

EU-Japan economic partnership agreement

Department for International Trade

RPC rating: **fit for purpose**

The IA is now fit for purpose as a result of the Department's response to the RPC's initial review. As first submitted, the IA was not fit for purpose.

Description of proposal

The EU-Japan economic partnership agreement (EPA) intends to eliminate most tariffs and reduce the non-tariff barriers that businesses face when trading goods and services, and when investing between the EU and Japan. The Department expects the EPA to enable UK firms to export and import at a lower cost and give UK businesses more opportunities to bid for public procurement contracts in Japan. It also expects the agreement to increase the welfare of UK households by lowering the price of goods and services and by increasing consumer choice.

The agreement has already been negotiated and agreed by the European Commission and Japan. The preferred policy option is for the UK to vote in favour of a Council decision on signature and the implementation of the EU-Japan EPA. The agreement would then enter into force early in 2019. The UK Government aim to make it possible for the UK and Japan to continue trading on equivalent preferences after EU exit.

Impacts of proposal

The assessment estimates impacts using external studies, mainly the 'Assessment of Barriers to Trade and Investment between the EU and Japan' (2009) study, produced by Copenhagen Economics. This study applies a computable general equilibrium (CGE) model that estimates the impact of the trade agreement across the UK economy. Two scenarios are modelled as an upper and lower bound differing by the size of non-tariff measure (NTM) reductions in manufacturing sectors, and on the reduction of barriers to cross-border service trade. The study uses survey data from EU and Japanese firms to estimate the level of NTMs, enabling levels to be reported for specific sectors.

The EPA is expected to increase UK GDP by between £2.1 billion and £3.0 billion per year in the long run, mostly driven by an increase in bilateral trade.

The increase in UK GDP is calculated by applying the estimated percentage increase in EU28 GDP to the current level of EU GDP. This nominal value is then apportioned based on the UK's share of EU28 total trade with Japan in 2016 (17.3 per cent).

Benefits to UK businesses

UK businesses currently trading with Japan will experience direct benefits from a reduction in regulatory barriers in Japan's services market and the reduction of NTMs restricting goods trade. These benefits to businesses are included within the overall gain in UK GDP as a result of the EPA. Tariff equivalent trade cost reductions broken down by sector are included in the assessment; these are calculated through surveys and gravity estimations.

The EU-Japan EPA is also expected to directly benefit UK businesses currently trading with Japan through reduced tariffs; the impact of reduced tariffs is estimated as a £266 million saving per year. Some of this gain may, however, be passed onto consumers through lower prices.

The EPA is also expected to result in direct efficiency savings through provisions such as the EU and Japan aligning themselves to the same international standards, product safety, and environmental protection in relation to motor vehicles. The agreement displays the UK and Japan's mutual commitment to aligning with international standards to reduce technical barriers to trade, and creates a more predictable regulatory environment in specific sectors.

The agreement increases the ease with which UK firms can access the Japanese service market through: Mode 4 provisions related to ease of movement of people for business purposes; and increasing access to the Japanese public procurement markets at local level, enabling non-discriminatory access for UK companies to government contracts. These provisions also increase access to the UK service market and government contracts for Japanese firms. The improvements in mobility of temporary workers between the UK and Japan could lead to greater competition for UK citizens. The assessment does not quantify this direct benefit.

The reduction in tariffs and NTM are estimated to increase bilateral exports between the UK and Japan by between £3.2 billion and £5.4 billion. The sectors expected to gain the most from the EPA are: chemicals, motor vehicles, and metal and metal products. Tariff and NTM reductions are expected to increase bilateral imports by between £5.5 billion and £8.4 billion.

The agreement is expected to increase UK business productivity in the long run by increasing competition and incentivising specialisation leading to a more efficient allocation of resources.

Costs to UK businesses

The assessment states that there will be a one-off direct cost to UK businesses from reading and understanding the agreement. Approximately 9,438 UK businesses export to Japan and 6,788 UK businesses import from Japan, according to the inter-departmental business register overseas trade statistics. It is estimated, using reading speeds and labour costs, that businesses currently trading with Japan will face a one-off familiarisation cost of between £3.1 million and £3.3 million.

The assessment also details three on going non-monetised direct business costs resulting from the EPA: custom declarations; outward origin quotas; and rules of origin certification. New firms trading with Japan because of the EPA will incur an additional customs declaration cost. Firms already trading with Japan, or those diverting trade from a third country outside the EU to Japan, already bear this cost. The outward origin quota will be borne by all firms trading in textiles and apparels under the EPA.

