



# What sort of trade deal should the UK negotiate with the EU?

Free trade arguments are examined in depth, and Patrick Minford considers the costs and gains should there be no agreement

**N**orway, Switzerland, Canada, Japan? The formulae are rolled out daily in this debate! In fact as David Davis as well as other ministers have said many times, the UK is unique and should negotiate its own deal.

What should this be? First let us put it in the context of the gains the UK gets from leaving the EU's Customs Union and Single Market, which the referendum result endorsed. The EU's protectionism of food and manufactures raises prices for all those products by an average of 20% over the best available prices in the developed world. Getting rid of this protection via Free Trade Agreements gives us a big gain from the resulting free trade: on our calculations, consumer prices would fall 8% and GDP be 4% larger<sup>1</sup>.

The EU's Single Market entails EU regulation across the whole of our economic life, even though only 12% of our GDP is involved in selling to the EU. By leaving the Single Market we can in time recalibrate that regulation to suit the UK economy, with gains we estimate at around 2% of GDP<sup>2</sup>. The 12% who sell to the EU simply need to meet EU product standards, nothing else.

We can also control immigration, especially of the unskilled where the EU Single Market forces us to give a 20% wage subsidy to EU immigrants, especially at the expense of poorer households whose living standards on our calculations rise 15% from Brexit.

Any trade deal we do with the EU needs to leave these economic gains from a 'clean' Brexit intact, while politically too honouring the referendum result. In the next section I go into the much-contested free trade arguments in more detail.

The simplest EU trade deal that achieves this is a simple zero reciprocal tariff agreement on goods. Since our product standards are already aligned, there can be no 'non-tariff barriers' either way. On this basis we would have 'Full

Access' to the Single Market. This and our other free trade agreements would give us effectively global free trade, without compromising our power to regulate our own economy and control our own borders.

Some City pressure groups are also demanding convergence of financial regulation. However, all that is needed is adherence to the WTO rules of non-discrimination under which we and the EU give each other's financial industries the same access to our financial markets as we give to other countries: mostly this takes the form of 'equivalence', effectively mutual recognition of regulative financial standards. This also makes sense since these standards are in-

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ternationally agreed within the BIS and other finance industry forums. In fact strictly it does not even need to be in the deal since it just follows WTO law.

An EU trade deal of this simple form - zero tariffs on goods, and non-discriminatory treatment in services - preserves the gains of a clean Brexit. It does not disrupt trade with the EU. It should be easily ratified: it does not require unanimous agreement by all EU countries and regions.

By contrast the idea being put around by some that we should 'shadow' EU regulation and Customs barriers in a 'soft Brexit' is incomprehensible. It loses us our Brexit gains; and for what? 'Access' to the Single Market that we would have anyway; and a compulsion to have industrial protection designed for the benefit mainly of continental industries, at the expense of both our and their consumers. Brexit can deliver us from such nonsense; and to that I say Amen.

### **Why free trade brings key gains to the UK economy - in spite of the latest Civil Service leaked scaremongering**

The Civil Service reportedly has redone the Treasury's Brexit long term forecasts with a new approach, so say numerous leaks via *Buzzfeed* and elsewhere. 'Officials believe the methodology for the new assessment is better than that used for similar analyses before the referendum', reports *Buzzfeed*. This new approach has, it seems, dumped the old Treasury calculations and methodology published in the original Treasury Project Fear report during the referendum<sup>3</sup>. Plainly, the criticisms of this old approach - persistently so from us- have hit home; if so, that is real progress.

Under its old approach, the Treasury used something they called the 'gravity approach'. This approach consisted of three sets of correlations over time and across countries and/or industries: between trade and membership of different trade blocs; between trade and Foreign Direct Investment; and between FDI and productivity. The final productivity effects were then fed into a standard macro model of the UK economy.

