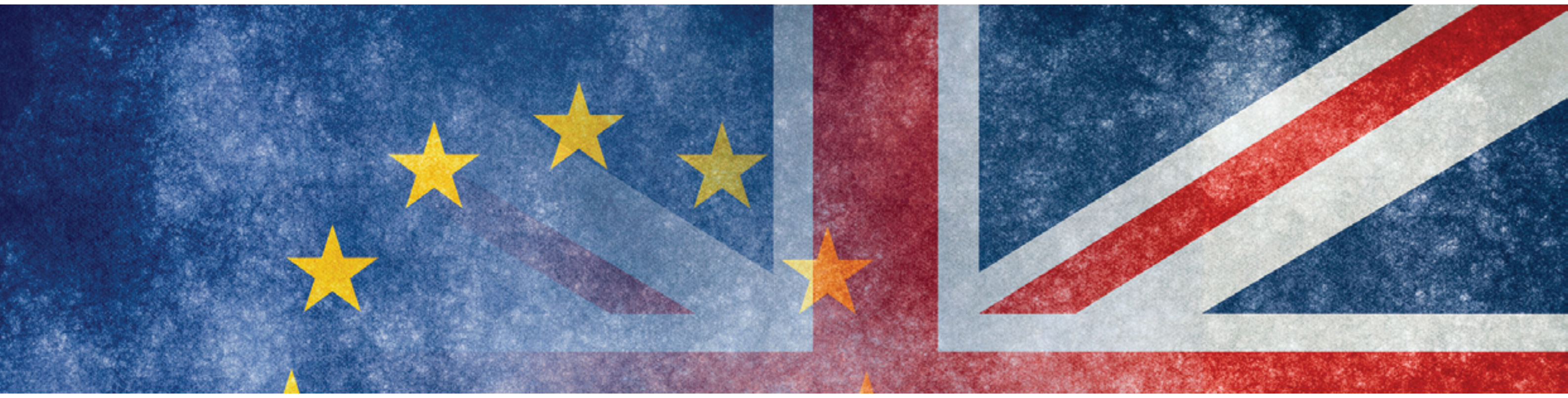
CIVITAS

January 2017

EUROPE DEBATE NO.6



British business need have little to fear from the tariff costs of being outside the Single Market. The UK would be well placed to introduce a series of measures that would, in line with a new UK industrial strategy, mitigate the costs of tariffs imposed by the rest of the EU

Mitigating the impact of tariffs on UK-EU trade

By William Norton

Previous research by Civitas estimated the tariff costs that could arise for both the UK and the EU on the trade between them in the event that a free trade agreement is not reached as part of the Brexit negotiations.[1] That research pointed to the likely costs as a strong argument for the conclusion of such a deal.

But what if no deal could be reached, and the two sides were forced to suffer these costs? What scope would the UK government have to offer compensation to the affected businesses?

UK policy will, after leaving the EU, remain subject to the constraints – and benefit from the protections – of a complex series of World Trade Organization (WTO) agreements. WTO rules limit both subsidies for exports and the scope to retaliate against the trade policy of other WTO members.

The UK government is, however, permitted to provide subsidies if they are based on 'criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise'. WTO rules also provide that retaliation is not justified where the subsidy complained of has a beneficial value which does not exceed a minimum threshold, or if the volume of sales being subsidised are 'negligible'.

HM Treasury is likely to receive surplus funds. The total receipts on imports from the EU27 would be in the region of £12.9 billion as against total tariffs on UK exported goods of £5.2 billion.

A difficult balance must be struck between the short-term political imperative to reassure UK business and the longer-run interests of the tax-paying consumer because, though exporting businesses may feel the impact of tariffs, it is consumers who will ultimately be paying import tariffs.

For the purposes of discussion, this paper confines itself to the narrower – and much simpler – question of how, without breaching WTO rules, government can deliver mitigating benefits at least equal in value to the costs which UK business is likely to incur.

The government will have to devise a series of mitigation measures which in aggregate relieve the impact of the EU27 tariffs. Care will have to be taken to ensure that in practice these measures are non-specific. For example, if the UK's only factory manufacturing super-widgets happened to be located in Barchester, a programme which declared Barchester to be a special Enterprise Zone with valuable rebates for the essential components of super-widgets is likely to be challenged. Assistance has to be delivered through objective, horizontal measures delivering benefits across the whole economy.

Such an approach is possible. The major constraint on government is not whether non-specific measures to assist affected industries can be devised, but whether HM Treasury can afford the cost of delivering 'unnecessary' windfalls to other businesses.

