



HOUSE OF LORDS

The Select Committee on the European Union

External Affairs Sub-Committee and Internal Market Sub-Committee

Corrected oral evidence: Brexit: Future trade between the UK and the EU

Thursday 15 September 2016

9 am

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Members present (External Affairs Sub-Committee): Baroness Armstrong of Hill Top (Chairman)¹, Lord Balfe, Baroness Brown of Cambridge, Lord Dubs, Lord Horam, Earl of Oxford & Asquith, Lord Stirrup, Baroness Symons of Vernham Dean

Members present (Internal Market Sub-Committee): Lord Whitty (Chairman), Baroness Donaghy, Lord Green of Hurstpierpoint, Lord Lansley, Lord Liddle, Lord Rees of Ludlow, Lord Wei

Evidence Session No. 3

Heard in Public

Questions 20 - 29

Witnesses

Dr Ulf Sverdrup and Dr Peter Holmes

¹ Baroness Armstrong of Hill Top was chairing in place of Baroness Morris of Bolton, who was unable to attend the meeting.

Examination of Witnesses

Dr Ulf Sverdrup, Director, Norwegian Institute of International Affairs, and Dr Peter Holmes, Reader in Economics, University of Sussex

Lord Whitty took the Chair.

Q20 The Chairman: Welcome. While you make yourselves comfortable I will just run through the process. You have been notified of a number of questions and we will run through them. Principally, the customs union questions will go to Dr Holmes. I hope that both of you will feel free to comment but, if possible, not repeat each other as we are fairly constrained by time.

This is an open, public session. It is being recorded and there will be a transcript of it. I hope that will not inhibit you too much but you need to know that.

If you have no questions about the procedure, I will kick off with the first question, which is directed principally at Dr Holmes. In fact, we will be concertinaing the first two questions and I hope that you have received notification of that. It is about the customs union.

From the UK point of view, what are the key benefits and drawbacks of being in the customs union as a non-EU country? What are the important distinctions that you see between a free trade area and a customs union, and what is the effect of being outside the customs union on trading with non-EU countries, particularly in relation to things like rules of origin, customs procedures and so on? That is directed principally at Dr Holmes but perhaps both of you can comment, for our elucidation, on what you see to be the advantages and disadvantages of a customs union and what the distinctions are.

Dr Peter Holmes: First, let me thank you for inviting me. It is a great privilege to be here and I hope I do not make too many mistakes in talking to you.

The Chairman: I am sure you will not.

Dr Peter Holmes: First, you have to be careful about talking about 'being in the customs union' as a non-EU country. I do not think that that is a possibility. Andorra, Vatican City, San Marino and Monaco are physically inside it and are effectively part of it, but the only country that is linked to the EU in a customs union relationship which is not a member is Turkey. It is not a member of the customs union; it is a country that has a customs union with the customs union. That is quite different, because the coverage of the customs union with Turkey is different from that of the EU customs union. As you point out, it does not cover services or agriculture, and, very strikingly, anti-dumping is still possible between the EU and Turkey. There was a WTO case some years ago involving relations between India and Turkey—I can perhaps send you the details—which highlights the incomplete nature of the EU-Turkey customs union. It is an important distinction but, if one moves away from that, the fundamental point is that a customs union is a trade bloc where the

partner countries agree to remove tariff barriers on each other's goods and to have a common external tariff against third countries, whereas a free trade agreement is where countries agree to remove tariff barriers on each other's goods but they do not have a common policy against third countries. The consequence is that within a free trade agreement you have to have customs barriers to check whether a product really comes from the partner or whether it is a third-country good, in which case it is not entitled to duty-free access. With a free trade area, you have to have rules of origin to check whether a product originated within the free trade area. With a customs union, in principle you do not have to have rules of origin, so the goods can flow completely freely.

So it sounds as though a customs union is an attractive arrangement because you do not have to stop goods at the border. In reality, however, the Turkish-EU customs union does have customs posts because it is not a complete customs union in the way that the one inside the EU is. So the advantage of the customs union is that you get complete exemption from tariffs for all goods across the border, but in principle you have to have exactly the same external trade policy as your partner, which means that Turkey has to sign free trade agreements with everybody that the EU signs an agreement with. It has, in principle, to accept any negotiating outcomes that the EU secures at the WTO. If there ever is another WTO round, Turkey will have to go along with the EU position. Basically, in a customs union you completely lose your ability to have your own independent external trade policy.

