

# BREXIT BRIEFING

## THE TRADE COSTS OF A “NO DEAL” SCENARIO

### **Transitional arrangements will reduce uncertainty for businesses**

In July 2017, the CBI called for agreement as soon as possible on transitional arrangements to govern UK-EU trade in the period between the end of the Article 50 process in March 2019 and such a time as a new deal comes into force. It is vital for British business to avoid a regulatory “cliff-edge”, where UK trade with EU suddenly defaults to a WTO framework, implying a return of tariffs and a host of other barriers to trade. The simplest way of achieving this bridge to a new relationship with the EU, will be for negotiators to agree that the UK should remain in the EU single market and customs union until a new deal is in force. This period should be short as practically possible: two to three years could allow sufficient time to get the final deal right, including agreement on a longer implementation phase for sectors that need more time to adapt.

An agreement with the EU on the details cannot come soon enough. Many companies have told the CBI that developments in the coming months will be crucial to their investment strategies, and contingency plans could be triggered if the UK’s ability to trade and invest freely with the EU beyond March 2019 looks to be at risk. It is vital that a transitional arrangement is agreed by the end of 2017 to give firms the confidence to continue growing their UK businesses.

In the long-run, however, even if the UK government is successful in negotiating a “bold and ambitious” free trade agreement (FTA) that keeps trade tariff-free, the UK still risks some degradation in its trading relationships with the EU relative to the status quo, given the likelihood that trade becomes administratively more complex. How costly this proves to be will depend on the extent to which practical solutions can be found to simplify new customs procedures, for example, and the precise mechanisms that are agreed in different sectors to facilitate co-operation with EU regulators. Crucially, it will depend on whether a FTA applies to goods or encompasses services trade and investment.

This briefing sets out evidence on the scale of barriers to trade in different sectors, to highlight the potential costs of leaving the EU with no deal in place, but also of securing a more limited trade deal over the long-run. The starting point is a discussion of the UK’s relative strengths in European trade, to highlight what’s at stake and the kind of trade-offs the UK may be facing during negotiations on a FTA.

### **UK-EU trade relations are both “broad” and “deep”**

#### **Trade and the trading system has become more complex**

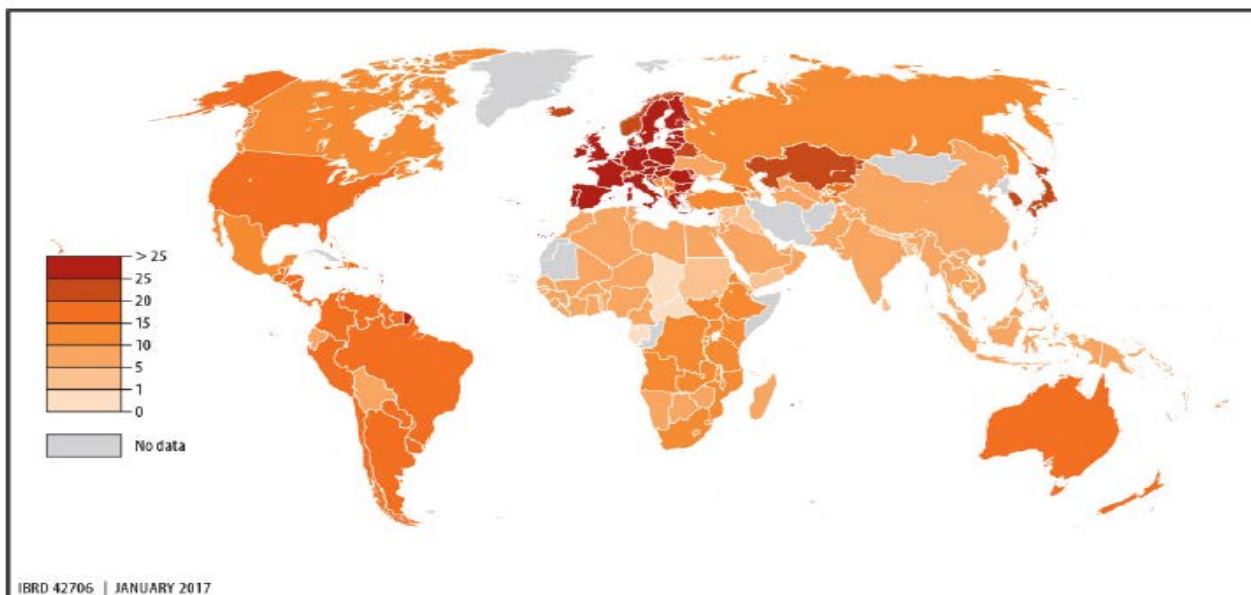
Negotiations over a UK-EU trade deal promise to be like no other, both in terms of breadth of issues covered and in light of the starting point of barrier free trade and free movement of people and capital. Traditionally, trade negotiations around the world have been based on a reciprocal exchange of “market access” for different sectors—the principle of “my market for yours”—where each side attempts to gain as much access as possible in sectors where their exporters are most competitive, while protecting industries that are politically more sensitive from greater competition from imports. The forthcoming talks are unique because the conversation will be about new restrictions being imposed on markets.

Changing patterns of trade both within Europe and globally mean that a failure to reach a deal with the EU could result in significant disruption to established supply chains. China’s rapid rise and the spread of technology have led to huge growth in global trade flows and the internationalisation of production across borders within global value chains. Nowadays, trade is less about selling across borders as much as producing across borders. As a consequence, the global trading system is becoming characterised by the increasing depth of trade agreements, which go well beyond “market access” issues, such as tariffs, to cover

rules and regulations for trade in services, cross-border investment, competition rules and the protection of intellectual property rights. This deepening has enabled services trade to flourish and production activities to be divided more efficiently across national borders.<sup>1</sup>

Nowhere have these trends been more in evidence than in Europe. As the map below shows, the EU's single market is the deepest trading arrangement in the world, encompassing more sectors and more areas of policy than WTO agreements or any other trade deal around the world. This has helped drive intra-regional trade, which is greater than for any other region of the world.

