HOUSE OF COMMONS

Business, Energy and Industrial Strategy Committee

Oral evidence: Leaving the EU: Implications for UK Business, HC 384

Wednesday 31 January 2018

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Watch the meeting

Members present: Rachel Reeves (Chair); Vernon Coaker; Stephen Kerr; Rachel Maclean; Albert Owen; Mark Pawsey; Antoinette Sandbach.

Questions 1 - 63

Witnesses

I: Emily Lydgate, Lecturer in Law, Sussex Trade Observatory; Stephen Booth, Director of Policy and Research, Open Europe.

Examination of Witness

Witnesses: Emily Lydgate and Stephen Booth.

Chair: Thank you very much, Stephen Booth from Open Europe and Emily Lydgate from the Sussex Trade Observatory, for coming to give evidence to our Select Committee today. We also asked the Legatum Institute to give evidence today, but unfortunately they pulled out at the last minute. We do appreciate both of you coming in.

As you know, we have been looking at the impact of Brexit on different sectors of the economy. We have looked at pharmaceuticals, automotive, aerospace and the food and drink sectors. We have tried to do deep dives into those different parts of the economy to look at Brexit's effects and different implications. We will be asking some questions about those sectors today.

Q1 **Antoinette Sandbach:** Ms Lydgate, could you explain whether a sector-by-sector approach would be legally possible? What examples are there?

***Emily Lydgate*:** It is a big question. The first thing is that, for the record, it should be stated that such a deal would have to be situated in a full free trade area that covers substantially all the trade between the UK and the EU in terms of tariff headings. The EU normally incorporates this WTO requirement into its FTA negotiations by saying that 90% of tariff headings have to be included in the FTA, with some coverage of all sectors. Once we go beyond that, it might be useful to think about this in terms of a customs union or tariff barriers and then single market or regulatory barriers. Another way of phrasing it is: could we recreate the additional benefits that we get from the customs union and the single market on a sectoral basis? If I may, I have a couple of thoughts on each of those.

In terms of a customs union, which creates a common external tariff, which allows good to circulate freely without needing rules-of-origin checks, we have to keep in mind that not all customs unions are created equal. When the UK leaves the EU, it will leave the EU customs union and it would need to conclude a separate customs union with the EU. The EU customs union is uniquely comprehensive and covers virtually all goods. We might not be able to recreate the type of market access that we have. Indeed, most customs unions do include some sort of border checks. The EU customs union did not, up until 1992. That is important to keep in mind. In terms of single market regulatory access, that would require some rethinking of red lines on both the EU and UK sides.

Q2 **Antoinette Sandbach:** What about services?

***Emily Lydgate*:** In terms of what services specifically?

Antoinette Sandbach: Financial services and legal services. Those are sectors too, are they not?

Emily Lydgate: Would we be able to recreate existing market access? Again, I think it would require rethinking of some red lines on the UK side, in terms of having some oversight by the Court of Justice. On the EU side, preserving the integrity of the single market is not something we can do through a sector-by-sector approach; that is something they have said. There is scope there.

I apologise for going on for so long, but to answer the second part of your question, the Swiss model would obviously be relevant here, because it is specifically based on bilateral agreements. It does not cover services but we could think about that as being relevant. Of course, the problem is that the EU is not a big fan of this model. They find it quite cumbersome.

Q3 **Antoinette Sandbach:** Mr Booth, Open Europe has said that a half-in, half-out approach would be bad. Do you regard the Swiss model and the Norway model as half-in, half-out?

Stephen Booth: It depends. The Norway model is pretty much fully in when you are talking about the single market. It is obviously out of the customs union. What we were talking about in terms of a half-in, half-out model there was referring to the customs union. We are very sceptical of one of the proposed models for effectively completely mirroring the EU customs union: maintaining the same external tariff, which would severely limit the UK's ability to conduct an independent trade policy. We find it very difficult to understand how that would reduce paperwork for business, because you would still have to prove that your products were originating in the EU customs union. In terms of the need to obviate customs checks, it is quite hard to see how that works. As Emily said, in the customs union, the Turkish model of the customs union with the EU still involves some degree of rules-of-origin checks and border checks. There is no precedent at this stage for a customs union with the EU that completely solves the issues that we are talking about.

Q4 **Antoinette Sandbach:** When assessing claims that we can get exactly the same benefits by being out of the single market and customs union but we could still leave the political institutions of the EU, how realistically achievable is that?

Stephen Booth: It is not realistic. We have to accept that there is a trade-off. We voted to leave the European Union. It is very difficult to see how everything else could remain the same. If the Government are serious about leaving the single market and the customs union, inevitably that is going to change the trading relationship with the EU. The goal should be to minimise the impact on business. There are lots of ways in which you can do that, and look at different precedents for how that might be done. In the sectors you are looking at in particular—the complex supply chain industries that have built up over time in our membership of the single market—it makes sense to try to remain as integrated with the EU as possible.

Q5 **Antoinette Sandbach:** How would you say that the Government should prioritise these negotiations? Should it be our biggest sectors, the most productive, the most integrated with the EU, or SMEs? What do you think would help minimise the damage, as you put it?

***Stephen Booth*:** You need to look at a series of trade-offs. In the sectors such as these, which are manufacturing supply chain industries, we need to look at what we are trying to achieve. Are we trying to create a new supply chain with NAFTA or Asia? Is that a realistic aim? There are a lot of reasons to be sceptical about that. Are we trying to effectively minimise the damage to our supply chain with the EU in these sectors? That seems to be the most obvious thing to do. Therefore, you have to be closely aligned. That means you will probably have to have a very similar, if not identical, regulatory system for those sectors.

Q6 **Antoinette Sandbach:** On that point, in terms of a regulatory system, if you are exporting to the EU, assuming we had third-nation status, would we not have to accept their regulation anyway?

***Stephen Booth*:** Yes.

Q7 **Antoinette Sandbach:** If we go out on to WTO rules, we become rule-takers in any event?

***Stephen Booth*:** In terms of exporting finished products or final products to the EU, yes. Again, that is why you need to think about distinguishing between exporting a finished car to a third market, be it the EU or around the world, and being part of making that car. At the moment, we are part of the European supply chain in manufacturing those products. It makes sense to stay integrated in that endeavour. In terms of exporting the final product, we already export cars to non-EU markets. If a UK firm wants to invest in being a part of a US supply chain, for example, there is nothing stopping a British company investing money in doing that or setting up a plant in those jurisdictions.

