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European Union Committee

5th Report of Session 2016–17

# Brexit: the options for trade

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## *The European Union Committee*

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Q in footnotes refers to a question in oral evidence.

## SUMMARY

The UK's decision to leave the EU will fundamentally change its terms of trade with the 27 other Member States, and with the rest of the world. The Government has stated that it will trigger Article 50 by the end of March 2017. The UK's current trading arrangements with the EU will cease at the end of the two-year period specified by Article 50, unless this period is extended by the unanimous agreement of the EU-27. This report considers the principal possible frameworks for trade after this time, namely joining the European Economic Area (EEA), a customs union with the EU, a Free Trade Agreement (FTA) or trade based on World Trade Organisation (WTO) rules. It asks whether they might be modified—in line with the Government's desire for a "bespoke UK agreement"[1]—and explores the implications of the different options for the sequencing and timeline of negotiations.

The UK is entering uncharted waters—no major Member State has ever left the EU.[2] While there is an interest on both sides in reaching an amicable agreement, the UK's withdrawal is an existential challenge to the EU. Its negotiating stance will be affected by elections and referendums in Member States over the coming months and is unlikely to be easy or accommodating. We recognise that deciding the future UK-EU trading relationship is likely to form part of wider negotiations on UK-EU co-operation on issues such as home affairs, security, research, acquired rights, and climate change.

There is always an inherent trade-off between liberalising trade and the exercise of sovereignty. The UK's original decision to join the European Economic Community involved a trade-off between sovereignty and preferential access to Member States' markets. Similarly, our analysis of the frameworks for trade finds that the more comprehensive the trade relationship, the greater the curtailment of national sovereignty. We highlight the importance of effective dispute resolution mechanisms for trade, and recommend that the Government consider which mechanisms it would find acceptable after Brexit.

From the outset, it is important that the Government, Parliament and the public are clear about the distinction between 'access to' and 'membership of' the Single Market. Many countries have 'access to' the EU's Single Market, either through agreed tariffs at the WTO or via a FTA. However, the only countries which have full membership of the Single Market—which entails the liberalised movement of goods, services, people and capital (the 'Four Freedoms'), secured through common rules interpreted by the European Court of Justice (CJEU)—are EU Member States. The EEA states only enjoy partial membership, because the EEA agreement does not include a customs union. On the other hand, Turkey's inclusion in a customs union with the EU does not entail the free movement of services, people or capital. Fundamentally, full membership of the Single Market is predicated upon acceptance of all Four Freedoms.

This principle is in tension with the Government's commitment to maintaining liberalised trade with the EU while also curbing the free movement of persons and the reach of the CJEU, via a bespoke arrangement. We note that both the process for pursuing this, and what such an agreement might contain, are unclear. Nonetheless, this report investigates the extent to which the different


1 Q 40 (Lord Bridges of Headley)
2 Greenland voted to leave the EU's predecessor, the European Economic Community, in 1982 and left in 1985.

frameworks for trade might be adapted to better suit the UK's interests and result in a bespoke outcome. We conclude that the prospect of fundamental modifications to the 'off-the-shelf' models is unlikely. Reform of the EEA Agreement to limit free movement and include voting rights on EU legislation is improbable. Creating a customs union arrangement with the EU would limit the UK's ability to have an independent trade policy. Even in areas not covered by the customs union, pressure would be put on the UK to shadow the EU's trade negotiations.

While a FTA provides the greatest flexibility in securing a bespoke deal and could potentially be combined with wider UK-EU co-operation after Brexit through an Association Agreement, we see no evidence that trade on terms equivalent to full membership of the Single Market (especially in services) could be achieved. We do not think it will be possible to negotiate a comprehensive UK-EU FTA within two-years. The Government therefore needs to have a clear 'game plan' for possible transitional arrangements before Article 50 is invoked. Although this would require clarity on the principles of what the UK is transitioning to, it would not delay the UK's withdrawal. But it would safeguard current trade and provide adequate time for negotiations. Temporary extension of participation in the customs union could be one important element of a transitional arrangement.

If no alternative trading arrangement is in place two years after Article 50 is triggered, UK-EU trade would by default take place under WTO rules. As the UK is unlikely to be able to retain access to the EU's FTAs with third countries after Brexit, WTO rules will also form the basis of the UK's trade with the rest of the world. But trading under WTO rules—often described as a fall-back option—is not straightforward. The UK must establish its own schedules of concessions, and negotiate with the EU its share of tariff rate quotas and subsidies. While the technical details appear relatively straightforward, politics may intrude: negotiations with the EU and other WTO members could complicate this process, further adding to the uncertainty.

We recommend the Government should initially focus on its future trading relationship with the EU and its WTO schedules. It should come to an early decision on whether the UK should remain in the customs union. Trade deals with third countries will be contingent on the outcomes of these negotiations, and so should be sequenced accordingly. As part of working towards these priorities, the Government should provide clarity on a number of important issues, including whether and to what extent the withdrawal negotiations with the EU will encompass negotiations on the future UK-EU trading relationship.

A transitional agreement will almost certainly be necessary. We see little evidence that agreeing a transitional arrangement would put the UK's wider interests at risk. Quite the opposite: a transitional arrangement would allow negotiations to be conducted in a less pressured environment, benefiting all concerned. We urge the Government to establish at the outset of negotiations a clear strategy for a future transitional agreement, with specific proposals as to what form it should take.

The timetable to engage with industry stakeholders, analyse the possible frameworks, and have simultaneous negotiations at the WTO is extremely tight. The Government needs significantly and systematically to scale up capacity in all its departments. The Government needs to provide clear leadership across Whitehall to deliver this highly complex and unprecedented task.

# Brexit: the options for trade

## CHAPTER 1: INTRODUCTION

1. Brexit will, for the first time in over 40 years, require the UK to determine the terms of its trade with the EU,[3] its biggest trading partner, and the rest of the world. In 2015, 44% (£222 billion) of UK exports (in goods and services) went to the EU, and 53% (£291 billion) of imports came from the EU.[4] While Brexit provides the UK with new opportunities, it also introduces major risks and will require complex negotiations involving difficult trade-offs. The withdrawal of the UK, a major Member State, puts both the UK and the EU in an unprecedented position.

2. Following the referendum on 23 June 2016, the European Union Committee and its six sub-committees launched a coordinated series of short inquiries, addressing the most important cross-cutting issues that will arise in the course of negotiations on Brexit.[5] The pace of events means that these inquiries will necessarily be short, with only two or three public oral evidence sessions in each case, and limited amounts of written evidence. But within these constraints, we are seeking to outline the major opportunities and risks that Brexit presents to the United Kingdom. A number of these inquiries are relevant to this report, such as the inquiries into financial services, UK-Irish relations and the implications of Brexit for the UK's crown dependencies. We do not comment on these issues in our report, although we recognise their importance.

3. This report deals with the critical issue of the future trading framework between the UK and the EU. It is based on an inquiry conducted jointly by the External Affairs and Internal Market Sub-Committees of the European Union Committee, and provides an early basis for parliamentary consideration of the trade options before Article 50 is triggered. Whatever the final outcome of the legal case before the Supreme Court on Parliament's role in the process of triggering Article 50, this report will help parliamentarians and the public to explore in detail the possible frameworks for a future trading relationship with the EU, and to understand the options, trade-offs, opportunities and risks each framework presents. As one of our witnesses, Dr Ulf Sverdrup, Director, Norwegian Institute of International Affairs, remarked: "There is no free lunch."[6]

4. This report will also provide a foundation for the two Sub-Committees' subsequent inquiries assessing the more detailed implications of Brexit for the UK's future trade with the EU in goods (by the External Affairs Sub-Committee) and services (by the Internal Market Sub-Committee).

