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Regulatory Policy Committee

Impact assessment of the EU-Vietnam Free Trade Agreement (EVFTA) on the UK

Department for International Trade

RPC rating: **'fit for purpose'**

The analysis in this impact assessment relies entirely on the UK continuing to trade with Vietnam under EVFTA preferences (or mirrored terms) post-Brexit. Given the Government's current position this approach is proportionate. However, it is only under this assumption that the RPC considers the analysis fit for purpose.

Description of proposal

The EU-Vietnam FTA (EVFTA) is intended to eliminate most tariffs between the EU and Vietnam and to reduce the non-tariff barriers that businesses face in the trade of goods and services. The FTA includes provisions for public procurement, services, investment, intellectual property rights, regulatory issues, technical barriers to trade, and sustainable development. The Department expects the FTA to increase bilateral trade and economic growth, and to signal the UK's support for Vietnam's economic and social transformation as Vietnam integrates into the global economy. As a result, the Department expects the agreement to increase the welfare of UK households by lowering the price of goods.

The agreement has already been negotiated by the EU and Vietnam. The UK and other EU member states must vote on whether to authorise signature and conclusion of the agreement. The preferred policy option is for the UK to vote in favour of the agreement. The UK Government aims to make it possible for the UK to continue trading with Vietnam on terms equivalent to the EVFTA after the UK's exit from the EU.

Impacts of proposal

The impact assessment (IA) estimates the effects of EVFTA using a study commissioned by the Department entitled 'The Impact of the EU-Vietnam FTA on the UK' (2019)[1]. The Department intends to publish the study to their website. This study applies a computable general equilibrium (CGE) model that estimates the impact of the agreement across the whole economy. Models of this type simulate the response

[1] This study is based on analysis produced by Baker and Vanzetti (2019).

of economic variables such as income, production and prices to changes in trade policy taking cross-market spillovers into account. The model used in the IA assumes levels of trade liberalisation based on the content of the final EVFTA text.

On this basis, the FTA is expected to increase UK GDP by £391 million per year in the long-run compared to a baseline in which the EVFTA is not in force. The Department uses a baseline in which the UK continues to trade with Vietnam under World Trade Organisation (WTO) rules and Most Favoured Nations (MFN) terms while Vietnam continues to trade with the UK under the Generalised Scheme of Preferences (GSP). The GSP allows developing countries to face low or no tariffs on their exports of certain goods to the EU.

Benefits to UK businesses

Tariff reductions

EVFTA, by reducing tariffs, is expected to benefit UK businesses by increasing the competitiveness of UK goods and services in Vietnam and reducing the cost of intermediate goods imported from Vietnam.

For example, tariffs on the UK's two largest export goods into Vietnam, namely machinery and mechanical appliance (3.5% tariff) and pharmaceutical products (up to 8% tariff) will be eliminated. Furthermore, tariffs on the UK's two largest import goods from Vietnam, wearing apparel (9.3% tariff) and leather (6.9% tariff) will also be eliminated. The effect of these tariff reductions is captured by the CGE model.

Reduction in non-tariff barriers

The EVFTA aims to align UK and Vietnamese regulations imposed on trade in services, which is expected to increase UK access to Vietnam's service sectors. For example, EU businesses currently are permitted to own up to 30% of Vietnamese banks; they will be able to own up to 49% under EVFTA. For distribution services, Vietnam will no longer require retailers to carry out an economic needs test when opening outlets and has committed to ensuring that its existing licensing of spirits will not become more restrictive. Vietnam will also permit foreign pharmaceutical companies to import pharmaceuticals authorised for sale in Vietnam. Additionally, EU suppliers will be able to bid for Vietnamese public procurement contracts, which is currently not possible for EU-based suppliers.

Balance of trade

Baker and Vanzetti (2019) estimate that EVFTA could increase UK imports from Vietnam by 33% or £1.7 billion per annum in the long run, when the full effects of the agreement have been reflected in the economy (by 2030). The same analysis estimates a long-run increase in UK exports to Vietnam of 60% or £490 million. The Department provides sectoral analysis, which indicates that the benefits of increased exports will be greatest in financial services (+£110 million), business services (+£80 million), air transport (+£80 million) and communications (+£50 million). The main beneficiary sectors of increased UK imports include wearing apparel (+£530 million), leather products (+£460 million), and motor vehicles and transport equipment (+£400 million).

