Regulatory Policy Committee

Ecuador Accession to the EU-Andean Free Trade 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

UK ratification of the accession of Ecuador to the existing EU-Andean free trade agreement (FTA) aims to provide benefits to UK businesses and consumers. The FTA should liberalise trade in goods and services and promote international trade that benefits all parties.

The EU, Ecuador, Colombia, and Peru signed the Protocol of Accession of Ecuador to the EU-Andean FTA on 11 November 2016; the protocol has been implemented provisionally since 1 January 2017. The preferred policy option is for the UK Government to ratify the agreement, in order to ensure that the UK benefits from trade liberalisation under the agreement. If the UK chooses not to ratify, the agreement would not enter into force and provisional application would cease.

The assessment assumes the UK will continue trading with Ecuador on equivalent terms after the UK's withdrawal from the EU. This is based on the Government's stated policy intention to seek continuity of effect in relation to the EU-Andean FTA.

Impacts of proposal

The EU conducted three annual reports on the implementation of the EU-Andean agreement with Colombia and Peru; these reports concluded that trade increased in sectors that were partially or fully liberalised under the agreement. However, the assessment acknowledges that trade between Peru and the EU, and Colombia and the EU has declined in the past two years due to economic downturns, and alongside overall reductions in total trade. Ecuador's accession to the agreement has not yet been covered by the Commission's reports; it will be included in the fourth annual report expected in 2018. The Department plans to present this report to Parliament, setting out the implications for the UK. The assessment uses the European Commission 2016 study 'Assessing the economic impact of the accession of Ecuador to the EU-Colombia/Peru Trade Agreement' to estimate the impact on the UK. This study uses a dynamic computable general equilibrium model to estimate the economic impacts on the EU of Ecuador joining the FTA. It is expected that the trade agreement will result in increased export opportunities for UK businesses, and greater competition from Ecuadorian firms that could in turn result in lower prices, and a greater variety of goods and services for consumers.

Benefits to UK businesses

The European Commission's study estimated Ecuador's accession to result in a net annual gain to EU GDP of around £405 million by 2035; this is equivalent to a 0.002 per cent increase per year. Although, current data suggest that gains are likely to occur later in the appraisal period. The study did not estimate the impact on the UK specifically. The assessment has estimated the impact on UK GDP based on the weighted average of UK-Ecuador trade as a proportion of EU-Ecuador trade between 2012 and 2016: approximately 8 per cent. The assessment estimates the impact of the Ecuador accession to the FTA to result in an increase in UK GDP of £37 million per year by 2035. The Department concedes that there is uncertainty around this figure and, therefore, provide a low and high estimate £30 million and £44 million per year respectively.

UK businesses currently trading with Ecuador are expected to benefit from reduced tariffs and a decline in regulatory barriers; these benefits are accounted for in the estimated impact on UK GDP. The assessment expects the agreement to have a direct impact on UK businesses through equivalent reductions in tariffs of: 3 per cent on trade in goods, and between 3.2 per cent and 3.9 per cent on trade in services. The benefit to UK businesses resulting from reduced tariffs is expected to primarily affect the trade of intermediate goods.

Costs to UK businesses

The Department acknowledges some direct transitional costs to businesses that have been trading with Ecuador, for example, reading and understanding the terms of the agreement. The provisional implementation of this agreement is likely to have rendered these transitional costs as sunk costs. The Government does not publish statistics on how many UK firms trade with Ecuador. The assessment assumes the total number is small: between 100 and 1,500 firms. The lower bound is calculated by applying the percentage of UK-Ecuador trade compared to total UK trade in 2015 (less than 0.1 per cent), to the number of businesses importing and/or exporting from the UK in 2016; resulting in 100 firms. The central estimate is calculated by comparing trade with Mexico, a market of similar geographical distance, which accounts for 0.3 per cent of total UK trade, with an estimated (by HMRC) 4,500 UK businesses trading with it. The Department assumes that if UK-Ecuador trade accounts for a third of UK-Mexico trade, then it is reasonable to assume the number of UK firms trading with Ecuador to be a third of those trading with Mexico: 1,500 firms. On this basis, it estimates familiarisation costs of around £339,000.

The assessment also details an on-going direct cost to UK businesses from the requirement to produce certificates to comply with rules of origin requirements. Businesses can submit these forms to HMRC to process for free (which would impose a cost on HMRC) or submit them to the British Chambers of Commerce for faster processing at a cost of £46.80 each. The Department states that studies have estimated the tariff equivalent trade costs associated with rules of origin compliance to range between 2 per cent and 6 per cent.

Ecuador's accession to the FTA is also expected to result in adjustment costs to UK businesses from increased competition. However, the Department argues that the market power of Ecuadorian firms is not expected to be significant relative to UK firms. Therefore, it is considered unlikely that UK firms will be greatly affected and any associated costs are considered negligible and have not been quantified. There are also expected to be one-off costs to customs and government officials from reading and understanding the text of the agreement; these are assumed to be minimal and have not been quantified. It is also likely these will be sunk costs due to the provisional implementation of the agreement.

Wider impacts

Consumer welfare is estimated to increase in the long run from tariff reductions reducing the price of Ecuadorian products in the UK. This is estimated at around £13 million to £19 million per year, apportioned from the estimated welfare gain to the EU from the European Commission study, using the same method as used to estimate the GDP impact. The study also estimated that the impact of Ecuador's accession on prices and wages would be negligible in the EU and by extension the UK, given the size difference between EU/UK economies and Ecuador.

