THE FUTURE OF UK-US TRADE: AN UPDATE

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UK TRADE POLICY OBSERVATORY

KEY POINTS

- Given the current political turmoil in the UK, a quick and economically significant outcome to US-UK trade negotiations seems unlikely.
- A great deal depends on the degree of alignment that the UK keeps with the EU on tariffs and regulations. Despite the current aggression towards the European Union, it is far from inevitable that the UK will cut its ties significantly.
- Aligning UK rules with those of the US, as per the US negotiating objectives, would create divergences with the EU and inevitably create extra frictions at the UK-EU border.
- The so-called Level Playing Field requirements, as set out in the backstop of the Withdrawal Agreement, constrain a potential UK-US agreement.
- The renegotiation of NAFTA into the United States-Mexico-Canada Agreement provides several insights into the US approach to trade agreements, not all of which are encouraging to the UK.
- Whilst the UK would benefit from including services in a UK-US trade agreement, the US's approach is likely to be aggressive.
- While a US-UK trade agreement may be of political importance, changes in investment and spending in the real economy will divert most private sector attention elsewhere.

INTRODUCTION

In July 2018, we reviewed the prospects for a comprehensive UK-US trade agreement in our Briefing Paper 20 - The Future of US-UK Trade: What case for a bilateral trade agreement?[1] Our conclusions were four-fold. First, while public support for a UK-US trade deal existed on both sides of the Atlantic this was tempered by concerns about existing trade agreements — primarily about NAFTA in the US and the shape and scope of the UK's future arrangement with the EU — and the kind of regulatory framework proposed that a UK-US agreement would entail. Second, to be meaningful an agreement between the UK and the US would need to deal with barriers to trade in services as well as in key manufacturing sectors. Third, by far the most taxing issue would be how the UK navigates (and indeed reconciles) the different and conflicting regulatory regimes operated by the EU and the US. And fourth, the UK would need to have settled its position in the multilateral trading system before meaningful negotiations with the US could commence.

1 Available at: http://blogs.sussex.ac.uk/uktpo/publications/the-future-of-us-uk-trade/

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In the 12 months since that first paper was published significant domestic and international events have occurred. Chief among these was that, despite repeated and valiant attempts by British Prime Minister Theresa May, Brexit was not delivered as promised on 29 March 2019. Such has been the extent of discord in the UK Government over the issue of departure from the EU that the failure to get Parliament to accept the agreement Theresa May had negotiated resulted in an extension of 31 October 2019 and ultimately cost the Prime Minister her job. May's resignation trigged a leadership contest in which Boris Johnson and Jeremy Hunt emerged as the two candidates to be put to the Conservative Party in the final ballot, with the former eventually becoming the winner by two to one.

The intervening period saw a number of meetings between US and UK officials in the so-called Working Group that was laying the groundwork for a proper negotiation when the UK was free to enter one.[2] However, that period also witnessed an escalation of trade tensions on a global scale, particularly between the US and China. The Trump administration negotiated a successor agreement to NAFTA — the USMCA — and issued stringent guidelines for US negotiators engaging in talks with their UK counterparts. Tensions between London and Washington were exacerbated by the leaking of comments made about the Trump administration by the UK ambassador to the US Sir Kim Darroch, leading to — among other things — Darrouch's resignation and criticism by President Trump of Theresa May's handling of the Brexit negotiations.

That said, many of the challenges we previously noted have endured, particularly around the issue of technical standards and regulations, and continue to animate the negotiations. Given these events, and the fact that negotiating a trade agreement between the UK and the US remains a key objective for both governments, we take a second look at some of the issues likely to loom large in any bilateral negotiation and bring into focus areas that we did not deal with in the first paper.

Our purpose here is not to return systemically to every one of the issues that we identified in the first paper. Rather, our aim is to assess the significance of some of the recent events, to probe a little deeper into areas that remain pertinent, and to explore new and related areas that warrant attention. We begin by considering the effects that Brexit uncertainty is likely to have on the capacity of the UK to agree a deal with the US. We then turn our attention to the issue of the backstop and the problems posed by the EU and US standards regimes in negotiating a bilateral agreement. Thereafter, we ask whether a deal is politically possible in the UK. We then explore the prospects and pitfalls of the guidelines issued by the US government to govern negotiations between the US and the UK before exploring what the conclusion of a replacement to NAFTA foreshadows for a future UK-US agreement. Beyond that, we ask what the US's strategic position is likely to be on services. In the penultimate section, we turn to the declining importance of the UK and Europe as traditional places of spending for US multinational corporations especially in the areas of information technology soft- and hardware. In the final section, we offer our concluding comments and note some of the other obstacles that are likely to lie in the way of a successful conclusion to a UK-US trade agreement.