Businesses will be required to produce a certificate to trade under EPA preferences that confirms that the export content meets rules of origin requirements. Businesses can submit these forms to HMRC to process for free, imposing a cost upon HMRC, or submit them to the British Chambers of Commerce for faster processing and a fee of £46.80 each. Studies have estimated the tariff equivalent trade costs associated with rules of origin compliance to range between 2 per cent and 6 per cent.

The EU-Japan EPA is expected to increase UK exports and imports across several sectors. However, some sectors could become less price competitive and experience a fall in domestic production. The Copenhagen Economics (2009) study identifies these sectors across the EU, however, the assessment has been unable to estimate the UK share of this decline.

Wider impacts

Consumer welfare is estimated to increase in the long run from increases in national real income. This is due to the EPA reducing the prices of imported goods through a reduction in trade costs; UK consumers will then experience lower prices. The EPA is also expected to result in a long-run increase in UK wages from the reallocation of

resources between sectors enhancing productivity. The combined impact of reduced tariffs and NTMs from the EPA is estimated to increase national welfare between £2.9 billion and £4.7 billion in the long run.

The agreement is also expected to have impacts on the UK Exchequer. These include a potential reduction in revenue from lower tariffs on imports from Japan, estimated at £266 million per year, partially offset by increased tax revenue from UK businesses. There are also expected to be one-off costs to customs and government bodies from reading the text of the agreement.

Small and micro business assessment

The assessment estimates that 60-64 per cent of UK businesses that trade with Japan are small and micro businesses, however these businesses account for only 10 per cent and 11 per cent of exports and imports to/from Japan respectively. Small and micro firms, including those not currently trading with Japan, will have the incentive to export to Japan if the expected increased revenues from EPA provisions outweighs the costs of selling into Japanese markets and complying with rules of origin requirements and declarations. Businesses can still trade under existing most-favoured nation terms if the regulatory cost of complying with the EPA outweighs the increase in business revenue from greater exports under the EU-Japan EPA preferences.

The EPA provides a basis for greater cooperation on customs and rules of origin, which could enable simplification of procedures, thereby reducing disproportionate burdens affecting smaller businesses.

The assessment states that some less-competitive small UK businesses may be adversely affected by greater competition, but expects the net impact to be positive on the grounds of tariff and NTMs reduction impacts outweighing lost sales. Therefore, mitigations or exemptions for small businesses are not considered.

Quality of submission

Issues addressed following RPC's initial review

As initially submitted for RPC scrutiny, the impact assessment was not considered fit for purpose. Following the RPC's initial review, the department submitted a revised impact assessment that responded to the points as follows.

The Department was asked to demonstrate the impact of developments in other trade agreements, particularly the Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP), on the UK-Japan trade baseline within the EPA. The assessment now provides a clear explanation of why the impact of these trade deals on UK-Japan trade is likely to be small:

- The Comprehensive and Progressive Trans Pacific Partnership (CPTPP), which does not include the US as a member, is likely to have only a small negative impact on UK-Japan baseline trade in the short term due to UK exports to Japan being concentrated in services and non-agricultural products, while the greatest negative impacts of CPTPP on EU countries were seen in agricultural and food products. Furthermore, Japan has an EPA with all CPTPP members except for Canada and New Zealand, and these countries trade with Japan in sectors in which the UK does not trade significantly with Japan. Trade diversion from this deal is, therefore, likely to be minimal.
- The comprehensive economic and trade agreement between Canada and the EU is unlikely to have a large impact given the smaller size of Canada's economy (\$1.9 trillion) compared to the EU (\$21.7 trillion) and Japan (\$5.3 trillion).
- The assessment does not take into account the impact of TTIP, and explains this is due to negotiations being currently on hold following the change of US administration. Similarly, the regional comprehensive economic partnership is not taken into account as negotiations have not yet concluded.

The Department was asked to provide sensitivity analysis to show the extent to which it expects the impact on the UK GDP to differ from the EU estimate. The assessment now provides a more robust method of calculating the impact of the EPA on UK GDP. This is calculated by apportioning the estimated increase in EU GDP based on the UK's share of EU total trade with Japan in different sectors. This method is more specific to the UK's trade with Japan, compared to the previous method used which involved applying the expected percentage increase in EU GDP from the EPA to the UK. This has resulted in an increase in UK GDP impact from the Department's original submission: from between £1.9 billion and £2.7 billion to £2.1 billion and £3.0 billion. However, reduced UK exports to the EU from increased

Japanese competition are unlikely to have been taken into account fully in the UK GDP figure.