Antoinette Sandbach: At the moment, anyway.

***Stephen Booth*:** We need to think about what it is we are trying to achieve in different sectors.

Q8 **Stephen Kerr:** Can I share with you something the Prime Minister said to the Liaison Committee? She said, "Alignment means that we have the same objectives… There will be some areas where we have the same goals—the same objectives in terms of regulation—but wish to achieve them by different means". I wonder if you can help me, in the context of that quote that I shared with you, in terms of what the advantages are for UK companies of regulatory divergence from the EU.

***Stephen Booth*:** That depends very much on the sector. We also need to distinguish between the snapshot of the day after we leave the European Union in 2019 or after the transition period, and five, 10, 15 or 20 years down the line. It is quite possible to imagine the EU coming up with regulation that is very costly to business, which not the entire sector would want to sign up to in the future. That is the important thing here. That is why I have sympathy with those arguing that we cannot forever be rule-takers in these sectors and that we need to have flexibility in the future, particularly if we are no longer shaping or voting on those rules of the single market. While we are clearly going to have to conform with those rules while selling into the market, why would we necessarily say that we want our entire economy to be regulated by effectively a foreign jurisdiction? Politically that is very difficult and, from an economic point of view, in certain sectors it is going to be very difficult to argue that that should be the case.

Q9 **Stephen Kerr:** In the context of the four sectors we have looked at, we have not had anyone make a case for greater regulatory freedom. Not one of the organisations we have spoken to thus far has identified regulations that it would like to do away with. What do you read into that?

***Stephen Booth*:** That is often the case. Once a business has taken on the cost of adapting to new rules, which might be costly in the first instance, it does not make much sense to then rip up those rules and adapt to a new regime. Business would often say that it is quite happy with the status quo because change is notably costly. The issue is that none of us can see into the future and none of us knows what the regulatory environment may look like. Particularly once we have removed ourselves from the political councils of the EU, which are deciding all of these rules, do we really want to subject ourselves not just for those industries that export into that market, but for the entire scope of those sectors in all our economic dealings? Do we want to outsource that to a foreign jurisdiction? That is quite a hard argument to stand up politically.

Also, in terms of the sectors, if you look at, say, when the chemicals regulation, REACH, came along, which is a very costly regulation that companies here complained about as it was being introduced, the Swiss had the opportunity to look at it and how it affected their economy, and they could make a decision. They decided primarily to align themselves with it but not word-for-word. That is an option the UK should give itself in the future.

***Emily Lydgate*:** Regulatory alignment and what it means is obviously a one million dollar question now.

Stephen Kerr: It is. At least, it is the four thousand dollar question.

***Emily Lydgate*:** We agreed in the joint report that we would have full regulatory alignment. It is worth noting that regulatory alignment does have a specific meaning to the EU. In the past, it has meant the gradual integration of countries at the periphery of the EU into the internal market. If you look at, for example, the Ukraine-European Union Association Agreement, words such as "harmonisation", "alignment" and "approximation" are used pretty much interchangeably.

Q10 **Stephen Kerr:** These words that you mentioned—"equivalence" and "harmonisation"—they mean something that is pretty much the same thing to the European Union.

***Emily Lydgate*:** Yes.

Q11 **Stephen Kerr:** To us, in English, they do not necessarily mean the same thing, do they?

***Emily Lydgate*:** They mean the same thing in that, for example, in this agreement Ukraine is, over a period of time, expected to conform its regulation to EU regulation. There are monitoring mechanisms of that in the European Commission. There are compliance mechanisms of the interpretation of EU law by Ukraine, underpinned by the ECJ. The question that we are wondering on the UK side is whether we could have alignment through mutual recognition, so alignment in a way that allows us to diverge.

This is not something that the EU has done on a sectoral basis, except in very limited circumstances; we can get into that. Again, the question also is about what the benefit of this is. Is divergence something that will benefit the UK? I would agree with Stephen, and with the previous evidence sessions you have heard, that in the sectors that you have looked at, divergence does not seem to be something that those industries are interested in.

Q12 **Stephen Kerr:** Let us focus on one of the sectors: aerospace. They are largely dependent on global standards. There is really not much possibility for a divergence in aerospace, is there, as an example?

***Emily Lydgate*:** Yes and no. Aerospace is a unique industry because, as you say, it is quite globally integrated. There are benefits to the UK of maintaining itself in the EU regulatory space—for example, EASA membership. The UK could try to become an associate member, like Switzerland and Norway, I think—I am not positive about that—but that involves not having voting status. One thing that really came across to me in listening to the oral evidence session is the extent to which the UK has really contributed to the expertise of that body, not only in making sure that our planes are safe but also in making sure that their safety specs are good for UK producers. We lose some of that influence and then we have to enter as a third country on the basis of mutual recognition. We will lose some of that influence.

Q13 **Stephen Kerr:** Can I ask Stephen to comment on the use of language here, in terms of "alignment", "harmonisation", "equivalence" and so forth?

***Stephen Booth*:** Yes. Perhaps I can also say something on the aerospace sector, because we are looking at air services in some of our work.

On alignment and mutual recognition—and this is something that Emily wrote in her paper on this—there are different methods of doing that. There is mutual recognition of, say, the certification of products, so whether a product is compliant with EU standards and whether the EU will recognise a UK body certifying that. There is another scope of mutual recognition, which effectively is about whether you have identical or equivalent actual regulation to the EU's. Again, you could look at how, in different sectors, perhaps you would want to use a mixture of those two models, if that was something the EU was open to.

Ultimately, a lot of this comes down to the governance framework for any new agreement. What dispute mechanism would there be? How do you manage divergence, which, whether business likes it or not, is inevitable to some degree? I do not think it is possible to say that we are going to simply be exactly the same. The EU will change in the future and the UK will change in the future. We are going to have to need some system to manage that process.

Q14 **Stephen Kerr:** It is the stuff of free trade agreements, is it not?