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3 Trade is undertaken with the 27 other Member States of the EU. Throughout this report, we use the term 'trade with the EU' to mean trade with these Member States, rather than with the institutions of the EU.

4 Institute for Fiscal Studies, *The EU Single Market: the Value of Membership versus Access to the UK* (August 2016), p 5: https://www.ifs.org.uk/uploads/publications/comms/R119%20-%20The%20EU%20Single%20market%20-%20Final.pdf [accessed 28 November 2016]

5 European Union Committee, *Scrutinising Brexit: the role of Parliament* (1st Report, Session 2016–17, HL Paper 33)

6 Q 25 (Dr Ulf Sverdrup)

5. All the inquiries undertaken by the European Union Committee are running in parallel with the work currently being undertaken across Government, where departments are engaging with stakeholders, with a view to drawing up negotiating guidelines. But while much of the Government's work is necessarily being conducted in private, our aim is to stimulate informed debate, in Parliament and beyond, on the many areas of vital national interest that will be covered in the negotiations. As far as possible we aim to complete this work before March 2017.

## Brexit: Future frameworks for trade between the UK and the EU

6. This report consists of eight chapters. Chapter 2 considers the UK's current trading relationship with the EU (through membership of the Single Market), its trading relationship with third countries, and what the Government has said about its aspirations for a new trading relationship with the EU. Subsequent chapters consider the different possible frameworks for its future trading relationship with the EU, and the extent to which they could be adapted or changed to better meet the UK's interests (reflecting the Government's desire for a bespoke deal).[7] The frameworks considered are briefly outlined in Table 1 below.

**Table 1: Possible frameworks for future trading relationship**

| Provisions included in each framework | EEA Chapter 3 | Customs union Chapter 4 | Free trade agreement (FTA) Chapter 5 | WTO Chapter 6 |
|---|---|---|---|---|
| Trade with the Single Market | Full membership of the Single Market in services, partial market access for trade in goods. | Almost full membership of the Single Market in goods, no market access for trade in services. | This depends on the scope and depth of the FTA. | Based on the EU's schedules of concessions at the WTO, applied on a Most Favoured Nation[8] basis. |
| Participation in the EU's customs union | No. | Yes. | No. | No. |
| Accept the principle of free movement of persons | Yes. | No. | No. | No. |
| Budget contributions | Yes. | No.* | No.* | No. |

7 Q 40 (Lord Bridges)

8 'Most Favoured Nation' in the WTO refers to the principle that members cannot discriminate between other WTO members trading partners. If they grant a lower duty on the import of a certain product, they have to do that for all other members too. WTO, 'Understanding the WTO: basics—Principles of the trading system': https://www.wto.org/English/thewto_e/whatis_e/tif_e/fact2_e.htm#seebox [accessed 28 November 2016]

| Provisions included in each framework | EEA Chapter 3 | Customs union Chapter 4 | Free trade agreement (FTA) Chapter 5 | WTO Chapter 6 |
|---|---|---|---|---|
| Autonomy over trade policy | Yes, although not able to change standards or regulations. | No, although FTAs can be sought on those aspects not covered by the customs union arrangement. | Yes. | Yes. |
| Dispute resolution | Through the EEA Joint Committee, and the EFTA Court.** | N/A. | Through state-to-state dispute resolution mechanisms. | State-to-state use of the WTO dispute settlement process. |

** Although arrangements can be made through separate treaties. Turkey is the only non-EU country to participate in a customs union with the EU, and does not pool revenue from the Common External Tariff with the EU. See Chapter 4.*

*** Although not under the jurisdiction of the European Court of Justice (CJEU), the EFTA Court does closely follow CJEU judgments. See Chapter 3. Source: House of Lords.*

7. Each chapter considers the implications of the different frameworks on the UK's laws. The more comprehensive the framework, the larger the obligation for the UK to share rules and regulations with the EU. We note that the Government and Parliament's review of which EU legislation to retain after the Great Repeal Bill has been passed, will in part be influenced by the choice of future trading relationship.

8. We also note that the future trading relationship between the UK and the EU may be considered as part of a wider deal covering co-operation on issues including home affairs, security, research, acquired rights and climate change.

9. Chapter 7 evaluates the Government's approach to negotiating a framework for trade with the EU and third countries. It considers the Government's engagement with stakeholders in industry, resources, and co-ordination across departments. The final chapter compares the advantages and disadvantages of all the frameworks on offer, and considers their implications for the sequencing of negotiations and the case for transitional trading arrangements.

10. The EU External Affairs and the EU Internal Market Sub-Committees, whose members are listed in Appendix 1, met jointly in September and October 2016 to take oral evidence from the witnesses listed in Appendix 2. The Committee is grateful for their participation in this inquiry. We also thank our two Specialist Advisers, Dr Holger Hestermeyer and Dr Ingo Borchert.

11. **We make this report for debate.**

## CHAPTER 2: THE UK'S TRADE AS A MEMBER OF THE EU

12. The UK independently develops and exploits commercial relationships with businesses in EU countries and around the world to support trade, but at present, the terms of the UK's trade are predicated on its membership of the European Union. As a member of the Single Market, the UK benefits from liberalised trade with other EU Member States in a wide range of sectors. Under the customs union, Member States have adopted a Common External Tariff, and through the Common Commercial Policy (CCP) the EU has the exclusive competence to negotiate trade agreements with third countries.[9]

13. Statistics on the UK's trade with EU countries and the rest of the world, that trade broken down into trade in goods and services, and UK exports to the EU and EU exports to the UK as shares of their respective total exports are presented below in Tables 2-4.[10]

**Table 2: UK trade in values and shares (2015)**

| | Exports | | Imports | |
|---|---|---|---|---|
| | £ billions | Share | £ billions | Share |
| EU countries | 222 | 44% | 291 | 53% |
| Rest of the world | 288 | 56% | 258 | 47% |
| Total | 510 | 100% | 549 | 100% |

*Source: Institute for Fiscal Studies, The EU Single Market: The Value of Membership Versus Access for the UK (August 2016), p 5*

**Table 3: UK goods and services trade shares (2015)**[11]

| | Share of exports | | Share of imports | |
|---|---|---|---|---|
| | Goods | Services | Goods | Services |
| EU countries | 47% | 39% | 54% | 49% |
| Rest of the world | 53% | 61% | 46% | 51% |
| Total | 100% | 100% | 100% | 100% |

*Source: ONS, UK trade: Mar 2016 (10 May 2016): http://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/uktrade/mar2016 [accessed 28 November 2016]; Institute for Fiscal Studies, The EU Single Market: The Value of Membership Versus Access for the UK (August 2016), p 7*

9 Article 3(1)(e) and Article 207, Treaty on the Functioning of the European Union, OJ C 326 (consolidated version of 26 October 2012); These trade agreements can contain provisions on trade in goods, services, commercial aspects of intellectual property, foreign direct investment and investment provisions.