BREXIT UNCERTAINTY

The negotiation of a UK-US Free Trade Agreement (FTA) is just one of the many casualties of Brexit uncertainty, both its existence and its content. As the Conservative leadership pushes the UK political debate ever further out to the extremes, the possibility of 'no Brexit' remains live. But setting that aside, the style of Brexit and the focus of the few months immediately after the UK's departure will have a profound influence on what can be agreed. The key variable will be the UK's degree of regulatory and tariff alignment with the EU, but the extent of UK political stability will also be important.

The simplest case to analyse is that something fairly close to the Withdrawal Agreement and the Political Declaration of November 2018 pertains. In the hustings to become the UK's next Prime Minister both Hunt and Johnson protested that they would demand – and achieve – significant changes in the Withdrawal Agreement and that if they failed, they would walk away leaving the UK with a so-called 'No deal' Brexit. Boris Johnson's first five days in office – in particular, his official statements and the appointment to his government of only those prepared to live with a 'No deal' Brexit on 31 October - have reduced the probability of this occurring. However, even now it is easy to believe that, given the political obstacles he faces in Brussels and Westminster and their capacity to derail his Premiership, Johnson will, in fact, turn out to be as Martin Sandu has argued, "a May continuity candidate. Reality admits of little else."[3]

We will not know for sure whether this is the correct reading until September or even October, but if it is, we can assume that the alignment issue will have largely been resolved and that although there may be much gnashing of teeth, the need to move on and heal the country will mean that no person of influence in Britain will have the stomach to re-open the issue. There will be a long negotiation with the EU, of course, but the UK is likely to remain very closely aligned with the EU so far as tariffs and regulations on goods trade are concerned. On services, the UK will retain more discretion, and it is possible that with constraints on goods it will 'cut loose' on services. However, it seems more likely that the forced acceptance of alignment in goods will signal the

2 The UK-US Trade and Investment Working Group has met six times: https://www.gov.uk/government/news/sixth-meeting-of-the-us-uk-trade-and-investment-working-group

3 Martin Sandbu, "Brexit deal or no deal?", Financial Times, 27 June 2019. Available at: https://www.ft.com/content/f6eb4d34-981d-11e9-8cfb-30c211dcd229

ascendency of market access over (essentially spurious) sovereignty, and that the UK will choose alignment on many services as well.

The inevitable result is that a UK-US agreement will be restricted to things like financial services, recognition of qualifications and audio-visual services. Worth doing for a UK cut out of EU services markets, but not very broad. President Trump would probably be willing to sign such a deal (which don't seem to impose many constraints on him, anyway); whether a different party would be willing is unclear. What is clear, however, is that such a deal would deliver very little of the US negotiating mandate.[4]

The second scenario is a 'No deal' Brexit. This could be followed by an economic crisis and an abject approach to reconcile with the EU; in this case, there would be no bilateral UK-US agreement. Alternatively, the UK will be defiant and would attempt to complete a quick negotiation of the UK-US FTA, the only case in which it is likely to receive sustained high-level political attention in the UK. Even so, much in the US mandate would be rejected, although one should expect inroads in access to UK markets on key issues like food standards and medical services.

Whether such an outcome is actually politically sustainable in the UK is uncertain, because it could — if nothing else has previously done so — force a general election. One hesitates to forecast the campaign in such an election, but it is possible that the Conservative Party would then pivot towards the centre and recognise public anxiety about such concessions.

In summary: as well as paralysing political processes during the extension period to 31 October, uncertainty will persist beyond this date; and although a deep-ish agreement with the US is conceivable, it does not seem likely.

THE BACKSTOP AND THE ISSUE OF RUNNING TWO STANDARDS BOOKS

The draft EU-UK Withdrawal Agreement includes a 'backstop' which maintains an open intra-Irish border and reduces border checks between Northern Ireland and the rest of the UK.[5] It would apply only in a set of circumstances that seem, at the time of writing, increasingly improbable: The UK Parliament would need to adopt the Withdrawal Agreement (which has already been subjected to the greatest Parliamentary defeat in history) but then fail to negotiate a future agreement with the EU that removes the need for a backstop.