Secondly, although a customs union gives you tariff-free access for your goods, it does not necessarily give you exemption from non-tariff barriers. The European Economic Area (EEA) is a different matter: it is what I would call a regulatory union. Dr Sverdrup is a much bigger expert on the EEA than I am. The EU-Turkey customs union was not a complete regulatory union, so for many years after it was signed Turkey was obliged to accede to all EU rules and regulations governing the internal market in industrial goods. However, that did not get Turkey free access for its products into the EU market because—I am sure that some of you know more about this than I do—the EU did not recognise Turkey's conformity assessment on testing and certification. So, even though Turkish goods, under Turkish regulations, had to comply with EU standards, the EU did not recognise the Turkish certificates that confirmed that. It was only about 10 years after the customs union agreement was signed that this recognition was given. That is probably more than you wanted.

The Chairman: It is more complicated than we wanted; nevertheless, it is very helpful.

Lord Green of Hurstpierpoint: I have a question just to clarify matters in respect of the Turkish agreement. My understanding is that, because it covers only certain sectors, it is those sectors only in respect of which Turkey loses its freedom to negotiate independently with third parties.

Dr Peter Holmes: That is basically correct. For any goods, any areas covered by the customs union Turkey must align themselves with the EU.

Lord Green of Hurstpierpoint: So if Britain had a customs union arrangement with the EU for certain key sectors, there would be a whole range of other sectors of the British economy for which we would have complete freedom with third parties to do FTAs.

Dr Peter Holmes: That is right.

The Chairman: The customs union has no direct implication for services in that sense.

Dr Peter Holmes: If it is a customs union that covers goods only, it will not affect services. But it is worth mentioning—I think that we both have comments to make on value chains—that more and more trade today consists of goods and services bundled together. They are either physically incorporated or you need to send the engineer to service the thing. You cannot quite separate goods and services as much as you could in the past.

The Chairman: Would Dr Sverdrup care to comment on Norway, which is outside the customs union but still trades heavily with the EU?

Dr Ulf Sverdrup: Yes. As you know, Norway is not a member of the customs union. It is a member of the EEA and a member of the internal market. To my knowledge, this has worked pretty well. The Norwegian government have to stick to the rules of origin, and there are three main difficulties arising from that. The first is that it introduces a bit of bureaucracy or paper-shuffling, so it increases the transaction costs for business. Secondly, as the economies become more integrated, they also engage much more in value chain economics, so it is a bit more challenging to determine where things are produced. The final point relates to consumers. In e-trading, for instance, you have customs at the border. For the individual consumer importing goods from amazon.com, or something like that, there will be a threshold for doing that. So you have to have a mechanism for declaring custom, which is a bit of a hassle.

Q21 **Lord Lansley:** Dr Holmes, if a non-EU country is part of the customs union for goods but not otherwise, what does that mean in practice? There are very few examples of this; perhaps Turkey is the only one. In practice, has that meant that Turkey has been able to enter into bilateral free trade agreements, or does the restriction on the flexibility of its external tariffs make the negotiation of bilateral free trade agreements extremely difficult?

Dr Peter Holmes: As I said, you have to distinguish between having a customs union with the EU and being part of it. My understanding about the deal with Turkey—and you would probably need someone from Turkish customs here to explain it fully—is that Turkey is obliged by its relationship with the EU to sign free trade agreements with everyone that the EU signs a free trade agreement with; this is about industrial goods, not agricultural goods, I believe. But there are all kinds of odd little anomalies in this. For example, Turkey was interested in signing a free trade agreement with Georgia, and the EU said, “Okay, you can do that”, but, strictly speaking, if the customs union with the EU was a complete

customs union, that would have been impossible. I have heard stories that Turkish manufacturers of television sets were selling them across the border into Georgia, getting them Georgian certificates of origin, and then sending them into the EU, because the EU had put anti-dumping duties or other restrictions on Turkish televisions, but if they came across as Georgian ones they would not be affected. The general principle is that Turkey has to sign agreements with countries that the EU signs agreements with, but those countries do not have to sign agreements with Turkey.

If there was a TTIP agreement between the EU and the US, Turkey would not automatically be included. That would mean that US goods could come into the EU and be trans-shipped into Turkey without paying Turkish customs duties, but Turkey could not send its goods into the US duty free. There is a special derogation clause somewhere in the EU-Turkey customs union that would allow Turkey to put extra duties on goods coming from the US into Turkey—it is called trade deflection—but it is very messy. Basically, Turkey has very little freedom to sign agreements with third countries. The pressure is on to sign agreements with countries that the EU has signed with. Turkey has to follow behind, as you rightly said, in the areas that the customs union covers.

The Chairman: Is that what is about to happen with Canada?

Dr Peter Holmes: I have not read anything about this, but I assume that the Turkish government will have to wait and see what is in the agreement with Canada and then start their own negotiations with Canada, which is not legally obliged to sign an agreement with Turkey but would in principle get market access into Turkey so that anything going into Piraeus could be put on a lorry. Whether the Turkish customs would in fact wave it through or find some technical reason for not doing so, I do not know, but there is no great incentive for Canada to sign an identical agreement with Turkey.