As the Treasury or Civil Service seems now to have conceded, this procedure makes no sense because all these relationships are 'correlations' - correlations do not reveal causation. We have a correlation between unemployment and crime; but it would be dangerous to use it to predict unemployment from data on crime. This is because both these data series are impacted by a complex causal system involving a lot of other factors.

So now the Civil Service seems to have adopted a full world causal trade model. It appears this is the GTAP model; this (Global Trade Analysis Project) model is produced by the GTAP centre at Purdue University in Indiana, USA. This model is the world leader in such analysis, having been continuously developed since 1993 by universities, governments and international bodies; so it is the blindingly obvious choice. Fortunately for us who want to know more about its Brexit implications, it was used by Open Europe in 2015, in a version with 57 sectors and 28 country groupings, containing all countries. It is likely the Civil Service is familiar with this model.

Fortunately, the group of economists working for Open Europe published a paper on their workings<sup>4</sup>. Ciuriak and Xiao do a scenario where the UK has unilateral free trade with the non-EU world, eliminating the 4% tariffs the EU currently imposes. There is a calculated gain to the UK of 0.8% of GDP. However, as explained above the true protection including non-tariff barriers is around 20%. Abolishing this would therefore give a gain of 4% of GDP. We can think of this scenario as close to what general Free Trade Agreements around the world would deliver as intended by current government policy.

They also do a 'Brefta' scenario which is essentially Canada-plus. Here they assume big costs at the UK-ROW 'border' - rules of origin and customs checks. The cost of these to the UK comes out at 1% of GDP. We query this assumption of border costs: how do they arise when the WTO's Trade Facilitation Agreement mandates that borders must be virtual (the median of 18 rich countries in 2016 only physically inspected 2% of its imports and cleared these in one

day)<sup>5</sup>. Such costs seem to assume that either the UK or the EU would act illegally at the border, which is of course absurd. On our assessment these border costs are nil.

So what this study finds - under its benchmark policy assumptions - is a loss of 0.2% of GDP. With reasonable policy benchmark assumptions this would become +4% of GDP. This coincides with the finding above (Minford, 2017, op. cit.) of +4% of GDP on policy benchmark assumptions where it is cautiously assumed that EU protection was on a downward trend to 10%, the number fed into that scenario.

We trust this estimate most because we have tested the Cardiff World Trade Model used for this, against the facts of UK trade over the last four decades and it passes the tough statistical test involved, whereas of course GTAP is too large to test in any serious way and certainly no test has been done on the UK aspects of it<sup>6</sup>.

So in sum what we have found is that the Civil Service seems now to be using a world trade CGE model which is a defensible and improved methodology; but it has (a) not been tuned to fit UK trade facts and (b) it has used absurdly pessimistic Brexit policy assumptions to 'cook' its anti-Brexit results. According to our trade model, which fits the UK facts and assumes the government's announced policy assumptions, there would be a gain from Brexit of +4%.

According to GTAP and Ciuriak and Xiao's policy assumptions, Brexit costs -0.2% of UK GDP. But put in the right policy assumptions to GTAP and you get +2%. Now put in the policy assumptions of the Civil Service and it is reported we get -5%! Since we only export 12% of our GDP to the EU, one is expected to believe that we will lose the value of almost half of our EU exports. This is pretty silly.

### **Why there will be a simple Canada+ trade deal with the EU**

What about the long-term effects of no deal? Here it is important to use a proper trade model. As noted in Minford

and Xu (op.cit.) the Cardiff World Trade Model is the good guide to the facts of UK trade and so we use it in what follows.

Under no deal, but one where the UK pursues its planned policy outside the Single Market and Customs Union, of creating free trade by signing agreements with the non-EU world, the key effect is to lower UK prices of food and manufactures and create competition inside the UK economy with these new prices. Plainly with an EU free trade deal with no reciprocal tariffs and other trade barriers, EU goods would also arrive free of any duty or other hindrance in the UK and would also compete with these world prices; we can assume that in order to preserve their sales their prices would fall in line. This would occur under the high competition assumed in the model as otherwise they would lose all their sales.

