Professor Alan Matthews (ABR0038)

1. You mentioned that the UK will have to develop its capacity to prove the origin of agricultural products and demonstrate conformity with regulatory standards, and that this would be an additional cost. Would you be able to elaborate on how the origin could be proved and what the scale of that cost increase might be?

Note that demonstrating conformity with regulatory standards raises different issues to proving the origin of products (not only agricultural products) which I addressed in my oral evidence and is not addressed further here.

Rules of origin are usually set out in annexes to a free trade agreement, setting out how the partner countries will assess whether imports from the other country are deemed to originate in that country and thus be eligible to benefit from the preferential duty rate. Rules of origin are complex and can be contentious – for example, just setting out the rules of origin alone takes up almost 200 pages of the NAFTA agreement. The basic idea is that "substantial transformation" should have taken place in the partner exporting country – it is not sufficient simply to repackage goods imported from third countries to benefit from duty-free access. To establish substantial transformation, rules of origin might apply the criterion of a change in tariff classification, or require a specific proportion of the value of the product to be added in either the exporting or importing country in the FTA (this is referred to as the principle of cumulation), or require that a specified manufacturing process be undertaken in the exporting country. Rules of origin are contentious because they can operate as protectionist devices. Strict rules of origin can negate the point of offering duty-free access in a free trade agreement. They can also provide an incentive for producers in the exporting country to buy inputs from the importing country under the cumulation principle, even if these cost more than inputs from third countries, because doing so allows origin to be conferred on the export and the value of the tariff preference obtained exceeds the higher input costs.

The way rules of origin work in the free trade agreements to which the UK is already a party (through its membership of the EU) are set out in the HM Revenue & Customs notice 828[i].

The most usual way to assess the cost of rules of origin is through 'revealed preference' by examining when exporters fail to make use of preferences when they are available and instead export under MFN or

other terms. The reasoning is that the cost of proving origin is sufficiently high in these cases that exporters opt to pay the tariff instead. By looking at the use of tariff preferences for different tariff lines with different MFN duty rates, a 'breakeven point' can be established indicating the MFN rate where preferences begin to be widely used, which is taken to represent the cost of compliance with rules of origin.

The following summary of studies which have attempted to measure compliance costs is taken from a WTO research publication:

> "On the compliance costs of rules of origin, beyond the production costs of complying with the requirements – i.e. the need to adapt the production chain to a given mix of products – multiple studies have highlighted the importance of administrative compliance costs. These are incurred both by the producer/exporter – the cost of getting the information and of certifying the product – and by the importer on verification procedures. These costs vary from country to country and depend on numerous elements, e.g. the extent to which "self-certification" exists, the number of RTAs a country is party to, the external exposure of the trade agents involved, the continuous existence of trade flows of a given product between them. Results of these studies have generally shown that administrative compliance costs may account for between 2% to 8% of the value of a shipment, with 5% threshold being widely used as a benchmark. A summary of some of these studies can be found in a 2010 publication by the World Bank".[ii]

In my view, the lower figures would be appropriate for UK exports to the EU and vice versa in a free trade agreement situation because of the prevalence of self-certification and electronic document exchange. However, as I stated in my oral evidence, these costs will differ by firm size, and will bear more heavily on smaller firms that may be only occasional exporters. For a specific application showing that small firms make less use of preferences than larger firms.[iii]

2. You also suggested that there may be tricky issues in the current trade negotiations between the EU, MERCOSUR, New Zealand and Australia. Could you elaborate on what these problems might be?

Essentially, the tricky issues can be summed up in one word: AGRICULTURE. All of these mentioned countries are significant agricultural exporters, and in particular, exporters of livestock products (beef and dairy) which are particularly sensitive for the European Union. A hint of the fears that are expressed can be found in this written question in the European Parliament last year on agricultural imports from MERCOSUR.[iv]

It is for this reason that the UK after Brexit may find it easier to conclude FTAs with these countries if it is more willing to offer concessions on agricultural imports than is the EU.

