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Trade Implications of Brexit for Commonwealth Developing Countries

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Background

This issue of *Commonwealth Trade Hot Topics* analyses 'Brexit' – the UK's departure from the European Union (EU) – and shows that the effects for some Commonwealth countries may be severe unless specific actions are taken to avoid this. Yet there is a danger of Commonwealth interests being 'crowded out'. Most member countries will have no representation in the decisions that could affect their trade,[1] being able to influence events only from the side-lines in an environment where there exists severe time pressure and great uncertainty over almost all features of the Brexit process (Box 1).

Box 1: Brexit uncertainty

Brexit is a journey into unknown territory, as no state has ever left the EU. This Hot Topic is based on the consensus, as far as it exists, at the time of writing – but as this evolves so may some of the arguments need to be refined.

The formal process will be triggered when the UK government informs the European Commission of its decision to leave under Article 50 of the Lisbon Treaty, which the Prime Minister has said is likely to happen in 2017. Whether, and at what point, the UK Parliament would be involved in the Brexit process is still unclear. Once the 'Article 50 button' has been pressed, the negotiations on the terms of exit should be completed within two years – a time period that could be extended by the EU-27 (but not by the UK). Whether the button, once pushed, can be de-activated (with the UK opting not to leave after all) is unclear.

Again, formally, there can be no negotiations between the UK and either the EU-27 or any other state on a new trade regime until after Brexit has happened. This is because the UK remains a part of the EU (and all its trade agreements) until the day it leaves ('Brexit+1'). There is of course a fine distinction between 'negotiations' and 'talks'. It seems inconceivable that nothing will be done until Brexit+1 (not least as this would guarantee a hiatus in trade policy unless the terms of exit included a transition period during which the status quo ante would continue).

Yet it seems unlikely that there will be any substantial 'ready to sign' deals on the table by Brexit+1. Not only is the devil in the detail in trade negotiations (with the most contentious issues left until last) but also the impact of any trade agreement will be influenced by the details of the exit deal. Potential trade partners will not know exactly what they are signing up to until the Brexit details are finalised – nor will the UK know what it can safely offer without prejudicing unacceptably its access to the European single market.

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1 Cyprus and Malta will be intimately involved in the negotiations as EU members. These apart, only countries with which there may be bilateral UK trade negotiations will have specific influence.

Brexit will affect the rest of the world along several direct and indirect pathways (Mendez-Parra et al., 2016). If the UK or EU economies slow, so may their import growth. The UK will create a new trade policy and its departure may provoke changes in the impact of the EU-27's regimes. Any reduction in investment as a consequence of short-term uncertainty or longer-term de-integration of the single European market will have possible adverse effects on growth and trade. Then there are indirect effects through the impact on investment and exchange rates, migrant remittances and global growth.

The trade policy effect

This Hot Topic focuses on what may be the most visible and, for some Commonwealth countries, potentially the most dramatic Brexit effect: changes to UK trade policy. The challenge is to ensure that the exports of Commonwealth countries are not disrupted immediately following Brexit and, more ambitiously, to use the UK's new-found policy discretion to fashion a trade regime that is better at supporting development than the *status quo*.

There will be trade policy effects in three arenas:

1. the UK and its current EU partners (including two Commonwealth countries);
2. the UK and those states that currently have favoured access to the EU market;
3. possible trade agreements between a post-Brexit UK and countries such as China, India and USA with which the EU does not have a trade agreement.

All of these are related, but the second is perhaps the most urgent for those Commonwealth developing countries that have 'better-than-Most Favoured Nation (MFN)' access to the EU market under either an Economic Partnership Agreement (EPA) or other type of Free Trade Agreement (FTA), or through trade preferences.[2] One point on which there appears to be legal consensus is that unless specific actions are taken to avoid this outcome the trade regime of the EU will cease to apply to imports into the UK on Brexit+1.

EU border measures will be replaced by those of the UK – but these are yet to be created. Negotiations within the World Trade Organization (WTO) will be needed to dissect the EU's commitments into a set applying to the UK and another set for the remaining members (see Box 2). But they are unlikely to be concluded by Brexit+1, given that creating a completely new MFN regime for goods and services would be a hugely complex and time-consuming task.

