

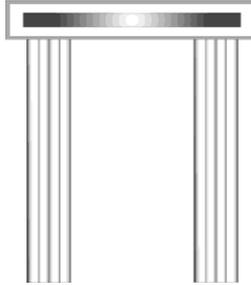


Martin Howe QC

**The Cost of Transition
Few Gains, Much Pain?**

POLITEIA

A FORUM FOR SOCIAL AND ECONOMIC THINKING



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A Forum for Social and Economic Thinking

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Introduction

The danger: a Vassal-State Brexit without the benefits of either 'Leave' or 'Remain'

The referendum campaign involved two opposed visions for Britain's future. Under the first, favoured by the Remainers, the UK would stay in the European Union, participate in its councils, and -- to the extent possible -- seek to shape its future development in line with the UK's interests.

Under the second vision, favoured by the Leavers, the UK would leave the European Union and take back control of its laws, borders and money, and would trade with the world outside the restrictive constraints of the EU's customs union and common commercial policy.

Each of these visions is internally consistent, and has its pros and cons. The British people however voted narrowly but decisively against the first and in favour of the second vision.

But where we stand today, we are in grave danger that neither vision will be achieved. Instead, we are in peril that a third scenario will come about, one not favoured by either side. That is for the UK to cease its formal membership of the EU, thereby losing its vote on EU laws, and its ability to influence -- or if necessary veto -- future Treaty changes. But at the same time we would remain subject to continued EU control of our tariffs and external trade policy, and continued EU control of a huge range of market-related internal laws. Our compliance with these requirements would continue to be overseen by the EU Commission and the European Court of Justice, bodies on which we would no longer have any nationals.

We would have changed our relationship with the European Union from being a Member State into being a Vassal State: a mere rule taker who must comply with laws devised, interpreted and enforced by foreigners and by foreign institutions. This would have the gravest economic and political consequences.

The economic consequence is that it would make it impossible for us to benefit from the freedoms which we will enjoy as a result of leaving the European Union. We would be unable to reduce the very high duties which the EU's Common External Tariff obliges us to impose on basics such a food and clothing. Reducing or eliminating these tariffs unilaterally - particularly on goods which this country does not even produce and where

the sole purpose of the current high tariffs is to benefit Continental producer interests - should be a no-brainer “first day of Brexit” action which would give an immediate and tangible Brexit dividend to lower income families in whose budgets these items form a disproportionate share.

We would be unable to pursue opportunities for free trade agreements all over the world. This is because we would be unable to offer to reduce or eliminate tariffs, and we would be unable to depart from the EU’s rigid rules on standards for goods or services in our domestic market in order to offer mutual recognition of standards to our trading partners.

We would be unable to reform the way our economy is regulated, or to escape the compulsory imposition of new EU laws on us, with their economic costs and their continuing political damage to our right to self-government. The City should be particularly fearful of such a regime, since its position could be carelessly or even deliberately undermined by Eurozone-inspired regulatory changes: the imposition of requirements to impose taxes - such as an FTT - which we would no longer have the right to veto, or rules which ban clearing of euro-denominated derivatives outside the Eurozone.

Such a vassal-state Brexit would inevitably lead to Brexit being dubbed a failure, when the truth would be that Brexit had never been tried.

But the political consequences would be even more dire. Such an outcome would be - and would be seen to be - a clear betrayal of the promise made to all who voted in the referendum that their decision would be implemented. There could be nothing more corrosive to the already strained trust of millions of people in our political system, or more likely to produce an explosion of frustrated anger.

Transitional or implementation period

This brings me to the transitional or implementation period proposed in the Prime Minister’s Florence speech. It is not difficult to see that for as long as it lasts it has all the characteristics of the vassal state arrangement which I mentioned above. But, it is said, it will be temporary and for two years only - or rather “about” 2 years only. What is this when we have been an EU member for 45 years, and will escape to freedom at the end of the transition?

The transition period and legal powers

The first question which the proposal raises is under what legal power would the transition be authorised, and how would it be negotiated? These questions have been dealt with at much greater length than is possible here in an article recently published on Brexit Central and on the Lawyers for Britain website: “*The legal ins and outs of implementation periods: avoiding the negotiation noose*”.¹

Put shortly, the EU has legal power under Article 50 to conclude a transitional arrangement if, but only if, the end state to which the transition will lead has been agreed at least as a framework. Article 50 confers no legal power on the EU to enter into a transitional arrangement which does not have a pre-agreed end point. The EU has other and wider external relations powers which in theory could enable it to conclude such an open-ended transition arrangement, but the EU declines to invoke them until after the UK has actually left in March 2019. In any event those other powers would probably involve mixed EU and Member State competence, necessitating national as well as EU ratification of any such agreement. So Wallonia would have a veto.

