March 6, 2019 (https://brexitcentral.com/2019/03/06/)

The curious effect of the EU Customs Union on the UK’s cars and carbs

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One way to assess the value of the Customs Union to the UK is to track the trajectory of our principal export sectors over time. Since 1998, the UK's fastest growing major goods exports (globally) have been pharmaceuticals, transport equipment and motor vehicles — in that order. None owe their commercial success to the Customs Union. Pharmaceuticals are almost free of global tariffs and so are aerospace products, which contribute 92% to the UK's transport equipment exports.

Meanwhile the UK's motor vehicle exports to EU peaked in 2007; the UK's outstanding growth in the vehicles sector is powered purely by global enthusiasm for British motors.

But any meaningful analysis of the impact of the Customs Union has to place UK sectors into proportion – which means ranking them according to two-way trade. Here, there are two easy winners. UK–EU trade in motor vehicles is easily the country's biggest, worth £67.5 bn in 2017. Next comes trade in food products and agriculture, worth £39.8 bn.

As the leading sectors in UK–EU trade, these pair have three things in common: they enjoy the highest levels of protection of any manufacturing sector in terms of the EU's external tariffs; they generate the UK's biggest EU deficits (£28 bn and £19 bn, respectively), and they are both represented by industry bodies that want the UK to maintain seamless trade with the EU.

MOTOR MANIA

First, cars. Using a three-year average at the start and end of this period and adjusting for inflation, UK motor-vehicle exports to EU have managed only fractional growth in 20 years: just 0.4% per year since 1998, or 6.7% over the entire two decades. Unnervingly, that growth is concentrated in the first half of the 20-year period. Adjusting for inflation, the value of average exports for 2008–2017 (£15.03 bn, in 2015 prices) was lower than 1998–2007 (£15.92 bn). This means by some measures, motor vehicles exports to EU are falling. Zero tariffs; zero market barriers; zero growth.

But here's the problem: since 1998, imports from the EU have motored along nicely, growing at 3.6% per year. The result is a gigantic £28 billion deficit just in motor vehicles and parts — almost sufficient to write off the UK's entire surplus in its trade in services.

Meanwhile, in the non-frictionless, non-seamless, non-Customs Union world of non-EU trade, UK exports have leapt ahead by a staggering 7.9% per year. Virtually all of the UK's growth in motor-vehicle exports since 1998 is attributable to selling premium models to countries outside the EU: principally China and the US, but also ultra-high-end luxury models to the Middle East. The result is that despite being worth just a third of EU exports in 1998, exports to non-EU countries zipped past EU exports in 2012 and are now worth substantially more — £25.3 bn to £19.6 bn in 2017.

And thanks to the iron laws of mathematics, this difference will now accelerate away.

So, for the UK's most-valuable trading sector, the Customs Union has operated as a one-way street. EU-based car-makers have retained a vice-like grip on the UK's most-valuable import market with an 83.8% share that has dropped only fractionally since 1998. But there's no reciprocity. Instead, UK auto manufacturing has relied for growth on global markets, with the result that the EU's share of UK exports has plummet from 73.5% in 1998 to 44.7% in 2017.

Incidentally, this is easily the fastest switch-around of any major UK export sector, in the sense of exports switching from EU to non-EU countries since 1998. What's more, the prominence of North America and China as markets for the UK's premium marques implies that the proportion of the UK's global motor exports already conducted on WTO terms probably exceeds the 73% average for UK goods.

Thus, the net effect of the Customs Union since 1998 has not been to create a springboard for UK manufacturing into continental Europe. Instead, it has placed a springboard in continental Europe, for overseas car manufacturers to ramp up their exports into the UK. Net investment has drifted from the UK to elsewhere in EU, and the growth in the UK's auto deficit from £8.1 bn in 1998 to £28 billion deficit in 2017 is the living, haemorrhaging proof of it.

In employment terms, that springboard has bounced, very roughly, the equivalent of 40,000 jobs straight into continental Europe (This calculation is approximate. The UK's trade deficit with the EU has widened by £17.32 billion (in 2015 prices) from 1998 to 2017. In the US, NBC (https://www.nbcnews.com/business/autos/trump-stresses-manufacturing-jobs-how-important-are-labor-costs-automakers-n716001) estimates that wages contribute 10-15% of the cost of the average motor vehicle, and the average salary of a UK car worker, according to *Auto Express* (https://www.autoexpress.co.uk/car-news/98986/the-global-car-manufacturing-wage-gap-what-do-car-factory-workers-earn), is £39,000. Using the lower figure, gives a value equivalent of 44,410 jobs.).

The lethal aspect to this trend, however, is the way it is now edging into the UK's premium sector – the power-house of the UK's non-EU export growth since 1998. Jaguar–Land Rover has now inaugurated production of its I-Pace and E-Pace models at Magna-Steyr in Graz, Austria, while BMW produces its second-generation Countryman models at VDL Nedcar in the Netherlands. Tellingly, the UK job losses announced by Jaguar-Land Rover in January 2019 followed the opening of a new £1 bn factory at Nitra, Slovakia, an investment decision that predates the UK's 2016 referendum, and was part-induced by €125 million of EU-approved Slovak state aid.

Thus, for the UK's biggest traded sector, the theoretical benefits of the UK's membership of the Customs Union have failed to translate into measurable benefit. The protection of a 9–10% external tariff has not stimulated demand for UK-made vehicles and parts among EU customers over the past 20 years. Nor yet have the supposed obstacles of trading on WTO terms held back British motors from tripling sales (in real terms) since 1998.

