BREXIT AND THE DISTRIBUTION SECTOR

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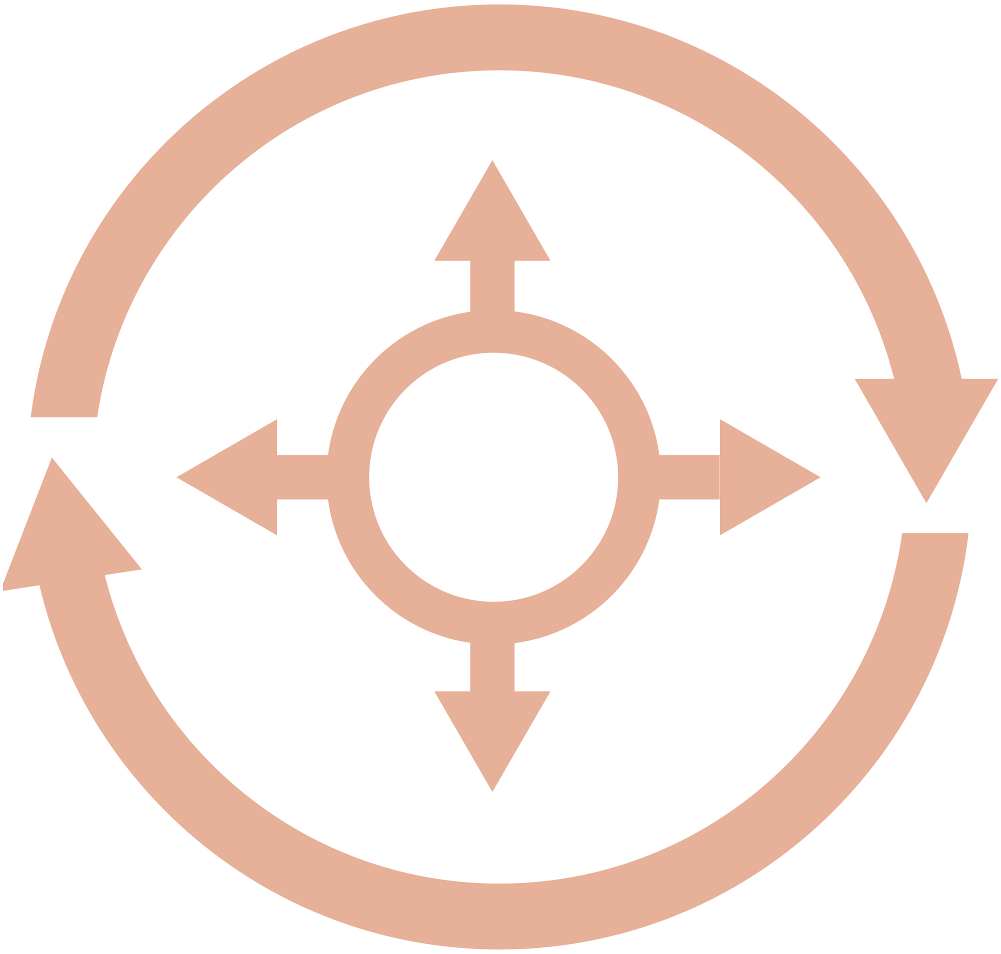

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John FitzGerald and

Edgar Morgenroth

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INTRODUCTION

Since the 18th century a simplistic mercantilist view of world trade has often found advocates among policy-makers across the globe. This vision sees economies deriving their strength from how much they export, while imports are perceived as being a loss to an economy and a sign of weakness. Economics moved on from this viewpoint two centuries ago. However, even today, in the analysis of the effects of Brexit on economies, much more attention is paid to the effect on exports rather than on imports[1]. In Ireland's case, as shown in Table 1, the UK is certainly an important market for our goods, but the UK is also an even more important supplier of imported goods. A number of research reports and papers have considered the potential effect of Brexit on Irish trade. Most have focused on exports, but as noted in Barrett et al (2015), if Brexit results in higher trade barriers for exports, it will also increase trade barriers for imports.

Therefore any changes resulting from Brexit, which impose tariffs on imports from the UK, will have deleterious effects for the Irish economy.

1 The current US administration exemplifies this misconception.

Even more serious may be the impact of non-tariff barriers, which interfere with this vital channel of inputs for the Irish economy.

TABLE 1: IRISH TRADE WITH UK, % OF TOTAL

Exports	2003	2016
Merchandise	18	13
Services	25	16
Total	20	15
Imports	2003	2016
Merchandise	30	23
Services	15	6
Total	23	11

Source: CSO Trade Statistics

The effects of Brexit on Irish imports from the UK will depend on the nature of Brexit itself. If the UK were to remain within the customs union, so avoiding tariff barriers and many non-tariff barriers, the effects would be much more limited than if the UK leaves the customs union. Also the effects of Brexit, in particular if the UK leaves the customs union, will be rather different for imports of materials for further production than for consumer goods destined for the retail market.