Thus it is impossible to use Article 50 for the purpose of creating the kind of transitional arrangement which seems to be favoured by the CBI and some strident City interests. This would be a general extension of EU rules and structures for a period during which the UK’s future relationship with the EU will continue to be negotiated after March 2019.

Therefore it is complete pie-in-the-sky fantasy for a transitional period arrangement to be agreed by the end of this year, as demanded by business interests. It is not unreasonable for businesses to want such certainty, if it were possible to achieve it. But that is an impossibility. Instead, such an arrangement could only be legally concluded at the earliest when an agreement has been reached on the framework -- or heads of terms -- of the UK’s future trade relationship with the EU. Even the wildest optimist would not suggest that this could be before late 2018 or early 2019.

So the EU cannot as a matter of law enter into a legally binding agreement which secures a transitional period until later on in the withdrawal process. In addition, the EU’s negotiating strategy dictates that they will not agree to such arrangement until the last minute, even if legally they could agree earlier. Their trump negotiating card is to

¹<http://www.lawyersforbritain.org/eu-deal-transition-negotiation-noose.shtml>

hang tough until the UK is driven up against the hard wall of exit in March 2019. “*Tick-tock*” as M Barnier puts it. Their entirely rational calculation is that the UK will simply fold, and give in to their demands for money and other terms, faced with this deadline. Why on earth then should they pre-agree to a transition period arrangement which from their point of view simply lets the UK off the negotiating hook?

So the transitional period proposal can become a dangerous noose for the UK’s own neck. The EU may well dangle the prospect of such a period, subject to everything else being agreed. But it will not legally commit to it. The UK will then lull itself into the false belief that it does not need to prepare for exit in March 2019 but has two more years. Whitehall and businesses will ‘goof off’, lulled into a state of doing nothing and fail to prepare.

The EU will then be able to demand whatever terms it likes for legally agreeing to the transitional period, including any extra demands which the EU or its individual member states have not yet thought of. Given the UK’s self-induced lack of preparedness for a no-deal exit, and no time by then to prepare, it will be, as the saying goes, completely naked in the conference chamber.

The inescapable conclusion is therefore that the prospect of a transition period does not absolve either the government or business from the absolute necessity of taking all required steps to prepare for a no-deal exit right up to the point when (or rather, if) the withdrawal agreement including its transitional period terms is actually concluded and ratified. That cannot happen until a very late stage. So the transition period proposal cannot possibly deliver one of the benefits claimed by some, which is that it would avoid the cost and disruption of making advance preparations for leaving in March 2019 without a deal.

So what other benefits can it deliver?

The Customs Union

Customs arrangements call for special mention. At present, we are inside the EU’s customs union. This entails zero tariffs on trade in goods between us and other EU member states, but requires us to charge tariffs at levels mandated by the EU under the Common External Tariff on imports from non-member states -- except those states with which the EU as a whole has free trade agreements.

After we leave the EU, the government is seeking to negotiate a comprehensive free trade agreement with the EU27 which, one anticipates, will involve across the board

zero tariffs in both directions. So why therefore will we need customs controls between us and the EU27?

The answer lies in the nature of free trade agreements, which operate differently from customs unions. Members of a free trade agreement are free to set their own tariffs on goods entering from outside the Free Trade Area. Indeed, a country can simultaneously belong to two or more different Free Trade Areas, enjoying and granting zero tariffs on trade with all countries with which it has a Free Trade Agreement.

However, this arrangement means that goods could indirectly bypass the tariff wall of another party to a free trade agreement. For example, if after exit the UK were to enter into a free trade agreement with Australia, Australian goods could flow into British ports and then go on to the Continent, by-passing the EU's tariffs on Australian imports, unless measures were in place to stop this happening.

The system which prevents this happening under free trade agreements is that the zero tariff concessions apply only to goods which *originate in* one the parties. The concession does not apply to goods which are imported from outside the FTA. Therefore customs controls are exercised at the internal borders of the FTA to check whether or not the goods originate within the other FTA partner according to so-called "Rules of Origin". If not, they are charged external tariffs as if they had come directly from a non-FTA country.

This means that it will be necessary for the EU27 and the UK to put in place customs controls between us when we leave the EU, whether or not a free trade agreement is in prospect.

However, one aspect of the Florence speech "implementation period" is the suggestion that the UK would continue to match the EU's external tariffs during the transition period, even though we had formally left the customs union. The purpose of making such an offer would seem to be in order to persuade the EU27 that they need not exercise customs controls on goods flowing inward from the UK during the transition period. In effect, the UK by matching the EU's external tariffs would prevent tariff circumvention and so obviate the need for the EU to exercise inwards rules of origin controls at the Channel ports.

