KEEP TRADE EASY: WHAT SMALL FIRMS WANT FROM BREXIT SCOTTISH SUMMARY

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Key Points

- About a sixth of Scottish smaller businesses currently export. Most trade with both EU and non-EU markets, however a significant minority trade exclusively with the EU.
- Businesses which trade with emerging markets are likely to have larger turnovers and derive a greater proportion of sales from exporting. Smaller exporting firms are most likely to trade with either the EU or Anglosphere, with ease of trade – both in terms of reacting to direct demand and favouring easy markets – being the overriding reason behind first-time exporting.
- While the majority of smaller exporters trade with EU and non-EU markets, the former remains the most important in terms of ease, cost and value of trade. Further, given the factors driving export decisions, it would be challenging for firms to pivot quickly towards prioritising additional trade with non-EU markets.
- Small firms are split over whether they expect levels of trade to change when the UK leaves the EU. Overall, those who expect change expect to export or import less.
- The standard tariffs which might apply in the absence of a Free Trade Agreement could deter between a third and two fifths of exporters from trading with EU markets, with businesses trading exclusively with the EU most likely to be deterred.
- Non-tariff barriers are as significant as tariffs for small businesses trading overseas.
- Small firms which have, or are part of, supply chains routed through the EU single market are likely to face disruption, including moving their supply chain to the EU.
- Small firms are twice as likely to have started exporting within the EU single market as outside of it. Potential exporters are more open to non-EU markets but are still likely to consider EU markets as their preferred first export destination.
- Small businesses say that Europe and the Anglosphere should be the UK Government's top priorities for securing trade deals, with the US and Germany seen as key countries for trade. Emerging markets, while becoming more attractive export destinations, are still likely to be more challenging for smaller firms, even if trade deals are secured.

1. CURRENT STATE OF INTERNATIONAL TRADE

Trade Status – where small firms export and import

FSB data suggests levels of exporting amongst smaller businesses has remained fairly static in recent years, with 16% of Scottish firms currently exporting and a further 18% considering exporting.[1] Recent evidence also suggests that, UK-wide, a large majority of export businesses (69%) are also importers.[2]

Most businesses trading overseas do so both within the EU single market and non-EU markets. Our data suggests that the vast majority sell to the EU, while around 50% sell to the Americas and just under 40% sell to Asian markets.[3] Around one in five (21%) exporters trade exclusively with the EU. Similarly, while most importers trade with the EU and non-EU markets, a significant proportion of current importers across the UK (37%) trade exclusively with the EU.[4]

Within the EU, France and Germany are the top export destinations. The US and Australia are the only two non-EU countries in the top 10 destinations of current exporters. Canada and New Zealand are the next highest non-EU markets, underlining the attractiveness of markets which use English and/or have links to the UK (the 'Anglosphere')[5] to small exporting businesses.

However, emerging markets are becoming more important for exporters, with a larger proportion of small firms exporting to countries including, China, India, South Africa and the Middle East, than in previous years. The mature markets of Singapore and Japan are also destinations for around a sixth of exporters.[6]

a) The virtuous circle of growth and trade

Trading internationally has long been associated with business growth; small business exporters, on average, generate more than double the turnover of those that do not export.[7] Similarly, those that do not currently export, but would consider doing so, are likely to have a higher turnover than those that will not, or cannot, consider exporting. On the other hand, this may reflect the view that trading overseas can be disproportionately challenging for smaller firms.

According to our data, the higher the small business' turnover, the more likely the business is to be trading with emerging markets, such as China, compared to those exporters with lower turnovers. Those with smaller turnovers are most likely to be trading with the EU and

