



Research for new economic policies

NERI Working Paper Series

Northern Ireland, the Republic of Ireland and the EU Customs Union

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August 2017

NERI WP 2017/No 47

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Northern Ireland, the Republic of Ireland and the EU Customs Union

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Keywords: Brexit, Trade Policy, Tariffs, Rules of Origin

JEL Codes: F02, F10, F13, F15

ABSTRACT

The EU Customs Union was one of the first and most significant steps toward economic integration on the continent of Europe. Following the decision of voters in the United Kingdom to leave the EU, the UK government has indicated that it also intends to leave the customs union. This decision poses a number of challenges for the economy of Northern Ireland given the land border with the Republic of Ireland and for the economy of the Republic of Ireland itself given the level of trade with both Northern Ireland and Great Britain.

The role of the Customs Union and subsequently the Single Market in removing barriers to trade among EU member states has been crucial to the establishment of an ‘all-island economy’ on the Island of Ireland. A Comprehensive Free Trade Deal between the UK and the EU could maintain some of these gains, but the nature of the Customs Union means that a significant level of disruption may be unavoidable. This paper looks at the impacts of the UK leaving the Custom Union for trade on the Island of Ireland and looks at what post-Brexit policy options are available to avoid such disruption. The Brexit process is likely to culminate in identifying the least worst option which is politically acceptable to all involved.

This version: 4 August 2017

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1. INTRODUCTION

Following a national referendum in June 2016 the UK government invoked Article 50 of the Lisbon Treaty on the 29th of March 2017. Article 50 is the formal procedure whereby a member state of the European Union begins the process of leaving the bloc. Whilst certain political parties and civil society groups have pressed for a further referendum before the UK formally leaves the bloc, it is expected that the UK government will complete the exit process. While the initial stages of the Article 50 process will involve extricating the UK from EU structures, much attention has been focused on what trading relationship will exist between the EU and the UK once the process is finished. The negotiations are still at a very early stage but the UK government has already expressed a broad outline of what it hopes that future relationship to be.

The UK Prime Minister Theresa May set out the UK government's position in a speech at Lancaster House on the 17th of January 2017. The speech stated that the UK government intends to negotiate a Comprehensive Free Trade Agreement (CFTA) with the European Union but, importantly, the UK will not retain membership of either the EU Single Market or the EU Customs Union. If this remains the case, the future trading relationship between the UK and the EU will likely be more distant than previously envisaged and more peripheral than most non-EU European economies such as Norway, Switzerland or even Turkey. The Single Market and the Customs Union represent the two most significant phases of European economic integration, but both can accommodate members from outside the EU. For example, it is possible to be a member of the Customs Union but not the Single Market (Isle of Man or Monaco). Equally, it is possible to be a member of just the Single Market but not the customs union (Norway or Iceland).

The customs union was established under the Treaty of Rome in 1958 and formed the centrepiece of the new European Economic Community. Although a gradual process, it was created to eliminate customs and duties on goods traded between members and to impose a common external tariff on goods imported from outside the union. The Single Market represents an even deeper form of integration. A common market is one in which people, goods, services and capital

can move freely between member countries. A Single Market has harmonised regulations for product standards, professional qualifications and other indirect barriers to trade.

Whilst the Single Market has been quite effective in boosting the trade in services it also removed many of the non-tariff barriers that hindered the trade in goods. The Single Market is a complex web of agreements and directives and therefore partial access to the Single Market is possible. Switzerland for example has numerous sectoral and industrial agreements that grant almost full access to the single market and the proposed Free Trade Agreement (FTA) between the EU and Canada will give it preferential access in a number of sectors. The UK government White Paper on Brexit (DEXEU, 2017) makes it clear that while the UK will leave the Single Market it will seek to retain the access in a number of key areas. It is envisaged that, as the UK already shares the EU's common regulatory framework, this agreement would be different to the EU's existing FTAs where access can be limited due to conflicting national regulations and standards.

Whether the UK will succeed or not in gaining preferential access to the Single Market will be a matter for the negotiations and a large range of outcomes are possible in this regard. The same cannot be said for the customs union. In contrast to the Single Market, the customs union is an older, simpler form of trade harmonization. It also tends to be a binary option; a country is either a full member or it is not. The UK government's White Paper on leaving the EU does not explicitly state the intention to leave the customs union but rather implies that a range of customs options are available to it, without specifying what any of these options might be. It is true that there are a number of customs arrangements that the UK could agree with the EU, but only one of those options, the status quo, involves full participation in the Customs Union. All other customs options would represent a significant departure from current arrangements.

Importantly the White Paper also notes that leaving the customs union will pose unique challenges for businesses operating in Northern Ireland (NI) and that the government should seek to limit any such disruption. This same disruption will apply equally to firms in the Republic of Ireland (ROI) that will be impacted through trade with NI but also through trade with Great Britain (GB). Leaving the customs union poses many challenges including the introduction of tariffs between the UK and the ROI and a divergence between the external tariff schedule of the UK and the EU. The ROI, NI and UK have dynamic, triangular trading relationship at present and membership of the customs union, and the EU, has strengthened that and so Brexit and the UK leaving the customs union threatens each facet of that relationship.

