



# Shattered Illusions

## The new Brexit proposals on customs

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With just five months to go, allowing three for ratification, what will the post-Brexit EU/UK relationship look like? On the colossal matter of post-Brexit arrangements, almost nothing has been agreed except the avoidance mechanism of 21 months of status-quo during the ‘transition period’ beginning late March 2019. And we are no closer to an answer to the most unnerving question: without any workable ‘deal’ on customs, will ports grind to a halt, generating gigantic queues of lorries? As recently as one month ago, a House of Lords report<sup>1</sup> still discussed the delusional UK customs proposals of August 2017 that had already been rejected by EU negotiators. The cliff-edge looms large over the UK government, the EU and business on both sides.

With time running out, the moment of taking decisions rather than chasing illusions caused a rupture in the UK government, though at least this opened the way to soften the Brexit notions of some. In the long-awaited UK White Paper on the future relationship between the UK and the EU-27,<sup>2</sup> new customs proposals have been incorporated which should (according to the UK) govern compliance of future cross-Channel trade in goods. However, they have major implications for the UK’s non-EU trade as well. The proposals are also intended to ensure that the Irish/Northern Ireland border remains without physical controls or delays. The White Paper provides – for the first time – an overall approach of what Brexit could mean for the post-29-March-2019 EU/UK relationship with plenty of possibly fruitful or at least potentially workable suggestions or concrete plans.<sup>3</sup> In this sequel CEPS Commentary to my critical analysis of last

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<sup>1</sup> House of Lords, EU committee, UK-EU relations after BREXIT, 8 June 2018, HL Paper 149, pp. 29 – 31.

<sup>2</sup> Of 12 July 2018, Cm 9583, see [https://assets.publishing.service.gov.uk/government/uploads/attachmen\\_data/file/724982/The\\_future\\_relationship\\_between\\_the\\_United\\_Kingdom\\_and\\_the\\_European\\_Union\\_WEB\\_VERSION.pdf](https://assets.publishing.service.gov.uk/government/uploads/attachmen_data/file/724982/The_future_relationship_between_the_United_Kingdom_and_the_European_Union_WEB_VERSION.pdf)

<sup>3</sup> See Michael Emerson, [Theresa May’s Brexit model: many questions, not least ‘why Leave?’](#), CEPS Commentary, 16 July 2018.

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year's UK customs proposals,<sup>4</sup> I focus solely on the hard core of future bilateral goods trade, including the ramifications for UK trade and trade policy with third countries.

## 1. What has changed in 11 months?

Three interesting changes have occurred in the Brexit customs saga. First, much of the debate in the UK has increasingly been on 'time' and (lack of) capacity. Until the agreement, in principle, between the UK and the EU-27 on having a transition period until the end of 2020, the spectre was raised of a stand-off between the EU, being highly sceptical if not downright dismissive of the August 2017 proposals, and the UK government, seemingly unwilling or incapable of producing more workable proposals. Both houses of the UK parliament began to favour staying in the EU customs union, as testimonies of specialists from business and the major UK ports demonstrated how doubtful the merits of the proposals were and how impossible the demands on customs, ports and business in the case of a 'no deal'. Being outside the EU customs union would imply a very significant increase in customs staff, probably major structural expansion of port infrastructure and facilities and much heavier demands on the emerging – but far from 'ready' – Customs Declaration Service ICT system, replacing the old CHIEF system.<sup>5</sup> In Dover, the biggest harbour of the UK and specialised in EU-UK trade, a no-deal scenario would cause a *hundredfold* increase in the number of customs declarations.<sup>6</sup>

Official reports have begun to speak of the serious risk of chaos in ports and airports (for air freight).<sup>7</sup> There is simply no 'quick-fix'. The agreement on a transition period (only arranged in principle, not yet in detail) may have lessened fears of immediate disruption, but it would only extend the UK's stay in the customs union for another 21 months, hardly any time at all for developing an adequate response. The insistence by Brexiters on leaving the customs union is not a carefully considered preference after weighing the pros and cons. They seem uninterested in the nitty-gritty, even when the nitty-gritty is big and costly,<sup>8</sup> and only focus on regaining freedom to conclude FTAs with third countries as a symbol of 'Global Britain'. The option of negotiating some kind of participation and 'say' in EU trade negotiations – short of a veto – is apparently not even floated.

