

Brexit and trade

How Theresa May can navigate the customs conundrum

January 2017



Bob Jones

Bob is a director at KPMG in London, where he leads the Customs, Excise & International Trade Services team.

bob.jones@kpmg.co.uk

At a glance:

- If Britain left the Customs Union with no other arrangements in place, all UK-EU trade would require customs clearance.
- Imports of goods into any EU country, including the UK, are subject to 135 different duty rates.
- A new customs arrangement needs new rules of origin and protocols to deal with tariffs at UK border.

We now know Prime Minister Theresa May plans to take Britain out of the European Union's Single Market that enshrines free movement of labour, goods, services and capital. However, the UK's future relationship with the EU Customs Union – the group of European states charging common import duties on goods from non-members – remains up for grabs.

In her objective to deliver a "global Britain", the prime minister was clear:

"I do not want Britain to be part of the Common Commercial Policy and I do not want us to be bound by the Common External Tariff. These are the elements of

the Customs Union that prevent us from striking our own comprehensive trade agreements with other countries. But I do want us to have a customs agreement with the EU."

– Theresa May, Lancaster House, 17 January

However, on the means, Mrs May said she had an "open mind": whether it be a completely new customs agreement, remaining an "associate member" of the Customs Union, or a signatory to some elements of it. Or possibly something else entirely.

So theoretically, is it possible to give the UK a high degree of access to the European Union while also giving it the latitude to make comprehensive free trade agreements with the rest of the world?

The rules of the Customs Union within the Single Market are very clear. Goods pass freely across its internal borders without facing customs duty or any physical barriers. By contrast, goods from outside the Customs Union face considerable non-tariff barriers such as customs clearance processes and potentially regulatory challenges, (for example in reviewing import licensing for pharmaceutical and chemical products), in addition to the Common External Tariff (CET).





So why is the customs union so important?

Customs law has broadly two aspects – procedural/administration and tariffs. If Britain left the Customs Union with no other arrangements in place, all trade between the UK and the EU would require full customs clearance and – absent an EU-UK Free Trade Agreement (FTA) – the Common External Tariff would be imposed. If the EU took this step, the UK would probably then reciprocate by imposing tariffs on imports from the EU.

That could quickly become costly in terms of tariff (i.e. duty) and non-tariff (i.e. bureaucracy and logistics). For example, goods need classifying; there are around 15,000 classifications subject to 135 different duty rates, ranging from over 70% on some tobacco products and 20% on lots of food and drink to 0-10% on many manufactured goods. Classification is only one of around 30 pieces of data from various sources needed, usually in real time at the border.

To illustrate that it's about more than just tariffs, according to an OECD estimate of trade costs, inefficiencies concerning just border clearance could add costs of up to 10% of the value of goods traded¹. Traditional customs processes can take up to three days to complete. For those in the next day (or less) fulfilment business, three days can be everything. These businesses may no longer be able to guarantee to British customers the ability to deliver overnight goods shipped from a European warehouse. Instead they would need to hold inventory in the UK ready to meet those orders. That means duplicating stock-holdings on both sides of the border.

For companies with interconnected supply chains – especially those designed specifically to be work most efficiently on a pan-European basis – the impact would be significant.

Take one of the sectors Theresa May often mentions: automotive. The supply chains that culminate in a car rolling off a British, French or German line weave back and forth across the Channel. A single car part may use raw materials from Brazil before being made in the UK, then shipped to Germany for polishing, sent on to France for partial assembly, and finally back to the UK to become a part of a "British" car. Trying to disentangle these supply chains would impact the global competitiveness of both British and European companies.

Does the Canadian model offer a way forward?

On the face of it, the Comprehensive Economic and Trade Agreement (CETA), which Canada signed with the EU last year, looks similar to the UK's preferred approach. Europe does not levy any duty on goods that originated in Canada. And, like Britain's proposed model it is already party to another deal, in this case the North American Free Trade Agreement. The difference however is that neither of these agreements is a customs union. That means that if the Canadians were re-exporting goods to the EU that came from the United States (which has no trade deal with the EU) the same European port would levy the appropriate positive tariff rate on arrival.

