

Written evidence submitted by Professor Holger Breinlich (FRE0067)

Before trying to answer your questions, let me say a few words about myself. I am currently a professor of economics at the University of Surrey. Previously, I have also held academic positions at the universities of Essex and Nottingham. I have conducted extensive research on the effects of international trade on economic outcomes, as well as on the effects of trade agreements. This research has looked at both goods and services trade, and the evidence presented below draws on both my own work and that of other researchers active in these areas. I am currently also the representative of academia on the government's Strategic Trade Advisory Group (STAG). In this function, I advise on matters related to the conduct of the UK's trade policy with the rest of the world, including negotiating new trade agreements with non-EU countries. I should note that I have been advised by the STAG secretariat that, in order to limit any potential risk of conflict of interest, I should limit my responses to your enquiry to questions on the EU deal, and to avoid discussing trade policy with the rest of the world.

Let me now turn to your specific questions. I should also note that I am not privy to the current positions in the ongoing talks with the European Union, so will not be able to answer the questions that deal specifically with the current state of the negotiations.

1. What are the key priorities of the various non-financial services sectors in the negotiations? Has the Covid-19 pandemic changed any of these priorities? What might be the consequences of a deal which does not meet these priorities?
The key mechanism through which any deal with the European Union will influence UK economic outcomes is through limiting or enhancing the volume of trade between the EU and the UK. Indeed, economic analysis and forecasting of the economic effects of Brexit generally predicts that the more bilateral trade is restricted by any future agreement, the more negative are the economic outcomes for the UK (see, for example, Dhingra, Ottaviano, Sampson and van Reenen, 2016).¹ Hence, a good guide to judging the importance of individual non-financial services sectors in the negotiations is to look at their importance in UK services trade. According to the UK Balance of payments, in the latest pre-Brexit year for which data is available (2018), other business services accounted for approximately £95 billion or 32% of total UK services exports, compared to only 21% for financial services² This highlights the often overlooked fact that, while financial services are an important component of UK services exports, the broad category of Other business Services, which includes a range of producer services, such as research and development or consulting services, is even more important. Within Other business services, Business management and management consulting accounts for the largest share (24.1% of all Other business services exports), followed by research and development (10%), and advertising and market research (8.8%). Given that business services are an

¹ A full list of all the references cited in this submission is provided below in the section "Further Reading".

² See UK Balance of payments: the Pink book: 2019, Office for National Statistics. Available at <https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/3tradeinservicesthepinkbook2016>

important input into the production process of many other economic sectors, including manufacturing, it is also important to consider the import side. Here, Business management and management consulting services are again the most important service type, accounting for approximately 15% of UK imports of Other Business services, followed by Research and Development (11.3%).³

While it is difficult to predict the exact consequences of an EU-UK trade deal with inadequate coverage of these business services, it stands to reason that a loss of market access will reduce output and employment in the sectors concerned. In this context, it is important to keep in mind that UK services exporters tend to be more productive and to employ a more highly-skilled workforce than other UK firms (Breinlich and Criscuolo, 2011), so that negative knock-on-effects on UK productivity and the relative remuneration of highly-skilled workers can be expected. Finally, while the focus in policy debates is often on the export side, it should be kept in mind that, as discussed above, loss of access to EU providers of business services, while presumably beneficial to competing UK providers of such services, will have negative knock-on effects on other economic sectors that would experience a reduction in the availability of producer services.

These conclusions are not fundamentally altered when taking into account the current Covid-19 pandemic. If anything, Covid is likely to particularly affect services trade, given the importance of face-to-face communications in many of these services (see Oldenski., 2012). This consideration would re-enforce the need for a comprehensive trade agreement in business services, to help with the swift recovery of trade as lockdown restrictions come to an end, and to avoid compounding the effects of the epidemic by an additional market access shock after the end of the current EU-UK transition period.

2. What implications could the trade in goods provisions of a future UK/EU agreement have on trade in non-financial services? How might the provisions on non-financial services impact upon trade in goods? To what extent are the two linked?

In recent times, both anecdotal evidence and more systematic empirical evidence point to the fact that goods and services trade are closely linked. This may partly reflect a

3. “servitization” process, i.e., a shift from products to solutions and integrated
4. “ product-service systems” (see, for example, Neely, 2008)⁴, as well as a greater reliance of manufacturing firms on intermediate services, both domestic and imported (see (Nordås, 2010; Timmer et al., 2013). In recent research, my co-authors and I have examined these interlinkages between goods and services trade more systematically, using detailed data on the services and goods imports of Belgium firms for the period 1995-2005 (see Ariu et al., 2019). We find that trade barriers to these imports interact in the sense that higher tariffs on imports from a given destination country reduce both goods and services imports from that destination. Likewise, higher barriers to services trade not only reduce services imports but also

³ Source: UK Balance of payments: the Pink book: 2019, Office for National Statistics. Available at <https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/3tradeinservicesthepinkbook2016>

