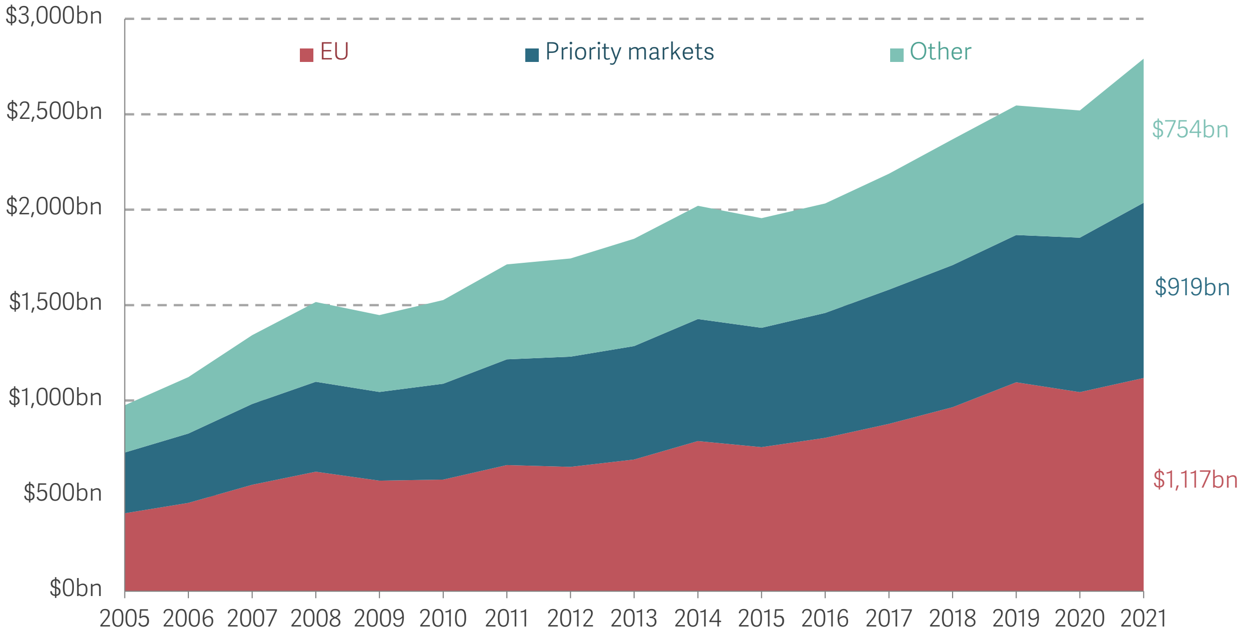
While this establishes a bilateral trade policy approach, the UK should explore opportunities to embed what is learnt into institutions, such as the WTO. If networks of services agreements can be successfully delivered, willing countries could be convened to deliver a plurilateral deal that could align access and simplify the process for exporters operating across multiple partners.

The UK may find willing partners in its pursuit for STAs

The UK has already been relatively successful in looking beyond the EU for its services exports. To maximise the impact of the services strategy, it should start by seeking liberalisation with the UK's largest non-EU trading partners, which would include the US, Singapore, Australia, Canada, Switzerland and Japan. Refocussing trade policy to services deals with these countries will target a large and growing demand for services in which the UK specialises – these six priority markets import 33 per cent of services where the UK has an RCA, and growth in demand since the financial crisis has outstripped that from the EU. Gravity means UK market share will naturally be lower (they are further away), but focussing on deep-liberalising arrangements will give UK exporters an advantage.