Yet, by sketching out the potential elements of a future UK-EU relationship, the backstop transcends the divorce issues addressed in much of the Agreement. Notably, Level Playing Field (LPF) requirements provide for cooperation between the UK and the EU on environmental and labour standards, State Aid, taxation and competition policy.[6] These LPF provisions will likely constitute a minimum standard in a future UK-EU agreement.[7] Thus ramifications for the UK-US relationship bear consideration. While the UK agrees to maintain alignment with EU rules on State Aid and Competition, its commitment to harmonise with other EU regulation, notably product standards, is minimal.[8] This light-touch approach (outside Northern Ireland, which must align broadly with EU regulation) accommodates US negotiating objectives in regulatory areas including food safety, pharmaceuticals and services.[9]

In another respect, however, the Level Playing Field (LPF) requirements greatly constrain a UK-US FTA: they were introduced in conjunction with a UK-EU customs union.[10] Whether to negotiate a customs union with the EU has proven one of the most divisive issues in UK politics. If a customs union is agreed or applied through the backstop, LPF requirements would still allow for divergence between the EU and UK approach to a US trade agreement. The UK (except for Northern Ireland) could align regulation with the US while mirroring EU-US tariffs. This would, however, be contingent on the conclusion of a US-EU FTA, talks about which have been stuttering along over the last few years. It is also, of course, perfectly possible that with an eye on trade being 'as frictionless as possible', the UK and EU will negotiate a future relationship that involves more product-based alignment than that provided by the LPF provisions. This would certainly constrain US-UK regulatory convergence.

4 See: https://blogs.sussex.ac.uk/uktpo/2019/03/05/the-us-negotiating-objectives-for-the-uk-us-trade-deal-clearly-put-america-first/#more-3305

5 Protocol on Ireland/Northern Ireland, available at: https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement_0.pdf

6 Ibid at Article 6 (1), and Annex 4

7 The UK and the EU have indicated that this future relationship will 'build on' these commitments (HM Government, Draft Political Declaration setting out the framework for the future relationship between the EU and UK, 22 November 2018, Article XIV para 79). The EU Commission has stated it will seek such commitments in any agreement, including a 'Canada-style' deal (European Commission, 'Internal EU 27 preparatory discussions on the framework for the future relationship: Level Playing Field, 31 January 2018).

8 With the potential exception of chemical substances, commitments to uphold current standards of protection for environmental and labour standards only apply to non-product-related regulation. See: E Lydgate (2019), 'Environmental standards and regulation', in Ensuring a Level Playing Field Post-Brexit, European Policy Centre, pp 33-47. Available at: https://www.epc.eu/documents/uploads/pub_9223_brexit_lpf.pdf?doc_id=2171

9 US-UK Negotiations: Summary of Specific Negotiating Objectives, US Trade Representative, February 2019.

10 Above footnte. 5, Article XIV, para. 79.

IS A DEAL EVEN POSSIBLE?

The unique set of circumstances surrounding the US-UK negotiation have explosive potential in the UK. The UK Government has placed a political premium on making a success of Brexit through the negotiation of new FTAs, with the US a top priority.[11] Yet Trump's rhetoric that the UK must make concessions to further US interests,[12] and US positions on sensitive areas such as the NHS and food safety regulation, have already prompted resistance—US chlorinated chicken, for example, has become a touchpoint of anti-Brexit discourse.[13] US negotiations would also be met by a large group of disenfranchised 'remain' voters disappointed that the UK has not maintained deeper trade and regulatory integration with the EU. A US-UK FTA can hardly avoid becoming a symbolic focus for this frustration.

Indeed, Mr Johnson's actions added to the obvious divisions over Brexit have made it impossible to predict how UK politics will fracture, but they do, at least, prompt the question of whether negotiating and ratifying a UK-US FTA is feasible. Mr Johnson has chosen a cabinet with an explicit loyalty requirement over his Brexit policy. Even if this holds, it is not inevitable that it implies unity over a UK-US deal. Trade negotiations about anything beyond mere tariffs require coordination, and it will be difficult to progress if, for example, the negotiating objectives of the UK agriculture ministry (DEFRA) contradict those of its trade ministry (DIT). Through repeated votes on the proposed Withdrawal Agreement, the Conservative Party has discovered an appetite for rebellion. When it comes to Brexit, let alone when it comes to aligning closely with US regulatory norms, the party unity that renders UK parliamentary democracy functional cannot be guaranteed.