Stephen Booth**:** Yes, although what we need here is something more sophisticated than the traditional free trade agreement. We need to look at a mixture of things. The Swiss have lots of intensive co-operation through joint committees. The EU clearly wants more than that in terms of oversight. There will have to be some degree of arbitration and judicial input. The UK would argue, rightly, that that has to come on both sides, but, to the earlier question, the UK cannot expect to change the EU regulatory environment. We have to deal with the fact that the EU is going to regulate how it wants to. The question is: if we diverge from that, what is the consequence of that? How can we manage that in a system that both sides have enough faith in that it does not blow up the entire agreement every time we come to one of those junctures?

Q15 **Antoinette Sandbach:** Is the EFTA court a good model, from that point of view? Emily, you spoke about us losing our influence; how much practical influence do EFTA countries have on regulation? There is some form of consultation, is there not?

Emily Lydgate**:** First of all, the EFTA model does fit some of our criteria. It does not have direct effect and it is at arm's length from the ECJ, so it can diverge in its rulings, but it is predicated on what is very clearly a rules-taking model of being within the single market and having all of those freedoms. I think the EFTA joint committee meets something like eight times a year and considers whatever changes there have been in EU regulation and how it can incorporate them. That is certainly not a kind of model that the UK seems to want to emulate.

Antoinette Sandbach: But in terms of the assessment of limiting the damage, as it were—

Stephen Booth**:** In terms of the principles of the EFTA settlement, if you are trying to align yourself in certain sectors and it is limited to those sectors, the basic principle of the UK saying, "In order to have single market-like access in these sectors, we recognise we need to align ourselves to your rules, with some potential wiggle room for our specific circumstances," is a model you could look at. The problem with the EFTA model is that it does not just apply to those areas; it applies to services, social employment law, environmental standards and everything else. That is where you run into very clear UK red lines that would be very difficult to overcome. That kind of model of aligning yourself to the EU model in certain sectors could work.

On the aerospace issue, if I could come back to that, we also need to look at this from the EU side. It strikes me that the obvious deal on air services, which the sector is already starting to adjust itself to, is that we are going to lose certain cabotage rights within the EU. Maintaining air services between the UK and European jurisdictions seems very sensible. Both sides want to do that. The UK right to fly between EU member states and within member states is going to be curtailed. You have already seen companies start to adjust to that by applying for licences and setting up subsidiaries in the EU territory. If the quid pro quo for that is that the UK industry wants to maintain a strong relationship with the agencies, it is surely in the EU interests for the UK to be part of those agencies and be part of a collective standard-setting procedure for what is effectively collective airspace. The argument on the EU side for excluding us from that, if the industry wants it, is pretty small.

Q16 **Mark Pawsey:** I am a bit unsure about where we are here, because one of the issues for those who advocated that we leave the EU was that we would be able to set our own rules and do lots of things in our own way, but both of you are telling us, and the evidence we have had in our Select Committee is, that we are going to have to adapt to the EU rules. We visited Honda, for example, last week and they are not going to manufacture a Honda Civic for the UK market that is slightly different from the Honda Civic that they are producing in Swindon for the entire European market. If we are outside of the EU, are we going to set up a whole new set of regulatory bodies that are going to negotiate with the EU? What is going to happen if there is some form of dispute? We spoke about the EFTA court, but are we going to continue to accept the jurisdiction of the European Court of Justice? Where does all that fit in?

***Emily Lydgate*:** For virtually all the sectors that we are considering—certainly aerospace, auto and pharmaceuticals—there are basically two games in town. There is the US and there is the EU. I do not think there is real scope for divergence, certainly not in the sense of coming up with a bespoke UK regulatory model. The EU is effectively a regulatory magnet that is sucking in not only countries in its periphery, but some further afield. What could UK companies do? They could diversify towards US specs and try to smooth trade barriers there. There are costs to doing that. In the context of TTIP negotiations, the European Commission did an impact assessment and they estimated that it would be equivalent to a 26% tariff.

Q17 **Mark Pawsey:** We are already doing that. If we go back to Honda, Honda are producing a lot of Type Rs—they sell brilliantly in the States. The products coming out of the factory are being manufactured for the European market, and some are going to the US. My point is that we are not going to create a third tier, are we, because the UK is going to be separate and independent? I am struggling to understand what the benefits are. What are we achieving by what we are doing?

***Emily Lydgate*:** In terms of market opportunities, the argument would be that there are low-hanging fruit. For example, if India has a 150% tariff on whisky, a trade deal with India could be lucrative for Scottish whisky producers. The idea is that there are other opportunities out there that were being held back. Another example that is illustrative of this question of why we are leaving an incredibly integrated free trade area to become a global free trade leader is an article last year, I think in *The Guardian*, about butterfly farmers who are very concerned about losing single market access because they pack the butterflies before they hatch and then they go to the EU. If there are border delays, they could hatch in transit. They want to stay in veterinary specifications. Butterfly consumers in the UK are arguing that we should deregulate the butterfly sector because, in that way, we will be able to get cheaper butterflies.

Q18 **Mark Pawsey:** I am not sure it is going to have a massive impact on our economy. I am going to come on to ask questions about opportunities outside the EU later on. Mr Booth, how is this regulation going to work? We are going to effectively continue to accept the rules of the EU and the judgment of the European Court of Justice in the event of a dispute. Is that going to be harmful to our interests?

***Stephen Booth*:** On the first part of your question, I can see the argument for seeing ourselves very much aligned in these specific sectors. In other sectors, particularly the services industries, the argument is much weaker. We need much more freedom to diverge.

In terms of dispute settlement, I do not see why the UK has to submit itself to the European Court of Justice as the final arbiter. What we will have to do as EU regulation develops, because the ECJ is part of that process—when the ECJ rules on a regulation it changes the nature of a regulation—if our market access is dependent on aligning ourselves with that, we will have to align ourselves with future ECJ rulings. That is not the same thing as saying that if we disagree about the nature of our regulation or the nature of our alignment with the EU, the ECJ decides whether it is aligned or not—that is a completely different issue. That is a dispute settlement. I cannot see the UK signing up to something for which the ECJ is the ultimate arbiter.

Q19 **Mark Pawsey:** Why would it be harmful to the sectors that we are looking at here if we were to adhere to judgments of the ECJ? How would that damage the interests or our economy?

