European & International Analysts Group

The UK and the EU: Two years after Brexit and one year into the Trade & Co-operation Agreement

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Introduction

On Christmas Eve 2020, the UK and the EU reached agreement on a trade and cooperation treaty governing their future relationship (the TCA). This agreement came into force on 1 January 2021.[1]

In this paper, we look at the consequences of Brexit and at the implementation of the TCA in its first year, including its economic impact, and current problems arising from the agreement and its implementation.

Although the Northern Ireland protocol, which governs the trading relationship between Northern Ireland and the EU and Great Britain and Northern Ireland, is laid down within the UK-EU Withdrawal Agreement and not the TCA, we nonetheless consider the negotiations around the implementation of the protocol since there is an interrelationship between the protocol and the TCA.

Background

The UK-EU TCA is a free trade agreement that provides for tariff and quota free trade for most goods between Great Britain and the EU (see below as regards Northern Ireland). Rules of origin apply to goods exported from GB to the EU, meaning that (in simple terms) the bulk of any item being exported must have been made in the UK. Services were largely excluded from the agreement because the UK prioritised regulatory autonomy over maintaining economic ties with the EU; this issue is dealt with below. It is important to note that there is a distinction between effects of Brexit generally (*e.g.* that the UK is no longer in the Single Market) and those of the TCA in particular (*e.g.* the alternative trading arrangements replacing the UK's former participation in the Single Market).

Leaving the customs union with the EU means the return of full customs controls on GB-EU trade for the first time since 1992. Because of the short implementation time, the UK unilaterally delayed introduction of full customs controls on most imports from EU until 1 January 2022. New sanitary and phyto-sanitary (SPS) rules governing the import of animal and plant products came partly in force from 1 January 2022; the remainder come into force on 1 July 2022.

1 The text of the finalised Treaty, following a legal text revision process by both parties, came into force on 1 May 2021 replacing the Christmas Eve edition: see HM Government, 'UK/EU and EAEC: Trade and Cooperation Agreement', 30 April 2021

The Government remains confident that Brexit was the right choice for the country. It has published a paper on the benefits of Brexit and is consulting on a prospective Brexit Freedoms Bill.[2] The Government has given examples of the greater flexibility the UK has outside the EU in some areas of public policy, including on VAT, migration in respect of EU/EEA citizens, in agriculture and in financial services.

The TCA is a large and complex agreement with major consequences for all businesses trading with the EU. An example of that is that the UK trade guide to importing and exporting goods to/from EU runs to 160 pages.[3] It has led to the reintroduction of a significant number of non-tariff barriers. Further details of the TCA can be found in an earlier SEE paper.[4]

Economic impact

Assessing the economic impact of Brexit and the TCA is complicated by the near parallel event of the pandemic. Nonetheless, the Office for Budget Responsibility (OBR) has estimated that Brexit will reduce UK GDP by four per cent in the long term, in addition to a two per cent fall in GDP as a result of the pandemic.[5]

There was a much greater fall of 15 per cent in UK trade with the EU in 2021. UK goods exports to the EU (nearly half of total exports) fell by 45 per cent in January 2021 before recovering somewhat in the months afterwards but they were still in August around 15 per cent lower than in 2020.[6] Goods imports from the EU also fell, by around 30 per cent in early 2021, recovering to 20 per cent below December 2020 in August 2021. Trade with both EU and non-EU countries was still lower at the end of 2021 than it had been before the pandemic in 2019 but the fall in the case of EU countries was double that with the rest of the world.[7]

The impact of the TCA on trade can be seen by comparing the trade performance of the UK and that of the main EU countries: UK trade has not recovered after Covid in the way EU countries' trade has.[8] In addition, the UK is now more dependent on trade with non-EU countries; 52 per cent of UK trade in first 10 months of 2021 was with non-EU countries.[9] While the UK has had some success in rolling over trade agreements between the EU and third countries, and has signed new FTAs with Australia and Japan, the modest growth in UK's trade with non-EU countries doesn't compensate for the fall in UK/EU trade.[10] And the FTA with Australia shows the UK's weakened leverage outside of the EU; the UK would not have agreed to such a deal before because the majority of the benefits will be to Australia and because it undermines UK animal welfare standards and SPS controls.