The Department also expects the EVFTA to increase UK business productivity through increased competition.

Costs to UK businesses

The Department argues that trading under EVFTA preferences is voluntary; businesses therefore have the option to trade under MFN terms as in the baseline. The Department's cost calculations, however, assume that all firms trading with Vietnam will avail themselves of EVFTA preferences.

In 2016, 2,874 UK firms exported to Vietnam and 2,611 UK firms imported from Vietnam which provides an estimate of 5,485. The Department assumes that 60% of firms will seek advice from a specialist agent and 40% will read the agreement themselves. On this basis, the Department estimates total familiarisation costs of £1.35 million in the central scenario. The costs are assumed to accrue in the first three years, 60% in the first year followed by 25% and 15% respectively.

Businesses will also be required to produce a certificate to trade under EVFTA preferences, which confirms that export contents meet Rules of Origin requirements. Businesses can submit these forms to HMRC to process for free, which could take several days, or submit them to the British Chambers of Commerce for accelerated processing for a fee of £52.20. The assessment also mentions – but does not monetise - other possible one-off costs such as IT set-up and custom declarations.

The Department also notes that UK businesses will be exposed to increased competition which could lead to declining profits for less competitive UK firms.

Wider impacts

Consumer welfare is expected to increase in the long run through: lower prices of imported final goods and services; lower prices for final goods and services produced with imported inputs; and (potentially) wider choice among goods and services. Another potential benefit is higher quality final goods and services, should consumers prefer this, funded by lower input costs and enhanced quality competition. The assessment also claims that real wages could increase in the long run if greater competition leads to productivity gains. Baker and Vanzetti (2019) estimate an increase in consumer welfare of £290 million per annum in the long run. These impacts are not captured in the total net present value (NPV), as such productivity gains will be divided between workers and consumers and the Department notes that they represent an alternative way of looking at the impacts on GDP.

The Department also notes that some UK firms may be forced to exit domestic markets as a result of increased competition which could lead to reduced choice for consumers.

The IA estimates reduced revenue for the UK government due to a reduction in tariffs of £104 million in the top five sectors. This could, however, be offset by tax revenue gained from increased economic activity. The Department argues (correctly) that both lost Government tariff revenues and increased Government tax revenues are transfers among the Exchequer, consumers and businesses.

Small and micro business assessment

The Department estimates that 1,483 small and micro businesses import from Vietnam and 1,609 small and micro businesses export to Vietnam. These firms account for 57% and 56% respectively of businesses trading with Vietnam. However, they account for only 12% of total UK imports from Vietnam and 27% of total UK exports to Vietnam by value. The Department also notes that small and micro businesses will choose to export to Vietnam under EVFTA preferences if and only if the benefit (profits from exporting to or importing from Vietnam) of a reduction in tariffs and non-tariff barriers outweighs the cost of complying with Rules of Origin requirements and declarations.

Rules of Origin

The Department concedes that small and micro businesses may not have the capacity and capabilities to understand and comply with the Rules of

Origin regulations. Therefore, the cost of compliance may fall disproportionately on those small and micro businesses that choose to export under EVFTA rules; some may opt for MFN preferences as a result. The Department does not propose any mitigation for this disproportionate cost.

Tariff reductions

Small and micro businesses may benefit from increased liberalisation through lower import costs and increased demand for exports. However, the Department notes that less competitive small and micro businesses may be negatively affected by increased competition. The net effect is expected to be positive.

Technical barriers to trade

The Department notes that the burden of understanding and complying with technical barriers to trade, such as different conformity standards in Vietnam, can disproportionately fall on small and micro businesses. However, it argues that EVFTA will lead to mutual recognition of such standards, which in turn would reduce the cost to small and micro UK businesses of compliance.

Quality of submission

The Department has provided a detailed economic background to the agreement and clearly explains the problem under consideration and the rationale for intervention. The IA makes good use of evidence gained from a study commissioned by the Department and conducted by trade analysis experts. The Department includes a detailed description of the baseline which includes the elimination of tariffs agreed in existing trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership. The RPC feels that the inclusion of existing trade agreements provides a realistic baseline. Most importantly the Department clearly lays out the limitations and assumptions of the model used to produce the results. The RPC commends this thorough and transparent approach.