**Figure 1. Depth of trade agreements: Number of legally enforceable provisions**



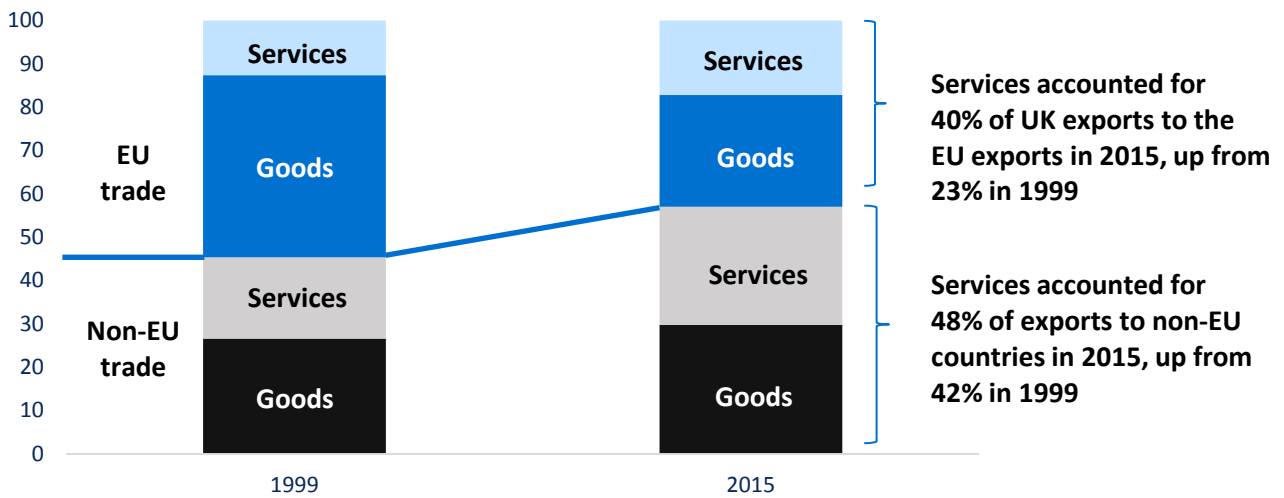
Source: "Trading off a 'soft' and 'hard' Brexit", Mulabdic, Osnago & Ruta; CEPR/World Bank 2017.

For the UK, EU integration has led many industries to become more deeply involved in European supply chains, especially in sectors like automotive, aviation and chemicals. In the motor vehicles sector, for example, a single car produced in the UK has around 30,000 individual parts, around 60% of which are imported, according to SMMT (the Society of Motor Manufacturers and Traders). The majority of these parts come from the EU, crossing the Channel multiple times before the vehicle is completed. Data from the OECD suggest that the share of foreign value added embedded within UK exports of motor vehicles has increased significantly over the past two decades, from 30% in 1995 to 44% in 2011.

EU membership has had a particularly strong impact on the UK's services trade. Over the last 16 years, the share of services in the UK's total trade has risen from 31% to 44%, an atypically high share (in most developed countries, services exports still tend to account for around one third of exports). The increasing "servicification" of trade has been most evident within EU trade, with the share of services in UK exports to the EU increasing by 17% points, compared with an increase of 6.5% points in non-EU trade. This change has been more dramatic in the UK than in other EU countries because the deepening of the EU's single market allowed the UK to capitalise on its existing strengths in services.

<sup>1</sup> Mulabdic, Osnago & Ruta, "Deep Integration and UK-EU Trade Relations", World Bank (2017).

**Figure 2: Composition of UK exports, %**

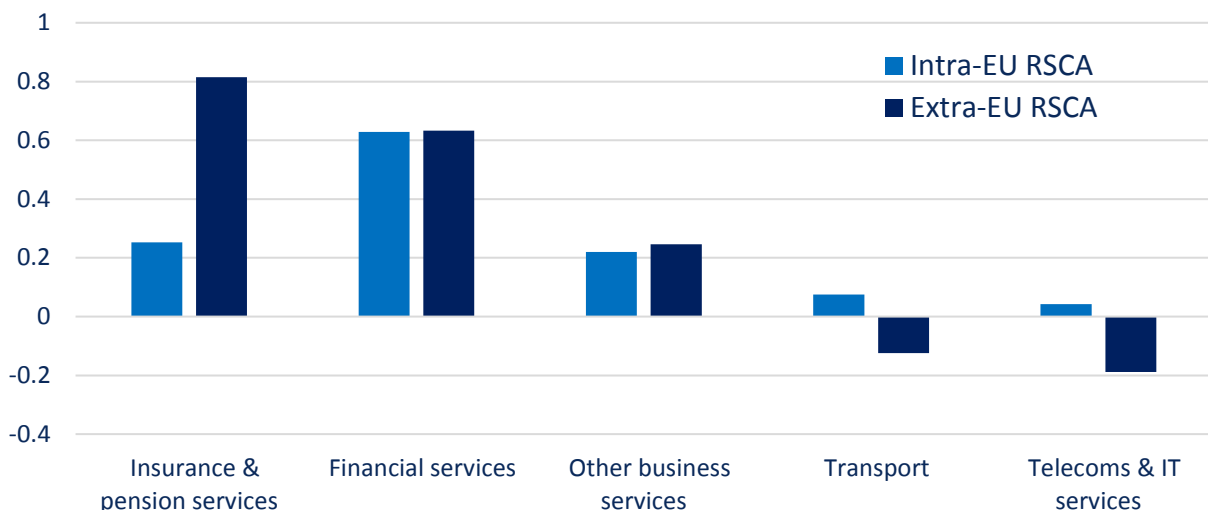


Sources: ONS Pink Book; CBI.

