HOUSE OF COMMONS

International Trade Committee

Oral evidence: UK Trade Options Beyond 2019, HC 817-iii

Tuesday 10 January 2017

Ordered by the House of Commons to be published on 10 January 2017.

Watch the meeting

Members present: Mr Nigel Evans (Chair); Liam Byrne; James Cleverly; Marcus Fysh; Mr Ranil Jayawardena; Sir Edward Leigh; Chris Leslie; Shabana Mahmood; Toby Perkins; Sir Desmond Swayne

Questions 205 - 263

Witnesses

Professor L Alan Winters, Director, UK Trade Policy Observatory, University of Sussex, Dan Lewis, Chief Executive, Economic Policy Centre, and Gary N Horlick, Attorney-at-Law and International Trade Lawyer.

Examination of witnesses

Professor L Alan Winters, Dan Lewis and Gary N Horlick.

Q205 **Chair:** Good morning, everybody. Welcome to this session of the International Trade Select Committee. We are grateful to you for coming this morning to give evidence and answer some questions. First of all, I apologise on behalf of the Chairman, Angus MacNeil, but he is otherwise detained in Hong Kong. I can only assume he will have a very good trade deal when he arrives back next week. As a means of introduction, perhaps we could start with you, Mr Lewis. Just perhaps introduce yourselves and then we will go straight into some of the questions, if that is okay.

Dan Lewis: Yes. Good morning, everyone. My name is Dan Lewis. I am the Chief Executive of the Economic Policy Centre. My interest in trade is primarily driven by a new website and online database I developed called eutariffs.com in order to capture in detail the changes, growth and, where it exists, deduction in import tariffs of the common external tariff wall.

Gary Horlick: I am Gary Horlick. I am an international trade lawyer based in Washington. My most relevant experience would be that I have advised eight Governments in free trade agreement negotiations.

Professor Winters: I am Alan Winters. I am a professor of economics at the University of Sussex and the director of the UK Trade Policy Observatory, which was created to discuss trade policy after Brexit. I tell people I have wasted most of my life studying international trade in a country that did not have a trade policy, so now it is rather exciting, if rather exhausting.

Q206 **Chair:** Thank you very much. We will start with you, Professor Winters. You have said that it is in the interests of everyone in the World Trade Organization not to get bogged down in awkward arguments and disputes over the United Kingdom's WTO schedules. Why would other countries not want to use this opportunity to promote their own interests in what we call the gritty areas? What sort of interests do you think that they would be interested in?

Professor Winters: By that comment I did not mean to say that no country would have an individual interest in opening a debate, but that collectively the world economy does not want the UK and the EU to collapse into trade chaos and both of their economies to suffer significantly. The issue then is a collective one, that the world community, the World Trade Organization membership, does not have an interest in this thing going badly wrong. Nearly all of them will have some small interest where they think they might opportunistically take advantage of the renegotiations that are going to be going on. The point I was trying to make is that it is a major job for diplomacy to try to avoid that situation by explaining to people what is going on, explaining that it is complicated and that it will converge on some fairly constructive equilibrium if we do not destabilise it.

Q207 **Chair:** We are fairly well in uncharted territory, aren't we, in this particular area. Perhaps I can open it up to the other witnesses to make a comment. Do you think it is going to go smoothly or do you think that some of them will use this opportunity to promote their own special interests? Two perfect examples, I guess, are the Falkland Islands and Gibraltar.

Dan Lewis: I would say why wouldn't they, but then this is a trade agreement where there has to be unanimity of the 27 states. If one state were to take a certain position over Gibraltar, I am not sure that the other 26 would see it that way.

Chair: It is mostly with the World Trade Organization generally, not just with the EU, when we are looking at those schedules.

Dan Lewis: Sure.

Gary Horlick: I agree with Professor Winters. Collectively, the world is better off not making that kind of fuss. Individuals will not be able to resist the opportunity. The smaller the country, logically the less they have at stake to do so. I would say in any major WTO negotiation there are always some headlines: will they, won't they etc. Those have always been overcome in the past where these small, niggling objections are made.

What I would add here is because it is an unusual situation, I realise—as far as I can tell—no decision has been made by the United Kingdom whether to be in the customs union or not yet. You can all tell me where that is headed, but if the UK is not in the customs union, then it will be negotiating agreements bilaterally with many other WTO countries. At some point, that will run in parallel with the WTO process, so any issues that the UK has with non-EU countries will be done bilaterally. Now, would you use the WTO as leverage in that temporarily? Yes, maybe, but in the end there will be a series of discussions with the major trading partners of the United Kingdom, assuming the UK is not in the customs union. These will be resolved bilaterally and then taken to the WTO.

Q208 **Chris Leslie:** I want to follow up on the complexity of Britain pursuing obviously now a backstop policy in case we fall back on to the WTO arrangement after April 2019. The Secretary of State has said he is going to effectively try to cut and paste the EU schedule of concessions and tariff arrangements and place those into a UK framework. We have yet to see whether that will cause political interest, I suppose, domestically and so forth. I just wanted to press you a little bit on that process of lodging the WTO schedules. The UK is going to have to do that in the next two years. Maybe starting with Professor Winters, could you give me your assessment of some of the issues that are likely to crop up? For example, the main one I was going to ask you about was the tariff quotas arrangement and subsidies, I suppose, as a flipside of that. It is not just a question of cutting and pasting the European rules, is it? It is much more complicated than just a sort of copy job.

Professor Winters: As a precursory comment, let me say that we have to regularise our position in the World Trade Organization no matter what we do. At the moment, we interact with the World Trade Organization largely through the European Union. We are no longer going to do that. Even if we created a customs union with the European Union, we would still need to make sure that we had a schedule of our own and so on in the World Trade Organization. It would be exactly the same as the EU's, but nonetheless it would have to be labelled UK.

For a large majority—the vast bulk, it seems to me—of policies obligations that we have in the World Trade Organization, we can legitimately handle them under the process of a so-called rectification. That amounts to crossing out "EU" at the top of the schedule and writing in "UK". We do that; we submit it to the WTO. The Director General circulates it and other members have, I think it is, three months to lodge objections. They can object that the changes that we are making are bigger than mere rectifications, but as long as we were not seeking to change any policy, they would have to work quite hard to make that point.

I think a lot of it can be handled fairly straightforwardly. That is not to say that it will be entirely without costs for other members. At the moment, they have negotiated in the Uruguay Round a particular tariff for the EU as a whole, a single market of 500-and-some million people. We would be proposing, even if we kept the same tariff rates, to have a market of 450 million, another market of 60 million, with a slightly uncertain degree of intercourse between them. Other members might say, "No, the fact that it is now a bit more difficult to trade between the EU and the UK is an inconvenience to us. It slightly reduces the value of the concessions that we paid for in the Uruguay Round, the tariff rate that we agreed you could have" so it is possible there will be objections like that. Again, it seems to me the issue is one of diplomacy, to try to persuade people that they may be real, but they are small and they are not worth disrupting the whole process for.

The two issues that you mentioned are both in agriculture. Tariff rate quotas and subsidies very clearly need to be handled explicitly and frankly I do not think can be handled as a rectification. I think we would trip over if we pretended they were mere rectifications. The issue in both cases is that there is an obligation that is EU-wide. In the case of both of them, the EU has enlarged quite a lot since the 1994 Uruguay Round rate and the WTO has not formally caught up with all of those enlargements. There is a bit of uncertainty about even exactly what the WTO thinks European Union commitments are. The EU say, "This is what we think is reasonable" and nobody has argued. The basic point is we have to split them up and there is no precedent, there is no law; we are just going to have to do it pragmatically and politically.

The tariff rate quota is an obligation to import a certain amount of certain agricultural goods at a lower than normal tariff. Often it is zero tariff. You import 100,000 tonnes at zero tariff and after that the importers have to pay 25% or something like that. That is an EU commitment. The question is: is there a bit that is UK specific; is there a bit that is EU27 specific? We do not have data—and as far as we understand the EU does not have data—on how much of that notional 100,000 I spoke about came into the UK and how much came into the EU. In a sense, that critical piece of information about who has used it most is not precisely available.

I think we are just going to have to work out some sensible formulae. My advice would be that we need to be fairly generous and if that involves increasing the tariff rate quota a bit for the rest of the world, we and the EU27—for whom it is a joint problem, let me say, it is a problem for both sides—in a sense can smooth over some of the difficulties by being generous.