The IA could be improved by addressing the following issues:

Baseline

The Department assumes that under the baseline, the UK, EU and Vietnam continue to trade under MFN and GSP terms. The GSP is regularly reviewed by the European Commission, and the list of countries covered is subject to change. It is unclear whether or how long Vietnam will remain in the list of countries covered by the GSP. It is possible that economic growth in Vietnam will ultimately undermine its eligibility for preferential trading arrangements afforded to developing countries. Given the uncertainty involved, the RPC believes that the approach taken by the Department is proportionate. However, the IA would have benefitted from a qualitative discussion of the impact on the baseline of Vietnam not qualifying for the GSP in the future.

Monitoring and evaluation

The IA does not include a commitment to review the impacts of the agreement. If the UK continues to trade under EVFTA preferences, or similar terms post EU exit, the RPC strongly recommends that the Department conduct an (interim or *ex-post*) evaluation of this FTA to assess the actual impacts on the UK. To support such an evaluation, the RPC suggests that the Department should also set out a plan to evaluate and monitor the effects of the EVFTA.

Small and micro business assessment

The IA provides a qualitative assessment of possible ways that small and micro businesses could be disproportionality affected by Rules of Origin, tariff reductions and mutual recognition of standards. The Department explains that it expects the impacts on small and micro businesses (SMBs) to be net beneficial, but the assessment could be greatly improved if the Department separated small and micro businesses in the analysis and considered ways to mitigate the disproportionate impact of, for example, complying with Rules of Origin. The SaMBA would also benefit from sectoral analysis to indicate whether SMBs could be disproportionally affected by increased competition from Vietnamese firms. The RPC believes that, in this case, the approach taken is appropriate given the guidance available to the Department at the time of writing. However, the RPC would expect future IAs to contain more detailed assessment of the impacts on small and micro businesses, consistent with the latest guidance.

Costs to business

The Department estimates familiarisation costs of £1.35 million, which include firms either reading the agreement themselves or hiring specialist agents. These estimates are limited and do not include other costs associated with familiarisation including IT costs, customs declarations and the cost of disseminating the terms of the agreement across all affected businesses. The RPC believes that the approach taken by the Department is, in this case, proportionate, as the total transition costs are likely to be small relative to the overall scale of the measure. However, the RPC will expect to see more comprehensive analysis of one-off transition costs in future IAs.

The Department estimates that approximately 5500 UK businesses trade with Vietnam. The IA notes that this figure could be an overestimate as it double counts firms that both import from and export to Vietnam or an underestimate as it does not include firms that trade in services. Given the available data, the Department's approach is reasonable. However, the IA could be improved by sensitivity analysis around this figure, especially given that the number of firms trading with Vietnam may change over the period. The IA would also benefit from sensitivity analysis around other familiarisation assumptions such as the timeline for cost accrual, assumed to be 65% in the first year, 25% in the second year and 15% in the third year.

Competition effects

The lowering of tariff and non-tariff barriers may have structural effects throughout the value chain. While the short-run effect may be to increase domestic-market competition between UK and Vietnamese firms, in the medium term this can lead to exit of uncompetitive UK firms and ultimately to a more concentrated market than at present. The resulting concentrated UK market may be dominated by Vietnamese firms or even by UK firms, if the Vietnamese competitors serve only as 'kingmakers' to drive domestic competitors out of business before succumbing themselves. Conversely, some of this adverse impact may be offset by increases in the competitiveness of UK firms (both small and large) selling into Vietnamese markets, with similar medium-to-long run structural and competition impacts. The IA would benefit from a description of these indirect impacts, even though they cannot easily be quantified with the tools available.

Benefits to UK consumers

The Department argues that consumers will benefit from lower prices on imported goods and goods made with imported inputs due to reduced tariff and non-tariff barriers; it categorises this as a direct benefit. However, this benefit relies on these savings being passed on to UK consumers in the form of lower prices. Under the better regulation framework, this would be considered an indirect benefit. As the agreement is outside the scope of the Business Impact Target (BIT), the RPC does not consider this misclassification a significant issue. However, when submitting IAs for regulatory measures stemming from trade agreements in future the Department will need to include an equivalent annual net direct cost to business (EANDCB) and, therefore, costs and benefits will need to be presented correctly as direct or indirect.

