

The potential impact of Brexit on the Irish Sheep Industry and wider agricultural economy

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Introduction

The triggering of Article 50 by the UK Prime Minister Theresa May on March 29th 2016 has set in train the prescribed two year process under Article 50 of the Treaty on European Union, which (with or without an agreement between the EU and the UK) will lead to the exit of the UK from the EU. The negotiations over the terms of the Brexit divorce and the negotiations over the terms of the future trade relationship between the EU27 and the UK will take place sequentially, with negotiations on trade only beginning when what the EU Council have termed “sufficient progress” has been made in the negotiations over the “divorce”.

The outcomes of both the divorce process and the negotiations that will set the terms of the future trade relationship are at this point unknown. In this paper we first review the importance of the UK to Irish and EU sheep meat markets and look at what impact a Brexit might be expected to have on the EU lamb supply and use balance.

In the second half of the paper we look at what tariffs might apply to bilateral trade in sheep meat in the event that the UK and EU trade relations revert to what are known as WTO rules. An important “known unknown” is how existing EU sheep meat Tariff Rate Quota are allocated between the exiting UK and the EU.

Results of recent static analysis of the impact of Brexit on average specialist sheep farm incomes from the Teagasc NFS is presented (Donnellan, Hanrahan and Thorne, 2016; Thorne, Donnellan and Hanrahan, 2017). The paper closes with some tentative conclusions.

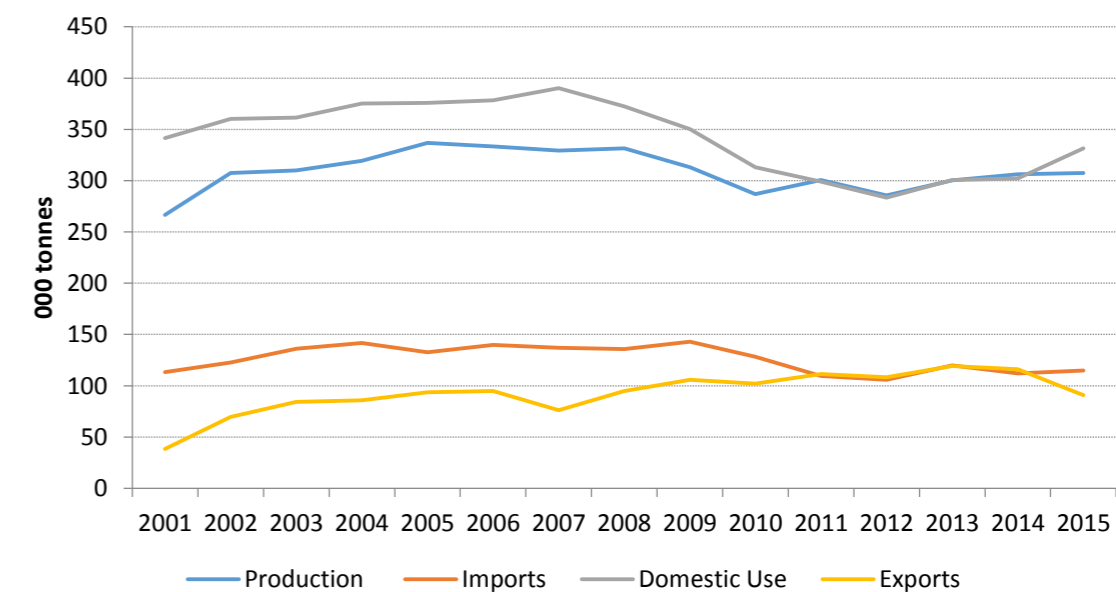
Sheep Meat Supply and Use Balance

The UK is the largest producer and the largest exporter of sheep meat in the EU. In 2016 the UK accounted for 40% of EU28 sheep meat production. In that year Ireland accounted for 8% of EU28 production and France accounted for 12%. The UK is also a significant importer of lamb. The UK government produces supply and use tables for all of the major agricultural commodities produced in the UK. The sheep meat supply and use balance is unusual due to the

importance within that balance of exports. The evolution of that supply and use balance is shown in Figure 1. In recent years imports and exports of sheep from the UK have been close to equal. Another aspect of the UK sheep meat supply and use balance that distinguishes it from other UK commodity supply and use balances and equivalent sheep meat supply and use balances for other EU member states is the role of non-EU imports. Imports from non-EU sources account for the vast majority of UK imports of sheep meat.