[1] FSB, *Destination Export*, July 2016.
[2] FSB Survey on Future of Trade with the EU and Non-EU, October-November 2016. Of 1,758 responses, 191 were from Scotland.
[3] FSB, *Destination Export*, July 2016. This data indicates that around 74% of Scottish exporters sell to the EU. However, additional data suggests that this figure could be as high as nine in ten exporters selling to the EU.
[4] FSB Trade Survey, October-November 2016.
[5] The term Anglosphere is not a legal definition and can, therefore, have various meanings. In its broadest sense, it is commonly used to describe a group of countries that were formally part of the British Empire and where English is an official language. For example, using a broad definition, the Anglosphere may include all the Commonwealth countries. However, for the purposes of this report, the term Anglosphere is used in its most restricted sense and defined as: a set of nations where English is the official and majority spoken language, with similar cultural roots, based upon populations that originated from the British Isles which today maintain close political and military cooperation. The only countries that are, therefore, included within this term (and referred to as being part of the Anglosphere in this report) are: the United Kingdom, Ireland, the United States, Canada, Australia and New Zealand.
[6] *Ibid*.
[7] FSB, *Destination Export*, July 2016.

Anglosphere. Similarly, the more dependent the firm is on exports as a proportion of sales, the more likely it is to be trading with emerging markets, compared to those less dependent on exports.[8]

Those exporting to emerging markets are not only more likely to have higher than average turnovers, but also have exports as a higher proportion of sales. This supports the view that exporting to emerging markets is likely to yield higher returns. However, it also suggests that exporting to these less established markets requires exports to be a larger focus of your business. And this, in turn, likely means dedicating greater levels of investment, resources and/or capability to trading overseas and mitigating risk.

b) The drivers of international trade – ease, cost and value

While the reasons behind export decisions will vary from business to business, there are a number of fundamental factors which drive small business trade with certain markets. Firstly, most (76%) small firms export to some extent on a reactive basis and are driven by demand from a buyer.[9] Other important factors include how easy it is to trade with a destination, the cost and the value of the export market (either market potential or a niche opportunity for the product). These factors are not mutually exclusive.

However, not all small firms value the same factors to the same extent. We asked current exporters and importers to assess different markets by ease, cost and value. The majority (58%) of exporting small firms say it is easier to trade within the EU single market than with non-EU markets, with Scottish firms even more likely to agree (67%).[10] This is not surprising, since discussions on trading with the EU single market frequently highlight the ease with which businesses can trade with other member countries – for example, it is as easy to sell to another EU country as it is to somewhere in the UK.

In addition to being the overall easier market to trade with, the EU single market is also less costly to trade with, compared to non-EU markets.[11] Small businesses are more likely to find trading within the EU single market to be of greater value to their business than trading with non-EU markets, even for those who trade both in and out of the EU. That said, one in ten current exporters find trading with non-EU markets to be more valuable. The findings for importers are similar.

Most small firms recognise the different benefits and trade-offs involved in doing business with non-traditional markets. However, the upfront investment that is often required to trade with less established markets, from human resources to capital investments, can be overwhelming for many small firms. Indeed, previous research showed that small firms who export to emerging markets were more likely to use intermediary services such as agents, distributors and translators – which all come at a cost.[12] Time to develop new trading relationships presents a challenge for small businesses because they typically run on tight margins with little flexibility in operations or cashflow.

[8] FSB Trade Survey, October-November 2016.
[9] FSB, *Destination Export*, July 2016.
[10] FSB Trade Survey, October-November 2016.
[11] *Ibid*.
[12] FSB, *Destination Export*, July 2016.

Experts in Business

2. OPPORTUNITIES AND RISKS IN A POST-BREXIT TRADE LANDSCAPE

a) Levels of future trade overall

Among exporters, one in two (49%) expect their level of exporting to change as a result of the UK leaving the EU.[13] Of that 49%, the majority (59%) expect to export less with 41% expecting to export more. Furthermore, of those who expect to be exporting less, more than half (58%) expect to be exporting 'significantly less' overall. Until the UK's new trade relationship with the EU is agreed, every small business will be basing their expectations on different ideas of what this relationship will look like. The expected net decline in overseas trade (among those that expect a change), therefore, reflects the impact that uncertainty over Brexit is having on small firms, on their level of confidence and future outlook.

b) Levels of future trade with the EU single market and non-EU markets

Of the UK small businesses expecting a change to their level of exports, more expect a decline in their exports to the EU single market than expect an increase (32% compared to 10%, respectively). This difference is starker for importers, only two per cent expect to import more from the EU market, while over one-third (37%) expect to import less.[14] While the majority of exporters (60%) expect very little or no change to their level of exporting to non-EU markets, over a quarter (26%) are anticipating trading more with non-EU markets.[15]