FIGURE 21: **Just six priority markets import 33 per cent of services where the UK has a revealed comparative advantage**

Value of services imports with a UK revealed comparative advantage: global excluding UK

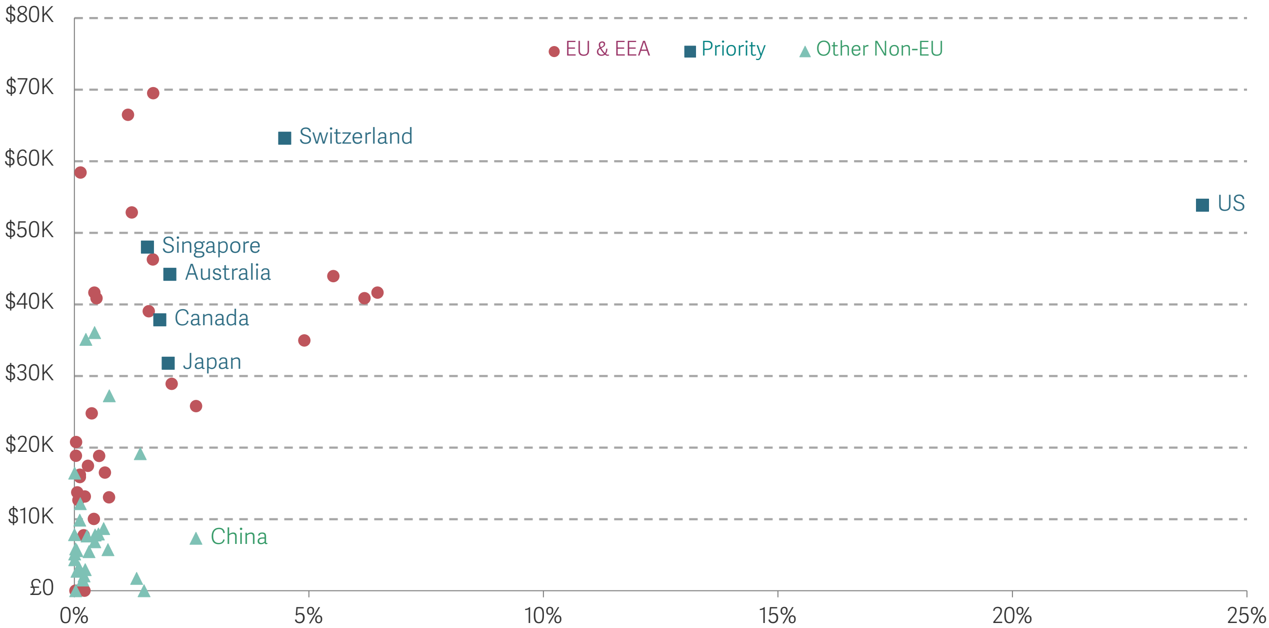


NOTES: Priority markets are the US, Japan, Canada, Switzerland, Australia and Singapore, the EU includes EU-27 plus Croatia for the whole time period. Includes the sectors where the UK had a revealed comparative advantage in 2019.
SOURCE: Analysis of OECD International Balanced International Trade in Services (BATIS).

However, the fact that the services barriers that must be addressed with partners are largely focussed around facilitating the movement of services suppliers across borders and achieving equivalence of regulatory regimes, has implications for the choice of partners. The UK will need to find partners with relatively similar regulatory regimes and a record of regulatory cooperation to maximise the likelihood that regulators can agree equivalence arrangements. Unlike regulatory arrangements, mobility remains an area where political and public interest is high. The public have more favourable views on immigration from some countries over others, typically favouring countries that could offer mutually beneficial agreements with some negative attitudes towards migration from economically poorer countries.[88] Many of the UK's largest non-EU trading partners, such as the US, Singapore, Australia, Canada, Switzerland and Japan, are developed countries with high incomes, and so have similarly high regulatory standards, lower perceived migration risks and as a result, likely more UK public support for improved mobility arrangements.

FIGURE 22: **The UK's largest non-EU trading partners are high-income countries**

Adjusted net national income per capita (vertical axis) and share of UK services exports (horizontal axis)



SOURCE: World Bank, Adjusted net national income per capita (current US$); ONS, Services trade data Q4 2022.

Other partners, such as India and China, may be less suitable partners for these deeper services deals, on the basis that pursuing deeper regulatory and mobility progress is less likely to be fruitful. However, a less ambitious services deal with India would still have

88 British Social Attitudes 38, Immigration: A meeting of minds? The impact of deliberation on attitudes towards post-Brexit immigration policy, October 2021.

value to the UK by establishing a first-mover advantage, even if the deeper liberalisation proposed within the STAs remains unlikely. This is also consistent with public support for establishing FTAs: agreements with the US, Australia and New Zealand are supported by 56 per cent, 65 per cent and 64 per cent of the public, compared to just 36 per cent and 45 per cent support for China and India respectively.[89]

The UK has already achieved broad coverage of liberalisation through traditional trade agreements and has existing FTAs with many of these partners. But, as discussed in Section 1, these do not provide deep liberalisation for services sectors: typically, they just lock in existing liberalisation. So, there is value in revisiting these partners to deliver services trade agreements.