**The UK specialises in a wide range of services, but a narrower range of goods**

A good way of illustrating the degree of specialisation in the UK’s exports across different sectors of goods and services is to look at measures of “comparative advantage”, which compare the structure of exports between two countries or groups of countries. (A positive score implies that the UK is relatively more specialised in exports of that good compared with other EU countries, while a negative score implies it is relatively less specialised—see Box 1, below for methodology). Ahead of trade talks, negotiators often look at such measures to clarify their “offensive” and “defensive” interests—the sectors in which they want to promote access to the other side’s markets and those where they want to restrict foreign competition. Equally, measures of comparative advantage provide a good starting point to understand the implications of Brexit, particularly the sectors where the impact of an increase in trade barriers would be felt asymmetrically by either the UK or EU.

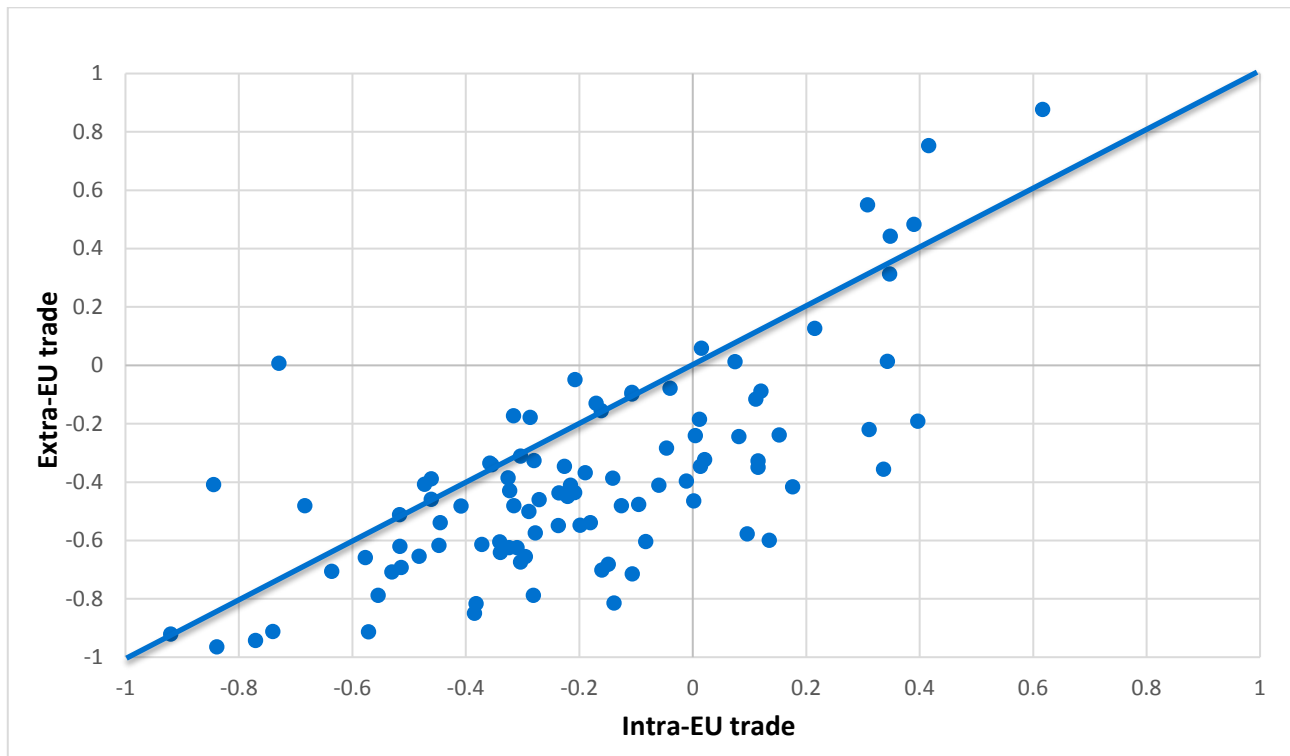
**Figure 3. UK Revealed Symmetric Comparative Advantage in intra-EU and extra-EU trade**



Sources: CBI; OECD Trade in Services.

The UK's strongest comparative advantages by far are to be found within the services sector. As Figure 3 shows, UK insurers enjoy a strong position in both global and EU markets, though they are particularly dominant in extra-EU trade (the UK is in fact the world's number one exporter of insurance services). In financial services and business services, UK firms also compete exceptionally well on both European and global stages, with an equally strong comparative advantage in intra- and extra-EU trade.<sup>2</sup> In other parts of the services sector, such as transport and telecoms & technology, UK firms are more clearly reliant on access to EU markets, showing a competitive advantage in intra-EU trade, but not in global markets.

**Figure 4: Revealed Symmetric Comparative Advantage in goods: intra-EU vs extra-EU trade**



Sources: CBI; UN COMTRADE.