And whether the consignment originated in Canada or the US, it would be held to go through customs clearance. It

is this aspect that Theresa May seeks to improve upon as she pursues "frictionless trade" in goods across the UK/EU border.

The Norway option

Norway is a member of the European Economic Area and as such has access to the Single Market for goods, services, people and capital. But they are not a member of the European Customs Union. This means Norway can sign its own trade deals in concert with fellow EFTA members: Switzerland, Iceland and Liechtenstein. EFTA established a trade deal with Canada in 2009 for example, seven years before CETA.

This arrangement means Norwegian exports can attract positive tariff rates when they cross the border into Sweden and other states inside the Customs Union. But crucially, that process is streamlined, with much of the bureaucracy completed already. One Norwegian client told us he saw little scope to improve the system further: "Proof of origin paperwork is fairly routine once a company has been established and doesn't add much administrative burden".

So the Norway model looks attractive. However, there is no guarantee that the EU would offer the same streamlined procedures to a country outside the Single Market. EU Customs Law is currently directly applicable to the UK. Without it being so, the EU is simply less likely to accept that goods coming from the UK are of British origin, without evidence in advance.

¹ [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC/WP\(2013\)3/FINAL&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC/WP(2013)3/FINAL&docLanguage=En)

How about Turkey?

Turkey joined the Customs Union in 1995, yet this is not a comprehensive customs union or free-trade agreement since it excludes both agricultural products and services. In exchange for access, Turkey has to maintain the EU's common external tariff on non-EU non-food goods coming into the country so it doesn't become a tariff-free staging post into the bloc (yet has no say on the setting of those tariffs). While it is entitled to set different tariffs for agricultural products, it is inevitably constrained from signing comprehensive free trade agreements with other countries.

This directly clashes with Mrs May's desire to establish free trade deals with the freedom to set tariffs.

How could a UK deal work?

If none of these precedent models fit the bill, the UK Government might decide to propose a new customs agreement altogether – something that looked and felt like a customs union, but was in reality a series of simplified procedures incorporated into a new UK-EU FTA.

But for the UK and EU to agree to such an arrangement, the deal would need to clear a number of hurdles:

1. Closing the EU's back door: The EU would need reassurance that their domestic markets remained protected from cheaper imports from outside Europe. That means that the walls surrounding their customs union have to remain intact.

2. A global Britain: The UK would need an arrangement that was compliant with WTO rules and which allowed it to sign new, comprehensive free trade agreements with the rest of the world – without having to consult Brussels first.

3. Frictionless trade: Businesses with cross-border European supply chains need zero tariff trading, and just as importantly, as few non-tariff barriers as possible

Taken in turn, let's look at how a system could reconcile these competing challenges.

1. Closing the EU's back door

If, for example, the UK signed a deal that allowed New Zealand lamb into the UK at zero tariff then without the appropriate border checks the UK would become a back door for that lamb into Europe. So as they received a consignment from UK, customs officials in EU countries would need to distinguish between British origin lamb (potentially covered by an FTA and 0% duty) and New Zealand origin lamb (which attracts a tariff of 12.8% plus a charge of €1.67 per kilo).

This issue revolves around the 'rules of origin' system. Imagine a British producer bought that imported lamb, cooked it, added gravy, topped with pastry and put it in a foil tin. Is the origin of that pie now Britain or New Zealand? So to work, a new customs arrangement would require new rules of origin and protocols to deal with the application of appropriate tariffs quickly at, or before, the border.

2. Global Britain

From the UK's perspective, it wants the freedom to unilaterally set tariffs with whom it chooses and at levels it determines. But it also wants a comprehensive FTA (including zero tariffs) on trade with the EU. Conventional wisdom says it simply can't be in the customs union with the EU because a customs union means common external tariffs. Mrs May has acknowledged that.

Could it be "in" for some sections of the CET and out for others? For some industries with low or no tariffs already (regardless of an FTA), such as aerospace, that might have made sense. Indeed the UK and EU could be served best by continuing to trade in certain goods as they do now. The snag would be the enormous practical difficulties in differentiating between that industries', and other industries', goods at the border.

