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A future EU-UK financial relationship

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The UK's financial relationship with the EU going forward, these come down to the terms-of-trade.

The two essential elements here are:

A. What replaces our current membership of the customs union and Single Market;

B. How we protect ourselves from predatory tax practices of other EU Member States.

The guiding principle is that it is impossible to remain part of the customs union and Single Market and also preclude predatory tax practices.

To solve the latter issue, the UK needs to rewrite its domestic corporate tax code by drawing up industry templates for cost/income ratios through which HMRC could run the group-wide figures of the likes of Google and Amazon, and the many other companies who benefit from the Freedom of Establishment and the sweeteners embedded in the domestic corporate tax codes of Ireland, Luxembourg and the Netherlands in particular.

Whatever the appearance these companies might present about the extent of their UK business, HMRC would be accorded the right to look through to the substance, and extrapolate the profits of their UK business from the company's group-level sales and from a template of costs that would apply to a UK company undertaking the same business from a 100% UK base, and not with the activities split between the UK and other EU Member States.

This splitting of activities is underpinned by the implementation of odorous "transfer pricing" that lands the costs in the UK and the profits in Ireland, Luxembourg or the Netherlands. Instead the UK needs a new regime:

HMRC can make assumptions about the group's UK sales from the group's global Profit and Loss account;

Then HMRC can derive their UK costs and their UK pre-tax profits through applying the industry templates for 100% UK-based companies undertaking the same activities;

Whatever the company says is the profit of the UK subsidiary, HMRC would then respond with the UK's official version of their profits, on which they would pay 16-17%, or whatever the standard rate is;

HMRC would send the company an Advance Payment Notice for the difference between what is in their own tax return and the UK's computation, regardless of what tax the company had paid in Ireland, Luxembourg or the Netherlands.

The remaining issue is import/export tariffs. These can be negotiated in the knowledge that the UK exports approximately £280 billion of goods and services to the EU now and imports about £360 billion, an annual trade deficit of £80 billion (Source: Walbrook Economics).

Given this imbalance to the UK's detriment, the UK should have no qualms about going onto World Trade Organisation (WTO) terms. If tariffs of on average 10% were applied by other EU Member States to the UK's exports under these terms, this would amount to a detriment of £28 billion per annum. However, the detriments caused by EU membership fees (nett £9 billion), Freedom of Movement (nett £20 billion) and Freedom of Establishment (£11 billion) total £39 billion, and outweigh the tariffs that would be imposed on UK goods and services under WTO rules.

By the same token, if the EU imposed 10% average tariffs on UK goods and services, the UK could do the same in return. In that case HMRC would receive £36 billion in customs revenues, enough to subsidise all of our EU exports:

Assume an export was to be made for £50,000 and the EU tariffs would have raised this to £55,000;

The UK government sets up a scheme allowing the UK exporter to still quote a £50,000 all-in price, but composed of a cash price of £45,454 plus 10% EU import duty of £5,454 = £50,000;

The UK government reimburses the UK exporter with the £5,454 of duty so the impact of the duty is neutralised;

Even if EU governments did the same in return, the UK as a whole

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would still be better off by £8 billion per annum: 10% of the UK's negative trade balance with the EU.

On top of that the UK would be able to strike trade deals with non-EU member states at lower tariffs than apply now, when they are set at an EU level.

There is, however, one proviso to the above. The UK government should only reimburse EU import duties to UK exporters where the UK goods and services being exported into the EU have a minimum of 70% UK content. There would be an exclusion where goods/service are prepared mainly outside the EU, imported into the UK for finishing, and then re-exported as UK product i.e. as an EU product. This kind of "trade deal shopping" adds little value to the UK. Where the Confederation of British Industry lobbies for continued access to the Single Market, it would be interesting to know how much usage their members are making of the UK as an entry port to "game" the Single Market rules, as opposed to their investing and creating proper jobs in the UK: the latter deserves UK government support, whilst the former does not.

The main penalties, then, of the UK negotiators failing to reach any kind of agreement with the EU negotiators by March 2019 can be summed up as:

1. EU import tariffs being imposed on the UK's exports of goods and services, which, for purposes of illustration, we have put at a detriment of 10% of £260 billion, or £26 billion;
2. The necessity of providing public services for 1.2 million UK citizens living in other EU Member States now, at an assumed cost of £10 billion per annum based on parity of cost with that the UK bears now for providing public services to the 3.6 million citizens of other EU Member States;
3. Loss of estimated £5 billion per annum of grants from EU bodies into the UK.

The total detriments would thus amount to £41 billion per annum.

Were the negotiations to fail in that way, the financial benefits to the UK would be:

A. Imposition of tit-for-tat import duties on EU goods and services, at the same level as imposed by the EU. If that were at 10% and on the current level of EU imports, the UK would book £36 billion of import duties;

B. Cessation of payment of £14 billion per annum EU Member Cash Contribution, out of which the £5 billion per annum of grants from EU bodies back into the UK are funded;

C. Cessation of the need to bear the cost of the public services for the 3.6 million citizens of other EU Member States currently in the UK, which is £30 billion per annum;

D. New revenue in Corporation Tax on tax-efficient EU business models where profits are currently concentrated in Ireland, Luxembourg and the Netherlands, calculated by the author for Global Britain at £11 billion per annum.

The cash benefits amount to £91 billion per annum, as contrasted with the cash detriments of £41 billion – a net cash benefit of £50 billion per annum.

The difference expressed as a Net Present Value may well be far higher if one were to calculate the relative periods over which public services would need to be provided to EU citizens in the UK compared to UK citizens in the rest of the EU, based on age demographic.

In addition, the failure of negotiations and the UK's exit from the Treaty of the Functioning of the EU would release the UK from EUR1.3 trillion of contingent financial liabilities. In order to ensure this release, the UK government should buy out all of the European Investment Bank's loans into the UK:

Adjusting the payment in the EIB's favour for their loss on redeployment of funds, where the EIB has funded its loans at higher interest rates than prevail now (the loans will be set to those higher rates so the UK would earn this adjustment back over the life of the loans);

Offsetting the value of the Student Loans to students from other EU Member States.

This last point could be of course be challenged, with the UK's position being that allowing these students to study here and take out a student loan here were part-and-parcel of the UK's membership of the EU and should not survive the UK's withdrawal.

Apart from that, the UK could simply enact the remainder without striking a Brexit deal in negotiation. This should then be the baseline: the negotiation needs to achieve a better outcome for the UK than the result if no negotiation were undertaken at all.

Since the "no negotiation" route can be expected to deliver £50 billion per annum cash benefits and release the UK from;

(i) EUR 1.3 trillion of contingent liabilities and

(ii) a liability to provide public services to EU citizens of a far longer duration than the likely need to take over public service provision for UK citizens currently in other EU countries, the UK negotiating position is straightforward: the above is a minimum outcome and is completely acceptable. The negotiating task is to improve on that, and walk away if that is all that can be achieved.

The walk-away can deliver £50 billion per annum cash benefits: 2/3rds of the UK's public spending deficit and enough to bring austerity to an end, and without Labour's Land Value Tax and financial conjuring tricks.

Bob Lyddon is the author of "*The UK's liabilities to the financial mechanisms of the European Union*".