Because the effects of Brexit would be much milder if the UK remains in a customs union, in this note we concentrate on the worst case scenario where the UK leaves the customs union.

The effect of barriers to UK imports will come in a number of different forms. Firstly, any tariff barriers will have an impact on the price of imports for Irish buyers. However, the final impact of such tariffs on Irish prices and producers costs will depend on the incidence of the tariff (whether the UK supplier or the Irish buyer pays the tariff) and the presence or absence of ready substitutes from elsewhere in the EU. Secondly, any restrictions on trade will impose indirect costs, not least through delaying movement of goods. Thirdly, any disintegration of the previously integrated Irish and UK retail market will reduce competition, raising prices. Fourthly, exchange rate changes resulting from Brexit have already had a significant impact, reducing the cost of imports from the UK. However, exchange rate effects tend to wash out in the long run as the UK inflation rate is raised by devaluation and inflation in Ireland is reduced.

We first consider the impact of Brexit, where the UK leaves the customs union, on imports of materials to be used as an input in Irish business (materials for further production) and we then discuss the impact on imports of consumer goods, especially goods destined for the retail sector.

TARIFFS, NON-TARIFF BARRIERS AND PRICES

As shown in Table 1, in 2016 23% of total Irish merchandise imports came from the UK[2], while the UK accounted for 13% of Irish merchandise exports.

The UK is either the only or most significant source for Irish imports of fuels and natural gas, and consumer products such as make-up, soft drinks and breakfast cereals.

Research has shown that even relatively low levels of trade barriers result in significant costs. A study on the cost of trade frictions between the US and Canada, who trade under the North American Free Trade Agreement (NAFTA), found that these amount to 2.7 per cent of the value of merchandise trade (see Taylor et al., 2004). Thus, if these costs are passed through fully to consumers, prices of US and Canadian goods imported into Canada and the US would be 2.7% higher than would be the case under completely free trade.

The degree to which cost increases arising from barriers to trade are passed through to prices is, in part, determined by the

2 If airplanes are excluded from total Irish merchandise imports the UK share of imports is 27.9%.

degree of competition – can goods be sourced competitively from alternative sources within the EU. Where competition is high the increased cost will typically largely be absorbed by the (UK) exporter. In contrast, where the level of competition is low, the effect will be passed through to the importer (Irish businesses).

TARIFFS AND PRICES – MATERIALS FOR FURTHER PRODUCTION

The impact of Brexit on Irish firms importing materials for further production from the UK will tend to be greater in the short run than in the long run. Where ready substitutes are available from elsewhere in the EU, the effects will diminish over time as inputs are sourced from new suppliers. Complex supply chains will gradually adjust. However, for firms importing goods which are not easily substitutable, such as milk from Northern Ireland, the effects could be more permanent. Importantly, the significant reliance on UK imports suggests that alternatives are more expensive, so even over the long-run with adjustment of supply chains a hard Brexit will have a negative effect.

Apart from direct imports from the UK, any trade barriers due to Brexit are also likely to affect the significant transit traffic between Ireland and other EU Member States.

(see Lawless and Morgenroth, 2017 and Ferris, 2017). Any additional costs incurred would impact on prices and competitiveness in Ireland. Thus increased costs for goods transiting the UK would fall primarily on Irish importers rather than the suppliers, especially where the suppliers were in countries other than the UK.

Much of the goods imported into Ireland are used as inputs by businesses in the Irish economy. This reflects the growing complexity of supply chains with an increasingly globalised world economy. Another recent Inter-Trade Ireland study (Lawless and Studnicka, 2018) shows a high level of integration between firms trading between the North and the Republic. Goods produced in one jurisdiction are frequently used as an input into businesses in the other jurisdiction.

One of the most obvious cases is milk; substantial volumes of milk, produced in the North, are processed in the South.

The integrated nature of supply chains has developed to minimise the overall cost of production in a global economy. Part of the increased efficiency reaped by firms depends on very efficient logistics. Stocks of inputs are kept to a minimum, reducing the need for storage, while at the same time ensuring no delays in production.

However, if the UK leaves the customs union, Brexit will almost certainly result in an increased regulatory burden for firms. These costs will be compounded by inevitable delays in transferring inputs from one jurisdiction to another.

Possible responses of firms will be to increase storage to deal with delays, holding higher stocks and, in the long run, seeking other more reliable or less costly alternative suppliers. Initially the cost of production in firms using UK inputs will impact on Ireland, with negative implications for these firms' competitiveness. However, the costs may ease in the longer term as the supply chain adjusts.

TARIFFS AND PRICES – CONSUMER GOODS AND RETAIL SECTOR

The retail and distribution sector is a key part of the domestic economy. It is the channel through which consumer goods are imported and provided to Irish households. In the case of the grocery sector, two thirds or more of what is on the shelves is either manufactured in the UK or imported through the UK. Thus this sector is very vulnerable to any barriers to trade arising from Brexit.