Due to the scale of UK sheep meat production in total EU production, due to the role of the UK as both the largest exporter of sheep meat to other EU member states and due to the large share of non-EU sheep meat in UK imports all mean that changes in the level of access to the UK for sheep meat imports from the ROW and changes in the level of access of UK sheep meat to other EU markets as a result of Brexit will lead to significant impacts on the EU sheep meat supply and use balance and on the prices for sheep meat on UK and EU markets after Brexit.

Figure 1. UK Sheep meat Supply and Use Balance (2001-2015)

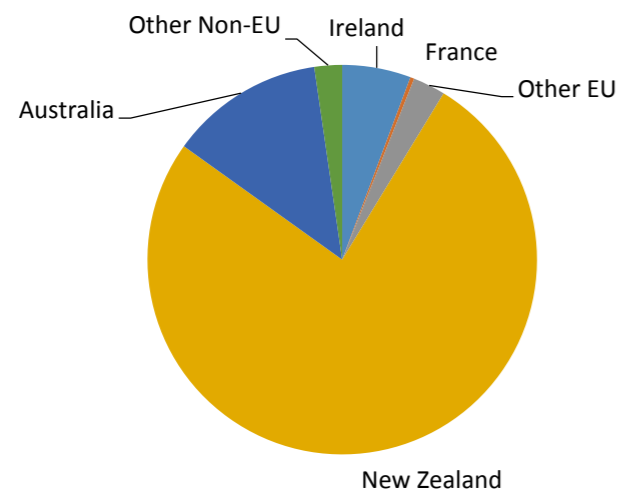


Source: DEFRA Agriculture in the UK

Following Brexit, the sheep meat “deficit” in the EU27 markets would tighten as compared to a world where the UK remained part of the EU. The trade rules that will govern EU-UK trade are at this point unknown but there will be non-tariff barriers and possibly tariff barriers to trade between the UK and the EU. If UK exports of sheep meat to EU27 markets face tariff barriers following Brexit it is likely that the current volume of UK exports to EU markets would

decline and would have to be absorbed on the UK or rest of world markets. Given that the UK exports close to one third of its annual production we would expect that UK prices would be negatively affected as prices would have to fall to persuade UK consumers to increase lamb consumption and to make UK lamb competitive on world markets.

Figure 2. UK Sheep meat Imports in volume terms (2016)



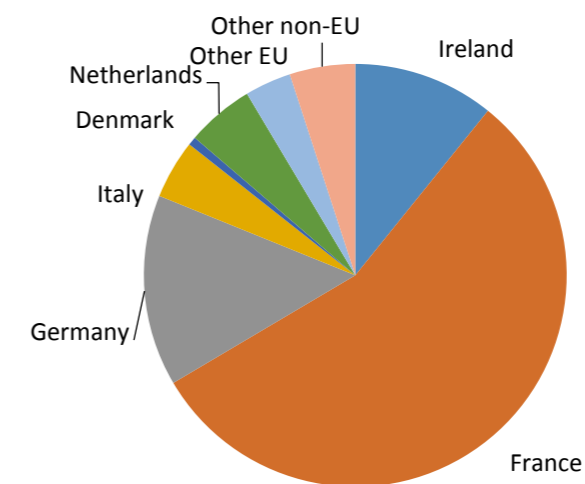
Source: Eurostat COMEXT

Brexit is likely to drive a wedge between UK and EU27 prices, with EU27 prices likely to increase and UK prices likely to fall. Whether or not EU imports of lamb from non-EU sources (New Zealand and Australia) would fall following Brexit will depend on how the EU, the UK as well as countries such as New Zealand and Australia decide to allocate the existing EU28 sheep meat tariff rate quota between the UK and the remaining EU27. If the EU27 retains all of the EU TRQ the positive impact of the UK exit on EU sheep meat prices might be mitigated.

The UK imports of sheep meat are currently dominated by supplies from New Zealand (see Figure 2). With exit of the UK from the EU, the resulting reduction in prices in the UK relative to the remaining EU would reduce the attractiveness of the UK (relative to the EU27) as a destination market for exports of sheep meat NZ and Australia under preferential trade terms. Lower UK prices would be expected to lead to a contraction in UK sheep meat production.

Close to 90 percent of UK lamb exports are shipped to EU markets. France alone took over 50 percent of British exports in 2016. In the event of Brexit resulting in increased barriers to trade faced by UK exporters of lamb, this would result in reduced competition for Irish lamb exports (from UK lamb exports) on the French and other continental EU markets.