Part of the difficulty in maintaining UK-EU trade in the first year derived from supply chain disruption. Global supply chains have been disrupted by the pandemic but Brexit has also been a factor. It is difficult to disentangle the two as possible explanations but the loss of EU

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2 See HM Government, *The benefits of Brexit: how the UK is taking advantage of leaving the EU*, 31 January 2022
3 See HM Government, *The Border with the European Union: Importing and Exporting Goods*, 16 December 2021
4 Senior European Experts, *The UK-EU Trade and Co-operation Agreement 2020*, 18 January 2021
5 'Impact of Brexit on economy "worse than Covid"', *BBC News*, 27 October 2021
6 Office for Budget Responsibility, 'The initial impact of Brexit on UK trade with the EU', 27 October 2021
7 *Ibid.*
8 See 'How Brexit and the pandemic changed UK trade in 4 charts', Sebastian Whale & George Arnett, Politico.eu, 10 January 2022
9 *Ibid.*
10 See map showing the UK's trade relations around the world prepared by Trade Economics, 'UK Trade Agreements After Brexit', 26 October 2021

citizens in the UK to drive goods vehicles and to work in food processing (roughly 200,000 EU nationals left the UK in 2020-21[11]), the impact of the restrictions on cabotage (the right to carry goods between more than one destination in the EU) in the TCA and the need to comply with customs and SPS controls at ports are all Brexit-related factors contributing to the difficulties.

The largest impact of the TCA on UK-EU trade has probably been in services. The loss of "passporting", that was the right of a UK-based company because it was regulated in one EU country to offer that service in all EU countries, was a significant blow to UK service businesses. To trade with the EU now they must now have a subsidiary in each EU country they operate in and comply with host country regulations. Prior to Brexit the UK had a large surplus in its trade in services with the EU and the EU Single Market was UK's largest destination for services exports, amounting to 40 per cent of overall services exports. After the TCA came into force, the fall in UK services exports to the EU in the second quarter of 2021 was at 30 per cent more than double the size of the fall in services exports to the rest of the world (14 per cent; the comparison is with same period in 2019).[12]

The impact of the TCA on energy has not been as great. The UK prioritised energy trade in the TCA resulting in a minimal impact on energy prices from Brexit. UK energy policies are (now) largely aligned with those of the EU.[13] The UK's current high energy prices are mainly due to global factors but also to some domestic ones such as the lack of gas storage capacity and the inadequate diversification of energy resources meaning that the UK is less resilient in energy supply.[14] In the longer-term, the fact that the UK is no longer in the energy single market may adversely affect the security of supply.

Inward investment has been volatile since 2016 with an overall downward trend, especially in expansion projects, and a big fall in FDI-created jobs.[15] The UK had been a major benefactor of inward investment while in the Single Market with non-EU companies often choosing the UK as a base inside the EU (for example, for vehicle manufacturing, pharmaceuticals and financial services). The Government has created an Office for Foreign Investment and established hubs around the UK to promote it but it will be hard to reverse the downward trend since 2016 given the limitations of the TCA.

Brexit has been one of the factors in driving inflation because of its link to supply chain issues, to labour shortages pushing up wages and to reduced business investment. The increase in inflation will affect the cost of living, will increase Government spending (through higher interest rates on debt, increase in costs of goods and services and linked increases in benefits) and potentially increase the cost of exports, leading to either reduced overseas sales or lower UK business profits.[16]

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11 See Office for National Statistics, 'Population of the UK by country of birth and nationality: year ending June 2021', 25 November 2021

12 Professor Sarah Hall, 'The UK services sector: a challenging first year outside the EU', UK in a Changing Europe, 9 December 2021

13 Michael G. Pollitt, *The Further Economic Consequences of Brexit: Energy*, Cambridge Working Papers in Economics, CWPE 2161, 6 September 2021

14 See Ian Bond, Elisabetta Cornago & Zach Meyers, 'Why have Europe's energy prices spiked and what can the EU do about them?', Centre for European Reform, 28 October 2021

15 '100 days since Brexit: The UK's self-inflicted wound', Greg Barklie, *Investment Monitor*, 6 April 2021

16 'UK faces slow growth, high inflation after pandemic and Brexit - NIESR', David Milliken, *Reuters*, 9 November 2021

Current problems with the TCA and trade in goods and services

Customs controls on goods

It is now more difficult, more costly and slower for UK companies to trade with the EU because the UK is no longer in the customs union with the EU or in the Single Market.[17] This is because although the burden of tariffs was avoided through the TCA, non-tariff barriers to trade with the EU are now in place. These include customs documentation on exports including declarations on rules of origin, VAT now being levied on exports, the reintroduction of SPS controls on fish and food exports and the need for some UK exporters to comply with more than one set of sectoral, product or employment regulations.[18] As a result the number of customs declarations made on GB to EU exports, and UK to the rest of the world, has increased sharply; it was 44 million for the whole of 2020 but 48 million for January to August 2021.[19] The cost to business of this increased bureaucracy is another factor adding to inflation as businesses pass on these costs to customers.