Lord Lansley: But in so far as the EU-Canada agreement is a comprehensive agreement including agriculture and services, conceivably would Turkey be able, as a non-EU member, to carve out those areas that are not part of its customs union relationship with the EU? Would trying to negotiate something different be unacceptable from the Canadian point of view?

Dr Peter Holmes: You would have to speak to the Canadians about that, but in principle it is possible. The Canadians would probably want to get the Turkish market for those things opened up to them, but I cannot answer that question, I am afraid.

The Chairman: Lord Balfe has questions on another aspect of Turkey.

Q22 **Lord Balfe:** I have some factual questions. First, what access do third countries have to free trade agreements with the EU and what access do they have to Turkey's market? Secondly, does Turkey retain the right to retain non-tariff barriers? Thirdly, 20 years after the customs agreement there are complaints in Ankara that it is now out of date, anomalous and affecting Turkey adversely, and that it needs to be either renegotiated or

ended. Do you have any comments on the durability on these sorts of agreements? Would they need to be permanently renegotiated?

Dr Peter Holmes: That is a very difficult question. In principle, a country that has a free trade agreement with the EU should have the same access to Turkey in the covered areas as it does to the EU, but whether there are compliance issues I really could not say. With regard to Turkey's ability to impose non-tariff barriers in the covered areas, clearly Turkey has to have the same regulations as the EU whether or not it can operate non-tariff regulatory barriers in areas such as mutual recognition and testing certification. I do not know the answer, but it would be logical because mutual recognition is technically outside the customs union; it is additional to it. The mere fact that the EU and Turkey recognise each other's standards and infrastructure as equivalent would not necessarily mean that Turkey has to recognise equivalence with a third country.

It is quite complicated. In principle, the Turks have some wiggle room on anything that is not directly mandated by the customs union, but exactly how it would work is a very technical matter. For example, the use of exception clauses in the case of the EU having a free trade agreement with a country and Turkey not having one is a right that the Turks have but do not want to exercise. Clearly, as you say, as the nature of commerce and value chains evolve, it is quite clear that the way in which rules of origin were done for third-country products in the 1990s, for example, is not the same as you would need today, so I do see the need for this to evolve, particularly considering the greater importance of services and the bundling together of services and goods. I am sure that is important.

The Chairman: Unless either of you wants to add something on the customs union dimension of this, we will move on to the European Free Trade Area (EFTA) and the EEA.

Dr Peter Holmes: Could I just add one reminder that customs unions are really about tariffs and the EEA is essentially about regulations? That is quite an important distinction.

The Chairman: That is a very good point.

Q23 **Baroness Donaghy:** What is your assessment of the appetite of the members of EFTA for the UK possibly to join EFTA and the EEA Agreement after it leaves the EU? Just to complicate things, do you think it would be possible for the UK to be a temporary signatory to the EEA Agreement as a transitional measure after negotiating its exit from the EU but prior to agreeing an FTA with the EU? If so, how would this work, and what would be the view of other EEA signatories? You have five minutes.

Dr Ulf Sverdrup: A brief question there. On the political appetite, first, I am not representing the Norwegian government; this is my assessment of it. I do not think they would be eager to go out and try to recruit the UK into the EEA, but the question then is: if it is served on the plate, would they take it? There is no tradition of expansion of the EFTA side of the EEA. That has never been done before. For instance, when the EU was about to enlarge, some countries in eastern and central Europe asked if

they could join the EEA first, but the EFTA countries were reluctant to let them do that.

Secondly, although there are many people in EFTA countries who love the Brits—of course—and share a lot of cultural sentiments and orientations, et cetera, there are some very significant differences in size, geography, history, et cetera. That is a factor. In addition, there are differences of interests in agriculture, political interests and political orientation. There would be some concerns about that. Finally, there would be some concerns about the functioning of the EEA institutions, because one reason why the EEA has been fairly successful is because there have been few attempts to play against the rules. We have been playing within the rules in a very co-operative spirit with the EU. The optics of the EEA for the EFTA countries have been to use the agreement to promote integration, not as a step away from integration. This is a slightly different approach. There are some difficulties but, that said, at the end of the day if the EU and the UK think that this a nice and attractive political solution, I do not think they will object to it.

You asked me whether this would be a suitable transitional arrangement. I will make two points on that. First, my background is that I have been reviewing Norway's agreements with the EU. I was head of the secretariat for this government report. One thing that struck us was the enormous complexity. Norway at that time had around 10,000 legal acts covering all ministries and all parts of society. Imagining that you could find a rapid solution to these problems in a short period of time seems very difficult. Looking for a transitional arrangement is probably a good strategy. Secondly, you should keep in mind that the EEA was at first signed as a temporary agreement. When you say "temporary", do you mean 25 years or two years? Transitional arrangements tend to stay on. Should I say something about the practicalities as well?

