

The Select Committee on the European Union

Internal Market Sub-Committee

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

Thursday 20 October 2016

10.10 am

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Members present: Lord Whitty (The Chairman); Lord Aberdare; Baroness Donaghy; Lord Green of Hurstpierpoint; Lord Liddle; Lord Mawson; Baroness Noakes; Baroness Randerson; Lord Rees of Ludlow; and Lord Wei.

Evidence Session No. 1

Heard in Public

Questions 1 - 9

Witnesses

I: Dr Angus Armstrong, Director of Macroeconomics, National Institute of Economic and Social Research, Professor Catherine Barnard, Professor of EU Law, Cambridge University, and Professor Holger Breinlich, Professor of International Economics, Nottingham University.

Examination of witnesses

Dr Angus Armstrong, Professor Catherine Barnard and Professor Holger Breinlich.

Q1 **The Chairman:** Good morning. Welcome. Thank you very much for coming. We have seen some of you in various capacities before, but you are all equally welcome. Can I perhaps start out by asking you to preface your responses by saying something about your own background? Starting from the WTO on GATS modes, can you explain to us the different forms that trade and services take and whether this schema is comprehensive and works for the modern structure of services and trade? Are there other forms of trade that we also need to take into account when devising a new relationship with the EU and with third parties?

Professor Holger Breinlich: My name is Holger Breinlich. I am Professor of International Economics at the University of Nottingham. There are four GATS modes. Mode 1 is cross-border trade, so an example would be a call centre in India providing services to a company in the UK or to customers in the UK where a provider and consumer of the service stay in their respective countries. Mode 2 is tourism, when the consumer moves into the other country, so consumer service. Mode 3 is what is also called local affiliate sales, meaning that a British company might establish an overseas presence and sell services from that overseas base. Mode 4 is presence of natural persons, which just means that rather than the consumer moving to another country to consume the service, it is the service provider that moves abroad—for example, a London-based consultant going to Paris to give a presentation there.

Dr Angus Armstrong: To add some flesh to this, modes 1 and 2 can be done from your home country; modes 3 and 4 are done in the foreign country and that introduces a lot of interesting aspects. Modes 1 and 2, because they are basically done from their own country, are primarily balance of payments-related data. Modes 3 and 4 get much more difficult and you have to start imputing and estimating the size from other data, such as the Foreign Affiliates Survey. Regarding quantities, it is clearly limited to a certain extent by the data but 3 is thought to be one of the bigger ones, setting up affiliations overseas. The unfortunate thing with this is some of the data is quite well collected but it is less clear-cut that the measures across all countries are the same, or that there is as much uniformity. The final point is that some people estimate that there should be a fifth mode, which is services that are embedded in manufactures. This is contested; it is not a GATS mode at all, it is just an idea. For example, software counts as a mode 1 delivery under GATS, but software embedded in some manufactured goods can count as a manufactured good so goes under GATT rather than GATS. There is this odd bit about what happens when services are embedded in goods. Many people think this is happening more and more. I know that Eurostat economists think it could be as high as a third of services, so this is a big element now. There was a very good discussion about Bentleys in the FT a couple of days ago showing how many parts and electrical parts which go back and forth. We make the spark plugs and send them to Germany for heat treatment, then they come back into this country and so on and so forth. It is a difficult area because of technology and the ability to break up these so-called production processes.

The Chairman: You refer to a third. Is that a third of the value of manufactured goods embodied in services or is it a third of the totality of services?

Dr Angus Armstrong: Of the manufactured goods, I believe.

Professor Catherine Barnard: I would just add to that that of those four modes, mode 4 is the most controversial because it is essentially about some form of migration. In fact, it counts for only about 5% of world services, as compared to 55% or 60% in respect of mode 3. In

reality, it is largely dysfunctional because, although it is intended to cover low-skilled through to high-skilled movement, in fact all the instances are of high-skilled and very high-skilled migration.

Q2 Baroness Noakes: Shifting to measuring trade in services, could you talk us through the different measures that are used? I know a number are used, such as trade in value added, exports and imports, et cetera? In particular, could you highlight those which you think might be the most useful for us to focus on as we are trying to get our hands around the subject of services trade in the EU?

Dr Angus Armstrong: There are a number of data sources; you are quite right. Some are quite standard, such as balance of payments data sources, but the question here, as you said, is: what is most useful to the Committee? It partly depends on the question you are trying to answer. If you want the best data, although very limited, then it is the balance of payments. However, that is fairly limited and does not tell you much about what you should be negotiating for, which I presume is the context of this point. Value added, the amount of input from UK workers and companies—that is, profits and wages—should ideally be the thing that you would like to maximise or think about getting most of. In that context, trade in value added is the most comprehensive dataset that I know of. That is produced now by the OECD and WTO as a joint initiative.

This is very interesting for services. If you look at balance of payments data, services go from 40% of gross exports or total exports up to 63% straightaway, so you get a very different picture. We say: do services matter for the economy? If you look at the balance of payments status you can say yes, a bit, but not that much. If you look at the value added, which is people's wages and profits, then the answer is yes, nearly two-thirds, so it changes the picture straightaway.

