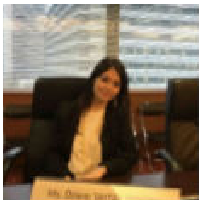
Keeping zero tariffs is good economics, but the EU's political interest matters too



Tariffs are a key element in any trade deal negotiated between the EU and the UK. ***Ozlem Taytas Ozturk (LSE)*** *explains why and writes that while a zero tariff arrangement is in the economic interests of all the business sectors involved, the final deal may be swayed by politics. The EU may impose some tariffs in order to discourage non-EU countries from seeking a better deal with the bloc, and discourage restless members from leaving.*

Because the UK is currently a member of the EU's Single Market and customs union, there are no tariffs applied in its bilateral trade with the EU. This has enabled both parties to develop supply chains and fragment their production processes across the Single Market for more than 40 years. The UK also applies the Common External Tariff (CET) on imports coming from other countries outside the Single Market.

As the second phase of Brexit approaches, the UK and the EU will negotiate a prospective trade deal which is expected to enter into force after the transition period ends in December 2020. What will happen to tariffs in the context of this deal? Which option seems most favourable for both parties?

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The negotiations will have to address tariffs. The sectors most affected by the UK's exit from the EU are motor vehicles, chemicals, pharmaceuticals, machinery, electronics, food and drinks, because these are the most important sectors in EU-UK trade. All of these sectors in the UK and the EU would like to maintain their current tariff-free access to the other's market.

Tariffs are important because of the complex value chains between the EU and the UK. This means multiple imports and exports of goods between these two parties throughout the production process. Tariffs on intermediate goods would therefore have a cumulative effect on final costs, to the disadvantage of producers and consumers. Failing any agreement between the EU and UK the default would be WTO tariffs. While the average WTO-bound tariffs are very low for the EU, they can be significantly higher for some products (WTO 2017). Therefore, it is important to make sure that they do not create an additional burden.

It is easier to measure the total costs of imposing tariffs on the bilateral trade between the EU and the UK compared to other regulatory measures. Given that both parties are developed economies and have low levels of Most Favoured Nation (MFN) tariffs in general (WTO 2017), other trade costs associated with non-tariff barriers and customs procedures are likely to create more hurdles in the forthcoming negotiations. However, this does not mean that tariffs do not have any significant impact. On the contrary, they may be an important bargaining tool, especially to get concessions in other areas.

The continuation of zero tariffs seems to be the best scenario for both parties – whether as an EEA member, in a customs union or a comprehensive free trade agreement (FTA) such as a CETA+ deal. Each of these models poses a number of difficulties for at least one of the parties. Nevertheless, taking into account the stated positions of both sides, the most probable option would be an FTA with zero-tariffs for all sectors.

Reverting to WTO rules and MFN rates is the worst-case scenario and the least efficient in welfare terms. Obviously, given that the starting point of these negotiations is no tariffs at all, introducing MFN rates to the bilateral trade would be a serious setback. Furthermore, under WTO rules the UK will lose its competitive advantage in the EU vis-à-vis the other 67 FTA partners of the EU. This poses a significant threat, and is a major reason for the UK to avoid this option.

It is clear that from the economic point of view, continuing the status quo is the best option for tariffs, but political aspects are also important. First, the EU may want to discourage its remaining 27 members from toying with the idea to leave the EU in the future. Thus, the EU may decide to impose some tariffs, even though it is not meaningful or desirable for both parties in economic terms.

Second, as mentioned before, the EU may want to use tariffs as a bargaining chip for the rest of the agreement. In this context, in exchange for allowing zero tariffs, the EU may limit the market access in trade in services or introduce some restrictive measures for customs procedures or other non-tariff barriers in their bilateral trade with the UK. The UK may also regard this as an effective negotiation strategy. The scope and content of FTAs are shaped by precedent. The EU will therefore be aware that offering more to the UK is also likely to be followed for demands from its other trading partners for equivalent access.

Finally, the EU may have difficulty satisfying the sometimes conflicting demands of individual member states. While member states with a close trading relationship with the UK would like to be close to the status quo, others may favour more EU tariffs on UK exports.

Overall, a bespoke deal like CETA + seems to be the most likely outcome of the negotiations. Although both sides are probably willing to accept zero or near-zero tariffs, the final outcome depends on other issues too.

This post represents the views of the author and not those of the Brexit blog, nor the LSE. A fuller analysis is available here.

Ozlem Taytas Ozturk is a master's student in international political economy at LSE.

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