10 The Office for National Statistics noted that exports from the UK to EU and non-EU countries grew on average by 3.6% and 6.5% respectively in each year between 1999 and 2014. The UK's stronger export growth to non-EU countries resulted in the proportion of UK exports to the EU falling from 54.8% in 1999 to 44.6% in 2014. Growth in the value of UK imports of goods and services from EU and non-EU countries grew on average by 4.7% and 5.5% respectively in each year from 1999 to 2014. Office for National Statistics, 'How important is the European Union to UK trade and investment?': http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/rel/international-transactions/outward-foreign-affiliates-statistics/how-important-is-the-european-union-to-uk-trade-and-investment-/sty-eu.html [accessed 28 November 2016]

11 The Office for National Statistics noted that between 1999 and 2014, goods imported by the UK from the EU rose by 4.9% per year on average, compared to exports which rose by 2.5% per year. The UK's trade in services balance with the EU is much more favourable, with a surplus in each year since 2005. Office for National Statistics, 'How important is the European Union to UK trade and investment?'

**Table 4: Comparing the UK & the EU's trade**

| | £billion | Share of total exports |
|---|---|---|
| UK exports to EU countries (2016) | 222 | 44% |
| EU countries' exports to the UK (2015) | 291 | 6-7% |

*Source: ONS, UK Perspectives 2016 'Trade with the EU and beyond' (25 May 2016): http://visual.ons.gov.uk/uk-perspectives-2016-trade-with-the-eu-and-beyond/ [accessed 22 November 2016]*

## The Single Market

14. The Single Market is an expression of one of the central aims of the EU: to create an internal market between its members that removes and reduces barriers to trade by ensuring the free movement of goods, services, people and capital (often referred to as the Four Freedoms).[12]

15. The scope and definition of the Four Freedoms are found in the EU's treaties, which establish a basic legal framework for EU action. The main Treaty Articles relating to each of the Four Freedoms are outlined below.

**Table 5: EU Treaty provisions relating to the Four Freedoms**

<table>
<tr><td rowspan="4">The Four Freedoms</td><td>Goods</td><td>Customs duties Arts. 28-30 TFEU</td><td>Internal taxation Art. 110 TFEU</td><td>Free movement of imports Art. 34 TFEU</td><td>Free movement of exports Art. 35 TFEU</td></tr>
<tr><td>Persons</td><td rowspan="2">Freedom of establishment Art. 49 TFEU</td><td>Free movement of citizens Art. 20-21 TFEU</td><td colspan="2">Free movement of workers Art. 45 TFEU</td></tr>
<tr><td>Services</td><td colspan="3">Freedom to provide and receive services Art. 56 TFEU</td></tr>
<tr><td>Capital</td><td colspan="2">Free movement of capital Art. 63(1) TFEU</td><td colspan="2">Free movement of payments Art. 63(2) TFEU</td></tr>
</table>

*Source: HM Government, Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market (July 2013), p 20: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227069/2901084_SingleMarket_acc.pdf [accessed 28 November 2016]*

12 The term 'Single Market' expresses the idea that national markets are merged into one. The treaties originally referred to the 'common market', but this was replaced with the Treaty of Lisbon by reference to the 'internal market', which is now defined in Article 26 (2), Treaty on the Functioning of the European Union. We use these terms synonymously in this report.

16. Through the Treaties, Member States are prohibited from keeping in place or creating disproportionate or unjustified barriers to the Four Freedoms (referred to as 'negative integration').[13]

17. The Treaties also provide the legal basis for the EU to legislate to remove tariff and non-tariff barriers to trade (referred to as 'positive integration').[14] The EU achieves this both through regulatory harmonisation, whereby the EU adopts legislation which all Member States have to transpose and enforce, and through the principle of 'mutual recognition', which requires Member States to recognise each other's regulations and standards, thereby allowing goods and services to be freely traded across the EU.[15]

18. Consultancy Europe Economics, in a paper published in April 2016, noted that "carried to its logical limit there is almost no policy area that could not be seen as in some way connected to the Single Market".[16] Accordingly, the *quid pro quo* for membership of the Single Market is that Member States have to comply with legislation regarding competition and mergers, state aid, environmental protection, employee protection, consumer protection, data protection, procurement, and sector specific regulatory frameworks.

19. According to the Institute for Fiscal Studies (IFS), the removal of barriers to trade in the Single Market has led to "lower prices and enhanced choice, specialisation and cross-border competition".[17] Joining the EU has, according to the National Institute of Economic and Social Research, increased the UK's trade with the EU by between 12% and 33%.[18]

### *Free movement of goods*

20. The free movement of goods in governed by the customs union component of the Single Market. A 'customs union' refers to an agreement between countries to remove tariffs and restrictions on the movement of goods within their borders, and to agree a common external tariff for all goods imported from countries outside their borders. The EU's customs union was incorporated into the Treaty establishing the European Economic Community in 1957. Today it is enshrined in Article 28 of the Treaty on the Functioning on the EU (TFEU):

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13 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 20: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227069/2901084_SingleMarket_acc.pdf [accessed 22 November 2016]

14 Tariffs are taxes or duties which are applied to imports or exports, while non-tariff barriers are all barriers to trade that are not tariffs, usually bureaucratic or legal issues that can hinder trade between countries. OECD, 'Glossary of statistical terms—tariff': https://stats.oecd.org/glossary/detail.asp?ID=2647 [accessed 22 November 2016]; OECD, 'Glossary of statistical terms—non-tariff barriers': https://stats.oecd.org/glossary/detail.asp?ID=1837 [accessed 22 November 2016]

15 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 20 and p 28. The principle of Mutual Recognition first arose in the Cassis de Dijon Case where the company Rewe-Zentral AG sought to import a liqueur from France into Germany but was forbidden to do so because of a German law forbidding the sale of spirits with an alcohol content of less than 32%—the liqueur they wished to import was only 15-20%. In this case, the CJEU ruled that barriers to free trade within the Community included national rules which had the effect of hindering intra-community trade.

16 Europe Economics, *Optimal Integration in the Single Market: A Synoptic Review* (April 2013), pp 13-14: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/224579/bis-13-1058-europe-economics-optimal-integration-in-the-single-market-a-synoptic-review.pdf [accessed 22 November 2016]

17 Institute for Fiscal Studies, *The EU Single Market: the Value of Membership versus Access to the UK* (August 2016), p 11

18 National Institute Economic Review No. 236, quoted in *Ibid.*, p 16

> "The Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries."[19]

21. Both tariffs and non-tariff barriers affect trade in goods. Non-tariff barriers relevant to the trade in goods include countervailing and anti-dumping duties, 'voluntary' export restraints, subsidies which sustain loss making enterprises, and technical barriers to trade.[20] In order to address non-tariff barriers, the EU has abolished internal customs duties, quantitative restrictions such as quotas on imports and exports, and prohibits any national measures which may be considered to have an equivalent effect.[21]

22. Goods imported into the EU need to comply with the formalities related to 'rules of origin', to determine where goods and their components were produced, thereby ensuring that the correct customs duty is levied.[22] This can be a complex process—requiring businesses to certify the origins of their materials, the country in which the final substantial production phase took place and the value added to the good by the work and processing done in each country in the supply chain.[23] Imported goods (just like goods originating within the EU) also need to comply with EU standards and regulations for product safety, which is checked at the EU's external border posts. Goods which comply with import formalities are allowed to circulate freely in the EU.[24]

