

## Customs unions and FTAs Debate with respect to EU neighbours

### SUMMARY

The EU neighbourhood is undergoing deep transformations and this raises debate on how best to establish trade relations with neighbouring partners, like Turkey and the Eastern Partnership countries (such as Ukraine, Moldova and Georgia). Moreover, Brexit will entail the reorganisation of EU-UK relations, which will shake up cross-border trade flows. The EU can negotiate two basic types of trade agreement granting preferential market access to partners' goods: free trade agreements (FTAs) and customs unions (CUs). CUs represent a higher level of integration, as the parties decide to harmonise their external trade barriers with the rest of the world.

As FTAs do not maintain a single external border, they may result in trade deflection, whereby third countries can 'free ride' on FTA concessions by entering via the least restrictive border. For this reason, FTAs need to discriminate between goods originating in an FTA member and goods from third countries, through the introduction of costly preferential rules of origin (PROO). Notwithstanding the cost of PROO, FTAs have been the main type of trade agreements used, while the smaller number of CUs is due to the higher negotiation costs involved. CUs have therefore mainly been considered as a first step towards deeper regional integration. This is why there are ongoing political debates on customs unions in three different contexts: the assessment of the EU-Turkey CU, a CU as a further step in EU-Ukraine trade relations and the issue of the UK's exit from the EU CU as a result of Brexit.

*This briefing may be read in conjunction with one by Krisztina Binder, [Reinvigorating EU-Turkey bilateral trade: Upgrading the customs union](#), EPRS, March 2017.*



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## Introduction

There is ongoing debate on what type of trade agreements should be established with some of the EU's neighbouring trade partners, as well as in the context of Brexit.

Countries can discriminate among trade partners through the conclusion of preferential trade agreements (hereafter referred to as PTA) whereby they grant lower import tariffs (preferential tariff) to selected trade partners. Under [World Trade Organization](#) (WTO) law, developed countries can conclude only two specific types of reciprocal preferential trade agreements: free trade areas (commonly referred to as FTAs) and customs unions (hereafter CU). An FTA substantially liberalises trade within the partners' territories, whereas a CU also harmonises tariffs with respect to the rest of the world, thus creating a single external border. Customs unions therefore represent deeper integration than FTAs. The [European Union](#) currently has only three customs unions: with Turkey, Andorra and San Marino. The Turkish agreement was clearly a step towards possible enlargement of the EU, while Andorra and San Marino are enclaves in the EU internal market. With other trade partners, the EU negotiated [free trade areas](#) instead.

However, discussions have started on whether the EU should opt for deeper integration with Eastern partner countries (in particular Ukraine, but possibly Moldova and Georgia too), including mention of [a customs union](#). The United Kingdom's notification of its intention to leave the EU led to the start of Brexit negotiations. While negotiations are not currently addressing future EU-UK trade relations, the Brexit vote raised immediate debate on the shape of future relations between the EU and the UK, and the consequences of exiting the EU Customs Union. Finally, the [EU-Turkey CU](#) is being reassessed in light of the scope of recent FTAs negotiated by the EU. Indeed, recent FTAs seek liberalisation of trade beyond just goods on which the EU-Turkey CU focuses.

## Customs unions versus free trade areas

### The economics of customs unions and free trade areas

According to J. Viner and the derived literature,<sup>1</sup> the two main effects from granting trade preference are trade creation and trade diversion. **Trade creation** can be defined as the extra-trade flows created between partners due to the internal liberalisation of trade in a PTA. **Trade diversion** by contrast is the redirection of trade flows from a third-country partner (still facing the higher external tariff) to the PTA partner that enjoys preferential treatment. Trade diversion is understood as an economic cost derived from PTA arrangements, as it entails supplies being *diverted* from a more efficient to a less efficient supplier, simply because the import tariff preference lowers the cost of using the PTA supplier. Trade diversion can be increased in a customs union if that increases the external tariffs of one of the CU partners, thus increasing the difference between external tariff and preferential treatment, giving a greater advantage to producers within the CU.<sup>2</sup> A third effect of PTAs is **trade deflection**. Trade deflection is a redirection of trade flows from third countries via the lower external tariff in a PTA. A 'perfect' CU avoids trade deflection by imposing a single external tariff with respect to the rest of the world. An example of the latter is the EU customs union where, once the good is cleared for free circulation by the customs authorities, it can move freely within the internal market. However, the problem of trade deflection can also appear in a CU whenever trade policy the latter is not fully harmonised and CU partners maintain different PTAs with non-CU members. This is a major issue in the EU-Turkey CU.