There is one further complication on tariff rate quotas, which is that when the UK and the EU are separate customs territories, UK/EU trade will potentially fall under the tariff rate quota. Even if we eased the tariff rate quota up by 10%, if then we were in a position where the EU claimed 80% of it, the rest of the world would feel very aggrieved. That, it seems to me, is something we are going to have to negotiate quite carefully with the EU. It seems to me that the sensible way of thinking about it is that we should work out with the EU what we think is a sensible and generous offer and go to members in the WTO and say, "We would like a small renegotiation on this. We think this is very reasonable. Do you not think it is reasonable?"

With subsidies, it is in a sense fairly similar. The obligation is not to subsidise above a certain amount, but the EU is well inside the limits that it negotiated in 1994 and therefore allocating subsidies should not be a significantly difficult issue.

Gary Horlick: Nothing gets people in the WTO more interested than agriculture, and particularly tariff rate quotas, so every tonne of that will, I think, be more controversial than Alan perhaps is telling you. He is quite right, of course. Let's say hypothetically there is a 1,000 tonne tariff rate quota within the EU as a whole, the 28, on Vegemite—I do not know if there is or is not—and obviously 900 tonnes of that was really destined for nostalgic Australians living in the UK, but it does not say that. It is possible, I think, and I am not sure of this, that you can reconstruct some of the data. You have to get in enormous detail on what Her Majesty's Revenue people report, but it may be possible. I don't know, but Alan is quite right, a huge problem there. The subsidy problem is much better, as he says, because there is a lot more room to play with.

There is huge interest in Brexit. I just finished teaching a course on Brexit in a law school in the US. Students of course always want to keep digging down. There are endless sub-issues here. The amount of permissible subsidies, for example, is denominated originally in ECU, which no longer exists, and now in euros and I would guess that assuming you all separate fully you are not going to want to do that. So what exchange rate do you use: 15 December 1993 when the deal was made; April 1994 when it was signed? This Committee will be sitting a long time.

I would focus it more on what I think of as the Day One problem, which is what has to happen before Day One? One of my friends—here with me—told me this is the world's largest corporate demerger, and in something like that, the day the demerger happens you will see photos of people sitting at a desk, a very large desk, signing things and then later it is all renegotiated. That is months and months of working out details in advance. For Day One, someone has to have instructions at the Revenue offices, "What do we do?" They have to know what to do when something shows up.

Q209 **Chris Leslie:** Do you think it is impossible to have this sort of new arrangement in place by that day one? Are you saying that we are going to have an interregnum after April 2019?

Gary Horlick: Whatever it is, someone has to have told them. Someone has to have told the shippers what to expect. Someone has to have told their advisers, consulting firms, customs brokers and so on. Someone has to have told companies, "Here is what the tariff will be on the parts" even if it is the same tariff. Someone has to have done. This works well back from day one. Someone planning to produce a motorcar has to plan months, perhaps even a year, in advance where the parts will come from etc. This is a very large, intricate thing that will all occur on Day One.

Obviously there will be some mishaps, which the newspapers will have a lot of fun with, but you have to get 99% of it working. That is really what I see as a major challenge, getting all these pieces done, and as I understand it—I am not qualified in EU or UK law—you are not formally allowed to negotiate on your own until you leave, which seems to me not realistic in terms of this day one problem. I will leave that to you all to solve, but I do focus very much on what happens in practice on the day. Even if it is the same thing, someone has to tell everyone well in advance.

Dan Lewis: First of all, I would just like to reassure Gary that there is no import tariff on Vegemite. That is something I looked into.

Gary Horlick: That warms my heart.

Dan Lewis: There are, however, plenty of others. Roughly 12,560 are in force at the moment. As part of regularising the tariff schedule, I do feel quite strongly we need to have a much closer look at each individual tariff and see which ones apply to British industry. We have just gone through

Christmas. You may be amused to know there is an existing import tariff on Christmas tree lights of 3.7%. There are an amazing amount of very obscure tariffs and I do think there really are quite a few thousand we could quickly identify as not being of strategic interest to the UK economy that we could do away with quite quickly.

Gary Horlick: Which—I am sorry to prolong this—is music to your eventual trade negotiator's ears because he or she can then offer that up to smooth the kinds of little problems that Professor Winters identified.

Q210 **Chris Leslie:** So it is not necessarily a cut and paste in this process? There might be reasons to open up the questions and to look again at why we pursue it, why we have pursued this particular tariff on this particular product?

Dan Lewis: Yes, and it is very much not just an EU issue. I think there are new tariff lines that come through the WTO; sometimes it may be coming from Brussels. Tariffs change every day. They change every day, so there are additions, deletions, amendments. We take a snapshot once a month, at the beginning of every month, and we have taken an annual snapshot since 2008.

Q211 **Chris Leslie:** I have been a bit indulgent with the answers. I have to ask the question about sector specific. Very quickly, obviously there has been some speculation that maybe the Government will pursue new free trade agreements that look for particular deals sector by sector. We obviously had the reassurances to Nissan, for instance, and the car industry. Financial services is obviously a very key part of the British economy. To what extent do you think that pursuing a sector by sector approach into a new free trade arrangement is either permissible under WTO legal arrangements or desirable?

Professor Winters: I am responsible for floating this word "sectoral" and I am beginning to regret that I perhaps used that term. The World Trade Organization rules on free trade agreements are pretty clear. A free trade agreement for goods has to cover substantially all trade, in services cover substantially all sectors I think is the terminology. There are also requirements that within a free trade area you reduce tariffs and other restrictive regulations on commerce to zero. Where does that leave the possibility of sectoral arrangements? It is the following.

First, the adherence to the practice of reducing other restrictive regulations on commerce to zero never ever applies. Secondly, the minute you get into agreements about standards, like in the single market, or conformity assessments, recognising each partner's ability to confirm that their goods meet the other partner's standards, you are in the realms of mutual recognition agreements, which are governed by a completely different part of the WTO. While they have best efforts clauses in the sense of making sure that if one party's regulations and conformity assessment are equivalent to the other they will be recognised, de facto that rarely happens.

If we look at the single market, which is by far and away the deepest integration agreement, it is partial. It just does not apply, for instance, in legal services. If you look at the arrangement between the EU and Korea, tariffs, yes, sure, were reduced across the board. The EU is keeping seven tariffs, I noticed. I did not even bother to ask which they were, but it hardly matters at all. Then there is a special agreement in electrical machinery and motor vehicles about recognising standards, recognising conformity assessments. That is the sectoral dimension.

The point is that while World Trade Organization rules are very specific on tariffs and, as it were, straightforward things like quotas and restrictions on the number of firms that might invest in particular service sectors, the minute we get down to the regulatory issues we are free of them and no one, but no one, including the European Union, has got to the stage of equalising, having a totally complete so-called national treatment where something from the partner is treated absolutely identically to something nationally. Someone has to decide. Someone has to negotiate which are the sectors we are going to agree mutual recognition on and which are not. That is the dimension in which there is sectoral scope. We will have to do it in the context of a free trade agreement that meets the World Trade Organization rules. It will have to be in the context of reducing tariffs within the bloc entirely to zero, but once we get beyond that someone has to decide which sectors you are going to press and which sectors you are not going to press.

Gary Horlick: Just from a legal perspective, what he says is completely correct. None of this has ever been litigated, because in the WTO system only member Governments can litigate and everyone lives in glass houses because none of these free trade agreements is perfect under the rules. The rules are there but no one has ever litigated them, and it would take someone mad enough in probably both senses to do so.

Having said that, from the industrial perspective, if you make, say, motorcars—and Alan and I at least are old enough, and some of you are, to remember getting off in France and painting the headlamps yellow and then getting to Germany and unpainting them—motorcar manufacturers who may have once benefited from protection along those lines do not want any of this. There is an effort, done oddly enough through a UN body in Geneva, in the auto industry to try to get down to one standard. This showed up in the US/EU negotiations. The cost was estimated in the billions of dollars. There is no benefit of having different standards for headlamps. The eyeballs are the same, so why do you have different headlamp standards or seatbelt anchors or things like that? It just added cost. Added cost means added price. Added price does not mean added profit, it means lower consumption, which if you make a lot of cars is not a good idea. Whatever the trade side of it, I think your industry is not going to want a lot of different rules.