For UK producers selling in the EU home competition would force their EU prices to equality with world prices: were one UK producer to get more others would divert output to their market, driving prices into line.

Suppose instead there was no deal and this consisted of existing tariffs being levied mutually by both sides (this in fact is the most likely scenario since non-tariff barriers would be discriminatory, given that the UK and the EU would both continue to apply current product standards). Then the same logic would apply for pricing by EU producers selling in the UK: they would have to match the new competition, so that their UK prices would remain the same as with a deal.

Similarly for UK producers selling into the EU; home competition would force them to match home competition with their EU prices. So EU producers would now have to absorb the UK tariff; and EU consumers would have to pay the EU tariff on top of the invariant UK price. Hence the tariffs on both sides would be paid by the EU, the UK tariffs by EU producers to the UK Treasury, the EU tariffs by EU consumers; of course the EU would receive the tariff reve-

nue from its own consumers, making its overall loss equal to the UK tariff revenue as well as some loss of consumer surplus- estimated at approximately £13 billion<sup>7</sup>.

On top of this with no deal the UK financial settlement and the transition period would not occur. The EU would be short of some £28 billion over the rest of its budgetary septennial to 2020; it would also lose the longer-term contribution to net liabilities, reported to be worth another £10 billion or so. Also because its customs union with the UK would stop immediately, it would lose two years' worth of the terms of trade gain its producers make on its balance of trade surplus with the UK - estimated at around £18 billion a year: so two years' worth of that would be another £36 billion one-off loss.

From the UK viewpoint paying no financial settlement would be a gain, avoiding the need to pay some £38 billion. Also with no transition period free trade, own-regulation and own-border-control would come two years earlier, bringing forward that long term gain - at roughly 6% of GDP excluding the budgetary transfer, that would amount to some 12% of GDP; assuming that it would otherwise arrive in 2030, bringing it forward to 2028, when discounted at 3% a year, means it would be worth around an extra one-off gain of 9% of GDP, around £180 billion. It would also gain that tariff revenue paid by the EU producers to the UK Treasury, of £13 billion p.a.; which again, discounted, would be worth some £433 billion.

Of course the short run disruption would be unpopular on both sides of the Channel, with industry and consumers affected. However, UK farming and manufacturing industry has already gained massively from the Brexit devaluation and thereby been given substantial short-term compensation for the efforts they must make to raise productivity; those efforts would have to be made rather earlier, but to the benefit of the national interest.

When one adds up all these gains and losses in present value terms, we obtain plus £651 billion for the UK versus minus £507 billion for the EU: it could not be more open and shut who least wants a breakdown. For the UK a break-



down would be a short-term nuisance but a substantial economic gain; for the EU it is both a short-term nuisance and a substantial economic loss.

## Conclusions

Plainly both the UK and the EU will strive to conclude a trade deal and in the process wrap up many other administrative details of cooperation. Failure to reach a deal will be greeted with incredulity and annoyance by citizens of both sides faced with a lot of potential short-run disruption. However, a breakdown remains possible if either side makes intolerable demands. It is for this reason we have made some calculations about the costs and gains of breakdown, besides the short run disruption that would be inevitable to both sides.

These calculations suggest that the EU has a lot to lose from no deal, while on a purely economic calculus the UK would actually gain a fair amount. This suggests that the trade deal, if it occurs, will be concluded on terms close to those the UK will ask for: namely a Canada-plus zero trade barrier on goods, with mutual recognition on services. The UK would remain free after transition to make free trade agreements around the world, to vary its domestic regulation as it sees fit, and to control its borders. ■

**Patrick Minford is Professor of Applied Economics at Cardiff Business School and Chairman of Economists for Free Trade (EFT), a group of leading economists**

## Endnotes

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