Having said this, the UK Parliament has little power vis-à-vis trade agreements as compared to the United States. While it can block treaties, it cannot amend them, and neither a Parliamentary debate nor a vote is required; the UK Government has concluded that having independent trade agreements does not merit reform to this approach.[14] However, post-ratification, if implementing the FTA requires changes to UK primary legislation, Parliament will also have scope to rebel, which it may well utilise. In sum, given current UK political strife, it is difficult to envisage the precise set of circumstances that would allow for a successful US-UK negotiation, bar perhaps the US abandoning some of its more controversial objectives.

11 See, for example, Liam Fox's 'Road to Brexit' speech, 2 February 2018, available at: https://brexitcentral.com/full-text-liam-foxs-road-brexit-speech-britains-trading-future/

12 See, for example, David Millward, 'Trump threatens to use US trade talks to force NHS to pay more for drugs', Telegraph, 15 May 2018.

13 See, for example, Rachel Schraer and Tom Edgington, 'Chlorinated Chicken: How safe is it?' BBC News, 5 March 2019.

14 'Process for making Free Trade Agreements after the United Kingdom has left the European Union', Department for International Trade, February 2019, p. 6.

US NEGOTIATING GUIDELINES

So, what is in the US negotiating guidelines? The Trump administration has made no secret of its desire to move away from multilateral rules towards bilateral arrangements which increase US exports relative to imports. It is, thus, no surprise that the US negotiating objectives published in February read as a very one-sided document[15,16].

The guidelines read more like an internal set of aims which the UK should not have seen. There is very little attempt to present the US proposals as balanced. US demands are spelled out accompanied by statements such as "Include general exceptions that allow for the protection of legitimate U.S. domestic objectives, including the protection of health or safety and essential security, among others," or on investment "Secure for U.S. investors in the UK important rights consistent with U.S. legal principles and practice, while ensuring that UK investors in the United States are not accorded greater substantive rights than domestic investors." The public procurement proposals are also asymmetric.

The most important aims are regulatory. Specific rules and regulations are not mentioned but the text makes it very clear that the UK should adopt what the US terms "science-based" approaches to regulation. There is no explicit reference to chlorine-washed chicken or hormone-treated beef but the description of the regulatory arrangements demanded would clearly allow the US to insist they have the right to challenge any UK ban on products that can be sold in the US.

On services there is no reference to the NHS but it calls for "Specialized sectoral disciplines, including rules to help level the playing field for U.S. delivery services suppliers in the UK", which gets close to demanding access to health services. Tariffs are significant and are also stressed. The US wants lower tariffs on cars and agricultural products as well as to "Secure duty-free access for U.S. textile and apparel products and seek to improve competitive opportunities for exports of U.S. textile and apparel products while taking into account U.S. import sensitivities". The one-sided nature of this approach is highlighted in the remarks on Rules of Origin, which read: *"Ensure that the Rules of Origin incentivize production in the territory of the Parties, specifically in the United States."* This quote also highlights the mercantilist mindset of the Trump administration: it explicitly favours domestic over foreign supplies and also over obtaining the efficiencies that result from purchasing imports when they offer better

15 See: 'The US negotiating objectives for the UK-US trade deal clearly put America First': http://blogs.sussex.ac.uk/uktpo/2019/03/05/the-us-negotiating-objectives-for-the-uk-us-trade-deal-clearly-put-america-first/

16 The guidelines can be found here: https://ustr.gov/sites/default/files/Summary_of_U.S.-UK_Negotiating_Objectives.pdf

value for money than domestic varieties[17].

Aligning UK rules with those of the US as per the US negotiating objectives would create divergences with the EU and inevitably create extra frictions at the UK-EU border. The regulatory changes, especially in areas such as food safety, environmental protection and health suppliers, would be highly unpopular in the UK. It seems unlikely that a UK Government, after signing an FTA with the EU, could sign up to much more than a very shallow agreement involving tariff reductions, which would not be without value, but would not meet the stated US aims.

WHAT DOES THE USMCA FORESHADOW FOR A FUTURE US-UK TRADE AGREEMENT?