To address this, we identify four key measures which assist exporters but which also have merit in their own right, thereby justifying some leakage of public funds on windfall gains for non-exporters. It would also enable the programme to carry the support of the vast majority of UK businesses who are not directly affected by tariffs.

So what the overall mitigation programme amounts to is, in fact, a UK industrial strategy.

Research and Development (R&D)

R&D support is the most attractive route for mitigating EU27 tariff costs. Based on our desired aim of targeting the businesses affected by the estimated £5.2 billion of tariffs imposed by the EU, the following three measures appear viable.

1. All businesses to become eligible for an R&D Expenditure Credit (RDEC) scheme, with credit at a rate of 22% (i.e. an increase of 11% on the current rate). The estimated cost would be £1,889 million. Of this 71% should reach industries impacted by new tariffs, with £541 million leaking to other businesses. This is an economy-wide measure; it is not specific.

2. Agricultural products businesses (as defined by the WTO, which includes food and beverages) to be eligible for an Enhanced RDEC at a rate of 33% for revenue spending on 'basic research'. This would cost £8 million and would all go to industries impacted by tariffs and under the special WTO rules for agriculture would not count as forbidden subsidies.

3. All businesses to be eligible for Enhanced RDEC at a rate of 33% for revenue spending on 'experimental development'. This is estimated to cost £954 million, with 76% reaching industries impacted by tariffs. Again this is an economy-wide measure, it is not specific.

The cost would come to £2,851 million, of which £774 million (27%) would count as leakage, and £2,077 (73%) million would go to industries affected by tariffs.

Regional policy

UK regional policy is currently governed by the EU and its rules on state aid. Current regional aid spending is estimated to amount to £259 million and is prohibited from covering more than 27.05% of the UK population. Without EU rules the UK will be free to develop a policy specific to its own needs.

Map 1 indicates the areas which could be covered by a new UK regional policy based on the original criteria under the WTO rules: (i) income per capita not exceeding 85% of the national average; and (ii) an unemployment rate exceeding 110% of the national average.

Regional aid is a devolved matter but for the purposes of this paper it is assumed that a consistent policy would be applied across the nations and regions.

Using these two tests to derive three areas, shown on the map, would amount to a very basic and rudimentary regional policy. Other neutral and objective tests could be used. The tests discussed in this paper are for illustration as an indication of the flexibility which arises on Brexit.

Using these tests, discretionary grants and loans could be provided for an expanded list of assisted areas, where on average 68.5% of funds could reach industries impacted by the introduction of tariffs. The total population coverage of the new policy, 64.85%, is significantly higher than under current EU-controlled policy.

> *The government will have to devise a series of mitigation measures which relieve the impact of the EU27 tariffs but are non-specific. Such an approach is possible.*

The cost would be £4,851 million with £3,146 million going to industries affected by tariffs, providing the largest portion of our suggested mitigation measures.

As the map highlights, nearly two-thirds of the UK population live in areas which on objective and neutral criteria can be regarded as ‘disadvantaged’. Perhaps regional aid ought not to be designed with the objective of mitigating the effect of EU tariffs. Rather, a comprehensive scheme should be designed within a coherent industrial strategy, one of whose incidental benefits is the mitigation of the consequences of Brexit.