In an FTA without harmonised external tariffs, trade deflection can be a problem. Preferential rules of origin in FTAs aim to eliminate the risk of trade deflection.<sup>3</sup> By

defining which goods originate within the PTA, preferential rules of origin distinguish between *originating goods*, benefitting from preferential treatment when moving from one PTA partner's territory to another's, and *non-originating goods* which must pay the full import tariff at the border when moving from one PTA partner to another. However, preferential rules of origin can be costly. First, by defining originating goods through the value of domestic content, or a requirement to source inputs or perform processes locally, preferential rules of origin can increase trade diversion by creating an incentive for producers to source inputs locally so as to gain preferential treatment for the export of the final processed good.<sup>4</sup> Preferential rules of origin are often also complex, adding to administrative costs, and could reduce trade creation if complying with the rules is more costly than paying the non-preferential import tariff.<sup>5</sup>

Trade creation often outweighs the costs of trade diversion and trade deflection thus explaining the [constant increase](#) in the conclusion of regional trade agreements.

### **Customs unions, rare birds and often 'imperfect': why**

CU are rarer than FTAs; they represent only 6 % (16) of the 246 regional trade agreements notified to the WTO ([as of 19 October 2017](#)). One reason for the rarity of CUs is the **negotiating cost** to conclude one. It entails, first, **agreeing on a common external tariff**. In several CUs sectors are excluded, and sometimes flexibility allowing for unilateral reduction of certain tariffs is envisaged.<sup>6</sup> For developed countries, the common external tariff in a CU must comply with requirements within Article XXIV GATT (see box below). A second potential issue is the allocation of **customs revenues**, with some CUs centralising collection of duties and setting up a mechanism for redistributing the revenues.<sup>7</sup> Finally, a 'perfect' CU entails a transfer of competence with respect to the conclusion of FTAs with the rest of the world. A **harmonised commercial policy** ensures that the common external border remains intact and avoids trade deflection. However, in most cases commercial policy is not harmonised, and trade deflection can become an issue (see below, on the EU-Turkey CU). Several African CUs, for example, have introduced preferential rules of origin.<sup>8</sup> Most CUs maintain **customs control** not only to avoid trade deflection but also to verify compliance with regulatory standards, which are not necessarily harmonised in the CU nor mutually recognised. CUs are often **political**, a first step towards **stronger regional integration** (internal markets and currency unions).

#### **Article XXIV GATT and regional trade agreements requirements under the WTO**

[Article XXIV GATT](#) sets the requirements for the conclusion of regional trade agreements. In particular, it allows only FTAs or CUs. Indeed, the first requirement is that the regional trade agreement substantially liberalises trade within the parties (often referred to as **internal trade requirement**). Other PTAs, only partly liberalising trade among contracting parties, were not permitted under Article XXIV GATT, and the [Enabling Clause](#) allows such PTAs only in agreements among developing countries.<sup>9</sup> FTAs and CU also have to comply with an **external trade requirement**. The latter specifies that the creation of the FTA cannot be used as a reason for higher duties and other restrictions with respect to non-FTA members. In the case of a CU, Article XXIV specifies that the new common external tariff and other regulation of commerce created with the establishment of the CU cannot on the *whole be higher or more restrictive than the general incidence of the duties and regulations of commerce* applicable before the creation of the CU. This assessment is [far from easy](#). The [Understanding](#) concluded in 1994 on the interpretation of Article XXIV specifies that the assessment must be done on the basis of weighted average tariff rates and customs duties collected. The Understanding also envisages a negotiation process through which a member joining a customs union can raise bound tariffs and offer compensation for such increases. In the [Turkey-Textile](#) case, the WTO Dispute Settlement Body (DSB) affirmed that joining a CU cannot justify the introduction of quantitative restrictions (tariff rate quotas and quotas). Indeed, in this dispute, Turkey had introduced quantitative restrictions in order to align its external tariff on textiles with the EU common external tariff. India successfully challenged the move as a violation of Article XXIV GATT.

## Assessing the functioning of the EU–Turkey CU

In the past 20 years, Turkey and the EU concluded a custom union (CU) and a series of preferential trade agreements, together forming a bilateral preferential trade framework (BPTF). In [May 2015](#), both parties agreed to start preparation of an upgraded BPTF, widening the scope of trade preferences and modernising the CU's functioning.