When it comes to goods trade, the UK tends to be specialised in a narrower range of sectors, and to account for a higher share of intra-EU trade than extra-EU trade, compared with other EU countries. As Figure 4 highlights, the UK has a comparative advantage in global markets in only 11 out of 97 sectors, compared with 27 sectors displaying a comparative advantage in intra-EU trade, which in turn compares poorly with countries such as Germany (53), Poland (51) or Italy (50). Sectors displaying a positive comparative advantages in intra-EU trade in the UK include aerospace, books, scientific & photographic goods, beverages, fuels, pharma and chemicals. And it's worth noting that although the UK does not display a positive comparative advantage in motor vehicles, this sector has seen by far the greatest improvement in its competitive position over the past decade, thanks to rising market shares in Asia, the Middle East and North America. Overall, the vast majority of goods sectors enjoy a relatively stronger competitive position within EU markets than in non-EU markets (being positioned well to the right of the 45-degree line).

<sup>2</sup> A crucial question for negotiators is the source of this strength: are UK financial and professional services firms reliant on their EU business to achieve the scale to compete globally, or faced with higher barriers to EU trade, could firms switch their focus to non-EU markets with limited disruption?

## Failure to reach a deal could see numerous barriers to trade emerging

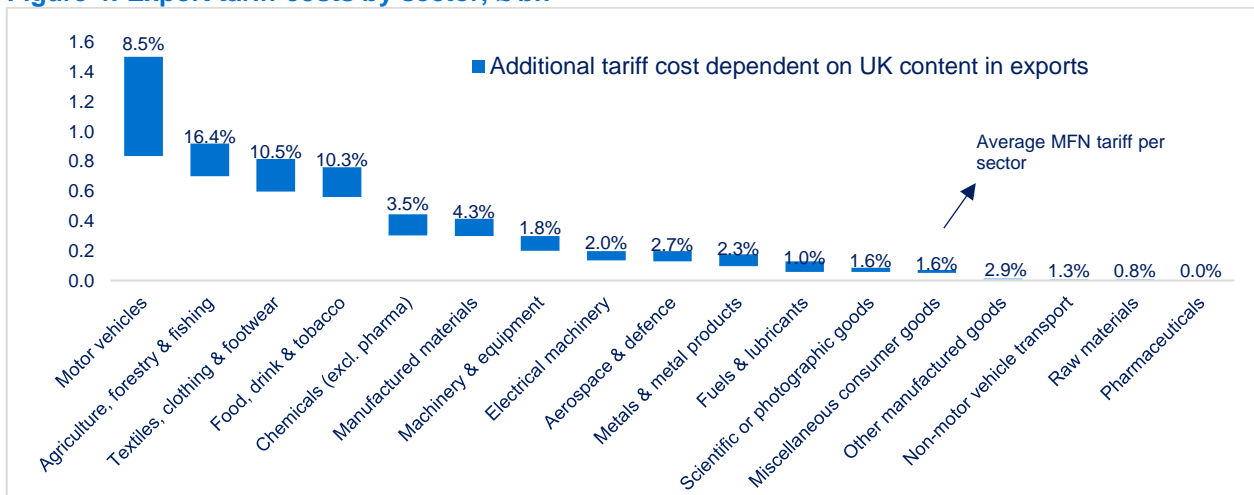
### Some sectors could see the return of significant tariffs

Without a deal, the UK would be turning its back on the simplicity and ease-of-trade resulting from membership of the single market and customs union. Trading relationships and supply chains would suffer serious disruption. We could see a return of much of the complexity which used to plague firms trading with Europe and there is a risk we would lose the mutual recognition of professional qualifications and licensing requirements that makes it easy to trade services across borders with the EU.

One of the forms these barriers would take would be tariffs imposed by the remaining EU member states on imports from the UK. In a “no deal” scenario, the UK would face tariffs on 90% of its EU goods exports by value. Figure 4 shows estimates<sup>3</sup> of the potential costs if UK-EU trade were carried out under WTO Most Favoured Nation terms. Our figures suggest that the average MFN tariff on UK exports to the EU (weighted by 2016 exports) would be 4.3%. If this were applied to total UK exports to the EU (around £141 billion in 2016), the **total increase in tariff costs would be between £4.5bn and £6.0bn**, depending on how much of the value of the good in question was produced in the UK, the EU or outside the EU (see Box 2, below, for an explanation of how these ranges are calculated).

However, some of the UK’s exports would experience tariff rates significantly higher than the average rate. The agriculture sector would face an average tariff of 16.4%, while textiles faces the next highest at 10.5%. Due to its size and relatively high tariffs (10% on vehicles and 4.5% on components), the automotive sector would have to pay the highest export cost of between £800 million and £1.5 billion. Adding to this, firms in all sectors will face an **increase in administrative costs** as a result of a requirement to provide a more detailed paper-trail tracking EU as well as non-EU intermediate inputs, to ensure the right amount of tax is paid. These additional costs are likely to significantly impact the competitiveness of UK exporters.

Figure 4: Export tariff costs by sector, £ bn



Sources: CBI; Heteronomics; HMRC; WTO.