Energy policy

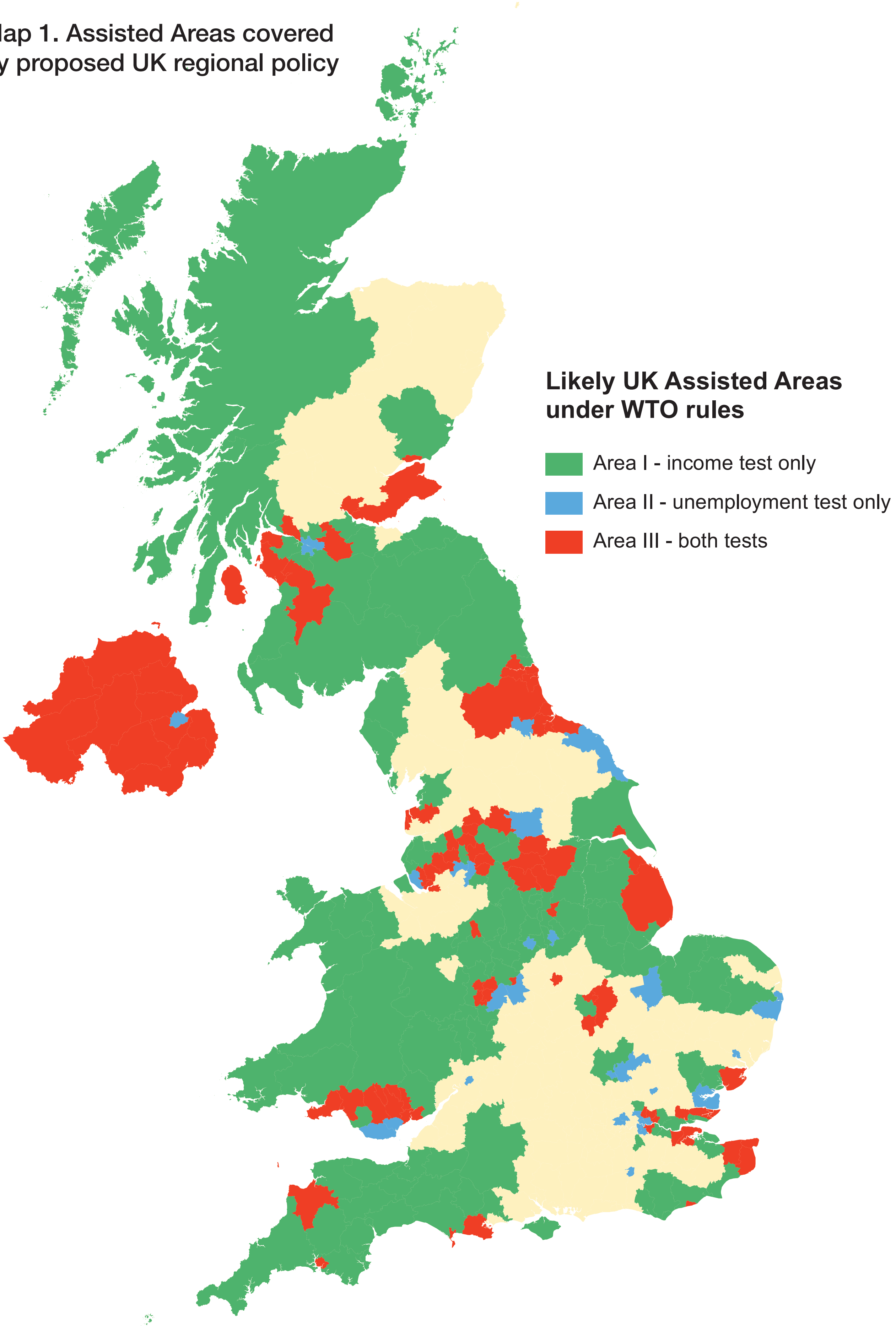
The third mitigation measure proposed is the abolition of the Carbon Price Support (CPS). In contrast to our previous measures, it has a high leakage rate, with only 30.6% of the cost targeting industries affected by tariffs. However, we can be certain that all UK businesses use electricity in some form or other and would therefore benefit from the removal of the carbon price floor. Indeed, by itself the abolition of the CPS fully mitigates tariff costs for 13 of the 96 product groups our report considers.

The cost would be £1,200 million. A leakage rate of 69.4% makes a reduction in the carbon price an extremely inefficient way of ‘compensating’ businesses for EU tariffs.

However, there are good arguments for this measure in its own right. Mitigation of tariff costs within the WTO regime will require UK-wide non-discretionary measures. Regional aid by itself cannot provide full mitigation, for the obvious reason that not every business operates in a disadvantaged area. Nor can additional support for R&D, because not every firm engages in it to the same extent.

Further still, domestic consumers also benefit from a fall in electricity prices. CPS abolition is the only measure studied in this paper which does that. Since those consumers are ultimately bearing the burden of tariffs on EU goods, simple political expediency suggests that they,

Map 1. Assisted Areas covered by proposed UK regional policy



too, ought to be offered a 'Brexit bonus' as part of a programme designed to benefit a comparatively small segment of UK plc.

A Transitional Assistance Programme (TAP)

The WTO regime provides that where, on investigation of a complaint, it is found that the subsidy does not exceed a minimum threshold of 1% of the value of the exports, countervailing action by other governments must stop. This creates scope for small-value direct payments as 'compensation' for exporters.

Merely because an exporter could be compensated at less than 1% of the value of their sales does not give the government a completely free hand. A programme which, say, permitted each business to reclaim costs up to the lower of either actual tariffs suffered or 1% of export sales, would be directly linked to export performance and would be a prohibited subsidy under WTO rules.