Besides Andorra and San Marino, Turkey is the [only](#) third country in a custom union with the EU. In 1959, Turkey [applied](#) for associate membership of the European Economic Community (EEC), and signed an Association Agreement in 1963. In 1970, an Additional Protocol relative to the lowering of tariffs and removal of quotas was signed, but limited to industrial goods. The customs union entered into force on 1 January 1996, following Decision 1/95 of the EU-Turkey Association Council.

The CU was conceived as a [prelude](#) to the accession of Turkey to the EU, and crafted to complement the accession process, which started officially in 2005. Some of the difficulties of the CU were meant to be resolved in the accession process, as it was planned as a temporary step.

### The current situation

*Framework.* The CU is [completed](#) by the free trade agreement on coal and steel products (1996) and an agreement on some agricultural and fisheries products ([Council Decision 1/98](#), amended by Decision [2/2006](#)).

*Institutions.* The CU Association Council is the main institution governing trade relations between the EU and Turkey. It acts unanimously on the basis of recommendations made by a CU Joint Committee.

*The state of trade.* Turkey is the EU's fourth [largest](#) export market and fifth largest source of imports, while the EU is number 1 import and export market for Turkey. The EU mainly [exports](#) machinery and chemicals to Turkey, while Turkey [exports](#) mainly machinery and transport equipment to the EU. Over 20 years, the CU has [enabled](#) Turkey to develop its economy, and to export more complex goods to the EU.

A 2014 World Bank [study](#) demonstrated that the CU was beneficial for both partners. Over 20 years, trade between the two partners has increased fourfold, reaching approximately €140 billion, with an EU [surplus](#) of €11.3 billion in 2016. In 2016, a study by BKP for the European Commission showed that the BPTF had a positive impact on EU-Turkey trade, improving trade for those commodities it covers more than trade improved in other sectors. It estimated that EU-Turkey trade was 9.1 % higher, and Turkey-EU trade 6.5 % higher in 2016 than it would have been without the BPTF.

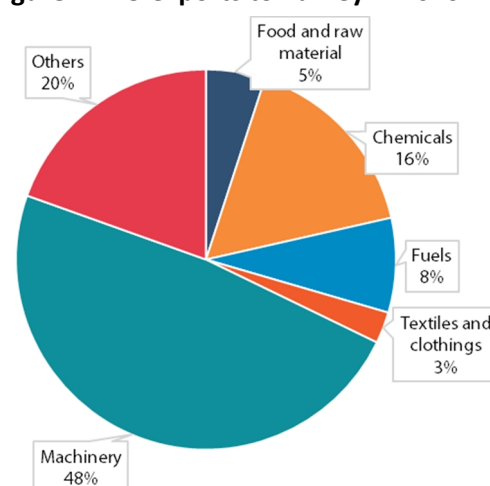
EU investors are also very [active](#) in foreign direct investments in Turkey, with 66 % of FDI in the country for the first six months of 2017.

### Shortcomings and perspectives

#### *Unfulfilled potential*

The BPTF's [exclusion](#) of many agricultural products, services and public procurement leaves unfulfilled potential for EU-Turkey trade. Agricultural products are covered by a

**Figure 2 - EU exports to Turkey in 2016**



Data source: [European Commission](#), 2017.

separate [preferential agreement](#), similar to those concluded by the EU with other FTA partners. In addition, the lack of agreed rules on transparency, some technical barriers to trade (TBTs) and sanitary/phytosanitary standards impede the predictability of the rules to access the market. Moreover, incomplete alignment on standards requires customs controls to verify compliance of goods imported. In a CU, TBTs are the main obstacles to trade. Turkey's accession to the EU was supposed to render the BPTF obsolete and remove most TBTs, but the accession process is now, at best, very slow.

#### *Institutional difficulties*

Notwithstanding the requirement for alignment to the EU common commercial policy, as a non-EU member, Turkey cannot participate in EU negotiations on trade agreements with third countries. For the moment, [Turkey](#) has only signed FTAs with EFTA (European Free Trade Association), Israel, the former Yugoslav Republic of Macedonia, Croatia, Bosnia and Herzegovina, Tunisia, Morocco, the Palestinian Authority, Syria, Egypt, Georgia, Albania, Montenegro, Serbia, Chile, Jordan and Lebanon. For example, South Korea has an FTA with the EU but not with Turkey, creating an imbalanced relationship in which South Korean products can enter Turkey through the EU. Because of the difficulty in concluding FTAs with third countries with which the EU already has an FTA, Turkey has introduced surveillance mechanisms and regulatory restrictions to avoid trade deflection.