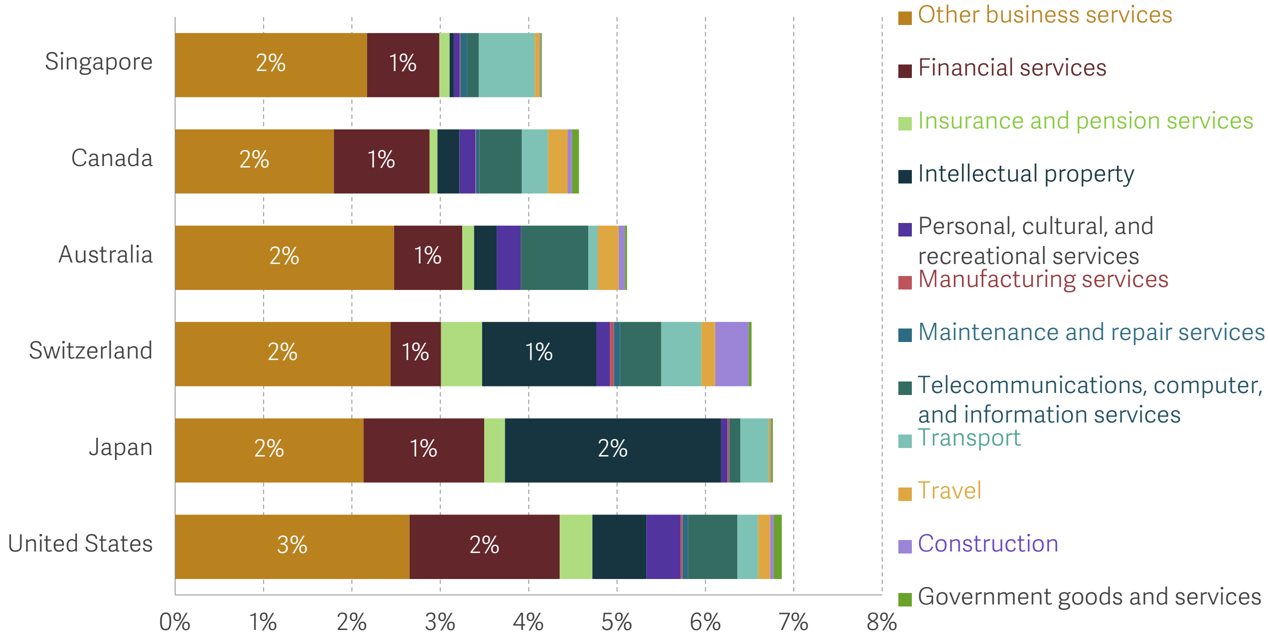
There are also reasons to suggest that, despite global trade tensions, the UK might find willing partners in this approach. As highlighted in Section 1, the wider geo-political trade context has become more challenging, but this has been mainly been about trade in goods. The success the UK has had with its early services liberalisation attempts has reflected the appetite of trading partners to explore alternatives to traditional trade agreements, such as future-proofing market access against technological change through digital agreements. Other partners are also pursing trade policies that have focused on areas outside or peripheral to traditional FTAs, including the US Indo-Pacific Economic Framework and the emerging agreement between the US and Taiwan.[90]

But, just as the UK is a major services exporter, it also accounts for a disproportionate share of global services imports – standing at the world's fourth largest services importer, behind the US, China and Germany. Across the countries we have highlighted above, the UK accounts for between 4 and 7 per cent of services exports, more than double the UK's share of global GDP, and substantially higher than the 1 to 4 per cent of goods exports the UK received from these countries in 2022.