3. Would it be possible to elaborate on the distinction between a bound and applied tariff and why that distinction is important in agricultural trade?

Again, this important distinction applies to all trade and not only agricultural trade. A bound tariff is only relevant to a country that is a WTO Member (as most countries now are). The bound tariff on each tariff line is the figure entered in a country's WTO Schedule of Commitments and is the maximum rate of duty it can impose on imports of that product from other WTO Members. In trade negotiations, countries exchange offers on their bound tariffs. Most but not all countries have bound all of their tariffs – in some cases mainly developing countries have not offered tariff bindings (the WTO has a table showing the extent of bound tariffs here[v]). However, following the WTO Agreement on Agriculture, 100% of agricultural tariffs are bound.

Applied tariffs are the tariffs that appear in a country's customs schedule and that are actually applied to imports. They are of two kinds; Most Favoured Nation (MFN) applied tariffs and preferential applied tariffs. MFN applied tariffs are those tariffs that are applied in a non-discriminatory fashion on imports from all trading partners that do not trade under a preferential trade arrangement. MFN tariffs can be set at any level from zero up to the bound tariff on that product, but cannot exceed the bound tariff. For developed countries, including the EU, applied tariffs are in most cases set at the bound tariff level, but this is not necessarily the case with developing countries which like to hang on to high bound tariffs out of a sense of security, even if in practice they apply much lower MFN tariffs. Preferential applied tariffs will reflect whatever tariff levels countries have agreed to offer in the context of free trade area negotiations or, in the case of developing countries, under non-reciprocal preferential schemes such as the Generalised System of Preferences.

Thus the UK has to make two tariff decisions before Brexit. It has to propose a Schedule of bound tariffs at the WTO, which should then be certified by WTO members[vi]. As we discussed in our oral evidence, certification is desirable to permit the UK to begin FTA negotiations with other WTO members (although Mr Green quoting Dr Bartels points out it may not be essential).

The more important decision is that the UK must decide on what applied tariff schedule it wishes to use on day one after Brexit. Customs officials will need to know what duty to charge on goods entering the UK on that

day (and for exporters, this information will need to be known well in advance when orders are being signed). The UK may well decide to apply the EU's TARIC tariff schedule (this is the EU's applied tariff schedule with both MFN and preferential applied tariff rates[vii]). But it may also want to take the opportunity to simplify its applied schedule and to eliminate tariffs on product which, at a minimum, the UK does not produce itself. The UK will need to make this applied tariff schedule known within the next twelve months in order to give exporters the certainty on which to enter contracts for delivery once Brexit has taken place.

In this connection, the tariffs applied to imports from those countries which presently export to the UK under preferential terms, including of course the EU but also countries with which the EU has FTAs like South Korea, Mexico, countries of the Mediterranean, and so on, must also be decided. In the absence of free trade agreements with these countries, WTO rules specify that the non-discrimination principle must apply, meaning that MFN tariffs would apply to imports from these countries on day one after Brexit. This will be enormously disruptive as well as likely to trigger uproar with its trading partners. The UK is likely to want to maintain tariff-free trade with these countries. It could notify its intention to the WTO, together with the affected trading partners, to create free trade agreements with these countries at a later date.[1] This might allow it and its trading partners to maintain the status quo of tariff-free trade while the process of negotiation took place. However, unless these intentions are clearly signalled within a year from now, the uncertainty among importers and exporters over the tariffs that might be charged on imported goods from these countries will have an increasingly disruptive influence on existing trade flows with these countries. But can the UK progress these interim agreements through the WTO while it remains a member of the EU? And if it wants to present these interim agreements to the WTO twelve months from now, it would need to begin the necessary dialogue and negotiations with the EU's FTA partners almost immediately.