This paper seeks to explore how the United Kingdom's (UK) exit from the EU Customs Union may impact on trade for both economies on the Island of Ireland. Section 2 will review some of the existing literature on the economic impacts of customs unions and whether it can provide any

indication of what could be expected from the UK's departure. Section 3 will look specifically at the Island of Ireland, outlining how an exit from the customs union will impact on the current arrangements. The two main avenues of disruption identified are a divergence in tariff schedules between the UK and the EU and a change in external tariff schedule by either the UK or the EU. Section 4 looks at strategies and arrangements that could mitigate or avoid this disruption and section 5 concludes.

2 . ECONOMIC IMPACT OF A CUSTOMS UNION

For both NI and the ROI it would difficult to isolate the economic impact of membership of the customs union by looking at the change in trade flows over the years since 1968. This is because trade between the UK, the ROI and the EU has also benefited from the incremental economic integration that eventually culminated in the creation of the Single Market. Furthermore, in the years since the establishment of the customs union, trade beyond the EU has undergone significant liberalisation under various rounds of General Agreement on Trade and Tariffs (GATT) and subsequently the World Trade Organisation (WTO). Examining the theoretical underpinning and the role that customs unions have played in trade liberalisation around the world can help to understand the distinct contribution of the EU Customs Union and what may lie ahead.

Why a Customs Union?

In general, the literature on customs unions focuses on the impact that a customs union makes to the level of trade between members inside the union and the level of trade between members and non-members. Olarreaga et al (1999) outline two reasons for the formation of a customs union, the terms of trade approach and the endogenous tariff formation theory. The first describes a situation where countries with a similar trade profile band together in order to gain market power, the larger the economic bloc the greater its influence in setting international prices. The second focuses on the formation of a customs union as a way of diverting income towards particular groups or lobbies in the protected country. While the two theories differ, they are not mutually exclusive. This literature does prove somewhat useful in assessing how the current EU Customs Union came about and the reasons why the UK should want to either leave the customs union or remain in it. Many proponents of Brexit have argued that the protectionist nature of the EU, set out in the customs union, favoured other European countries over the UK. As the following paragraphs will show that sentiment has been a recurrent theme in customs unions internationally.

There is also a broad literature on whether a country should or should not join a customs union based on the welfare impact for member countries. The historical experience of customs union formation will show that the scale and scope of these impacts is very much dependent on the dynamics of the trading relationship that already exists between prospective members. Viner (1950) developed a simple method for evaluating whether or not a country should join based on the cost of trade diversion versus the benefit of trade creation. Joining a customs union favours fellow members over non-members and this brings negatives and positives with regard to trade. Johnson (1998) maintains Viner's original formula for customs union formation but details the complexity involved in actually estimating the various trade diversion and creation effects, mostly on the basis that trade creation can also give rise to diversion and vice versa. The multitude of knock-on trade effects from the formation of a customs union make any assessments of welfare impacts highly questionable.

Berglas (1979) challenged the theoretical benefits of a customs union by comparing it with what could be achieved through unilateral tariff reduction. The hypothesis was that the trade benefits from a customs union could be achieved through a strategic reduction in tariffs without the loss of sovereignty inherent in a customs union. However, as Wonnacott and Wonnacott (1981) pointed out much of the theory behind unilateral tariff reduction ignored how other countries would respond in terms of their tariff regime and transportation costs which are key considerations in the formation of regional trade agreements. They still see the balance between trade diversion and creation as the key consideration for determining whether a country should join a customs union or not.

When a customs union should be formed and how membership should be determined are areas of contested research. However, there is more agreement on the benefits of a customs union once it is in place. Gnutzmann and Gnutzmann-Mkrtchyan (2016) claim that despite the lobbying and distortionary impacts of customs unions, they lead to higher welfare than any other bilateral trade agreement. Park and Park (2008) use gravity regression to show that customs unions among East Asian economies would lead to higher welfare and output than a Free Trade Agreement and that a customs union is not only the most desirable outcome for the economies involved but also for the world economy. Fortunately, there are examples of customs unions over the last century and a half which can test these theories.

A History of Customs Unions

Westrate (1948) notes that before the onset of the rampant protectionism of the 1930s, customs

controls were the main barrier to trade between countries and so a customs union between two countries effectively made them one economic bloc. Therefore, a customs union was the most significant form of economic integration that two countries could undertake. Ploeckl (2010) outlines the history of the Zollverein, a customs union between German states, which began as a process of harmonizing customs arrangements between Prussia and the new territories assigned to it following the conference of Vienna in 1815. The process then involved regional customs unions between states that eventually joined together culminating in one customs union by 1834. Ploeckl emphasises that the process was not a multi-lateral agreement, but a sequential process whereby a series of regional agreements merged into one union. This is important because it reflects the experience of the creation of the EU Customs Union which began with six countries coming together to agree limited customs arrangements on certain goods (coal and steel) and eventually broadening that arrangement in terms of both goods and members. It is also worth noting that the Zollverein was also a process of aligning the economies of the German states which ultimately culminated in the creation of the German Empire in 1870. Whilst a customs union did not create the German Empire it shows that a customs union can be a prelude to greater economic and political integration.