89 Department for Business and Trade, Public attitudes to trade tracker (PATT): wave 5, November 2022.
90 Office of the United States Trade Representative, USTR Announcement Regarding U.S.-Taiwan Trade Initiative, May 2023.

FIGURE 23: **The UK accounts for between 4 and 7 per cent of key partners' exports**

Share of services exports to the UK by sector: priority services trade partners, 2021



SOURCE: Analysis of OECD, International Balanced International Trade in Services (BATIS).

Despite this, it is clear that not all partners will be open and willing, and the approach above should be considered a framework for guiding the direction of trade policy decisions rather than a prescriptive list of targets. As the UK has already learnt, interest can cool even with initially willing partners, such as the US. But geopolitics, foreign and domestic policy agendas are always changing, and the UK could also find that previously unwilling partners become more open to a services dialogue, and so the direction of policy can adapt over time to reflect what is possible at any time with specific partners.

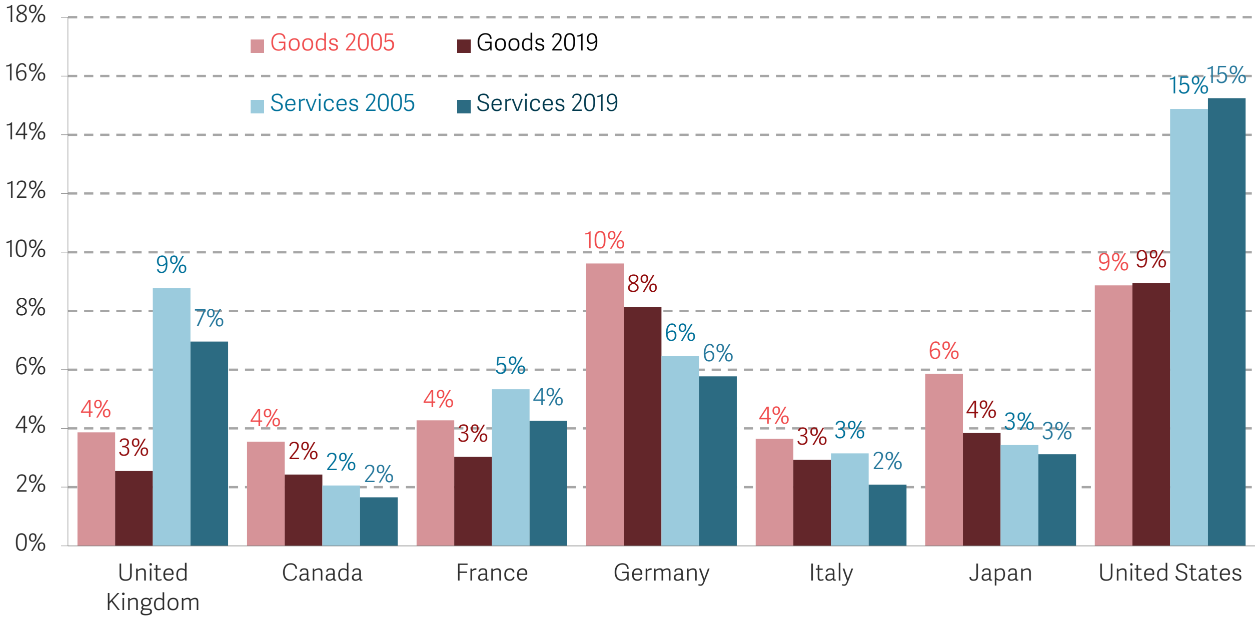
Wider domestic policy must be aligned to deliver the strategic goals of trade policy

Expanding market access opportunities for exporters with international partners should be seen as just one important component of the UK's trade strategy. Trade policy also covers the broader domestic agenda that is vital to supporting the international competitiveness of British firms, which has gradually declined over the past 15 years. Figure 24 shows that the UK has seen the largest decline in its market share in the G7, but this sluggish economic performance pre-dates Brexit.

The UK's services export performance has been particularly weak compared to others in the G7, for example the US, Japan and Germany. In key services such as financial services, the UK has experienced even larger relative declines, with the UK's market share falling by 22 per cent since 2005, compared to growth of 12 per cent for the rest of the G7.