⁴ An often cited example in the UK context is Rolls Royce, which has increasingly paired its key business of the production of aircraft engines with the delivery of accompanying services, such as maintenance and research and development services.

goods imports. From these results, it seems likely that higher barriers imposed on UK services exporters after the end of the Brexit transition period will also reduce UK manufacturing goods exports. In our paper, we discuss a few economic mechanisms behind this result. Most important is the fact that certain types of services are best provided by the firm that also produces related goods. The competitive advantage of the goods producer could, for example, be due to proprietary knowledge that can give an advantage to original component manufacturers in tailoring services to their own goods, or in using the services to make the goods more relationship-specific. The example of Rolls Royce which provides both aircraft engines as well as the accompanying maintenance services, has already been mentioned.⁵ In conclusion, our research highlights that the negotiations on the future UK-EU relationship in services and goods trade are intricately linked to each other. Better access for UK goods will in all likelihood also lead to higher services exports, and vice versa.

5. How might the new immigration regime impact the non-financial services sector? To what extent might any risks and opportunities be influenced by the labour mobility provisions envisaged in the UK and EU's negotiating positions?
A key fact about the production and export of services is that both are highly skill-intensive activities (see, for example, Breinlich and Criscuolo, 2011). Thus, any immigration regime will either hinder or support the production and exports of services to the extent that it hinders or supports high-skilled immigration. A further twist in the case of services exports is that a key channel through which services can be provided abroad is through the (temporary) movement of natural persons (the so-called mode 4 of the general agreement on trade in services (GATS)). To the extent that an immigration regime also changes the ease with which people providing services can temporarily move to the destination country of the service export, it will also directly affect services exports, independent of its effect on the availability of high-skilled labour more generally. Note, however, that other legal provisions in the destination country, such as the mutual recognition of professional qualifications, will also influence the UK's ability to provide services in the remaining EU member states. Finally, recent research has demonstrated an interesting link between immigration and the off-shoring of services production. In particular, Ottaviano et al., (2016) show that UK labour markets with more immigration experience less off shoring, presumably because migrants are able to carry out tasks that previously had to be off-shored (i.e., imported from other countries). The same authors also show that immigrants increase overall productivity in service-producing firm, again highlighting the importance of immigration for services production.
6. What would happen if agreement was not reached between the UK and the EU on non-financial services? What would be the international legal baseline they would fall back on?
The legally binding conditions that would apply to the UK as a WTO member in its own right in the absence of any other arrangement with the EU would be defined by the EU's GATS schedule of commitments. As discussed by Borchert (2016), the implications of this for the market access of UK services exporters are complex. On the one hand, most WTO founding members of the general agreement on trade in

⁵ see footnote 4.

services (GATS) did not make very ambitious commitments on market access and national treatment, therefore trading on GATS terms is typically rather undesirable. On the other hand, countries are free to apply more liberal policies than they committed to under the GATS, and many do, so that actual MFN policy regimes typically afford (much) better market access than what GATS schedules would prescribe. Hence, while market access and national treatment for the UK as an ordinary WTO member may be somewhat worse compared to the status quo as an EU member, it may not be as bad as GATS schedules might suggest. However, a clear downside of trading on WTO terms is that it lacks the legal certainty and predictability of membership in the Single Market. Hence, it stands to reason that falling back on GATS market access terms will depress UK-EU services trade. Empirically, The superiority of EU membership compared to other forms of market access has been documented by Ebell (2016), who shows that foregoing single market membership will lead to a long-run reduction in bilateral UK-EU services trade by 61-65%. However, this decline in trade flows would be similar if single market membership were to be replaced by a simple free trade agreement (FTA) similar to FTAs currently notified by other countries to the world trade organisation (WTO). According to Ebell, only full EEA membership would allow UK-EU services trade to continue at current levels. A further consideration is that UK-EU services trade is likely to be affected by increased uncertainty even before the failure to reach an agreement will become clear (see, for example, Graziano, Handley and Limão, 2018).

Further Reading

- Ariu, A., Breinlich, H., Corcos, G., and G. Mion (2019), "The interconnections between services and goods trade at the firm-level", *Journal of International Economics*, volume 116, pages 173–188.
- Borchert, Ingo (2016), "Services trade in the UK: what is at stake?", UK trade policy observatory briefing paper 6, November 2016.
- Breinlich, Holger and Chiara Criscuolo (2011), "International trade in services: a portrait of importers and exporters. *Journal of International Economics*, Volume 84 (2), pages 188–206.
- Breinlich, H., Soderbery, A., Wright, G.C., 2018. From selling goods
- Dhingra, S., G. Ottaviano, T. Sampson and J. Van Reenen (2016), "The consequences of Brexit for UK trade and living standards," CEP Brexit Brief #2, available at: <http://cep.lse.ac.uk/pubs/download/brexit02.pdf>
- Ebell, M. (2016), "Assessing the impact of trade agreements on trade", *National Institute Economic Review* No. 238 (November 2016)
- Graziano, A., Handley, K., and Nuno Limão (2018), "Brexit uncertainty and trade disintegration", NBER Working Paper 25334, National Bureau of economic research.