The Chairman: Yes, please.

Dr Ulf Sverdrup: In general, for more than 25 years Norway has been trying to square the circle—how to be inside but at the same time be outside. We have learned that you have to put an emphasis on political will and then there are some legal elements, and these things have to be balanced. In general, if there is strong political will and commitment from the parties, it is possible to find all kinds of solutions. Legally, there are two options for joining the EEA, but first let me remind you that the UK is already a member of the EEA; not everyone in the UK knows that. All EU members and the EFTA EEA countries are members of the EEA; they are contracting parties to the EEA.

In principle, there are two options. The first is to remain in the EEA as a contracting party but leave the EU. The second is to leave the EU, remain in the EEA and just switch sides and go into EFTA. This could be done automatically or you would have to re-enter. The first strategy of moving from the EU, while not into EFTA, but remaining an EEA partner, I do not think is feasible. In addition, it would be unacceptable to the UK, because you would have no voice in new legislation coming into the EEA because that would be a deal between EU countries and EFTA countries. The

question then is how to switch sides from the EU into EFTA. There are no rules in the EFTA treaty regulating entry. It has to be via treaty change and based on unanimity. There are three different treaties you will have to enter into. The first is the EFTA treaty from 1960. There are four contracting parties to that: Switzerland, Norway, Iceland and Liechtenstein. In addition, you have to enter into an agreement on the surveillance mechanism in the EEA and the EFTA Court. There are three contracting parties: Norway, Iceland and Liechtenstein. Finally, you will probably have to make an agreement with the EU on the financial contributions.

The Chairman: The financial contributions to EFTA or to the EU?

Dr Ulf Sverdrup: Probably both. The financial contribution to EFTA is very modest, just running a small secretariat in Switzerland and Brussels. I am referring to the EEA grant mechanism to the EU. That is an agreement with the EU. The big question—and I am not sure about the answer—is: what would the voice of the EU be on this? Could the EU object to this? Will it be necessary to have some kind of ratification by the EU on moving from one side to the other of the EEA Agreement, from one pillar to the other? I am not sure about that. We have never seen this before so we are entering uncertain territory. But you should keep in mind that Sweden, Austria and Finland were members of EFTA prior to joining the EU. That at least happened very smoothly.

The Chairman: Things that happen smoothly in one direction are not necessarily the same in the other. We have covered some of this territory—Lord Rees?

Q24 **Lord Rees of Ludlow:** I think my question has been mainly answered, unless you are prepared to hazard a guess as to how long joining the EEA might take?

Dr Ulf Sverdrup: First, I do not think it can happen before you have left the EU. It should not take too long. You probably need ratification and parliamentary approval in the various EFTA EEA countries. That probably could be done in a year or so. Some of the EFTA EEA countries might make some claims and have some desires about what they want to achieve. It could be fish or something else.

The Chairman: I heard someone at a seminar yesterday saying that if you go into EFTA and the EEA, you are substituting a veto by Slovenia for a veto by Liechtenstein, which might be important in financial services and elsewhere. Is there usually unanimity within the EEA?

Dr Ulf Sverdrup: Yes.

The Chairman: That is what I thought.

Dr Ulf Sverdrup: This is a very important point. The mechanics of the EEA are that the EU makes a legal act that it considers relevant for the EEA Agreement and presents it to the parties on the EFTA side; they then, speaking with one voice, accept it. So in reality the Prince of Liechtenstein has a veto power over Norway, and vice versa. They speak with one

voice. You are right: there will be a veto power for the Principality of Liechtenstein.

Baroness Symons of Vernham Dean: Just to follow up the point about practicality, you imply that the UK would have to conclude all its business with the EU before even beginning a discussion with the EEA. Is that really the case? Obviously, you could not conclude an agreement with the EEA unless you had finished with the EU, but would it not be possible to have negotiations running alongside each other, and when one set is finished, you conclude the second one? This has real implications for how long this is going to take.

Dr Ulf Sverdrup: What I said was that I do not think you can enter into that agreement while being an EU member. I did not say that you cannot start reflecting upon these things. If you moved in the direction of the EEA, I am pretty sure the EU would be quite happy with that. There have been various studies from the EU about the preferred model of association for third countries. As seen from the EU, the EEA is the most preferred model. But of course that would not solve all the difficulties relating to free movement of persons, parliamentary sovereignty, et cetera.

Q25 **Lord Horam:** Thank you for what you have said already, Dr Sverdrup, about the EEA Agreement and so forth. It is extremely interesting. For the sake of our thinking and clarity about what it implies, in your view to what extent does the EEA Agreement provide full access to the Single Market? Which sectors are accommodated and which are not? I am thinking particularly of services, which are so important to the UK. What would be the advantages and disadvantages to the UK of being in the EEA Agreement?