4. In the session, you suggested that "the UK might wish to obtain some of the EU's current bound aggregate measurement of support". Could you elaborate on that process of splitting the AMS? Furthermore, in the light of the Government's intention of continuing current funding commitments until 2020, i.e. a year after the planned withdrawal, is there a potential conflict for the UK continuing Pillar I and Pillar II schemes if the UK does not get access to a share of the EU's AMS?

There is no precedent for a WTO Member withdrawing from a shared AMS commitment so we cannot be sure how the process will work. My view is that splitting the EU-28 AMS between the UK and the EU-27 may be an

[1] Article XXIV of the GATT 1947, which deals with customs unions and free trade areas, makes provision for interim agreements leading to the formation of a free trade area. An interim agreement shall include a plan and schedule for the formation of such a free-trade area within a reasonable length of time.

acceptable outcome to the other WTO Members because (a) it is the reverse procedure to what happens when a country joins the EU, and (b) it would lead to a lower Bound Total AMS (BTAMS) for the EU-27 which would be more restrictive on future EU trade-distorting agricultural policies. The precise modalities on which the EU-28 BTAMS would be shared would have to be worked out and would also be complicated (see the discussion in the following blog posts[viii].

However, in my oral evidence I also pointed out that this would mean that the UK would claim an entitlement to a Bound AMS. Many countries in the WTO do not have such an entitlement because they did not provide trade-distorting support in the base period (1986-88) of the WTO Agreement on Agriculture, but they would love to have such an entitlement today (China and India are obvious examples where both countries are currently alleged to exceed their current *de minimis* limits on trade-distorting support). One might not be surprised if some objections were raised from these quarters to the idea that the UK would be entitled as of right to a BTAMS.

The second part of your question asks whether, after the planned withdrawal, there could be a potential conflict for the UK continuing Pillar I and Pillar II schemes if the UK does not get access to a share of the EU's AMS? In my view, this would not be the case. The great bulk of these payments are made up of the Basic Payment Scheme, agri-environment payments and payments to areas facing natural constraints, all of which are reported by the EU as Green Box payments and thus not disciplined by WTO rules. The limited amounts of trade-distorting support (mainly provided by the devolved governments) would easily fit within the UK's *de minimis* limits. The issue is what happens after 2020 if the UK Government decides to eliminate the Basic Payment Scheme and some UK administrations then wish to increase, for example, coupled payments to farmers or use other forms of trade-distorting support. Although the UK's de *minimis* limits would seem sufficiently generous (http://capreform.eu/establishing-the-uks-non-exempt-limit-on-agricultural-support-after-brexit/), it would need further work to say this for certain.

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[i] https://www.gov.uk/government/publications/notice-828-tariff-preferences-rules-of-origin-for-various-countries/notice-828-tariff-preferences-rules-of-origin-for-various-countries.

[ii] Abreu, M. (2013), Preferential rules of origin in Regional Trade Agreements, Staff Working Paper ERSD-2013-05, Geneva, World Trade Organisation (this also gives the reference to the World Bank study)

[iii] see Bureau, J., Chakir, R. and Gallezot, J. (2007), The Utilisation of Trade Preferences for Developing Countries in the Agri-food Sector, Journal of Agricultural Economics 58, 2, 175-198.

[iv] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+WQ+E-2016-003627+0+DOC+XML+V0//EN

[v] https://www.wto.org/english/tratop_e/schedules_e/goods_schedules_e.htm

[vi] David Allen Green has a good article on this 'Brexit and the issue of the WTO schedules' in the Financial Times 28 February 2017 https://www.ft.com/content/42b59126-794c-3a0b-b19a-6d4b0a11c990

[vii] http://ec.europa.eu/taxation_customs/dds2/taric/taric_consultation.jsp?Lang=en

[viii] http://capreform.eu/wto-dimensions-of-a-uk-brexit-and-agricultural-trade/ and http://capreform.eu/uk-brexit-and-wto-farm-support-limits/.