Dan Lewis: Just briefly, I cannot comment on the legal side of it, but it does seem to me that it is quite important obviously to identify which sectors we are talking about. I think it is really the protected sectors of the economy, so it is cars; it is probably steel and agriculture. I think it is those three that we might seek that for.

Q212 **Mr Ranil Jayawardena:** Professor Winters, UK car manufacturing is at a 10-year high and we are exporting more cars than ever before. I understand your Observatory raises the possibility of a special deal for the car industry in the UK whereby this particular sector would be, as I understand it—as you have articulated it—in a customs union and single market regulatory union arrangement. How would that work and what are the particular benefits as you see it of negotiating a special deal for the car industry over anyone else?

Professor Winters: I am not sure that I want to advocate that the car industry should receive special treatment. The issue that we were writing about at the time was the Government announced a secret agreement and we all speculated about what could possibly be in here. How could you possibly make it consistent with the other statements and obligations that we had?

The customs union within the free trade area works like this. A free trade area agrees that there should be zero tariffs between the partners of the free trade agreement for products originating in those territories. For an agricultural product, if you grow it, you export it, it is clearly originating in your territory. But for a car, which has all these parts that come from all over the world screwed together, there is a test, so-called rules of origin. In some cases, there is a sufficiently high amount of foreign content to these things that it would not qualify as originating, say, in the UK going into the EU and therefore would not get zero tariff. It would have to pay the most favoured nation tariff.

The origin of the rules of origin in free trade areas is to avoid so-called trade deflection. If you imagine that you have a free trade area of two members, one has a very low tariff on something, one has a very high tariff on something, and you were an exporter—zero tariff between them, remember—what would you do? You would send it all to this guy and send it on at zero tariff to this guy. You would evade and undermine this guy's tariff. What do you do? You have this rule of origin that says you can only send it in at zero tariff if you produced it, not if you essentially imported it.

A customs union adds to the free trade agreement by having a common external tariff all the way around outside. Full customs union has common tariff not only on the final product but on the intermediate goods. In that case, trade deflection does not exist. There is no case for doing trade deflection because whichever country you came into you would pay the same tariff on that good.

So how could you have something customs union-like in motor vehicles? Maybe you would just follow the EU, but you would confirm that you would have the same tariff on motor vehicles themselves, on all the various component parts or significant component parts and therefore that there was no worry, no concern about trade deflection. Therefore, even if you had a rule of origin written down, you would not seek to enforce it in a very bureaucratic way because the problem it was designed to solve would not arise. It is a very pragmatic sort of thing. It is not a separate trade agreement. It is about the implementation of UK trade policy to say that all the things that matter in this particular sector—cars was the example that we were looking at—we will make sure that we have the same tariffs as the EU, including though if the EU has free trade agreements, zero tariffs with some suppliers and that therefore we will come to an agreement with the EU that rules of origin are enforced in an extremely relaxed way on that particular trade.

Q213 **Mr Ranil Jayawardena:** But how would it be possible to differentiate between the components used in a certain industry, hypothetically the car industry, and those same components that might be used in another industry? Wouldn't it be very bureaucratic and ineffective in delivering the objective that you have outlined?

Professor Winters: Yes, that would be absolutely silly. You would have to have the same tariff on the intermediate goods for all their uses. The idea of charging different tariffs for different uses in the economy is something that has largely died out of practice even in developing countries. It is a complete nightmare. It is a real recipe for corruption.

Q214 **Mr Ranil Jayawardena:** It is not a special deal for a particular industry, it is looking at the outputs that you want to achieve for every part?

Professor Winters: It is a deal that is focused on the products that that industry exports and imports, yes.

Q215 **Mr Ranil Jayawardena:** We have looked at free trade areas, but what about free trade zones? Do you think free trade zones, Professor Winters, would be a helpful step forward in reducing the amount of bureaucracy and allowing goods or indeed components coming into this country and through this country to the EU, if necessary?

Professor Winters: I think that is a somewhat separate issue about the administration of customs within—

Mr Ranil Jayawardena: Well, as an alternative route, if you like.

Professor Winters: A free trade zone essentially would be an area of Britain that would, as it were, lay outside the UK customs wall. The point is when anything travelled from within the free trade zone into the rest of the UK it would pay the tariff. If you have an industry that is a pure assembly industry, it imports lots, they throw it together, they export nearly all of it, a free trade zone makes a lot of sense. It is very convenient. But if you have an industry that is not willing to commit that it is exporting all its products, it wants to sell some years into Britain, some years not, it starts to get rather bureaucratic. While one might have slightly enlarged areas around the ports for transhipment trade and so on, by and large I think we would be much better advised to get a trade policy for the whole of the country that works, roughly does what we want, rather than carve out particular bits of Lincolnshire or Hampshire or what have you and declare them to be free trade zones.

Q216 **Mr Ranil Jayawardena:** But you would not rule out free trade zones as an option, if necessary? They could work?

Professor Winters: I think if one wants to have a free trade zone, someone needs to make the case as to why, why you have a trade that can use local labour but the intermediates are imported, the output is exported and that therefore the free trade zone makes sense. I am not saying that it is inconceivable that a free trade zone might be useful, but I would not want to be quoted as saying, "No, they are absolutely fine, don't worry". They are a complication and you are better to try to get a single trade policy for the whole country that works.

Q217 **Mr Ranil Jayawardena:** Mr Horlick, perhaps I can turn to you, because the Centre for Policy Studies suggested that free trade zones, if they are as successful in the UK as in the US, where I understand you call them foreign trade zones, it could create around 86,000 new jobs for the UK. Are there any changes—given your time at the Department of Commerce, where you were responsible for FT zones—that the UK should consider making if that is a route that we want to take?

Gary Horlick: It really follows from what Alan was saying and hinting at, which is that a free trade zone is a measure of how much complication you have added in your normal course of business.

Q218 **Mr Ranil Jayawardena:** Of course it might not be us that has added the complication, so it is possibly responding to complications added by others.

Gary Horlick: Right. You are better off getting it right the first time.

Q219 **Mr Ranil Jayawardena:** But we are not always in control of those things, are we?

Gary Horlick: No.

Mr Ranil Jayawardena: It might be that other parties do not want to do that, and this could be—

Gary Horlick: I was and am a big fan of the free trade zones the US runs, and some other countries do as well, but they are a reaction to the added cost of a border. Let me address that, because he was hinting at it. The UK right now is a member of a customs union. When you ship things within the customs union—as I say, I am not an EU lawyer, I do not know perfectly how it works—basically there are fewer formalities at the border. If you choose to leave that customs union, then if you have border formalities, even with no tariffs—and I think that is part of what he was getting at—the minute you have the lorry having to stop or papers being done, God forbid, then you have added costs. In effect, it is a tariff. It is a hidden tariff. If you want a rough approximation, find a parcel delivery service, DHL or whoever you use. Find out how much it costs to ship a five-pound packet from here to Hull, then ship it the same distance to, say, just within the customs union. There is added cost. Shipping it outside the customs union is astronomical. I have done this. It costs three times more to ship something from Washington to Toronto, 800 miles, as to Los Angeles, 2,400 miles, and there have been no tariffs between the US and Canada for 25 years. That is solely the cost of having a border.

Q220 **Mr Ranil Jayawardena:** If complications are put in by others and a response from the UK needs to be to introduce FT zones to mitigate that, what changes would we need to make?

Gary Horlick: I don't know your system here. You want one that obviously has the least paperwork possible because that is the whole point. Even with free trade zones, as Alan hinted, you have to safeguard them to make sure they do not leak, which is more paperwork. Trade negotiators, myself as well, do not typically think about this when they are doing the agreements. This is stuff that shows up afterwards. In any agreements you do, assuming you are negotiating your own trade agreements, you want to build in some possibilities of going back and revisiting things. The US did this after NAFTA but has not done since. There are some provisions you will want to change.

I will give you a very specific example though. The first US FTA was with Canada, which was Canada's first FTA. They go off, they do rules of origin and 30 pages of exceptions. A year later, I was in practice by now. I was counsel to Canada during the negotiation. It had not occurred to me, but it certainly had not occurred to the US Government. A client calls up that made fancy fireplaces. They wanted to sell their fireplaces in Canada. It did not qualify because the rule of origin required that everything be made in the US for the fireplace and there was one necessary component from Italy. Boom, didn't work. The component was necessary, but it was not even 1% of the cost. It did not qualify. The reaction to that was in NAFTA they negotiated a de minimis level, "Below 7% we don't care". That is the kind of thing you do in advance because if you do not, you are going to have all these complications.