With this dataset you can look at which sectors. It is very nice because it looks at the size of exports by domestic value, countries we trade with—so you can look at it by the destination—and then by sectors, which allows you to do a sectoral approach, which I guess is probably where you will end up. For me that is the most interesting. There are of course weaknesses with this dataset. The mind boggles when you think how you put that together. You put it together with what is called a world input/output table which means inputs that are used in your industry come from a firm, which is their output. You do this at each nation level and then you add up the nations to get a world one.

Baroness Noakes: It is as good as the data that goes into it.

Dr Angus Armstrong: It is a huge undertaking. Trade is the residual bit and so that means there is a weakness in the data inevitably, but it is very impressive and comprehensive and one that I would recommend the Committee look at very closely.

Baroness Noakes: It is a good enough view for policy formation.

Dr Angus Armstrong: Holger will have his own view, but in my view the weakness of it is that the categories are too large. Trade policy will get down to quite granular details about which trade—finance for example, but what do you mean by finance? It just depends. As you are doing it across nations, you have to make these categories quite big because not all nations have the same input/output tables. I see that as a kind of weakness but as a starting point for where to think about trade and which sector is the most important, then I would say the answer to that is yes.

Professor Holger Breinlich: To follow up on the weaknesses of this data, the level of aggregation is clearly an issue. A lot of assumptions go into the calculations and quite often the devil is in the detail. To use the data, one really needs to understand what the data is. There is also a problem of compatibility between the input and output tables. They are usually based on sectors in the economy—say, manufacturing services—whereas services trade is often measured as the specific service type, such as professional services, which might be provided by different sectors, so manufacturing firms might also provide these services. In the trade in value added they kind of combine these two, which creates difficulties. I would not rely only on that dataset. I think it is the most useful one but it also has to these deficiencies. I think it should be read in conjunction with the other datasets as well.

Q3 **Baroness Randerson:** You have described the difficulties with the statistics but perhaps you could give us a picture of what they tell us in the current format. Can you describe trade with the EU and the EEA? Which sectors are most significant and why? Are there systemic differences in services trade regarding sectors or modes with different regions of the EU? I strongly suspect you will say, “Of course there is”.

Professor Holger Breinlich: I looked at the figures this morning. I will start with the big picture. The UK is a big outlier regarding services trade. Usually, if we look across countries around the world, services trade accounts for roughly 20% of total exports. In the UK it is 40% and then, looking at value added, it can go up to 60%, so the UK is a clear outlier. Our services trade surplus was close to 5% of GDP in 2015 compared to a goods trade deficit of 7%, so adding up to a total deficit of 2%. Exports that go to the EU is roughly 40% of total exports, I think £90 billion in 2015. There is a big trade surplus with the EU of roughly £20 billion.

The sectoral structure of UK-EU exports is roughly as follows: financial services is a quarter at £22 billion; other business services, which is a long list of different types of services—consulting, legal services, accounting, advertising, engineering and others—account for another quarter; travel—mainly tourism, educational services, transportation and aviation services—is 15%; transport is 11%; of the rest, telecoms is around 6%, and the other categories are much smaller, so 5% and less than that.

Regarding regional specificity, I think the clear outlier is financial services. If we look at the statistics the entire surplus of roughly £20

billion is explained by financial services. We exported £22 billion in 2015; we imported only £3 billion. It basically accounts for the entire surplus. There is also a surplus in business services but it is slightly smaller, so I think it is something like £23 billion exports, £17 billion imports. That is also substantial but not anywhere near financial services. The one sector where we are in deficit is tourism, not surprisingly. Exports were £14 billion in 2015 and £25 billion imports. That also explains the regional structure of exports and imports. There are only a few countries with which we have a trade deficit in services and these are Spain, Greece and Portugal, all due to tourism. If you look at what explains it, it is all down to tourism.

It is interesting to look at the statistics. If you look at the countries with which we have a big surplus in services—countries such as Germany and the Netherlands, for example—these are also the countries where we have a large deficit in goods trade. It is an exchange of goods versus services, if you like. The goods deficit is much larger than the services surplus, so we are still in deficit. One explanation that has been advanced in the literature is the manufacturing firms use a lot of services as well. German manufacturers might rely on the City of London to acquire other firms, for example, or rely on business consultants, et cetera. There seems to be a kind of exchange between these two categories. If you look at who takes financial services and who takes business services, who buys them, Germany and the Netherlands buy a lot more than their overall share of services exports to these countries. These are the main patterns.

Dr Angus Armstrong: I would add a couple of points to that. First, in the balance in services, one must not forget the rest of the world, which in 2015 was £68 billion: £20 billion with the EU, £48 billion with the rest of the world. This one gets lost a little bit. The data for financial services is a bit out of date. We only have the data for 2014. In 2014 there was a surplus of nearly £40 billion. We trade quite a lot of services with the rest of the world as well.