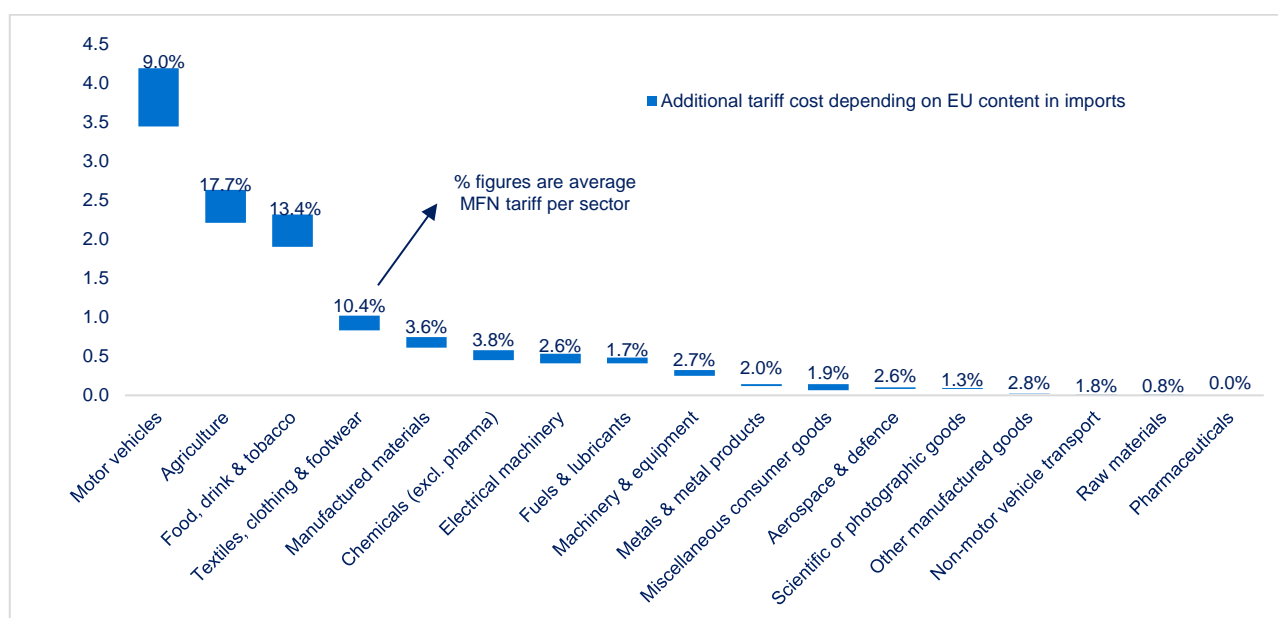
It should be noted that these are static estimates: they do not consider how the pattern of trade might shift in response to relative price changes, nor do they factor in the wider macroeconomic impact. It has been argued by some that exiting the EU without a deal would be less damaging than feared as the likelihood of a further depreciation in sterling would improve export competitiveness and offset some of the cost of tariffs. This is true, but only up to a point. As supply chains have become more internationalised, currency depreciations have increasingly become double-edged swords. Major exporters also tend to be major importers, with the result that higher import costs would be likely to dilute the benefits of a weaker pound over the short-term at least.

<sup>3</sup> CBI and Heteronomics calculations.

For UK consumers, a weak pound combined with the prospect of new tariffs on imports would amount to a double whammy, pushing up prices and squeezing household incomes. Our estimates<sup>4</sup> suggest **the cost of tariffs on imported goods could be more than double the cost on exports**, reflecting the fact that the UK runs trade deficits across many categories of goods (exceptions being fuel & lubricants, and aerospace & defence). The average MFN tariff rate on the UK's imports from the EU would be around 5.7%. When applied to UK imports of £237bn in 2016, this would amount to an additional **cost of £11bn-£13bn (around 0.6% to 0.7% of GDP) for UK consumers and businesses** (depending on the pass-through to prices).

Again, average tariffs can be much higher for certain sectors. Within the food sector, for example, dairy goods attract an average tariff of 32%, with levies on specific products, such as Italian mozzarella or Irish cheddar as high as 45.5% and 44.1% respectively, according to the British Retail Consortium. Even businesses operating in sectors with low tariffs on end-products, such as the technology and life sciences industries, and in domestically-focussed service industries, such as energy, utilities and environmental services, also highlight the importance of tariff-free UK-EU trade. These industries want to avoid vehicles, machinery and other supply chain costs increasing.

**Figure 5: Import tariff costs by type of import, £ bn**



Sources: CBI; Heteronomics; HMRC; WTO.

Given the potential consequences of higher import costs for inflation, external competitiveness and wider economic activity, there have been some suggestions that the UK might seek to reduce import tariffs unilaterally, to remove these costs for importers altogether. However, to do so legally would require the UK to drop import tariffs for every country. A sudden reduction in the level of market protection could be detrimental for many domestic businesses, particularly in agriculture and the manufacturing sector, and would also remove the UK's most powerful card in future trade negotiations.

### **Non-tariff costs are higher than tariff costs**

Higher tariff costs are just the tip of the iceberg. As noted above, the worldwide shift from domestic production to production within global value chains has driven a change in the focus of trade agreements from traditional market access issues to the broader rules and regulations that govern production, investment decisions and trade in services. Even if the UK can secure a deal promising tariff free trade in goods with the EU, UK businesses could still face new paperwork requirements and restrictions on their

<sup>4</sup> CBI and Heteronomics calculations.