But it would be possible to establish a TAP, limited for say five years. The remit of the TAP would be to make discretionary grants to any UK business, to assist them with the transition costs of Brexit if they could justify their case against published criteria. This would notbe specifically limited to exporters, although they would obviously have an easier time of demonstrating that they had suffered one-off costs.

In theory, then, the TAP could be designed to have a leakage rate of 0%. However, we make the planning assumption of a 20% leakage rate to provide for some flexibility. On that basis, this measure would cost £869 million, with £695 million provided to affected businesses, and £174 million in leakages.

Conclusion

This paper sets a puzzle: how to 'compensate' industries facing £5,220 million in tariffs on their sales to the EU27, using a fund of £12,861 million revenue derived from imports from the EU27.

Combined impact of mitigation measures on industries affected by tariffs	
Tariff Costs	**-£5,220m**
Mitigation Measures	**£6,286m**
CPS abolition	*£368m*
Increased R&D credits	*£2,077m*
TAP payments	*£695m*
Regional grants	*£3,146m*
Net Impact	**£1,065m**

Combined impact of mitigation measures on UK Budget	
Tariff Revenues	**£12,861m**
Mitigation Measures	**-£6,286m**
Leakage	**-£2,475m**
CPS abolition	*-£832m*
[including savings for Domestic Consumers]	
R&D credits	*-£774m*
TAP payments	*-£174m*
Regional grants	*-£695m*
Net Impact	**£4,100m**

But it would be imprudent to ignore the risk that the sensitivity of sales to tariff-induced price increases, which could materially drive down revenue for HM Treasury whilst increasing the losses of UK exporters. Therefore, we have designed an overall programme with a low total cost and leakage rate.

Our four proposed measures provide £6.3 billion in support for industries facing the impact of £5.2 billion in tariffs. In total the four mitigation measures provide support to exporting industries which is at least equal in value to the tariffs levied on each on exports within that industry.

A further £2.5 billion will go to supporting other UK businesses and in total the measures cost £8.8 billion, far less than the estimated £12.9 billion the Treasury might expect to collect following the introduction of tariffs.

Hence, the real question is not 'how soft a Brexit can we achieve?'…

…but rather 'how hard a negotiation do we wish to drive with the EU?'

Hitherto, the political debate about the UK's departure from the EU has focussed upon the risks of a 'hard' Brexit and the need to soften this by avoiding costs for business such as tariffs being levied upon exports to the EU27.

But these tariff costs can be managed. In an ideal world, British exporters would not have to suffer them, but it is possible to mitigate their impact through other measures which are justifiable in their own right. It makes sense to remove a self-inflicted wound like the carbon price floor, which is damaging British competitiveness and low-income households. It makes sense to provide greater tax incentives for research and development. A case can be made for regional aid given the imbalances in economic performance and employment across the UK as a whole.

Hence, the real question is not 'how soft a Brexit can we achieve?' but rather 'how hard a negotiation do we wish to drive with the EU?' The balance of negotiating strengths is far more favourable to the UK. If the EU27 wish to impose a self-inflicted wound by levying tariffs on British exports, Britain has little to fear.