We are quite a big importer of financial services and we get this very lopsided number with the EU. We are quite a big importer from the US and Switzerland and that is really this issue of people using the UK as headquarters for the export of financial services to the European Union. I am always surprised by how lopsided we are in the value added. There are four sectors: business services, finance, insurance and real estate and wholesale and retail distribution, plus chemicals. Those four sectors have more value added than all the other sectors added up. It is quite interesting when you look at value added, which is quite lopsided, with the caveats regarding data quality, which we completely accept.

Lord Green of Hurstpierpoint: Can you clarify one point? For the purpose of data collection and the kind of statistics you have just quoted, if you take a company such as Rolls-Royce, where I am told that half the export is services after sales—not so much embedded, so not your mode 5—how does that get treated for the purpose of these numbers? Is that

not in this because it is all in with manufacturing or is it stripped out of the manufacturing line and included in those breakdowns you have just quoted?

Professor Holger Breinlich: It is recorded separately. Usually the way the statistics work in the UK is that companies are sent questionnaires for services trade and they are asked how much services they actually exported. It is up to Rolls-Royce to decide what it answers to that question. In principle it should separate it out. Unless of course the service is embedded in the goods, as we discussed previously, and then it would not show up in the service statistics, but if it is sold separately as a maintenance service, for example.

Lord Green of Hurstpierpoint: That would come up in your business line.

Professor Holger Breinlich: It would be a technical service, yes.

Dr Angus Armstrong: On this idea—and it is only an idea—of mode 5, for example, some software counts as mode 1 if it is embedded in a computer. When you get a Dell computer with Windows or whatever, it counts as traded goods.

Professor Holger Breinlich: The figures we have just discussed all exclude mode 3. They are only the other three modes. It is nothing to do with the local affiliate sales. The data is not very good but looking at the foreign affiliate statistics, as a rule of thumb, they are roughly twice as big as the other modes combined.

Lord Green of Hurstpierpoint: You mean mode 3.

Professor Holger Breinlich: Mode 3 is twice as important as the other three combined, basically.

Lord Green of Hurstpierpoint: Where does that show up in the UK current account?

Professor Holger Breinlich: It does not. The balance of payments is meant to measure transactions between residents and non-residents and, if there is a foreign company in the UK, that company would count as a resident and would not be part of the balance of payments.

Lord Liddle: Does it show in the capital cut on repatriation of profits? What are the figures on that?

Dr Angus Armstrong: The flow should be in the direct investment flows, except that is for 10% ownership, and a BOP (Balance of Payments) definition, whereas control of a foreign affiliate, depending on your definition, is usually 50% to have control of the foreign affiliate. There is a proxy. The connection between mode 3 and foreign direct investment is thought to be close but it is not exact because of the differences—that is, one is 10% and one is control. The FDIs will give us an indication about the amount of foreign ownership of companies.

Lord Green of Hurstpierpoint: Do we have any sense of a balance of trade in mode 3?

Dr Angus Armstrong: We know what our stocks of foreign direct investment are both ways and we know the sectors that they tend to go towards. We also know the employment and turnover by affiliates in different countries. The OECD produces a number of statistics by affiliates. We have turnover figures for affiliates by the OECD but these are again subject to the problems of these input/output tables.

Lord Green of Hurstpierpoint: The net position on FDI has been not exactly deteriorating but certainly shifting towards net foreign ownership. You would therefore expect, on that analysis, the net position on mode 3 income to deteriorate from a surplus possibly into a deficit.

Dr Angus Armstrong: Fortunately I can tell you the figures. The net balance with the EU in direct investment is still a small plus. That was back to 2012.

Lord Green of Hurstpierpoint: I am thinking about globally, not just the EU.

Dr Angus Armstrong: Our net foreign asset position is running down all the time. We usually have portfolio inflows which offset still direct investment positives in our IIP (Index for Industrial Production), but it is getting less.

Lord Green of Hurstpierpoint: It would follow from that, if there is a close connection between FDI patterns and mode 3—which is plausible—that our net position, whatever it is, from mode 3 revenues is declining.

Dr Angus Armstrong: I accept that and I understand your point entirely. The key for trade of course is not necessarily your trade balance. It is the allocation of resources, the efficiency and the wages and salaries you generate from this. We can have zero balance but do a lot of trade between countries, and this would still be a good thing for us because it means we can specialise in what we are good at and therefore we import much more from what they are good at, but we eat more, which is good.

Lord Green of Hurstpierpoint: We have a big goods deficit to cover.

Dr Angus Armstrong: We do, that is true. There is a reason why it is important on a balance of payments.

Q4 **Lord Mawson:** I worry about the data and the information you have. We have had a situation this week where the Government have spent nearly a £1 billion on troubled families, and we are told by the local authorities which have ticked all the boxes and filled in all the information that they had a 99% success rate. It makes those of us who deal in those areas laugh. There is clearly a gap between what they say and the reality. I wondered what work has been done to dig into the boxes that have been ticked and how accurate they are and what is actually happening in that interface between what information is received and what is going on.

Maybe you are very confident that it is accurate; my experience of the public sector is that it is far from accurate. A lot of games go on and it tells you very different things to what you think you are looking at.