23. Member States can only restrict the movement of goods if their free circulation would impact on "public morality, public policy or public security; the protection of health and the life of humans, animals, plant; the protection of national treasures … or the protection of industrial and commercial policy".[25] The Government's review of the Balance of Competences between the UK and the EU with respect to the Single Market concluded that these restrictions constitute "a closed list", which has "been vigorously policed by the Court [of Justice of the EU]".[26]

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19 Article 28, Treaty on the Functioning of the European Union

20 Countervailing measures refer to measures that can be undertaken whenever an investigation, by the investigating authority of the importing country, has led to the determination that the imported goods are benefiting from subsidies, and that they result in an injury. They may take the form of countervailing duties or undertakings by the exporting firms or by the authorities of the subsidising country. OECD, 'Glossary of statistical terms—countervailing measures': https://stats.oecd.org/glossary/detail.asp?ID=460 [accessed 22 November 2016]

21 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 22

22 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment* (February 2014), p 74 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279322/bis_14_591_balance_of_competences_review_Trade_and_investment_government_response_to_the_call_for_evidence.pdf [accessed 22 November 2016]

23 The rate of duty that must be applied to imported and exported goods depends on three elements: the type of good, the country the goods are being imported into and where they are judged to have 'originated' from. There are two main categories of origin rules 1) goods wholly obtained or produced in a single country and 2) goods whose production involves raw materials from more than one country. HM Revenue & Customs, *Guidance: Rules of origin for imported and exported goods* (6 August 2012): https://www.gov.uk/guidance/rules-of-origin [accessed 22 November 2016]

24 Article 28(2), Treaty on the Functioning of the European Union

25 Article 36, Treaty on the Functioning of the European Union

26 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 22

### *Free movement of services*

24. More so than the trade in goods, trade in services is affected by non-tariff barriers regarding how the provision of services is regulated in a different territory.[27] Non-tariff barriers affecting trade in services include subsidies which sustain loss-making enterprises, technical barriers to trade, and obstacles to the establishment and provision of services.[28] The latter are pertinent because, in order to provide services across borders, it is often the case that the producer has to be present at the same place that the service is used by a consumer.[29] Although many have commented that the Single Market in services is much less integrated than that in goods,[30] the TFEU attempts to address non-tariff barriers in the following ways:

    - Under Articles 56–62, persons or firms have the right to deliver services on a cross-border temporary basis in different Member States;[31]
    - Articles 49–55 provide for the freedom of establishment, which gives persons the right to establish themselves permanently in another Member State as self-employed individuals, and gives companies the right to establish branches or subsidiaries;[32] and
    - Article 53 provides the legal basis for Member States to recognise equivalent qualifications for professions from across the EU.[33]

25. The EU has also developed different regulations for specific service sectors such as telecommunications, aviation, road transport, and audio-visual media services. The free movement of services is also supported by Directive 2005/36/EC, which enables service providers to have their qualifications recognised in different Member States. EU legislation on consumer rights and data protection are also vital for trade in services.[34]

### *Free movement of persons*

26. The free movement of persons is enshrined in treaty provisions, secondary legislation (Directives and Regulations) and the evolving case law of the Court of Justice of the European Union (CJEU).[35] EU nationals can exercise their free movement rights in two respects: first, as EU citizens, and secondly, as workers. Under Articles 18–25 TFEU and Directive 2004/38,[36] EU citizens have, among others, the following rights:

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27 According to the OECD, non-tariff barriers refers "to all barriers to trade that are not tariffs. Examples of these include countervailing and anti-dumping duties, 'voluntary' export restraints, subsidies which sustain in operation loss making enterprises, technical barriers to trade, and obstacles to the establishment and provision of services." OECD, 'Glossary of statistical terms—non-tariff barriers': https://stats.oecd.org/glossary/detail.asp?ID=1837 [accessed 22 November 2016]

28 OECD, 'Glossary of statistical terms—non-tariff barriers': https://stats.oecd.org/glossary/detail.asp?ID=1837 [accessed 22 November 2016]

29 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 24

30 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market: Free Movement of Services* (Summer 2014), p 6: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332668/bis-14-987-free-movement-of-services-balance-of-competencies-report.pdf [accessed 28 November 2016]

31 *Ibid.*

32 *Ibid.* The freedom of establishment for persons is considered to complement the free movement of workers.

33 *Ibid.*

34 Directive 2005/36/EC, 7 September 2007, on the recognition of professional qualifications, OJ L 255

35 *Ibid.*, p 23

36 Directive 2004/38/EC, 29 April 2004, on the right of citizens of the Union and their Family members to move and reside freely within the territory of the Member States, OJ L 158

- To reside in any Member State for up to three months if they have a valid identity card or passport;[37]
- To reside for more than three months in any Member State if working, self-employed or studying; having sufficient resources and comprehensive sickness insurance;[38]
- To acquire permanent residency in another Member State after living there continuously for five years;[39]
- To have their family members accompany them in another Member State, subject to certain conditions;[40]
- Not to be deterred from going anywhere in the EU;
- Not to be discriminated against in another Member State on the basis of nationality.[41]

27. Under Articles 45–48 TFEU, EU workers have the right to work in any Member State; to travel to any Member State to seek employment; to live in any Member State; and to claim some benefits after being employed. Article 48 allows for the co-ordination of social security payments.[42]

28. Although the general principle of non-discrimination on the grounds of nationality applies to all the Four Freedoms, it is particularly important for the free movement of persons, as it means that EU citizens and workers cannot be discriminated against in terms of access to opportunities, working conditions or access to benefits or entitlements on the basis of their nationality.[43]

29. Membership of the Single Market, often conflated with 'full access', is predicated upon acceptance of all Four Freedoms—and the principle of the free movement of persons in particular. The Government's report, *Alternatives to membership: possible models for the United Kingdom outside of the European Union*, published ahead of the referendum, stated: "in return for full access to the EU's free-trade Single Market in key UK industries, we would have to accept the free movement of people".[44]

### *Free movement of capital*

30. Articles 63–66 TFEU state that capital should be allowed to move without restriction between Member States, and between Member States and third countries for the purposes of investment or payment. There are some broad exemptions, such as under Article 66, to protect the integrity of national tax

37 European Commission, 'Movement and residence': http://ec.europa.eu/justice/citizen/move-live/index_en.htm [accessed 23 November 2016]
38 *Ibid.*
39 *Ibid.*
40 *Ibid.*
41 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), pp 23-24
42 *Ibid.*, p 24
43 *Ibid.*, p 23
44 HM Government, *Alternatives to membership: possible models for the United Kingdom outside the European Union* (March 2016), p 5: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504661/Alternatives_to_membership_possible_models_for_the_UK_outside_the_EU_Accessible.pdf [accessed 23 November 2016]

systems and other safeguard measures to prevent capital movement during exceptional circumstances for a period of three months.[45]

### *Enforcement*

31. Member States are responsible both for transposing EU Directives into national legislation and for enforcing EU legislation domestically. If Member States fail to do either of those two things, the Commission, other Member States, companies or individuals can take legal action against them in national courts (because EU law takes primacy over national laws) and, if required, in the CJEU.[46]

32. In addition to the courts, other mechanisms are used by the Commission and Member States to monitor barriers to the free movement of goods and services. For example, SOLVIT is a platform that allows businesses and citizens to solve, without formal legal proceedings, problems caused by Member States not enforcing or not implementing EU legislation.[47]