The only observable impact of Customs Union membership has been to preserve the UK as a highly lucrative captive market for EU producers, with an 83% share of motoring imports.

FOOD FOR THOUGHT

Trade isn't just exports, though. The equally vital role of trade is to secure for UK consumers the best quality goods at the lowest price. And if there's one sector where this matters more than any other, it's the UK's second-biggest EU trade sector: food and agriculture.

At 0.7% of GDP, the UK's agricultural sector is easily the smallest per head of any major economy in Europe. The UK is, perforce, a massive importer of food and agriculture products — currently to the tune of £42.9 billion per year. And so, even for non-free-traders, this is one area of trade where the interests of UK consumers easily outstrip the interests of UK producers.

Consequently, the UK's strategic interest should be uncomplicated: to enable UK citizens to buy the cheapest and the best-quality food available on global markets. Yet this is precisely what the Customs Union prevents. By imposing ultra-high tariffs on non-EU food and quotas on imports, the EU forces UK consumers to purchase food from EU producers, who just happen to be the highest-cost food-producers on the planet.

But here's the kicker: thanks to the Customs Union, the UK's forced dependency on high-cost food is actually rising (Tab 8, Food, in UK's Top 10 Sectors (http://2mbg6fgb1kl380gtk22pbxgw-wpengine.netdna-ssl.com/wp-content/uploads/2019/02/UKs-Top-10-sectors_BC.xlsx)). Back in 1998, the EU supplied 67.8% of food products imported into the UK; this has now risen to 76.3%. The balance moderates slightly if you include agricultural produce (e.g. cereal) but agricultural produce is just 23% of the food that the UK imports. Add that to the mix and the UK's reliance on EU for imports of all food-stuffs is still increasing, and stands at a 69.9%, totalling £30 billion in 2017.

Does this matter? Recent analysis (https://www.ifs.org.uk/uploads/publications/bns/BN225.pdf) from the Institute for Fiscal Studies by Peter Levell downplays the effect which the removal of tariffs would have on consumer prices, asserting the net effect on average households of the removal of all tariffs would be just 0.7% – 1.2%. The excellent analysis misses three factors, however: the effect of competition, the role of regulation, and the qualitative impact of changed spending habits – especially on less-well-off households.

First, the opening up of a protected or captive market to global prices would instantly stimulate competition, and competition would then become the dominant price-setting factor, not the old tariff differential. If overseas food producers bit straight into EU producers' market share, EU producers would have to do reduce prices and become more efficient to retain market share (or gain fresh subsidies). There's no telling how far price reduction would go but the dynamic of fresh competition for market share is the factor that would drive price reduction, not the original tariff advantage.

Second, some tariffs are particularly high, and their removal would disproportionately impact some households' quality of life. As the IFS itself has itself pointed out (https://www.ifs.org.uk/uploads/publications/bns/BN213.pdf), the least-well-off 20% of UK consumers spend more than 20% of their income on food. Imagine, then, the consequence of eliminating the effective 60% EU tariff on beef. Argentinian and Brazilian producers would charge into the UK market, and prices would quickly drop. But the effect would be qualitative. Families – and individuals, more to the point – would change spending habits and start eating high-quality beef, while paying less for the novelty. On them, the effect of tariff-free food would be immense.

Third, creating an open market in UK food stuffs wouldn't simply be a matter of removing tariffs, but of reforming regulation to ensure it becomes non-discriminatory. And for consumers to benefit, a post-Brexit UK would also need to ensure compliance among trade partners. Analysts need only contemplate the effect – on consumers and UK car production – of the 2015 demise (https://www.bbc.com/news/uk-england-birmingham-24446070) of the Land Rover Defender, when Jaguar Land Rover decided to comply with EU emissions regulations which other European car makers chose to flout. Without re-regulation, and compliance among trade partner, UK markets – especially food markets – will not become genuinely open, and value won't flow to consumers.

In summary, a practical test of the utility of the Customs Union has to rest principally on the experience of motor vehicles, and food/agriculture. They are the UK's two largest two-way sector trade with the EU and it's where protective EU tariffs have the greatest trade-distorting impact.

In both cases, the trade data for 1998–2007 show the effect of the Customs Union is to retain or grow the UK as an essentially captive market, without reciprocal benefit to UK producers (in the case of cars) or UK consumers (in the case of food). And even from UK food producers' perspective, exports of food products to markets outside the EU have grown faster than inside it (3.5% to 2.7%) despite the high tariffs and regulatory burdens common in trade in food. The rise in salmon sales to Korea following implementation of the 2011 FTA implies that the UK has much to gain from negotiating access to Asian markets – not just for fish, but also cheese and beverages.

I invite you to step through the experience of all the UK's biggest trades by downloading the spreadsheet The UK's Top 10 Sectors (http://2mbg6fgb1kl380gtk22pbxgw-wpengine.netdna-ssl.com/wp-content/uploads/2019/02/UKs-Top-10-sectors_BC.xlsx). The story described above repeats to a greater or lesser extent in each. The UK's record inside the Customs Union is so unrelentingly poor that it begs a bigger question: do other countries fare any better? Is the UK's experience just uniquely, inexplicably bad?

To answer that question, in a final instalment I will compare UK performance against other EU countries, non-EU exporters, the US's and the Eurozone's own growth rate.

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