BREXIT UNIT

The case for 'MaxFac'

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31st May 2018

Of the three current options for the UK's future customs arrangements with the EU, 'MaxFac' has the best chance of making the most of the opportunities created by Brexit. MaxFac isn't something completely new: it simply means agreeing to keep customs arrangements as streamlined as possible. What's more, the systems and technologies for MaxFac already exist and are being applied elsewhere.

Some critics have focused on the additional costs of customs declarations and 'rules of origin', which HMRC has suggested could be as high as £17-20 billion. A figure of around £5 billion may be more realistic. More importantly, though, supporters of MaxFac are not claiming that it will eliminate trade frictions completely.

Instead, the real question is whether the costs of leaving a customs union would be justified by the benefits, notably the ability to lower barriers to trade with the rest of the world and reduce market distortions at home. There is plenty of evidence that trade liberalisation and regulatory optimisation could deliver huge gains that would dwarf any additional costs to the UK economy.

The options

There are currently three options for the UK's future customs arrangements with the EU after Brexit:

(i) remaining in some form of **customs union**;

(ii) entering a '**new customs partnership**' (NCP), where the UK operates the EU's customs regime in parallel with its own;

(iii) a comprehensive free trade agreement incorporating highly streamlined customs arrangements, sometimes known as 'maximum facilitation', or **MaxFac**.

A customs union?

In short, a customs union eliminates tariffs on trade between member states. In return, all members agree to impose the same tariffs on trade with the rest of the world.

There might be some differences in scope between membership of 'a' customs union with the EU, and 'the' Customs Union. It has been suggested, for example, that a new customs union might only apply to industrial goods, allowing the UK to open up its markets for agricultural products as well as services. However, membership of any form of customs union would restrict the ability of the UK to operate its own independent trade policies.

What's more, the advantages of a customs union are frequently overstated. Tariffs could also be eliminated by a comprehensive free trade agreement. Nor is the free movements of goods across borders simply about tariffs; it is also likely to require extensive regulatory alignment, meaning that remaining in a customs union with the EU could only ever be a partial solution to the Irish border problem.

Key points

- Membership of any form of customs union with the EU would severely restrict the ability of the UK to operate its own independent trade policies.
- Against this, the advantages of remaining in a customs union are frequently overstated. Tariffs could be eliminated instead by a free trade agreement.
- What's more, the free movements of goods across borders is not simply about tariffs; it is also likely to require extensive regulatory alignment, meaning that remaining in a customs union could only ever be a partial solution to the Irish border problem.
- The UK government has therefore proposed two alternatives. One is a 'new customs partnership' (NCP), where the UK would mirror the EU's customs regime. But there is a growing consensus that this option would be impractical.

The New Customs Partnership?

The UK government has therefore proposed two alternatives. One is a 'new customs partnership' (NCP). Here, the UK would apply the EU's customs regime to imports from the rest of the world whose final destination is the EU, but its own rules for imports which will remain in the UK.

There is now widespread agreement that this option is a non-runner. The NCP would require sophisticated tracking technology and/or a burdensome tariff repayment system, both of which would have to be developed from scratch. Even then, the EU would only ever be likely to delegate control of its customs borders if the UK also maintained regulatory alignment, with ECJ oversight and potential fiscal implications too.

MaxFac

It would be more realistic simply to leave the customs union and to focus instead on minimising the additional costs. In practice, this would mean incorporating a customs chapter in a new UK-EU free trade agreement which aims to keep procedures as streamlined as possible.

There are many examples of how this could work, such as Authorised Economic Operator (AEO) schemes and new forms of electronic documentation. Most customs experts agree that there would be no need for additional infrastructure at the Irish border (even those who argue that some extra time might be required for implementation).

HMRC has estimated that the additional costs of customs declarations and 'rules of origin' could be as high as £17-20 billion annually. But there are many reasons to question these figures. In particular:

(i) intra-EU trade still requires invoices and other paperwork, for example to deal with VAT. Systems are therefore already in place;

(ii) HMRC's calculations assume a high cost for additional declarations of £20-55 (averaging £32.50), despite the prospect of further savings from new technology (such as 'smart ledgers');

(iii) this cost is then applied in full to a theoretical maximum of 400 million individual transactions (twice the number of additional declarations that HMRC actually thinks will be necessary);

(iv) this is topped up with an estimated cost for rules of origin of around 4% of the value of the goods, whereas international studies have shown that best practice elsewhere can reduce this cost below 2%.

A more realistic figure might be around £5 billion, which is roughly 3% of the value of UK goods exports to the EU (1% for the additional customs costs, based on the experience of companies such as JML, and another 2% for rules of origin).

More important than the precise numbers, though, supporters of MaxFac do not claim that it will eliminate trade frictions completely. This is a straw man. The real question is whether the benefits of leaving a customs union, notably the ability to lower barriers to trade with the rest of the world and reduce market distortions at home, exceed the costs.

There is already plenty of evidence of the huge gains that can come from trade liberalisation, the reduction of behind-the-border barriers, and regulatory optimisation. What's more, these gains are usually far greater than originally expected (including the cautious assumptions of the like made in the leaked Whitehall analysis of Brexit).

For instance, trade liberalisation is now estimated to have boosted Australian GDP by more than 5% over the period from 1986 to 2016. Econometric simulations in the 2000s suggested that increasing competition in the euro area to US levels would boost output of the euro area by as much as 12.4%.

This sort of analysis requires updating, of course, and needs to take account of the specific circumstances of Brexit. But the IEA already has several projects underway. For example, preliminary work suggests that a 30% reduction in market distortions in the UK, US and Trans-Pacific Partnership countries, from 2019 to 2034, could boost their GDP by 7.25%.

In summary, a full cost-benefit analysis is likely to see MaxFac come out on top, despite some of the recent negative headlines. A short transition period should also be sufficient to sort out any remaining implementation issues.

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- It would be more realistic simply to accept that there will be some new frictions, but to minimise the additional costs – 'MaxFac'.
- There are already many examples of how this works in practice, such as Authorised Economic Operator (AEO) schemes and forms of electronic documentation which can be handled well away from the border itself.
- It has been estimated, rather pessimistically, that the additional costs of customs declarations and 'rules of origin' could be as high as £17-20 billion annually.
- A more realistic figure might be around £5 billion, which is roughly 3% of the value of UK goods exports to the EU.
- But the real question is whether the additional costs can be offset by the benefits of leaving a customs union. Some more work is required on the numbers here. However, past studies, and our own analysis, suggest that the scope for gains is more than sufficient.