Regulatory Policy Committee

The UK-Japan Comprehensive Economic Partnership Agreement

Department for International Trade

RPC rating: fit for purpose[1]

Description of proposal

The impact assessment (IA) states that the UK and Japan are the world's fifth and third largest economies respectively, together accounting for 9.2 per cent of global GDP in 2018. It reports that total trade between the UK and Japan was worth an estimated £31.6 billion in 2019 accounting for 2.2 per cent of total UK trade. Since February 2019, the UK and Japan have traded under the terms of the EU-Japan Economic Partnership Agreement (EPA) which will cease to apply in the UK following the end of the UK-EU transition period on 31 December 2020.

The UK and Japan have negotiated a UK-Japan Comprehensive Economic Partnership Agreement (CEPA); if ratified this will come into force on 1 January 2021. The CEPA aims to ensure the continuity of the existing EU-Japan trading relationship following the end of the UK-EU transition period and to enhance the UK and Japan's trade and investment relationship.

Impact of proposal

The figures in the IA are all based on long-run modelling outcomes – about 15 years after signing a CEPA. The IA states that all figures within the IA should be interpreted as being only indicative of magnitudes and not precise estimates or forecasts.

According to the IA, the UK-Japan CEPA is estimated to increase the UK's GDP by £1.5 billion compared to the counterfactual of trading on World Trade Organization (WTO) terms. To put this in context, the increase represents 0.07 per cent of the 2019 UK GDP (£2.2 trillion). The associated reshaping of the economy, price changes and long-run productivity increase are expected to raise real wages for UK workers by around 0.09 per cent. If applied to 2019 wages, this would amount to £0.8 billion.

[1] Where the Department for International Trade (DIT) requests the RPC to review the impact assessment for an international free trade agreement (FTA), the RPC may issue a "fit for purpose" or "not fit for purpose" rating on the quality and robustness of the analysis and evidence presented in the FTA impact assessment. The RPC's rating in this opinion is based on a checklist developed in conjunction with and agreed by DIT, the Better Regulation Executive (BRE) and the RPC. This rating is different from the ratings which the RPC issues on Regulatory Impact Assessments (RIAs) prepared by government departments in accordance with the Better Regulation Framework which relate to domestic policy changes. In its opinions on RIAs, the RPC rates the RIAs as "fit for purpose" or "not fit for purpose" based on the quality of the department's (i) analysis and estimate of the equivalent annual net direct cost to business (EANDCB) and (ii) its small and micro business assessment (SaMBA).

Among other provisions, the CEPA intends to reduce tariff and non-tariff trade barriers between the UK and Japan. In the long run, this reduction in the cost of trade is expected to raise UK goods exports to Japan by 17.2 per cent and imports of goods from Japan by 79.9 per cent. If applied to 2019 levels, these percentage changes would raise exports by £2.6 billion and imports by £13 billion. Overall, bilateral goods trade between the UK and Japan is expected to increase by 50 per cent. The IA suggests that although this is a substantial increase, the impact on total UK goods trade with all countries (including Japan) is more modest given the small (2.2 per cent) proportion accounted for by UK-Japan trade. On aggregate, total UK goods exports and imports (including Japan) are expected to increase by 0.58 per cent and 0.51 per cent, respectively in the long run, as a result of entering the CEPA.

Trade in services between the UK and Japan is expected to increase by 46 per cent in the long run. The largest increases in service exports are expected to be in financial services, insurance, and business services.

The IA notes that the UK and Japan have close investment ties, most notably in the UK's automotive industry. Japan accounted for 5.9 per cent of the total UK inward foreign direct investment (FDI) stock in 2018. Japanese data shows that the UK was the second largest destination for outward Japanese FDI. The CEPA contains provisions aimed at securing the liberalisation of FDI between the UK and Japan, and domestic business investment is expected to increase by 0.02 per cent in the long run.

Monetised costs and benefits to businesses

Data within the IA show that in 2018 around 6,700 UK businesses imported goods from Japan, while around 9,500 UK businesses exported goods to Japan. The IA suggests that comparable data are not available on the number of UK businesses that trade with Japan in the service sectors, including financial services.

The IA states that "*Firms have the option to choose whether to trade with businesses in Japan under preferences in the UK-Japan CEPA or under MFN*[2] *terms. Therefore, there is no net cost to businesses for those who do not wish to trade under the agreement's preferences*." The IA explores the voluntary costs for businesses choosing to utilise the CEPA and estimates potential one-off familiarisation costs from reading and understanding the agreement to be £4.6 million, ranging from £4.5 million to £4.8 million. A portion of this cost is associated with the hiring of an agent, reflecting a 2015 HMRC report showing that 60 per cent of businesses seek an agent for tax affairs.