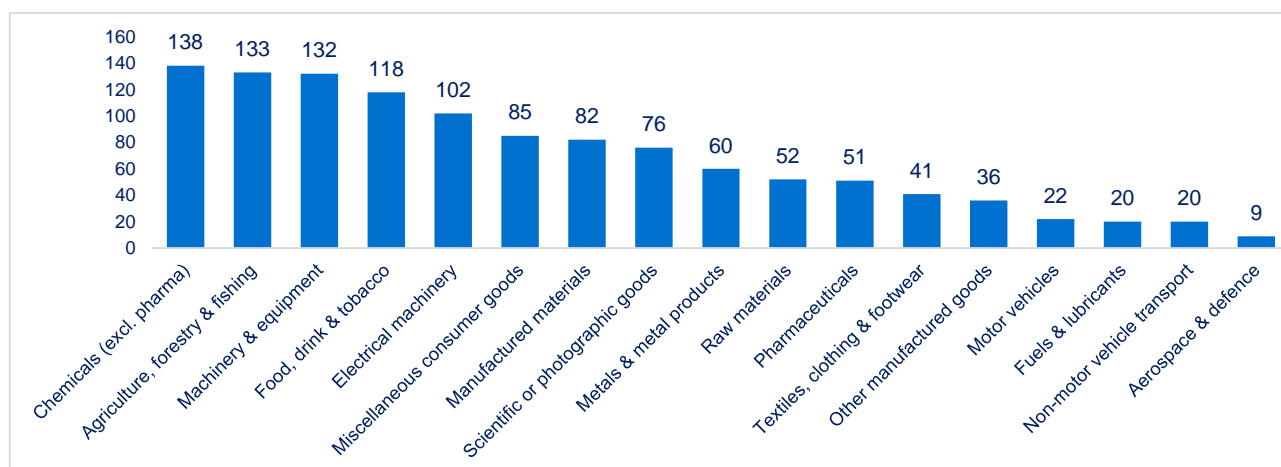
freedom to operate across borders. And these so-called non-tariff barriers (NTBs) are likely to have a more significant impact on competitiveness than tariffs, especially for smaller companies.

It is useful to divide these NTBs into two broad groups: “at the border” measures and “behind-the-border” measures. These two different types of NTB have a very different economic logic to them and will require a different approach by trade negotiators. The first group—at the border measures—covers customs procedures and quotas. It includes paperwork requirements to determine the appropriate level of duties to be applied, including rules of origin, processing history and food traceability, so that customs officials know where goods have ultimately come from. Such requirements make trade more complicated, less efficient and affect competitiveness by creating a wedge between the domestic price and foreign price of the good. In traditional trade talks, negotiators would seek to whittle away such costs through the principle of reciprocal exchange, opening up access to each sides’ markets and reducing the costs of trade for both parties.

The second set of NTBs—“behind the border” measures—relate to domestic legislation governing the conditions under which goods are produced. They include sanitary and phytosanitary rules (for the protection of humans, animals and plants); processing rules (such as conditions of production, restrictions on the use of substances, testing requirements, labelling & packaging requirements); product quality or performance requirements; consumer and environmental taxes; and “non-technical” rules (such as on public procurement, the protection of intellectual property or provisions on after-sales services). Negotiations over these “behind the border” measures require a very different approach to traditional trade negotiations, one based on co-operation and mutual trust in regulatory systems, rather than a trade-off (of one side’s environmental rules against the other’s consumer protection, for example).

How the UK proposes to approach EU regulations—and vice versa—will be crucial to a future deal. Currently, the responsibility for monitoring and ensuring compliance with such rules rests with a combination of national bodies and pan-European regulators. UK firms operate under these regulatory regimes irrespective of whether they are producing for the domestic market or for export. However, once the UK leaves the EU, and in the absence of a deal, the responsibility for ensuring UK exports comply with EU rules would effectively shift from UK regulators to EU customs officials. This could mean that UK exports to the EU could in theory be held at the border until compliance with EU rules had been established. The Repeal Bill will enshrine EU regulations into UK law, but it cannot guarantee reciprocal recognition across the EU and nor will it deal with the likelihood that UK and EU regulations will diverge over time.

**Figure 6: Number of non-tariff barriers faced by exporters to the EU, by sector**

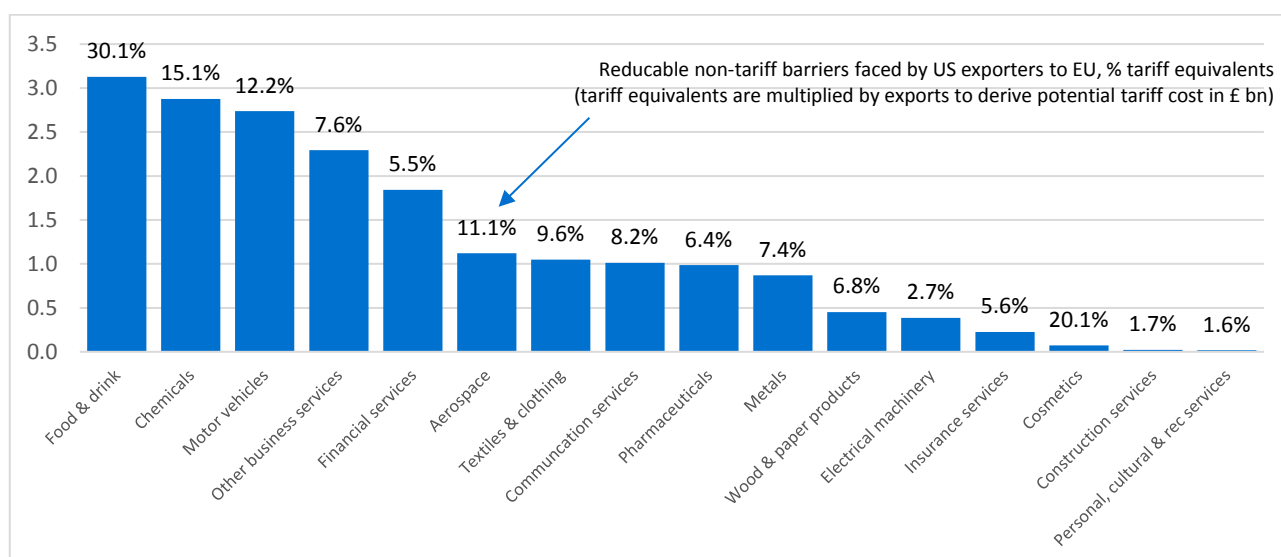


Note: UNCTAD’s TRAINS database lists a total of 405 different NTBs facing goods exporters to the EU across different industrial groups, but the costs of overcoming different NTBs varies considerably. One of the nine requirements listed for the aerospace & defence sector is for the aircraft to be airworthy, with detailed legislation covering everything from structural integrity, materials used, to the safety of propulsion systems  
Sources: UNCTAD TRAINS database; CBI.