Stephen Booth: They are two different issues. Adhering to judgments of the ECJ pertaining to specific regulations and what they mean is inevitable. That is what the Swiss have to do if an ECJ ruling changes the nature of a specific regulation. That is not the same thing as when the EU says to us, "Your regulation is no longer aligned with ours. We are going to get the ECJ to tell you it is not." That is a different process. I do not think the UK would submit itself to that politically, and it is not in our political or economic interests to have a foreign court, in effect, tell us whether we are compliant with a treaty or not.

Q20 **Mark Pawsey:** Do you think they would do that? Do you think the European Court of Justice would arbitrarily see a UK regulation and say, "That is different from ours. We are going to instruct you to change"?

Stephen Booth: I do not think the UK would sign up to an agreement that does that. The important precedent here is the withdrawal negotiations in which the EU started off by saying that any disputes over the rights of EU citizens have to go to the ECJ. We ended up with an agreement that said that the ECJ will have say over this for a sunset period of eight years, and after that it will be done through arbitration of some kind. The model that we should be looking at is some form of arbitration over which both sides have input.

Emily Lydgate: This is an obvious point, but the more regulatory integration we have with the EU, the more judicial oversight they are going to want to have. Perhaps it would be useful to think about some of the existing models of EU trade agreements in this context. For example, CETA, which the UK Government have cited as a potential model, has dispute settlement that is independent of the ECJ. Essentially, parties talk to each other, and, if they cannot work it out, they go to arbitration; it is a classic FTA model. It does not require parties to change their laws. They can impose trade sanctions. The key question for the UK right now is how much regulatory integration such a model can bear.

I am a bit sceptical. The EU is quite protective of the ECJ as being the ultimate authority on matters of EU law. It is also worth noting that, even for CETA, the investor state dispute settlement element of CETA is facing controversy in the EU, because it allows for the awarding of damages. Belgium has requested the ECJ to look into whether this undermines the competence of the ECJ. We could probably expect that there would be a role for the ECJ in more regulatory integration.

Q21 **Rachel Maclean:** We have heard from the former Minister, Dominic Raab, who says that where there is a demonstrable national interest in continuing a relationship with an agency or EU body, the Government will look very carefully at that. That would apply to the European Medicines Agency and EASA. Do either of you think it would be in the national interest to remain in both or either of those?

Emily Lydgate: Yes, in both cases certainly. We talked a bit about EASA. In the EMA context, my understanding is that the EU has been clear that we would be a third country. I could be wrong about that. We could have it as a negotiating objective that we be part of the EMA. In terms of third-country relationships with the EMA, they are quite distanced as compared to what we get now.

Stephen Booth: It is complicated. It clearly makes sense to have a working relationship and a co-operation agreement with them. For EASA, it is very obvious why that is the case. It is very important in developing the technical standards. The UK has provided lots of input into that in the past. We are clearly not going to create a separate aviation market to that of the EU. In medicines, I am not as familiar with the workings of the agency, but there might be a case for more divergence than in aviation.

Q22 **Rachel Maclean:** Why do you think that?

Stephen Booth: Again, I am not entirely sure how that works but, in terms of us wanting to approve certain medicines in our market that might not be approved in the EU market, we might want to take different decisions. In terms of how our products are marketed in the EU, we are going to have to work with the EU authorities on that. The stance we might take on certain issues domestically in that sector might be different, because there is a domestic market that is not tradable, whereas the aviation sector is, by its very nature, a cross-border industry at all times.

Q23 **Rachel Maclean:** We heard from witnesses who told us in EMA a standalone UK regime would increase cost and delays and make it a less attractive place to develop new medicines. Emily, do you have a view on that?

Emily Lydgate: I am not a sectoral expert on medicines, but there did seem to be issues with batch release. If you have that separate regulatory relationship then you have to establish a subsidiary in the EU. Based on that perspective of industry leaders, it seems that that was desirable.

Q24 **Rachel Maclean:** If we have to remain in the remit of these bodies, do either of you think that will necessarily mean we have to accept the free movement of people? Is it possible to have a relationship with them that does not include free movement of people?

Stephen Booth: That is very difficult to say at this stage, because we do not know exactly what the EU's position on that is, but that is up for political negotiation. It is quite likely that any future deal with the EU will involve some degree of co-operation and possibly a preferential system for EU citizens. Right now it is purely speculative to ask what the EU's trade-off is going to be in terms of our market more generally and what that means for free movement of people.

Q25 **Stephen Kerr:** Are mutual recognition agreements essential for a good deal? Do we have to get mutual recognition agreements?

Stephen Booth: They are a very important aspect. As we discussed earlier, there are two different ways of thinking about it. Mutual recognition of testing and conformity assessment is very important in that it reduces costs for business; otherwise, you might have to test your product in different markets at extra cost. Again, in the sectors in which we are going to align ourselves, voluntarily or otherwise, to EU regulation, it does not make much sense to do that if we are not going to get credit for it in the sense of it being mutually recognised by the EU and gaining market access for that. Mutual recognition is obviously the other side of the coin of us saying that we want to be aligned with the EU in these sectors.

Q26 **Stephen Kerr:** Given what the Commission has said, do you think they will agree to regulation from a third country? We will be a third country. Is there a track record of being willing to recognise the regulatory bodies of third countries?

Stephen Booth: Yes, in different contexts and different precedents. Countries that do not have trade agreements with the EU have mutual recognition agreements on conformity assessments of certain products. They have mutual recognition agreements on customs procedures and so on. The UK is aiming for more than that. If we want to have mutual recognition agreements for the actual meaning of our regulations and standards, the EU's demand for that will be that our standards are very closely aligned, if not identical, with the EU. That is the trade-off the UK has to weigh up in terms of whether that is worth it.

Emily Lydgate: I agree with Stephen. It is really important to be clear about what we mean when we say mutual recognition. We can look at EU practice now and it is doing two things. The first thing is mutual recognition agreements of conformity assessments. It has done this on a limited basis with the US pharmaceutical industry, for example. That means US companies can certify their products and meet EU specs. We still have separate product lines.