Professor Holger Breinlich: I can only repeat what we have said. I think the quality of services trade data is not that great and everyone would agree. In that sense I agree with the statement. It is unclear what trade we are missing. It is a very difficult problem basically because there are so many things that go unobserved. We have not discussed transfers within multinational companies, for example. If McKinsey has a consultant in Paris and in London and they work together, which is basically a services trade, it goes completely unrecorded. In my opinion the figures we have are an underestimate of what is truly going on. That is what we can say for sure. By how much, it is unclear unfortunately.

The Chairman: I think you have convinced us that the factual basis of our work is not only complex, it is also confusing and inadequate. Can we move on to policies, even though we are working from a difficult database for those policies?

Q5 **Lord Aberdare:** I understand that most measures affecting trade and services take the form of non-tariff barriers. Could you elaborate a little on the sorts of legislative measures that typically apply and whether particular measures and barriers are especially significant in particular sectors and how they break down between different sectors?

Professor Catherine Barnard: Perhaps the best way of tackling that question is to have a look at the EU Services Directive. The 2006 Services Directive—the controversial Bolkestein measure, which is perhaps more infamous than famous—helpfully identified the most egregious non-tariff barriers, so regulatory measures, that obstruct trade in services. The key thing to understand about the Services Directive is that it helpfully breaks down services into two parts: services provided by a company established in another state, so permanent provision of services on the one hand, and temporary provision of services on the other. You have that distinction drawn in the GATS, but it is very clearly articulated under EU law as it stands. As far as the first group is concerned—where you have a permanent establishment providing services—the real problems have been authorisation schemes. Indeed, the Directive then goes on to list so-called “black list” rules, so rules that Member States cannot have at all, and they would include, for example, nationality requirements for those providing services, having a minimum number of staff of various sorts, a requirement of not having more than one establishment in more than one member state, and a requirement of authorisation subject to the existence of economic needs. Those are the things which are black list rules and they are seen as the worst type.

As far as services are concerned, that is the temporary provision of services. In that case the Directive does not go down the black list route, partly because of the compromises necessitated to get the European Parliament on board, but the Directive has a grey list of rules that the EU really does not like. That would be, for example, rules on requiring a

service provider to have infrastructure in the host state before they can provide the service, or requirements about the contractual arrangements regulating the staff providing those services. The one that has caused the particular problem is that you cannot provide services at all on a temporary basis; you have to be established there. That requirement, of course, totally undermines the idea of a temporary provision of services.

The Chairman: Does anybody want to add to that?

Professor Holger Breinlich: These vary across different types of services. The sector that is most heavily regulated and has the highest barrier is professional businesses, things such as accounting, legal services et cetera, where all these restrictions apply. In transportation and aviation, things are quite different. That is also one of the focuses of this inquiry—things such as the open sky agreements. In general, if you think of the level of restrictiveness, professional services are the most heavily restricted because of all these different regulations. Transport is another sector which is less but also heavily regulated, I would say. The types of barriers are very different across the different sectors. In professional services, regarding educational requirements, there is a prohibition on establishing a company in a foreign country, et cetera.

Q6 **Baroness Donaghy:** I am still hypnotised by the concept of a grey list. As you have indicated, services trade in the different modes may be linked, for instance commercial presence may facilitate or render obsolete cross-border services trade. Can you elaborate on such relationships and what those linkages could imply for the impact of regulatory barriers across modes of supply? To save time, with respect to mode 3, do you think decisions by foreign services firms about where to locate their businesses in the past were predicated upon the UK's access to the single market? If so, what implications might this have in the future?

Dr Angus Armstrong: That is quite a difficult question. Outside the single market, mode 3 gets covered with a services free trade agreement. This depends on what sectors countries allow each other to invest in. Some countries, such as the US, have a negative list whereby they say, "You cannot invest in these"; the European Union has a positive list which says, "You can only invest in these". It depends on how they want to do it. Inevitably, this brings you to the issue that the fuller one would want to have a services free trade agreement—that is, the more sectors you would be able to invest in, the closer that gets to movement of people, which brings you to this point. For example, at the moment, if you set up a hotel in Munich you could put your manager there as a key person and get a very fast visa right under this sort of agreement. That is not the same thing as taking over workers costlessly in the sort of numbers that you want. Depending on how trade policy gets into the idea of deep agreements, which are really the services are, and the question of what you allow foreign affiliates to be able to set up and put direct investment into, that inevitably starts dragging you into issues such as free movement.

One of the principles of the single market is the right of establishment, of course. The single market is not a free market for services; there are many non-tariff barriers, as Professor Barnard has already explained. However, there is no need to have these services free trade agreements because it is a single market in principle and therefore one can have the right of establishment as member of the EU. Financial services is the most obvious but it goes to others such as computing services and business services, where there are data requirements and passporting matters for those as well. We tend to focus a lot of financial services. It is the depth of these agreements which is important; it is about sectors you can invest in, which is about a mode 3, and that is where the single market is particularly important but potentially even more important regarding its future deregulation.