Box 2: WTO uncertainty

Like Brexit, the challenge for the WTO is unprecedented: it has never before had to disentangle the joint commitments of a grouping that has split. The EU is unique in having 29 WTO members: the 28 member states plus the EU itself. They have combined rights and obligations that, following Brexit, will need to be divided between the EU-27 and the UK. This will have to be negotiated by the UK and the EU-27 with each other and with any WTO member that considers its interests affected (Ungphakorn, 2016: 2).

These negotiations are likely to extend long after Brexit. The EU and its WTO partners have not yet agreed how Europe's commitments (established when there were only 15 members) should be adapted to take account of the three subsequent enlargements, despite 12 years of negotiation (Ungphakorn, 2016: 4).

Since the UK must have some form of tariff schedule on Brexit+1 it follows that the initial years of its independent trade policy will take place in an environment of intense scrutiny. Other members may be looking, for example, at trade preferences with an eye on how they might affect MFN rates in which they have an interest.

The only reasonable working assumption is that the Brexit+1 default option – if nothing better is put in place – is that the UK's MFN regime will be the same as, or very similar to, current EU policy. This would affect seriously some Commonwealth developing countries. To flag the scale and incidence of the impact we have analysed all UK imports from each vulnerable Commonwealth trade partner and, where this is possible, calculated whether they would face a tariff hike.[3]

2 There is a large (but not total) overlap between this group and 'Commonwealth developing countries'. Two advanced economies (Cyprus and Malta), for example, have better-than-MFN access to the UK, whilst Brunei and Maldives are among those states that do not.

3 Because the EU's tariff structure is so complex, it is not possible to take all types of tariff into account. In addition to simple *ad valorem* tariffs (e.g. 10%) there are *ad valorem* tariffs with a minimum and/or maximum entry price (e.g. 18.4% min 22 €/100 kg max 24 €/100 kg), compound duties (5% + 24 €/100 kg), specific duties with a minimum/maximum *ad valorem* equivalent (0.5 €/p/st min 2.7% max 4.6%) and specific duties only (0.9 €/%vol/hl). The calculation of potential tax is based only on any ad valorem elements of these – using the highest applicable where a range applies to different ten-digit national tariff line codes within an eight-digit trade code. This introduces scope for both overstatement and understatement: the former as a result of using the highest applicable *ad valorem* element (usually at least one item within a range carries a zero tariff) and the latter in respect of their specific duty elements. All tariffs have been obtained from the EU's 2015 schedules in UNCTAD's TRAINS database.

Table 1: Scale of potential effect of application of EU MFN tariffs

Commonwealth country	Calculable potential tax (€ thousands)	Calculable potential tax as % of total UK imports from country concerned
Top ten countries affected in absolute terms		
Bangladesh	247,976	11.7%
India	122,272	1.7%
Pakistan	108,322	9.2%
South Africa	63,822	1.4%
Mauritius	41,232	14.3%
Seychelles	25,685	23.4%
Ghana	22,468	6.9%
Sri Lanka	18,859	2.3%
Kenya	18,337	5.3%
Papua New Guinea	10,083	6.7%
Top ten remaining countries affected in relative terms		
Swaziland	1,739	10.6%
Uganda	1,787	8.8%
Tanzania	3,110	8.4%
Namibia	5,381	8.0%
Tonga	2	6.3%
Lesotho	31	5.5%
Bahamas	317	5.3%
Samoa	31	5.2%
Grenada	24	4.1%
Solomon Islands	581	4.1%

Source: Authors' calculations using data from Eurostat's COMEXT database and UNCTAD's TRAINS database.

It is easier to list the Commonwealth countries that will not be affected significantly by Brexit than those that will. Based on average annual EU imports in 2013–15, only 12 of the Commonwealth developing countries[4] face a potential calculable tax hike representing less than 1 per cent of the UK's total imports from them.[5]

How big a hit? A simple indication is €715 million. This is the 'new tax' that would be levied on UK imports from the Commonwealth from (calculable) tariffs that are higher than today's. It is a broad guide only, taking account of the precise calculation issues explained in footnote 3.