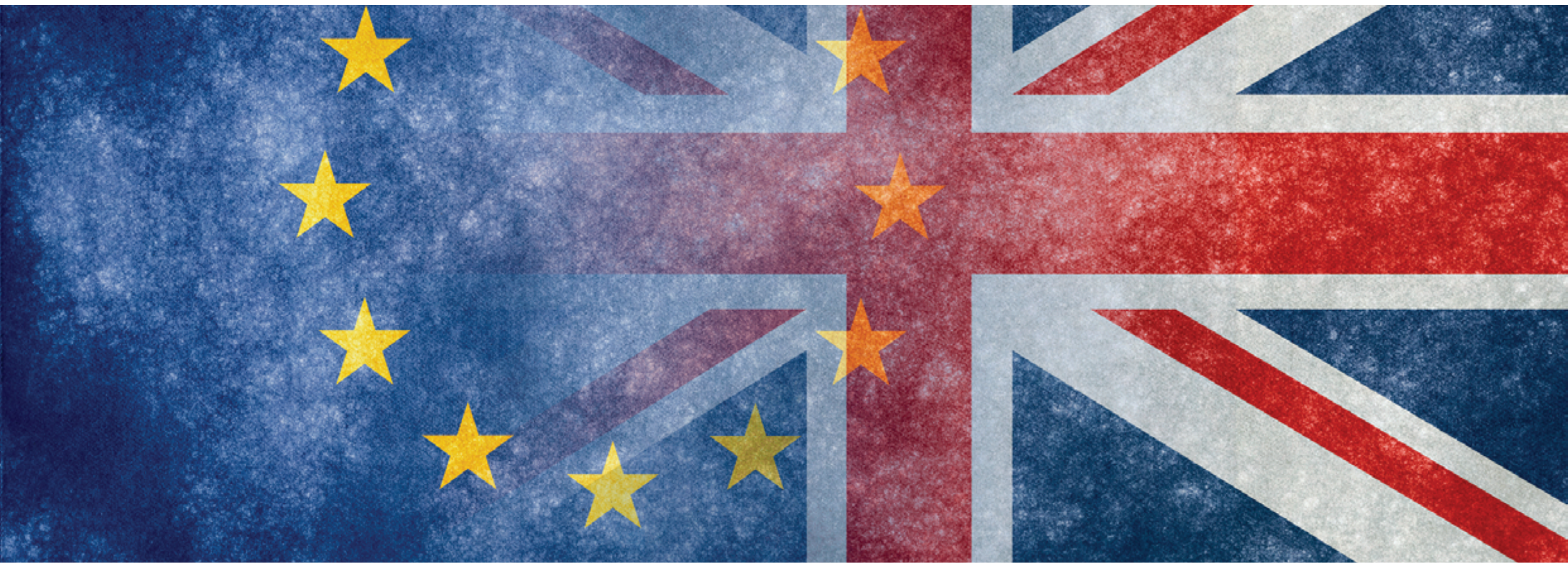
This is an edited version of a longer online Civitas report, 'Mitigating the impact of tariffs on UK-EU trade', which is available in full at www.civitas.org.uk.

Notes

1 Justin Protts, 'Potential post-Brexit tariff costs for EU-UK trade', Civitas, October 2016, available at http://www.civitas.org.uk/reports_articles/potential-post-brexit-tariff-costs-for-eu-uk-trade/

Author — William Norton

William Norton is a non-practising solicitor who has worked in the City of London and as a policy adviser in Westminster. He was a core member of the James Review on Taxpayer Value and the Conservative Party Policy Unit (2004-5). He worked for the victorious designated lead campaigns in the North East referendum (2004), the AV referendum (2011) and the EU referendum (2016). Among numerous articles, papers and books, William is the author of *Monument and Bank: Capitalism and the Anglo-Saxon Mind* (SAU, 2011).



Also from CIVITAS

The Real Sterling Crisis

Roger Bootle and John Mills

The fall in the value of sterling since the vote for Brexit has had commentators wringing their hands with concern. But why are so many so quick to assume that a cheaper pound is a bad thing? The truth, as leading economists Roger Bootle and John Mills explain here, is that the British economy has suffered from an overvalued pound for many years. It has restricted exports by making them more expensive and stimulated imports by making them cheaper; it has therefore been a leading cause of the UK's large current account deficit. The real sterling crisis, then, is not that the pound has fallen in recent months – but that it had previously been priced too high for many years.

Price £9 **Published** September 2016 **ISBN:** 978-1-906837-83-9

CIVITAS is a community of researchers and supporters committed to discovering how best to strengthen democracy, uphold limited government, maintain personal freedom, achieve opportunity for all, and encourage free enterprise. We strive to achieve our ideals through independent research, reasoned argument, lucid explanation and open public debate. We stand apart from party politics and transitory intellectual fashions in pursuit of the enduring ideals that have made Britain a fortress of liberal civilisation.

We make our work available in books, pamphlets, online, and in electronic formats and encourage authors to make their arguments accessible to non-specialists. Some publications are designed for use in schools and universities, including a series a factsheets about the European Union for sixth forms. Most recently, we have published a knowledge-rich primary school curriculum designed to enable children of all abilities to share in the intellectual heritage of Western civilisation. We also carry our arguments into schools and universities by organising talks and debates.

Uniquely among think tanks, we play an active, practical part in rebuilding civil society, particularly by running schools on Saturdays and after school hours so that children who are falling behind can achieve their full potential.

If you would like to support our work, subscribe to our publications or become a member, please get in touch on the contact details below.

CIVITAS

Civitas: Institute for the Study of Civil Society

55 Tufton Street, London SW1P 3QL

Phone: +44 (0)20 7799 6677 Web: www.civitas.org.uk Email: info@civitas.org.uk

Images: iStockphoto.com

Layout and Design: Luke Jefford – luke.jefford@ntlworld.com