Dr Ulf Sverdrup: The EEA Agreement provides not only full access to, but membership of the internal market. It includes all four freedoms, as well as competition policy, public procurement, and other elements concerning the internal market. There are some exemptions. Norway is not part of the common agricultural policy, the common fisheries policy or the taxation policy. But even in those areas, for example on veterinary standards Norway is a member. When we reviewed Norway's relationship with the EU, we concluded that Norway is pretty much a member of the internal market, subject to around three-quarters of all EU legislation.

Lord Horam: Three-quarters?

Dr Ulf Sverdrup: Yes. Of course, there are different ways of measuring that, but Norway is deeply integrated in the EU. The EEA is not the only agreement Norway has with the EU. Norway has agreements in other areas, such as justice and home affairs, and security and defence. In total Norway has around 80 agreements with the EU in various fields. In a sense, it is this totality that makes up the Norwegian model.

Lord Horam: I noticed that in your paper to the European Council on Foreign Relations you concluded: "Like some local products with an acquired taste, Norway's odd ties with the EU should be tagged as 'not for export'". Could you elaborate on that?

Dr Ulf Sverdrup: It has worked for Norway, but you have to understand that Austria, Finland and Sweden left because they felt it was not attractive. Switzerland rejected it because it did not feel that it was attractive. You also have to understand the EEA as part of a domestic compromise in Norway. It is a deeply political conflict. As you know, political compromises are often not very nice. They are not elegant, they reflect special histories and concerns, and they tend to be very messy. Nobody really loves them but most of us can accept them because the alternatives are not so attractive. After joining the EEA, Norway considered applying for EU membership and it was rejected in a referendum in November 1994. The day after, the political leadership moved to, "Let's maintain the EEA and promote integration through that path". It has been a compromise.

The Chairman: Essentially, Norway has the same problem as us: the politicians wanted to be in the EU but the population did not agree, and that remains broadly the case.

Lord Liddle: And the business elite.

The Chairman: And the business elite, yes.

Dr Ulf Sverdrup: Yes, you have to look for second-best solutions and you have to find solutions that basically work for you, not ideal solutions. Another element that we have learned in Norway is that there is no free lunch. You cannot have it all. You have to decide what you would like to have and play hard to try to get that, but at the same time you have to accept that others have legitimate interests as well.

Dr Peter Holmes: It is fascinating to hear what Dr Sverdrup says. I will add three small points. The first is a reminder that Norway is part of the Single Market but, because of rules of origin, there is incomplete access for goods that incorporate components produced outside the EU. I think this is less important for Norway and for the EU in facing imports from Norway, but the Japanese government in their recent submission pointed out that Japanese firms would risk losing the ability to sell freely into the EU if they had to comply with rules of origin.

Secondly, it is worth thinking about the comparison we looked at regarding the customs union issue. If you are looking at temporary solutions, it might be worth asking yourself whether staying temporarily in the customs union before making any new arrangement would make sense. Negotiating into the EEA and then out again sounds very complicated. One option would be to stay inside the customs union temporarily.

Thirdly, I had great difficulty finding this out about Turkey. I was reminded when Dr Sverdrup mentioned grants. In a true customs union, customs revenue is pooled. In looking at even a temporary arrangement, it is worth asking: what would happen to customs revenue in an EU-UK customs union? My understanding is that with Turkey there is no pooling of customs revenue, but it is a bit of an anomaly. Mercosur for a long time did not; it has now set up a revenue-sharing arrangement. The Southern African customs union (SACU) has a revenue-sharing arrangement. If you

are talking about a customs union, you have to ask: what happens to customs revenue on third-country goods? Does it go to the place where the good is actually consumed or is it shared? Those are just some small extra points.

The Chairman: That is probably rather an important point, politically.

- Q26 **Earl of Oxford and Asquith:** I have more questions on trade procedures. To what extent does being a member of EFTA limit member states' ability to independently negotiate FTAs with third countries? In particular, if the UK joined EFTA, would it be able to participate in existing FTAs with third countries, or would it be in the UK's interest not to do so or to negotiate bilateral FTAs?

Dr Ulf Sverdrup: There is no limitation on this. As an EFTA member you are free to make FTAs by yourself. Historically EFTA has tried to do things together because it is easier to be invited into negotiations if you have a slightly bigger market, and there are benefits from negotiating together. But in reality they can make agreements themselves; for instance, Iceland has signed an FTA with China, as has Switzerland. Norway also negotiated an FTA with China but the negotiations terminated after the Nobel Peace Prize was awarded to Liu Xiaobo. In terms of sequencing, there is a history where EFTA has negotiated free trade agreements after similar agreements have been signed with the EU. Recently, in the past 10 years, EFTA has signed some FTAs in advance of the EU; for instance, I think the agreement with South Korea was signed a year or a year and a half prior to the EU's.