The other thing they have done is the mutual recognition of technical regulation in the context of broad regulatory integration. We are talking about the idea that you have all this harmonisation but you have some regulations where you do not align but countries will still accept each other's goods anyway. That is how the EU member states function in the EEA, and this principle of mutual recognition is also extended to Turkey.

The idea of having mutual recognition of technical regulation strictly on a sectoral basis, where you genuinely acknowledge that there are differences but they are equivalent—they are the same—is not something that the EU is really doing, even when it looks like that is what they are doing. For example, in the EU-Korea FTA there is a section on mutual recognition for autos. If you read the section, essentially what it says is that Korean autos are going to follow UNECE—basically EU—specifications.

The idea of regulatory divergence is perhaps not going to enter in so much in this mutual recognition of technical regulation. What we could do is ask for something similar. We could say that the UK vehicle certification agency has equivalent standards to EU standards and will be recognised. We could expand this to more sectors. This could be our ask. The downside of this is that there is less judicial oversight. It is based on trust. That means there are less services for businesses. Either party could pull out but it could allow for a more arm's-length relationship.

Q27 **Mark Pawsey:** I want to follow on from part of the discussion we had earlier, which is the opportunities that might exist for the UK industry, and particularly the sectors we are looking at in this inquiry, outside of the EU. I have been a bit disappointed to hear from business that there are challenges in generating extra business. Emily, you told us about the opportunities in India, as we heard from the Food and Drink Federation, if we were able to negotiate a reduced tariff on whisky. Could you give us some examples of the opportunities that exist for the sectors we are looking at in markets around the world that we are not able to work hard and achieve successfully in the current climate?

***Stephen Booth*:** In some of the developing markets that you mentioned, some of them are still quite protected in terms of tariffs. If the UK is able—and I would argue it should seek to be able—to negotiate its own trade agreements, there is an opportunity to reduce costs on trade with those markets, in terms of what are quite high tariffs if you compare them to the EU tariffs and tariffs globally, in some markets—for cars and food and drink, as we have heard.

On a more general point, even if we had remained in the EU, diversifying away from Europe in terms of building our market share in non-EU markets had to be part of the UK's objective anyway. That is now even more important as we are leaving. If we think about it in those terms, it may also change some of the calculations we have been talking about in terms of the need to be a rule-taker or the desirability of that. Our current exports to the EU are just over 40%, at 43% or 44%. If they are reduced to 35% or 33% in 10, 15 or 20 years' time, the argument that we need to have all of our regulations aligned with the EU is much weaker at that point.

Q28 **Mark Pawsey:** If we are going to go out and search for business in these other markets, and they have been negotiated up until now with the EU and we have not been able to take advantage of any arrangements that the EU have, why should those countries give us more favourable status than they would give the EU?

***Stephen Booth*:** I do not think they necessarily will.

Q29 **Mark Pawsey:** What is the benefit of being out on our own, then?

***Stephen Booth*:** There are certain countries with which the UK can negotiate that the EU has not done a deal with—India and China, for example. Looking beyond the sectors that you have chosen to look at, which are traditionally strong EU sectors because other major member states, such as France and Germany, have a strong interest in them, if you look at the services sectors where the UK has a much strong interest than the other EU economies, we are going to have a lot of areas in which we do think we can go further than the EU. We are already more liberalised. We would be able possibly to integrate more with non-EU markets.

The opportunity for the UK is in emerging markets. The demand for the kinds of services that we are strong in is only going to increase as those countries become wealthier and the middle classes in those countries grow. Those are the thing that the UK needs to bear in mind when thinking about whether we want to hamstring ourselves in our ability to trade with non-EU countries.

Q30 **Mark Pawsey:** How important is it to have trade agreements? We have WTO rules. We have the existing arrangements that the EU may have negotiated with some of the countries already. If we are going to negotiate our own agreements, those are going to take an awful lot of time. How important are they? Once we are out and are able to negotiate on our own, should we just crack on with it without worrying about getting agreements in place?

***Emily Lydgate*:** You would have to answer that on a sector-by-sector basis.

Q31 **Mark Pawsey:** Is there a sector where there are going to be real opportunities?

***Emily Lydgate*:** Cars, for example. We would want to maintain tariff-free access with the EU. Maybe there are opportunities for, say, Aston Martin in China, if we did a trade agreement there.

Q32 **Mark Pawsey:** How many more Aston Martins would we be able to sell if there was a trade agreement compared to how many we are selling now? What would the terms of the agreement need to be to give us a significant difference?

***Emily Lydgate*:** This is the key question: whether the trade-off will be worth it. Right now, we are inside the EU regulatory space. If we are able to conclude an FTA that gives us, say, tariff free access, would that then offset the disadvantages in terms of increased regulatory barriers with the EU? I do not have the sense that there is a huge amount of low-hanging fruit in the rest of the world, if you consider the kinds of supply chains that we are talking about. We are talking about technologically advanced, high-tech industries, which are extremely specialised, which get their profit margins based on efficiency. We have these set up and integrated throughout the EU. Again, I am not a sectoral expert but it seems quite a high risk.

Q33 **Mark Pawsey:** If we left to one side the sectors we have looked at here, which you have described as being high-tech, are there any other sectors? We have spoken about services. Is there anything in manufacturing goods where we could do particularly well in overseas markets, free from being constrained by our membership of the European Union?

***Stephen Booth*:** It is not something I necessarily see. In manufacturing sectors and the goods sectors, it is much harder to make that argument, because effectively the EU has been set up to do that. The EU single market is set up to create manufacturing supply chains and export those things to the rest of the world. That is what Germany is very good at, and it is no coincidence that Germany is the most important European state and the EU is good at those things. In terms of manufacturing, that is not obvious.

In new technologies, in data and in services, where traditionally the EU has been weak and market integration has been weak, the EU has often taken steps that have made itself uncompetitive versus the rest of the world.

Q34 **Mark Pawsey:** If we have strengths in those areas, are we currently impeded from going ahead and doing deals with countries outside of the EU because of our membership of the EU?

***Stephen Booth*:** It is generally recognised that in the sectors in which we probably have the most offensive interest, in services, the EU has not necessarily taken as strong a position as the UK might do alone.

Q35 **Mark Pawsey:** What has prevented us from pursuing our own route even as a member of the EU? Why have we not done that?

