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UK Trade Agreements after Brexit: How To Address Tariffs and Regulatory Trade Barriers

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International economic integration often takes place in tiny increments, but every now and then there is a big jolt that forces everyone to reconsider the foundational principles of the system. Brexit is such an event. If Brexit goes forward, the UK will have to rethink the carefully constructed balance of the economic relationships it currently has with the EU and with the rest of the world. Brexit will force the UK to consider exactly how much economic integration it wants with each, in two main areas: Tariffs on trade in goods, and regulatory barriers that affect both goods and services trade. Tariffs are mostly about economics, and in this case they involve the classic debate over customs unions versus free trade areas, and how deeper integration with a small group of countries compares to shallower integration with a large group. Regulatory trade barriers, in contrast, are more complex and contentious, as they have important political implications and involve the delicate balance between economic efficiency and sovereignty / regulatory autonomy.

Starting with tariffs, the UK is currently part of a customs union with the EU, meaning that all *internal* tariffs between the UK and the EU have been eliminated. In addition, there is a common *external* tariff to be applied to non-EU trading partners. This common tariff takes away any UK discretion to set its own tariff rates on its external trade. Beyond the tariffs themselves, a customs union also eliminates burdensome customs procedures between the members, with the importing process vastly simplified. Imports from outside the customs union, by contrast, face burdensome procedures that look into the nature of the product, its value, and its origin, among other things, upon importation.

With Brexit, the UK will be faced with two related questions on tariffs. First, what kind of tariff relationship should it have with the EU? The answer to this first question has an impact on the second question, which is, what kind of tariff relationship should the UK have with the rest of the world?

As to the relationship with the EU, the debate is over whether to maintain a customs union, and, if not, what tariffs to adopt as part of an FTA. A customs union is the most liberalizing option for trade within the EU, but, as noted, it limits the UK's options for trade arrangements with the rest

of the world. If a free trade area with the EU is chosen instead of a customs union, the UK can then negotiate with the rest of the world on its own. At that point, it can decide what external trade arrangements it would like. Should it focus on multilateral trade liberalization at the WTO? Should it participate in “mega-regional” trade agreements such as the TPP or TTIP? Or should it pursue bilateral FTAs, and, if so, with which countries?

Most economists agree that tariffs should be as close to zero as possible. Tariffs are bad economics, leading to inefficient production patterns and imposing costs on consumers. And they are bad international relations, as discrimination against foreigners can lead to escalating tensions.

The UK’s situation is difficult, as there is a tradeoff between tariff policy towards the EU and tariff policy towards the rest of the world. While there are benefits to being part of the EU customs union, in terms of reduced customs procedures and the avoidance of complicated “rules of origin,” being part of a customs union would, unfortunately, constrain the ability of the UK to lower tariffs on its trade with non-EU countries.

Therefore, what makes the most sense is a zero tariff arrangement with the EU, but through a free trade area rather than a customs union; and then a series of FTAs with the rest of the world, which could be bilateral, regional or multilateral (although in the current environment of trade negotiations, bilateral trade deals might be the most promising). In this way, the UK can maximize its tariff-free trade.

Regulatory issues are much more complicated. They affect both goods and services, and generate a great deal of criticism and skepticism from groups — on both the left and the right — who worry about sovereignty or regulatory autonomy.

The EU’s “single market” is generally considered to be a form of deep integration that eliminates many of the impediments to internal trade caused by the regulations of EU member states. But single markets, including even domestic ones such as the United States or Canada, tend to be partial rather than full, with various exceptions thrown in. The EU single market has gone quite far with its integration, but there are still limits. (And it is important to note that integration related to regulatory trade barriers also exists at the WTO and in bilateral and regional trade agreements.)

The UK benefits greatly from being part of the EU single market. As things stand now, EU rules on non-discrimination and mutual recognition, as well as supra-national EU regulations, allow most UK producers of goods and services to sell directly to EU customers without having to navigate through additional domestic government regulations. The rules are broad and have a strong enforcement mechanism. Generally speaking, if UK companies comply with domestic regulations, they may sell in the rest of the EU (as noted, with a few exceptions).

But while there is clear value here, there is also controversy. It is in the area of regulation that sovereignty and autonomy concerns arise. While the motives for the Brexit vote vary, and immigration and financial contributions to the EU probably played a bigger role, clearly one factor has been the idea that the UK has lost some amount of control over its domestic policy-making as a result of EU rules that affect domestic regulation. Thus, the value of the single market needs to be considered carefully, and compared to alternatives.

In this regard, in terms of their substance, EU rules that require regulations to be non-discriminatory are fairly similar to those of the WTO. On the other hand, the EU goes much further with principles such as mutual recognition and harmonization, and covers more areas of services regulation than does the WTO. And EU rules are easier to enforce.

Clearly, there will be something lost by leaving the EU. However, as noted, international rules on regulatory trade barriers do exist at the WTO, and could be supplemented with an FTA. Thus, where particular regulations are an important issue, such as financial services and “passporting,” the UK can negotiate rules through an FTA.

The degree of lost economic benefits due to the shift from deep EU integration to shallower WTO/FTA integration is difficult to measure, but could be substantial. The problem, however, is that with regulatory trade barriers, politics is as important as economics. The economic benefits of integration need to be balanced with the feelings of lost sovereignty and autonomy that come with constraints on domestic regulation. It may be more efficient, for example, to have one EU-wide rule on tobacco regulation. But in doing so, deep integration imposes greater constraints on domestic policy-making, and some people feel like choices have been taken away from them. You can call this a sovereignty or an autonomy or a democracy consideration. Whatever it is, it is almost certainly a motivating factor in resentments against international institutions. For this reason, the UK should consider not being part of the EU single market as it relates to the regulation of goods and services, and rely instead on the alternative that already exists in the WTO, and which could be developed further in a negotiated FTA with the EU. In general terms, this alternative would focus on less intrusive non-discrimination and mutual recognition rules, and avoid more sensitive harmonization efforts. There will still be an impact on domestic regulation, but in a more limited way.

The fundamental question here is one of balance between economic efficiency and sovereignty / autonomy. The benefits of local control over policy may be hard to measure, and to incorporate into economic models, but they can be seen in people’s expressions of discontent over international institutions. For the UK voters at the present time, the WTO and FTAs may offer a more appropriate and acceptable balance than does the EU (or the EEA).

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