The UK has twice delayed the introduction of full UK customs controls on EU imports. This reflects the difficulties for UK business of adjusting to controls, especially those concerning animal products and delays in bringing new infrastructure and staff online.

Sanitary and Phytosanitary (SPS) controls

The UK decision not to retain EU SPS standards means that UK food and drink exports to the EU are now subject to SPS controls at the border, making it more difficult and more costly to export from GB to the EU. Exporters have published many examples of the impact on their businesses, including the 60 steps necessary to export plants from GB compared to 27 before Brexit and some exports no longer being viable as the cost of compliance is greater than value of product - a £2 packet of seeds costing £100 to export for example.[20] Overall, most food and drink exporters must go through 20 steps now compared to just two before Brexit.[21] The greatest impact appears to be on products with the lowest profit margins. One fish merchant showed the BBC the 76 pages of forms, including approval from a vet, needed for each consignment of cuttlefish and monkfish exported to the EU.[22]

Agriculture and fisheries

The largest decline in commodity exports to the EU in January 2021 was in the category of food and live animal exports at 73 per cent. Data from the Food & Drink Federation suggested it had recovered but was still over 45 per cent down at the end of the first quarter.[23] By contrast, exports of food and drink to non-EU countries rose by 0.3 per cent over the same period so even allowing for the pandemic, there was a major fall in overall exports to the EU and SPS controls were probably the biggest reason.

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[17] See House of Lords European Affairs Committee, *4th Report of Session 2021–22: One year on—Trade in goods between Great Britain and the European Union*, HL Paper 124, 16 December 2021

[18] The double regulation problem particularly affects companies in the chemicals and/or medical products sectors.

[19] National Audit Office, *The UK border: Post UK–EU transition period*, HC 736, 5 November 2021, p. 10

[20] House of Lords European Affairs Committee, *op. cit.*, pp. 21-22, paras 71 and 74

[21] National Audit Office, *op. cit.*, p. 51, para 2.14

[22] *'Brexit: One year on, the economic impact is starting to show'*, Faisal Islam, *BBC News*, 24 December 2021

[23] All figures in this paragraph quoted in National Audit Office, *op. cit.*

In respect of fisheries, the most noticeable impacts of the TCA were the reduced fishing opportunities compared to the expectations of UK fishermen, the delay in agreement with Norway and Iceland about access to their waters in 2021 and the dispute with France over access to UK waters for their boats. The UK fishing sector was angered by the TCA as they argued that it had led to £300 million in lost business compared to the pre-Brexit position, not the £148 million gain the Government claimed.[24] In addition, the absence of agreements with Iceland, the Faroes, Greenland and Norway meant a loss of fishing opportunities for UK boats in 2021. Agreement was finally reached with Norway in December 2021 to allow reciprocal access to catch cod, haddock and hake in 2022 but the overall amount is below the pre-Brexit position. One company has estimated that the quota it has received for 2022 amounts to just one week's work for one large Hull-based trawler, the Kirkella.[25]

The Government was able to point to the relative success of the first post-Brexit negotiations with the EU on total allowable fishing catches (TACs) for 2022 which saw the TACs for 2021 largely rolled over; but the sector would still say that this is below the expectations the Government had itself set before Brexit. The spat with the French over historic fishing rights for their vessels in UK and Channel Island waters has mostly been resolved.

<u>Services</u>

In addition to the loss of passporting rights, the loss of free movement rights is impacting UK business because it has ended short-term working in the EU. Businesses cannot deploy staff to EU countries to respond to surges in demand or to address trade problems. In addition, the lack of mutual recognition for qualifications hampers professionals from both UK and EU and imposes costs on UK employers even when visas are granted (*e.g.* the NHS).

