UK trade and exports – the challenge of how British firms succeed after Brexit

By Sir Martin Donnelly, 28 February 2018

We face the challenge of how public policy can best help UK firms to compete effectively as we leave the European Union.

Against that background I want to set out the economic implications of the choices the UK faces in 2018; and then put forward some structural policies to support the future competitive position of UK firms.

When discussing the economics of trade and exports it is useful to remember that:

- Trade requires effective access to markets, and competitive firms producing quality products. It is firms not governments that determine how much is exported.
- Governments influence market access through agreements on how markets are regulated, acceptable product standards, competition policy and, less importantly, tariff levels; as well as through exchange rates.
- Public policy also helps in the longer term to shape the available skills, research base, infrastructure and access to capital which determine longer term productivity, and support the competitiveness of firms.

The modern UK economy is very much service based – around 80% of value added comes from services.

UK exports account for around 21% of UK GDP (on a value added basis, see Llewellyn 2016) with services representing more than half of that total. Business services, finance and insurance, and the wholesale and retail sectors provide as much UK export value as the top twelve industrial sectors.

The EU takes 46% of UK service exports; nearly four times what we export in services to the US, which in turn is roughly twice our total service exports to India and China combined. No other overseas services market is significant.

On goods the UK's exports to the EU are around 49% of our total sales abroad; just over four times our exports to the US and twelve times current exports to China.

The distinction between what the statisticians define as services or goods is no longer as robust as it used to be. Recent estimates from the CER and Trade Policy Observatory find that services valued added directly linked to manufacturing exports, design, software etc., is worth more than £50 bn annually, about the same magnitude as UK financial service exports.

The income gained by manufacturers and their supply chains from servicing advanced products from aircraft to medical diagnostic machinery is often half or more of the total value of a contract.

So economic activity is more like a bowl of entangled spaghetti than separate courses neatly labelled as goods or services; and this is particularly true of trade inside the EU.

The European single market in services is still less developed than in goods. But it is the only functioning cross-border services market in the global economy, because the EU is the only organisation combining mutual recognition of qualifications, technical standards and free movement of workers with shared regulatory structures and a legal dispute resolution system able to provide certainty to suppliers and consumers.

Losing guaranteed access to service markets currently open across the EU will therefore have an immediate, significant and lasting negative impact. The UK is predominantly a service economy; around half of our service exports go the EU; and there are no plausible alternative markets for these services which combine the scale and depth of current service exports to Europe.

Examples of this impact which do not involve financial services include UK legal services, where net exports amounted to over £3bn in 2015. Outside the single market UK law firms would no longer be able to represent clients in European court hearings, nor engage directly with the Commission on competition investigations. Similarly, international arbitration work depends on being able to plead before the European Court of Justice; and intellectual property disputes require representation rights before the EU IPO tribunals.

The creative services sector exports over £4bn to the EU, with more than half of fashion, graphic design, film and video exports going to EU countries. The UK could no longer be the hub for pan-European broadcasting it has become since the audio-visual market was opened up, as broadcasters are required to base themselves in an EU member state; and current EU free trade deals do not cover broadcasting and programme production rights.

Our manufacturing economy is, as the logic of the single market implies, now deeply integrated with the rest of the EU. Just under half of UK exports, and over half of UK imports, come from within the European Union single market. For the last 25 years there have been no customs checks or border tax adjustments on these transactions, so trade is frictionless. The ability to move workers, with mutually recognised qualifications, freely between member states makes firms significantly more cost effective.

Much single market trade is within closely managed supply chains which require certainty of rapid delivery, clarity of technical standards, the lowest possible transport costs, and the ability to provide unified support services, for example in data analytics, design and maintenance. Larger companies make investment decisions within the EU by comparing the cost of different plants within integrated cross-border supply chains.

Components, particularly in the automotive, chemical, pharmaceutical and aerospace sectors, can cross national boundaries several times within these supply chains. VAT formalities continue to be streamlined and the EU's digital single market ensures free data movement within a shared legal framework. So, services and goods trade are becoming ever more interdependent within the EU.

No plausible economic analysis concludes that the extra customs, tax, security and regulatory barriers necessarily required by a trading border, and the inevitable delays, expense and bureaucracy that go with them, could increase UK firms' competitive advantage. Losing level playing field access to the EU's internal market, and to the customs union that goes with it, would immediately put UK based producers at a lasting disadvantage to their competitors within that market.