#### *Upgrading the BTPF*

In [December](#) 2016, the European Commission requested Council authorisation to launch talks on deepening the BTPF, to widen its scope and modernise the functioning of the CU. The [impact assessment](#) done by the European Commission considered three options: marginal improvement; modernise the CU to cover more goods and add a FTA for services and public procurements, or replace the BTPF with a deep and comprehensive free trade agreement (DCFTA) which would enlarge the BPTF and replace the CU with full liberalisation covering all industrial goods. This third option could have the effect of [introducing rules of origin](#) in bilateral trade as well as sending a negative signal in discontinuing the CU which was conceived as a step to accession. The Turkish leadership insists on a mechanism for joint negotiations with third countries and not to create alternative paths to membership. EU leaders have discussed the prospects of EU-Turkey relations, including the upgrading of the CU, a debate which currently appears to be frozen.

### **Ukraine: A new CU?**

EU-Ukraine bilateral trade relations are governed by a DCFTA (part of a broader Association Agreement, AA) which [came fully into force on 1 September 2017](#) (after provisional application from January 2016), ten years after negotiations started, and following a tortuous ratification process. To drive the relationship forward, a number of political actors, including [Ukrainian President Petro Poroshenko](#), have suggested that Ukraine should start preparations to join a customs union with the EU. The same prospect is also being discussed in the European Parliament with reference to the [‘EaP+’ model](#) covering the other two countries – Georgia and Moldova – with which the EU has a AA/DCFTA.

#### **The DCFTA in action**

Buoyed by the strengthening of the recovery in the EU, the DCFTA between the EU and Ukraine has already contributed to an upward trend in [trade relations](#) between the two partners. It has helped consolidate the EU position as the first trading partner for Ukraine, with €16.5 billion in exports and €13.1 billion in imports in 2016. This amounted to an

overall trade volume increase of 10 %, with both exports (+18 %) and imports (+2 %) recording gains in 2016. The trend continued in the first four months of 2017, with exports from Ukraine to the EU and Ukrainian imports from the EU both up by roughly 25 % compared to the same period in the previous year.

With conditionality clauses, the AA/DCFTA acts as a lever for reforms in Ukraine. Since provisional application, the DCFTA has triggered trade liberalisation over a transitional period of a maximum of 10 years. The DCFTA would bring the EU and Ukrainian economies closer through gradual incorporation of the EU *acquis* into Ukrainian law, and through regulatory cooperation and the elimination of TBTs.

In addition to the trade concessions already available through the AA/DCFTA the European Parliament voted on 4 July in favour of granting [temporary autonomous trade measures](#) for Ukraine after reaching agreement with the Council on a September 2016 Commission draft regulation. This unilateral measure allowed Ukraine to export larger quantities of six agricultural products free of duties as of [1 October](#).

### **Prospects for an EU-Ukraine Customs Union**

#### *Why a Customs Union?*

Proponents of an EU-Ukraine Customs Union, such as former Danish prime minister and NATO Secretary General, [Anders Fogh Rasmussen](#), underline how EU-Ukraine relations need a new pull-factor, especially considering that two magnets for reforms – the AA/DCFTA and visa liberalisation – are now in place. It is argued that the prospect of establishing a CU would provide Ukraine with an additional incentive to implement the DCFTA, it would serve as a stronger lever for reforms through conditionality and would guide Ukraine's long-term economic integration with Europe.

#### *What an EU-Ukraine CU would entail*

Going beyond the DCFTA, an EU-Ukraine CU would not only eliminate all trade barriers and tariffs to trade in goods between the member countries, but also set a common external tariff *vis-à-vis* third countries. The scope and application of the CU would also have to be the subject of negotiations. If Turkey is taken as an example, the CU applies only to industrial products and processed agricultural products, but not to steel, coal or agricultural products, where there are other types of [preferential agreements](#).

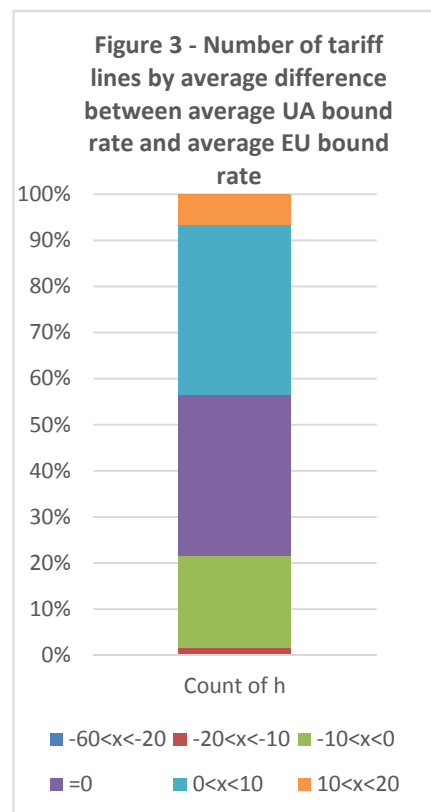
#### *Assessing the feasibility of an EU-Ukraine CU*