I will give you the bad news: you may know better than I; you as well. The studies that I have seen show that, for preferential trading arrangements of all kinds less, than half of the transactions used the preference. It is too much bother to do the rule of origin, to do the added paperwork, whatever. Negotiators go off and work very hard and do all this and half their work is wasted. This is Stefano Inama's paper, but I am sure there are others. As you see, there is a lot of paperwork burden just by leaving a customs union you would be taking on with zero tariffs, zero quotas. Just the piece of paper costs money to do.

Q221 **Mr Ranil Jayawardena:** As I understand what Professor Winters was saying around having broadly harmonised arrangements that are very informal, very fluid, but deliver the objectives for our industries, if we were to take such an approach where we followed a sectoral, in effect, customs union limited to certain components regardless of what those components might be used for, but limited to certain countries, would that violate the most favoured nation obligation under GATT and, if so, could that then be justified under the exceptions to that obligation?

Gary Horlick: As I said, this has never been litigated in the FTA context. What in general WTO dispute resolution shows—and I participate in a lot of cases—is the mechanism, which are neutral people, is very good at detecting evasion of the rules. So whatever you call it will not matter. If they think you are trying to favour one country over another, they will go after you. If you are not, if there is some logical reason where you are not favouring anyone, you may get it. Whatever you label it is not going to fool anyone.

Professor Winters: International trade is complicated. There are always many dimensions. The basic obligation in the World Trade Organization is the so-called most favoured nation obligation. You have to charge the same tariff on everyone, pretty much. There is an exception. You can have free trade areas and that means the partners of the free trade area charge zero tariffs on each other. Those are the two rules. The suggestion of a customs union-like arrangement for cars is that we, the UK, will charge exactly the same tariff on everybody else as the EU does and we will have zero tariffs between ourselves. It falls within those two WTO rules. There is no way in which one could sign an agreement that said, "We want to integrate very closely with Europe. We will let their engines in tariff free but any engine from the US or something will have to pay 5%". That is absolutely out of the question. They will not have to work hard to catch you.

Mr Ranil Jayawardena: Mr Lewis, did you have anything to add?

Dan Lewis: Thank you, yes. I did read that paper. It was very interesting and had a lot of good information. If I could take a step back, what is being proposed with a number of these free trade zones is that a select group of producers do not pay tariffs, but the rest of the country does. I do not think that is very equitable, so I would like to echo Professor Winters and Gary that it is far better to get one deal for the whole country.

Q222 **Mr Ranil Jayawardena:** What happens if you can't though? Then possibly to stimulate economic growth in certain parts of the country, to support certain sectors that might be based in certain parts of the country, would you never go down an FTZ route even if the FTA cannot be negotiated, even if barriers are put in by the European Union or others?

Dan Lewis: There are a number of avenues, free trade zones being one of them, that you could follow. I suspect we will come to that a bit later. I am not a legal expert at all—I am sure Gary will have strong views—but I would struggle to see our European friends accepting that. By using the principle of tariff inversion, we could then produce a good much, much cheaper, which they are not able to do, and then we sell it to them. I am just not sure that is a flyer.

Gary Horlick: That is why these things attract lengthy rules of origin. As I said, the original US FTA had 30 pages of exceptions; the next one five years later had 240 pages of exceptions because everyone realised there were games you could play. Those are not productive for the country as a whole, they are just one company getting an advantage in the same country over another. Go back to the paperwork part of it, which I think is very important for you, that is why I keep coming back to it. If you are in a customs union, and that is about a half of the UK's trade, you are now putting half of your trade into a paperwork environment it has not been and that will raise costs even if there is "free trade".

Q223 **Sir Edward Leigh:** I was bemused by the way, Professor Winters, within free trade zones you mentioned Lincolnshire for some reason. The mind boggles on Lincolnshire becoming Shanghai, but still, we will leave that. I am not asking you about that, don't worry. You have written that, "Negotiations with the EU will not be easy because the UK's negotiating position is weak". Just to amplify this, just reading what you have said in the past, "Negotiations between the UK and the EU27 will not be easy because the UK's negotiating position is weak. The average UK exporter sends approximately 45% of its exports to the EU, while the average EU exporter sends a bit under 7% of its to the UK. Who, then, is going to be keener to sign a deal?" Now, I understand what you are saying there, Professor Winters, but we have always been told all along, have we not, that overall there is a massive balance of trade surplus, the EU over us?

You have said, I think, earlier and we all know that they are negotiating as a bloc, they are not negotiating for particular companies and all the rest of it. Surely they will have a mindset—or am I being too simplistic—to negotiate as a bloc, they will recognise that they have a massive trade surplus with us and therefore it is simply not in their interests to have any kind of tariff wall? That is what I have always thought, but perhaps I am wrong and perhaps you can enlighten us.

Professor Winters: By and large, economists think that tariffs are not very helpful and that in the long run if one can handle everything it is worth reducing them. I do not agree with Dan that we should reduce them immediately, but that is a separate debate.

The EU has tariffs for some purpose. Let us not ask why, but let us just assume they arose through some political process and there they are. Do they want to reduce them? Not very much has changed for them; it is not clear that they would. The important point about market size is really the following, to take this in personal terms: if I change something that meant that half of your income was vulnerable to a hit of, say, 5%, would you be more concerned or less concerned than if I did something that made 7% of your income vulnerable to a 5% hit?

Q224 **Sir Edward Leigh:** But you are looking at that in terms of a competitor, as if I were your competitor and we were in business competing with each other. Doesn't the EU have a slightly different concept of it? You are assuming that there is a sort of aggressive mentality.

Professor Winters: No, I am not at all. I am saying here is a company that is selling 7% of its output into a particular market that is going to become more hostile.

Q225 **Sir Edward Leigh:** Yes, but you are talking about companies again. I agree that for an individual company it is more important for our companies—if we are talking about an individual company, I quite understand that. That is why I was being entirely fair to you, I was reading out your argument. But I am asking about the overall negotiating position.

Professor Winters: Where does the negotiation position come from? What is the Department for Exiting the EU doing, and even the Department of Trade? They are talking to companies, talking to sectors. Of course what happens to companies determines how much they lobby, what they are pushing for. The average exporting company in the EU is sending 7% of its exports to the UK. That is what is vulnerable to what is happening. They will work appropriately with that 7%. They also, remember, have a very strong interest in maintaining the health of the European economy, the EU27 economy, to which they export more. They might have other objectives as well.

Think about the average UK exporting company. If the relationship between the EU and the UK goes wrong, half of their exports are vulnerable. They will just work harder. Supposing they are making a profit margin on 8% and we say, "We are going to do something to halve your exports and reduce the profits that you can earn on that by 4% of your turnover". You are halving their profit rate. For an EU company with a smaller commitment to the UK, it is less of an issue. It is still an issue. They still would say, "You know what? We would rather earn more than earn less" but it will not become the dominating issue.

Frankly, I think the British Government will come under a lot of pressure to find deals to preserve some reasonable access to the EU market because it is very important to a lot of economic activity in the UK.

Q226 **Sir Edward Leigh:** I will not keep pressing the point; I have made my point. You do not think that this argument is going to carry a lot of weight. They had this massive trade. Was it £80 billion a year with us overall or something? You think they will just say, "I am sorry, we are talking to this company or that company in Germany or France or Spain and they are not too worried about it".

Professor Winters: I think you are exactly right. It will cover some weight, but nothing like the weight of the point that we are very, very heavily dependent on the EU market and EU trade as well.

Q227 **Sir Edward Leigh:** I think you have made your point now, but let us look at it from another point of view. Let us look at it from the point of the companies. Is it 100,000 German cars coming into this country every year? Surely this is a massive argument that Mrs Merkel will be hearing, is it not? Boris Johnson has talked about the Italian Prosecco industry and Chris Grayling has talked about French wine and cheese. Even if we accept your argument for a moment that it is all about companies and the British companies have much more of a stake in this than the average European company, for the arguments that you have given, surely Mrs Merkel will listen somewhat to the German car industry, won't she?

Professor Winters: I am sure she will listen somewhat.

Q228 **Sir Edward Leigh:** They will be a very powerful factor, won't they, motivating her towards an accommodation on some sort of free trade deal?

Professor Winters: They will be more powerful than many other trading interests in Germany, yes, that is sure. But will they be more powerful than the wish to maintain unity within the EU27? No, they will not. The point is that it is a less critical issue and therefore it will carry less weight.