FIGURE 24: **The UK has been losing market share faster than most G7 comparators**

Market share of global goods and services trade in 2005 and 2019: G7 countries



SOURCE: Analysis of OECD International Balanced International Trade in Services and UN Comtrade.

For this reason, the remit of supporting UK competitiveness and exports can't lie just with the DBT; the Home Office, the Department of Education, HM Treasury and the Department for Energy Security and Net Zero all have key roles to play.

In many places, supporting the expansive services trade objective will be about leveraging the existing strengths of the economy, which have consistently contributed to the persistent comparative advantage of the UK across these service sectors. The highly skilled workforce stands out as one of these strengths. Action here should primarily focus on fostering the growth of domestic skills, bolstering higher education in the UK, and encouraging on-the-job training. [91]

But this should also extend to attracting top international talent and skilled labour. Recent immigration figures have received significant media and public attention, but the Government should refrain from responding in a way that risks damaging its ability to attract highly skilled migrants, and to bolster the UK's educational and tourism exports.[92] The Government should instead double down on its current approach: continuing to limit migration for non-essential low-earning sectors while streamlining the process of bringing in high-skilled professionals will support the expansion of tradeable services

91 We will publish two reports on skills later in the Economy 2030 project.

92 For example, see: C Hymas, Eighteen Birmingham-sized cities needed for housing 'if record net migration lasted 25 years', Telegraph, June 2023. R Picheta, L McGee & C Edwards, Britain sees record net migration levels, increasing pressure on government, CNN, May 2023; M Honeycombe-Foster, 3 years after Brexit, UK net migration has never been higher, Politico, May 2023.

sectors that align with the objectives of the trade strategy. The barriers, including visa costs and paperwork, to uptake of existing visa access should also be reviewed to reflect this.

In other places, aligning domestic policy will be about addressing the long-standing weaknesses of the UK economy, such as the damagingly low levels of business investment. Business investment in human capital, as well as intangible assets and physical infrastructure, lies at the core of cultivating globally competitive firms and services sectors. Yet business investment was only 10 per cent of GDP in 2019, far behind an average of 13 per cent in France, Germany and the US.[93] Despite being a long-standing public-policy priority for the current Government, which has thrown significant public funds at the problem, business investment has remained stubbornly low.[94]

Finally, as is the case with goods, the regulatory environment will play a major factor in domestic investment decisions, foreign firms' decisions to locate in the UK and trading partners' willingness to commit to MRAs. Firms are looking to the Government to offer certainty and confidence about the UK's future regulatory environment, following an extended period of business and regulatory uncertainty, elevated by risks relating to Brexit, the Covid-19 pandemic and then the cost of living crisis.

Regulatory policy should also strive to support the UK's competitiveness, by safeguarding the UK's reputation for upholding high regulatory standards. This reputation serves as a competitive advantage for numerous service sectors –UK banking, for example, is differentiated by its reputation for safety, giving it an advantage over competitors – and any cost-saving dividends from ill-considered deregulation will be quickly offset if there is a perceived reduction in the quality and security of the product. The benefits and strategic aims of regulatory reform should be clearly considered and communicated, demonstrating what reform seeks to achieve beyond simply being different from the way that the EU did it. As with trade policy, regulation has an essential role in supporting the economic agenda that must go beyond using it to express stances on Brexit or satisfy demands for a 'Brexit dividend'.

But supporting the international competitiveness of UK services will take more than just enhancing our long-demonstrated strengths: governments should also look to support UK firms to develop capabilities in emerging and growing sectors. It is expensive and risky to use industrial policy to try to substantially change the UK's industrial structure. But by channelling investment through existing strengths in tradeable services that support wider domestic objectives –such as the services activities that support the

93 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.
94 T Bell et al., We're going on a growth Hunt: Putting the 2023 Spring Budget in context, Resolution Foundation, March 2023.

green transition – the Government can achieve positive spillovers by also enhancing international competitiveness.