This data reflects a 'wait and see' attitude that many small firms have adopted as their approach to dealing with Brexit, particularly in relation to non-EU trade. With day-to-day operations paramount for most small business, at least in the short term they are more concerned with the direct impact it will have on their trade with the EU single market, relative to non-EU markets.

c) Tariffs and Non-Tariff barriers (NTBs)

Tariffs

Tariffs are a factor for around half of all Scottish exporters (49%) when they decide where to export. However, a similar proportion (50%) say that tariffs play no role in where they export.[16] Where tariffs do play a role, opinion is fairly evenly divided about the extent to which it plays a leading, moderate or minor role in exporting destination decisions.

Tariffs are more important for importers, probably because in the majority of cases, it is the importer that pays the duties and they are, therefore, more directly impacted.[17]

Around ten per cent of both exporters and importers would not be deterred by tariffs and would continue to export/import regardless.

Under World Trade Organisation rules (which would apply if no Free Trade Agreement was in place), UK exporters are estimated to face a potential average tariff of between four to

[13] FSB Trade Survey, October-November 2016.
[14] *Ibid.*
[15] *Ibid.*
[16] *Ibid.*
[17] *Ibid.*

six per cent. Certain industries would likely be subject to a higher tariff, such as vehicles at 10%. However, data based on the trade-weighted average tariff of the EU's tariff regime suggests an average tariff rate could fall between two and four per cent. If a rate between four and six per cent were introduced, around two fifths of current exporters would be deterred from trading with EU markets. A rate of two to four per cent would deter around one third of exporters.[18]

For just under one-third (27%) of firms, any tariff rate would deter trade, while those firms which do business exclusively with the EU are most likely to be deterred from trading.[19] Overall, compared to exporters, importers are more likely to be deterred by the introduction of tariffs. Around half (51%) would be deterred from trading with the EU should they face a tariff rate that falls between four and six per cent.

Many small firms operate on thin margins and even small increases in tariff rates would mean their product is no longer competitive in certain markets. Understandably, small firms that export exclusively within the EU single market are significantly more likely to be negatively affected by any change to the status quo regarding tariffs.

Non-Tariff Barriers (NTBs)

As global use of tariffs has declined, non-tariff barriers (NTBs) have become more important. A variety of NTBs exist, from directly trade-related quotas, to transit requirements e.g. packaging, to those linked to general government policy e.g. regulatory, procurement related. The application and impact of NTBs varies across industry, so discerning their impact on small businesses can be difficult, but they are often characterised and described as "paperwork" or customs issues.

Our data suggests that non-tariff barriers are of equal importance to tariffs for small businesses, with NTBs more important than tariffs for Scottish exporters. The majority of both Scottish exporters (67%) and importers (56%) say that NTBs play a role in where they decide to trade.[20] It is worth noting that both tariffs and NTBs appear to be given even greater consideration by potential exporters and importers.

This may also suggest that trade barriers play more of a role at the beginning of an exporter's journey – with experience, the exporter is better at mitigating their impact and costing it into their business model. Irrespective, it is clear that both tariffs and NTBs present a risk and, were new tariffs or NTBs to be introduced, it is imperative that they do not form a deterrent for small firms starting or continuing overseas trade.

d) Global supply chains

In addition to the direct impact on exporters and importers, small firms which have a relationship with global supply chains may also be affected by the UK's changing trading relationships, particularly those that rely on goods passing easily across state borders.

Combining both firms which have their own supply chain, as well as those which are part of a global supply chain, where the chain moves through the EU, around one in five small businesses (21%) could be meaningfully affected by changes to the status quo.[21] This might particularly affect sectors where perishable goods move between member states, such as

[18] *Ibid.*
[19] *Ibid.*
[20] FSB Trade Survey, October-November 2016.
[21] FSB Trade Survey, October-November 2016.

agriculture and food processing in Ireland and Northern Ireland. Further, many small firms may not realise that their products are part of a global supply chain, meaning the proportion of firms affected could be even higher.