What options are available to manage this challenge?

A bilateral free trade deal between London and Brussels is an obvious candidate.

The additional costs to business of such a deal compared with the status quo would be significant. HMRC have estimated the annual administrative burden of moving out of the customs union to a free trade agreement with the EU at over £5 billion, a 350% increase. Up to 5000 new permanent Customs staff would be needed, a deadweight cost to the taxpayer, as well as additional physical infrastructure to process over 10 000 containers a day in channel ports.

More than half of the UK's 300 000 plus traders trade only with the EU. At least 130 000 of those have no current dealings with Customs authorities. The number of customs declarations is projected to increase fivefold, from 50 million to 250 million.

A free trade deal requires rules of origin certificates for cross border trade to ensure that there is sufficient domestic content to justify tariff free status. One UK car company estimated that it would need some 15000 rules of origin certificates, at a minimum cost estimated at £15 each. UK supermarkets relying on just-in-time food imports could need 80 000 separate import declarations annually, costing large businesses £25 each and smaller ones without economies of scale around twice as much. Similar challenges apply to food exports. Around 70% of UK food and drink trade takes place within the EU.

Technology cannot offer a frictionless solution to border controls. The need for formal product standard approvals, phytosanitary checks, advance security declarations, VAT calculations and payment, and the inevitable delays at the border, cannot be wished away. Together these complexities threaten all just-in-time supply lines and make companies manufacturing for the European market see further investment in the UK as higher risk than in other EU economies without these added costs and delays.

The UK's stock of inward investment is also at risk as investors seek to maintain that wider market access. Over 1000 Japanese companies in the UK employing some 140 000 people are here because of free access to the wider EU market, not simply the smaller UK home market. The 2000 German companies employing 370 000 people with 110bn Euro of direct investment are part of seamless pan-EU supply chains. In the chemical sector for example 60% of UK exports go to the EU, and 75% of imports come from the EU.

Two thirds of UK exports to the EU are estimated by the IFS to be intermediate inputs to wider supply chains; as are 55% of imports here from the EU. Investment to build these supply chains will be at risk if UK based firms can no longer access the single market on equal terms. Half of the £1 trillion stock of UK foreign direct investment comes from other EU based investors so the potential impact is large.

An important factor in the UK originally joining the European Community in 1973, in the abolition of exchange controls by Mrs Thatcher's first administration in 1979, and in the UK's leadership of the single market programme from the mid-1980s was to ensure a more competitive home market, as the basis for viability in the global economy. For the last 25 years the EU single market has achieved that goal with a rigorous control of state aids, active pro-competition policy and open public procurement markets worth over 2000 bn euro, five times that of the UK alone.

The competitive spur of the single market has provided cheaper imports for business as well as consumers, and pressured UK firms to improve their productivity or go out of business. By restricting firms' access to the largest and most prosperous single market in the world, taking the UK out of the EU negotiated preferential trade deals which cover another 12% of UK exports, and increasing investor uncertainty about access to skilled labour, Brexit risks undermining the global competitiveness of the UK economy.

The Brexit implications for entrepreneurship and innovation in the UK are also problematic. The welcome growth in tech start-ups, in London and more widely across the UK, has been fuelled by the ease of movement of young professionals into Britain from the rest of the EU and the freedom to transact data and digital services across the single market. £7 bn was invested in the UK's digital tech sector in 2016, 50% more than in any other European country.

The growth of available start-up and scaleup capital, incentivised by the EIS and Seed EIS tax breaks, has been a further UK advantage. The research sector has benefitted from the UK government's decision in 2012 to develop an industrial strategy with increased research and innovation funding; while universities have benefitted from EU Horizon 2020 funding for research programmes and their ability to recruit talent freely across the EU.

After Brexit there will be more constraints on European entrepreneurs seeking to settle and open businesses in the UK. The EIF which provided one third of the funding for UK based venture capital funds in the four years to 2015 -some £2.3bn – is now winding down its operations here. The £400 million new UK funding to be provided through the British Business bank, while welcome, will still leave a significant gap in public funding for venture capital.