## The EU's external trade policy

33. The EU has exclusive competence over trade policy. This requirement for a coordinated trade policy with third countries stems from the creation of the EU's customs union, which requires Member States to agree a Common External Tariff on goods imported from outside the Union. The Common External Tariff and the EU's exclusive competence in trade policy is formulated through the Common Commercial Policy (CCP). This is the foundation for decisions regarding tariffs on imported goods (including agricultural and industrial goods), quotas (particularly in relation to agricultural goods), and other restrictions and controls on imports and exports.[48]

34. Under Article 207 TFEU, the Commission can make a recommendation to the Council of Ministers that it should mandate trade negotiations with third countries or regional blocks; the Council of Ministers has to agree before any trade negotiations can begin. The Commission has to keep the European Parliament and a Committee of the Council informed of developments in negotiations, and both the Council and the European Parliament have to authorise a final trade agreement.[49]

35. In conducting trade negotiations, the Commission and Member States have to follow the general principles of agreed external EU action. These include support for democracy, the rule of law, human rights and sustainable development.[50]

36. In addition to negotiating trade agreements, the EU has the exclusive competence to investigate unfair trade practices by third countries and

45 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: the Single Market* (July 2013), p 26
46 *Ibid.*, p 30
47 *Ibid.*, p 31
48 HM Government, *Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment* (February 2014), p 25
49 *Ibid.*, p 26
50 *Ibid.*, p 28

to propose trade defence measures to remedy any harm caused to EU businesses—including sanctions, and extra import duties on goods.[51]

37. Finally, the European Commission, in exercising EU competence over trade, generally represents Member States at the WTO in negotiations on rounds to reduce global tariffs or in representations on trade disputes.[52]

### 'Access to' versus 'membership of' the Single Market

38. Since the referendum, there has been considerable discussion of 'access' to the Single Market. We note that 'access to' and 'membership of' the Single Market are distinct concepts. Any country can trade with the countries of the Single Market, on the terms established by the EU in its schedules at the WTO. Such 'access' to the Single Market is currently enjoyed by, for example, the US.

39. Countries that have concluded a free trade agreement (FTA) with the EU, such as the Republic of Korea, Mexico and Switzerland, also have 'access' to the Single Market, but on preferential terms. Imports from countries outside the Single Market need to comply with relevant EU legislation (for example, product safety and environmental standards). The EU's FTAs sometimes include provisions for the EU and the third country to align and recognise the equivalence of domestic rules and standards to facilitate trade.

40. By contrast, 'membership' of the Single Market involves all economic activity—whether or not engaged in cross border trade within the EU—being subject to the legislation established by the EU, and acceptance of the Four Freedoms. This allows highly liberalised trade with other members of the Single Market in all areas where the Single Market operates.

41. For EU Member States, 'membership' of the Single Market is a consequence of and coterminous with membership of the EU itself. There are two ways in which countries can participate as a member of the Single Market, while remaining outside the EU, though neither provides complete coverage. Non-EU EEA states[53] are members of the Single Market in all aspects covered by the EEA Agreement, and benefit from the same liberalised trade conditions as the EU Member States. However, a number of areas fall outside the scope of this Agreement, such as agriculture and fisheries, as discussed in Chapter 3. Participation in a customs union with the EU allows Turkey to participate in the Single Market for goods; however, as discussed in Chapter 4, this is an incomplete arrangement and provides no participation in the Single Market in services.

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51 *Ibid.*, p 33. The EU's trade defence measures are given effect through Implementing Acts, which are considered by experts on the Commission's Trade Defence Instruments Committee. This Committee can advise on proposed measures before these are considered by Member States (the advisory procedure); or they can impose defence measures (through the examination procedure). The imposition of trade defence measures can be appealed to a separate Committee which represents both the Commission and Member States. European Commission, *The Trade Defence Instruments Committee* (October 2015): http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_151013.pdf [accessed 23 November 2016]

52 *Ibid.*, p 31

53 The EEA comprises the 28 EU Member States, and the three members of EFTA which have signed the EEA Agreement, namely Iceland, Lichtenstein and Norway. We refer to the three countries as 'non-EU EEA states' and 'non-EU EEA members' in this report.

## The future trade relationship between the UK and the EU

42. Lord Price CVO, Minister of State for Trade Policy, Department for International Trade (DIT), and Lord Bridges of Headley MBE, Parliamentary Under Secretary of State, Department for Exiting the EU (DExEU), told the Committee that the Government was "looking at all the options",[54] and was "not ruling [anything] out"[55] for a future trading relationship between the UK and the EU. We took these options to be:

- Becoming a non-EU member of the European Economic Area;[56]
- Remaining a member of the EU's customs union;
- A free trade agreement with the EU; and
- Trading according to WTO rules.

43. We note that trading under WTO rules will also determine the basis of the UK's trade with the rest of the world. So while the first three frameworks focus on the UK's trading relationship with the EU (and therefore are mutually exclusive), trading under WTO rules also encompasses trade with third countries and to this extent is compatible with the other three frameworks. If the UK leaves the EU without agreement to a FTA or membership of the EEA, then the default position will be to trade with the EU under WTO rules.

44. WTO members cannot normally discriminate between their trading partners (the Most Favoured Nation principle—discussed in Chapter 6). However, Article XXIV of the General Agreement on Tariffs and Trade (GATT) and Article V of the General Agreement on Trade in Services (GATS) allow countries to offer preferential trade terms—not applied to all WTO members equally—by creating a free trade agreement or a customs union. A customs union and a free trade agreement (including in this case the EEA) are examples of this derogation from the Most Favoured Nation principle.

45. Importantly, the GATT and the GATS stipulate that such customs unions or free trade agreements must liberalise "substantially all the trade" in goods or have "substantial sectoral coverage" for trade in services.[57] This means that sectoral agreements (those covering just telecoms, for example) are not legal under the rules of the WTO. We note that these conditions have rarely been raised in dispute settlement procedures at the WTO, have been poorly enforced, and there is considerable uncertainty over the definition of "substantially all".[58] Nonetheless, the UK Government is a member of the WTO and thereby bound by the rules laid out in the GATT and the GATS, which restrict the parameters of the deal the Government will be able to negotiate with the EU.

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54 Q 50
55 Q 40
56 The EEA comprises the 28 EU Member States, and the three members of EFTA which have signed the EEA Agreement, namely Iceland, Lichtenstein and Norway. We refer to the three countries as 'non-EU EEA states' and 'non-EU EEA members' in this report.
57 Article XXIV:8, General Agreement on Tariffs and Trade 1994: https://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_09_e.htm [accessed 23 November 2016]; Article V:1(a), General Agreement on Trade in Services: https://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm [accessed 23 November 2016]
58 Tevini, 'Article XXIV of the GATT', in *WTO–Trade in Goods* ed. by Wolfrum, Stoll, Hestermeyer (Brill, 2011). We note that Switzerland's multiple bilateral agreements with the EU, when considered in their entirety including the 1972 EU-Switzerland FTA, are sufficiently comprehensive to be compliant with the requirements of the GATT and the GATS.