Most of the FTAs in EFTA have different elements to them. For industrial production, for example, EFTA agrees on it but when it comes to agricultural production and fisheries, that adds a bilateral element into the FTAs, because the Swiss do not sell that much fish and Norwegians are not that interested in international property rights, et cetera. So there are some differences. This also answers the second part of your question about whether the UK could join these agreements. I would say: no, there is not so much to join because there are also these individual agreements. In addition, third countries would probably like to look into it and see whether they would like to renegotiate those agreements.

The Chairman: Lord Wei has a specific question about the mechanism of EFTA.

- Q27 **Lord Wei:** What is the role of the EFTA Court? Can you comment on its efficacy? What opportunities, if any, does it provide for businesses to seek arbitration or dispute resolution if they feel that the principles of the Single Market have been violated to their detriment?

Dr Ulf Sverdrup: One of the unique elements of the EEA agreement is that there is this court system and the EFTA Surveillance Authority. It is like a micro-version of the European Commission and the European Court of Justice. You asked how the EFTA Court works. In principle, it should be more or less similar to the European Court of Justice, but it is much smaller, of course, with only three judges. Their caseload is much smaller and their offices are much smaller. The idea is that it should work to

make sure that there is homogeneity. I think it has been fairly successful in doing that. It has established itself as an international court and is considered to be autonomous and independent, acting in the capacity of taking care of the EEA agreement.

There are three kinds of cases. The first is instances where there might be deviation between EEA law and EU law so it might have to make a ruling on interpretation. The second set of cases relates to whether there might be differences in geography that require different rulings in the EFTA Court. The third kind are cases that have not yet been clarified by the European Court of Justice, and that are first popping up in the EFTA legal system. Then the court has to reason: what would the European Court of Justice have ruled in a case such as this if it were presented with one? The idea is to make sure that there is some kind of homogeneity and to rule in the same way. The overall line is that the EFTA court has been trying rather forcefully to put forward this idea that the main principle is to secure homogeneity.

Lord Wei: To clarify—and this is probably a very technical question so I understand if it cannot be answered now—does the framework that the court uses ever have to draw on the European Court of Justice’s framework of human rights, which in Britain is a big area of discussion, or are the cases generally more of a commercial or trade nature and you never really need to get into the issue of the European court’s framework of human rights? That is a very technical point but of political interest here.

Dr Ulf Sverdrup: You should probably ask somebody else but in general the court deals with all kinds of issues, not only economic or commercial law. It covers all the issues where the EEA is relevant—a wide number of areas.

Q28 **Lord Liddle:** On the question of the extent to which the court and the EEA interfere with Norwegian sovereignty, as it were, my understanding, on the basis of various discussions I have had with friends in the Norwegian Labour Party, is that Norway has pursued a more active industrial policy; for example, some elements of public ownership and using the sovereign wealth fund to try to ensure that Norway has some remaining competitive strengths in manufacturing, which is also a British concern. Has the state aid policy, or the court, tried to interfere with Norway in doing this as a member of the EEA?

Dr Ulf Sverdrup: As I said, Norway is part of the internal market and therefore also part of the EU state aid regulations. It is not the EFTA Court but the EFTA Surveillance Authority that looks into this. In the issues that are related purely to the EFTA countries, you have to notify the EFTA Surveillance Authority and it has to accept it. If it is a trans-border issue, the state aid competence will be decided by the European Commission. The rules are not more lax in Norway than in the EU. They are exactly the same.

Lord Green of Hurstpierpoint: Does that also apply to government procurement regulations—it would also be the EU framework, even if it is tagged differently?

Dr Ulf Sverdrup: Yes. Norway is part of the public procurement rules. It is part of the same tendering mechanism so if you have a procurement above a certain threshold you have to announce the calls throughout the whole EEA area.

Baroness Brown of Cambridge: Perhaps I might ask a supplementary question. Are there therefore different implications between a customs union and the EEA; for example, for a Government's ability to support a company's R&D? At the moment, we are constrained to pre-competitive research because of state aid issues. Would that be different if we were just part of a customs union?

Dr Peter Holmes: Again, it depends what you mean by being part of a customs union. The EEA is what I would call a regulatory union. It covers all aspects of regulation, public procurement, technical standards, and so on. In principle, a customs union covers tariffs. For example, Turkey is obliged to set its technical standards on the EU basis. It is supposed to have the same state aid and competition rules as the EU but that is because the customs union extends to that.