***Stephen Booth*:** We have.

Q36 **Mark Pawsey:** Have we been successful?

***Stephen Booth*:** If you look at it proportionally, we export more of our goods to the EU than we do to the rest of the world. In services, we are much more diversified to the rest of the world than we are to the EU, despite it being the most sophisticated single market in services that exists. We are already trading to our strengths, to a degree. I would expect that outside of the EU we would expect to do that even more. We could be more aggressive in furthering our interests in those services and acting independently than we do as part of the 28.

Q37 **Mark Pawsey:** Do you think our membership of the EU has prevented us from going out and being an aggressive salesman for UK services in recent years? Is that about to change?

***Stephen Booth*:** I do not think it has prevented us from being aggressive salesmen. It might have prevented us negotiating agreements with third countries that might play more to those strengths than we might otherwise have done independently.

Q38 **Rachel Maclean:** The four sectors that we are looking at you have already said are EU-heavy sectors, in a sense, and the EU has been set up to focus on those. Do you think that in the negotiations the Government are right to focus on making it a priority to roll over existing EU trade deals with third countries in those sectors? Do you think that is the right thing to do, or should the Government seek to do something different from that?

Emily Lydgate**:** Overall, EU FTAs cover certainly more than 15% of UK trade. I am not sure of the breakout for these particular sectors, but in general it certainly seems to me that rolling over existing FTAs as seamlessly as possibly would be an important objective in order to preserve those tariff-free export opportunities.

Stephen Booth**:** I agree. I would add something to that, which is obviously going to be a point of negotiation during the transition as well, about how much the EU wishes to help us with that. There is a strong argument for why the EU should do, given that, as we have been talking about, these are complex supply-chain industries. A lot of EU companies have had investments in the UK, in terms of manufacturing these products, that would be harmed if we are not able to triangulate the relationship between the EU, the UK and those third countries. Despite it being a point of negotiation—and I am sure there will be some politicking around it—I think there is a strong interest for both parties, the UK and the EU, to work in concert to deal with this issue, just as the UK and the EU have worked together in terms of rectifying the UK and EU schedules at the WTO as well, for the same reason.

Q39 **Rachel Maclean:** Do you think that no deal and WTO tariffs would be better than a bad deal for these four sectors?

Emily Lydgate**:** This is a bit of a spoiler alert, but UK TPO has a paper coming out next week, which we are launching at Chatham House, which looks at the impact on manufacturing under various scenarios; one of them is no deal. One of the things that we see is that in processed food, the erection of very high tariff walls between the EU and the UK—because we would be applying EU tariffs, and it has, for example, 35% to 45% tariffs in dairy—would encourage UK dairy production. What economists would call trade protectionism would then stimulate domestic industry. Of course there are other questions: do we have the processing facility to handle all this additional demand for dairy? Do we have the labour? What kind of impact would this have on consumer cost and availability and diversity of the product?

On the other hand, the sectors that would be the most harmed are these high-technology, complex supply chain products, like vehicles. Whether we would want to have a trade policy that embraced or suppressed these crown jewels of UK export and encouraged agricultural production is another question.

Stephen Booth: It depends on the extent of the damage to different sectors. Generally, a deal that removed tariffs is better than no deal. The issue of no deal is really a political one, rather than an economic one. The question is about what the political price is that the EU is demanding for the deal. It comes back to the question of rule-taking and so on. If the only deal on offer is one that effectively means that we have to be in the single market and accept all the rules written in Brussels, that would be very difficult to accept from the UK point of view. That is a political issue rather than an issue of tariffs or whatever. Quite clearly, it is in everyone's interests, including the EU's, to avoid tariffs in these sectors.

Q40 **Antoinette Sandbach:** You have answered many of these questions already, but I will give it a go. How much of a negotiation and negotiating priority should tariff-free and frictionless trade be for each of the four sectors that we are looking at? Emily, you have answered that with the example of the butterflies. Is there anything more you want to add, Mr Booth?

Stephen Booth: We have to be careful with the word "frictionless". That is quite a difficult ambition to reach. We need to be honest about that and accept the fact that leaving the single market and customs union is likely to mean there is greater friction than now.

The question is how much there is and how much we can minimise that. There are particular issues on the border of Ireland. When Emily referred to the withdrawal agreement earlier, about the UK agreeing to apply regulatory alignment, the end of that sentence is about regulatory alignment in the aspects of customs union and single market that are essential to north–south trade in Northern Ireland. That is where we have to become much more focused on what the specific things are that the EU thinks we have to be aligned with in order for them not to erect border posts, in effect, to test our regulatory alignment. No one has defined that yet. The EU has not defined that for us either. We need to get to the nub of that.

Q41 **Antoinette Sandbach:** There have been all sorts of suggestions that in relation to Ireland we can have some kind of whizzy electronic customs system that can implement this frictionless trade. I use the word "frictionless" deliberately, because that was what was claimed by the Leave campaign: that it would be possible to secure frictionless trade. Are you aware of any customs system that operates on that basis: that is frictionless and does not involve delays?

Stephen Booth: All the borders that we have looked at—Canada-US, Switzerland-the EU, and Norway-Sweden—require some degree of infrastructure.

Q42 **Antoinette Sandbach:** Does that mean friction in terms of delays, increased wait times at borders and increased paperwork cost for businesses?

Stephen Booth: Yes, increased as opposed to now. They are still quite minimal in many cases but in terms of paperwork, probably. The issue again here is that the UK and the EU are starting from a point of no friction, so it is about what we can do to remain as close to that as possible.

Why the Northern Ireland issue is complicated is because it is not simply about whether we are in the customs union or not; it touches on the issues you are looking at, such as regulatory alignment and so on. Dealing with the customs issue—collecting tariffs, for example—is something that can very easily be done away from the border. It can be done through a database, spot checks and so on.

Q43 **Antoinette Sandbach:** Does that not incentive smuggling, though?

Stephen Booth: We already have smuggling across the Irish border.

Q44 **Antoinette Sandbach:** Yes, but are we not creating a massive border that would have huge incentives for smuggling? At the moment, the customs arrangements either side of that border are identical.