Lord Green of Hurstpierpoint: To what extent is this tied up with progress on mutual recognition of professional qualifications, which has been making progress but painfully slow progress?

Dr Angus Armstrong: Absolutely. That is a very fair point. In an ideal world, a perfect single market, so trading between Liverpool and London would be the same as between Liverpool and Lisbon, then obviously you have the same set of chartered accountants. The fact that we do not have means that these services become more restricted. At least you can trade some of those services do some of those by different modes of export. One can do accounting services or legal services over the phone. However, the right of establishment is, at least in principle, taken away but then you have this restriction of whether you recognise a professional qualification. You are quite right: there is this directive, which is extremely helpful, but does not seem to have gone as far as liberating service trade anywhere near as much as people had hoped.

Professor Catherine Barnard: I would add one point to that while you are specifically mentioning mutual recognition of qualifications. As you know, there is the very complex directive but it has at least helped to lever open the professional services market. One of the key pillars of that directive—and it is now being applied in respect of, for example, public procurement of services—is the IMI, the internal market information system. The IMI sounds incredibly dull but, functionally, it is extremely important for those who are engaged in the process of trying to work out whether your qualification is the same as what is required in my country. It is a database set up by the EU with built-in translation facilities and standard questions that can be asked. It can be used, for example, if we take the field of public procurement, to check whether a document is authentic or to check that the company has the required qualifications. This co-operation is really crucial in the field of services. I have talked about public procurement. It is also used for mutual recognition of qualifications and in respect of the posting of workers—that is the temporary provision of workers—to check who these people are and what is going on. To fall outside access to that database would be really serious for any future ongoing co-operation in the services sector.

Professor Holger Breinlich: Could I add something on the substitution between the different modes, as I think that is what the question was referring to as well? It is very important for the negotiations to bear in mind that services can be provided through these different modes. For example, if there is no recognition of professional qualifications, that would make it very difficult to trade through mode 1 across borders or mode 4, sending people abroad, but it would still allow for the possibility of having mode 3, so setting up a local affiliate and hiring people there and they would obviously fulfil these requirements. It is important to bear in mind that even if one channel was closed companies might still be able to access foreign countries through another channel. You cannot just look at them individually; you need to see the full picture.

Q7 **Lord Liddle:** To probe a bit more on how significant the single market is for services, you get the comment that the EU has established free trade in goods but it has not made much progress on services, therefore leaving the EU would not do much damage to our service sector. That is a popular comment that is often made. What would be your critique of that? Does the impact of the single market vary between the different service sectors? Could you try and illustrate that to us? If Britain were outside the single market, what progress do you foresee in a deepening of the single market in services and how this might affect commercial opportunities in different sectors in the future? It is often said of the Services Directive which you quoted that it was a weak directive that has not been fully implemented. Is the Commission likely to implement it more fully through enforcement action? Would that mean that there would be fewer opportunities outside than there are in, and in which sectors would that be likely to be most evident?

Professor Catherine Barnard: I will kick off that very interesting and highly complex question. The issue with services is that you are dealing with a vast gamut of services, and so you are dealing with situations where the individual moves to provide the service, or where the service moves to the recipient, or, indeed, where nobody moves and the services are performed intangibly, electronically. Trying to regulate all those sectors or, more to the point, deregulate them, already makes services far more complex than goods.

My next point is that you talk about the failings of the Services Directive, which are many and varied, not least because it covers only about 43% of the services industry and it is the less complicated services that are covered. As you say, some Member States have been much less willing to engage with this than others. I should say that particularly the UK, the Netherlands and, to an extent, Germany, have been on the side of the angels with this. One of the innovative features of the Directive which has been under-recognised is that it required a thorough screening of all legislation by the deadline of 2009, when the Directive came into force. The UK vigorously screened all of our legislation from Acts of Parliament to local by-laws to see whether they were compatible with the Services Directive. Thus there was a spring clean going on. Somewhat surprisingly, we found only a handful of measures that were incompatible

with the Services Directives that were dealt with, but it at least engaged the issue of what sort of rules should we have and whether they can be justified.

The other point you made was whether the Commission will follow up and enforce with those Member States who have taken a less enthusiastic approach to the Services Directive? That touches on what I think is by far the most important issue in this area, which is the question of enforcement. At the moment, enforcement under EU law is such that if there is a rule that obstructs me as an independent contractor, a consultant, from providing advice of some form—for example, providing teaching services in France—I can go to the French local court and invoke EU law and get my rights enforced. If they are not enforced in France, I can ask the court to make a reference to the Court of Justice. If that does not work, I can go to the Commission and ask the Commission to take action on my behalf or to use the SOLVIT mechanism. When that has gone, you fall back on the GATS regime and, as we have already heard, GATS is particularly dysfunctional in respect of mode 4. However, the reality with GATS is that the enforcement vehicle is extremely cumbersome. Because it is an international law agreement, it means one state bringing action against another. Will the UK Government be concerned that my little business, from which I want to provide some services in France, cannot get on to the French market, or the French are making it very difficult, and will the UK start a panel proceeding on my behalf? The answer is categorically no.