One other issue is that under WTO rules, customs unions – like FTAs – should cover "substantially" all trade. So even if it is in both parties' interests, they may not be able to cherry pick such sectors. It is also worth noting that average non-tariff costs are now higher than average tariff costs. So the new "customs agreement" could do most good simply by eliminating non-tariff barriers in innovative ways. Technology is already making this a reality.

The EU collects less than €25 billion a year in duties in total, of which only €4.2 billion is collected in the UK. This compares for example to the c£48 billion the UK collects a year nationally in excise duty on oil, tobacco and alcohol. In many sectors it costs more to collect the customs duty on imports than it yields in revenue. So for trade with the EU, it may be better simply to conclude the FTA for tariffs quickly and instead focus on the potential new non-tariff barriers to be created by the UK removing itself from the customs union.

3. Frictionless trade

A consensus seems to be developing that, post-Brexit, it will be necessary to establish some sort of customs border between the UK and the EU – not least to address risks around the origin of goods and the tariffs to be charged tariffs payable as well as demonstrate the origin of their goods. The UK already shares the EU's comprehensive customs infrastructure, so why not together modify, develop and leverage it for the post-Brexit world?

For example, why shouldn't your EU export declaration for goods consigned to the UK also be the UK import declaration, and vice versa? Why shouldn't the UK "wave through" exports received from accredited, trusted exporters in the EU and vice versa, through comprehensive mutual recognition provisions? Why not – rather than Dover, Calais or the Irish border being the point of import – make the point of dispatch or destination the "border".

Can such a border exist virtually, at least for firms who can demonstrate compliance with strict criteria and procedures? If it could, lorries would avoid being stopped routinely, and pan-European supply chains would function much as they do today. And with a "virtual border", perhaps companies could complete customs via self-assessment or pay any tariffs at the end of the month?



Which way now?

What I have described above is one possible way forward. But is it feasible from a political perspective? Here we stray into territory where the play between Britain and 27 other sovereign nations means it is impossible to say. Nevertheless here some of my colleagues and I have given our assessment of the situation.



Karen Briggs

Head of Brexit, KPMG in the UK

"It is clear that negotiating a new type of deal in tight timeframes will not be easy but the potential rewards, increasing our trade with the world's fastest growing economies provide significant upsides for the UK while minimising

disruption to Europe's interconnected supply chains and services markets"

Mark Essex

Director of Public Policy and author of KPMG's weekly Brexit Column

"The prime minister's Brexit speech on Tuesday offers a coherent opening gambit for talks, now just weeks away. Yes, the vision of a global Britain creating free trade deals with the rest of the world is ambitious and will need further definition. Can the new deal create an arrangement that works like a customs union for interconnected supply chains, but protects the EU from back doors? I believe the government can achieve that balance with some creative thinking."



Tim Sarson

Partner, Value Chain Management

"Before celebrating an agreement that is still at least two years from coming to pass, and possibly much longer (it took Canada seven years), let's not forget that the government

has proposed an arrangement with our closest economic partners that might, at best, be almost as good for trade as what we already have. The best case scenario is that "it won't be that bad", and the extra bureaucracy and red tape might be manageable if we invest a few billions in IT infrastructure. Meanwhile any comprehensive FTAs with other international trading partners will take many years to negotiate."



Shenoa Simpson

KPMG Global Strategy Group and former US trade official

"I think it's really hard for people in trade, including myself, to hear policies that have no precedent. But I think we have to get away from using 'impossible' and 'never'

as the policies will shape the negotiations and the ultimate agreements. Policies will determine ultimately what the UK is willing to accept or not accept. We are in new territory and need to explain how things have been done in the past while also recognising they could be done differently in the future."



Bob Jones

Head of Customs, Excise & International Trade Services

"For pan European trade, the deal described can only be a second prize to being in the single market and customs union. But how much worse will it be? Regardless of tariffs, it will take a lot of effort to make the UK/EU border frictionless once we are outside the club. It won't be "no border" as we have now, and it won't be as high a priority for the EU as it is for the UK. There will be pain and it could be significant."

kpmg.com/uk



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2017 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

CREATE | CRT070295K | January 2017