Further insights can be gleaned if we look at agreements that the US has recently concluded. The replacement agreement to NAFTA — the new United States-Mexico-Canada Agreement (USMCA) — is instructive in this regard. As the main agreement that Trump has negotiated so far, the USMCA is a bellwether of the Trump administration's approach to trade agreements. The process of signing trade agreements recently got a boost from the United States International Trade Commission (USITC), the quasi-independent government agency responsible for the official economic assessment of prospective US trade agreements: it estimated that the USMCA would increase US real GDP by 0.35 per cent. While this number may seem small, it is actually larger than many observers had anticipated. The reasons for this are worth considering.

Given that USMCA was being evaluated relative to NAFTA, small gains were to be expected. Many observers thought the economic gains might be nil, or even negative, because of several Trump-inspired provisions aimed at engineering a reduction in the US trade deficit with Mexico and promoting US manufacturing-driven employment. Chief among these was the chapter on automobiles, which includes extraordinarily strict rules of origin and various other burdens placed on vehicle and parts production in Mexico. Indeed, the USITC report estimated that the auto chapter would significantly reduce North American trade in the auto sector and decrease US GDP.

Interestingly, however, this fact has not received much press coverage and has not emerged as a point of contention in Congress, despite opposition to the chapter by US automotive companies. The Trump administration considers the automobile chapter to be a major victory in its quest to reduce trade imbalances and deliver jobs to blue-collar workers in politically important states. All of this suggests that future trade agreements with the US are likely to involve very limited, if any, trade liberalisation in manufacturing.

The surprise element of the USITC report is its finding that gains from new commitments in the areas of services, data flows and investment are enough to more than offset the negative effects within the automotive sector. These new commitments are essentially the same to those contained in the Trans-Pacific Partnership (TPP) negotiated by Obama. The reason this is surprising is that the relevant chapters do not involve any actual liberalization; rather, they contain only commitments not to further restrict services, data flows or investment in the future.

To understand this point, a bit of history is in order. For decades, the USITC has based its estimates of the economic impact of trade agreements only on tangible trade liberalisation in the form of tariff cuts or reductions in non-tariff barriers to trade. This is because the modelling tools the USITC uses are well suited to estimating these effects. The USITC's report on TPP in 2016, for example, used this traditional approach, even though TPP contained many of the very same commitments that the USMCA does, and concluded that the overall gain in US real income from TPP would be less than 0.2 per cent of GDP.

With the USMCA, the USITC faced a dilemma. If it used the traditional method of evaluating only tangible changes to trade barriers, it would be trapped into concluding that USMCA's effect on US real income is negative—the result of the automobile chapter. On the other hand, if the USITC departed from the traditional method solely to deliver a positive finding for the USMCA, this might trigger a backlash from critics questioning the Commission's credibility and independence. In the end, the USITC decided to depart from the traditional approach.

It did so by drawing upon recent academic literature on trade policy uncertainty. This literature has found convincing evidence, albeit in specific cases such as Portugal's accession to the EU and China's accession to the WTO, that trade agreements can have a significant positive effect on trade and welfare even if the trade-barrier reductions involved are small. This is because trade agreements contain commitments to not raise barriers in the future, and this reduction in uncertainty emboldens firms to make sunk-cost investments, which increase trade and welfare.

Based on this idea, the USITC reasoned that if restrictive policies on services, data and investment have the effect of depressing trade flows by an amount equivalent to a tariff of X per cent, then a commitment to not use such policies in the future should be equivalent to a tariff reduction of one-quarter of X per cent. While the details of how USITC arrived at the number X as a tariff equivalent and the factor one-quarter as the multiplier are complicated, the point is that all of the estimated gains from the USMCA derive from this kludge.

17 See: Briefing Paper 33 – Winners and Losers from International Trade: What do we know and what are the implications for policy? : https://blogs.sussex.ac.uk/uktpo/publications/winners-and-losers-from-international-trade-what-do-we-know-and-what-are-the-implications-for-policy/

A critic of this new approach might point out that: (a) the method is arbitrary and imprecise; (b) it falsely attributes commitments on the part of Canada and Mexico to USMCA, when in fact they had already made these commitments as part of the TPP; and (c) the USITC has no basis for assessing the credibility of commitments under a trade agreement. Trump has repeatedly invoked national security and other emergency powers to override trade agreements, which should call into question any uncertainty-reducing effect of the USMCA. The USITC would probably be prohibited from taking this into account, even if it were inclined to so.