The impact of restrictions on travel and tourism are not fully clear because of the impact of the pandemic but some employment opportunities for British citizens have clearly been lost, for example those working in tour guiding or those working in alpine resorts. There are specific problems for creative professionals (*e.g.* musicians, many of whom earned half or more of their income from working in the EU before Brexit) as they must comply with rules of each EU country and the transport of instruments and other equipment can be affected by both customs and cabotage rules.[26] The restrictions on visits to 90 days in 180 days a year is a major disadvantage for UK property owners in the EU (and vice versa).

<u>Education & science</u>

Despite an assurance from the Prime Minister that the UK would not withdraw from Erasmus+ after Brexit, the EU-managed international student and university staff exchange programme, the UK has done so. It has been replaced by the Turing scheme but that offers lower-level grants to students compared to Erasmus, does not make up for the loss of £200 million in income to UK universities from EU students who formerly came under Erasmus+ and it is an annual programme unlike Erasmus+ which being multi-annual provided certainty for institutions, students and staff when planning courses and exchanges.[27]

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[24] See report by Gary Taylor, former DEFRA lead fisheries negotiator: *Brexit Balance Sheet*, National Federation of Fishermen's Organisations, 30 September 2021

[25] See *'Brexit fishing deal: Kirkella owners "devastated" by UK-Norway pact'*, *BBC News*, 21 December 2021

[26] See Ilze Jozepa, Niamh Foley & Melanie Gower, *EU-UK Trade and Cooperation Agreement: Temporary business travel*, House of Commons Library Research Briefing CBP 9130, 17 November 2021

[27] See Professor Paul James Cardwell & Dr Max Fras, 'The Turing Scheme: does it pass the test?', UK in a Changing Europe, 12 March 2021

Although the TCA provided for the UK to rejoin the EU's Horizon science programme, this has not happened because of on-going negotiations with the EU on other issues.[28] This short-sighted position takes no proper account of the mutual benefit to the UK and the EU of co-operation in science and research and ought not to continue.

Northern Ireland Protocol

The Protocol was part of the Withdrawal Agreement and designed to ensure no new border on the island of Ireland so as to protect the Belfast/Good Friday Agreement. It keeps NI in the Single Market for trade in goods. This in turn means that goods travelling between Great Britain and NI (and vice versa) are subject to EU import controls.[29] Implementation has proved difficult for both business and the public sector with some trade between GB and NI stopping altogether (for example, of plants) but an increase in trade from NI to Ireland/EU.

In July 2021 the Government asked for substantial changes, including a new approach to the regulation of goods travelling between GB and NI, an end to a role for the EU institutions including the Court of Justice in policing the protocol and the adoption of a new disputes resolution procedure.[30]

Negotiations began in September 2021 but the atmosphere was not helped by an earlier EU suggestion (quickly withdrawn) that it would use emergency procedures to prevent supplies of Covid vaccine being shipped to GB via NI and by repeated suggestions from UK Ministers that they would use same emergency procedure (Article 16) to remove EU controls on trade if UK demands for changes were not met.

The EU response to the UK proposals was to offer an 80 per cent reduction of spot checks on agri-food imports to NI, a 50 per cent cut in customs paperwork between GB-NI through expanding trusted trader schemes and exempting some goods and the EU unilaterally decided to ease the rules on the movement of medicines from GB to NI.[31] But UK would still have to put necessary customs infrastructure in place to enable other checks to operate.

In reality, neither side appreciated the complexities of implementing the Protocol at the time it was agreed.

The Joint Committee on the Withdrawal Agreement met at ministerial level on 21 February. The Foreign Secretary and the Vice-President of the Commission agreed that the negotiations should continue during the period of the forthcoming Assembly elections in May. But the future of the Protocol has become a major issue in the elections, with all Unionist parties demanding changes to the Protocol or its abolition. In February, the DUP First Minister resigned in protest at the Protocol, with the Sinn Fein Deputy First Minister obliged to resign too. The UK Parliament passed legislation extending the permitted maximum time for the setting up of the Northern Ireland Executive after the elections from seven days to 24 weeks.