If you look at the figures, which are very crude—it is more of an order of magnitude rather than comparable statistics—in the last 20 years there were 488 issues raised before WTO panels across the whole gamut, not just GATS but GATT as well. Last year the Court of Justice dealt with 1,700 cases. That was a big year but even so, in a more average year there are 1,300 or 1,400 cases. It gives you a flavour that the enforcement mechanism under EU law is a far more effective vehicle than any of the alternatives.

Lord Liddle: Thank you for that.

The Chairman: You started by referring back to the Services Directive, which clearly is the most important but within the areas of services there are other directives and other regimes—for example on transport, aviation and financial services, which another Committee is looking at in more detail. Nevertheless, it is part of the picture. One of our recent studies was on digital single market and so forth and, indeed, broadcasting and telecoms. There are sectoral and cross-sectoral directives as well as the general Services Directive. Presumably each of those has esoteric potential barriers, or actual barriers, to trade which they are trying to remove.

Professor Catherine Barnard: What is interesting on the Directives on audio-visual media services is that the basic principle is the same as with the Services Directive and has been much more functional than the Services Directive, which is the principle of home state control. In the

case of audio-visual media services, it is the state that is broadcasting the programme which regulates and checks on the quality. The receiving state usually cannot interfere with the operation of the receipt of those programmes. That is the basic idea underpinning the Services Directive, too: that it should be home state control. However, because the Services Directive is what is called a horizontal measure and applies across sectors, the home state control principle is less effective when you have a general directive than a specific directive.

Dr Angus Armstrong: You asked us to think being about outside the EU. There is something called the services trade restrictiveness index, which most EU countries rate very well on; we have fairly high scores, which means we are not restrictive on that and are higher than countries outside. That is one crude metric that one can use. It is really mode 3 and mode 4 which have such political issues. Across borders, that can be reasonably accepted. Modes 3 and 4 get into this issue of deep integration and investing in foreign countries' service sectors. We can see from the popularity of TTIP and other trade negotiations that this becomes very political. That is what you are going into with these sorts of service trade agreements.

The Chairman: There are two supplementary questions on this.

Lord Green of Hurstpierpoint: You raised a number of quite detailed points about the way in which British businesses would have to interact with the EU once outside the EU, and whether technicalities and detail matter a whole lot. Is there a dialogue between any of you three and the Department for Brexit at that sort of level?

Professor Catherine Barnard: No.

Dr Angus Armstrong: Not at a formal level, no.

The Chairman: That is interesting.

Lord Green of Hurstpierpoint: It is a serious point.

The Chairman: Indeed.

Lord Mawson: Have you looked at specific cases where small businesses in France have tried to use the legal system and what it has cost them, and how complicated that is? I am aware of areas where it becomes so difficult that people do not bother because it is too expensive. I wonder how much knowledge we have about the mechanics of how it happens when a small business decides to go through a French court.

Professor Catherine Barnard: I cannot give you specific costings for going to court in France, but I can tell you that there is a very cheap mechanism for a small business that has proved highly effective. One is the so-called SOLVIT mechanism, which is intended to deal with just that sort of point that you raise when small businesses have a problem. The Commission intervenes on behalf of the small business to try to sort the problem out.

The other possibility is that if a small business has a problem, it writes to the Commission itself and the Commission has the discretion to bring enforcement proceedings against the defaulting member state. It is a discretion and it does not always do so but some of the major enforcement cases being brought against Member States have come about as a result of these complaints. We used to say it was the cost of a first-class stamp but now there is an online form you can fill in and complain. So there are, dare I say it, much cheaper mechanisms than just judicial mechanisms for resolving disputes for small businesses.

The Chairman: Thank you. Would SOLVIT, or indeed IMI, be available to a small business from outside the EU?

Professor Catherine Barnard: It depends what future relationship the UK has with the EU because SOLVIT is for solving problems with EU/EEA law and if we are not subject to EU law, it will not apply.

The Chairman: Would a current outsider—a small firm in Canada, say, or the United States—have equal access?

Professor Catherine Barnard: I would not presume it. It is aimed at small, European businesses.

Baroness Noakes: What evidence is there on the extent to which small businesses have benefited from these mechanisms?

Professor Catherine Barnard: I am sure the Commission has data on how many cases it hears. What is striking, both in respect of services and goods, if you look at the cases that go to the Court of Justice, none of them involves the big players in the field. If you look at the free movement of goods cases, not a single one is brought by Carrefour or Tesco; they are all much smaller players. It is clear that the system does work to an extent. Likewise, in the services case law; again, it is not the big players in the field. You do not see the Arthur Andersens and so forth as litigants. There are other reasons for that—these organisations do not like to sue and they do not like to have their name in the press—but, clearly, they have been able to use EU law to get what they want. Indeed, a lot of Member States respond to the fact that there is a directive. This was one of the aims of the Services Directive, which largely codified the case law of the court. The idea behind it was to give traders and service providers a document to wave under the nose of an official to say, "Look, you can't do this because Article 15 of the Services Directive says you can't." The Services Directive was aimed at small and medium-sized businesses.