The Department states that consumers will benefit from greater choice through increased competition. The IA does note however that the possible exit of firms in some UK sectors could instead reduce consumer choice. Given the uncertainty, the RPC believes that the Department's summary is appropriate. However, the assessment would benefit from a more comprehensive discussion of the impacts of EVFTA on UK market structure. For example, trade liberalisation could lead to UK firms exiting a market as a result of increased competition from more efficient multinationals.

Impact on wages

The assessment claims that in the long run real wages could increase along with UK labour productivity. The RPC recognises potential long run increases in average wages but the Department should consider short term impacts on affected markets, which may be negative. Furthermore, in competitive markets consumers are more likely than workers to capture productivity gains (especially advances in total factor productivity or multifactor productivity). Furthermore, taking account of possible falls in UK employment through increased competition with Vietnam it is unclear how EVFTA will impact UK real wages; whether average wages will rise or fall and how this will be spread across occupational and skill groups.

Model assumptions

The Department also notes that the CGE model used assumes a UK GDP growth rate of 2.3% in 2015 falling to 1.9% in 2030. The IA does not justify these growth rates. Given the uncertainty surrounding the UK's economic future, the IA would have benefited from sensitivity analysis on assumed UK growth rates.

The CGE model assumes full employment and that workers displaced from an industry by increased foreign competition will be fully reallocated to other sectors. The RPC understands that this assumption is common in general equilibrium modelling, but the IA would benefit from a qualitative assessment of possible increases in UK unemployment (especially for certain skills) as a result of increased competition faced by UK firms. It might also be useful to consider the impact of such displacement on wages and domestic demand.

Revealed comparative advantage

The Department highlights both the UK's and Vietnam's revealed comparative advantage (RCA), in particular that Vietnam has a comparative advantage at exporting products compared to the UK. The IA would benefit from a discussion of the disadvantages of using RCA analysis, particularly given that this approach is static and therefore will not respond appropriately to changes in the three-way trade between the UK, EU and Vietnam.

Regulatory alignment

The Department argues that the UK and Vietnam will benefit from aligning themselves to the same international standards, but this benefit depends on the standards and the nature of the alignment. There are likely to be cost savings compared to a scenario where firms produce products to two different sets of standards, but more aligned UK-Vietnam standards may diverge from those in place in other countries, which could offset efficiency gains for both parties.

In addition, savings from the predictability and effectiveness of the regulatory environment may be offset by 'least-common-denominator' standards that impose costs on countries whose standards are changed from what was considered an optimal position. Finally, this alignment may reduce the variety of specific standards and product varieties reflecting different national, market and technological circumstances. The IA would benefit from a more balanced discussion of the impacts of regulatory alignment between the UK and Vietnam.

Environmental impacts

The Department's discussion of wider impacts should have considered the environmental consequences of EVFTA. The agreement is predicted to increase economic activity by making it easier for the UK to trade with Vietnam. Increased production in both the UK and Vietnam and increased shipping could both have adverse effects on (for example) air and water quality. The RPC will expect to see consideration of environmental impacts in future submissions.

Equivalent annual net direct cost to business (EANDCB)

The Department has chosen not to present an EANDCB, as the agreement is outside the scope of the BIT, 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.

EU exit

The Department assumes that the UK will continue to trade with Vietnam on equivalent terms following the UK's withdrawal from the European Union. However, it is not necessarily the case that a deal reached between the UK and Vietnam, after the UK's exit from the EU, would mirror the terms set out in EVFTA. The assessment could have been improved had the Department discussed how the negotiation of a UK-Vietnam free trade agreement could influence the estimated costs and benefits of EVFTA. Furthermore, the assessment would benefit from a discussion of whether the UK could continue to trade with Vietnam under EVFTA preferences if the UK left the EU before the agreement was ratified by member states.

Following the UK's exit from the EU, and therefore from EVFTA, the RPC expects the Department to submit a further impact assessment appraising any final trade agreement negotiated between the UK and Vietnam.

Departmental assessment

Classification	Not a regulatory provision
Societal net present value	£5,100 million

RPC assessment

Classification	Not a regulatory provision – following legal advice from the Better Regulation Executive

Small and micro business assessment	Sufficient

Regulatory Policy Committee