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Challenges of Negotiating a Free Trade Agreement between the UK and the EU

Now it is official: at the end of January, the United Kingdom left the European Union – and not in the hard Brexit some observers had feared but an orderly departure. That notwithstanding, Europe is already facing its next challenge. The exit agreement stipulates that the UK will remain a member of the customs union and the common market until the end of 2020. By that time, the EU and the UK must have concluded a free trade agreement. If not, customs duties and other trade restrictions would enter into force. However, reaching such an agreement takes time.

While the UK conducts about half of its foreign trade with the EU, the EU conducts only 9 percent of its foreign trade with the UK. Nevertheless, trade barriers are damaging to both sides. According to estimates by the ifo Institute, a free trade agreement would permanently increase the UK's gross domestic product by more than 1 percent. For the EU, the gain would be around 0.2 percent. These calculations are conservative estimates because they do not account for the impact that the agreement would have on the intensity of competition and on innovation. So there is a lot at stake.

Sticking Points Concerning Trade

The joint political declaration that the UK and the EU signed alongside the withdrawal agreement provides a broad outline of the economic relationship they aspire to have in the future. Both sides want a comprehensive free trade agreement. There are to be no tariffs or quantitative restrictions on goods; specific agreements will be sought for key sectors such as the financial or energy production industries. The UK and the EU wish to collaborate closely on administrative processes, such as VAT compensation in cross-border trade. The detrimental effects of border controls should be kept to a minimum.

However, the UK has explicitly ruled out a customs union with common tariffs for third countries; it wants to pursue its own trade policy. This decision is regrettable, as a customs union would greatly facilitate trade. Above all, it would be unnecessary to request proof of origin for products exported from the EU to the UK; for example, to confirm that they were manufactured in the EU and not imported from third countries via the EU.

The Issue of Fair Competition

One item in the political declaration of intent that could prove to be a stumbling block is the demand for a level playing field. The idea behind it is to prevent one side from gaining unjustified advantages through subsidies, tax breaks, or regulations. EU chief negotiator Michel Barnier speaks openly about the risk of “regulatory, fiscal, or social dumping.” The underlying fear is that the UK could engage

in “unfair” competition through lax requirements or very low taxes. It is difficult to pin down, though, to what extent different taxes and regulations are acceptable and where unfair dumping begins. For its part, the UK fears that excessive EU social standards could destroy its economic momentum. It is for this reason that the country has opted out of the Maastricht Treaty's provisions on social policy in previous years. Now, EU negotiators could try to impose such provisions on the UK as part of the trade talks.

Tax Policy Fraught with Conflict

Tax policy is similarly a minefield of disagreement. The UK may want to offer tax incentives that will encourage multinational companies to relocate there post-Brexit. However, the EU Commission is increasingly employing state aid control to crack down on member states' use of tax policy strategies targeting particular firms or sectors. The proceedings against Ireland over state aid for Apple are a recent case in point.

One of the UK's key motivations for Brexit was and still is that it wants to break away from EU rules in tax and regulatory policy that are perceived as restrictive. The UK is therefore unlikely to accept a free trade agreement that allows these constraints to return through the back door. Protectionist forces on both sides could try to torpedo the free trade agreement at this level.

New Green Deal = New Challenge

Climate policy poses a further challenge to the free trade agreement. Under its new “Green Deal,” the EU is likely to introduce a wide range of new regulations, including a carbon border adjustment mechanism, which would render EU imports subject to a duty calculated based on CO₂ consumption in the manufacturing of the goods. This would also have to be governed by a free trade agreement.

All the points above suggest that it will be difficult to reach an agreement within eleven months. Consequently, if it will take one or two more years to work out a free trade agreement, the UK government should abandon its plan to end the transition period at the end of 2020. The EU's chief negotiator Barnier has repeatedly labeled Brexit as a “school of patience.”

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