Table 1 shows the most-affected countries. The top half lists the ten countries that would face the greatest absolute effect in terms of the extra import duty they would have to pay and also shows this new tax bill relative to the country's total exports to the UK. Bangladesh faces overwhelmingly the largest absolute hit, but proportional to current exports the worst affected state would be Seychelles, followed by Mauritius.

Because this ranking focuses on countries with large exports to the UK it can obscure serious relative impacts on small states. The lower half of Table 1 lists a further ten countries not included in the top half of the table for which the potential tax bill would equal 4 per cent or more of the value of exports to the UK. Swaziland takes the greatest hit followed by Uganda, Tanzania and Namibia.

How could this outcome be avoided? Four stylised options (each with scope for many nuances) cover the ground.

Option 1: continuing the *status quo*

The simplest option, given that the time available may be barely more than two and a half years, would be for the UK initially to adopt the pre-existing EU regime if this were legally and politically feasible. This could buy time for a home-grown trade regime to be developed. But so great are the Brexit unknowns that even 'continuing the status quo' is open to alternative interpretations.

Full de facto replication of current EU tariffs

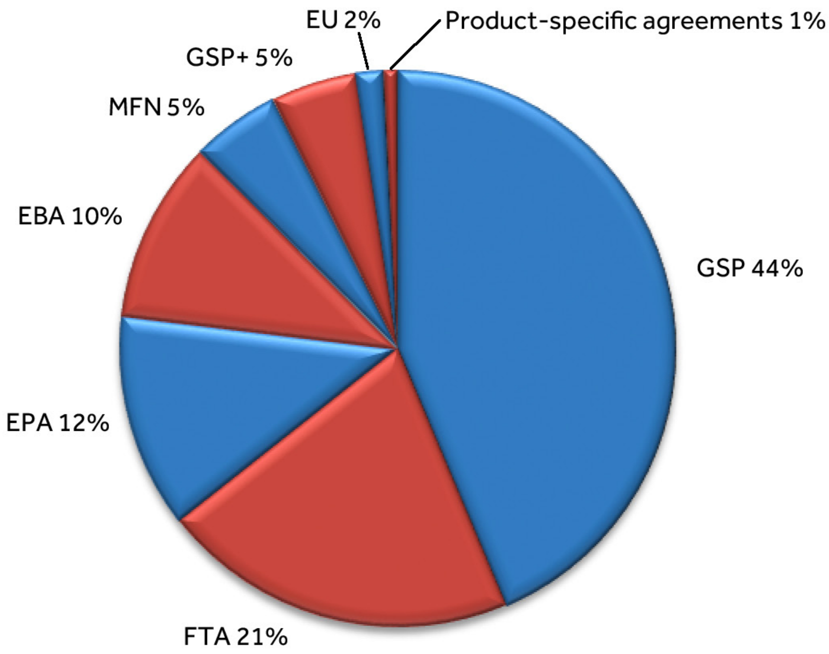
The extreme case is a regime that exactly replicates the mosaic of tariffs currently applied (Figure 1) to imports into the UK regardless of their legal basis. By definition this would leave the exporters' market access unchanged for goods.

Even so, it could still hinder the intra-European movement of Commonwealth goods destined for more than one national market. Options for a continuation of unrestricted movement will depend largely on the Brexit deal, but this in turn may be influenced by expectations about the UK's

4 The 12 are Antigua and Barbuda, Barbados, Belize, Botswana, Cameroon, Fiji, Guyana, Nigeria, Rwanda, Sierra Leone, Saint Lucia, Trinidad and Tobago. In addition, there will be no effect for the seven Commonwealth countries that already pay full MFN duties – Australia, Brunei, Canada, Malaysia, Maldives, New Zealand and Singapore. UK imports from these seven have not been analysed because they already pay full MFN duties.

5 And all of these 12 export items on which further, non-calculable, duties apply, which may well bring them above this threshold.