I think the issue about Prosecco is frankly a bit of a diversion. The tariff that we have on Prosecco is 32 cents per litre. It amounts to about 20 pence on a bottle of Prosecco. It is barely here nor there; it is a very funny example to have chosen. Cars are big, cars are important, cars are powerful. Yes, of course Mrs Merkel will listen, but it absolutely will not be the only thing she listens to.

Q229 **Toby Perkins:** I want to expand on that point slightly. I think we all understand the general premise of your point on a national basis, that they are 27 markets, we are one and so there is that imbalance there. I recently had a situation in the last couple of days where 200 jobs in Chesterfield have been lost. This is a big thing to me. There will be individual businesses, individual sectors, for whom losing the UK market would be catastrophic. As we go down the length of this two years, you will start to see German Members of Parliament, Italian Members of Parliament and others getting businesses in their industry saying, "We have to sort something out with the UK because we are going to be shutting the factory if we cannot get this sorted out". There is going to be a significant pressure coming from businesses, not to try to do Britain over, but to say, "Can't we just carry on as we were?"

I wonder—we have heard Professor Winters—maybe from Mr Horlick and Mr Lewis, the extent to which that political pressure is going to really focus minds among political leaders that, yes, they want to be seen to have a tough deal but also do not want to be seen to be the cause of thousands of job losses in their own areas.

Dan Lewis: Yes, if I may. I am a bit more optimistic than Professor Winters. The first point to absorb is that no member state has said that they want to impose tariffs on the UK on day one of Brexit. I think it is extremely unlikely, and you may disagree, that all 27 states unanimously agree to do that. I think the danger is not tariffs per se from the EU on the UK, I think the danger is the pace at which the negotiation goes. I think a slow Brexit would be quite damaging. I would like to see a much swifter Brexit. It should be possible, but then we are into the realms of politics and so on.

We are 100% compliant with the single market, we have established trading relationships. This should not really be that hard. Having said that, on the other side, the EU is famously slow to make trade agreements. That is a risk in itself, so if there are things that we can do, and I think one of those is to decide and be upfront quite quickly on what is for negotiation and what is not. That is still something to be done.

Gary Horlick: I certainly do not feel qualified to get into this, but I would want to add something. The EU is quite a large economy in the world. It is fifth in GDP, I think, although obviously you can argue about what that is, but it is large. Leaving aside whether the UK is a member or not and whether it leaves the customs union or not, it is a desirable trading partner. On the other hand, the EU is larger. Both fall in the realm, if you look at the scale of things, if you were a country you would want agreements with both of those. You would.

Professor Winters: I deeply, deeply wish us to have a deep arrangement with the EU. All I am saying is let us be realistic. It is not that the EU is going to fall over and say, "Anything you want is fine with us because we are desperate for your market". It is going to be more likely the other way around.

Your example of the pressure that you come under as an individual MP I think illustrates exactly the point that I am making. I do not know what the numbers are, but my guess is two-thirds of British MPs have serious interests in their constituencies that are exporting to the EU. In Germany, the big exporter within the EU, I bet it is not as high. Therefore, in the end—as you all know better than I—this is a compromise: you win some, you lose some. The point is that the pressure from constituencies will be very widespread in the UK. It will be much less widespread in Germany, in France and Italy and therefore is less likely to prevail.

Q230 **Toby Perkins:** Two of you have referred to what it is that we ask for as part of the British Government red lines. The EU has responded very negatively to a Swiss request to restrict freedom of movement, which is, we are told, one the Government's red lines, without any diminution in access to the single market. Should we read anything into that? We are obviously a very different country to Switzerland, but should we read anything into that in terms of the likely success or otherwise that the UK will have if it is trying to insist on this freedom of movement red line, on its impact on our trade negotiations?

Dan Lewis: I think Switzerland is a special case, for all sorts of reasons. I do not really see the freedom of movement as something that could be negotiated. I think it is quite clear that the Government are going to reassert democratic control over freedom of movement, and that is a red line. It may be there is a lot of huffing and puffing and then we will get to a deal. I hope we get a deal, absolutely.

Q231 **Toby Perkins:** You think that we will not move on that, so that will also have implications in terms of single market, so it will be about having to start a new trade deal on the basis of starting from the point that there will be no freedom of movement?

Dan Lewis: I think there will be quite a lot of movement. It is not as if we are going to go from having 300,000 people a year coming in a year to zero. I think there is going to be quite a long period where that will continue for some time, whether it is wanted or not. It is just the idea that you put it under democratic control. I am not sure I can add much to that.

Q232 **Sir Edward Leigh:** Can I ask you a supplementary on Switzerland? You said it was a special case. What did you mean by that? I can imagine that because it is in the middle of Europe and it is a very small country we are entirely different. Were those the things that were in your mind or what were you thinking of? It is often put to us that, "The Swiss have tried this on and got absolutely nowhere, so you are going to get nowhere". I am not sure that that necessarily follows, that the UK experience would be the same as the Swiss experience, especially, as you say, that nobody is suggesting that you cut EU migration from 300,000 to zero. We might cut it to 200,000, we might argue there should be broad equivalents, roughly the same number coming in or anything. I do not know what we will say, if you see my point.

Dan Lewis: I do. Switzerland has obviously been independent these last few decades and indeed for a very long time. They have their own tariff schedule. I think the tariffs are a little bit higher going to Switzerland than if we were to come out on straightforward MFN WTO terms. To hark back to your earlier question, as I understand it, the average tariff, if it did get to that point, would be between 3% and 4% that we would impose on goods from the EU. I would not want that, I certainly would not, but if it came to it that would raise twice as much as the tariffs that would have to be paid by our own exporters to get into the EU, because they would have those same rates.

Q233 **Toby Perkins:** You have written that if migration control was not too draconian we should still be able to negotiate single market-like access to the EU in a number of sectors. I invite you to respond to that question about Switzerland and what we should read into that and what you mean by "not too draconian".

Professor Winters: I agree with Dan. We are not looking at closing the doors. It is not 300,000 from the EU, by the way, it is about 160,000, I think. It is 300,000 overall. But we are not looking at locking the doors altogether, so exactly as the Prime Minister says, this is not black and white. It is not bifurcated; there is a space in between.

I think the response to Switzerland tells us how very seriously the EU takes free movement as part of the defining characteristic of the single market and the EU. I think they hold that very dearly. What is different between Switzerland and the UK is we are bigger, so that might help a little bit. Also things are changing a bit in Europe and as we go forward in the next two years maybe attitudes within Europe towards unfettered mobility may start to change.

Therefore, I do think that there is scope for a negotiation that says, “We have had this referendum. There is no way that we cannot do something about the free mobility. We would propose to do this and that and in return we understand that we cannot have total free market access and membership as we used to have, because we are now withdrawing something that you hold as part of the definition. Nonetheless, for a small reduction in mobility, maybe we can negotiate a small reduction in single market rights”.

How can you divide the single market up? That is how I have arrived at the view that I think in the end we are going to negotiate sector by sector. Not on tariffs, I will be very clear. Tariffs will just go to zero, no question. But on things like mutual recognition, harmonising standards and so on, a long, gruesome business of trying to negotiate something equivalent to single market rights.

What do I mean by not draconian? I am not an expert of migration from the EU, but the sort of things that I would expect would be that a deal would have some very free arrangements for skilled workers who, after all, we are desperate to get. It would perhaps be very liberal on students, who are currently lumped into the migration statistics in a rather unhelpful way. They are consumers who pay us a lot of money and you could pull those out.

There might be a cap on unskilled workers, but you could implement that in a number of ways. You could say that there is cap, possibly by geographical region in the UK, but you could then say that once an unskilled worker has arrived in the UK they could work only for that employer and have to leave before they can seek another job. Or you could say that once they have arrived they can work for that employer for six months and then can seek another job from within the UK. It makes a lot of difference to the way labour markets function and is clearly much to the advantage of the migrants themselves, the EU citizens. There are dimensions under which you can make these things more draconian or less draconian. I do not want to claim expertise on it. You should talk to, say, Jonathan Portes about that, but there clearly is a continuum that we can pick points in.

Gary Horlick: The deadline for action in the Swiss Parliament is next month, so stay tuned.