The assessment includes more detail on the differences between the provisions the Copenhagen Economics (2009) study is based upon and the final provisions agreed in the EPA: the study assumes all tariffs between the EU and Japan are eliminated and the final EPA eliminates 97 per cent of tariffs; and the impact of reductions in NTMs on the chemical and motor vehicle sectors included in the study are compared to the provisions agreed for these sectors in the EPA. The assessment would have benefitted from further explanation of why the tariff equivalent reductions in these sectors are likely to be similar to the provisions agreed in the EPA.

More detail has been provided on the sectors of EU managers questioned by the survey included in the Copenhagen Economics (2009) study. However, the Department has provided no information on the extent to which UK business managers were represented in the survey. Additionally, the Department should justify the assumption that the 2009 environment remains sufficiently relevant, given the subsequent economic downturn and the structural change that accompanied this.

The Department provided an explanation that revealed comparative advantage (RCA) is based upon static, backward-looking trade patterns that are subject to change. RCA is most likely to change between countries where one is facing rapid industrialisation. The UK and Japan are already both predominately service-based and high value-added economies, so the Department argues that their RCA is unlikely to change significantly in the future.

The assessment acknowledges that Mode 4 provisions could lead to greater competition for the UK job market for UK citizens as movement of people for business purposes becomes easier. A discussion of possible negative impacts on UK firms from greater competition for UK government contracts from Japanese firms would have been beneficial.

Other comments

The Department has provided a detailed economic background to the EPA, and clearly explains the problem under consideration and rationale for the intervention.

The assessment acknowledges that UK businesses may become less price competitive and experience a fall in domestic production, and the Copenhagen Economics (2009) identifies sectors that will potentially experience a decline in production across the EU. The Department should provide a justification of why it has been unable to estimate the UK share of this decline, and acknowledge a possible increase in UK unemployment from increased competition. It would also have been beneficial for the assessment to consider the impact of the agreement on the environment in the analysis of the wider impacts of the EPA.

The assessment assumes that lower barriers lead to more choice for consumers. A discussion of other factors that could interfere with this assumption, for example, economies of scale or network externalities leading to fewer choices for consumers, would have been beneficial. Further justification of the expected net positive impact of the EPA on small and micro businesses would also have improved the assessment, along with consideration of the impact on small and micro businesses at a sectoral level.

The assessment claims a benefit from the UK and Japan aligning themselves to the same international standards, however, this will depend on the nature of the alignment. There is likely to be a saving compared to a scenario where firms produce products to two different sets of standards, but more aligned UK-Japan standards may diverge from those in place in other countries, which could offset efficiency gains. The assessment would have benefitted from including a discussion on this. Additionally, savings from the predictability of the regulatory environment may be similarly offset by 'least-common-denominator' standards which impose costs on countries whose standards are changed from what was considered an optimal position.

The Department argues that the EPA has a positive impact on UK GDP despite the fact that increases in UK imports (£5.5 billion to £8.4 billion) exceeding increases in UK exports (£3.2 billion to £5.4 billion). It does not provide a clear explanation of its reasons for believing this to be the case within the IA, but has provided relevant evidence in subsequent correspondence. It should add this evidence as soon as possible, and in any case before publication of any IA in support of subsequent implementing regulations.

The Department has chosen not to present an equivalent annual net direct cost to business figure, as the agreement is outside the scope of the business impact target, but it has discussed the impacts of the agreement on businesses in some detail. The

RPC considers the analysis of impacts on businesses included in the impact assessment to be fit-for-purpose.

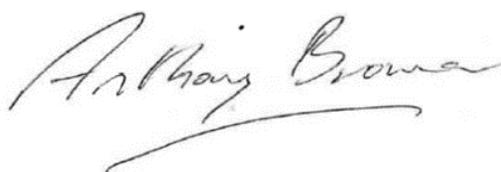
Following the UK's exit from the EU, and therefore from the EU-Japan EPA, the RPC expects the Department to submit a further impact assessment appraising the final trade agreement that is negotiated between the UK and Japan. The RPC also recommends that the Department conduct an evaluation of this trade agreement to assess the actual impacts of the agreement on the UK, especially in the light of the UK's increased involvement in developing such deals in the future.

Departmental assessment

Classification	Not a regulatory provision
Societal net present value	£22,400 million (initial estimate) £25,000 million (final estimate)

RPC assessment

Classification	Not a regulatory provision - following legal advice from the Better Regulation Executive
Small and micro business assessment	Sufficient
RPC rating of initial submission	Not fit for purpose



Anthony Browne, Chairman