If we were part of the EU customs union, we would have all the rules of the EEA plus no ability to change tariffs. If I may follow up on one point that Dr Sverdrup and I corresponded about before this session, a member of the EEA is completely free to sign free trade agreements in so far as they affect tariffs. I think I am right in saying that you would not be free to sign a free trade agreement with regard to non-tariff components as a member of the EEA—all these other things that we are talking about, such as public procurement. For example, you frequently hear complaints from developing countries that EU food safety rules are too restrictive: the famous aflatoxin in peanut butter case that came up some years ago. The UK as a member of the EEA, although it could reduce all its tariffs on Chinese products to zero, would not be able to relax the conditions under which Chinese goods, or anyone else's goods, could be imported and put on the market—in terms of technical inspections and so on—because the EEA gives free circulation to all goods put on the market in the EEA, and to put them on the market in the EEA you have to comply with EU standards. The agreement to include non-tariff elements in a free-trade agreement would definitely be restrictive. I think that was the point that Dr Sverdrup was making in our correspondence.

The Chairman: So, in effect, all this shadowing of EU legislation and procedures is not only within the EEA countries but also to some degree prescribes the FTA so that they can line up with third parties?

Dr Peter Holmes: The Chancellor recently gave an interview in which he said that the UK could sign an agreement with China like the New Zealand agreement. The New Zealand agreement says that any product—in a number of sectors, electronics in particular—certified in China by a Chinese inspector in order to be in conformity with New Zealand standards could then be imported into New Zealand. However, because of the nature of the free trade agreement between New Zealand and Australia, that product can then circulate freely into Australia. I suspect it is unlikely that as a member of the EEA, the EU would allow us to import

stuff from China that had not been inspected according to EU norms rather than merely Chinese norms. It is very messy and complicated, but those are the things that one would have to look into in looking at the ability of the UK as a member of the EEA to sign third-party agreements. As I said, we had a brief discussion about this earlier.

Lord Green of Hurstpierpoint: Just to get something clear, in my mind at least, if the UK were a member of the EEA and signed a free trade agreement with China that set all the tariffs on Chinese imports into the UK at zero, transshipment to the rest of the EEA would be possible as a member of the EEA, but that would get stopped by the rules of origin procedure?

Dr Peter Holmes: You could move them freely, but you would have to pay the common external tariff on those goods.

Lord Green of Hurstpierpoint: So we are not bound by the common external tariff in respect of the UK market, but would be bound via the rules of origin in respect of the rest?

Dr Peter Holmes: Yes, and where it gets really complicated is where you have a value chain. If you have an electronic product that says "Made in Britain" but it contains 45% Chinese components, or a car made by a Japanese-owned company—Nissan, of course, is controlled by the French government, which is a twist—how do you separate these things out? The component that says "Made in Malaysia" will in fact have had bits coming from China, and so on.

Lord Green of Hurstpierpoint: The realistic conclusion is that the UK would in fact be bound by the tariff rates set by the EU as a matter of practice, because of supply chains and rules of origin.

Dr Peter Holmes: That is something for Dr Sverdrup.

Dr Ulf Sverdrup: The main point is that if you look around the world, you see that tariffs are not a big issue. The big issue is technical barriers to trade.

Lord Green of Hurstpierpoint: Ten per cent in the case of autos.

Dr Ulf Sverdrup: Of course tariffs are important. But a big issue relates to non-tariff barriers to trade, standards and so on.

The Chairman: Have you covered your subsequent question, Lord Green?

Lord Green of Hurstpierpoint: We have talked about the ease with which the UK could become a member of the EEA, but of course the UK Government—or at least some of them—are publicly musing whether they would even want to take a single template, or whether they would want add-ons to or subtractions from the current EEA-type arrangement. Would it be right to presume that in the event of whatever the UK Government seek to negotiate, or do indeed negotiate in the end, is EEA-like but not identical—so it is either plus because we have sought to negotiate voting rights in certain key areas or minus because we have sought in particular

to curtail freedom of movement in some way—this would significantly further complicate the process of joining the EEA and could conceivably lead to a need to revise the whole EEA arrangement?

Dr Ulf Sverdrup: Again, there are two options, if I understand you correctly. One is that the UK finds another platform than the ones we know of—more voting rights, for instance. The other EFTA countries would then be interested in that and would say, “Okay, this is something for us as well”. The question is then therefore whether the UK should try to negotiate together with the others. The other element of your question is whether it is possible, if the UK enters the EEA, to attempt to renegotiate the EEA agreement in a significant way. So far in the past 25 years, the main framework of the EEA agreement has never been renegotiated. In some sense, that is a bit surprising because in the same period the EU treaties have been changed several times. So there has been a growing gap between the EU treaties and the EEA agreement, and the parties have tried to compensate for that.