The EU external tariff is the maximum level of tariff that the EU can apply to trade imports subject to the most-favoured-nation principle (MFN) in accordance with WTO law. Also under WTO law, tariffs of a customs union must not, 'on average', be higher than prior to the formation of the CU. A comparison of the existing EU and Ukrainian external tariffs offers an insight to how much Ukraine would have to depart from its current external tariffs in order to align with the EU's common external tariffs.

While the 'average incidence' requires complex calculations of the weighted average tariff applied, the introduction of higher bindings from joining a CU can trigger negotiations with, and requests for compensation from, non-CU members. Therefore, it is interesting to look at how big a change a CU would bring for Ukraine, first by simply comparing the mismatch between tariff bindings and whether the adoption by Ukraine of the EU's WTO bindings entails an increase in its WTO bindings. Moreover, the WTO DSB has prohibited the insertion of new quantitative restrictions as part of joining a CU.

The first comparison of interest can be to assess the existence of *ad valorem* (AV) and *non-ad valorem* (NAV) duties for the same tariff lines in EU and Ukraine WTO tariff bindings. As Table 1 in annex shows, the EU has several NAV that correspond to AV in Ukraine's current bindings. NAV are generally considered less transparent and more restrictive than AV and can include also quotas; in other words it appears that there are some tariff lines for which the EU can introduce quotas while Ukraine is bound to apply an AV duty. These tariff bindings – with AV duties in Ukraine's schedules, but where Europe has the possibility to introduce NAV – are mainly in the agricultural sector, but also in chemicals and the miscellaneous category.

Another way of measuring the size of the existing divergence, and thus the adaptation required with a CU, is by comparing the differences of average AV bound duties, by subtracting the EU average bound rate from the Ukrainian average bound rate for the same goods defined at HS6 level. This is shown in detail, by sector, in Figure 1 in annex. Negative differences mean that the EU bound is higher than the Ukraine binding and therefore Ukraine would have to raise its WTO binding for those tariff lines to match the EU binding. Differences vary from -54.9 to +20. The sectors with the highest number of tariff lines with a negative difference between Ukraine and EU average AV bound tariffs are agriculture, textile, metals and machinery. Figure 3 shows that, for 78 % of tariff lines analysed, there is either no difference or the difference is positive (entailing a more liberal EU binding), while for 22 % of tariff lines the difference is negative. Of those 22%, 7 % have differences bigger than 10%.



#### *An EU-Ukraine CU through Turkish lenses*

The successes and failings of Turkish experience with the CU are likely to influence debate on an EU-Ukraine CU (and the same applies for Georgia and Moldova). Turkey does not participate in EU FTA negotiations with third countries, and does not benefit automatically from trade provisions contained in the negotiated FTAs. This issue would also have to be addressed with Ukraine, in order to ensure that its interests are properly safeguarded with respect to EU negotiations with third countries. On the EU side, the weakness of the political conditionality of the Turkish CU has been a subject of contention, and it would equally have to be addressed with respect to Ukraine.

## **Brexit: Consequences of exiting a Customs Union**

### **Brexit negotiations**

On 29 March 2017, the UK Prime Minister Theresa May triggered [Article 50 TEU](#) in order to start negotiations for the UK's exit from the EU (Brexit). Indeed Article 50 TEU provides that withdrawing from the EU entails the need to negotiate new arrangements between the exiting Member and the Union, in recognition of the [important legal and economic consequences](#) that a withdrawal from the EU entails. The European Council, meeting without the UK on [29 April 2017](#), decided that negotiations would be divided in two phases. The first phase would focus on clarifying the impact of Brexit for citizens and business, and settle the consequences of the UK ceasing EU membership, which entails the ending of the rights and obligations of the UK under the EU Treaties and international agreements. The second phase would then cover negotiations on a possible framework for future relations with the EU (hence this second phase will also include discussions on

trade relations, and the type of trade agreement that might be concluded). The [Council of the EU](#) has so far issued negotiating directives only for the first phase of negotiations, in line with the decision of the European Council. Therefore, the [Commission](#) is not yet authorised to negotiate on the second phase (i.e. on a future trade arrangement). The European Council, meeting on [20 October 2017](#), concluded that negotiations on the first phase topics were not sufficiently advanced to allow the start of the next phase, however, the European Council called on the Council and Union negotiator to start internal preparations on the position to adopt in future talks regarding the possible future relationship and transitional arrangements. Even if there is no agreement, the UK will leave the EU on 29 March 2019, unless otherwise agreed under the provisions of Article 50 TEU.