A major factor in increasing efficiency in the distribution (retail) sector across the EU over the last 30 years has been the development of centralised distribution. Rather than suppliers delivering to every shop, they deliver to a central warehouse. Then, regular deliveries are made to each shop by one lorry carrying all the shop's needs. This minimises the costs of delivery and has been fully exploited in much of the

EU, facilitated by the absence of borders. However, this model is incompatible with a world where customs clearance is necessary. Where there is some form of customs checks, every different item in a lorry will have to be separately identified for customs, to ensure that the correct tariff (or none is applied). The appropriate treatment will depend, not just on the nature of the product, but also where it was produced.[3]

The administrative burden of these procedures, even if handled electronically, may force a major change in distribution networks. In turn, this is likely to increase costs and could also lead to some retailers pulling out of the market.

Many of the big retailers are UK firms which operate an integrated supply chain across the UK and Ireland, reaping the scale economies common across the EU (and the US). The retail structure could, as a result, be impacted by Brexit, directly affecting competition on the Irish market. The level of competition tends to be lower in small countries like Ireland, partly because the scale economies are not available, discouraging entry by major international players. Separating the Irish retail supply chain from the UK chain will be costly and, in the absence of competition from retailers who are part of the continental EU supply chain, much of the additional costs will be passed through to Irish consumers.

The problems arising from increasing delays due to non-tariff barriers will be particularly acute for perishable goods.

While some of these costs could be avoided by establishing a direct supply chain to the EU mainland, the sea journey tends to be longer than the time needed to transit the UK at present.

An ESRI study has shown that the effect of a WTO based outcome of Brexit would see very significant tariffs on imports of food and food products from the UK (Lawless and Morgenroth, 2018). This study also shows that the potential impact of non-tariff barriers is greater than that of tariffs. Thus even if the ultimate Brexit outcome does not involve tariffs but other barriers to trade, the impact could be substantial. The analysis suggests that, depending on the nature of Brexit, it could raise the price level in Ireland by between 2% and 3%, with the effects being greater for those on low incomes than those on high incomes.

Breaking the existing integrated retail sector covering Ireland and the UK into a separate purely Irish retail sector will impose significant costs. It will also reduce competition in the Irish market.

Some existing retailers, which organise on a joint Ireland-UK basis, may pull out because of the significant increased costs of supplying the Irish market, and it will also make future new entry for UK retailers more difficult. Existing retailers may find the reduction in competition in the short to medium term a benefit. However, in the long run, by reducing competition Brexit could permanently raise the price level in Ireland unless new supply chains, linking in with the rest of the EU, are developed.

TRANSPORT LINKS

Approximately two thirds of products on supermarket shelves have either been manufactured in the UK or transited through the UK for delivery to Irish shops. Any delays in transit arising from Brexit will impact on availability in Irish shops. Because most retailers have very limited storage they will not, in the short run, be able to counter such delays by holding bigger stocks.

One solution to the logistical problem of sourcing goods from the rest of the world, that currently transit the UK, would be to develop alternative direct supply routes to Rotterdam and Antwerp.

However, this will take time and Irish ports, which specialise in the Ro-Ro trade, may not be able to handle an immediate big increase in Lo-Lo traffic to the continent. It will also be more expensive than the existing "land bridge " through the UK.

3 Under the Anglo-Irish Free Trade Agreement of 1965 a minimum of 25% of the cost of a good must have arisen in the UK for a good to be classified as a UK good for tariff purposes. Similar rules will be applied to all trade between the UK and the EU with the percentage domestic content to be decided.

Because shops in Donegal are supplied by lorries passing through the North, any delays at the border could be particularly severe for consumers there. The obvious solution to the Donegal issue would be to agree that lorries are sealed on leaving the warehouse in Dublin and unsealed in Raphoe or Letterkenny.

CONCLUSIONS

In the long run, an increase in the level of consumer prices will be passed through into wage rates. Thus a permanent increase in the price level due to Brexit would have a permanent effect on Irish labour costs, and a resulting long-term negative effect on Irish output and employment. The appropriate Irish policy response should be to aim to keep the UK in the customs union so that there are no customs barriers, whether physical or electronic. If this does not prove possible, policy will need to concentrate on helping business to develop alternative supply chains. Because supply chains in the retail business are specific to individual retailers, it may not be efficient just to develop a different supply chain for branches in Ireland.

In the long run, to maintain Ireland's competitiveness, enhanced domestic competition will be essential, benefiting all those living in Ireland. If the UK leaves the customs union, policies will need to be developed to encourage new entry by retailers from outside these islands, incorporating Ireland into a wider EU supply chain.

The Irish authorities need to focus attention on attracting retail and distribution firms from elsewhere in the EU to come to Ireland and provide competition in the future.

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The Institute of International and European Affairs,

8 North Great Georges Street, Dublin 1, Ireland

T: +353-1-8746756 F: +353-1-8786880

E: reception@iiea.com W: www. iiea.com