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<sup>4</sup> Jacques Pelkmans, [The Brexit Customs vision – Frictions and Fictions](#), CEPS Commentary, 22 August 2017.

<sup>5</sup> It is also worth noting that many other departments are involved in customs affairs, mainly due to regulatory controls.

<sup>6</sup> There is no room to detail the possible impacts here, but, in just one example of the scale of the problem, it is estimated that the number of customs declarations in the UK would rise from 55 to 255 million, most by companies making them for the first time ever. See, for example, J. Owen, M. Shephard & A. Stojanovic (2017), *Implementing Brexit: Customs*, Institute for Government, London, September; and the House of Commons Report, *Home Office Delivery of Brexit: customs operations*, 16 November 2017, which leans strongly on the Owen *et al.* paper.

<sup>7</sup> The ports of Dunkerque, Calais, Zeebrugge, Rotterdam and Antwerp might also suffer from capacity bottlenecks if flows of lorries are slowed or interrupted.

<sup>8</sup> The additional costs of losing the customs and trade facilitation and duty benefits are estimated to range between GBP 19 billion and £26 billion, while a no-deal would require some 3,000-5,000 extra staff needing to be trained and acquire experience. House of Commons Report, *op. cit.*, p. 14.

Second, one of the serious weaknesses of last year's proposals was the absence of any clarity about UK preferences for the post-Brexit trade agreement with the EU. While the preference for an FTA with no bilateral tariffs has since become explicit, an FTA introduces rules of origin. These have not even been mentioned, but generate considerable costs and complications both for customs officers and business. The EEA-3 countries are not a useful example in this context. Due to their production structures and size, their industrial exports are very small in comparison to those of the UK, to say nothing of the manifold ways UK business is involved in complex regional and global value-chains.

Third, in August 2017, the UK presented two proposals: a highly streamlined customs arrangement and a new customs partnership with the EU. On 12 July 2018, the UK presented a mix of the two previous proposals.<sup>9</sup> It is called a Facilitated Customs Arrangement (FCA). The FCA may or may not work but, in any event, it is less unrealistic than the previous proposals. It is closely connected with the EU customs union and the enforcement of EU regulatory requirements at borders as well as with processes and procedures for VAT and excise duties. A close reading of the text<sup>10</sup> gives the impression of yet another opt-out suggestion for the UK – be it once again with some fiction, here and there – as an EU member rather than a plain Brexit option. So, what is it?

## 2. Nature and weaknesses of the FCA

The UK advocates far-reaching accommodation and common arrangements leading to a situation for business and public administration (as well as numerous private intermediaries providing customs-related services) “as if” in a combined customs territory. However, the immediate Brexit addition is “while still enabling the UK to control tariffs for its own trade with the rest of the world”. The underlying purpose of the FCA is also a Brexit objective: being sovereign in concluding trade agreements with third countries. The FCA includes a ‘common rulebook’ for manufactured goods, agriculture, food and fisheries (and related forms of equivalence), common cross-border processes and procedures for VAT and excise, the Common Customs Code as well as robust domestic market surveillance and cooperation between the UK and the EU.<sup>11</sup> How radically different this is from the picture that the UK would drift away from the EU when seeking to ‘take back control’.

However, a little over half of UK goods trade is with third countries.<sup>12</sup> The critical problem is, therefore, how the “as if” approach for EU-27/UK trade in goods can be combined with a

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<sup>9</sup> However, the highly complicated ‘tracking mechanism’ has been deleted. See Pelkmans, *op. cit.*, note 7.