Lord Green of Hurstpierpoint: I would like to underscore the point that this is serious and there needs to be a really good dialogue with the Government.

The Chairman: If there is anything in writing you can provide us with on that, it is the usual arrangement. Can we move on to trade in services with third countries?

Q8 Lord Rees of Ludlow: I want to ask about trade in services with the rest of the world. In particular, how does the degree of integration and market access that we see across the internal market compare with the type of access conferred by the WTO's general agreement on trade in services and other free trade agreements? Could you go further and speculate on future trends in services as a result of technological innovation and, perhaps, a rebalancing of the world economy?

Professor Holger Breinlich: Let me start with the last part of the question, which is easier, on the general trends. I think technological innovation is overrated in the services trade. If you look at data, distance plays as much of a role in services trade as it did 20 years ago, the same for goods trade, and if you look at the way trade in services declines with distance it is about the same as goods trade, so it seems that face-to-face interaction is very important for services trade. Also, if you look at the more micro-level statistics, the number of firms that export to China, for example—about 70% of firms that export services in the UK export to the EU—it is something like 2% or 3%, so there is a massive decline in the number of firms, in overall value, as we move to countries that are further away. Going back to trade in services with third countries, it is very important to keep that in mind; it is just this tyranny of distance. Europe is kind of our natural trading partner, and even if there is free trade with China, just because of the distance-related cost between businesses, we will never be able to fully compensate for that access.

Lord Rees of Ludlow: You do not think that will change?

Professor Holger Breinlich: I do not think that will change very much. Look at the statistics, or at the importance of statistics¹—it is a related question. Despite all this technological progress, I think face-to-face interaction is still very important nowadays, as it used to be 20 years ago.

Dr Angus Armstrong: I can add a couple of points. Holger mentioned distance and, just to give a bit of context, a doubling of distance between two countries roughly halves the amount of trade. For goods, that has been a surprisingly robust finding among economists over the years. If anything, distance seems to be becoming more important rather than less important because of the importance of global value chains. In other words, going back to the Bentley example, which was in the *FT*, the bumpers and the spark plugs and everything else go around Europe because it is the nearest trading partners. So you trade much more in value chains, and it tends to be the final product which goes a long way, to the extent it does go a long way. It is quite a powerful issue.

On your question about free trade agreements, I suppose this is where the real challenge for the UK will be. We will have a goods free trade agreement, I presume, and a services one. The services one will be the most difficult because of the third and fourth modes and what they imply

¹ The witness clarified that he meant to say was something like: "Look at the effect of distance, or at the resurgence of cities which is a related question."

about what is normally the natural domain of the nation state and the movement of people, because you get straight back into that. When one thinks about the other 27 members, you can quite quickly envisage that this looks like cherry-picking.

The Chairman: We have talked about the inadequate—nevertheless some—progress on liberalising trade in services within the EU. Outside the EU, how liberalised is trade in services?

Dr Angus Armstrong: Less, and because of the right of establishment in the EU we have been able to make greater gains in that area. Nevertheless, as I pointed out at the beginning, trade in services outside the EU is a big number and the growth rates have been not incomparable to within the EU—slightly slower, I believe. It is really this question of the right of establishment and mode 3, which is not captured by this sort of data. That is where the biggest problem for the UK will be because that immediately drags you into the domain of national governance and free movement.

The Chairman: I want to take us on to free movement.

Q9 **Lord Green of Hurstpierpoint:** On mode 4, can you explain how it works from the point of view of the UK now and what the differences are between moving from membership of the single market to not being a member of the single market so far as mode 4 and the flow of people between the UK and the EU would be? What impact does this have on the British services economy?

Professor Catherine Barnard: Mode 4 seems to feature almost not at all as far as UK immigration is concerned. The only thing I could find on the Government's website about mode 4 of GATS was in respect of diplomats and those entering into the private households of diplomats. You can get a temporary worker agreement, a Tier 5 (Temporary Worker—International Agreement) visa. What is striking about what the Government say is that this applies only if you come from outside the EEA, so our entire migration system has been largely set up in respect of these sorts of migrants using EEA or EU law. The free movement has been low-skilled, under Article 45 of the treaty; higher-skilled people come under Article 45 as workers or they have been temporary providers of services under Article 56.

Of course in the referendum campaign, as we know, some of those who advocated "leave" said that, with our immigration systems being so distorted by our membership of the EEA, one of the advantages of leaving the EU would be to have much greater access to workers from India, Pakistan and so forth. We have dealt with all this through immigration controls and, contrary to what is popularly perceived, we have a points-based system; we do not call it an Australian points-based system but it is a points system. Depending on the needs of the UK economy and on the skill levels of the individual, they will get higher points and then they will be able to come in.