In the long run, however, the USITC's new method of explicitly accounting for trade commitments is likely to have benefits. It gives a boost to the ratification of the USMCA, which despite its flaws is better than no agreement. It may even embolden trade negotiators to negotiate further commitments on services, data flows, investment, and perhaps other areas, in future trade agreements. It is likely to lead economists to formulate better methods of measuring the value of commitments. Above all, it puts the credibility of trade agreements in the spotlight, which could perhaps tame the unilateralist instincts of future political leaders.

WHAT IS THE US' LIKELY STRATEGIC POSITION ON SERVICES?

Given this new method and our emphasis on the need to reach a deal in services in our first paper, it is worth noting the US' likely strategic position. This is particularly the case because the US and the UK are the world's leading exporters of services; and both countries generally seek liberalisation of foreign markets for services, as their providers are among the most globally competitive. Moreover, each party believes that it runs a services trade surplus with the other, which may lubricate the deal-making.

Research indicates that US services firms strongly support US Free Trade Agreements. Compared to firms in goods-producing industries, services firms are much less likely to disagree over trade agreements. Services firms tend to lobby industry trade associations to achieve the liberalisation of partner country services markets.[18]

Despite the strong US comparative advantage in services, the current US administration does not emphasize trade in services in its public statements on trade policy. The Trump administration has released two major documents outlining its trade policy objectives (the 2018 and 2019 Trade Policy Agendas). Both documents mention the potential for a US-UK FTA. The 2018 document[19] devotes a paragraph to the January 2017 meeting between President Trump and Theresa May, in which the leaders "agreed to deepen US-UK trade and investment and lay the groundwork for a future trade agreement". The prospect for an "ambitious FTA" is briefly discussed. Among the areas identified as "mutually beneficial" outcomes of such an agreement include "commitments in services ... that can foster deeper trade and innovation". The document further recounts the establishment of a US-UK Trade and Investment Working Group, which focuses on "ways to strengthen trade and investment ties ahead of Brexit".

The 2019 Trade Policy Agenda[20] devotes one paragraph to a potential Free Trade Agreement with the UK, in Section 2 ("Pursuing New Trade Deals with Strategic Partners"). Here there is only a blanket call for liberalization: *"In a Free Trade Agreement with the UK, the United States will likewise seek the elimination of tariff and non-tariff barriers, and aim to achieve a fairer and deeper trade relationship."* The document does not provide any details about what services liberalisation in a US-UK agreement might entail, but the US's approach is likely to be aggressive. Moreover, given how little attention has been paid to services in the UK's discussions of Brexit, it is not at all a given that the UK Government will match this aggression.[21]

THE CHANGING MARKET FOR US MNC FOREIGN AFFILIATE SPENDING

All of this sits against a backdrop of enduring change in flows in investment and spending, which will inevitably serve as a partial frame for the negotiations. Three phenomena are noteworthy: (i) the growing importance of software and IT to firm innovation; (ii) the increasing globalisation of R&D activity by US multinational corporations (MNCs); and (iii) the rise of new R&D hubs, and the differences in the type of activity done in them.[22] These are not separate phenomena but in fact are closely related, and also to the fact that the shift toward increasing reliance on IT/software in innovation is driving MNCs abroad in search of scarce talent.

The increasing use of software and IT hardware in innovation is an important global technological development. Engineers can now enhance product functionality increasingly through software engineering rather than mechanical, chemical or electrical engineering. As a result, software and information technology (IT) patents have been growing in importance since the 1990s—the share of software patents in all

18 See Leonardo Baccini, Iain Osgood, and Stephen Weymouth. "The service economy: US trade coalitions in an era of deindustrialization." The Review of International Organizations 14, no. 2 (2019): 261-296.
19 https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2018/2018-trade-policy-agenda-and-2017

20 https://ustr.gov/sites/default/files/2019_Trade_Policy_Agenda_and_2018_Annual_Report.pdf
21 On the neglect of services, see, for example, Ingo Borchert and Julia Magntorn Garrett (2019) 'Hiding in Plain Sight – Why Services Exports Matter for the UK', https://blogs.sussex.ac.uk/uktpo/2019/04/01/hiding-in-plain-sight-why-services-exports-matter-for-the-uk/#more-3422
22 See: Lee G. Branstetter, Britta Glennon and J. Bradford Jensen, "The IT Revolution and the Globalization of R&D", Innovation Policy and the Economy, 19 (2019) 1–37.