There are three reasons why they have not attempted to renegotiate the EEA agreement. First, the EFTA countries basically think that they cannot get a better deal. You have to take into account that at the time when the EEA agreement was signed, the EU consisted of 12 countries and EFTA consisted of seven. At that time the EFTA countries, I believe, accounted for 50% of the EU’s external trade—they were the EU’s biggest trading partner. Now the pillars have shifted, so the EU consists of 500 million people and the EEA is only 5 million, so it is more asymmetrical. The second reason is the sentiments in the EU. Why should the EU give voting rights to a non-member? Why would an EU member country accept being outvoted by a non-member? It is not very likely to be accepted. That said, there is the element of the Schengen agreement. In Schengen there is a slightly different mechanism for representation: non-EU members sit in on Council meetings. They have a right to share their views, listen in and talk, but they do not have a vote. That is slightly more representation than in the EEA, so that may be possible. In addition, of course, a revised EEA agreement has to be ratified by all member states, which is not very easy. So the assessment in Norway so far has been that we have what we have, and it is very difficult to negotiate it ‘up’ or ‘down’.

The Chairman: Mentioning Schengen takes us on to freedom of movement.

Q29 **Lord Liddle:** There has been some discussion in the British press that under the EEA it would be permissible to negotiate some control on freedom of movement. Basically, we want to know whether you think that is possible and whether, as a member of the EEA, Britain could negotiate some kind of emergency brake, for instance, and how the example of Switzerland and Liechtenstein, which I believe are the countries for this, has all worked out, and what the lessons are for us.

Dr Ulf Sverdrup: That is also a big issue. As you know, the EEA provisions on free movement of persons are fairly similar to the ones in the EU. To that I would just add a small footnote: you have to bear in mind that free movement of persons also relates to the free movement of

services. A lot of people moving around are employers in a company, so suspending the free movement of persons will probably also include the suspension of free movement of services.

There are two differences between the rules on the free movement of persons in the EEA and those in the EU. The first relates to non-EU citizens, or those from third countries, and the second relates to Union citizenship. The rules for non-EU citizens, or those from third countries, are not part of the EEA agreement, but the EFTA states incorporate elements of that through Schengen and the Dublin agreement. On Union citizenship, it is a bit trickier because, as you know, the Union citizenship directives give rights to people moving around as citizens, not just as economic actors operating in a market. This was not included in the EEA agreement because, politically speaking, it would have been a bit strange to give Union citizen rights to citizens who are not members of the Union.

For the last 10 years there has therefore been a gap in the legal framework in the EEA agreement and the EU on this. During that time the court has tried to look into that gap. In my understanding, the general policy of the EFTA court has been to make rulings in the direction of homogeneity. So although there are formal differences in the legal framework on the free movement of persons in the EEA and the EU, in reality they are interpreted similarly. They parallel the developments in the EU.

You also asked about the emergency break in the EEA agreement: Article 112. This is a standard safety clause, and basically says that in certain circumstances a country can move back from some of its obligations. Such a country has to notify its partners and its measures should be temporary and proportionate, et cetera. I do not know how frequently this special clause has been used. I suspect that it was used in relation to suspending the free movement of capital in Iceland after the financial crisis.

I am also aware that it was used in relation to the free movement of persons in Liechtenstein. As you know, when Liechtenstein entered the EEA agreement they asked for a special exemption on the free movement of persons. Their argument was that Liechtenstein is a very small country but, at the same time, has a very high proportion of non-Liechtensteinians working there. They said that they had to have some restrictions. They were granted a temporary exemption from the free movement of persons. This expired in 1998 and the EU would not extend it further. Then Liechtenstein used Article 112 to say that they needed a limitation on free movement of persons. But when the EU was enlarged in 2004, the parties made some sort of adjustment as an annex to the EEA agreement—you will have to check on that—basically accepting that this exception is going to be integrated permanently into the agreement.

In general, I do not think the Article 112 strategy is designed for countries that want to be left out of the free movement of persons.

The Chairman: Thank you very much for all your comments. We are right at the end of our time so perhaps you could make any final

comments that you may have.

Dr Peter Holmes: Very quickly on free movement, it is worth looking at the WTO obligations. We would still have whatever Mode 4 GATS commitments to allow people to come in. That is not relevant at the moment for European citizens but, if there was no agreement on free movement, those rights would still remain. It is worth checking what the implications of that would be.

Dr Ulf Sverdrup: I have just a few short remarks. First, Norway's experience has clearly indicated that it is possible to be outside the European Union. That is the good news. Secondly, it is fairly easy to get out of representation but getting out of integration is a slightly different and more difficult issue. Thirdly, it will require hard work. There will be no free lunch and it will probably be very messy and technically complicated. Therefore, searching for second-best solutions, compromises and transitional arrangements would be of critical importance.

The Chairman: Thank you very much for that general indication of the complexity of the Government's task which we are due to scrutinise. I think we all realise that these areas are a bit complex. You have brought clarity to the complexity but we have probably ended up realising this morning that it is even more complex than we thought an hour ago. It has been very useful to us, and if you think there is anything more that we should take into account, please send us it in writing. Thanks a lot for your time and for your written material. It has been a very worthwhile session.