46. Lord Bridges said the Government was pursuing a "bespoke UK agreement", rather than a fixed model, because "we perceive ourselves as being in a unique position as regards the EU".[59] The Government wanted an agreement that would allow the UK to "control our borders and our laws" and provide "the freest possible relationship as regards trade for our businesses".[60] We note that the process for agreeing a bespoke arrangement and what it would contain are unclear.

47. More broadly, Lord Price said the Government believed that "open and free trade, the reduction of tariffs and making sure that there is mutual recognition of standards all help business perform better". He said free trade helped to "reduce the costs of doing business" to the "benefit of consumers", and that this was "what we want to promote".[61]

48. The comments of Lord Bridges and Lord Price prompt a number of questions. It cannot, for instance, be guaranteed that the other 27 Member States will embrace the same objectives as the UK—and the UK will be unable to formally gauge their views until it has invoked Article 50. These views are likely to shift over the coming months due to forthcoming referendums and elections within Member States. Even if the EU-27 did embrace the same objectives as the UK, negotiating such an agreement could take several years, raising the question of transitional arrangements. We have therefore had to adopt an open mind, and the following chapters consider all four potential frameworks for UK trade with the EU after Brexit, and the ways in which they could be altered to better meet the UK's interests and reflect a bespoke outcome. Each is considered on a stand-alone basis, although as noted above trading under WTO rules is of wider significance, as it forms the basis for the UK's trade with all countries.

49. We have sought to provide information on the process of adopting each framework, the broad implications they might have, and risks they might pose for trade with the Single Market and with third countries. We have set out the wide range of issues the Government will need to consider, and some of the questions that it will need to address, in determining its negotiating position on future trade arrangements with the EU. We set out the implications of each framework for the regulation of goods and services in the UK and the UK's trade with third countries. We recognise more detailed work is required—this report does not make detailed economic assessments of each framework. A sector-by-sector analysis will be the focus of three forthcoming reports, on future UK-EU trade in goods, on trade in services, and on trade in financial services.

### Conclusions and recommendations

50. **It is important to distinguish between 'access to' and 'membership of' of the Single Market. Many countries have access to the Single Market through trade agreements and the rules of the WTO. Only EU Member States have full membership of the Single Market—setting, implementing and enforcing all the EU's rules to enjoy highly liberalised trade in all the areas that the Single Market operates.**

59 Q 40
60 Q 40 (Lord Bridges of Headley)
61 Q 52

51. **We note that the Government's aspiration, to secure a bespoke agreement with the EU which ensures open and free trade and control over the UK's borders and laws, is in tension with the fundamental principles of the Single Market—which require members to accept all the Four Freedoms, including the free movement of persons.**

52. **Moreover, the Government's desire for a bespoke deal will also need to be compatible with the rules of the WTO, where the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS) prohibit trade agreements focused only on one sector.**

53. **The Single Market includes clear mechanisms through which to implement, enforce and handle disputes about the rules that govern trade between its members. When the Government is evaluating the different frameworks for trade between the UK and the EU, it should consider what mechanisms it will find acceptable to handle possible future disputes.**

## CHAPTER 3: MEMBERSHIP OF THE EUROPEAN ECONOMIC AREA

54. The UK could in principle join the European Free Trade Area (EFTA) and become a signatory to the EEA Agreement, becoming a non-EU EEA member.[62] It would then join the current non-EU members of the EEA, Norway, Liechtenstein and Iceland. An overview of the EFTA and the EEA is given in Box 1.

### Box 1: The European Free Trade Area (EFTA) and the European Economic Area (EEA)

The European Free Trade Area (EFTA) is an intergovernmental organisation that promotes free trade and economic integration to the benefit of its four members: Norway, Iceland, Liechtenstein and Switzerland. The EFTA Convention regulates the free trade relations between its four members. Although EFTA has the right to conclude FTAs with third countries, members are also allowed to negotiate their own trade deals.

The EEA brings together all the EU Member States and three of the EFTA states (Norway, Iceland and Liechtenstein). It was established by the EEA Agreement, which entered into force in 1994, and which enables these three EFTA states to participate almost completely in the Single Market. The Agreement covers the Four Freedoms: the free movement of goods, capital, services and people. It guarantees the same rights and obligations of the Single Market for citizens and economic operators in the EEA as for those in the EU Member States.

Although the three non-EU EEA countries are a part of the Single Market in services, including financial services, they are not part of the EU's customs union. Non-EU EEA countries have the autonomy to negotiate Free Trade Agreements with third countries, either independently or through EFTA.

Non-EU EEA countries are required to implement into national law all EU Single Market legislation, which includes legislation on consumer protection, company law, environmental protection and social policy. The EEA Agreement does not include: the common agriculture and fisheries policies; the Common Foreign and Security Policy; Justice and Home Affairs; or the Economic and Monetary Union.

The principles of direct effect and primacy[63] are not part of EEA law, and the EFTA Court refused to include them in the EEA legal order. However, the non-EU EEA states undertake to introduce, if necessary, a statutory provision to the effect that EEA rules prevail in cases of conflict with other statutory provisions and a non-EU EEA state has to provide compensation for loss to individuals where EEA law is breached.[64]

62 The EEA comprises the 28 EU Member States, and the three members of EFTA which have signed the EEA Agreement, namely Iceland, Lichtenstein and Norway. We refer to the three countries as 'non-EU EEA states' and 'non-EU EEA members' in this report. Switzerland is a member of EFTA but not a signatory to the EEA Agreement.

63 In contrast, in the EU, the principle of direct effect enables individuals to invoke a European provision before a national or European court, and the principle of primacy means that EU law should prevail if it conflicts with national law.

64 Páll Hreinsson, 'General Principles', in *The Handbook of EEA Law* ed. by Carl Baudenbacher (Berlin: Springer International Publishing, 2016), pp 349-353

The Agreement is constantly updated with the introduction of new EU legislation.[65] Since 1994, more than 5,000 new legal acts have been incorporated into the Agreement either as Annexes or Protocols. Substantive decisions on the Agreement and its operation are made by the EEA Joint Committee, consisting of representatives from both the EU (represented by the European External Action Service) and the ambassadors of the non-EU EEA countries.

Non-EU EEA countries have no formal powers over decision making in any of the EU's institutions.

Non-EU EEA countries contribute towards EU programmes (such as Horizon 2020), and make payments towards the social and economic development of EU Member States, including Bulgaria, Hungary, Latvia, Poland and Portugal. These contributions are negotiated through the EU Multiannual Financial Framework. For 2014–20, their collective contribution will be approximately €3.22 billion.[66]

*Source: HM Government, Alternatives to membership: possible models for the United Kingdom outside the European Union (March 2016), pp 12-21: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504604/Alternatives_to_membership_-_possible_models_for_the_UK_outside_the_EU.pdf [accessed 28 November 2016]*

### The process for joining the EEA

55. Dr Sverdrup argued that even though the UK was already a member of the EEA through its membership of the EU, in order to join the EEA as a non-EU country it would have to join EFTA. Article 126 of the EEA Agreement states that the Agreement only applies to EFTA or EU Member States and it is therefore impossible to be a party to the EEA Agreement without being a member of the EU or EFTA.[67] Dr Sverdrup explained this is because the EEA Agreement was "constructed as a two pillar system", which "means that members of the EEA are supposed to be either members of the EU or members of EFTA."[68] The UK could do this by entering into three different Treaties and agreements: the EFTA Treaty (which has all four EFTA states as contracting parties); the "agreement on the surveillance mechanism in the EEA"; and the agreement on the EFTA Court (which has the three non-EU EEA states as contracting parties).[69] The process of entering these various agreements would "not take too long", and ratification of the various Treaties and agreements by the partner countries "could be done in a year or so."[70] If the UK joined EFTA, it is unclear whether it could remain party to the EEA Agreement if its withdrawal from the EU coincided with its joining of EFTA, or if the UK would have to re-join the EEA Agreement after joining EFTA.