There is therefore a real risk that UK businesses will face a significant increase in the cost of trading with the EU. A number of studies have tried to quantify such costs against the backdrop of the TTIP negotiations. One considered the barriers that US exporters to the EU face (and vice versa), based on a survey of trans-Atlantic businesses<sup>5</sup>. Firms were asked their views about regulatory divergences between the US and the EU in different sectors, with results used to calculate the costs in terms of equivalent tariffs that could in theory be eliminated through a trade agreement. Taking their data on the tariff equivalents in different sectors, we estimate that if UK firms were to face even half of the reducible costs, this would be **equivalent to an additional tariff of 6.5% on UK exports to the EU**—nearly double the average MFN tariff.

The result that the costs of NTBs are higher than tariff costs is supported by several other studies<sup>6</sup>. Another important finding from research is that there is a significant degree of variation between NTBs between different sectors. For example, NTBs are high in sectors such as food, chemicals and automotive, and are generally low in sectors such as electrical machinery & electronics, metals, wood & paper products. One possible interpretation of these findings is that the need for regulatory harmonisation and co-operation following Brexit may be greatest in sectors where NTBs are high.

**Figure 7: Indicative range of non-tariff costs on UK exports to EU, £ bn**



Sources: CBI analysis of OECD/ITC trade data using NTB estimates from “Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis”, Berden et al, European Commission (2009).

### **Some services sectors could lose their legal basis to export**

Regulatory co-operation will be particularly important in services, where for the most part negotiations will have to address “behind the border” regulations that will determine market access in much the same way that product regulations or sanitary rules determine market access for goods. These include things like rules on broadcasting standards, financial regulation and supervisory requirements, intellectual property rules, aviation regulation and recognition of professional qualifications, to name but a few. And for many service providers, WTO rules alone would not provide the legal basis to export services to the EU—if the UK is unable to secure agreements covering access to the single market in services, companies in some of our most successful exporting sectors would be unable to export specific types of services at all.

High on the list of UK “offensive interests” will be an agreement allowing financial services firms to continue to service European clients from the UK. As noted above, financial services are a particularly successful UK export industry. Banking is the largest sub-sector, accounting for around half of the surplus in finance

<sup>5</sup> Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis, Berden et al (2009).

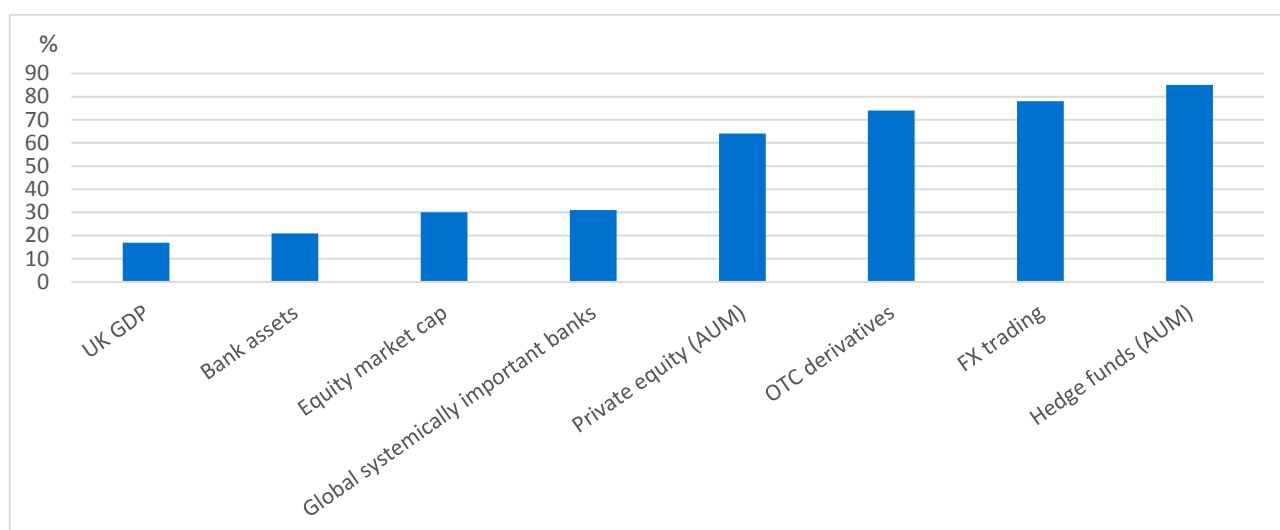
<sup>6</sup> For an overview, see “Quantifying Non-Tariff Measures for TTIP”, Berden & Francois, Centre for European Policy Studies (2015).



services trade, but the UK's comparative advantage is actually in asset management and wholesale activities, with UK-based firms dominating EU markets in areas such as OTC derivatives, foreign exchange and hedge funds. Without a specific agreement on financial services, however, UK firms will no longer be able to rely on the freedom of establishment or on EU "passporting" rights, and would instead have to rely on an evolving body of rules whereby "third-country" firms are allowed to operate under their own national authorisations in specific areas. While these "equivalence frameworks" tend to be most developed for activities where EU service provision is weakest, equivalence determinations from European policymakers often take years to secure and require ongoing co-operation between regulators to maintain them on an ongoing basis. In the absence of a deal, such an approach may be a poor substitute for current passporting arrangements: research by Oliver Wyman suggests that a loss of passporting could directly affect between 7% and 10% of value added in financial services, while spillovers to other activity could lead to the loss of a further 7% of value added within the sector.