As a result of the UK leaving the EU, almost half of UK small firms with EU supply chains (47%) will consider changing their supply chain arrangements; with 20 per cent likely to consider moving more or all of their supply chain to the EU, which for many may mean relocating all or part of their business to the EU.[22]

e) Pipeline of small business exporters

Understanding where and why small firms export for the first time is key to improving the pipeline of exporters. It should also provide some insight on how the UK leaving the EU single market may affect future exporters.

The majority of exporting small businesses (68%) made their first export to the EU single market (Ireland was the most popular individual country for first exports).[23] However, regardless of where a small business first exported, around half were triggered by responding to a direct demand for their product.

Ease of trade appeared to play a bigger role driving exporters to the EU single market than non-EU markets. Small businesses highlight a variety of factors which made exporting to certain EU countries easier than elsewhere: the proximity of countries; low costs involved, including delivery; easy access to the markets; similarities in culture and business environment; and language.

By contrast, current exporters that first exported to non-EU markets were more likely to have done so driven by a strategic approach, for example considering market potential, than because the market was explicitly easy to export to. However, as the average exporter has been selling overseas for twelve years, global and technological change in that time may mean new potential exporters have a different view.[24]

Nine of the ten most popular exporting destinations for potential exporters are all mature economic markets, which are either part of the EU single market or the Anglosphere. Germany (30%) is as likely to be considered as the US, followed by France (24%), Ireland (21%) and the Netherlands (15%). For those considering non-EU markets, US, Canada and Australia are the most attractive options, while India and China are also popular.

On balance, the majority of small businesses are indiscriminate about actual countries or regions in themselves; anywhere in the world is a possible market as long as it is easy to trade with. In this respect, the growing ambition to export further afield, even just on principle, is promising. The challenge is to ensure non-EU markets are as easy to trade with as possible, given the reactive nature of most small business exporters, coupled with the overriding driver to trade with the easiest market. In the meantime, though, the prevalence of the EU single market, as an export destination for first-time exporters, means that the

UK's withdrawal from the single market needs to be carefully managed to mitigate any deterring effects it may have on small firms.

[22] *Ibid.*
[23] *Ibid.*
[24] FSB, *Destination Export*, July 2016

3. PRIORITY MARKETS FOR A GLOBAL UK

a) Priority markets

When the UK leaves the EU, the UK government has made it clear that it will seek a free trade agreement (FTA) with the EU that provides access to the EU single market, as well as a customs agreement. Understanding the importance of these agreements, as well as which non-EU markets the UK should prioritise developing new trade relationships with is key.

There are different ways to segment different markets – whether by geography, language, culture, or economic similarities. Common groupings include the 'BRICS' and 'MINT' countries[25], as well as the Commonwealth. We asked exporters and importers (both current and potential) which regional groups are most important for the UK to prioritise in terms of trade deals.

Overall, the Anglosphere and the EU single market are the markets UK small businesses are most likely to want to prioritise securing trade deals. Around two-thirds of current exporters would prioritise countries from the Anglosphere (68%) and EU single market (63%), with the US, Australia and Canada, Germany, France and Ireland top priorities.[26]

Around half of small firms would prioritise North America and the Commonwealth. For the latter, the countries to prioritise are Australia, India and New Zealand. Over one-third of exporters (40%) and importers (39%) would prioritise the BRICS market. Yet, it is clear that the majority of these small firms are significantly more likely to be focusing on China and India over Brazil, South Africa or Russia.

It is noteworthy that not all the emerging markets are being prioritised to such a large extent. Despite a similar proportion of businesses exporting to China and India, South Africa and UAE, the latter two are seen as less of a priority, perhaps owing to the size and pace of growth of the Indian and Chinese markets. A slightly larger proportion of potential exporters and importers would also prioritise BRICS – again, with the majority choosing China or India. This reinforces the view that emerging markets, albeit some more than others, are becoming more attractive export and import destinations.

b) Balancing risks and rewards with emerging markets

Unsurprisingly, current exporters and importers prioritise trade deals with countries with which they currently trade. In this respect, while the EU single market and the Anglosphere are priority markets for the majority of small firms, it is especially the case for exporters with smaller turnovers and for those firms in which exports do not form a core part of their business.