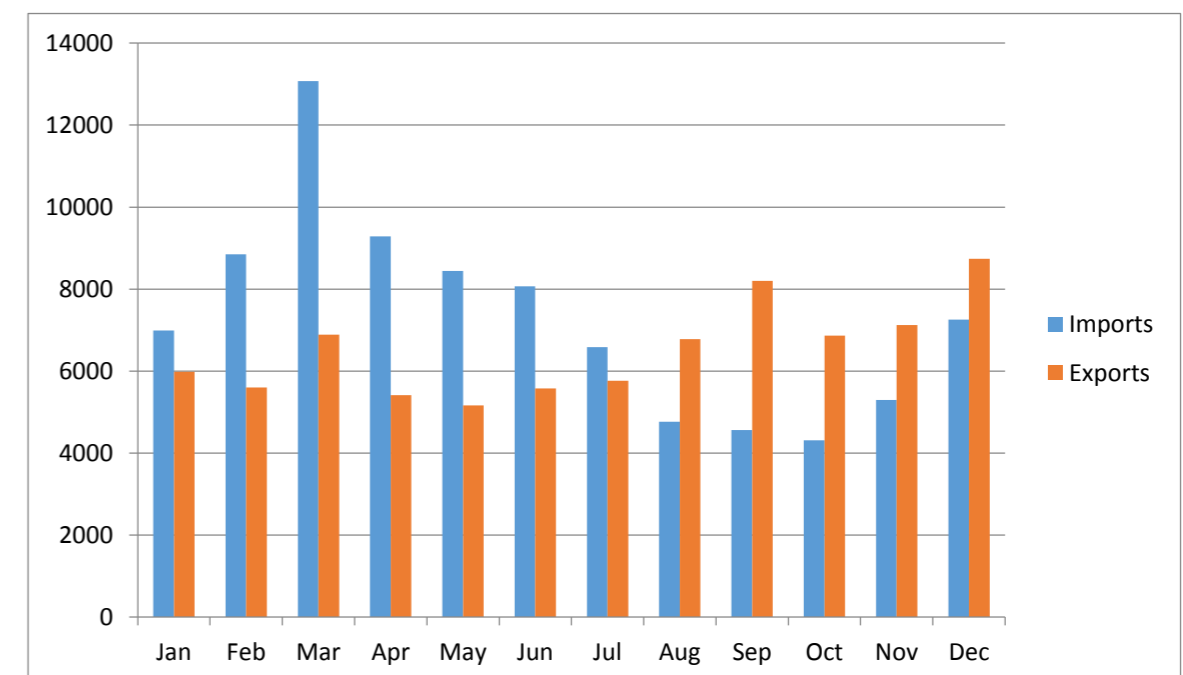
Figure Error! No text of specified style in document.. UK Sheep meat Exports in volume terms (2016)



Source: Eurostat COMEXT

UK trade in sheep meat is also seasonal with exports of lamb to French and other continental EU markets largely coinciding with Irish spring lamb exports. Imports of fresh and frozen lamb from New Zealand, while consistent throughout the year, are highest in the early spring in advance of the peak levels of North Western European lamb production.

Figure 4. UK Monthly Sheep Meat Imports and Exports



Brexit and WTO Rules: Possible future trade barriers to sheep trade between UK and EU

The nature of the trade rules that will govern future trade between the UK and the EU will be the subject of negotiation between the UK and EU. The UK has made it clear that it wishes to leave the Single Market and most commentators have viewed its enthusiasm for future trade deals with non-EU countries as indicative that it will not be part of the EU Customs Union. Even with a deep and comprehensive trade agreement, that the UK government has stated it wishes to conclude with the EU, the exit of the UK from the Single Market and the EU Customs Union will lead to additional costs to trade between the UK and the EU. Whether or not the trade deal negotiated between the UK and the EU will leave trade between the EU (and Ireland) and the UK at zero tariff rates is also unclear. To date no trade deal that has been concluded by the EU has treated agri-food trade as just another element of trade and agriculture in the EU has retained levels of protection in excess of the zero tariff rates envisaged by some. This means that there is more than a possibility that there will be some tariffs on trade and there will almost certainly be non-tariff barriers to trade.

In the event that negotiations between the UK and the EU fail in the sense of not reaching either the deep and comprehensive free trade agreement desired by the UK or another less comprehensive deal, then trade relations between the UK and the EU would revert to what are known as WTO rules. The UK (as an EU Member) has a tariff schedule that has been notified to the WTO. On exiting the EU the UK will inherit this EU tariff schedule and outside of Free Trade Agreements that the UK might agree with EU and other WTO members, this tariff schedule will govern the maximum tariff levels the UK can impose on trade between the UK and other WTO members (including the EU). The UK would be free to reduce the tariff rates it applies to below the bound levels.