Finally, it is essential to guarantee an adequate regulatory capacity. As highlighted above, the negotiation of services deals will require significant regulatory input into dialogues and negotiations as a prerequisite for success. To achieve this, there should be a review of grant-in-aid funding arrangements, enabling the provision of the upfront investment of regulators' time that is necessary for active participation in rigorous regulatory dialogues and negotiations. For professional bodies, arrangements should also be explored to ensure sufficient input can be provided.

Section 4

Conclusion

Following a period of 15 years marked by a relative economic decline, the UK needs a coordinated trade strategy to boost growth and productivity. The current approach of signing FTAs has reached the end of the road. But replacing this approach with a new strategy means confronting the tough decisions on the UK's future international relationships and domestic policies; fundamentally, we need to grapple seriously with the issue of how the UK can succeed in the 21st century.

The current debate has not risen to that challenge. Instead, too much energy is focused on arguing whether the UK was right to leave the EU, and the choice we face is framed as a binary one between re-joining the EU or branching out alone. Those proposing even marginal improvements to the current relationship risk being accused of trying to drag Britain back into the EU. Although many now agree that Brexit is harming trade and the British economy, the fear of being branded either a 'Leaver' or 'Remainer' prevents many from considering how a trade strategy could support the UK economy, and the trade-offs we face as a country.

Further, the proposals that are currently on the table look to only tweak the current trading relationship with the EU, and fail to tackle the fundamental issues. These tweaks will provide little comfort to the manufacturing industries that rely on the EU for economies of scale, or that are importing from and exporting to the EU as part of integrated supply chains; this lack of ambition is symptomatic of policy makers focussing on what can be achieved today.

Instead, we need a honest and thorough debate on the future of UK manufacturing, acknowledging that there are intensifying pressures from the EU and US as they seek to onshore production. In this report, we have set out evidence that points to a defensive objective on goods and an expansionary one for services, both underpinned by supportive domestic policy decisions, not just trade policy. Policy makers need to face the choice over whether or not to stay part of EU supply chains, to support high-productivity manufacturers, and they need to accept that doing so means addressing the EU border.

But this is not a counsel of despair: we can make the most of opportunities beyond the EU with a new strategy that breaks with traditional trade policy to deliver a new services-oriented approach. This means building on our successes in previous negotiations by introducing a new form of agreement assembled from the parts of ambitious deals emphasising services liberalisation, with a targeted set of partners. Trade is familiar with policy innovation: the first agreement focussed on services trade, the General Agreement of Trade in Services (GATS), was launched in 1995, and has become ubiquitous 30 years later.[95]

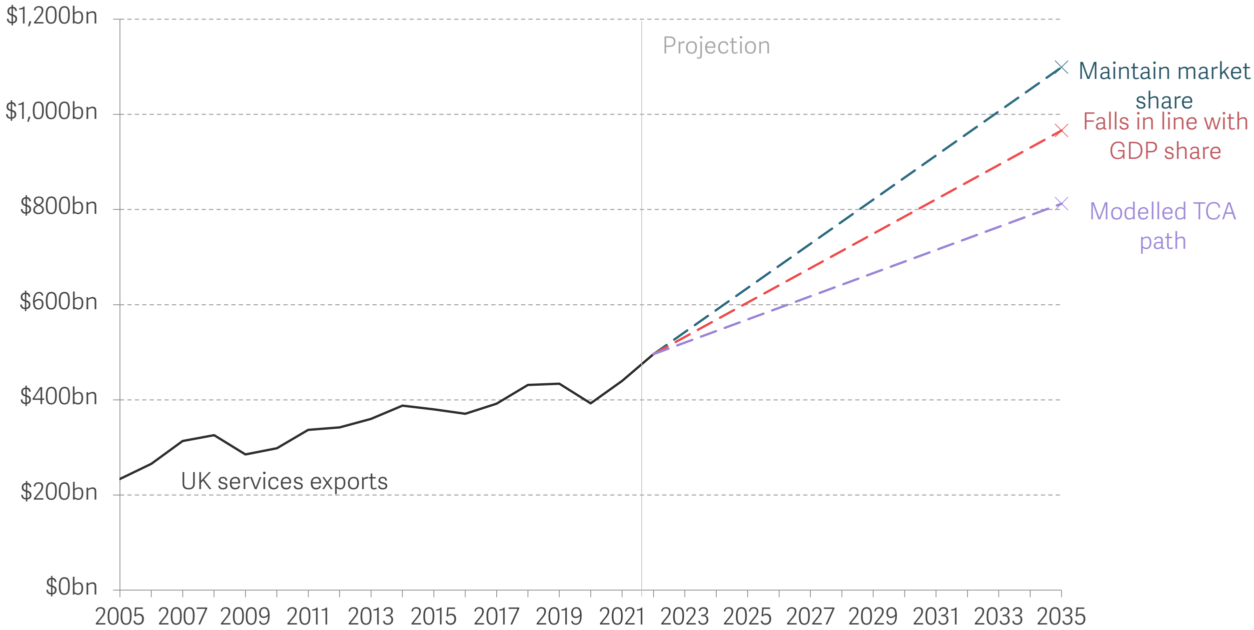
This report sets out a strategy that has clear objectives and a plan for how to achieve these. These proposals are not new: many called for a closer goods arrangement between the EU and UK before the TCA was signed. But trading patterns post-implementation provide further evidence of the need to act. As we've set out, this will be hard to deliver, with policy makers facing both technical challenges and the need to persuade partners. We have shown that simply just relying on what is on the table now will fall short of a trade strategy. Instead, a meaningful strategy involves clearly articulating your objectives, to enable you to progressively work towards them in the months and years to come. But starting on this journey can't wait - the further UK and EU firms go in adapting to the new trading arrangements, the more the impetus to make changes will fade, leaving the UK poorer.

