The 'No Deal' Brexit

Implications for the UK Construction Sector

Impacting 3 million people
and 300,000 firms

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Foreword by

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The chance of the UK leaving the EU without a withdrawal agreement in place has increased in recent months, particularly given the extent of opposition to the prime minister's negotiating position.

The potential impacts of a 'no deal' Brexit are overwhelmingly negative for the construction industry, very unpredictable and could be severe if necessary mitigating action is not taken. Far from freeing UK businesses from red tape, a 'no deal' Brexit threatens to do exactly the opposite, loading firms with potential barriers to trade and new bureaucracy. A 'no deal' Brexit is likely to push up construction costs and may delay project completion or make construction commencement unviable in some instances.

This paper analyses the short term and practical impacts on the construction industry of the UK leaving the EU in March 2019 without a formal withdrawal agreement in place. Here, we consider the level of trade and interconnectedness between the UK and the EU construction markets and the severity of the knock-on effects that leaving the EU without a deal will have. The paper explores labour mobility, products and materials and wider economic impacts.

At a time of great uncertainty, Gleeds has a duty to raise awareness of the specific challenges we will face as an industry and the opportunity to share our recommendations for the benefit of the wider economy. Through this study, we are appealing for a changing landscape which works for, rather than against, the construction sector and supports the many inspired innovations that are under development and set to propel the industry forward.

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About this paper

This paper is designed to consider some of the short-term ramifications for the UK construction sector of the failure to reach an agreement with the EU on exit. It does not attempt to consider what settlement might be reached in the medium-to-long-term following a 'no deal'.

It is not within the scope of this paper to consider the economic impact of a 'no deal' to the UK. The majority of economists have, however, forecast a hit to economic output, with estimates including a 1% hit to GDP (Capital Economics), a 4% hit (International Monetary Fund), a 5% hit (Organisation for Economic Co-operation and Development) and a 7.7% hit (HM Government). Many economists forecast a 'no deal' Brexit would lead to a further devaluation of Sterling. This paper therefore briefly considers how any general economic weakness resulting from a 'no deal' might impact on construction.

Scenarios considered in this paper

In the event of a 'no deal', the UK government has indicated it will likely fall back on trading under World Trade Organisation (WTO) rules.

It is worth bearing in mind that even within the 'no deal' scenario there are different ways it could play out. The most challenging would be a last-minute, unexpected breakdown of negotiations shortly before the departure date, which would leave the UK and EU without time to make alternative arrangements. This "worst-case" scenario is primarily what is being considered here.

There is also the possibility of what some have described as a 'no deal Brexit deal', in which the UK and EU sides agree that an overarching deal is not possible, and then agree solutions to individual issues prior to departure. In this scenario, some of the obstacles described below may be avoided or mitigated. However, it should be noted that under WTO rules, both the EU and UK will not be able to agree any special trading arrangements that aren't simultaneously offered to all other non-EU nations. Any 'better than WTO' terms would only be possible as part of an overarching trade deal.

Methodology

This paper has been derived from a review of relevant literature and publications, as well as interviews with several senior construction figures and academics. All quotations and data referenced are sourced in the 'summary of sources' section of this paper.

Key anticipated impacts on the construction sector as a result of a 'no deal' Brexit:

- Greater difficulty and cost in importing the 15% of products and materials used in UK construction projects which currently derive from the EU
- No defined status for existing EU-born workers, who make up 7% of the UK construction workforce, with new bureaucracy likely
- Increased complexity and huge uncertainty in recruiting EU-born workers to fill future skills needs
- Amplified effort required to sell professional services such as architecture and engineering in to the EU which currently generate a significant trade surplus
- Potentially significant fall in construction workload, with knock-on effects to output and employment, if broader forecasts of negative economic impact of 'no deal' are realised

Chapter One

Existing UK construction industry reliance on EU trade and skills

The UK construction industry had output of £162bn in 2017, accounting for 6% of UK GDP.

At first glance the industry does not appear to be heavily reliant upon EU membership. UK construction services are primarily produced for a domestic market, with UK contractors not heavily reliant upon export revenue. Exports in 2017 totalled just over £2bn, according to the Office for National Statistics (ONS), of which half went to the EU. Imports, similarly, were modest, at just £1.6bn, indicating low UK reliance on foreign construction.

However, this top line figure hides a very significant reliance upon EU products, materials and labour in UK construction, as well as significant EU trade in architecture and engineering professional services.