Stephen Booth: There is a potential risk that you would have some smuggling, but we already have different excise rates for tobacco and alcohol, for example, on both sides of the border. There already is a great incentive to smuggle. The value of that would be bigger than what we are talking about in the value of potential tariffs that would be avoided on either side of the Irish border. It is not a huge amount of money that would be collected on tariff trade across the border.

On the customs issue, we already operate a system of spot checks and paying VAT in arrears, in effect, on a monthly basis. These are all areas where the UK and the EU are happy to trust each other at the moment. Why could we not do that in the future? The issue is going to be on specific regulatory issues around agriculture, for example; to make it work, clearly the Northern Irish side of the border and the Republic side of the border will have to be very closely aligned to avoid checks.

Emily Lydgate: We could perhaps sub-divide friction into two categories. One of them has to do with impacts on businesses. The other has to do with the actual border infrastructure and border checks. If we want to maintain the status quo on that border, my position would be that we would have to have the softest Brexit imaginable. Whatever arrangement that we have will necessitate the EU and the UK enforcing their borders.

The key question is: can we have a hard border without any border checks? That is where you get into this issue of smart borders, everyone doing their paperwork at home and then they just whizz through the scanner. There certainly seems to be scope for these state-of-the-art technological solutions to managing it so that people have the experience of just driving through the border. That does not mean no border checks; that just means that they are not being done at the border, which means that there is still a lot more paperwork than there is now.

You have to apply to be an authorised economic operator or do your rules-of-origin paperwork; that could be really easy for a Nissan or a GlaxoSmithKline, but if you are a smaller business that might be more challenging. We did a study recently with the British Chambers of Commerce where we talked to businesses about whether they were doing their rules-of-origin paperwork to get tariff-free access. A surprising number of them just did not do it. They would not get tariff-free access because they did not want to deal with the paperwork. They did not understand it. There are very real issues here in terms of creating additional barriers.

Q45 **Vernon Coaker:** All the sectors we have spoken to are pan-European with respect to their supply chains. They are worried about the future. How realistic is it that arrangements could be made to allay those fears about the implications for their supply chain?

Stephen Booth**:** In general terms, people have talked about various models for the UK-EU relationship: Canada, Norway, Switzerland and so on. Canada is instructive not necessarily in terms of its relationship with the EU, but in its relationship with the US and NAFTA. The US itself is obviously a customs union but Canada has a free trade agreement with them via NAFTA, as with Mexico. That has enabled Canada to be integral to a cross-border supply chain in the auto industry, for example. It shows you that being a member of a customs union is not a prerequisite for being a member of a supply chain.

Q46 **Vernon Coaker:** Why are they worried about it?

Stephen Booth**:** It is going to mean change. Change inevitably means a degree of transition cost. As we have described, you can see, from their point of view, why there is the potential for greater friction. It is the job of Government to try to minimise that and the job of negotiators on both sides to do that. As I was saying earlier, the EU's interest in doing that in these sectors is very strong, as opposed to some of the service industries where they might be less inclined to help us out in terms of maintaining cross-border trade. In these sectors, there should be a strong incentive on both sides of the Channel to minimise the friction.

Q47 **Vernon Coaker:** There is not much need to worry about it. It will be sorted out.

Stephen Booth**:** I do not want to say that. They are right to consider the scenarios and what they might mean. Clearly, change for any business is potentially disruptive. What we need to focus on, and what Government need to do a job of explaining and weighing up, is what the interests are in diverging in these sectors. As we have argued, in these sectors it is not obvious what the immediate advantage of that is. I am of the view, probably more so than Emily, that in the long term the UK cannot effectively sign a blank cheque and say, "We will adopt every single regulation in the future." We have to have the ability to say no.

Q48 **Vernon Coaker:** What is "long term"? In the short term, will there be a problem?

***Stephen Booth*:** In the short term, the UK and the EU are saying that they are going to keep everything the same. In the short term, we are going to have a transition that is basically identical to being in the single market and the customs union, if everyone keeps to their word.

Q49 **Vernon Coaker:** We will replicate what we have at the moment.

***Stephen Booth*:** That is the stated objective of both sides at the moment, yes.

Q50 **Vernon Coaker:** For how long?

***Stephen Booth*:** Currently up until December 2020.

Q51 **Vernon Coaker:** Do you think it would have to be longer than that?

***Stephen Booth*:** I am not sure. Effectively, what we are saying at the moment is that there is going to be a standstill transition until December 2020. I can see a point after that where things might change gradually, rather than overnight, on 1 January 2021, but exactly how that works, I am not sure.

Q52 **Vernon Coaker:** One of the things people might say is that what we are actually seeking to do is to replicate exactly the arrangements we have at the moment. Why bother?

***Stephen Booth*:** You are looking at four sectors, with all due respect. The UK-EU relationship touches on effectively almost our entire economy, and much more besides. In the sectors you are looking at, possibly that might be the objective of the UK Government. I am not sure. I can see the argument for minimising the disruption to the supply chain industries, which we benefit from and have been benefiting from our membership of the single market in. In other sectors, that is a much more difficult argument to make.

Q53 **Vernon Coaker:** If we were not able to come to these deals, do you think the UK supply chain would be able step up to it and deal with those problems? Airbus, for example, is a pan-European plane-maker. If we could not get to an agreement around Airbus, would the UK be able to deal with that, or would we just lose those jobs?

***Stephen Booth*:** I do not know. You would have to speak to the sector. Even if we do get a trade deal, you are already starting to see that there will be some degree of on-shoring and off-shoring, and the supply chains will adapt, to some degree. There will be jobs that move from the continent to here, and vice versa.

Q54 **Vernon Coaker:** Do you think the EU would be perfectly happy to negotiate with us? I think you said that because it is mutually advantageous they will come to a deal with us about it, because it is in their interests as well. To sum up your argument, that is why they will do it.

***Stephen Booth*:** In the goods sectors, it is very much in their interests. It is not just in their interests in terms of looking at Government revenues, trade balances and so on; it is also in the interests of the private enterprise of those countries that have made big investments here, and vice versa. As I said, the EU is set up to do arrangements in goods much more easily than in the services sectors, where it is a challenge for the EU to negotiate a collective position because often there is not a single set of EU regulations on services. There is a different patchwork of national ones.