Figure 1: Share of UK imports from Commonwealth countries with better-than-MFN access by regime (average 2013–15)



Key:

MFN	*Products imported from India and Nigeria for which they are graduated out of GSP*
GSP	*India, Nauru, Nigeria, Sri Lanka, Tonga*
GSP+	*Pakistan*
EU	*Cyprus, Malta*
EBA	*Bangladesh, Lesotho, Kiribati, Malawi, Mozambique, Rwanda, Samoa, Sierra Leone, Solomon Islands, Tanzania, Tuvalu, Uganda, Vanuatu, Zambia*
EPA	*Barbados, Belize, Botswana, Cameroon, Dominica, Fiji, Ghana, Grenada, Guyana, Jamaica, Kenya, Mauritius, Namibia, PNG, Seychelles, Saint Lucia, St Kitts, St Vincent, Swaziland, Trinidad and Tobago*
FTA	*South Africa (since subsumed into the SADC-EU EPA)*
Product-specific agreements	*India and Pakistan (for two rice products)*

Source: Authors' calculations using data from Eurostat's COMEXT database.

post-Brexit trade policy. If the UK's market regime, including its rules of origin (RoO), is different from the EU-27's the latter may require more stringent border checks to avoid trade deflection. If this resulted in new import points being created in the UK to avoid trans-shipment costs it could work to the advantage of Commonwealth exporters by shortening supply lines. But this is only a possibility not a certainty.

Replicating the Generalised System of Preferences (GSP)

Simply replicating the current array of tariffs might be open to WTO challenge. While an Everything but Arms (EBA)-replica regime for least developed countries (LDCs) is probably secure,[6] EPA/FTA access is more problematic as it is legitimised under GATT Article 24.[7] Unless the UK were to negotiate its own FTAs (see Option 4 below) it could be challenged in the WTO for discriminating in favour of some and against other members if it limited such liberal access just to those states that have signed EPAs/FTAs.

Instead, the UK could apply a copy of the EU's GSP to all developing countries. EBA, GSP+ and the standard GSP are applicable to some 59 per cent of UK goods imports from Commonwealth countries with 'better-than-MFN' access (see Figure 1).

6 Since there seems to be a consensus that importing states can give these countries special preferences.
7 And Article 5 of the General Agreement on Trade in Services for services.

Table 2: Scale of potential effect of application of EU MFN and GSP tariffs

	Calculable potential tax (€ thousands)	Calculable potential tax as % of total imports from country concerned
Top ten countries affected in absolute terms		
South Africa	63,822	1.4%
Mauritius	41,232	14.3%
Seychelles	25,685	23.4%
Ghana	18,003	5.5%
Kenya	13,812	4.0%
Namibia	5,381	8.0%
Cyprus	5,228	2.9%
Malta	4,547	2.5%
Papua New Guinea	4,224	2.8%
Botswana	2,582	0.3%
Relative effect for remaining countries		
Swaziland	1,422	8.7%
Bahamas	317	5.3%
Grenada	24	4.1%
Dominica	47	3.1%
St Vincent and the Grenadines	22	2.4%
Jamaica	1,514	2.2%
St Kitts and Nevis	3	1.3%
Barbados	52	0.6%
Saint Lucia	48	0.6%
Antigua and Barbuda	16	0.6%
Belize	530	0.6%
Trinidad and Tobago	164	0.2%
Fiji	121	0.2%
Guyana	30	0.0%
Cameroon	40	0.0%

Source: Authors' calculations using data from Eurostat's COMEXT database and UNCTAD's TRAINS database.

But the GSP would not cover services (except as far as the EU had taken action under the WTO LDC services waiver) and it would still result in a significant increase in tariffs on some imports from non-LDCs. The 'extra tariff tax' levied on UK imports from the Commonwealth would fall from the €715 million under the 'MFN only' option to €184 million,[8] but the impact on some countries would still be substantial (Table 2). Mauritius and Seychelles remain the most affected relatively, with Swaziland and Namibia close behind.

There are three reasons for this limited mitigation. Only a few countries are eligible: just 23 meet the maximum income criterion, which is that they must be classified as lower-middle or low-income (LMIC or LIC) by the World Bank.[9] Second, the GSP does not cover all goods and provides only a modest reduction on MFN rates for some that are covered (3.5 percentage points or fewer for the majority).