About 15% of products and materials used in UK construction are imported from the EU. This equated to £10.3bn of imports in 2017, outweighing the £6.7bn of materials brought in from other parts of the world. UK product manufacturers also rely on EU customers for £4.4bn of export sales. While some EU products, in the event of a difficult import/export environment, would be able to be replaced by domestically-produced alternatives, others, such as timber, would be very difficult to replicate. £1bn of timber is imported from the EU each year, against around £60m of exports, while around £750m of aluminium products are also imported. There is also a big reliance on EU suppliers for a number of more highly engineered products, such as electrical wiring and fan systems.

UK construction is also heavily reliant upon EU labour. According to the ONS, there were in July 2018 around 165,000 EU nationals working in UK construction, equivalent to 7% of the workforce, which is above average for the UK economy as a whole. The picture for London, which is the UK's dominant construction market accounting for a fifth of output, is more extreme. In the capital, 28% of workers are EU nationals. Likewise, certain industry sub-sectors, such as the construction of buildings, show a disproportionate reliance upon EU labour.

The figures for international trade in construction don't include the trade in professional services such as architecture and engineering. According to the ONS, architects and engineers export more than £10bn of services each year. While the ONS does not break down the proportion of these exports that go to EU countries specifically, if it followed the proportion for construction service as a whole, it would equate to EU exports of £4.9bn. A report by the Royal Institute of British Architects (RIBA) in December 2017 found that £73m of exports a year would be put at risk by Brexit.

Chapter Two

Issues raised by a 'no deal' exit

Given the level of trade and interconnectedness between the UK and EU construction markets described in the previous section, the prospect of leaving the EU without a deal raises a number of serious issues. These are most obviously apparent in four areas: labour mobility; products and materials; professional services trade; and wider economic impacts.

2.1 Skills and labour

The 165,000 EU nationals working in the UK construction industry comprise a broad range of skills and expertise. EU nationals make up, for example, a quarter of all architects working in London.

The provisional deal agreed earlier this year guaranteeing the rights of EU nationals in the UK, and vice versa, was contingent upon a full and final withdrawal agreement being signed. A 'no deal' Brexit therefore leaves EU citizens without the legal status to reside in the UK. Hence the 165,000 UK construction industry workers who are EU nationals would not have a clear right to work in the UK.

Ministers have given no sense they would seek to prevent EU nationals in the UK from continuing to work, and many are optimistic a way will be found for them to do so.

However, the government has failed to publish its long-promised migration white paper, while it has also shown its willingness to use the status of EU nationals as a bargaining chip to secure reciprocal rights for UK citizens living abroad. There is the possibility that this uncertainty, added to any further drop in the value of Sterling that makes UK earnings worth less, might drive EU workers to quit the UK of their own accord. Andrew Dixon, policy director at the Federation of Master Builders added: *"The problem is for individuals and businesses there's a lingering threat, and workers might feel so unsettled as to leave themselves."*

Even more uncertain is the system under which new EU workers might come to work in the UK. While the government and industry have been working to train up further UK staff to cope with Brexit to the December 2020 deadline, a 'no deal' may require the industry be self-sufficient as of 31st March 2019.

Currently, most workers from non-EU countries are barred entry. The UK allows a limited amount of immigration for work reasons in certain named 'Tier 2' shortage occupations where salaries are above a certain level. These occupations include civil engineers and some project managers and architects alongside additional construction occupations. But movement of other workers, for example site labourers, is all but impossible.

The government's failure to publish its plans for how the immigration system will work post-Brexit (the white paper promised last autumn is now expected at the end of 2018), means businesses have no idea what system the government is seeking to move to, or would fall back on as of 31st March 2019.

Conceivably, in a 'no deal' situation, the government could either seek to temporarily (unilaterally) preserve Freedom of Movement into the country, or else apply to EU workers the existing 'Tier 2' rules governing movement of workers from outside the EU. Under the 'Tier 2' system, firms wanting to hire workers from outside the EU must first advertise the job for a certain period in the UK, and then apply for permission to do so. The most recent government figures, for example, show that just six non-EU architects were granted permission to work in the UK in the seven months to April 2018, in an industry employing over 90,000 people. A report by the Migration Advisory Committee earlier this year said employers found the system *"time consuming, costly and overly complex."*

2.2 Products and materials

Falling back on to WTO rules would mean the sudden imposition of a range of tariff and non-tariff barriers for the import and export of construction products and materials.

Actual tariffs on most products are relatively modest under WTO rules, averaging out, according to the CBI, at around 4.3% on exports and 5.7% on imports. However, the CBI analysis suggests significant import tariffs could be placed on forestry products, which would include timber. The average agriculture, forestry and fishing tariff is 17.7%.