<sup>10</sup> White Paper, *op. cit.*, pp. 15 - 19

<sup>11</sup> The latter also hinges on trust. In 2017, two major issues were reported that undermine trust in the discipline and rigour of UK customs authorities. One is that the UK would seem to have turned a blind eye to a massive Chinese-led fraud in textiles and footwear (a € 2 billion fine is mentioned); in addition, there is an infringement case against the UK for falling short on VAT collection. Source: Politico, “Brussels scoffs at Britain’s customs proposal ahead of Brexit talks”, 24 August 2017.

<sup>12</sup> Not in agro-food. 70% of UK agro-food imports are from the EU. This might change if, post-Brexit, the UK were indeed to lower the higher agro-food tariffs and relax tariff rate quotas, unilaterally or via FTAs.

‘sovereign’ trade policy vis-à-vis third countries. It is helpful to quote the White Paper directly (p. 16): “As if in a combined customs territory, the UK would apply the EU’s tariffs and trade policy for goods intended for the EU. The UK would also apply its own tariffs and trade policy for goods intended for consumption in the UK”. Why this highly unusual proposal? Why not accept that the UK is a third country after Brexit, hence not act “as if” in a combined customs territory? The answer is that, if the UK could serve as a trusted agent for the EU customs union, for goods imported into the UK (from the rest of the world) but destined for the EU, the Brexit costs of formally moving outside the customs union would be drastically lower. Together with UK-produced goods intended for the EU-27, the FTA with the EU and the full acceptance of the rule book as well as the EU customs code, there would appear to be no need to incur significantly extra costs for EU-UK trade in goods in Dover and the Channel Tunnel, etc. But how can officials know, let alone be sure, what the ‘intended’ destination of goods imported in the UK from third countries is? And in the world of modern fragmented production processes and regional as well as global value-chains (GVCs), what does the term ‘destination’ really mean?

Intermediate products might be upgraded in the UK and subsequently re-exported to the EU-27 and they might well return to the UK after further adaptation, or, after inclusion in another intermediate or final good. This is not a small matter – almost 50 % of EU external trade is in intermediate goods. But even outside GVCs, logistical companies routinely modify marginal aspects or the packaging of goods before further – often highly dispersed – distribution throughout Europe.

The White Paper does not offer convincing answers and hence looks much like the delusional proposals of August 2017. One answer is to “agree a new trusted trader scheme”. This is based on the assertion that trusted traders (AEOs)<sup>13</sup> will “robustly” demonstrate the destination and hence pay the UK or the EU tariff, whichever applies. The UK notes that this is relevant for finished goods. It is anything but clear why AEOs would be the ‘robust’ partners for finished goods while SMEs and others (e.g. retail imports) would not be. . The reliance on AEOs appears to be an attempt to avoid the ‘repayment mechanism’ needed when the destination is uncertain and the higher (EU or UK) tariff would be levied, only to find later that the tariff paid was too high once the destination becomes verifiable. Though the repayment mechanism was included in the previous proposals, the UK now proposes an agreement between the EU and the UK on the ‘circumstances’ in which repayments can be granted. It is held that it would be relevant for intermediate goods. This repayment mechanism would enable the UK to further minimise differences between the EU-27 and the UK and hence “preserve frictionless trade for the majority of UK goods trade and reduce frictions for UK exporters and importers”. The White Paper asserts that it would apply to only some 4 % of UK goods trade.

The repayment mechanism is yet another price the UK would pay for Brexit pulling the UK out of the EU customs union. The proposal includes attempts to soften the expected criticism that the repayments will lead to a nightmare of bureaucracy and delays: payments ought to take

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<sup>13</sup> Authorized Economic Operators, an existing scheme in the EU (and elsewhere). These are typically multinationals with a lot of intra-firm and intra-GVC trade. Accreditation is required for eligibility.

place as soon as possible in the supply chain, e.g. when the good is “substantially transformed” rather than at the point of final consumption.<sup>14</sup> The fear that SMEs will find this ‘solution’ an additional source of complications and red tape, along with an increased risk of late payments, is implicitly acknowledged. Similarly, the EU would need to be reassured by rules and processes governing the eligibility for repayment: this would involve risk profiling and effectively targeted audit and assurance efforts. All in all, despite being extremely burdensome, such arrangements would necessitate a great deal of trust (think of re-exporting tricks, etc.). In addition, the UK proposes a tariff revenue formula for (net) remittances, because the EU will not apply UK tariffs.<sup>15</sup>