United States Patent and Trademark Office patents, for instance, grew from 6 per cent in 1990 to nearly 40 per cent by 2014. More important than the simple fact that software/IT intensity in innovation is increasing is the evidence suggesting that firms that do not invest in software and IT are actually left behind. Because software and IT are general-purpose technologies, firms across a broad range of industries needed to invest in IT and software engineering capabilities, and the intensity of this imperative increased over time.

These technological developments have increased the demand for IT and software engineers since the 1990s and the US began importing foreign engineers on a large scale. While many countries supplied talent, China and India were the most important sources. In 2016, 62 per cent of new H-1B visa applications (temporary visas for foreign workers in speciality occupations) were from India. Indian and Chinese students combined earned 18 per cent of doctorates in science and engineering from US universities in 2016, and this share is even larger for some key disciplines. If we view the large number of Indian and Chinese students pursuing graduate education at American research universities as the extreme right tail of a distribution of science and engineering talent, most of which remains at home, then this suggests that a significant supply of software- and IT-trained human capital is available in China and India.

Another way US MNCs acquired the needed IT talent is by opening R&D facilities in countries like China and India with large and growing pools of engineers. In 1989, US MNCs were conducting 74 per cent of all foreign R&D in just five countries—the UK, Germany, Japan, France, and Canada. They were prominent R&D locations because of their historical importance as global centres of scientific research (and as lucrative consumer markets for US MNC products). By 2014, however, only 43 per cent of all foreign R&D was being conducted in these five countries.

These findings have important implications for policymakers.[23] First and foremost, they suggest that there is a constraint on the supply of IT and software human capital in the US (and other developed economies) and that these human resource constraints are limiting the invention possibilities, even in the domains where innovative activity and technological opportunity seem to be at the highest levels. Global flows of investment, people, and ideas can help relax these constraints to some extent, through open immigration policies and liberal trade and foreign direct investment policies. When successful, these flows will not only benefit innovating multinationals but could also raise growth, productivity, and consumption possibilities around the world. The inevitable result is that while a US-UK FTA may be of political importance, changes in investment and spending in the real economy will divert private sector attention elsewhere.

23 Policy Brief 19-9, 'The Rise of Global Innovation by US Multinationals Poses Risks and Opportunities' Lee G. Branstetter, Britta Glennon, and J. Bradford Jensen (June 2019) Peterson Institute for International Economics: https://www.piie.com/system/files/documents/pb19-9.pdf

CONCLUSION

We have focused our attention on some of the areas that we consider pertinent to the conclusion of a UK-US trade agreement. Other factors will also have an effect on the likelihood of a transatlantic deal coming to fruition. These include, among others, the terms on which the UK Government leaves the EU, the 2020 US Presidential election result, the role that individual US states may play in any negotiation, and the effect of any future trade hostilities between the US and its other trading partners.

What is clear is that the prospects for a clean and swiftly negotiated deal being reached are as challenging as they were 12 months ago. While we remain of the view that a US-UK bilateral trade deal is conceivable, it is unlikely to be deep or meaningful. The backstop and the need for deft navigation of two regulatory regimes, parliamentary discord, the US's position on negotiations and services, as well as the decline in US MNC foreign affiliate spending in the UK particularly in key information technology areas present formidable obstacles. The result is that hard technical realities are likely to get in the way of the art of political possibility on both sides of the Atlantic.

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FURTHER INFORMATION

The authors are members of faculty at the universities of Georgetown and Sussex. This briefing paper is the second output of a collaborative venture exploring the future of US-UK trade. We are grateful for the on-going commitment and of our respective institutions to this project.

The UK Trade Policy Observatory (UKTPO), a partnership between the University of Sussex and Chatham House, is an independent expert group that:

1) initiates, comments on and analyses trade policy proposals for the UK; and

2) trains British policy makers, negotiators and other interested parties through tailored training packages.

The UKTPO is committed to engaging with a wide variety of stakeholders to ensure that the UK's international trading environment is reconstructed in a manner that benefits all in Britain and is fair to Britain, the EU and the world. The Observatory offers a wide range of expertise and services to help support government departments, international organisations and businesses to strategise and develop new trade policies in the post-Brexit era.

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