65 European Free Trade Association, *A short introduction to 50 years of EFTA* (April 2010), p 2: http://www.efta.int/sites/default/files/publications/fact-sheets/General-EFTA-fact-sheets/efta-50-years.pdf [accessed 23 November 2016]

66 European Free Trade Association, 'EU Programmes with EEA EFTA Participation': http://www.efta.int/eea/eu-programmes [accessed 23 November 2016]

67 European Free Trade Association, 'Frequently asked questions on EFTA and the EEA': http://www.efta.int/faq [accessed 23 November 2016]

68 Written evidence from Dr Ulf Sverdrup (ETG0010)

69 Q 23 (Dr Ulf Sverdrup)

70 Q 24 (Dr Ulf Sverdrup)

56. Importantly, Dr Sverdrup told us that the EEA Agreement worked on the basis of unanimity and that all the non-EU EEA states "speak with one voice". This had important implications, because it meant that "in reality the Prince of Liechtenstein has a veto power over Norway, and vice versa".[71] Joining the EFTA treaties and agreements would require unanimity of the other parties.[72]

57. Dr Sverdrup did not think the current non-EU EEA countries would be "eager to go out and try to recruit the UK", for a number of reasons. First, expansion of the EFTA side of the EEA "has never been done before". Before the EU's enlargement, when some Central and Eastern European countries asked "if they could join the EEA first … the EFTA countries were reluctant to let them do that". Second, while the UK and the EFTA countries "share a lot of cultural sentiments and orientations", there were some very significant differences "in size, geography [and] history". Third, and more importantly, there were "differences of interests" and "political orientation" in important policy areas such as agriculture. Finally, there would be some reservations about the "functioning of the EEA institutions" if the UK were to join.[73] We note in particular that expanding a bloc of five million people to include an additional 65 million people would considerably alter the balance of the non-EU EEA bloc.[74]

58. On balance, however, Dr Sverdrup suggested that it might be possible for the UK to join the EEA: "at the end of the day if the EU and the UK think that this a nice and attractive political solution, I do not think they will object to it." The "big question" therefore was the EU-27's view, as the UK joining the EEA would require their consent.[75] Although this was "uncertain territory", Dr Sverdrup was "pretty sure the EU would be quite happy with that".[76] Various studies had shown that from the EU's perspective, "the EEA is the most preferred model" of association for third countries.[77]

59. Dr Sverdrup was also asked whether the UK could seek membership of the EEA as a transitional measure, between withdrawal and agreement of a comprehensive FTA. He had sympathy with the need for a transitional arrangement, which he said was a "good strategy", but he underlined that both parties would need to be clear about when the transition would come to an end: "You should keep in mind that the EEA was at first signed as a temporary agreement. When you say 'temporary', do you mean 25 years or two years?"[78] This was borne out by Dr Peter Holmes, Lecturer in Economics, University of Sussex, who cautioned that "Negotiating into the EEA and then out again sounds very complicated."[79]

71 Q 24
72 Q 23
73 Q 23
74 Q 28 (Dr Ulf Sverdrup); Office for National Statistics, 'Population estimates': https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates [accessed 28 November 2016]
75 Q 23
76 Q 23 and Q 24
77 Q 24
78 Q 23
79 Q 25

### *EEA membership and free movement of people*

60. Non-EU EEA states comply with the principle of free movement in broadly the same way as EU Member States. Although the EEA Agreement differs from EU law both in terms of the rights of free movement for third country or non-EU citizens and in not providing for 'Union citizenship', Dr Sverdrup said the EFTA Court had sought to overcome this gap by making similar rulings to the CJEU. As a result, "they are interpreted similarly", and the judgments of the EFTA Court "parallel the developments in the EU".[80]

61. Dr Sverdrup also noted that the EEA Agreement included a "standard safety clause", Article 112, which enabled a state in certain circumstances to "move back from some of its obligations" on free movement of persons. Such an 'emergency brake' "should be temporary and proportionate". Bearing these factors in mind, he concluded: "I do not think the Article 112 strategy is designed for countries that want to be left out of the free movement of persons."[81]

### *Complying with EU law*

62. Although certain policy areas are excluded from the EEA agreement, Dr Sverdrup told us that in practice Norway and other EEA states were "subject to around three-quarters of all EU legislation". In those areas, he added that Norway had to have the same rules in place as an EU Member State.[82] Thus in reference to the operation of state aid rules, he said: "The rules are not more lax in Norway than in the EU. They are exactly the same."[83]

63. Despite being subject to three-quarters of EU legislation, non-EU EEA states have little or no influence over the preparation and adoption of EU law. More information is given in Box 2.

**Box 2: Non-EU EEA states' influence over EU legislation**

Officials from the non-EU EEA countries can participate in expert groups and committees of the European Commission, and may submit comments on forthcoming legislation. Norwegian officials participate in just over 200 Committees in the European Commission.

Non-EU EEA states can ask to amend EU legislation, but only in circumstances where this is required for the law to make sense in domestic legislation. Any amendment has to secure the agreement of the Commission. Non-EU EEA countries can refuse to implement or veto EU legislation, but this veto would suspend the application of the whole affected part or annex to the EEA Agreement for the country exercising the veto. Norway has never exercised its veto right.

*Source: Open Europe, What if … ? The Consequences, challenges and opportunities facing Britain outside of the EU (March 2015), p 52: http://2ihmoy1d3v7630ar9h2rsglp.wpengine.netdna-cdn.com/wp-content/uploads/2015/03/150507-Open-Europe-What-If-Report-Final-Digital-Copy.pdf [accessed 28 November 2016]*

80 Q 29
81 Q 29
82 Q 25
83 Q 28

64. In 2012 the Norwegian Government published a report evaluating its relationship with the EU through the EEA Agreement. This report found that:

> "The most problematic aspect of Norway's form of association with the EU is the fact that Norway is in practice bound to adopt EU policies and rules on a broad range of issues without being a member and without voting rights … This raises democratic problems."[84]

### *Reform of the EEA Agreement*

65. Dr Sverdrup was asked about the likelihood of the UK being able to negotiate changes to the EEA agreement, so that non-EU countries could have voting rights over EU legislation. Dr Sverdrup explained that while existing non-EU EEA countries might find this appealing, the "main framework of the EEA Agreement has never been renegotiated" in the "past 25 years".[85]

66. This was due to a number of factors. First, non-EU EEA countries "basically think that they cannot get a better deal". When the EEA agreement was signed in 1992, EFTA had seven countries while the EU had twelve. Now, however, the "EU consists of 500 million people and the EEA is only five million". A second reason was that "sentiments in the EU" would not favour such an approach. It was "not very likely" that an "EU member country [would] accept being outvoted by a non-member." Finally, any change to the Agreement would have to be ratified by all the signatories, which was "not very easy". Bearing all these factors in mind, Dr Sverdrup concluded that Norway had accepted that "we have what we have, and it is very difficult to negotiate it 'up' or 'down'." [86]