The IA uses tariff equivalent trade costs to estimate potential on-going administrative costs to businesses. This is done by estimating the costs of complying with the rules of origin[3] requirements and applying them to the volume of predicted UK-Japan trade. The IA's central estimate is £11.3 million per annum, within a range of £10.9 million to £11.7 million (2019 price base year). The IA outlines the limitations of these methods and reiterates that these estimates are included in the IA to provide indications of magnitude.

[2] Most Favoured Nation (MFN). An MFN clause requires a country to provide any concessions, privileges, or immunities granted to one nation in a trade agreement to all other World Trade Organization member countries.
[3] Rules of origin are the criteria needed to determine the national source of a product.

The benefits to businesses of the CEPA are mostly aggregated, given the nature of the CEPA. The IA breaks down the benefits by sector and region, highlighting those most affected. The IA provides a breakdown of the benefits from tariff reductions and includes similar estimates for the reductions in barriers associated with non-tariff measures (NTMs),[4] outlining the scale of NTMs in Japan and the UK respectively, alongside the expected percentage point reductions resulting from the CEPA.

Wider Impacts

Given the broad nature of the CEPA, the IA explores in depth the direct, indirect and wider impacts on (trade and investment) businesses, on consumers' choices, prices and on the labour market; as well as environmental, competition, innovation and distribution effects.

The detailed analysis of consumer impacts in the IA states that the extent to which businesses or consumers in the UK will benefit from reduction in the CEPA's tariff schedule will depend on the rate at which lower costs are "passed through" from importing businesses to consumers. The IA claims that liberalising trade with Japan could lead to greater consumer choice, providing easier access to products that are currently imported, as well as new products that would not have been available without the CEPA.

The IA considers the environmental impacts of the trade agreement in some depth and presents the implications of the CEPA for the UK environment, including greenhouse gas emissions (CO_2 and Non-CO_2), energy usage, trade-related transport emissions and wider environmental impacts on areas such as air quality, biodiversity and water use/quality. The CEPA is expected to increase domestic greenhouse gas emissions marginally by 0.028 per cent compared to projected levels in 2035. The IA explains the potential for marginal increases in GHG emissions in some sectors compared to current projections in the baseline, but this does not take into account future policy to decarbonise these sectors. The CEPA is also expected to increase energy consumption of fossil fuels marginally by 0.028 per cent when compared to the projected 2035 UK energy usage. The IA concludes that the CEPA is not expected to affect the environment significantly.

The IA also presents evidence relating to competition effects of the CEPA. The IA indicates that the estimated impacts reflect a combination of increased competitiveness of UK exports in Japan and increased competition from Japanese firms, together with other price changes associated with lower transactions costs, are expected to drive productivity gains in the UK. The IA also notes that the evidence shows that greater competition from trade promotes business innovation and growth; some businesses (and the employment they generate) may expand, but some businesses may be adversely affected by the increased competition.

The IA also analyses intellectual property (IP) services, highlighting that £375 million of IP services were exported to Japan, representing 5 per cent of all UK services exports to Japan in 2019. Over the same period, £2.5 billion of IP services were imported from Japan, representing 37 per cent of all UK services imports from Japan. The IA states the CEPA includes a comprehensive chapter on copyright and related rights, upholding the balanced and effective copyright regime in the UK, which protects rights for holders and users of copyright. The IA suggests that UK businesses that own registered trademarks have the

[4] Non-tariff measures are generally defined as policy measures other than ordinary customs tariffs that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both. These include regulations.

exclusive right to manage their use and application; and also includes provisions to protect for at least 25 years independently-created industrial designs by UK businesses that are new and original.

Distributional impacts of the CEPA are considered throughout the body of the IA. The IA acknowledges the distributional consequences of FTAs – that is, who is affected and by how much - depend upon the interaction of a range of complex factors. These include the structures of the economies involved, their comparative advantages in producing different goods, sectoral patterns of trade in each country and their physical and institutional infrastructures. Distributional impacts are also affected by the ability of individuals and firms to adjust to increased trade and short and long-term domestic policies. The IA analyses distributional impacts by sectors, regions, businesses, consumers and workers.

Quality of Submission

The Department has responded constructively to discussions with the RPC in preparing the final IA. The Department has undertaken a detailed assessment of the UK-Japan CEPA impacts.