Q234 **Sir Edward Leigh:** I want to ask you a legal question, which is related to what Dan Lewis said. Say the worst came to the worst and our exporters have to pay 3% to get into the EU. Given though this overwhelming balance of trade surplus with them and therefore the British Government are going to make a lot more money out of this than the other way around, would it be legal under WTO rules to bung our exporters the cost of this, just transfer the money straight to them? Would that be legal?

Gary Horlick: No.

Q235 **Sir Edward Leigh:** Tell me why not.

Gary Horlick: There is an explicit ban on export subsidies.

Q236 **Sir Edward Leigh:** There is no way you can get around that?

Gary Horlick: No.

Q237 **Sir Edward Leigh:** Right. A simple question, a simple answer.

Gary Horlick: Yes, one of the few.

Q238 **Chair:** Can I just add one point? On the strengths of the negotiating position, people take different views and it is not an exact science. Last night Boris Johnson talked to a number of President Elect Trump's people, including Bob Corker, the Foreign Relations Chairman. We are now at the front of the queue for a trade deal with the United States. Mr Horlick, with your experience, how quickly could a trade deal be done with the United States of America, as we are at the front of the queue?

Gary Horlick: Empirically the fastest one would have been, but with very small countries, a year, but the longer ones—NAFTA was quite quick; it was two years. TTIP has been going on for four. The larger the country the longer it takes.

Staying within the US, decisions on whether to start a free trade agreement are made essentially by the President, but it has to be not disapproved by the Congress within 90 days. The constitutional arrangements are different in the US than here, and the political ones, although one commonality that we got from you is revenue starts in the House of Commons and it starts in the House of Representatives. Trade agreements involve revenue. Congress constitutionally in the end controls it.

Q239 **Chair:** But there does seem to be general goodwill within the United States about doing a trade deal.

Gary Horlick: What it means is that there is a large dose of congressional politics in any trade agreement negotiation.

Q240 **Chair:** I appreciate that. What impact would that have on the United

Kingdom economy if a very good trade deal were done between the two countries?

Gary Horlick: Obviously you are a major trading partner and we are a major trading partner. Our largest trading partner is with Canada, second is China, third is Mexico. Obviously you are an important trading partner. US/UK cross-investment in both directions is enormous, so the economic relationship is quite large. As I said, I am not about to get between you and the EU in the discussions. The US has been negotiating a trade agreement with the EU since 2013. No one knows what any new Administration will do, not this one or any, so like any other trading room, we have to see what the new Administration will do.

Obviously the United Kingdom—I am well aware and I know the people—have been very active participants in the negotiation by the EU with the US. The United Kingdom is well aware of what those issues have been. They get heavily into the issues that Alan went into. All US trade agreements start from the proposition that all tariffs will go to zero. Possibly one or two will not. The issues are always all these other issues, and all these other issues take a lot longer than trade agreements.

Q241 **Chair:** My final question is to Mr Lewis and Professor Winters. Should a very good, favourable trade deal be done between the United Kingdom and the United States of America—and we are talking about leverage with the Europe Union to do a very favourable trade deal with access to the single market at lowest trade tariffs, if not zero, the regulatory also being as little as possible—do you believe that the prospect of a trade deal between the United Kingdom and the United States of America would have an impact on the Europe Union’s attitude towards a trade deal between the UK and the EU?

Dan Lewis: I cannot see it not having an impact. The basic issue is that in some ways Brexit is about rebalancing the British economy, in terms of trade, to the faster-growing parts of the world. That is what you should be aiming to do over the longer term. Europe has been very slow growing and seems set to be slow growing for some time. It is a declining part of the world economy.

To see Britain do a deal with the USA would hopefully be a great motivation for them to do something, because although Europe has over 50 free trade agreements—none of which, incidentally, require freedom of movement of people—it has done these with lots of small people. I think the real gains are from doing so with the really big countries, like the USA, like India, like China and one day perhaps, when those regimes become friendlier, with Russia and Iran and so on. I would hope that that would have a positive impact.

Professor Winters: Yes, I agree with Dan. It is difficult to see it would have no impact at all. I think Europe would pay attention to the fact that a very good trade deal that made the UK economy dynamic would in a sense allow the UK to continue to be an attractive location for US investment from which we could serve Europe, even if there were some tariffs in the way. So I do think it would have some effect. I do not think, however, it would change everything, because, frankly, the European Union sees itself as more than just a trade deal.

Gary Horlick: If I could add to that, as I said, the UK, as part of the EU, has been very active in the negotiations with the US to date. Your embassy in Washington—I will get in trouble with all the other embassies—is undoubtedly the most active of any member state and does a very good job. A lot of the start-up problems do not exist. You have been doing this since 2013, so you know how US TR works. US negotiations with no country are easy. I have been counsel to Governments on the other side. The US thinks it is the largest economy in the world and thinks therefore it has the most bargaining power and so it bargains very hard until the bitter end. The US and the UK obviously have an extremely friendly relationship under any Administration.

Q242 **Sir Desmond Swayne:** Professor, your Observatory has said in its evidence that almost surely Brexit will lead to a deterioration in market access for service providers but the extent of that is difficult to gauge. Can you elaborate?

Professor Winters: Yes. We talk about services as a single aggregate. In fact, it is an immense variety of different activities, each of which is facing a different regulatory environment. Trade and services is typically not controlled by anything like tariffs but by differences in regulation and details of regulation.

There are three reasons really that make it difficult to make this assessment. The first is that the EU has made a series of commitments in the Uruguay Round of the GATT, the WTO, about restrictions that it reserves the right to impose on services. However, its actual policy is generally quite a lot more liberal than that, but in fact it is not all written down in one place and one has to pick over it.

The second thing is that in fact services are still partly—and in 1994 were entirely—the competence of the national authorities, so that although the EU has submitted to the WTO the schedule of services, when you look at it, it consistently mentions, “It is like this in France, it is like that in Italy and the Netherlands has a reservation of this sort”. So in fact the controls on service trade are difficult to locate and they vary from member country to member country.

The third complication is that the WTO approach—and I think we have fairly much learned to live with this—is to recognise four different modes of supplying services: cross-border services, where you download a film from America or something; where the consumer moves, health tourism; where the producer moves, foreign direct investment; and where the service provider, ie the person, moves, so-called Mode 4.

The problem is they interact in very complicated ways and different ways per sector. But there are plenty of places where, for instance, in order to take advantage of a very liberal Mode 3 regime, where another partner can invest in our country very liberally, they need something on Mode 4 to guarantee that they could bring their technicians in if the thing works, that they can bring their designers in. So you can liberalise Mode 3, but if you really are very restrictive on Mode 4, as we often are in this country, you are not going to get the benefit of Mode 3. We are talking about huge disaggregation, quite difficult sources of information varying across the 27 members and it is extremely complicated technology.

The question is—maybe you are going to ask me—how do you work it out? In the end you have to have information from the providers. The people who work these markets really are the only people who are going to have full information. What the Government needs to do is to make sure they are getting information from the producers and the purchasers, from both importers and exporters, and they have essentially robust systems in place to test that they are getting real information rather than being spun a yarn for the sake of lobbying.

Q243 **Sir Desmond Swayne:** A single market in services has yet to fully exist anyway. To what extent is it going to be any different?

Professor Winters: That, in a sense, depends on how the negotiation goes. If we dropped back to so-called World Trade Organization rules—we have just had the MFN offer—it would not be what is written down in the schedules. It would be something more liberal, but it would be considerably less liberal than what we get at the moment in the single market.

The financial services sector is one where we hear a lot about passporting, but there is a similar sort of regulation, I understand, about broadcasting. As you go through the various sectors there are things that we are able to deliver single market but are clearly not possible if we relied on the MFN position. So, no, I do not think it would just be the same. Most people think it would be very different.

Gary Horlick: If I could add a practical aspect, a number of UK industries have maintained very robust involvement in international trade negotiations even though the UK is part of the EU. The financial services industry, an organisation called TheCityUK, is very active with its counterparts in the US, for example. In the EU/US negotiation the problem was not problems between the industries, it was the US Treasury Department that was blocking progress. Scotch whisky producers are quite familiar with WTO and bilateral agreements. There are a number of UK industries that have maintained the infrastructure with the Government, so the UK Government are quite well informed about what needs to be done in a practical sense, so you are not starting from zero, in those areas at least.