The Southern African Customs Union (SACU) formed in 1910 was a regional agreement between South Africa and three High Commission Territories (HCT), Basutoland (Lesotho), Swaziland and Bechuanaland (Botswana). The 1910 SACU removed all internal tariff barriers and imposed a common external tariff which though collectively agreed amongst the members tended to follow the lead of South Africa. As McCarthy (2003) notes, the 1910 SACU also included a provision for revenue sharing from centrally collected tariffs. Excise duty was also divided among members at a fixed percentage rather than as proportion of the overall trade which was unusual at the time. McCarthy notes that it was the strong intention of South Africa that the three High Commission Territories would become fully integrated into the Union of South Africa as they were almost completely economically dependent on it. This is similar to the role that Prussia played in the unification of German states. However, in the case of South Africa, as McCarthy notes, the imposition of the Apartheid system eventually made that impossible.

The 1910 SACU was replaced in 1969 by a new SACU union to reflect the fact that the three High Commission Territories had received independence from the British Empire. Landell-Mills (1971) notes that the British had, before independence looked into the idea of the three HCTs adopting their own customs system. The British report and the report of the post-independence government of Botswanan both judged that the level of customs revenue that could be raised independently would not be larger than that received under the existing customs union

Agreement, and that there would be an additional cost to developing independent custom controls. However, where governments did find fault with the 1910 agreement was the fact that the level of revenue generated from tariff remained fixed even if the volume of trade increased in one country over another. It was this issue which dominated negotiations for the second SACU and subsequent revisions to it up until the new agreement in 2001. At all stages in all negotiations the collective view amongst the former HCTs was that whatever the costs of membership of the customs union was, the costs of leaving it were far more severe due to their economic dependence on South Africa. As Kirk and Stern (2005) point out, while the 2001 agreement does include a better deal on revenue distribution, it entrenches the economic dependence of the four member-countries and South Africa.

Another point that should be mentioned in any evaluation of the SACU is that whilst it did not develop into a full political or economic unit as happened in Germany, it did create a monetary union. The Common Monetary Area was informally in existence since 1921 as the South African pound (subsequently the Rand) was the effective solo currency among members of the SACU (Harris et al, 2007). This was formalised among all members in 1974, but Botswana left the CMA in 1976.

Mercosur, or the Southern Common Market, is a regional economic agreement between Argentina, Brazil, Paraguay, Uruguay and Venezuela first agreed in 1991. Whilst the gradual removal of internal tariffs began in 1991, the adoption of a common external tariff did not begin until 1995. Mercosur is the most well known and most enduring but not the only regional economic block in South America. The first attempt at regional integration, as Mothiane (2015) points out, was the Latin American Free Trade Agreement (LAFTA) between Argentina, Brazil, Chile, Mexico, Paraguay, Peru, Uruguay Bolivia, Colombia and Ecuador signed in 1960. The Agreement fell apart mostly due to the fact that the eradication of internal customs did not apply to all goods and that goods considered as 'sensitive' for a particular member were exempted. This led to tension between members largely to do with the import substitution policies of the larger members, with smaller members feeling that they were receiving little benefit from the arrangement. The LAFTA split along these lines in in 1969 with the formation of the Andean Pact amongst the smaller members of LAFTA. The Latin American Integration Association attempted to resurrect regional integration in 1980, but this failed largely for the same reasons as LAFTA.

It is in this context that Mercosur was initiated, with most of the remaining LAFTA members, many of whom had only recently transitioned back toward democracy. Laird (1997) notes that while intra member trade did increase significantly in the early years, trade was already on the

increase between members and some of the largest increases were in goods that tariff reductions did not apply to. Mercosur initially did allow national exceptions to the CET, but these were not of the same order as previous agreements, and as Branddo et al (1997) point out the elimination of almost all intra member tariffs has been the real success to date. However, both Crawley (2004) and Mothiane (2015) note that one of the real and continuing weaknesses of Mercosur is the lack of institutional efficiency and that this is most likely preventing the bloc from achieving its full potential.

Another more recent event in customs union formation was the Agreement reached between Turkey and the European Union in 1996. This agreement was a culmination of a series of attempts at European economic integration with Turkey that began in the 1960s but was boosted when Turkey began to liberalise its economy in the mid-1980s. The customs union with Turkey involved the elimination of all intra-union tariffs, adoption of the CET and the adoption by Turkey of all EU preferential trade agreements with third countries. To say that Turkey is a member of the EU Customs Union is slightly misleading, Turkey acts as if it is a member but in reality, it has no power to affect outcomes of the EU's trade negotiations in its favour. The EU-Turkey customs union is an unbalanced arrangement and that is only sustainable because it was seen as a precursor to full EU membership. Mercenier and Yeldan (1997) argue that the current customs union arrangement is partial trade integration and that only when non-tariff barriers to EU trade are removed will Turkish households see the full benefit of liberalisation. Togan (2012) notes that there has been a substantial cost to Turkey, administratively and otherwise, from implementing the agreement and this was justified at the time as a price worth paying for EU membership.