Ecuador's accession to the FTA is also expected to have impacts on the UK Exchequer. UK firms currently importing from Ecuador will pay a reduced level of tariffs to the UK Exchequer. This is estimated as a £17 million reduction per year, apportioned from the estimated loss of tariff revenue to the EU from the European Commission study. This cost is expected to be a transfer from the Exchequer business to UK consumers and businesses who will divide the benefits of tariff reductions.

Small and micro business assessment

The net impact on small and micro businesses is expected to be positive, due to the agreement removing trade barriers in Ecuador that prevent firms from exporting. Furthermore, firms that use imports from Ecuador will benefit from a reduced cost of importing. The assessment acknowledges that some firms may be adversely affected by competition from Ecuadorian firms. The Department does not have statistics on the number of UK businesses trading with Ecuador and therefore cannot quantify the number of small and micro businesses trading with Ecuador. However, the assessment notes experimental HMG statistics that suggest 50% of firms trading with Mexico were either small or micro and assumes Mexico has broadly similar trade characteristics to Ecuador.

Quality of submission

Issues addressed following RPC's initial review

The Department has adequately addressed the two red-rated points and the majority of the 'areas for improvement' that were suggested by the RPC. These points are discussed in more detail below.

The Department was asked to explain why the method they have used to calculate the total net present value is an accurate interpretation of the European Commission's estimates. The Department has explained that the use of the term 'absolute' refers to GDP as being measured in volume terms as opposed to relative terms. It has presented correspondence with the study's authors confirming this. It also states that the calculation of total net present value presented within the IA is consistent with the normal presentation of estimated attained through CGE modelling. The assessment now clarifies that the European Commission describe their analysis as showing annual GDP gains from the impact of Ecuador's accession to the EU-Andean FTA in 2035 compared to not having the trade agreement in 2035.

The Department was asked to provide a clear explanation of why it expects the trade deal to have a positive impact on the UK's GDP given the balance of trade deficit between the UK and Ecuador. It now provides an explanation of how the FTA will affect components of GDP other than imports and exports, for example, the ability for UK businesses to import intermediate goods at a lower cost, passing the benefit on to consumers in the form of lower prices, increasing consumption. Cheaper intermediate products could also increase UK businesses profitability. These profits could then be used for increased domestic investment, higher wages, or increased tax revenues. Although the Department explains why it expects the trade deal to have a positive impact on UK GDP in theory, it would have benefitted from providing more UK-Ecuador specific analysis on how lower intermediate product prices could benefit the UK in practice.

The Department was asked to explain why it chose not to perform sector level scaling. It explains that data on the sectoral pattern of UK trade with Ecuador are not readily available. It also states that it would not be proportionate to weight the UK GDP gains based on sectors due to the relatively small value of Ecuador's accession to the EU-Andean FTA to the UK economy, £37 million per year, compared to other recently concluded trade agreements.

The Department was asked to provide evidence to explain why the chosen tariff equivalent reduction in costs of 3 per cent applies specifically to the EU-Andean FTA. The assessment explains that it uses a study by Decreux and Fontangé (2011) that estimated the binding of service sector protection to equate to a 3 per cent tariff equivalent reduction in costs, when modelling the impact of the Doha Development Agenda. The European Commission deemed this applicable in the EU-Ecuador FTA context for both goods and services NTM reductions. It is not clear that a 3 per cent tariff equivalent reduction in costs accurately captures the UK-specific impacts but the RPC believes that the approach taken by the department is, in this case, proportionate; the assessment could have been improved by conducting sensitivity analysis around this assumption.

Other comments

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

The assessment acknowledges that UK businesses may become less price competitive, and explains why the impact of this is likely to be small. It would have been beneficial for the Department to provide analysis of which sectors would likely be affected by increased competition, and the resulting impacts on UK unemployment.

The European Commission study used to estimate the impact of Ecuador's accession on the UK was written before the Second and Third Annual reports. These reports acknowledge a downturn in trade between the Andean countries and the EU. The assessment does not make it clear whether their analysis took the downturn into account. The Department should explain that re-using the European Commission's analysis has likely resulted in an overstatement of benefits to the UK.

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.

The Department analyses the impacts of greater market access between the UK and Ecuador but does not acknowledge the impacts on the UK of greater market access between the EU and Ecuador. The assessment should provide a discussion of how Ecuador's accession to the FTA could lead to trade diversion away from the UK.

The assessment states that Ecuador's accession to the EU-Andean FTA is likely to only have a negligible impact on prices and wages in the UK, due to the negligible impact found on EU prices and wages in the European Commission's study. While the overall impact on UK wages and prices may be insignificant, the Department should have conducted sectoral analysis to determine if any sectors are likely to be significantly affected.

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-Andean FTA, the RPC expects the Department to submit a further impact assessment appraising the final trade agreement that is negotiated between the UK and Ecuador. 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. The Department should also set out a plan to evaluate and monitor the effects of Ecuador's accession to the FTA to better prepare the UK for any future trade agreement between the UK and Ecuador.

Departmental assessment

Classification	Not a regulatory provision
Societal net present value	£288 million

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

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