Q244 **Chris Leslie:** Just to follow on financial services trade issues, some people are arguing that it is okay if we lose direct passporting rights because there is an indirect approach from the EU to equivalency for non-EU countries and from third parties. For instance, maybe the US is currently being considered for whether its regulations are equivalent to EU financial standards, giving them the right of access.

Of course, if Britain leaves the EU we may lose passporting rights. But some are saying we can then just apply to the EU to grant us the same equivalency as they might grant to America or wherever. To what extent though are the EU obliged to treat the UK in the same way for equivalency proposes? Is there not Article 7 of the GATT arrangement? Would that apply or would it not apply because it is services?

Gary Horlick: That is interesting, because services, as Alan said, the MFN obligations are less certain than with goods. The structure of GATT in practice lets you differentiate in the commitments you make. You can tweak them in ways that effectively discriminate. It is not a good idea, and again you would want to talk with your financial services community about how much they want differentiation, because they like to have a single rule in one place also. One thing London has is lots of good lawyers who can tell you better than I can what they would need in Europe on that.

Q245 **Chris Leslie:** But we cannot bank on the equivalency right as a sort of surrogacy for passporting?

Gary Horlick: You would have to look at the EU's very detailed commitments in GATT on financial services, which tend, as I said, not to be that much and then see what you can do bilaterally. But in a bilateral agreement you can discriminate. As I said, I defer to your own excellent lawyers what is necessary, other than passporting, but in a bilateral agreement you could do less than MFN deals. That is the whole point of the bilaterals.

As I said, the attempt to do that with the US was blocked not by your Government or either industry but by our Government—I am not telling you any secrets, this is quite public—for their own reasons, which has been quite a problem in the negotiations.

Q246 **Sir Edward Leigh:** Could I ask about passporting? I do not know the exact figure, but given that there are 8,000 EU passports coming into the City of London and 6,000 passports going back the other way, why would it be in the interests to stop passporting anyway? It is not a question you can answer.

Perhaps this is a question you can answer. If you are a bank operating in the City of London, say for the moment there is not passporting and at the moment you have a branch in another EU country, you can do that because there is full equivalency of passporting and all the rest of it. What is to stop you from setting up a bank in Frankfurt or Paris if you want to?

Gary Horlick: Apparently people in Frankfurt and Paris are offering that opportunity.

Q247 **Sir Edward Leigh:** But you could still keep your bank in London and set up a sub-bank in Frankfurt, can't you?

Gary Horlick: The question is where you do the work. London has a lot of advantages, but I am really not qualified to answer.

Sir Edward Leigh: Perhaps none of you are qualified to answer. Mr Lewis?

Dan Lewis: I only have personal experience that 20 years I was working in Luxembourg for the Royal Bank of Scotland processing fund deals, Mercury Asset Management fund deals, and that was not through a passporting arrangement. It was only there—and in fact there were a lot of US banks there as well—because they could market funds across the whole of Europe from Luxembourg because there was no tax on UCITS.

Q248 **Sir Edward Leigh:** So tax is as important as the passporting or the lack of tax?

Dan Lewis: Absolutely.

Professor Winters: If I can comment on the passporting, and I certainly do not want to claim expertise in the details of this sector, if you move certain functions to Frankfurt, you are moving certain staff jobs, you almost certainly change the tax liabilities and you certainly change the regulatory responsibilities. So it is not clear that it is just a matter of switching 20 people and changing the address on the letterhead. You would have to have a very serious engagement with the German regulatory authorities acting on behalf of the Central Bank and so on.

I cannot judge the veracity of it, but the banks talk as if this is a fairly major investment that they have to make to move activities. I suggested that we needed robust mechanisms to test that out. That, it seems to me, is one of the important jobs that Government should be doing to investigate quite what the costs of that are and then the consequences so far as regulation and tax of the UK financial sector is concerned.

Chair: We are now moving on to the final section about transitional arrangements and Edward and Toby are leading on this.

Q249 **Sir Edward Leigh:** An article in *The Economist* last month argued that a temporary UK/EU customs union might be a good form of transitional arrangement so as to minimise, "The risk of falling off a cliff edge into trading on WT terms alone". I know *The Economist* has a political line so we know where they are coming from, but what do you think of that view?

Dan Lewis: I think there is a lot of difference between a transitional arrangement and a transitional period of time. I can see good arguments for a transitional period of time, which might be weeks or months, where new procedures have to be brought in and seen through. My concern about a transitional agreement is it would take a long time to negotiate and then see through. Then you have to go on to stage 2, which is the supposedly permanent agreement. I would just rather get it right the first time.

Gary Horlick: I would just add on the legal side, calling something a transitional agreement does not get you away from the rules. People figured this out in 1947, "Shall include a plan and schedule for the formation of the customs union or free trade area". You cannot just call it transitional.

Q250 **Sir Edward Leigh:** Another question we have relates to what Michel Barnier, their chief negotiator, said—that you have to have some idea of what the post—you cannot just overcome these things by calling it a transitional arrangement.

Professor Winters: Transitional arrangements come in many different flavours. As always, if the terminology is not clear we can get ourselves confused. It is very clear, as Dan has pointed out, basically as implicit in the WTO law, that you are sitting in place A, you decide you want to get to place B and it takes some time. There is an interim period.

The regulations in Article 24 of the GATT, which governs free trade areas, are very little used for interim arrangements because they give the other GATT membership a chance to interfere, so everybody tries to avoid that. They would rather declare, "This is not interim, it is definite, it just has a phase-in period". There is, however, another transitional arrangement, which says, "Here we are in A. Working out where B is is immensely complicated, particularly if you are not going to let us start until Article 50 has worked its way through, and therefore what we need to do is to create something that gives us enough space to work out where we want to get to".

That has all the uncertainty that worries Dan and worries lots of us. On the other hand, if the alternative is March 2019, here we are, MFN rules are applying, we raise tariffs and other restrictions only to reduce them again in three years' time because by that time we have fairly much agreed we want to have a fair trade area, then indeed we are creating a lot of inefficiency. It is possible to imagine a system that says, "No, we are going to create a transitional arrangement that gives us some time to work out where we are going". Two issues about that. You could say, "Indeed, we will postpone exit. We will negotiate. Exit is a done deal but exit will not occur until 2024. That will give us a chance to work out the free trade agreement". That is one thing.

The second thing is to say, "No, we exit in March 2019 but we will try to have something that is fairly much like this while we work out the details of a free trade area". To do that we would have to go to the World Trade Organization and seek a waiver. We would essentially have to say to our friends, "This is a really complicated problem". Exactly as I said at the beginning, "No one has an interest in the European and UK economies crashing completely, therefore cut us some slack for three years or four years and we can work it out". One attraction of a WTO waiver is it is time-limited. It will reassure the people who are concerned that you are just going to hide in the transitional arrangement forever, because the WTO waiver is time-limited. So you go for three years, for four years, and you say, "Please, guys, just give us the space to work this out sensibly".

Q251 **Sir Edward Leigh:** I have a last question. The Secretary of State for Exiting the EU, David Davis, told the Exiting the EU Select Committee last month, and I am quoting him, "It seems to me that it would be perfectly possible to know what the end game will be in two years" ie at the end of the Article 50 process. What is your view of that? Do you think he is right? Do any of you want to comment?

He told the Committee last month—not this Committee, the other Committee, the other place on this subject—that, "It will be perfectly possible to know what the end game will be in two years." That is quite a significant statement. He is saying you can crack it. Do you think he is right? Do you want to each have a go at that, just to sum up?

Professor Winters: He could declare that the end game is WTO rules, MFN treatment. Yes, we know that it is fine, we can do it. You could declare that we have talked to our partners for two years, we are all committed to a free trade agreement, it will have broadly the following sorts of characteristics but we still do have some of the details to fix. That, it seems to me, is not inconceivable.

I think it is inconceivable that we will have a trade agreement that can be signed by the time that we leave the EU, not least because the European arrangements for agreeing a trade deal are more demanding and different from Article 50.

Q252 **Sir Edward Leigh:** He did not say that, of course. He was quite careful what he said and he did not say that. He did not say we will have a trade deal in place. His words were, "We will know what the end game will be".

Gary Horlick: If I could suggest—I am not taking any position on that—from a commercial perspective or industrial perspective you really do not want this hanging around a long time. Uncertainty has costs.

Let me add one other thing: it is not strictly a transitional arrangement. Somewhere in GATT, and I cannot find it—you remember where it is—you are allowed specific treatment, not particularly well defined, for border areas, which could solve some of the Ireland/Northern Ireland border issues.