As set out in the introduction, the EU Customs Union was the first and most significant liberalisation of the trade in goods across Europe. Whilst the customs union was 'completed' in 1968, customs border posts remained between EU countries up until 1993. This was because whilst internal tariffs had been removed and a common external tariff was in place the Treaty of Rome allowed member states derogations on the basis of certain national interests. This meant that member states could still impose quantitative restrictions on the movement of goods for a number of reasons. Furthermore, customs laws were not centralised and so the movement of goods was still subject to the restrictions of national regulations. As Limbach (2015) notes, the restriction on goods coming into the customs union received far more attention than the free movement of goods between the member states. All remaining restrictions on the free flow of goods within the EU were removed with the creation of the single market but this was largely achieved through the adoption of the Community Customs Code a year previously.

Lessons from history

The historical perspective on customs unions provides some interesting insights into the current Brexit situation for the UK and the ROI. The Southern African experience showed that membership of a customs union can entrench trade dependencies, meaning that as the time spent within a customs union increases so too does the trade dependency. For Ireland, this has meant that whilst the UK is still its most important trading partner, membership of the EU has made the UK relatively less important, and is the reason why there is currently no serious political effort for the ROI to follow the UK out of the EU or the customs union. Whilst the Ireland's membership of the EU was seen as co-dependent on the UK's membership in the 1960s and 70s, the experience of being in the EU and the customs union has changed these circumstances. This is a frequent argument of those who believe that the European trade lost by the UK leaving the customs union could easily be replaced by trade opportunities that were forgone over previous decades.

Making exemptions and designing optouts weakens the integrity of a customs union as the case of LAFTA and the 1910 SACU show. This is important for the Brexit debate and those who seek to argue that the issue of the Irish border should be solved through flexibility in the current custom union. Flexibility may be in the interests of trade on the Island of Ireland but it may not be in the broader interest of the EU Customs Union.

Both the Southern African and the Turkish experience along with Imperial Germany show that for the most part a customs union is meant to be an initial stage of greater economic integration. Along with the experience of Mercosur they also show that there are significant disadvantages to a customs union where there is a significant power imbalance, economically or politically between neighbours. What stands out from the EU experience of customs union is its relative stability and cohesion. This is mostly because the EU followed the theoretical prediction that a customs union, if fully implemented, would encourage members to gravitate toward full economic and political union. This also has important implications for post-Brexit policy with regard to the customs union and section 4 will bear this out. The following section looks at the economic impacts of leaving the customs union for the Island of Ireland and how these impacts will affect the same policy challenges.

3 . LEAVING A CUSTOMS UNION

There is not a large volume of research assessing the economic impact of leaving a customs union, for the most part, because there have been few historical examples of countries leaving a customs union. As mentioned in the preceding section both SACU and Mercosur have seen departures of member countries with differing impacts, but the economic motivations for these departures

were very different to the case of the UK. There is also a literature covering the impacts of the formation of a customs union on non-members, particularly the trade diversion impacts. However, these studies tend to focus on the impacts for countries that have never been members of the customs union rather than ex-members.

In terms of members of customs unions that have left, there are very few examples that hold any significance for the UK. This is quite simply for the reason that in most cases, a member has left a customs union because the existing arrangements were either disadvantaging that member or skewed in favour of another member. The split in the LAFTA and Botswana's exit from the SACU respectively provide examples of these. It would be difficult to argue that either of these situations applies to the UK at present. In fact, most arguments for the UK leaving the customs union are premised on the idea that there are large trade gains available to the UK, that are currently not available or not in the interests of the EU as a whole. Under this assumption it is therefore very difficult to assess, based on historical examples, what the impact of leaving the customs union could be for the UK.

For the ROI, there is even less literature exploring what the impacts of one member leaving a customs union might have on another. This follows the logic of the preceding paragraph, that if it were in the interests of one member of a customs union to leave, it would most likely also be in the interests of that member's closest trading partner to do likewise. Therefore, there is little evidence with which to make a prediction about the likely impact for the ROI.

In terms of the impact of a customs union on non-members, the evidence is mixed. Schiff and Winters (2003) summarize the literature and they do find trade diversion between members and non-members in customs unions, but the effect is small. Estevadeordal, Freund and Ornelas (2008) suggest that this is because whilst a common external tariff may divert some trade from non-members to members, the costlier aspects of this diversion will induce the members of the customs union to lower the tariff in order to re-establish some trade flows with non-members. However, there is still some trade diversion and intuitively this makes sense. For members of a customs union, one member's trade diversion is another's trade creation. What one member loses in the forfeiture of cheaper imports from a non-member, it must gain in the form of increased exports to a fellow member. Absent this virtuous circle, the customs union does not pass a basic cost-benefit analysis. In the context of the UK's exit from the EU Customs Union, there is little incentive for the EU to impose a large tariff barrier with the UK, however it may equally be in their interest to impose a small one.

In the broadest terms, there is scope for a negative impact on the island of Ireland through two channels; the trade between NI and the EU including the ROI and the trade between the ROI and the UK including NI. Theoretically, NI could gain from new trade deals signed by the UK in both imports and exports. Theoretically, the ROI could experience a gain if EU members substitute Irish imports for those they currently import from the UK. Both these gains are likely to be significantly smaller than the loss from a disruption in the trade relationship with their largest export market. Both will also only have token influence on the parties that will ultimately determine that settlement. Whilst there is a myriad of factors to be considered in assessing the economic impact, the bulk of disruption is likely to come from the two central pillars of the customs union; the internal tariff regime and the common external tariff.