The third reason has wider ramifications. It is that countries eligible for the Standard GSP are 'graduated out' for specific product groups if they account for 17.5 per cent (14.5% for textiles) or more of total EU GSP imports from GSP beneficiaries during three years. India, Kenya and Nigeria are among the Commonwealth countries that are graduated out from at least one product group. The wider ramification is that Brexit may affect the product graduation of Commonwealth exports to the EU-27. The 'total' against which the 17.5 per cent of imports is calculated will be reduced by the UK's departure potentially altering the impact on some countries' exports.

GSP plus EPAs/FTAs

A potential option for the EPAs is for the UK to become a party to them in its own right. The legal basis for this is uncertain. The CARIFORUM–EU EPA, for example, makes explicit provision for new accessions – but only for new EU states (Article 247) or Caribbean states (Article 248). The SADC–EU EPA is more accommodating: Article 119 refers to the possibility of an accession request being received from 'a third state or organisation having competence for the matters covered by this Agreement', but the context implies (unsurprisingly) that it is other southern African states that were in the negotiators' minds.[10]

8 In calculating this figure the authors have assumed that all Commonwealth countries currently eligible for GSP preferences according to the EU's TARIC (although many of them also currently have better-than-GSP access) would remain so (including Nauru, which is currently high income), and that Papua New Guinea (not currently listed as eligible) would become so (as it is an LMIC).
9 Those countries that are too rich for the Standard GSP include all the Commonwealth Caribbean states and Botswana and Namibia.
10 And the Canada–EU Comprehensive Economic and Trade Agreement does not anticipate any new signatories other than new members of the EU (Article 30.10).

But politically it may be feasible to follow this route if there were a willingness on the part of all signatories to do so. Because UK accession as a separate signatory would require assent all round it might take time to agree, especially if it prompted requests for broader negotiations, however modest. [11]

Although this route would reduce the danger of a 'shock' on Brexit+1, it would also tie the UK into the current EU trade policy pattern. While it might still be feasible in principle to fashion in the future a more 'development friendly' UK trade policy, the momentum would have been lost. And aspects of the UK's Brexit deal with the EU-27 might have been predicated on this retention of the *status quo,* creating an obstacle to future change.

Option 2: an improved UK GSP

How would a wholly new GSP meet the twin objectives of avoiding immediate Brexit+1 problems and creating a more development-friendly UK trade policy? Its main advantage is one of practicality: no external negotiations are involved. It would still be a substantial task to finalise all the details by the time of Brexit+1, but the timetable would be wholly under the UK government's control.

Autonomy is both the GSP's greatest attraction and its greatest risk. As the design of a GSP would be an internal UK decision it could, for example, offer EBA terms to all Commonwealth developing countries and RoO that are more liberal than any of the EU's. But in the pre-Brexit pressure-cooker atmosphere, with UK firms lobbying hard to influence uncertain outcomes, it is also possible that it could be less liberal and fail to maintain the access of some Commonwealth exports. And, like Option 1, any coverage of services would be limited to LDCs.

Any GSP regime would need to meet WTO requirements, but these are fairly vague. The Appellate Body has given some guidance, indicating that differentiation between developing countries is acceptable provided two key criteria are met: members receiving extra preferences must share a widely recognised trade need to which these special preferences are relevant. But this still leaves a great deal of room for doubt.

Some OECD states (such as Norway and Australia) autonomously offer superior market access to sub-groups of developing countries.[12] And, of course, the USA's African Growth and Opportunity Act is available only to Africa – and only to some countries in that region. While a WTO challenge could not be ruled out, the existence of precedents would allow the UK to take action quickly in the belief that it is WTO-compliant and, if necessary, make amendments later if there were a successful challenge (which would probably take several years to reach a final verdict).

None the less, it will require a fine line to be drawn if the new barriers to UK imports from Commonwealth countries are to be avoided without creating arbitrary distinctions. Some combination of relatively large Brexit impact plus income and/or vulnerability status could provide a good starting point. Of the countries flagged in Table 1 as facing particular shocks only South Africa is neither in the World Bank's LMIC or LIC income groups nor UNCTAD's Structurally Weak Vulnerable and Small Economy (SWVSE) classification.

