Treasury and International Trade Committees

House of Commons, Committee Office, London SW1A 0AA

Email treascom@parliament.uk; tradecom@parliament.uk

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Dear Colleague,

The remaining stages of the Trade Bill and the Customs (Cross-Border Taxation) Bill will provide an opportunity for the House to consider the UK's future relationship with the EU, and the options for its external trade policy, at a critical juncture in the Brexit process.

In April, our Committees took oral and written evidence on the economic impact of different trade policy choices. We investigated in particular how far the gains from greater trade openness with non-EU countries – through free trade agreements and unilateral trade liberalisation – might offset the consequences of leaving the EU; and hence how far the UK may wish to seek a relationship with the EU that may limit its trade policy choices, in order to minimise those consequences.

Our Committees have not yet taken a collective view on this evidence, so to assist the House in its scrutiny of this week's important legislation, this letter summarises what we, as Committee Chairs, consider to be the key themes.

1. Free trade agreements between the UK and non-EU countries, including the United States, will be economically beneficial; but even a wide-ranging set of deals is unlikely to offset losses arising from leaving the single market and customs union in the short- to medium-term.

EU Member States, together with the 65 countries with which the EU has signed free trade agreements, collectively account for 64% of the UK's trade. Further agreements negotiated by the UK with countries beyond this group could therefore cover up to 36% of its current trade.

Trade deals that the UK might reach with this group of countries would be less deep and comprehensive than the single market, particularly in respect of services trade, in which the UK has a competitive advantage. These countries are also more geographically distant and less economically developed, on average, than the EU; and the evidence that distance and prosperity affects international trade flows is compelling. As a matter of logic, it is therefore implausible that the economic benefits of free trade deals with non-EU countries could exceed the costs arising from leaving the single market and customs union in the short- to medium-term.

This point is borne out by the evidence on the impact of a UK-US free trade agreement, which alone would account for nearly half of the trade that could be covered by post-Brexit deals. Analysis commissioned by the previous government estimates that the proposed EU-US Transatlantic Trade and Investment Partnership would raise UK GDP by 0.14-0.35%. Meanwhile, trade with the EU will become more restricted than it is now. More conservative estimates of the economic cost of leaving the EU in a way that returns full control over trade policy fall within the range of 2-3% GDP.

2. Just as with estimates of the economic impact of Brexit, estimates of the impact of free trade agreements and unilateral trade liberalisation are highly sensitive to the assumptions underpinning them. Extreme or incoherent assumptions lead to extreme or incoherent results.

The validity of analyses that purport to measure the economic impact of Brexit and future trade policy choices should be judged on the coherence of their underlying assumptions, and how closely they approximate reality. Economists for Free Trade (EFT), which have produced the only major set of studies to find positive effects from leaving the EU on WTO terms and pursuing "unilateral free trade" use the same form of model as many other studies, (including that used by the Government in its April 2018 "Cross-Whitehall Briefing"). But their assumptions are very different. Among other things, they assume:

- that there will be no border checks, or any additional non-tariff barriers, between the UK and EU, after Brexit on "WTO terms".

- that EU non-tariff barriers raise the cost of imports to the UK by 16%, and these would be substantially or entirely eliminated after Brexit

The two assumptions are mutually inconsistent. In measuring the *benefits* of hard Brexit, EFT assume that the cost of imports will fall because the UK will abolish non-tariff barriers erected by the EU. But in measuring the *costs*, EFT assume that UK firms will not face any such barriers when they export to the EU.

3. Unilateral trade liberalisation affects the ability to strike free trade deals, and may interfere with other legitimate public policy objectives

Outside a customs union with the EU, the UK could unilaterally cut tariffs below those applied by the EU. The theoretical economic case for such unilateral trade liberalisation is strong. However, tariff liberalisation will limit the UK's leverage in negotiations over free trade agreements, and does nothing to improve opportunities for UK exporters.

Equally, outside a regulatory union with the EU, the UK could unilaterally reduce non-tariff barriers, by taking a permissive approach to the standards it applies to imported goods and services. This would have consequences for consumer protection and safety. It would also put domestic firms at a competitive disadvantage, unless the UK were to allow domestic goods to be produced, and services provided, to whatever standard the suppliers chose. In short, a programme to reduce non-tariff barriers to trade will inevitably conflict with other public policy objectives. These conflicts are often seen when general discussion over regulatory barriers to trade moves to the specifics of which EU regulations would be altered or discarded.

4. While free trade improves welfare in aggregate, it creates winners and losers. The adjustment process must be managed carefully. Public consensus for unilateral free trade may be particularly difficult to secure.

The distributional effects of different trade policy choices on the UK – between sectors, regions and income groups – are poorly understood, and there is a need for further research. However, the rising tide of anti-globalisation sentiment shows that many feel they have not benefitted from trade liberalisation, and that adjustments need to be managed carefully.

The economic adjustment to unilateral liberalisation would be particularly marked. Jobs lost in formerly protected sectors would not be rescued by better market access to formerly protected sectors in other countries. Adjustment would take place through changes in the exchange rate, and through movement of labour and investment out of some sectors of the economy and into others. The direction of this movement is likely to be from tradeable sectors, such as manufacturing, to less tradeable sectors, such as services.

We hope that the above provides useful background for colleagues contributing to this week's debates.

Yours sincerely,

Rt Hon. Nicky Morgan MP
Chair, Treasury Committee

Angus MacNeil MP
Chair, International Trade Committee