The IA makes use of a computable general equilibrium (CGE) model. The model is based on the standard Global Trade Analysis Project (GTAP) model and GTAP 10 dataset, which is one of the most widely used tools for international trade analysis. The IA's technical annex provides further detail of the GTAP 10 database's sectoral coverage of 57 sectors. These have been aggregated to 23 sectors to ensure consistency with the previous published government analysis of long-term impacts of EU Exit. The structural model assumptions and aggregation appear to be well-defined and suitable to support the level of analysis undertaken in the IA. The specification of model inputs relating to tariff and non-tariff barriers also appears to be clearly defined. For the purpose of calibration, the monetary figures provided in the IA are constructed by applying percentage changes to the relevant 2019 figures. This appears reasonable in view of the complexities of trade system dynamics and current uncertainties.

The model sets out several impacts as stated above including on the economy (GDP), trade (imports and exports), labour market (wages), productivity, business, and consumer (price and choice) effects. The voluntary nature of trading under CEPA preferences means that there are no direct cost to businesses, but CEPA may result in indirect costs on businesses arising from their competitors', suppliers' and customers' exercise of this option, which would not arise if all firms had to trade either on MFN terms (the counterfactual) or the CEPA preferences.

Baseline: The IA sets out that the impacts of the CEPA are assessed against a baseline where the UK and Japan do not have a FTA, representing the 'do nothing' scenario (the outcome that would happen without ratification). Although this can be considered an appropriate comparator, there is a practical difficulty arising from the fact that the UK has recently been trading under the EU-Japan EPA. It is therefore difficult to separate trade effects from the EU-Japan EPA and WTO terms. The IA tests the stylised assumptions for the 'do nothing' and presents alternative estimates by changing these assumptions. However, in using recent 2019 data to estimate the magnitude of impacts, these data reflect the existing EU-Japan EPA. This may therefore be seen as an inconsistency and should be clarified. The uncertainty around the use of the 'do nothing' baseline should be made clearer in the IA and set in context with the existing EU-Japan FTA.

Uncertainty: The IA explores the uncertainties and analytical limitations of the modelling, building in sensitivity analyses of the estimated impacts. The IA sets out that the estimated scale and distribution of impacts from the modelling exercise depend upon a range of assumptions, including the baseline and the scale and sectoral pattern of assumed trade cost reductions. All modelling outputs are estimated relative to a 'baseline' that is meant to represent the economy in the absence of a UK-Japan agreement. An important element of this baseline concerns the future trading relationship between the UK and the EU. Stylised assumptions are used to represent a future hypothetical FTA between the UK and EU using assumptions from previous-published government analysis of long-term impacts of leaving the EU. The choice of baseline influences the assessment of the CEPA due to the trade-diversionary impacts resulting from the UK's future economic partnership with the EU. To assess the sensitivity of the main results to the choice of baseline inputs, the impact of the CEPA is assessed against an alternative baseline where the UK trades with the EU on WTO terms. The RPC welcomes this sensitivity analysis which helps to address some of the uncertainty in the baseline and estimates.

Data: The IA uses FDI data to illustrate the FDI flows between the UK and Japan. FDI figures are highly volatile and significantly change year-on-year due to large transactions. For example, the 2016 FDI data were strongly affected by the £24 billion acquisition of ARM Holdings by Softbank. In addition, FDI estimates vary widely by source and the IA should make use of official statistics where possible to provide the most robust estimates. According to the ONS publication, FDI involving UK companies: inward[5] Table 3.1 for stocks and Table 2.1 for flows, Japan accounted for 6.41 per cent of the stock of UK inward investment (sixth place) in 2018. The relative importance of Japan's FDI flows into the UK may be weaker than currently illustrated in the IA which could potentially make the FDI liberalisations in the CEPA even more beneficial.

Monitoring and Evaluation: The Department has committed to publish a monitoring report for the CEPA every two years, and a comprehensive evaluation within five years of its entry into force. The evaluation report will synthesise findings from monitoring, evaluation, and stakeholder engagement activities to assess the impact of the CEPA and answer the Department's core evaluation questions. The RPC welcomes this commitment and considers it critical to understanding the true long-term effects of the CEPA.

Long-term vs. short-term effects: While the Department identifies the long-term effects, and the most affected sectors and regions throughout the IA, there is a noticeable tendency towards highlighting and exploring the beneficial effects of the CEPA. Any bilateral agreement will have positive and negative effects, such as increased competition effects on UK firms, and further exploration of both aspects should be provided in the IA.

For example, the IA acknowledges that the UK motor industry will contract as a result of the CEPA in the long-term, and notes that this industry has a large footprint in the West Midlands. Page 65 of the IA, states that "*the location of production and employment may evolve significantly over the assumed 15-year time horizon for the economic modelling. It is*

[5] https://www.ons.gov.uk/businessindustryandtrade/business/businessinnovation/datasets/foreigndirectinvestmentinvolvingukcompanies2013inwardtables

therefore difficult to accurately assess the impacts of the estimated changes in composition of sectoral employment on various regions of the UK." While broadly acceptable given modelling limitations, this overlooks that there are likely to be significant short-term disruption effects on this industry. The IA should explore further the effects of competition on industry and the possible short-run regional disruptions, as these effects could be hidden in the long-term impacts presented in the IA.

