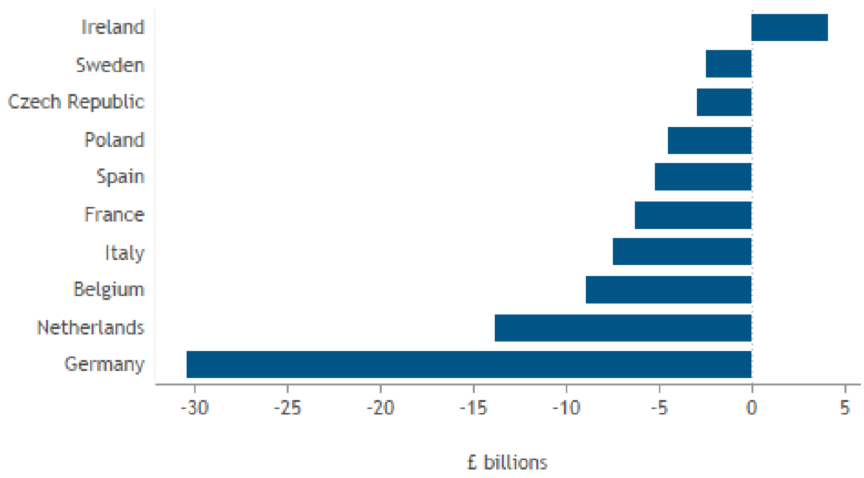
An £18bn misunderstanding

Blog post by Partner Stephen Adams, 31 October 2016

A British think tank rather definitively announced last week that it had added up the potential tariff bill for EU-UK trade in a 'hard Brexit' scenario – and declared the EU the bigger loser by some margin. Applying the EU's existing tariffs by tariff line to existing trade flows gave them a 'bill' for EU exports of around £13bn. The implied tax on UK exports to the EU was less than half this. Inevitably this has got quite some media coverage, although it largely reflects the volume of flows in both directions – i.e. the UK's deficit in goods trade with the EU. However, to see this differential purely as UK leverage in a future negotiation with the EU requires you to ignore two basic things about trade.

The first is that this EU 'bill' is ultimately paid by UK consumers, retailers, manufacturers and other importers. Of course, it represents a competitive disadvantage for EU exporters who would see their real price to a prospective buyer in the UK rise, and they will no doubt prefer to avoid this outcome. But for that cost not ultimately to be borne to some degree by a UK buyer presupposes a tariff-free alternative on the UK market – which is far from guaranteed. Oddly, the same UK observers who quite like the apparent implications of these numbers very much 'get' who actually pays the tariff when they are talking about things like new EU tariffs on Chinese imports.

UK merchandise trade balance with selected EU countries in 2015



Sources: CEIC, GC calculations

The second is that in many cases the companies on either end of these trade flows are actually the same ones, or very closely linked in supply chains. A simplistic reading of these numbers imagines a world in which all that is traded around the EU (or indeed the global economy) is finished goods. We do not know for sure, because it is not systematically measured, but it is a safe bet that somewhere between a third and a half of EU trade with the rest of the world is intra-company trade – goods moving down international supply chains on their journey from parts to finished product. We can be fairly sure that UK-EU trade is no different. And in fact, the tariff and customs free nature and harmonised regulation of the single market means the share of intra-company trade in EU-UK trade is probably higher.

That means that a sizeable chunk of that big 'EU' tariff bill is actually a tax on the supply chain of UK-based manufacturers, moving goods from factories or other operations in the EU. Like, for example, the UK car manufacturer who uses parts from their German operation to complete a finished car or component in the UK. The same is of course also true in the other direction, but EU producers have a much bigger pool of tariff-free alternatives to draw on inside the single market that their UK equivalents.

All of which is simply to say that ultimately tariffs on EU-UK trade would hurt everyone to the point that arguing that one side or the other is more exposed, or has more leverage, largely misses the point. Any outcome that left such a tax in place on such trade would not so much be hard Brexit, as plain dumb Brexit, for almost everyone.