China and India are the clear front-runners in the pack of emerging markets that potential exporters and importers would prioritise for trade deals. They are the only two emerging markets that rank in the top ten countries for both groups. However, based on turnover size and dependency on exports, emerging markets are likely to be a more realistic proposition for larger businesses. It is likely that exporting to these markets will require a higher upfront investment compared to more established and typically easier markets, such as the EU single market and the Anglosphere.

[25] BRICS – Brazil, Russia, India, China, South Africa. MINT – Mexico, Indonesia, Nigeria, Turkey.
[26] FSB Trade Survey, October-November 2016.

Many small firms will, therefore, find it more challenging – or perceive it to be more challenging – to export to emerging markets. Even for the small firms that could comfortably export to such markets, they may decide that the investment necessary – for example, to contract intermediaries, such as agents, distributors and translators, or the additional market research involved – is not worthwhile when there are other viable and easier options. Of course, many small firms do not tend to make these types of calculations, especially if they export primarily on a reactive basis.

4. RECOMMENDATIONS

Intermediate to short term – negotiating the best deal for small firms:

Secure the easiest and least costly access to the EU single market as possible

The EU is the easiest, most valuable and least costly market to trade with. Maintaining this ease of trade is particularly important for smaller exporting businesses, who may not be able to absorb the additional costs or administration of exporting further afield. A sensible transitional/implementation period should be put in place as part of the negotiation plan for the UK to leave the EU.

Any new trade barriers, whether tariffs or NTBs, will make trading with the EU less easy and more costly. On an individual level, this is likely to result in small firms reducing their level of trade overall, at least in the short term. On a macro level, this increases the likelihood of a widening trade deficit.

The UK Government’s plan for negotiating a new trade agreement with the EU must be underpinned, first and foremost, by the aim to ensure as free and easy access to the single market as possible. This means the trade agreement must be comprehensive in securing barrier-free access, covering both goods and services, across all sectors.

Identify and protect vulnerable small firms by sector and trade experience

Small firms which trade exclusively with the EU will be particularly vulnerable to disruption to the trade environment. Identifying these firms and establishing different types of support to help them take advantage of opportunities and mitigate risks must be a priority. Support might include advice and communication on diversifying markets, tailored to specific sectors.

Medium to longer term – supporting small firms to flourish post-Brexit:

Prioritise easy non-EU markets for first-time and occasional traders

The most important factor for exporting small firms is ease – be this in the form of direct demand, proximity, language, administration and so on. Post-Brexit trade opportunities will, therefore, gain the greatest traction with small businesses if they are communicated in terms of ease of access.

In respect of priority markets which the UK should aim to secure an FTA, in addition to the EU, the US, Australia and Canada should be prioritised given these countries are known quantities in the exporting landscape and appeal to small businesses. This is important because in the event that a trade agreement is not reached with the EU by the time the UK leaves the EU single market, there may be a risk of a lull or decline in small business exports.

While a sizeable proportion (27%) of small firms expect to increase their exports to non-EU markets, this will take time and support. Designing country-specific support and a strong narrative to emphasise the ease of trading with established export markets should create an attractive and accessible proposition for exporting beyond the EU. This is likely to be particularly effective with first-time exporters or importers and with small firms that export on an occasional or ad hoc basis.

Prioritise emerging markets for more ambitious and growth-orientated small firms

The UK should prioritise securing FTAs with China and India, as well as other prominent emerging markets such as South Africa and the UAE, in addition to 'easy non-EU priority markets' such as the US. However, while there is a growing desire to trade more with these nations, in practice this is more of a challenge due to a variety of reasons such as distance, language, unfamiliarity, business practices, and differing legal and political systems.