The pay-offs for the UK to pursuing a strategy that delivers on these objectives are substantial compared with the status quo. Services exports are expected to grow faster than goods in the coming decade, growing from 25 per cent to 28 per cent of total exports by 2035.[96] As shown in Figure 25, if the UK was to maintain its market share, service exports would be $290 billion higher (more than £200 billion) in the year 2035 compared with the modelled post-TCA path. So, although the road ahead is a difficult one, the rewards for a successful services strategy are potentially very substantial.

95 World Trade Organization, The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines.
96 UK Government, Global Trade Outlook, February 2023.

FIGURE 25: **The rewards for successfully prioritising services trade could be huge**

Services exports past and projections (various): UK, 2005 to 2035



NOTES: 'Maintain market share' shows UK maintaining 2021 market share of 7.3 per cent. World growth in services trade projections from Global Trade Outlook and in nominal Terms, and the share of services to grow from 25 per cent to 28 per cent by 2035. 'Modelled TCA path' means that the UK loses 23 per cent of services exports due to trade barriers in the TCA. 'Falls in line with GDP share' means GDP share falls from 3.3 per cent to 2.9 per cent by 2035.
SOURCE: Analysis of OECD, International Balanced International Trade in Services; ONS Services Trade, Global Trade Outlook 2023, IMF World Economic Outlook, 2023; S Dhingra, E Fry, S Hale & N Jia, The Big Brexit: An assessment of the scale of change to come from Brexit, The Resolution Foundation, June 2022.

Annex 1: Analysis of the services provisions in the Trade and Cooperation Agreement

Approach

This analysis takes a novel approach to estimating the impact of the provisions on cross-border services trade and investment in the TCA (Articles 127 to 139) on trade in services, between UK and EU, since implementation in January 2021. It uses the variation (across sectors and countries) in the reservations taken out by parties to the TCA to understand how restrictive the barriers these provisions seek to remove are on services trade.

Data

We use UK trade in services data from the ONS. The data includes all UK trade flows at the country-sector level, by quarter, over the period Q1 2015 to Q4 2022, for 58 countries (EU and non-EU). The level of sector aggregation is based on the level of aggregation we are able to match to the reservations data (discussed below). Earlier data cannot be used as pre-2015 data is not available at the same level of disaggregation, but the starting period of Q1 2015 provides sufficient data covering the pre-referendum period. Q4 2022 is the latest time period for which the data has been made available and we intend to add more periods as they are released. Gravity variables like distance, common colonies etc are taken from CEPII.