For start-ups the UK risks moving from being the most open major European country to being the most bureaucratic, with no guarantee that new firms can import staff freely from within the EU, the loss of significant EU funding in the research and innovation sectors, and uncertainty over the alignment of UK and EU data protection rules. Universities already report the loss of EU staff amid worries that the UK will no longer be able to lead cross-European research teams funded by the EU, and wider concerns about the status of family members under more restrictive migration rules.

Can these disadvantages be remedied through new bilateral trade deals with the rest of the world?

It is right to look seriously at the alternative markets which may open to the UK outside the EU, some fast growing. But as David Hume reminded us, a wise person proportions belief to the evidence.

There is a marked lack of evidence that leaving the EU customs union and single market will lead to greater UK trade with third countries.

It is for example unclear why third countries such as China, India or the United States should agree to negotiate bilateral trade deals with the UK which favour Britain's comparative advantage in the service sector. They will instead seek acceptance by the UK of their own national regulatory, environmental and technical standards as part of even a limited trade deal.

Given the reciprocity which runs through trade negotiations, third countries will also be aware that any concessions made to the UK will be expected by other trading partners; and the degree of their interest in the UK market will be strongly influenced by how far UK based firms continue to enjoy competitive access to the much larger European market.

In trade negotiations size does matter. Even implausibly favourable market access deals with some third countries are arithmetically unable to make up for the loss of unrestricted access to more local EU markets in which many UK producers are currently integrated.

On current trade flows, a tripling of total services trade with China would not equal a fifth of the UK's current services exports to the single market. Germany already does more than four times as much trade with China as the UK. The major barrier to additional UK trade with China or other markets is our relative competitiveness.

Moreover, for most products outside the agriculture, textiles, food and automotive sector, tariffs are an administrative burden rather than a significant cost. Few high value products are so price sensitive that a reduction in bilateral tariff levels will massively shift trade. Market access in advanced service economies is largely about regulatory standards, access to data, and effective dispute resolution. Investors require reassurance that market access will not be threatened by political disagreements or arbitrary anti-dumping decisions.

It is of course helpful to achieve more market access through negotiation. The EU as a trade negotiator has the economic weight to deal with China and the US as trade equals. The UK does not. The European Commission has negotiated trade deals with over fifty countries, most recently with Canada, Korea and Japan, and continues to engage with the US. Some £55bn of UK exports, 12% of UK trade, benefit from these third country agreements.

So, for the UK to give up existing access both to the EU single market and to the preferential trade agreements which the EU has in place with over 50 countries in exchange for its own bilateral trade deals at some future date, is like rejecting a three-course meal now in favour of the promise of a packet of crisps later.

There is no evidence of untapped global markets waiting to welcome UK companies. The key trade deal for the UK is therefore the one with our largest market, the European Union. Here the choice is clear. We can remain connected to the EU customs union and single market if we follow the same rules as everyone else. Or we can leave.

Having our cake and eating it is not an option in the real world; 'frictionless trade' is a phrase without legal content. The EU opposition to sectoral cherry picking in market access is grounded in a defence of the four freedoms which make up the single market. To provide UK business with guarantees of full and equal access to the single market without equal acceptance of EU regulatory structures would require not so much a skilled negotiating team as a fairy godmother specialised in trade law.

The UK could choose to unilaterally remove all tariffs and quotas, which would reduce prices of agricultural produce, textiles and steel. This would undermine the viability of many UK producers, particularly in farming. In the unlikely event that the UK took this step other countries would still maintain their own restrictions in both goods and services markets. UK suppliers to Europe would therefore still face barriers.

If Parliament does vote to leave the single market and customs union after a brief transition period, what damage limitation measures could be taken to support UK competitiveness and trade in this less favourable environment? I suggest three priority areas.

First, increased supporting for entrepreneurs and innovation across the economy. This is best achieved by focussing on their need for skills, research support, access to data and a supportive tax environment. Specifically:

- Delivering visa decisions on staff for small businesses rapidly and easily online, with minimal restrictions so that researchers, entrepreneurs and growing companies can access the skills they need rapidly and at low cost. A user-friendly visa system becomes a key test of UK attractiveness for innovative investment. This would be best organised separately from the current visa system, with separate targets and incentives for staff in a new Business Visa Agency.