Q253 **Sir Edward Leigh:** You might just put that in a note to us. That is quite interesting.

Gary Horlick: Yes, I will try to find it. Border areas are different. For all I know, Gibraltar has other considerations.[i]

Dan Lewis: It seems plausible to me, yes, that the big lines of what a deal will look like will be transparent.

Q254 **Toby Perkins:** Following on from that, giving evidence to the Treasury Select Committee, the Chancellor appeared to countenance the possibility of two different types of transition arrangements, namely with or without a clear and firm end state having been agreed. Given what Mr Horlick just said about the need to have certainty as quickly as possible, how wise would it be and how likely is it that we will end up with two different types of transitional arrangements, do you think?

Professor Winters: There is a trade-off, isn't there? If the choice in March 2019 is something awful or a somewhat undefined transitional arrangement, you might decide that a somewhat undefined transitional arrangement is better. We know in our own personal arrangements that in a sense if you do not like the only solid alternative, indeed you try to postpone the decision and work out something better. It seems to me we might be in that position.

Q255 **Toby Perkins:** Under transitional arrangements, what can the UK expect from the EU in terms of treatment of our service providers as equivalent to those from EU member states?

Professor Winters: Dan made the very good point that the minute you let a transitional agreement have very much detail or very much change, you are in another negotiation and you might as well do the job properly the first time. The only plausible sort of transitional arrangement is a very broad-brush one. At least one of the forms is you let it run as is now. The minute you start to try to work out, "Yes, as is now, but we want to take banking out and we want to take cars out" or something, you are negotiating again, and the purpose of this is to create space for a proper negotiation. The transitional arrangement has to be, simply specified, something fairly similar to what we have now.

Gary Horlick: If I could add something, I would not call it a transitional arrangement, but you need something at the other end of the telescope, if you will, also. Once whatever agreement you do with anyone—not just EU, but bilateral agreements—is done, you need some provision for revisiting things to go and fix them. One of the problems much discussed about NAFTA has been that it was done 25 years ago and never changed. You need an ability to go back and change things. The term usually used is "living agreement". It is some way you do not have to go through the whole process just to change a little thing.

Dan Lewis: I would like to emphasise that in this transitional period, if it comes to that, then what we should have on the first day of it is the freedom to go and negotiate with other countries to have deals, which we currently do not.

Q256 **Toby Perkins:** On that point, Professor Winters wrote that, "The UK will need transitional deals with many other countries as well as with the EU".

What sort of deals do you think will be possible, how should the Government go about seeking them, and as far as you are aware, are we well positioned at the moment in terms of the expertise to take on many other arrangements at the same time?

Professor Winters: That is a very good question. I think that the logic of that argument is the following: other countries seeking a trade deal with the UK are very likely to want to know what our arrangements in the WTO are, ie what are they getting exemptions from by way of signing a trade agreement, and at least in some detail, if not precise detail, what is our relationship with the EU, because that determines how much you want to get into the UK economy. Given that those are going to take time, we are not going to be able to have a proper negotiation with most other countries, whether they have an agreement with the EU now or not, before 2019.

What we would propose is the following: if we can persuade the partners—and this requires them to agree, and they will not necessarily do so, but here is a job for the diplomats again—if we can persuade the other countries to say, "We will carry on as if the UK were part of the EU for four or five years, we go again to the WTO and seek a waiver, time-limited, and we are just making the commitment that over that four years after Brexit has occurred we will then negotiate a full agreement and then implement it" it seems to me again that is better than saying, "Here we are at March 2019. We have not managed to negotiate anything with South Korea, up go the tariffs. But we are really keen to have a trade relationship with South Korea and they to have one with us and in 2022 they are going to come down again". It just does not make sense.

As long as we can get to a position where there is broad agreement that, yes, indeed, the countries that currently have arrangements with the EU would like to have something rather similar with the UK, it seems to me that is the basis upon which we might seek again a time-limited waiver from the WTO to be able to do the job.

Q257 **Toby Perkins:** Is the EU likely to object to us carrying on trade arrangements with other countries on the basis as if we have not left? Is there nothing they can do about that?

Professor Winters: They could bully the other partners, I suppose, but one hopes they would not. Yet again, the point is that if we play this game in an unco-operative fashion, it is much, much less likely to end up in a sensible place than if we play it in a co-operative fashion. Of course, a negotiation argues about some stuff, but we do need really carefully to cultivate goodwill and common understandings of many of the issues. Under those circumstances I think it is perfectly plausible that the EU will shrug and say, "Yes, it is time-limited, it is three or four years, fine, work out what you can. Good luck".

Q258 **Toby Perkins:** Do you have a sense we are cultivating that goodwill currently?

Professor Winters: I think we could do better.

Q259 **Mr Ranil Jayawardena:** This is a question to all of you, but in the interests of time perhaps we could have very short answers. With regards to British jobs and incomes, is the UK's trade in services with the EU, including by overseas affiliates, more or less important than the UK's trading goods with the EU?

Dan Lewis: Off the top of my head, we are an 80% service sector economy. It generates a lot of wealth. I understand services are roughly about half, I think, of our exports. Potentially they could be much, much more. We should not also seem to think that it is all about trade deals, because trade happens anyway, especially in this era of ever-faster internet. People are able to do software coding. I work with quite a lot of developers myself from all sorts of corners of the globe with whom we have no trade deal and probably will not have one very soon and these things are really growing. There are a lot of skilled people we can tap into who are going to fall outside of that. I would remind everyone that in the next few years another few billion people are joining the internet, so I think that is a great trade opportunity right there.

Gary Horlick: I would simply add, following what you said, the digital side of this is very important; it is not well covered by trade agreements. There were some steps forward in the apparently soon to be killed TTIP, but Governments in general—no disrespect to the UK Government; it is one of the most advanced. But in general the trade negotiators are not well advanced on dealing with digital.

Q260 **Mr Ranil Jayawardena:** Services or goods? Which would you say is—

Gary Horlick: It is all digital. Forget it. There is no distinction. Forget it. You will be printing your car in a few years.

Q261 **Mr Ranil Jayawardena:** Would you agree with that, Professor?

Professor Winters: I am not sure I would go so far as printing my car, but I have some hard numbers for you for overall exports from Britain, only from 2011. So far as British exports are concerned, services account for 46% of the gross value of exports, but 53% of the so-called value added, the incomes that are generated. That is just the cross-border exports. By the time we have added in the other things, yes, services are likely to be generating more income from exporting activity than our goods.

Services also are a major component of our manufactured exports. Around 20% of the value of our manufactured exports is in fact embodied services, services that the manufacturers have brought in, which may be traded or may be not, but they are brought in.

Gary Horlick: But mostly digital.

Professor Winters: Probably mostly digital, and even some printing cars, Gary, I will give you that.

Q262 **Mr Ranil Jayawardena:** Mr Lewis, I was struck by what you said, and you are absolutely right, of course, that we trade with countries that we have no free trade deal with and with which we are very unlikely to have a free trade deal with any time soon. Do you think that businesses understand or are prepared to make a success of the opportunities that we can have with the rest of the world, whether or not we have free trade deals, as we create a level playing field?

Dan Lewis: People will always do business with you if you have goods and services they want to buy. That is the starting point.

Q263 **Mr Ranil Jayawardena:** But are we prepared to export more? Are we prepared to access those new markets?

Dan Lewis: Yes, I think we are. Certainly we could do a lot more. I think it is interesting that China has a 25% import tariff on cars, but Jaguar Land Rover seems to be doing very well there. I think there are huge opportunities to tap into in the Pacific Basin particularly.

We are also an import-driven economy and imports add value too. I always think of coffee. There are so many coffee shops all over the country and lots of baristas. If we were to suddenly decide we were not going to import coffee a lot of people would be unemployed. More seriously on coffee, you have the issue of tariff escalation. Raw, untreated coffee beans have a 0% import tariff, but if they are roasted then it jumps up to about 8% or 9% from Brazil. So what you might see is a divergence of the big coffee chains who have their own roasting and coffee preparation facilities, and the smaller independents who like Fairtrade coffee, but they may also like fair and tariff-free trade coffee. So let us see. I do not know where it is going to go.

Chair: Thank you. That concludes our evidence session this morning. We are extremely grateful for you coming in and giving your expertise to us and answering our questions.

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[i]Article XXIV:3(a) of GATT: https://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_09_e.htm