For the purpose of this analysis variables were created to represent the prevalence of reservations to cross-border services and investment provisions in the TCA by reviewing the reservations under Annex 19 for Articles 127-139 of the TCA. There are 11 provisions, which include those related to national treatment, most favoured nation, market access, senior management, local presence and performance requirements. For each EU country and the UK, service sector (defined as per the Provisional Central Product Classification, CPC) and provision, we create a variable indicating whether there is law mentioned in Annex 18 of the TCA, that is non-conforming to the provision, for each the country. As the reservations are recorded by CPC code, these were then aggregated to the 2010 Extended Balance of Payments Services Classification (EBOPs) sector level to match to the trade data. The share of reserved CPC codes under each EBOPs is calculated for each provision and country. A value of 1 means the given provision does not apply to imports of that sector into the country with the reservation. These shares are our main independent variable and provide both cross-country and cross-sector (EBOPs) variation. To the best of our knowledge, we are the first to code up the reservations of the TCA to create such measures.

We combine provisions on National Treatment, Most Favoured Nation and Market Access, to create an aggregate that we refer to as the WTO provision. This is because these provisions are obligations under the General Agreement on Trade in Services (GATS).

Empirical Strategy

We run a gravity-type equation with fixed effects to estimate the effect of the reservations under each provision on trade in services. The main specification is:

$$\ln trade_{sdit} = \beta_1 Postref_t WTO_{sdi} + \beta_2 Postref_t Mgt_{sdi} + \beta_3 Postref_t Perf_{sdi} + \beta_4 Postref_t Local_{sdi} + \beta_5 Posttca_t WTO_{sdi} + \beta_6 Posttca_t Mgt_{sdi} + \beta_7 Posttca_t Perf_{sd\,i} + \beta_8 Posttca_t Local_{sdi} + \alpha_{pi} + \alpha_{pt} + \alpha_{it} + \epsilon_{sdit}$$

Here, s refers to the source country, d destination country, i service sector, t time (year-quarter). $Postref_t$ is a dummy variable that indicates the period between the referendum and the TCA coming into effect i.e. Q3 2016 to Q4 2020. $Posttca_t$ is a dummy variable that indicates the period after TCA came into effect i.e. Q1 2021 onwards. WTO_{sdi}, Mgt_{sdi}, $Perf_{sdi}$ and $Local_{sdi}$ give the share of reserved CPC codes for the provisions under GATS, on senior management, performance requirement and local presence, respectively, for a country-pair and EBOPs sector. We interact these with $Postref_t$ to capture the fact that some of the reservations may be anticipated by firms based on the reservations that are present in the trade agreements of UK and EU with other countries.

The estimates β_5 to β_8 are our main coefficients of interest and when multiplied by 100 these approximate the percentage change in trade flows when the share of reserved CPC codes in the respective provisions increases by one percentage point after the TCA comes into effect as shown in Section 3.

Note that the main regression is run for bilateral flows of UK services trade with other countries. Since, for each observation, either the importer or the exporter is the UK, we take the fixed effects with respect to the partner country in the trade flow, denoted by p. We include partner-country x service-sector, partner-country x time and time x service-sector fixed effects. Including these fixed effects omits the standard gravity variables, due to collinearity. We run the Poisson Pseudo Maximum Likelihood (PPML) regression as suggested by previous academic work to take care of zeros in trade flows.[97]

As sensitivities we also run a standard fixed effect regression which finds similar results to our main regression.

97 J Santos-Silva & S Tenreyro, The Log of Gravity, The Review of Economics and Statistics Vol. 88 (4), November 2006.

Findings

The estimates from the regression indicate how much the value of trade in each sector could change if all countries' reservations were removed, i.e. if the share of reserved CPC codes fell to 0 for all country-sector. Our results, discussed in the main text, suggest that the restrictions included in the TCA have negatively affected trade between UK and EU countries, suggesting the provisions corresponding to the reservations have a trade-increasing effect. The anticipation on the restrictions also has a negative effect on trade flows, but less than that of the TCA. However, the overall scale of impact has been relatively small. Caution is recommended in interpreting the results as this analysis is based on only two years data post-implementation of the TCA. This, therefore, can be interpreted as the short-run impact of these provisions and reservations only.

THE
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