- Neely, A. (2008), “Exploring the financial consequences of the servitization of manufacturing.”, *Operations Management Research*, volume 1 (2), pages 103–118.
- Nordås, H.K., (2010), “Trade in goods and services: two sides of the same coin?” *Economic Modelling*, volume 27 (2), pages 496–506.
- Roy, R., Shehab, E., Tiwari,
- Oldenski, Lindsay (2012), “Export versus FDI and the communication of complex information”, *Journal of International Economics*, vol. 87, pages 312-322.
- Ottaviano, G.I.P., Peri, G. and G. Wright (2016), “Immigration, Trade and Productivity in Services: Evidence from U.K. Firms”, NBER Working Paper No. 21200, National Bureau of Economic Research.
- Timmer, M.P., Los, B. Stehrer, R and G.J. Vries, (2013), “Fragmentation, incomes and jobs: an analysis of European competitiveness.” *Economic Policy*, volume 28 (76), pages 613–661.

July 2020



Committee on the Future Relationship with the European Union

House of Commons, London, SW1A 0AA

Email: freucom@parliament.uk Website: <https://committees.parliament.uk/committee/366/committee-on-the-future-relationship-with-the-european-union/>

25 June 2020

Professor Holger Breinlich
Professor of Economics
University of Surrey

Dear Professor Breinlich,

The House of Commons Committee on the Future Relationship with the European Union is inquiring into the progress of the negotiations between the UK and the EU. Under normal circumstances, the Committee holds regular oral evidence sessions in Westminster. However, measures to prevent the spread of the coronavirus make this difficult.

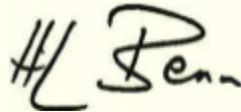
The Committee is keen to gather as much evidence as possible to inform its deliberations so I am writing to you to ask whether you would be willing to help us with our work by making a written submission. We welcome general responses to our [call for evidence](#), which was published on 4 March. We also hope that you would be willing to answer some of the more specific questions set out below on issues that fall within your area of expertise. Submissions need not address every bullet point and can include other matters that you think are relevant to the negotiations and should be drawn to the attention of the Committee.

- What are the key priorities of the various non-financial services sectors in the negotiations? Has the Covid-19 pandemic changed any of these priorities? What might be the consequences of a deal which does not meet these priorities?
- To what extent did the UK Government consult these sectors before publishing its negotiating aims and draft texts? How well does what the Government has proposed meet their needs? What further provisions would you have advised the Government to seek?
- How do the UK and the EU's positions in the negotiations compare with regard to non-financial services? On which areas are the UK and EU's aims farthest apart? Where do their positions align? What is your assessment of the level of technical detail the negotiators have grappled with on this topic to date?
- How does the EU's position on non-financial services compare to that which it held in negotiations on CETA with Canada and the EU-Japan FTA? To what extent are these FTAs suitable precedents for a UK/EU deal?
- To what extent is the UK seeking provisions on non-financial services unprecedented in existing FTAs (for example on the mutual recognition of professional qualifications)? What would be the advantages and disadvantages of agreeing these provisions for each party? Why might agreeing such provisions prove difficult?
- Why do you think the EU does not want to include audio-visual services in any agreement? How might the EU's reluctance to consider audio-visual services in the negotiations affect the UK broadcasting sector?
- What implications could the trade in goods provisions of a future UK/EU agreement have on trade in non-financial services? How might the provisions on non-financial services impact upon trade in goods? To what extent are the two linked?
- Could you sketch out a possible compromise between the UK and the EU on trade in non-financial services and how it might be achieved?
- Based on the parameters set out by the UK and EU draft legal texts, could reaching an agreement with the EU restrict the UK's ability to pursue a free trade agreement covering trade in non-financial services with third countries? If so, how?

- How might the new immigration regime impact the non-financial services sector? To what extent might any risks and opportunities be influenced by the labour mobility provisions envisaged in the UK and EU's negotiating positions?
- What would happen if agreement was not reached between the UK and the EU on non-financial services? What would be the international legal baseline they would fall back on?
- Is it clear what businesses in non-financial sectors must do to prepare for the end of the transition period? How much progress have been made on preparations so far? Do SMEs face any additional challenges?
- What provisions exist in the Ireland/Northern Ireland Protocol on cross-border trade in non-financial services? How might the all-island economy be affected by the UK leaving the transition period with different forms of UK/EU future relationship?

The Committee staff will be happy to discuss the inquiry, any issues raised, or the process for submitting written evidence. You can contact them at freucom@parliament.uk.

Yours,

A handwritten signature in black ink, appearing to read 'H/ Benn', written in a cursive style.

Hilary Benn
Chair of the Committee