- Within the UK's industrial strategy, delivering the needed doubling of public sector spending on innovation and scale ups, to compensate for the loss of European funding and to ensure that universities continue to engage locally with tech and digital start-ups;
- Guaranteeing that, whatever the wider relationship with the EU, the UK will continue to remain within the EU data protection regime, a vital requirement for the tech sector, and increasingly for manufacturing too. This will require continued acceptance of a role for the ECJ as legal arbiter.
- Committing to maintain the current favourable tax breaks for entrepreneurs and venture capital for at least the next ten years.

Second, avoiding additional UK regulatory bureaucracy. There are currently over thirty EU regulatory agencies which if duplicated in the UK would add massively to the administrative burden on firms based here and seeking to export. Where the current EU regime is satisfactory, in medicines, chemicals, intellectual property, telecoms, energy and other sectors, we should commit to staying formally aligned with it rather than diverging and thereby adding unnecessary costs and uncertainty to business faced with double regulatory standards, domestic and European.

Third, provide more active support for smaller firms seeking to export. They will face extra costs, delays, complexity of regulatory rules and uncertainty about supply chain access. Together these risks reducing UK exports significantly and increasing costs in the domestic market. UK companies are already significantly less open to exporting than their continental competitors and leaving the EU will only exacerbate this trend.

There can be no export subsidy schemes. These are illegal under WTO rules and would lead to immediate retaliation by our larger trade partners, as would market-distorting state aids. The government should however ensure its trade support bodies provide transitional funding to cover the initial cost of the extra administrative burden to smaller exporters; and use digital channels to provide targeted training to those 130 000 companies currently exporting to the EU who will be dealing with customs formalities for the first time.

Continued trade missions to developing markets are worthwhile at the margin to highlight new opportunities, but do not move the dial. Growth from a low base even in a fast-growing developing economy is not a substitute for sales to larger richer markets. Ministerial visits can have a limited role in less open markets, but it is not one that substitutes for underlying competitive advantage.

The reality is that most companies start exporting to neighbouring markets with similar rules, which for the UK usually means European Union members, then look further afield. Making exports to Belgium or Germany more expensive and complex will have a chilling effect on sales to more distant and challenging markets. Changing specific third country rules which hold back exports, for example intellectual property theft of branded goods, is something the EU with its massive trading footprint can do more effectively than the UK.

An urgent negotiation priority for 2018 must be to confirm that UK firms will continue to benefit from the market access to EU negotiated trade deals to which they will lose their legal entitlement at the end of March next year. Otherwise Range Rovers exported to Korea will face higher tariffs; Canadian public procurement markets will be less open to UK firms; UK value added will no longer count towards EU value added in free trade deals; and UK exporters will lose a level playing field in Switzerland, Norway and other EEA members.

Similarly, the transition period must be flexible enough to dovetail smoothly with any new UK-EU trade deal – which is likely to require at least five years to agree, sector by sector. The EU has a complex set of national interests to take into account when determining its negotiating position, and this takes time.

To summarise, trade requires a competitive economy. Competition thrives on openness and a large domestic market with shared rules, particularly in the service sector. Leaving the customs union and creating barriers within the single market which takes around half of our trade must by definition move the UK economy away from openness and thereby reduce the ability of UK firms to attract investment, compete and export globally. Measures to maintain open labour markets, focus on entrepreneurs and innovation and support exporters can mitigate but not remove this competitive handicap. That is what the facts tell us.

In today's globalised economy policy choices reducing competitiveness can have long lasting effects on living standards, innovation and investment. The question is therefore how far the undoubted economic harm to UK jobs, growth, tax revenues and public services caused by moving away from full EU market access can be justified on wider grounds.

The international commitments made to ensure regulatory alignment on the island of Ireland in the 1998 Good Friday or Belfast Treaty are also relevant. It is significant that, in paras 49 and 50 of the 8 December 2017 joint report with the European Union, the UK Government committed itself to maintaining full alignment if no alternative solution were to be agreed; and also stated that no new regulatory barriers between Northern Ireland and the rest of the UK would be introduced. This may lead to the UK remaining within the internal market as the only practical way to achieve both objectives.

Given all the negative consequences of leaving, and the lack of any significant offsetting advantages, it is in any case likely that UK will seek to return to full membership of the EU single market in due course. But significant damage to employment, the structure of the economy and the competitiveness of UK firms can be expected in the meantime.