Q55 **Antoinette Sandbach:** Can I come in on the service sector? In terms of our main exports to all of the countries, the recent report that you released analysed that we have better relationships in the service sector; they operate around using English as a principally understood language and links with our legal system. That is not going to change as a result of Brexit.

***Stephen Booth*:** No, I did not say it would. I am saying that the argument for a deal in goods is very strong because of the mutual interest. In services, our interests are different and our need to be integrated in the services markets is less. The EU is less set up to deal with a third country when it comes to market access for services.

Q56 **Vernon Coaker:** If we get a free trade agreement between the UK and the EU, that solves the issue of tariffs. What about rules of origin? How would you expect that to be undertaken?

***Stephen Booth*:** It depends. In these sectors, I would expect the UK to possibly align itself very closely with the EU's rules on those. It is not just the question of rules of origin between the UK and the EU. Again, it is this issue of third-country agreements and the degree to which those rules mean you can count UK and EU content together for access to those third markets. That is also going to be an issue, but it is not just going to be an issue for us; it is also going to be an issue for EU manufacturers who currently rely on aspects of the UK supply chain to create EU content. In those sectors, there is an interest. It is debatable but there is an interest for the EU to also look for relatively liberal rules of origin in these sectors, if people are interested in maintaining integrated supply chains on both sides of the Channel.

Q57 **Vernon Coaker:** Are there examples that you can point to where it has worked, in terms of rules of origin in free trade agreements? How has it worked elsewhere? Is there anywhere you have an example of where there is a free trade agreement and then there is not a problem with the rules of origin? Is there anywhere that that has occurred?

***Stephen Booth*:** The rules of origin differ and depend on how integrated and effective you want to be in the supply chain. When Canada, for example, negotiated with the EU in terms of the auto industry, rules of origin were a big issue, because Canada has to balance its integration with the US market against any possible future integration with the EU market. For Canada, it clearly makes more sense to be integrated with the US market that it does with Europe. From our point of view, given where we start from, it is going to be more important for us to be integrated with Europe in these sectors than it is with third markets.

Q58 **Chair:** Vernon's question was whether there are other countries you can point to, Stephen Booth, where, for rules of origin, you can count components that do not come from your country or a group of countries that are in their own customs union or free trade area.

***Stephen Booth*:** Yes. In Europe, you have pan-European cumulation of rules of origin with some of the north African countries, for example. Morocco has a big car plant that would benefit from rules of origin. Yes, they do exist but it is very much in that European neighbourhood; it is very much on a European model.

Q59 **Chair:** Is there a free trade agreement between the European Union and Morocco?

***Stephen Booth*:** Yes.

Q60 **Chair:** For Morocco, in terms of rules of origin in cars as part of that agreement, they can include components from other countries.

***Stephen Booth*:** Within the European area, yes, and vice versa. That is how I understand it. Emily may have more expertise than me but that is how I understand it, yes.

***Emily Lydgate*:** I cannot tell you precisely how Morocco does it, but I would add that this has to be an explicit ask of the UK to the EU, and that it needs to go back to its existing FTA partners—its 40-odd partners—and request that they reopen the rules of origin and include diagonal cumulation with the UK, because these are encoded into all of these FTAs. It would, first of all, require that we roll over the FTAs and, secondly, it is not clear to me that the EU has agreed that it would do that, so that needs to be an explicit request.

Q61 **Chair:** Having listened to the evidence over the last hour or so, it does not seem that either of you have identified any advantages of diverging from EU regulations in the four sectors that we are looking at, and perhaps manufacturing in general. I wonder, particularly for you, Stephen Booth, whether your argument is that the advantages of regulatory freedom in services outweighs the costs of either being a rule-taker or perhaps coming out of or being less involved in some of the sectors that we are looking at today. I might be wrong about that. I am just trying to see where you are coming from. It does not seem, in the sectors that we are looking at, that you have suggested any advantages of diverging. Is it that you think there are advantages that outweigh it?

Stephen Booth: There are two things. In these sectors, broadly that is the case. As you look at it now, it is hard. As you said, you had lots of evidence from businesses saying that they do not want to rip up the status quo; I can understand that. What we have to consider is that in 10, 15 or 20 years' time, there may be new rules that we do not agree with. What do we do then? The UK needs the flexibility to say no. That is why we need to have a strong governance framework for the agreements, so that both sides understand the consequences if one side or another says, "This no longer works for us in this particular regulatory issue." That is a very important part of a future framework. We need the ability to say no, but we need a framework that allows that to happen in a managed way. That is a very important part of the overall deal.

In the other sectors you are looking at, there is an argument about divergence or much more regulatory discretion and control in services. That is not just in services but other flanking measures, such as social employment law. The CBI, for example, despite its desire to be very close to the EU, has said it does not want to be a rule-taker in future employment law. In those areas, the UK cannot be a rule-taker and needs much more flexibility in the medium to long term to regulate differently. That is my overall position.

Q62 **Chair:** You feel that, as I tried to summarise, there are advantages to having regulatory divergence or at least that opportunity in other sectors of the economy that outweigh, perhaps, the costs to the sectors that we are looking at.

Stephen Booth: I am not sure that is the choice on offer. I am not sure that is the choice we have to make. There is the potential for being very closely integrated in these sectors that you are currently looking at and being closely regulatory aligned, but being more divergent in perhaps the services sectors. I think that is a false choice.

Q63 **Chair:** That is fine. I am not trying to put words into your mouth. What you are saying, perhaps, is that you would be happy to retain some regulatory alignment in those sectors, possibly being part of the EMA and EASA, et cetera, but to have divergence, and perhaps to have some sort of sectoral approach, where in some sectors we stay heavily integrated, if that is indeed possible, and in other sectors we seek divergence.

Stephen Booth: Correct.

Emily Lydgate: I would add that if we are thinking about FTAs that give us more market access for services, that will happen as part of an integrated negotiation. Oftentimes, we will see, for example, trade-offs between agricultural liberalisation and services market access. Before we negotiate new FTAs—if we are going to have an FTA with India, for example—we should do impact assessments and sustainability impact assessments so that we have more information about not only what the economic impacts will be but also the impacts on different UK populations and environmental impacts.

Chair: Thank you very much, Stephen Booth and Emily Lydgate, for coming to give evidence to our Select Committee this morning.