Internal Tariffs

The UK government's white paper on Brexit set out that, whatever the final agreement regarding the EU Customs Union, their intention is to continue the 'zero tariff' arrangement that currently applies to goods traded with the rest of the EU. This intention is theoretically compatible with a UK exit from the EU Customs Union. As set out earlier, in purely economic terms, it may be in the interests of some EU economies to have a small external tariff with the UK, but such urges could be overcome through political negotiation. However, as the Brexit negotiations have begun, the UK government has also let it be known that they reserve the right to walk away from the negotiation if they feel that the deal on offer from the EU is suboptimal. If the UK were to leave the EU, and by extension the customs union without a deal, the trading relationship between the UK and the ROI would be changed completely.

In this scenario, the UK would be subject to the full common external tariff of the EU. As members of the WTO the UK would trade under the EU's most favoured nation schedule of tariffs, but even these would pose some significant challenges for trade, particularly between the UK and the ROI. The average most-favoured nation tariff rate on imports into the EU can be as high as 33.5% for dairy products or 19.4% for beverages and tobacco. Within these groupings there are large variations and the effective tariff across industries will vary widely. This schedule of tariffs looks even more challenging when set alongside the sectoral breakdown of exports from the ROI to the GB and NI, and the exports from NI to the ROI. Lawless and Studnicka (2017) modelled this scenario under the assumption that the UK would apply the same schedule of WTO tariffs to goods imported from the EU. They found that a WTO scenario would impact NI trade with the ROI most (-11%). The ROI's trade with NI and GB reduced equally by 8%. However, as the level of trade between the ROI and UK is much larger in volume terms than that with NI, the impact of the

former would have the largest impact in monetary terms.

External Tariffs

A key assumption in the Lawless and Studnicka (2017) analysis was that the UK would continue to maintain the EU's common external tariff (CET). This is indeed one option for the UK and subject to agreement by the WTO, the UK could retain most of its current external tariff schedule. However, the UK could also seek to adopt a schedule of tariffs that is on average either higher or lower than the existing EU CET. A lower average CET is unlikely but as the UK wishes to increase its trade with the rest of the world more generally upon leaving the customs union, it may decide to unilaterally adopt a lower common external tariff in advance of any new bilateral trade deals. This would follow the logic of Berglas (1979) but as Wonnacott and Wonnacott (1980) point out this only works if other countries respond in kind. Furthermore, with regard to possible future Preferential Trade Agreements (PTA), the greater a tariff reduction one has to offer a third country, the greater the reciprocal reduction one can expect.

The option of a higher average UK CET is even less likely but still plausible if the UK decides to opt for a more protectionist approach to trade and imposes a higher trade barrier on goods from the EU and the rest of the world. Getting agreement for such a measure at the WTO would be difficult but it could enable the UK to sign better PTAs as it would have greater tariff reduction to offer any prospective partner.

For NI and the ROI the impacts of these arrangements are different but share some common outcomes. The loss to trade outlined in Lawless and Studnicka can be considered a baseline level disruption to trade on the Island of Ireland. If the UK decided to put in place a schedule of tariffs, on average higher than the current EU schedule, the ROI suffers more than under the baseline scenario and NI is not impacted from its baseline loss of trade to the ROI. If the UK puts in place a schedule that is on average lower, the benefit of reduced tariffs for the ROI is moderated by the benefit that non-EU countries gain in trade with the UK. Under this scenario, the ROI might face lower tariffs for its exports of dairy produce to NI or UK, but so too would countries such as Argentina and New Zealand. For NI, a lower CET could result in increased competition for the domestic market and sales to UK from countries such as Argentina and New Zealand who have heretofore had to trade with the UK under the EU CET. The situation becomes more serious for both the ROI and NI if the UK decides to sign new PTAs with either of these countries.

It is quite likely, as Lawless and Morgenroth (2016) point out that, in the interim at least, the UK

may adopt the EU's common external tariff. However, it is almost inevitable that the UK would seek to make preferential trade deals with the US, India or China in this scenario, given that these new trade deals are the main political motivations for leaving the customs union. Even if the possibility of internal tariffs is removed under a zero-tariff CFTA between the UK and the EU this does nothing to address the trade diversion from third countries. If the UK signed a PTA with Argentina which resulted in its beef enjoying the same terms of access to the British market that EU countries currently enjoy, this could be as damaging to the ROI's beef trade with the UK as a WTO scenario described in Lawless and Studnicka. This is because in effect, the two scenarios achieve the same outcome, a level playing field between Argentina and the ROI in terms of tariff treatment. The impacts of PTAs for NI are similar to those raised by a lower UK CET. If the UK signs PTAs with countries with significantly cheaper agricultural outputs, NI could lose out in terms of the domestic market and its own internal trade with UK.

How tariff quotas are worked out in any of these PTAs is extremely important and existing business links, non-tariff barriers and marketing could stem some of the losses, but significant disruption is almost unavoidable. Whilst the prospect of an internal tariff barrier between the UK and the ROI is very worrying, changes to the CET and PTAs can be equally as disruptive. Even in more benign scenarios, external trade arrangements can pose further problems for NI and the ROI as the following section discusses.