Other sectors that could lose their legal basis to conduct business in EU member states in the event of no deal include airlines, broadcasting and a range of professional and business services. These are all sectors where the UK currently enjoys a comparative advantage within EU trade. And it is worth noting that without an agreement on data flows between the UK and EU, any company that transfers data across borders will face complex additional requirements, affecting trade in both goods and services.

**Figure 8: Percentage of EU-wide financial services activity taking place in UK\*, 2015**



Source: "Brexit and Financial Services", *Oxford Review of Economy Policy*, J. Armour (2016).

\*The first column, GDP, refers to the UK's share in total EU GDP, putting UK dominance in wholesale markets in context.

## Conclusion

Trade data highlight some of the UK's key offensive interests. One is to secure continued tariff free access to the EU single market in goods. Without a deal, exports to the EU would be subject to the EU's common external tariff, with identical tariffs likely to be applied by the UK to imports from the EU. But access to the EU single market involves more than tariffs. Research into the extent of NTBs suggest that, in the event of no deal being reached, the rise in non-tariff costs faced by UK firms exporting to the EU is likely to be higher than new tariff costs. To minimise the costs for UK exporters of leaving the EU, negotiators will need to give a high priority to securing regulatory co-operation, alongside avoiding a return of tariffs. And given its comparative advantage in services trade, the UK has a strong interest in maintaining access to the EU's single market in services. As in goods trade, trade in services is currently based on a high degree of harmonisation through the EU Services Directive, and associated pieces of legislation, regulation and agreements, with specific regulatory regimes for financial services. And as with goods, the degree of market access services is likely to depend on the extent to which the UK continues to apply EU rules.

## Appendix

### **BOX 1: Reveal Symmetric Comparative Advantage (RSCA)**

Traditionally, the gains from trade were believed to flow from differences in resource endowments: countries specialised in goods that they could produce relatively more efficiently than other goods (ie, with the lowest opportunity costs), so that through trade, both sides would be better off. More recent trade theories highlight the role of trade in promoting economies of scale across borders and the selection of the most productive firms. In a world of cross border production, firms can increasingly specialise in specific tasks or activities within the value chain. Estimates of revealed comparative advantage can give an idea of where this specialism exists, especially when carried out at a detailed sectoral level.

Our figures provide a measure of how specialised the UK is in a particular sector compared with the rest of the EU. The higher the score, the more the UK dominates exports in this sector, and vice versa. The figures are calculated as the ratio of a sectors' share in total UK exports (goods & services) to the equivalent share in the rest of the EU. We then converted these to an index that is symmetric around 0. Scores range between -1 and +1. A score of 0 means a sector's share in total exports are equal, a score of one would imply that the UK supplied all of the good or service in question, while a score of -1 would imply it supplied none. The index is non-linear, so that the closer to +/-1 implies even greater dominance or absence from particular markets. For example, a score of 0.3 means that a UK sector's share is twice the EU share, a score of 0.6 would mean it's four times greater, while a score of 0.8 implies that the UK's share is nine times bigger.

### **BOX 2: Estimating tariff costs**

To estimate the potential scale of levies that could be imposed by EU countries importing UK goods, we applied the relevant tariffs from HMRC on over 5,000 products to UK exports and imports to and from the EU, to get an idea of the maximum tariff costs incurred. Most tariffs are expressed as a percentage of the value of the good (ad valorem tariffs), but some agricultural goods tariffs depend on weight. For these non-AV tariffs, we used AV equivalents from the International Trade Centre.

Next, we adjusted these figures to take account of the origin of inputs typically embedded with our exports. The logic to this is twofold. First, inputs sourced from outside the EU customs area already incur tariffs when they enter the EU. Second, the duties payable would also depend on the extent to which firms made use of duty relief under Inward and Outward Processing rules, which are likely to be retained, and seek to ensure that duties are charged in accordance with where value has been added. To capture this, we used OECD data on Trade in Value Added to approximate the share of UK value added in UK exports across sectors, and EU value added in imports from the EU, and applied the additional tariffs only to these respective components.

As an example, if exports from the motor vehicles sector were 100% produced in the UK, they would incur the maximum tariff cost, which would have amounted to £1.5bn in 2016—this is the top of the range shown in Figure 4. However, TIVA data shows that on average, the UK value added content of motor vehicle exports is around 55%, suggesting that the additional tariff costs would be less than £1.5bn, around £830m—this is the bottom of the range. The latter figure takes into account that around 20% of value added comes from non-EU countries, and already incurs tariffs under existing single market rules, and around 25% comes from within the EU, which if re-exported back could be subject to duty relief.

The estimates serve as guide to the varying sectoral impact if the UK is unable to reach a trade deal with the EU upon leaving the Union. However, the final impact would reflect a number of considerations that are not accounted for, but which are more likely to increase the cost of “no deal” than to mitigate them. One difficulty in estimating potential costs relating to the agri-food sectors in particular concerns the potential for the UK to negotiate “tariff-rate quotas” (TRQs), which allow lower-tariff access to markets up to agreed limits. Upon leaving the EU, the UK will have to agree TRQs for imports and exports of agricultural produce with both the EU and with non-EU countries. The estimates above also do not include the impact of higher tariffs on trade beyond the EU if the UK is unable to ‘grandfather’ all of the existing trade agreements that the EU has with other countries. Currently the UK imports significant quantities of duty-free clothing from Turkey, for example, which has a customs union agreement with the EU.

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