[28] See 'Europe spat will weaken research – science leaders', *BBC News*, 22 December 202

[29] See HM Government, 'Moving goods into, out of, or through Northern Ireland', 7 January 2021

[30] HM Government, *Northern Ireland Protocol: the way forward*, CP 502, 21 July 2021

[31] 'From agri-food to medicines: What's new in EU proposals', *RTE*, 13 October 2021

Security co-operation

The TCA provided for a high level of UK-EU internal security and law enforcement co-operation but some former co-operation mechanisms were lost (notably the Dublin III regulation to return asylum seekers to the first Member State reached and real time access to the Schengen II database). In addition, arrangements for continuing the Prüm data exchanges on DNA and number plates and data on Passenger Name Record (PNR) air passengers have yet to be concluded. Although, not a direct consequence of Brexit, a loss of goodwill is also an issue, notably with France over the return of illegal migrants. It is too early to judge the overall impact on security of the TCA but information exchanges are now slower.

Data protection

An important step forward for the UK came when the EU accepted that the adequacy of UK data regulations to EU ones, enabling cross border data exchanges to continue. But retaining this will not be easy if UK ministers' promises of regulatory divergence are realised. Failure to retain adequacy would have major negative implications for both trade in goods and services and in security co-operation.

UK standing in the world

The TCA did not include any provision for co-operation in the fields of foreign policy and external security. These latter issues, including the consequent loss of routine participation and influence in EU CFSP meetings, are covered in detail in a separate SEE paper.[32]

Brexit has seen a loss of UK influence in the world with adverse consequences. For example, it was seen in the European dispute with US over aluminium and steel exports. The EU, and subsequently Japan, have successfully reached agreement with the US over this question but without the UK, which has only just announced talks with the US on this issue. There is for now no sign of the UK-US FTA that had been promised.[33]

Despite the Government's vigorous support for Ukraine in the face of Russian threats to its independence, the UK's absence from the so-called Normandy format talks on bringing peace to the Russian-occupied parts of Ukraine is a symbol of the UK's marginalisation from policy-making on a question of vital importance to the UK's security.

Britain's standing has been further damaged by the Government's repeated abandonment of the UK's traditional position as a supporter of international law. On three occasions since Brexit the Government has asked parliament to legislate contrary to our international obligations.[34]

In the same timeframe as Brexit, British soft power has been diminished by cuts in overseas aid, in the BBC World Service and in the British Council.

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[32] Senior European Experts, *Britain's Foreign & Security Policy after Brexit: the European Dimension*, 17 December 2021

[33] 'Brexit Britain at 1: Here's what we've learned', *Politico.eu*, 3 January 2022

[34] The three occasions were: the *United Kingdom Internal Market Act 2020*, c. 27; the *Overseas Operations (Service Personnel & Veterans) Act 2021*, c. 23; and the *Nationality and Borders Bill*.

Future developments

The question of the Government's economic policy ambitions for the UK after Brexit remains unanswered. Do we want a low tax, low regulation economy or something closer to the European model? The absence of a decision about the direction of travel hampers the UK's ability to develop economically after Brexit. Part of the difficulty in determining the policy direction lies in splits within the Conservative Party and in the business community but also because many of those who voted for Brexit oppose the low tax, low regulation model making it hard to deliver politically.

Over time some regulatory divergence with the EU is likely. This could have far-reaching effects if it applies in fields such as data protection, employment law and product safety. Big shifts away from EU approach in these sectors would imperil the TCA. Exporters are concerned that the costs of regulatory divergence would outweigh the benefits (because of the need to comply with two sets of rules, one for the UK market and the other for the Single Market).

The structures of the TCA are cumbersome, unwieldy and politicised, which makes dealing with problems unnecessarily difficult. Parts of the consultative mechanism have also taken a long time to get started and appear to be having little impact so far, frustrating businesses who are anxious to clarify technical but important details.

Resolving the problems with the TCA identified in this paper requires leadership from both sides at the top, both to create a more positive spirit after many months of tit-for-tat arguments and to encourage bottom-up participation. Within the UK Government, it remains to be seen whether the transfer of responsibility of UK-EU relation to the Foreign, Commonwealth & Development Office from the Cabinet Office makes a difference, and whether the subsequent appointment in the Cabinet Office of a Minister responsible for the opportunities of Brexit (Jacob Rees-Mogg) will lead to substantial divergence (inadvertent or deliberate) from EU rules.

The TCA includes a provision specifying that there will be a review of the agreement after five years (*i.e.* in 2026) which will be an additional opportunity to make changes. It could also be a point of danger for the UK if it pursues regulatory divergence from the EU over the next four years as the EU may see that as giving the UK a competitive advantage.

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