In anticipation of the need to negotiate a new arrangement with the EU after Brexit, the White Paper published by the UK government in [February 2017](#) set out the intention of the UK government to exit the internal market and also the EU customs union, and thereafter to establish a free trade agreement. In [August 2017](#), a [second paper](#) from the UK government suggested that the UK would ask to retain, at least temporarily, membership of the customs union as a transitional trade arrangement with the EU but such an arrangement should still allow the UK to pursue trade negotiations with third countries on its own (not aligning with the common commercial policy, i.e. what could be called an ‘imperfect’ customs union arrangement).

#### **Current trade relations of the UK with its EU partners**

In 2016, 49 % of UK trade was with the EU. The top EU trade partners for the UK are Germany (25 % of total UK trade with the EU), the Netherlands (14 %), France (12 %), Belgium (9 %) and Ireland (8 %).<sup>10</sup> Moreover, the EU accounted for 42 % of total UK trade in services in 2014.<sup>11</sup> However, the customs union versus free trade area debate does not affect (at least directly) the impact of Brexit on services. Indeed, customs union and free trade area define two models for the movement of goods, whereas significant liberalisation in services has to be done through membership of the internal market. In the absence of the internal market principle of free movement of services, services trade is liberalised by the EU in its most recent FTAs subject to sectoral reservations, which can vary between Member States.<sup>12</sup>

#### **The consequences of leaving the EU for trade policy**

##### *Internal border controls*

As a member of the EU customs union and of the internal market, goods circulate freely from the UK to the EU. Currently, UK firms can source inputs from the rest of the world, pay import duties on these inputs at the UK border, use them in further processing and then export the final processed good to the EU without internal border controls. Exiting the EU customs union signifies the re-establishment of the customs border. Even if standards of production are identical in the post-Brexit UK and the EU, compliance with EU standards will have to be verified at the customs border. Without mutual recognition agreements, certification will not be recognised by authorities on both sides of the Channel. Mutual recognition agreements could be concluded and solve this problem, but the certificates of compliance would still need to be presented at the border. Moreover, an FTA would institute preferential rules of origin. In order to obtain preferential treatment, goods produced in the EU for export to the UK, and goods produced in the UK for export to the EU, would have to comply with the preferential rules of origin requirements. In the case of a future FTA arrangement, preferential rules of origin risk becoming the most contentious issue in Brexit negotiations. Indeed, several foreign



investors in the UK export primarily to the EU market, and source inputs from outside the UK. The definition of local content in order to obtain preferential treatment to the EU will determine whether such manufacturing investment would lose the currently privileged access to the EU consumer market or not (such fears have been raised in particular in the context of Japanese investments [in the car industry](#)).

#### *Common commercial policy*

In order to ensure proper implementation of the EU customs union, there is a single trade policy which is an exclusive EU competence. Exiting the EU therefore signifies also exiting EU trade policy. All trade regulations that are currently undertaken at EU level will have to be done at UK level (trade defence regulation and measures, generalised system of preferences, tariff regulations and other trade regulations). However, the more complex problem arises from the consequences of Brexit on trade agreements.

While, the UK is a member of the WTO [in its own right](#) (as is the case for every EU Member State), the schedule of commitments within the WTO are currently tied to the EU schedule.<sup>13</sup> While for *ad valorem* tariffs, this does not seem to be a big issue, in the sense that the EU tariff bindings can simply be ‘copied and pasted’ by the UK into its new separate tariff schedule, tariff rate quotas limiting agricultural goods market access cannot be easily ‘copied and pasted’. Quotas are set to satisfy the demand of 28 EU Member States and would thus be disproportionate for a single country. Therefore, the UK will have to renegotiate its bindings in the WTO as a consequence of Brexit. Considering that the UK is one of the major importers of agricultural goods in the EU and that [UK import demand](#) had been taken into account when the EU first negotiated its own bindings, the EU may also have to renegotiate its quotas for a reduced EU-27. The EU and UK have to trigger negotiations at the WTO following [GATT Article XXVIII](#) as a consequence of Brexit. The WTO rules include particular time schedules for requesting [renegotiation of bindings](#), and negotiations in the WTO will most probably be lengthy. For that reason, even though the EU had decided not to start negotiations on trade matters, the question of quotas has already been discussed during the first phase, and [an agreement on splitting quotas](#) between the EU and UK has been found and submitted to the WTO in October 2017. Other WTO contracting parties have not reacted positively to the agreement announced. Argentina, Brazil, Canada, New Zealand, Thailand, the USA and Uruguay issued [a joint letter](#) to the EU and UK Ambassadors at the WTO raising concerns about the reported agreement. The letter highlights that the TRQs are binding on both the EU and the individual Member States and that, if this market access is changed, they expect concessions to be made to compensate for the loss of market access, and point out that modification of these commitments must be done with their agreement.