The only scope within the rules of the WTO (of which both the EU and the UK are members) for preferential market access is within the framework of a free trade agreement. UK exports to the EU in the absence of a FTA between the EU and UK would face the EU common external tariff. If the UK, post Brexit, chose to reduce its tariff levels to below the bound WTO levels it will inherit from the EU these tariffs will apply to all suppliers to the UK market that are WTO members – so while lower tariffs might seem to offer the prospect of continuing levels

of access enjoyed under the Single Market, the preferential nature of that access associated with UK membership of the EU will disappear with Brexit.

The series of agreements under the GATT in the post-World War II era reduced most tariffs on merchandise trade to very low levels. Agriculture was only included in this liberalisation process in the GATT round that concluded in 1994 – the Uruguay Round – and levels of tariff protection accorded to agriculture by the EU (and many other WTO members) remain much higher than other sectors of the economy. If EU and UK agri-food trade following Brexit is on the basis of only our mutual membership of the WTO then this trade will face significant tariff and non-tariff barriers.

The tariffs applied to agricultural trade by the EU are detailed in the EU tariff schedule. EU agricultural and food product tariffs are a mixture of ad valorem (or percentage of value) tariffs and so-called specific tariffs (usually expressed in euro per 100 kg). These tariffs can be converted to “ad valorem equivalents” by translating the specific components of the tariff schedule to their percentage equivalent using data on the value and volume of trade. For example imports of fresh or chilled Sheep legs (Tariff

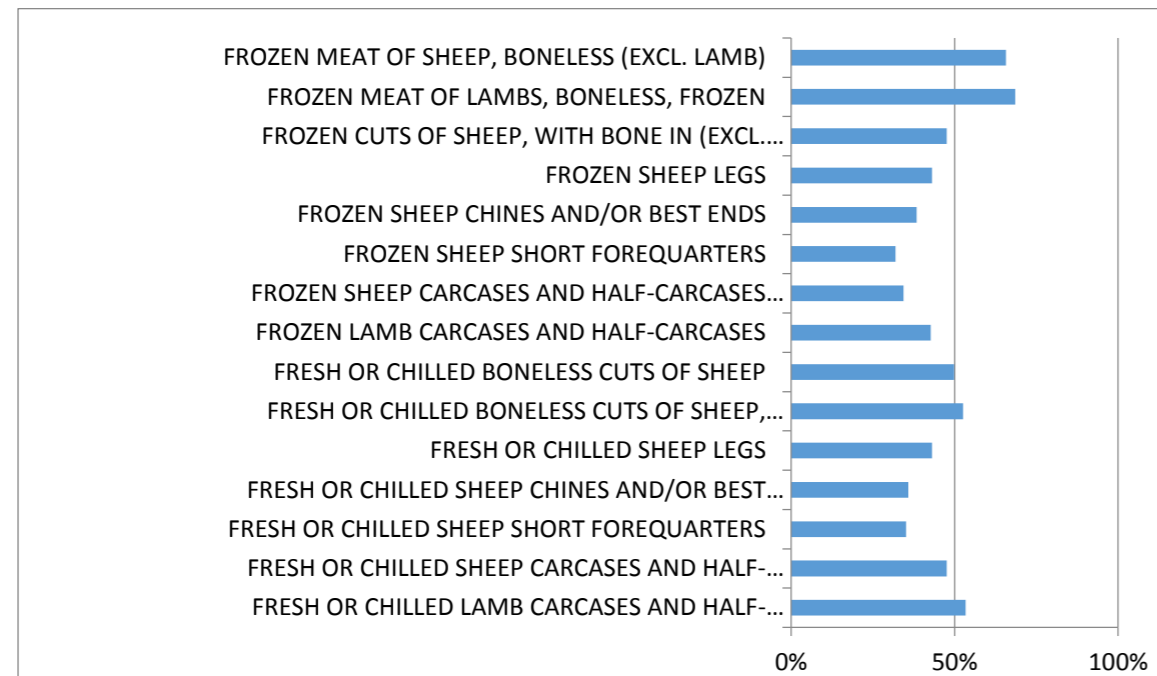
Using data at the tariff line level on UK imports of sheep meat we have calculated the ad valorem equivalents of the 15 tariffs that apply to trade in sheep meat that would be applicable by the UK if it choose to apply its WTO bound rates. The ad valorem equivalents of the EU tariffs are presented in Figure 5. The levels of tariff protection in AVE that would be faced by UK suppliers to the EU market in the absence of a FTA between the EU and the UK would be similar to those in Figure 5.