There has been some suggestion that the UK could unilaterally choose to abolish all import tariffs if it desired. The problem is that the WTO operates a 'Most Favoured Nation' principle for all trade, meaning that (in the absence of an overarching trade deal) no favourable treatment is allowed and any reductions in tariffs have to be offered to all nations with which one trades on WTO terms, making the abolition of all import tariffs less likely.

Potentially more serious for construction are the so-called non-tariff barriers which would be imposed: these are the standards, regulations and other red tape which have to be borne when trading with another country. The fact the EU and UK already have regulatory convergence of their construction products and materials under the Europe-wide CE-Mark product certification system, means that on day one, EU and UK products will at least, in theory, be tradable.

Regulatory convergence is, unfortunately, only the first step. Upon departure from the EU, the UK suddenly becomes a 'third country' for EU customs purposes. Rather than being waved through, products would be checked at borders for appropriate paperwork, raising the prospect of big delays at borders. Highways England has already worked up plans for a 13-mile section of the M20 in Kent to be used as a lorry park in the event of customs delays, with Dover Council saying recently this arrangement could last for years.

Noble Francis, economics director at the Construction Products Association, said: *"The problem is not about tariffs, it's more about the industry working on "just in time" delivery models where stocks of materials are not held. The impact of a 'no deal' scenario is completely dependent upon the extent of the delays."*

There is potentially a more serious problem than delays. The UK's 'third country' status will mean the EU will not recognise certificates of UK products issued by UK testing houses, and vice-versa. In a statement in July 2018 the EU stated that after withdrawal: *"UK bodies will not be in a position to perform conformity assessment tasks pursuant to Union product legislation…"* and in the EU *"a certificate delivered by a recognised EU Notified Body will be required for products placed on the market from the date of withdrawal."* For example, all products sold in Europe would have to be EU certified, and vice-versa. This non-tariff barrier would potentially mean products being held at customs for significant periods – and at significant expense – while samples are sent for testing.

The construction industry is working to avert this. The body which administers the CE mark system, CEN/CENELEC, is separate from the EU and already has non-EU members, so it could theoretically still cover UK-EU trade. However, agreement is needed from its individual country members for the changes in statutes necessary for it to do so post-UK exit.

This agreement alone would not solve the matter. It would still be down to the EU and UK governments to state that they continue to recognise CE-marked products certified in the other jurisdiction. Guy Lougher, head of the Brexit team at law firm Pinsent Masons, said the UK government could do this relatively simply by laying down a statutory instrument. However, given other pressures the government will face at that time, it is not clear whether that action would be quickly forthcoming.

Fears that firms would also have to shoulder the burden of paying VAT on imported goods up front have been allayed, which could have had a significant impact upon project cash-flow. In August 2018 the government made clear that importers will be able to account for VAT payments in their VAT returns to government, rather than upon arrival of the goods in the UK.

Nevertheless, the threat is that the impact of non-tariff barriers, delays, additional tariffs and any resulting product scarcity will increase the cost of construction products and materials. The CBI has said that average non-tariff barriers for goods would add a further 6.5% to cost. This inflationary effect could be exacerbated by any further fall in Sterling (see 2.4).

2.3 Construction services (including professional services)

The EU single market for services is not completely harmonised in the same way that it is for goods. Individual member states retain control of services trade in a number of areas, limiting the benefits that EU membership itself provides.

The EU Services Directive does cover the provision of construction, architecture and engineering services. Ingo Borchert, fellow of the UK Trade Policy Observatory, University of Sussex, said the single market is still by a wide margin the best international market for services in the world, meaning departing from this will be *"very disruptive"*.

Of most concern to UK construction, given the volume of trade (see Chapter 1), will be the impact upon professional services such as architecture, project management and engineering.

In the event of a 'no deal', WTO rules allow cross-border trade in services under the General Agreement on Trade in Services principles (GATS). These are significantly less detailed than the equivalent WTO provisions around trade in goods, and split trade in services into four modes:

- Direct cross-border trade: This covers the transmission of products electronically, such as the emailing of architects' or engineers' plans
- Consumption abroad: Where the consumer moves overseas to buy from the seller, such as with tourism
- Establishment of a commercial presence abroad: Foreign Direct Investment, where firms open up offices in foreign countries
- Natural person moving abroad to provide services: Where individual professionals, such as architects or engineers fly in to other countries to work

Three of these categories, 1, 3 and 4, are directly relevant to the provision of construction services. Assessing the exact outcome of 'no deal' departure is very complex, because where the EU retains a competency, for example in mode 3, the terms of trade post-Brexit will be governed by the EU's common position toward third countries. In areas where regulations are the competency of individual member states, such as with rules governing the ability of overseas "natural persons" to provide services, the extent of any barriers will be dependent upon the laws of each EU member state.