Finally, leaving the EU signifies leaving the EU's exclusive trade-related agreements (for example mutual recognition agreements). Even though EU FTAs are mixed agreements and were concluded by the EU and its Member States jointly, they are only applicable within the territory of the European Union and of the partner country. This territorial application states that the trade agreement is binding and applicable only to the territories in which the EU Treaties apply and the territory of the third country with which it is concluded. As soon as the EU Treaties are no longer applicable to the UK after Brexit, application of EU mixed trade agreements to the UK territory should cease.

Table: Overview of some of the trade consequences after Brexit by trade arrangement

	Current situation: EU Membership	CU with Common Commercial Policy (CCP): 'perfect' CU	CU without CCP: 'imperfect' CU	Free Trade Area
<b>Goods internal circulation</b>	free movement	Duty free (could be subject to exceptions)	Duty free (could be subject to exceptions)	Duty free; sectoral exceptions
<b>Preferential rules of origin</b>	no	no	Could be an option to avoid trade deflection	Yes
<b>Standards</b>	Mutual recognition principle; harmonisation	Could be subject to alignment or sectoral negotiations of mutual recognition arrangements	Could be subject to alignment or sectoral negotiations of mutual recognition arrangements	Sectoral negotiations of mutual recognition arrangements
<b>Customs arrangement internal border</b>	No internal border, free circulation	Border to verify TBT and SPS compliance if standards not aligned	Border to verify TBT and SPS compliance if standards not aligned; border to verify trade deflection (via rules of origin)	Border needed for control of preferential rules of origin; TBT and SPS verification compliance
<b>Services and investments</b>	Free movement of services and investments	Subject to reservations on both market access and national treatment	Subject to reservations on both market access and national treatment	Subject to reservations on both market access and national treatment

Source: EPRS.

### The impact of CU in the context of Brexit

The above table shows that customs controls will probably be reintroduced after Brexit. The only situation in which border controls would not be necessary would be the maintenance of CU membership, with alignment to both preferential trade agreements and regulatory standards. The latter would also make the need for renegotiation of FTAs and in the WTO disappear. However, such an option has not been mentioned on either side. The other two options ('an imperfect CU' or an FTA) would introduce some barriers. In an FTA, the main barriers will be PROO and regulatory standards. An 'imperfect CU' will still need to find a solution to the trade deflection problem via customs controls or PROO. Thus, a CU would have similar problems to an FTA. For that reason, most econometric analysis find losses from Brexit since some non-tariff barriers are introduced in all of the alternatives considered so far, and therefore even optimum scenarios still represent a decrease in integration from the current status quo.<sup>14</sup> Losses are expected [on both sides](#), though they could be more important for the UK.

## Annex: Tariff bindings analysis on potential EU-Ukraine Customs Union

**Table 1: Comparison between UA and EU bindings of the type of tariff bound used**

Product groups	HS chapters	UA bound type of tariff	EU bound type of tariff	No of lines
Agricultural and animal products	01-24	AV	AV	454
			mixed	115
			Non-AV	145
		mixed	mixed	1
		Non-AV	AV	4
			Non-AV	3
Chemicals	28-38	AV	AV	777
			mixed	4
			Non-AV	5
		mixed	mixed	1
Machinery	84-85	AV	AV	768
Mineral products	25-27	AV	AV	147
			mixed	1
Miscellaneous	90-97	AV	AV	342
			mixed	1
			Non-AV	19
Metals	72-83	AV	AV	568
Plastics – Rubbers	39-40	AV	AV	213
Leather – Skins	41-43	AV	AV	69
Stone – Glass	68-71	AV	AV	190
			mixed	5
			Non-AV	1
Textiles – Clothing	50-67	AV	AV	849
			mixed	1
Transportation	86-89	AV	AV	131
Wood products	44-49	AV	AV	237
Total tariff lines analysed				5051

Source: DG EPRS calculations from WTO data. Analysis at HS 6 level.