For all of the tariff lines applicable to trade in sheep meat and lamb the AVE of the EU mixed tariffs are in excess of 30%. The trade weighted average of the 15 tariff lines presented in Figure 5 is just under 50%. The highest rates of duty apply to fresh and frozen deboned sheep meat and lamb.

The impact of tariffs on trade is to increase the price of the imported good so as to reduce the demand for the imported good. The punitive and prohibitive level of the tariffs that apply under the EU tariff schedule, as notified to the WTO are sometime surprising to those unfamiliar with agricultural trade rules. The very high levels of protection accorded to agri-food markets by the EU tariff schedule are a reflection of the “community preference” principle of the EU

Common Agricultural Policy (CAP) that essentially gives first preference to EU suppliers in the EU agri-food market.

Figure 5. Ad Valorem Equivalent of the EU Tariff Schedule Bindings



In the absence of an FTA between the EU and the UK, UK exports of sheep meat and lamb to the EU market would face punitive tariffs similar to those presented in Figure 5. The impact of such tariffs on trade depends on what economists call the elasticity of import demand. At any plausible elasticity a tariff (tax) of 50% would render the much if not all of UK exports of lamb to EU markets uncompetitive. This would lead be likely to lead to reduced prices for lamb on the UK market and higher prices on remaining EU market. As noted earlier how existing Tariff Rate Quota for sheep meat, under which almost all imports of sheep meat into the EU from NZ and Australia currently enter, would be allocated between the UK and the EU27 will significantly affect the impact of Brexit on EU and UK sheep markets.

While Brexit appears to imply that EU lamb prices could increase and provide a fill up for Irish sheep farm incomes, gains from higher sheep prices may well be largely offset on many sheep farms from the negative impact of lower cattle prices that are likely to result from Brexit. Another channel through which Brexit will affect Irish sheep farmers (and EU farmers in general) is via the impact of the UK exit on the EU budget and on the resources available to

support the CAP. The average Irish sheep farmer's income is still significantly dependent on direct income support payments from the CAP. A reduced EU budget and concomitant reductions in the size of the CAP budget and Ireland's receipts from same could have a significant negative impact on incomes in Irish agriculture and on the incomes of Irish sheep farmers.

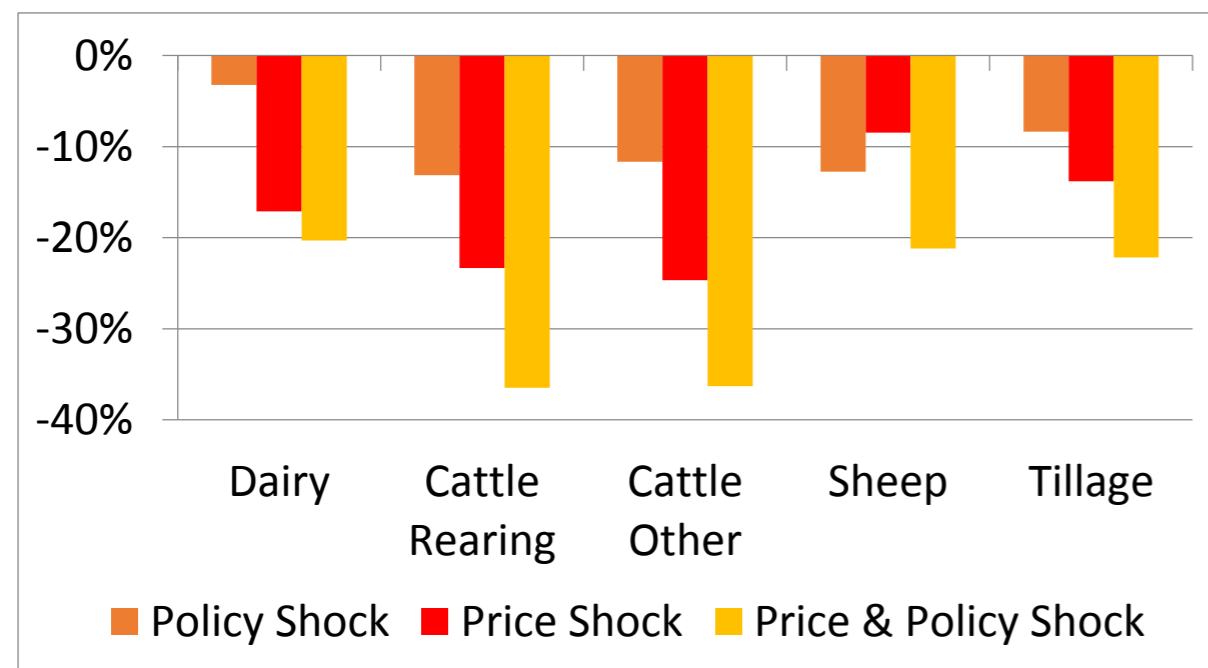
The UK is, even with the UK rebate, a significant net contributor to the EU budget. The size of the net contribution varies from year to year but has been as high as €10 billion. If other member states do not increase their contributions to the EU budget so to fill the hole left by the UK exit the EU budget will inevitably shrink. To date most other net contributors to the EU budget have expressed an unwillingness to put more of their tax payers' money into the EU budget. The CAP still accounts for close to 40% of EU budget expenditure and a cut in the EU budget would almost inevitably be reflected in reduce CAP budget.