As I have said, the problem about mode 4 is that the GATS rules are problematic, and they are problematic for a number of reasons. Importantly, the GATS rules do not have any safeguard clauses or emergency clauses. Commitments that have been entered into are difficult to change, and Governments are reluctant to enter into commitments because they do not often reflect the cyclical nature of the labour market. It would be sensible to have commitments plus safeguards so that when the economy is in a downturn you can put the brakes on. As a result of the dysfunctional structure of GATS and the operation of GATS, it means you have very little migration under mode 4.

Lord Green of Hurstpierpoint: That is very helpful but it is focused entirely on movement into the UK. Once we are out of the single market and out of the EU, a question for the British services sector is: how can it get its people into the EU? Is mode 4 relevant to that or are we forced to assume there will be some kind of free trade agreement with the EU under which movement of people for recognised jobs, or whatever it is, will be permissible? To put that point even more strongly, if, as some people say, we will end up with a WTO relationship with the EU and that is perfectly okay, what would your comment on that be?

Professor Catherine Barnard: I would say that, of course, the EU is a member of GATS but it seems to have had almost no impact either on the EU rules, but the EU does have rules on blue-card workers—highly skilled workers from third countries. The EU also has rules for migration in respect of temporary workers—intra-corporate transfers—and EU law has rules on those who are long-term residents and family reunification. This is EU law and GATS does not seem to have shaped those decisions at all. It will be those rules that apply to UK nationals who want to work in the EU.

I should say that until about 15 years ago, we used to be able to say very clearly that Member States of the EU really had control over the admission of third-country nationals—third-country nationals being the jargon for non-EU nationals—coming into their countries, but with the advent of the legislation I have just referred to on seasonal workers, interns and students, intra-corporate transfers and the blue-card directive, the space left for individual Member States to determine their policies in respect of migrants coming from third countries has been significantly reduced and EU law has largely governed that field.

The Chairman: We are coming to the end of our time. It would probably be sensible for me to take Lord Green's question a little more pointedly. Of all the various forms of future relationship between the UK and the EU, varying from the WTO through the EEA—Swiss and Norwegian—a possible customs union with Turkey or association agreements with Ukraine, from the point of view of the providers of services in the UK, do you have a short answer as to which of those models would be the most advantageous?

Professor Catherine Barnard: Apart from staying in the EU itself?

The Chairman: Yes. That is what Mrs May says.

Professor Catherine Barnard: The EEA is the answer in terms of enforcement. It is the one that will give maximum access. Even CETA, the Canadian free trade agreement, which has some provisions on services, including financial services, does not have the robust enforcement mechanisms that you currently have under EU law or even under EEA law.

Dr Angus Armstrong: Moving along the line, purely on the interests of services industries, which was your question, it would have to be EEA. EEA is a regulatory union, as Peter Holmes has put it, which is a very nice way of putting it. That speaks for itself. I completely endorse the comments about enforcement. It is a factor that is often forgotten. People talk about financial services and passporting, but what about enforcement when the next bank falls over? What is the legal structure?

Professor Holger Breinlich: The EEA is clearly the answer, hopefully in a slightly reformed way, with the UK having a bigger say than Norway, Iceland and Liechtenstein.

The Chairman: Of course, the enforcement within the EEA, directly or indirectly, involves the ECJ.

Professor Catherine Barnard: No, it does not.

The Chairman: Indirectly it does because the EFTA Court effectively follows the ECJ. Does it not?

Professor Catherine Barnard: It follows the ECJ but not slavishly. I heard a talk a couple of weeks ago in Cambridge by the main référendaire at the EFTA Court, and I put that very point to him. He was adamant that they do not follow the European Court of Justice slavishly. Furthermore, because there is no duty to refer cases to the EFTA Court as there is under EU law, national courts do not have to refer and they do not have to comply with the EFTA Court ruling, so there is some wriggle room. Of course, that is the formal, legal position; in practice, they generally do, but there has been a recent example where the Norwegian Supreme Court said it did not like what the EFTA Court had said and done because it did not understand properly the nature of the Norwegian labour market, and it was going to do something rather different.

The Chairman: That is very interesting, thank you. Are there any final points you want to register with us?

Dr Angus Armstrong: I just feel the need to say, after Holger's comment, that of course the EEA would have to be reformed, if that was to be the option, because the consensus might not always suit us. Liechtenstein is a small country to have always to form a consensus with. There would have to be reform, but the EEA answer stands. Thank you.

The Chairman: Lord Green has a quick question.

Lord Green of Hurstpierpoint: Does this look a bit like the proposal that came from the Bruegel institute, for this new association framework? That amounts to EEA plus reform. That is one way of describing it.

Professor Holger Breinlich: Plus reform of the principle of free movement of labour. That was an important point in its proposal, which would be a more substantial difference.

The Chairman: Thank you all very much. I should have said at the beginning that all this is being recorded. We will send you the transcript. Because of the complexity of this, I will ask you to check the transcript very seriously. If there is something you want to add, please let us know, particularly if there is anything else you can provide us with in writing that would help us with what we had already realised was a complex task but during the last hour has probably become somewhat more complex, certainly to me. Thank you very much. You have been very helpful and set our exercise off to a very good start. We look forward to any further help you can give us.