**Table 2: Average differences per sector between the average UA bound tariff and the EU bound tariff rate, and the number of lines with differences below, or equal to, 0**

Product groups	HS chapters	Total No of tariff lines	No of tariff lines diff<0	average	min	max
Agricultural & animal products	01-24	570	239	1.8	-54.9	20.0
Chemicals	28-38	782	45	0.7	-6.5	8.0
Machinery	84-85	768	133	2.5	-10.7	17.8
Mineral products	25-27	148	6	7.4	-3.5	20.0
Miscellaneous	90-97	343	45	3.6	-3.7	17.3
Metals	72-83	568	138	0.4	-9.0	10.0
Plastics – Rubbers	39-40	213	26	1.8	-6.5	10.0
Leather – Skins	41-43	69	11	3.2	-4.0	19.2
Stone – Glass	68-71	195	16	5.6	-3.0	10.8
Textiles – Clothing	50-67	850	334	-1.7	-12.0	10.0
Transportation	86-89	131	23	3.5	-8.5	10.0
Wood products	44-49	237	32	-0.1	-7.0	10.0
Total tariff lines		4874	1048			

Source: EPRS calculations from WTO data. UA bound minus EU bound, calculated at HS6 level without *non-ad valorem* tariff lines.

## Main references

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## Endnotes

- <sup>1</sup> R. W. T Pomfret (ed), *Economic analysis of regional trading arrangements*, Edward Elgar Publications 2003; Trade blocs - Economics and Politics, P. Krishna, Cambridge University Press, 2005.
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- <sup>4</sup> Laura Puccio, *Building Bridges between Regionalism and Multilateralism: enquiries on the ways and means to regulate preferential rules of origin and their impact on the systemic problems of FTA*, EUI PhD thesis (Cadmus repository), 2013; Paola Conconi, Manuel García Santana, Laura Puccio, Roberto Venturini, '[From final goods to inputs, the cascade protectionism effect of preferential rules of origin](#)', CEPR discussion paper 11084, 2016.
- <sup>5</sup> Olivier Cadot, Antoni Esteveordal, Akiko Suwa-Eisenmann, and Thierry Verdier (eds), *The Origin of Goods: Rules of Origin in Regional Trade Agreements*, Oxford University Press, 2006.
- <sup>6</sup> The [Southern Common Market \(Mercosur\)](#) excludes some sectors and allowed [temporary national exceptions](#). Temporary national exemptions are provided for in the [East African Communities](#) (EAC).
- <sup>7</sup> This is for example the case of the [Southern African Customs Union](#) (SACU).
- <sup>8</sup> See the [East African Communities](#) (EAC), [Common Market for Eastern and Southern Africa](#) (COMESA), [Economic Community of West African States](#) (ECOWAS), [West African Economic and Monetary Union](#) (WAEMU).
- <sup>9</sup> Under the [Enabling Clause](#), developing countries can agree on preferential trade agreements that do not comply with the requirements of substantial liberalisation. The enabling clause also allows to exclude sectors from the CU.
- <sup>10</sup> Comtext data.
- <sup>11</sup> Eurostat data.
- <sup>12</sup> For an example, see: L. Puccio, W. Schoellmann and G. Sabbati, [CETA and public services](#), EPRS, February 2017.
- <sup>13</sup> For a very good analysis of this, see: Lorand Bartels, [The UK's status in the WTO after Brexit](#), 23 September 2016.
- <sup>14</sup> An [HM Treasury](#) analysis looks at three alternative scenarios. The first corresponds to membership of the EEA (an FTA plus access to the internal market) and is expected to bring a decrease in trade volumes of 9 % after 15 years. The second refers to a negotiated bilateral agreement (using the models of Switzerland, Turkey and Canada, thus a broad range) and is expected to bring changes, according to the study, of between -14 and -19 % in total trade volumes. Finally, the third relates to WTO membership with no preferential treatment, and bringing changes of -17 and -24% in total trade volumes. The HM Treasury study also quotes a variety of external studies conducted mainly by private banks and all with varying negative results ranging from a decrease in GDP of -1 % over 1 year to -8 % over 5 years. An [LSE study](#) considers an optimistic version with internal market access and a pessimistic scenario with only WTO membership. They find results between -1.13% for the optimistic scenario and -3.09% for the pessimistic scenario. Finally, an economic analysis for the EP looks at the impact on the UK and EU Member States.

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