In November 2016 Teagasc AEFS researchers used the Teagasc NFS database and assumptions concerning reductions in the EU CAP budget resulting from Brexit and conservative assumptions concerning the market price impact of Brexit to look at how Irish farm incomes might be affected by Brexit Donnellan et al. (2016). The static nature of the analysis explicitly does not account for the negative impact of reduced production that might plausibly be expected to results from a hard Brexit. The impact of Brexit was found to be greatest for those sectors with A) a high share of exports destined for the UK market and B) a high dependence of family farm income on CAP funded direct payments.

Results in Donnellan et al. (2016) indicated that the cattle systems were most exposed to the price and policy shocks applied given their exposure to the UK market and reliance on direct payments. As a result, a 10% price reduction was envisaged to result in a 37% reduction in Family Farm Income (FFI). The presence of a cattle enterprise on dairy farms alongside an assumed reduction in the Irish milk price of 5% resulted in an expected decline in dairy farm incomes of the magnitude of 20%. Similarly, FFI on sheep farms was estimated to decline by 21%. The decline in incomes was also driven by a high dependence on subsidies and a very high output share of beef on Irish sheep farms. Similarly FFI on tillage farms was estimated to decline by 22% (due to the beef component of output) and the high dependence on subsidies

In Figure 6 the results of a static analysis of the impact of Brexit on Irish farm incomes is illustrated. We break the negative impact into a market price impact and a budgetary or policy impact. For sheep farms the impact of the policy shock to incomes dominates. With the negative price shock largely reflecting the importance of cattle output on these farms that more than offsets any positive impact of Brexit on Irish lamb prices. Readers should note that this analysis is static and farmers faced with a negative shock to incomes of these magnitudes would almost certainly reduce their level of production with further on dynamic consequences for farm incomes and upstream and downstream activity in the agri-food and wider Irish economy.

Figure 6: Static impact of Brexit on Irish Family Farm Income



Source: Donnellan et al. (2016)

Conclusions

It is hard to see any upside to Brexit from the perspective of Irish farming. The Irish agri-food industry remains significantly dependent on the UK. Over 40% of the value of Irish agri-food exports is earned on the UK market. Barriers to trade with the UK that result from Brexit will have a negative impact on Irish agriculture and food industries. The exact nature of Brexit is still an unknown. However, a deterioration in the terms of trade Irish agriculture and food enjoys with the UK is inevitable – the task in the negotiations surrounding the Brexit process from the perspective of the Irish food industry is to maintain as much preferential access to

the UK markets as possible and to mitigate the negative impact of Brexit on the EU budget and on the resources available to the CAP.

The sheep market seems to offer a glimmer of hope of a positive impact of Brexit. In the event of a hard Brexit it seems likely that UK exports of lamb to the EU27 market will be negatively affected. It is not unreasonable to assume that in the event of EU and UK trade relations reverting to WTO rules that UK exports of lamb to the EU could cease. How trade with other non-EU countries such as NZ is managed could have an important bearing on the positive impact of Brexit on EU lamb prices. However, it is likely that EU lamb prices will increase as a result of Brexit. Will Irish sheep farmers be better off because of Brexit? It appears unlikely due to importance of cattle output on many sheep farms, and Brexit will almost certainly negatively affect Irish cattle prices, and because of the continuing dependence of Irish sheep farms on CAP direct payments.

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