Finally, the White Paper is replete with suggestions, largely migrated from the previous proposals, conveying the UK’s firm intention to arrive at the least friction possible in trade. These include accession to the Common Transit Convention (not necessary inside the customs union and only relating to transits through the EU), mutual recognition of AEOs (again, in the customs union that is an EU accreditation process), allowing traders to calculate their own customs duties, speeding up authorisation processes via better use of data and making existing simplified procedures “easier for traders to access”.<sup>16</sup> Much of this reduces the costs of exit and/or can be done just as well inside the customs union. Last but not least, the UK proposes a ‘phased approach’ through discussions on the future economic partnership. There is one aspect – the emphasis on AEOs – that is possibly misleading and may well require some further factual information. The UK (in 2017) had 548 AEOs covering between 60% and 74% of all goods trade. The EU-28 has over 14,000 accredited AEOs. There is obviously nothing new about the arrangement. However, the UK customs currently processes declarations from some 145,000 firms and another 180,000 firms would join them following Brexit. The AEOs, no matter how useful, are not the real problem or a solution. Moreover, while being an AEO reduces costs for major traders, it is far from certain that there will be any effective cost reduction for SMEs after Brexit, when the costs for traders might go up steeply.

### 3. Conclusions

The recent political turmoil in the UK and the White Paper, published in its aftermath, show that the illusions about the 2017 customs proposals have been shattered. The new proposals are less unrealistic and relate more closely to the EU regulatory *acquis* in several ways. A critical and helpful aspect is that the UK will embrace – or, retain, one might say – the application of the EU Customs Code. The document also sets out a much more cooperative agenda with the EU. However, there is still a considerable amount of wishful thinking and open-ended promises to ‘explore’ new ideas in the UK or together. Some proposals will require a high degree of trust

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<sup>14</sup> Another suggestion is to “explore an approach with the EU using concepts” found in the Regional Convention on pan-Euro-Mediterranean preferential rules of origin.

<sup>15</sup> As a result, the EU and the UK would have to agree on mechanisms including institutional oversight for ensuring that this process is resilient and verifiable. Still more intricacies, therefore.

<sup>16</sup> Even more speculative suggestions are made with respect to machine learning, AI and storing the entire chain of transactions for each goods assignment, none of them supported by any detail.

between the EU and the entire UK customs organisation (some 30 instances), right after two painful failures on the UK customs side.

The two connected weaknesses of the proposal are found precisely where Brexit matters most. Starting with the idea that leaving the customs union would not be so costly in terms of red tape, waiting time, strict requirements for GVCs and just-in-time systems as well as major public investment in compliance and infrastructure, if the UK could act as the EU's customs for goods 'intended' for the EU. For goods 'intended' for the UK, UK tariffs (or tariff rate quotas) would apply. Not only does it appear next to impossible to ensure this 'intended destination' in all cases, even without the 'tracking mechanism' of last year (now deleted) there is still a need for complicated compliance mechanisms. The distinction between finished and intermediate goods, supposedly fitting the designation of the destination in most instances, is not at all convincing. As a corollary, however, a repayment mechanism has to be put in place, which, it is feared, would be very costly in terms of red tape and the risk of delayed payments, especially for the overwhelming majority of firms not accredited as AEOs. Also between the EU-27 and the UK, the net remittance tariff formula promises to be controversial, given the shaky foundation of the arrangement. It is not *a priori* clear whether the EU would regard these proposals as sufficient to initiate negotiations on a workable arrangement for late 2020. What the EU might wish to do instead is to make a counter proposal, now that the UK is willing to embrace a full rulebook as well as the common customs code and suggesting a cooperative agenda. The firm intention to agree on a common (EU-based) rule book, including for indirect taxation, for all goods traded implies that the post-Brexit FTA with the EU is far deeper than CETA and – for goods at least – close to the EEA-3 model or (after another decade or so) Ukraine.