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We must leave the customs union, the worst aspect of EU membership

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A time traveller from 2016 would be bemused by the current economic debate around Brexit.

Think back to the referendum. The Treasury published its controversial report laying out the “long-term economic impacts” of leaving. It saw three feasible scenarios: remaining in the single market (like Norway); a bilateral free-trade agreement (FTA, like Canada); or trading on World Trade Organisation terms. Economists for Brexit argued that the UK should unilaterally slash tariffs upon EU exit; Vote Leave talked up striking free-trade deals with non-EU countries. The single market was a major point of debate. But nobody (Leave or Remain) thought a customs union with the EU was a politically viable or economically desirable post-Brexit relationship.

Yet a customs union once again rekindled Theresa May’s deal this week. The Prime Minister’s deal lost by 149 votes. With the support of the 75 Conservative rebels, it would have passed. The reason most rebels voted against it was the inability of the UK to unilaterally exit the Irish backstop arrangement, which of course includes a “temporary” customs union.

Yes, it was unacceptable to risk a sovereign country being locked into an economic arrangement against its wishes. But many Brexiteers feared as much what the backstop could lead to – the EU insisting that only a full, permanent customs union could replace it. Brexiteers foresaw Britain being pressured into remaining within the EU’s common external tariff and common commercial policy forever. This would have undone a manifesto promise and chopped away a key economic benefit of leaving.

A customs union comes with a basic economic trade-off. It allows tariff-free and relatively frictionless trade in goods between member countries. One does not need complex administrative or “rules of origin” checks to ascertain the national source of products, as with FTAs. But the price for these benefits is high: giving up an independent trade policy, including the ability to sign FTAs and set rates for the 12,500-plus goods tariffs the EU currently imposes.

It would be churlish not to admit then that leaving a customs union brings costs. Upfront investments would be needed in technology and customs facilities. If an FTA were not agreed, UK exports would face significant EU tariffs in sectors such as cars, chemicals, beverages, tobacco and clothing and food. There would be ongoing frictional costs too, not least due to customs declarations, permissions to move goods and (if we obtain an FTA) rules of origin checks. For many manufacturers, this would be time consuming, costly and disruptive. Some would choose to locate parts of operations elsewhere.

Yet the overall macroeconomic impact of all this would be small. Even the Treasury's grossly pessimistic model (where the Norway option proxies reasonably for the effects of leaving the customs union alone) estimates GDP would be lower by just 3.8pc after 15 years. That though seems highly exaggerated compared with other assessments.

Switzerland is outside of the customs union. Its experts estimate the border friction cost with the EU at about 0.1pc of the value of goods traded. That would imply commensurate from a British customs union exit of around 0.01pc of GDP. Even if these were higher given a more distant relationship from the single market than the Swiss, this is an order of magnitude smaller than the Treasury work. Claims that a customs union is essential to cross-border supply chains also runs afoul of evidence from the North American car market. Nafta is emphatically not a customs union, as President Trump persistently shows.

Then there's the upsides of exiting the customs union. A German think tank, the IFO Institute, recently showed the potentially positive impact of tariff cuts. They calculate a hard, no-deal exit from the EU would reduce UK GDP by 2.8pc. But a Brexit where we unilaterally slashed tariffs would reduce that loss to just 0.5pc of GDP. Pharmaceuticals and machinery manufacturing industries, according to their analysis, would boom. The ability to set tariffs on the rest of the world even after an FTA could offset or even swamp any GDP impact of any customs union friction.

Then there's the opportunity for new free-trade deals. An independent trade policy allows us to cut deals with fast growing economies without balancing the interests of 27 other EU member states. In time, we could explore a deeper trade deal with Canada, new agreements with Australia and New Zealand, and less ambitious but liberalising deals with the US and China. An EU assessment from 2012 estimated FTAs with a range of big countries would increase EU GDP by 2pc if one includes direct and indirect impacts. The effects on Britain would be similar.

Clearly then, the economic case for the UK leaving the customs union is strong. So why is Theresa May willing to risk being locked in? And why is Jeremy Corbyn advocating permanent membership?

One factor is the lobbying of incumbent firms. They have built their business models around current arrangements and clearly do OK. The Confederation of British Industry and Institute of Directors have advocated forms of customs unions since 2016, and bear some responsibility for the current mess.

For the EU and Remain, there's also a desire to limit the opportunities of post-Brexit Britain. Binding the UK closer and preventing an independent trade policy means less chance of post-exit success and fewer barriers to rejoining.

The result of all this is the current baffling wrangle. The precise form of Brexit has always been debatable. Some wanted to exit the EU's political institutions but remain tied economically into the single market. Others wanted a more distant relationship with greater autonomy over regulation. Somehow, we remain stuck debating whether to remain part of the worst aspect of membership.

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