The problem with this idea is that it is staggeringly costly, both in direct financial and economic terms, in the cost of lost opportunities, and in terms of cost to our ability to govern ourselves under our own laws.

I have already pointed out that immediate tariff elimination or at least reductions on food and clothing on the first day of Brexit would give an immediate and tangible Brexit dividend to lower income families in whose budgets these items form a disproportionate share. My friends and colleagues in Economists for Free Trade have estimated that their favoured policy of unilateral elimination of all tariffs would boost the UK economy by £135bn per year. But you do not need to go all the way in accepting their proposals to appreciate that the reduction or elimination of tariffs on ranges of goods which are not produced in the UK, and where the CET charges high tariffs for the sole purpose of benefiting Continental producers at the expense of British consumers, is, as they say, a “complete no-brainer”.

However, it seems that the proposed transition period would prevent us from doing that at all, at least for “about two years” after March 2019. Viewed in crude political terms, this means that the Brexit dividend for lower income voters could not begin to come through until a few months before the latest possible date for the next General Election, when it is probably far too late for it to affect the political climate.

The other, even greater, cost of transitional adhesion to the EU customs union is that it would (at minimum) defer our ability to implement free trade agreements. Even more seriously it could prevent us from taking advantage at all of some important current opportunities which might not come again. We would have to negotiate with our prospective trade partners on the basis that the earliest date when we could implement any agreement would be “about” 2 years after March 2019 - with the word “about” itself introducing uncertainty which would deter our negotiating partners. This would be coupled with uncertainty as to whether the transition period might be extended, and uncertainty about how the details of our agreement with the EU might adversely affect our ability to agree terms with other trading partners.

There are some current opportunities to secure trade agreements rapidly, which could well disappear altogether if there is a minimum 2 year deferment. Most obviously, we do not know where the Trump administration will be by 2021 or the composition of Congress.

Trade with the rest of the world is already over 55% of our exports, is growing more rapidly than our trade with the EU27, and will continue to grow more rapidly in future years. Only a completely bizarre sense of priorities could lead to the tail of our EU27 trade wagging the dog of our trade with the world via this transitional period customs proposal.

Customs union mirroring would severely affect our ability to govern ourselves and

make our own laws. This is because customs controls are not just about tariffs, but also about enforcing a huge range of controls on the standards of goods which can be imported, from health controls on foods to e.g. safety of toys. The EU-Turkey customs union agreement provides a template for this kind of agreement, which of necessity involves a completely servile relationship between the EU and the non-EU partner. For those who are interested, the EU-Turkey agreement is analysed in some detail on the Lawyers for Britain website.²

It is plainly a relationship between empire and subservient vassal state. One aspect of that relationship which is particularly telling is that Turkey is required to admit goods to its market tariff-free from states which conclude free trade agreements with the EU, even though there is no obligation on those states to admit Turkish goods tariff free. The same would happen to the UK under the transitional deal. We would be required to admit goods from the EU's existing free trade partners (such as Canada and Korea), and the fact that this would happen without reciprocity would remove the incentive on these countries to novate (i.e. replicate on a bilateral basis with the UK) these free trade agreements.

Why not just set up customs controls?

The alternative to this vassal membership of the EU customs union during the transition period is simply to set up customs controls ready to operate from the day after exit. Then we shall be ready, whether or not a framework or heads of terms for the long term trade relationship is agreed. If such a framework is agreed by them, we and the EU27 would then operate zero tariffs and rules-of-origin controls, under an interim free trade agreement which is permissible under Article XXIV of GATT 1994.

The cost of setting up customs facilities at Channel ports and building some overflow lorry parks on the A2 is trivial compared with the staggering costs of a transitional customs union arrangement. Charlie Elphicke MP has published a paper: "Ready on Day One - Meeting the Brexit Borders Challenge",¹³ which explains the practicalities of setting up a modern, electronic based, customs control system. With electronic pre-clearance and "authorised economic operators", modern customs systems no longer rely on a man in a peaked cap with a clip board rummaging through the cargo on the dockside.

And, as I have explained, these customs controls will be needed come what may at the

²<http://www.lawyersforbritain.org/eu-deal-customs-union.shtml>

³ <http://elphicke.com/downloads/ready-on-day-one--meeting-the-brexit-borders-challenge.pdf>

end of the transition period in order to operate the prospective free trade agreement between the UK and the EU27. So why not get going now?