Option 3: a very liberal MFN trade regime

WTO acceptance of such a 'creative GSP' may be affected by the atmosphere within which the UK's broader negotiations take place (Box 2). If the atmosphere is hostile it might increase the attractions and feasibility of an option favoured by some Brexit supporters: creating a UK MFN regime so liberal that it makes unnecessary special preferences (at least on tariffs) for developing countries. This could apply to services as well as goods.

But the task would be enormous, making it less feasible that Option 3 could be completed by Brexit+1. For this reason, it would need to be supplemented by other options to avoid a Brexit+1 hiatus.

Moreover, Option 3 would bring to the fore a longstanding argument associated with 'preference erosion'. Are trade preferences a desirable way to help (some) developing countries compete with (some) advanced countries or are they a 'second-best', conferring a temporary advantage to less competitive states on goods that are too sensitive to be liberalised across the board? The former view sees the removal of restrictions on imports from a growing number of states as 'eroding'

11 See, for example, an early expression of interest in South Africa's *Engineering News* (15 July) – http://www.engineeringnews.co.za/article/davies-says-brexit-risk-for-south-africa-does-not-lie-in-trade-arena-2016-07-15/rep_id:4136.

12 Notified to the WTO under the Enabling Clause.

development support. The latter, by contrast, sees wider liberalisation as the ultimate goal that will produce the greatest economic gains.

Because of this disagreement not all observers will see Option 3 as the most development friendly – but the most powerful opposition to it is likely to come from within the UK. Achieving this outcome (and to a lesser extent a very liberal GSP open to many developing countries) would require the government to withstand the lobbying that can be expected from producers of goods that might face stiff competition from imports.

It would also raise even more strongly than Option 2 the uncertainty over where the balance will settle in the febrile pre-Brexit period between liberalism and protectionism and between conformity with EU norms (to facilitate trade with the single market) and exciting innovation. Moreover, it will not necessarily be only the 'usual suspects' that are active in the lobbying: UK exporters may also have mixed interests in both this and the liberal GSP options.

Option 4: a set of free trade agreements

Export interests and the mercantilist nature of trade negotiations might push the UK government towards some level of 'tactical protectionism' given that Brexit will cause to lapse UK participation in the kaleidoscope of FTAs that the EU has negotiated (unless, as suggested under Option 1, the UK becomes a separate party to these agreements).

The EU has notified in the WTO no fewer than 39 FTAs with developing countries (Stevens et al., 2015). The details vary widely but all provide EU exporters with some preferential access to the signatories' markets. After Brexit exporters based in the EU will continue to receive these preferences.

This could put *some* UK producers of *some* goods at a competitive disadvantage – which would be substantial in *some* cases. This multiple use of the vague word 'some' shows the need for detailed market research, but there will be casualties.[13]

FTA negotiations focus on a reciprocal removal of access barriers. If the UK has already removed most tariffs either on an MFN basis (Option 3) or through a liberal GSP open to many developing countries (Option 2) this could dilute the incentive for its trade partners to complete FTA negotiations.

Way forward

None of these negative effects is inevitable. The UK government has adopted a liberal, outward-looking stance. But the message of this Trade Hot Topic is that a favourable outcome is not inevitable; it must be explicitly created in an atmosphere of rapid change, limited resources and lobbying from all sides. The default options if Commonwealth interests are crowded out are either undesirable or vulnerable to challenge.

Affected Commonwealth countries will need to press their case actively if their voice is to be heard above the clamour. And they will need to act fast. There might be more time: the EU-27 may agree to extend the two-year deadline triggered when Article 50 is invoked, or the *status quo* might be extended from several years after Brexit+1 to allow for a more orderly transition. But it would be unwise to bank on this.

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13 Three illustrative examples give a flavour of the extreme cases. Both the UK and France export certain types of electrical equipment (HS85021300 – electrical generating sets) to South Africa and both enter that market duty free; after Brexit UK exports will face a 20 per cent tariff. Both the UK and the Czech Republic export vehicles (HS870323300 – motor cars and other motor vehicles) to Egypt at a preferential 20 per cent duty, but after Brexit UK exports will face a 40 per cent tariff. After Brexit German exporters of iron and steel articles (HS7326909090 – other articles of iron and steel) to Egypt will have a 25.5 per cent tariff advantage over UK exporters.

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