A detailed assessment of these rules in individual member states is beyond the scope of this piece, but they could potentially be used to make it difficult or impossible for UK professionals to practice. As an example, in the legal sector only 10 out of 27 member states have no restrictions on non-EU lawyers setting up firms in their country, with Austria only allowing licensed lawyers from EEA countries to open branches. Other potential barriers could be in the form of data processing agreements, labour market tests, maximum duration stay times, or quotas for services suppliers.

The CBI said that, in the event of a 'no deal' *"businesses in some of our most successful exporting sectors would be unable to export specific types of services at all [… including] financial and a range of professional and business services."*

Keith Brooks, chairman of construction consultant, Cast said: *"UK businesses could find themselves barred from competing for EU contracts or from working in the EU if they do not have businesses registered in the EU."*

A key issue to the continuation of professional services trade is the mutual recognition of qualifications. The 2005 recognition of qualifications directive provides quick routes for recognition of qualifications gained in other EU countries, with architects, for example, having automatic recognition without the requirement for any further tests or training.

The EU said in July that, in the event of a 'no deal', it would recognise decisions already made by EU states on professional qualifications gained in the UK before the March 2019 departure date, but not after. That would seemingly protect the ability of UK architects, engineers and surveyors already trading in EU countries to continue post Brexit, while cutting out newly qualified architects, engineers and surveyors or those who have not yet traded abroad.

However, it is not even clear that those already qualified will definitely be protected. The UK Trade Policy Observatory's (UKTPO) Borchert said that Brexit would mean the dis-application of the 2005 directive, leaving no legal basis for EU recognition of UK qualifications. *"The impact of this could be really severe,"* he said.

A spokesperson for RIBA called on the UK and EU to show flexibility. She said: *"An ongoing agreement is crucial to the continuing health of the sector both in the UK and EU."*

The cumulative effects of this are hard to predict. In a study that compared intra-EU with EU/rest-of-the-world trade in professional services, RIBA found a 'no deal' Brexit could reduce exports to the EU by 29% a year. This would hit architecture by £20-30m a year, and engineering and construction services by a cumulative £640m each year.

2.4 Wider economic impact

If predictions of a significant negative hit to the broader UK economy were to be realised in the event of a 'no deal', then this would put pressure on construction on a number of ways. The most obvious potential impacts are:

- Reluctance of construction clients to invest in development in an uncertain economic setting
- Resistance from potential occupiers of new buildings to commit to leases (a conventional trigger of construction activity) in a turbulent business environment
- Increase in cost of imported materials with a decline in value of Sterling

A number of interviewees for this piece cited this as their primary concern in the event of a 'no deal'. Steve Beechey, managing director of government affairs at £2bn turnover contractor Wates Group, said: *"Businesses are not going to make any investment decisions. This situation could trigger a significant construction downturn. I'm more worried about that than anything."*

These negative impacts would likely be mitigated by other factors. The government has made it clear that it will consider withholding the £40bn 'exit fee' due to the EU in the event of a 'no deal', leaving it the option of investing this elsewhere. It is understood the government is already considering contingencies including investment in construction as a way to stimulate the economy in this scenario. In addition, any fall in the value of Sterling will reduce the cost of overseas investment in the UK, potentially attracting foreign developers and investors to back UK projects.

Industry analyst Alastair Stewart said: *"There could be major government investment, monetary and fiscal stimulus packages, most probably aimed at housebuilding. We will have a greater range of economic levers to hand than members of the Eurozone."*

Conclusion & **Recommendations**

The clear conclusion of this piece is that there would be significant negative ramifications to the UK construction industry of a 'no deal' Brexit, at least in the short term. Given the range of scenarios, interviewees for the piece were not able to predict a monetary value of this impact, though many categorised it as significant or severe.

The severity of impact would be ultimately capped by the relatively modest level of international trade in the construction sector. In addition, were a 'no deal' scenario to occur, the government could take a number of actions to mitigate the potential negative short-term effects as follows:

- Draw up a multi-billion pound construction stimulus package to keep the industry moving and shore up UK GDP
- Ensure necessary legislation is drawn up and implemented quickly to continue recognition of EU-tested construction products in the UK market, in a way which avoids a need for lengthy border checks
- Implement an immigration system "fall-back" which – at least temporarily – mirrors as closely as possible the existing system of Freedom of Movement
- Unilaterally grant recognition of the qualifications of EU construction professionals including architects and engineers

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