On 11 October 2017, the Chancellor of the Exchequer, Philip Hammond, wrote an article in *The Times* which he followed up with his evidence to the Treasury Select Committee on that day. Mr Hammond exhibited a huge reluctance to spend money on any Brexit related preparations until the last possible minute, and until it was proved that they were necessary. But as has been pointed out above, it will be necessary in any event to spend money on customs facilities; and it is necessary to get going now because (to put it at its lowest) there is no guarantee that a transitional period agreement will be reached at all; and at the earliest conceivable time it could be legally agreed, it will in any event have been necessary to spend the money and train the staff in order to be ready in March 2019.

And yet Mr Hammond appeared to be suggesting that it might be possible to avoid spending the money on customs controls altogether – which the UK will need in any case, irrespective of whether there is a deal or there is no deal.

Why he might think this is a total mystery, until one looks for clues at a Future Partnership paper on “Future Customs Arrangements” published by the government in August 2017.⁴ This paper proposes, as one would expect, a “highly streamlined customs arrangement” between the UK and the EU involving electronic pre-clearance and the other facilitation measures which are already global standards under the WTO Trade Facilitation Agreement but which could no doubt be further improved and streamlined.

However, the paper also proposes as an alternative “A new customs partnership with the EU” which it describes as “*aligning our approach to the customs border in a way that removes the need for a UK-EU customs border*”. The paper acknowledges that this is “*an innovative and untested approach that would take time to develop and implement.*”

In fact, this proposal is both entirely unworkable, and highly undesirable even if it could be made to work. The suggestion under this proposal is that UK customs would continue to apply the EU’s external tariffs and non-tariff controls against imports from outside the EU, and that there would then be a “robust enforcement mechanism” which would ensure that goods allowed in to the UK domestic market would not migrate into the EU. It says (para 41):

“This could involve, for instance, a tracking mechanism, where imports to the

⁴https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/637748/Future_customs_arrangements_-_a_future_partnership_paper.pdf

UK were tracked until they reached an end user, or a repayment mechanism, where imports to the UK paid whichever was the higher of the UK's or the EU's tariff rates and traders claimed a refund for the difference between the two rates when the goods were sold to an end user in the country charging lower tariffs. Businesses in supply chains would need to be able to track goods or pass the ability to claim a repayment along their supply chain in order to benefit."

The tariff pre-payment mechanism would kill our ability to negotiate free trade agreements with other countries. We would have to say to them that when we offer tariff-free access to our markets, that would actually mean that their exporters would need to pay EU-mandated tariffs and then pursue some complicated repayment mechanism on condition of proving that the end consumer of the goods was in the UK.

And it is impossible to see how this system could prevent goods which do not comply with EU standards from crossing into the EU market. Is it contemplated that every (mythical) chlorinated chicken from the USA would be tracked to its end destination on the dinner table? Such a tracking system would involve vast costs on companies and sectors of the economy not trading with the EU, in order theoretically to benefit the small and declining minority of the overall UK economy involved in export trade to the EU.

But where this idea really breaks down is that it is impossible to see the European Union agreeing to it. The EU is virtually paranoid about its external customs borders. As the Commission explains it:⁵

"The Customs Union is a foundation of the European Union and an essential element in the functioning of the single market. The single market can only function properly when there is a common application of common rules at its external borders. To achieve that, the 28 national customs administrations of the EU act as though they were one."

There is not the slightest chance of the EU agreeing to a system under which customs controls are removed from the Channel ports, goods are circulating inside the UK which do not comply with their standards, and the sole way of preventing them from entering the EU is an untried tracking system of this kind.

So it seems that we are being led into a huge and costly policy error of extending our subordination to the EU's Common External Tariff, with the vast direct costs and

⁵ https://ec.europa.eu/taxation_customs/general-information-customs/eu-customs-strategy_en

opportunity costs that that entails, solely because the Treasury seems bewitched by the mirage of a future customs arrangement which it describes as untested but which a more sober assessment must describe as completely barmy.

A Clear Course for the UK in March 2019- leaving the EU, leaving the customs union

The proposed transition period has other important aspects, notably continued alignment of our internal market-related laws with EU regulations. Whether the benefits outweigh the costs of that aspect of the arrangements is a further complex topic on which further work is needed.

But on the customs union aspect of the transition period, it is glaringly clear that the direct and indirect costs of complying with it will be huge. In no way can they be justified by the limited administrative benefits which it might bring for a limited sector of the economy. It also seems that much of the policy justification for pursuing it arises from a misplaced belief in a completely unrealistic plan to make UK customs into a branch agency of the EU customs union and to festoon our domestic economy with complex and unworkable tracking systems.

Whether or not some form of transition arrangement or implementation period is desirable, it should not extend to mirroring the EU's external customs tariffs and controls. The UK needs to leave the EU's customs union as planned on 30 March 2019, both in name and in reality.

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