Rules of Origin

Beyond the trade diversion that might occur from changes to the UK CET or PTAs, there are further issues of concern with regard to trade beyond the EU. As mentioned earlier a zero-tariff CFTA between the UK and the EU will regulate trade between the EU and the UK but it is very unlikely to have any impact on trade that the EU and the UK have with third countries. This means that goods from third countries will potentially enter the UK and the EU under different tariff arrangements. The trade in third party goods between the UK and the EU may not seem large enough to pose a major problem for UK-EU trade, but the nature of the modern manufacturing process means that goods traded between the UK and the EU may contain component parts from beyond both. In this case it is common practice for countries or trading blocs to have a system of Rules of Origin (RoO) which govern how such goods are treated for tariff purposes. At the most basic level any RoO will specify either of the following determine whether a good would qualify it for third party tariff treatment;

- the proportion of third country inputs in a good or;

- where the good underwent its last substantial transformation.

Mirus and Rylska (2001) posit four negative effects of RoO in creating disruption to trade. This first is trade distortion, firms are more likely to use domestically produced and more expensive inputs, creating an import substitution effect. Secondly firms operating in different countries may face different tariff regimes based different RoO that apply in that country, creating price distortions for what is essentially the same product. Thirdly, RoO, like any trade barrier, are open to lobbying and interference with interest groups vying for different definitions in order to disadvantage competitors. Finally, RoO are also quite complex and dealing with them can add significantly to business costs. In discussing whether the North American Free Trade Agreement (NAFTA) should become a customs union, Georges (2007) shows that any loss to Canada from having to apply a CET with the US is more than made up for by the gains to trade from eliminating RoO between the US and Canada.

The rules of origin system itself does not pose an insurmountable challenge for businesses and it has long been a feature of global trade. There are measures that can be taken to mitigate the worst impacts. Ironically if the UK does not sign a trade deal with the EU, then RoO become quite a simple matter. RoO are in the first instance preferential or non-preferential depending on whether the countries involved in the trade have a PTA. If there is no PTA, no tariff reduction is in prospect and the goods are simply subject to a CET. Non-preferential RoO are therefore only used if it's possible that goods fall outside of Most-Favoured Nation status or are subject to non-tariff barriers (Satapathy, 2006). If a PTA exists between the two countries, RoO are used to establish whether the origin of the good qualifies it for tariff reduction or elimination under the terms of the PTA. If the good does not qualify for preferential tariff treatment it is subject to the CET of that country or bloc.

In the case where two countries have a PTA, distortions can arise if there is a difference in how the origin of a good is determined. If the RoO in one country allow tariff free access for a good, but the RoO in the other country do not grant the same treatment, significant trade distortions can arise. In a PTA, it is therefore necessary to have contractual, reciprocal preferential rules of origin to eliminate the trade disruption that might occur from difference in RoO between the UK and the EU. This may not be as intuitive as it sounds. Once the UK gains control of policy in this area there may be intense pressure to use RoO to aid domestic producers or offer preferential access to non-EU countries. This could cause significant disruption to trade and would increase the need for more intrusive enforcement of RoO on borders.

The possibility of tariffs applying to composite goods can also be ameliorated through a system of cumulation. Cumulation allows for partners in a PTA to allow inputs from other countries to be used in production processes without causing the final good to lose its origin status. Full cumulation would allow value added production in a range of partner countries without sacrificing origin status. However, as noted earlier, RoO are complex and Satapathy (2005) argues that whatever full cumulation gives in terms of evasion of tariffs, it takes away in terms of bureaucracy and increased compliance costs. Furthermore, whilst cumulation and reciprocal RoO may make things easier for cross-border trades on the Island of Ireland, there is no evidence that these measures or any other in practice can eliminate the need for a physical border presence of some kind.

Norway and Sweden, both members of the Single Market have a customs frontier because Norway does not participate in the customs union. While it is true that Norway also does not participate in all areas of the single market, border fortifications are most necessary for customs controls. One of the key differences between compliance with the single market and compliance with the common external tariff is that the CET is a revenue issue. This poses a significant challenge for the Brexit negotiations. Maintaining the current border between ROI and NI is a central part of the current UK government Brexit strategy. However, if the UK, including, NI, leaves the customs union there will be a border of some kind on the Island of Ireland. How the Brexit negotiations will deal with this central conflict is crucial and the following section sketches out how that might occur.

4. POLICY OPTIONS

The stated aim of negotiators of both the UK and the European Commission is that the Brexit process should preserve in so far as is possible the trade links and supply chains on the Island of Ireland and with that avoid the reintroduction of a physical border. While the Single Market is very much a part of that debate, the customs union will play a key role in the success of this ambition. In the period since the Brexit referendum there have been many policy options proposed that seek to avoid creation of a border and disruption to trade on the Island of Ireland. Many of these policy options are tied up with considerations of the single market and many other facets of European integration. These are too varied and numerous to give full consideration to in this paper. With regard to the customs union however, there are four scenarios for the ROI and the UK post-Brexit. This section will assess the likelihood of these possibilities and how the issue of all-island trade and the border could be managed in each one.

1. The UK including NI leave the customs union.
2. The UK including NI remains in the customs union.
3. NI alone remains within the customs union.
4. The ROI leaves the customs union.