In another example, on page 23, the IA states that "*UK professionals have certainty through a number of routes to enter and stay in Japan on a temporary basis to provide services or establish, with clearer and streamlined processing for temporary business visas*." The IA should explore the impacts associated with the reverse of this situation for Japanese professionals having a clearer and streamlined process for stays in the UK. There are potential short-term benefits to the UK excluded in this section as a result of not exploring both the positive and negative effects.

Global supply chains: The IA should explore further how the CEPA will affect existing trade flows and the change from a bilateral EU-Japan EPA to a triangular EU-UK-Japan arrangement. For example, under the trade deal, it is likely that car parts from Japan used in the UK will not be treated as British, so some exports to the EU may see higher tariffs. There will be significant implications for global supply chains and the IA could benefit from considering the nature of existing arrangements and the ease for business to implement changes.

Financial trade flows: Given, the IA states the UK's close investment ties with Japan, there is only limited discussion of the effects on trade in services and inward investment, and the impact on financial trade flows. The IA should further explore changes in the composition of financial trade flows and allocation of inward and outward FDI.

Financial services. Although the IA has set out the long-term impacts on trade in services, given the significance of the financial services sector to the UK economy and relatively limited UK-Japan cross-border financial services business at present, particularly in retail financial services, the impacts of the CEPA could be significant for the financial services sector. The IA should present further evidence and analysis of the effects of the CEPA on the financial services sector and consider consequences for other trade agreements.

UK-Japan balance of trade: On page 43, the IA states that "*UK exports to Japan are estimated to increase by 17.2% in the modelled scenario…this would imply an increase in UK exports to Japan of £2.6 billion. UK imports from Japan are estimated to increase by 79.9%…this would imply an increase in UK imports from Japan of £13.0 billion. Overall UK-Japan trade is estimated to increase by £15.7 billion in the long run using 2019 UK-Japan trade data*". This paragraph focuses on the increase in the overall trade between the UK and Japan but does not discuss the UK's balance of trade, which according to these figures would weaken by £10.4 billion. The IA should explore any negative balance of such impacts, providing a more-balanced narrative in this section.

Impact on other FTAs: The IA has usefully considered whether any developing nations will be disproportionately affected by the CEPA. However, it would also benefit from highlighting any developed nations that may be disproportionately affected as a result of the CEPA, as this may influence future FTA negotiations (and their impacts on the UK).

Areas for improvement (and future consideration)

Business compliance: The IA could improve compliance cost estimates by taking account of the differences in costs between inward and outward trade and across different sectors.

Consumer protection rights: The IA considers consumer impacts in some detail but the analysis could benefit from describing in more detail how consumer protection will be maintained with the CEPA and consider whether UK consumers maintain the same legal protections and rights for goods and services with a change in origin.

Foreign investment and national security: Although the IA has undertaken analysis of inward investment, it could go further by considering possible amendments to the CEPA relating to investments in specific business sectors that could pose national security threats or involve other national interests.

Foreign ownership and headquarters (HQs): The IA could consider further the implications of the trade deal on the ownership of businesses and how foreign companies select locations for HQs and operations (for example, assembly plants). The IA could consider whether there are likely to be changes in business ownership and whether the CEPA could increase mixed ownership or joint venture deals. Also, consideration could be given to whether existing HQs could be affected, or HQ classifications change due to the new trade relationship or for other trade requirements such as access to the EU market.

Food standards and animal welfare: The IA states that the CEPA does not prevent the UK from upholding high environmental, food safety and animal welfare standards. Although aggregate impacts on the agri-food sector are reflected in the IA, further analysis to understand the potential impacts on business of protecting standards, and the potential for expanded trade to create market pressures affecting these standards could be explored further.

Coronavirus implications: While the Department notes that the analysis in the IA does not reflect the recent economic consequences of Coronavirus, the IA would benefit from a qualitative exploration of how the combination of the CEPA and the consequences of Coronavirus for both UK and Japan could affect the analysis. While the RPC does not think it is proportional (or even possible) for the Department to quantify the impacts of the virus, the IA could benefit from acknowledging the implications for the validity of the analysis presented. Many sectors and regions of the UK and international trade patterns have been heavily disrupted by this recent event. Thus, the IA's analysis of the CEPA based on comparison with prior year data may not provide as accurate an indication of the impacts and outcomes given the current circumstances.

Regulatory Policy Committee