Overall, small businesses that trade with emerging markets are consistently shown to have larger turnovers and be more dependent on overseas trade than the average small firm. While not wishing to exclude any businesses – many of whom already trade with these markets – support and messaging around these priority markets should focus on small businesses that are realistically more able and willing to exploit the opportunities they offer. For example, small businesses that are already exporting and are looking to expand and diversify their markets, start-ups that plan to trade globally from birth, or more mature small businesses with higher turnovers.

To make real inroads with emerging markets, small firms will require more support. Those that trade with emerging markets are more likely to use intermediaries such as agents, distributors and translators. However, there is generally low awareness and understanding of these types of intermediaries among exporting small firms. This intermediary space needs to be better understood and, in turn, become more accessible for small firms.

Export vouchers to incentivise and accelerate small businesses exports

Although a majority of small firms already trade outside the EU single market, it is clear that for most, developing new trade relationships, or even increasing trade, with non-EU markets is not simple. Overcoming risks and concerns about increasing trade with new markets will take time. More than ever, small business exporters need to be encouraged to continue or start exporting – an incentive, packaged as an export voucher, could help small firms to accelerate this exporting process or mitigate some of the risks or costs involved.

Similar to the principles behind the UK's Growth Voucher Programme and Innovation Vouchers, export vouchers could enable small firms to access the support that would be most beneficial to them. For example, using the vouchers towards translation services, agents or on small business trade missions.

Explore export tax credits to incentivise strategic exporting

Broadly modelled on research and development tax credits, the UK government should explore whether expenditure on certain activities, such as trade missions or market research, could receive a tax rebate. Such an incentive might be targeted at encouraging existing exporting businesses to take a more strategic approach – for example, increasing the level of exports, or percentage of sales derived from exports. Export tax credits could also work in tandem with, or complement, export vouchers where each initiative is targeted to a different audience or priority market.

Spotlight on Brexit's hidden impact on importers and small firms in global supply chains

The impact of Brexit on overseas trade – both positive and negative – is not isolated to exports. Small business importers and those that operate, or are part of, global supply chains will also be equally affected. Overall, small business importers are less confident about the impact of Brexit on their trade than exporters, and a large proportion (37%) trade exclusively with the EU. However, it is noticeable that, while many of these firms will likely face significant disruption, they have not received the same prominence as exporters in current debates. Similarly, around one in five small firms own, or are part of, global supply chains that are routed through the EU single market.

Current providers of export support, including Scottish Development International (SDI), should develop support and information dedicated to small business importers and global supply chains.

Champion small business brands – in sectors where Scotland and/or the UK has a competitive advantage – to target markets abroad

Efforts to increase exporting amongst small firms need to be matched by efforts to raise awareness of Scotland and the UK as desirable destinations from which to source products. Initiatives which have developed brands in areas such as a food and drink should expand to cover other sectors where Scotland has a competitive advantage, from research to arts and culture.

Growing the profile of small business brands, and products in general, will drive the demand directly to small firms, triggering many to start exporting and capitalising on the reactive nature of small business exporting.

Including a small business chapter in all future trade agreements

Within the small business community, many differences exist between various subgroups and profiles. These differences can be more fundamental or nuanced but, importantly, they cause small firms to behave and react differently to trade opportunities and risks. This dynamic will only be magnified when comparing small businesses with far larger businesses, underlying the importance of ensuring that small business interests are explicitly considered in all future trade agreements between the UK and other nations.

The inclusion of a small business chapter must form a key objective in any future trade agreement that the UK negotiates. The Transatlantic Trade and Investment Partnership (TTIP) is envisaged to include a small business chapter – the first of its kind in any free trade agreement – to help small businesses take full advantage of new market access in lucrative markets and raise awareness of the opportunities available to them through trade negotiations.

There have already been numerous policy discussions around what this small business chapter should entail. Regardless of the outcome for the TTIP negations, the UK Government should tap into this body of knowledge and further consult small business representative bodies, such as FSB, to develop a robust position on what a UK small business chapter should look like.

Co-ordinated action from both governments and their agencies to mitigate the impact of future changes in trading conditions

Given the challenges facing small firms which currently export, import, or are part of a global supply chain, it will be crucial to get the right information and support in place as quickly as possible. Both governments should work together to ensure their support and advice is consistent and complementary and delivered in partnership.