These scenarios are presented in the order that they are likely to happen. To begin with least likely outcome, scenario 4, the ROI would leave the customs union and adopt a UK CET. This would maintain frictionless trade with both NI and UK for the ROI but at a cost to trade with the rest of the EU. No territory that was once part of the EU Customs Union has left without first leaving the EU and so this scenario would almost inevitably involve the ROI leaving the EU. While this option has received backing from some former policymakers, it is highly unlikely to occur. While the UK is the ROI's largest trading partner for goods, it is only marginally ahead of Belgium and the total EU goods trade for the ROI is far larger than that of the UK alone. For this and many other political reasons, the ROI leaving the customs union is an almost implausible scenario.

Scenario 3 gained some traction in the early part of 2017 and then again in the summer of 2017 with many policymakers arguing that it would make sense for NI to remain within the customs union, if and only if the UK as a whole agreed a zero-tariff CFTA with the European Union. In these circumstances, it would be argued that the rules of origin border checks would be more easily administered between NI and the rest of the UK at sea and air ports rather than on a land border on the Island of Ireland. While there is some logic to this scenario, it faces two significant challenges. The first problem is similar to that experienced in scenario 4, in that whilst the ROI is a very important market for NI, it is less than a fifth of NI's total sales to the rest of the UK. Whilst administering RoO checks at ports may be easier, the total volume of goods that would face disruption is so much larger, any perceived benefit to trade with the ROI may be offset by the level of disruption to trade with UK. The second problem with this scenario is political. It is unlikely that political parties that favour the union between NI and the rest of the UK would countenance any kind of border between both territories, particularly in order to attain closer access to the ROI.

Whilst the UK government has indicated that it is its intention to leave the EU Customs Union, the White Paper on Exiting the EU does not explicitly state this. Therefore, it is conceivable that the UK as a whole may seek to remain in the EU Customs Union post-Brexit. Scenario 2 may seem like the cleanest and most simple arrangement to avoid a border and retain custom free trade between NI and the ROI. However, this option is not as clear cut as it first seems. As discussed previously, the EU Customs Union as it currently exists is not what it was when completed in

1968. The customs union and the benefits that flow from it have become entwined with the Single Market and other facets of European integration so that for the UK to retain 'membership' of the customs union alone is not immediately straightforward. As mentioned in the introduction Turkey participates in the EU Customs Union, but its membership should not be conflated with the membership enjoyed by EU member states. Firstly, the customs union between Turkey and the EU does not cover Agriculture (except processed agricultural products). Turkey applies the common external tariff for goods covered under the customs union and has amended its laws to reflect the Union Customs Code (UCC) which means that it has aligned customs procedures including rules of origin to those of the EU. This is different to being a party to the Union Customs Code and at present, provisions of the UCC are still being extended to cover Turkey. For example, a 2016 agreement was brought in to align 'Generalised System of Preference Rules of Origin' between the EU and Turkey. The UCC is as important as the CET with regard to maintaining frictionless trade on the Island of Ireland, one would be of little use without the other.

Turkey has also amended its laws to reflect the EU's Common Commercial Policy, in essence deferring to the EU's trade policy, with minor exceptions for limited regional trade deals which Turkey has signed. However, while Turkey must accept imports from third countries on the basis of EU negotiated trade deals, its goods do not necessarily gain the same access to third country markets as those emanating from the EU. There is not automatic extension of the EU's trade deals to Turkey and it must negotiate a parallel deal to gain the same trading rights. Yilmaz (2011) suggests that while the initial years of the customs union arrangements were good for the Turkish economy in terms of boosting competition in the domestic market, changes to the EU's trade strategy have called the future of the agreement into question. The shift in the EU in 2006 towards Free Trade Agreements with Asian economies presents a dilemma for Turkey, if EU membership is still in prospect, then maintaining the customs union is sensible. If EU membership is not in prospect then a EU-Turkey Free Trade Agreement would appear to be more welfare enhancing, in order to allow greater exploitation of third country trade by Turkey, particularly in Asia.

Whilst this shows that membership of the customs union outside the EU is possible, it also shows that that relationship is deferential to the EU and suboptimal to the form of membership that the UK currently enjoys. It is possible that, because the UK is currently a full member of the customs union, it can expect a better deal than that enjoyed by Turkey. The customs union negotiated between the EU and Turkey was unbalanced because the EU held out the prospect of EU membership. That will not be the case with UK negotiations. The UK could conceivably improve on the Turkey arrangement by gaining full reciprocal trade status within a UK-EU customs union if the UK became a party to the common commercial policy. The example of the Isle of Man may

be more instructive in this case. The Isle of Man is a dependency of the British Crown, but not part of the UK and therefore in no way a member state of the EU. However, the Isle of Man is part of the Customs Territory of the EU as set out in the UCC. While it is subject to the Common Commercial Policy (CCP), the Isle of Man neither transfers nor receives funds from the EU (IOMG, 2016). This arrangement is aided by a customs union that the Isle of Man enjoys with the UK and so in most matters, the Isle of Man acts as if it were part of the UK. The Isle of Man is treated as a part of the VAT territory of the UK and therefore also part of the VAT territory of the EU. This arrangement allows full membership of the customs union, without the applications of any other rules of the EU and would provide the most practical route for the UK's continued membership. Whether this arrangement would be agreeable to the EU will be the subject of negotiation.

This leaves scenario 1, in which the UK has left the customs union, and the limited options available to avoid customs and border disruption on the Island of Ireland. Once again, borderless solutions are only possible in this scenario if the UK agrees a zero-tariff CFTA with the European Union. It would be possible under these circumstances for the UK not to enter a formal customs arrangement with the EU but maintain existing external trade regulations in order to preserve frictionless trade. This would involve the UK unilaterally adopting the EU CET, maintaining and updating the UCC in UK law but importantly would not include the common commercial policy. This would mean that the UK would maintain much of the infrastructure of the customs union but not necessarily be party to any of the other structures of the EU. The UK would technically be able to make third country trade deals independently in this scenario but any trade deals that it made that were manifestly different to the EU in terms of tariffs would wipe out the benefit of frictionless trade on the Island of Ireland.

The case of Greenland may be instructive for the UK in the case of scenario 1. Greenland left the EU in 1985, but remains an Overseas Territory of the EU because of its relationship with Denmark. Greenland is not in the Single Market or the customs union, but it does apply the EU CET. It also enjoys non-reciprocal trade regime which allows unlimited duty-free access for its fisheries into the EU market, which could be a model for agricultural produce in the UK's case. Greenland does not implement either the UCC or the CCP. In order to avoid customs checks, the UK would have to be willing to adopt the UCC so scenario 1 would actually be a closer form of association than Greenland. In essence, the UK would have the power to make its own trade deals but would only use this power in limited circumstances.

As mentioned previously even though Turkey applies the CCP, it has to negotiate its own free trade deals with third countries in order to gain the same access rights as EU members states.

Under scenario 1, if the EU signs a new trade deal with a third country, the UK would not have to open its markets until it secured reciprocal rights from that third country. However, it should be emphasised that if the outcomes of the UK's negotiations are materially different to those of the EU, maintaining an open border between the UK and the EU becomes untenable. The danger in this scenario is that the UK may not be able to sign trade deals equivalent to the EU and may end up diverging from EU equivalence involuntarily. However, this could conceivably be overcome by closer informal cooperation between UK and EU trade officials.

The benefit of scenario 1 is that the UK assumes control of its external trade policy but maintains the status quo as long as it is in the interests of the UK. If the EU signed a trade deal that was damaging to the UK or if the UK were able to agree new trade deals which provided significantly better outcomes for the UK, this could be done. However, any UK deal that substantially altered the status quo or equivalence with the EU would have to be measured against the losses that would be incurred from increased trade disruption with the EU. Initial modelling (Ebell, 2017) would indicate that the gains to the UK from new trade deals would be far outweighed by the reduction in trade from leaving the single market. If similar projection showed a net loss for the UK in diverging from EU trade agreements, the arguments for maintaining parity with the EU could be made. What scenario 1 does provide for is control over international trade with an acceptance that the UK and the EU's interests are not necessarily that far apart and the limited flexibility that the UK would enjoy would not be at the expense of existing trade.

The four scenarios outlined here range from implausible to quite likely. Scenarios 3 and 4 protect all-island trade but do so at too great a cost to more valuable streams of trade. The interconnectedness of trade across the ROI, NI, GB and the EU means that any solution which creates asymmetry in these trade relationships is unlikely to succeed. In that case, the most likely solution lies in scenario 1 or 2 where the UK as a whole seeks to maintain the status quo with regard to the customs union either formally in the case of scenario 2 or informally in the case of scenario 1. All of these options are suboptimal to the current situation regarding trade on the Island of Ireland. In reality, the Brexit process is likely to culminate in identifying the least worst option which is politically acceptable to all involved.

5 . CONCLUSION

The decision of the UK to leave the European Union poses significant challenges for both the ROI and NI. This paper has focussed on how one aspect of that process, the customs union, will impact both economies on the Island of Ireland. The theoretical and historical perspectives on the

customs union show that the economic dividends can be higher than any other form of trade integration but also that it builds a dependency making exit more difficult. A customs union requires a pooling of sovereignty and greater economic and political union is a sign that a custom union has succeeded in its aims. While Free Trade deals may be able to limit the disruption of tariffs between the UK and the EU, a significant disruption lies in a divergence of external trade relations for the UK and the EU. This a significant challenge for any post-Brexit arrangement regarding the customs union.

Options for the ROI to leave or NI to remain in the EU Customs Union have too great an economic cost, but the UK remaining within the EU customs union is not without difficulty. The conundrum that faces policymakers is that many who argued that the UK should leave the EU, based their arguments on regaining sovereignty and control. Intuitively this would mean that the UK would leave the customs union and in this scenario, there is limited scope to avoid the disruption to trade outlined earlier. A scenario in which the UK mimics EU external trade relations provides the only way in which trade disruption can be avoided outside the customs union.

Finally, it should be emphasised that whilst this paper does not deal with the many options that are possible with regard to the Single Market, this issue is crucial. Whatever the efforts made with regard to the customs union, maintaining a frictionless border on the Island of Ireland could be impossible in the event of a significant divergence between the regulatory environment of the EU single market and a post-Brexit UK.

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