67. As an alternative to renegotiation, Dr Sverdrup thought it might be possible for the UK and other non-EU EEA countries to negotiate representation at Council meetings, albeit without voting rights. This was the mechanism used under the Schengen Agreement, and it gave states "a right to share their views, listen in and talk".[87]

68. Dr Sverdrup noted that EEA membership as a basis for trade had not worked for everyone: "Austria, Finland and Sweden left because they felt it was not attractive."[88] But for Norway it was a "part of a domestic compromise": the day after a referendum in November 1994, where the population rejected membership of the EU, "the political leadership moved to, 'Let's maintain the EEA and promote integration through that path'".[89] Since that time, "one reason why the EEA has been fairly successful is because there have been few attempts to play against the rules". [90]

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84 Norwegian Government EEA Review Committee, *Outside and Inside: Norway's agreements with the European Union* quoted in HM Government, *Alternatives to membership: possible models for the United Kingdom outside the European Union* (March 2016), p 20

85 Q 28

86 Q 28 (Dr Ulf Sverdrup)

87 Q 28

88 Q 23

89 Q 25

90 Q 25

69. In summary, Dr Sverdrup concluded that a key lesson Norway had learned from EEA membership was:

> "there is no free lunch. You cannot have it all. You have to decide what you would like to have and play hard to try to get that, but at the same time you have to accept that others have legitimate interests as well".[91]

## Trade with the Single Market

70. In its report, *The EU Single Market: The Value of Membership versus Access to the UK*, the IFS argued that "EEA would mean stronger economic performance than an FTA scenario", worth potentially 4% of GDP relative to trading with the EU under WTO rules.[92] Mr Michael Emerson, Associate Research Fellow, Centre for European Policy Studies (CEPS), agreed that the advantage of the EEA option was that:

> "It is a system that exists, offers legal clarity and actually works. It is closest among other options to sticking to the status quo in economic terms and it would avoid uncertainty and thereby minimise damage to the UK as a destination for foreign investment aimed at the EU market."[93]

### *Goods*

71. Dr Holmes told us that the EEA agreement only provided "incomplete access" to the Single Market in goods, because non-EU states were outside the EU's customs union.[94] Instead the EEA Agreement includes a provision that waives the Common External Tariff on goods (except certain agricultural and fish products) exported from non-EU EEA states into the EU, as long as the majority of their parts are produced in the EEA ('rules of origin').[95] The Government's paper, *Alternatives to membership: possible models for the United Kingdom outside the European Union*, said that while this arrangement worked well for countries like Norway, three-fifths of whose exports are raw materials (gas and oil), it would be more problematic for the UK—where on average 23% of the value of the UK's goods exports is derived from foreign components.[96]

72. Dr Sverdrup told us that complying with rules of origin had introduced "a bit of bureaucracy or paper-shuffling", and so increased "the transaction costs for business". He noted that as "economies become more integrated", with supply chains crossing national boundaries, it was "more challenging to determine where things are produced".[97]

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91 Q 25
92 Institute for Fiscal Studies, *The EU Single Market: The Value of Membership Versus Access for the UK* (August 2016), p 33
93 Michael Emerson, Centre for European Policy Studies, *Which model for Brexit?* (14 October 2016): https://www.ceps.eu/system/files/SR147%20ME%20Which%20model%20for%20Brexit.pdf [accessed 28 November 2016]
94 Q 25
95 European Free Trade Association, *Free Movement of Goods* (August 2014), p 7: http://www.efta.int/media/publications/fact-sheets/EEA-factsheets/GoodsFactSheet.pdf [accessed 28 November 2016]
96 HM Government, *Alternatives to membership: possible models for the United Kingdom outside of the European Union* (March 2016), p 20
97 Q 20

73. Dr Holmes also told us that while "the EEA gives free circulation to all goods put on the market in the EEA … to put them on the market in the EEA you have to comply with EU standards".[98] This means that while goods are checked at the EU's borders for compliance with rules of origin, they are not checked for compliance with EU technical rules, "because membership of the EEA implies full legal compliance with all EU rules".[99] Goods intended for domestic consumption also have to comply with EU rules.

74. For those sectors outside the EEA Agreement, such as agriculture and fisheries, EU and non-EU EEA states trade on the basis of bilateral treaties. Where bilateral treaties do not exist, the EU imposes tariffs on goods imported from non-EU EEA countries, and the EU can apply safeguard measures, such as antidumping policies, as it has done in the past on fish products, for example.[100] This could potentially pose difficulties for the UK, as 64% of the UK's fish and 73% of vegetable exports go to the EU.[101] This has implications for the UK's border with the Republic of Ireland—the subject of our report on the implications of Brexit for UK-Irish relations.[102]

### *Services*

75. Dr Sverdrup told us that the EEA Agreement provided "not only full access to, but membership of the internal market" in services.[103] More broadly, while free movement of services within the Single Market is still developing, the EU has increasingly focused on reducing non-tariff barriers over the last two decades.[104] Dr Holmes described the EEA as a "regulatory union" which, in parallel to the EU, has aimed to remove and eliminate non-tariff barriers to trade. He contrasted this with other trade relationships, such as a customs union, which focus on removing tariffs on goods.[105] Under EEA membership, all service providers have to comply with the relevant EU law even if they do not trade with the EU.

## Dispute resolution

76. Dr Sverdrup described the EFTA Court and Surveillance Authority as "unique elements" of the EEA Agreement. They worked as "micro-version" of the European Commission and the CJEU.[106] They are described in Box 3.

98 Q 28
99 Written evidence from Dr Peter Holmes (ETG0011)
100 European Free Trade Association, 'Free Movement of Goods–Factsheet' (August 2014): http://www.efta.int/media/publications/fact-sheets/EEA-factsheets/GoodsFactSheet.pdf [accessed 28 November 2016]
101 HM Government, *Alternatives to membership: possible models for the United Kingdom outside the European Union* (March 2016), pp 17-18
102 European Union Committee, *Brexit: UK-Irish relations* (6th Report, Session 2016–17, HL Paper 76)
103 Q 25
104 HM Government, *Alternatives to membership: possible models for the United Kingdom outside the European Union* (March 2016), pp 10-11
105 Q 28
106 Q 27

### Box 3: The EFTA Court and Surveillance Authority

The EFTA Court, based in Luxembourg, deals with infringement actions brought by the EFTA Surveillance Authority (ESA) against non-EU EEA states with regard to the implementation, application or interpretation of EEA law, with appeals concerning decisions taken by the EFTA Surveillance Authority, with actions for failure to act, and with actions for damages. It also gives advisory opinions to courts in the non-EU EEA states on interpretations of EEA rules, and is competent for settling disputes between two or more non-EU EEA states. The Court has three judges (one from each non-EU EEA state).

The ESA investigates compliance and implementation of the EEA Agreement and law including restrictions on state aid and rules relating to competition. The ESA's powers in this regard correspond to those of the European Commission, with which it co-operates closely. Located in Brussels, the ESA is led by a College of three members, each appointed for four years by the three participating non-EU EEA states.

*Source: Q 27 (Dr Ulf Sverdrup); Carl Baudenbacher, 'The EFTA Court: Structure and Tasks', in The Handbook of EEA Law, p 139; European Free Trade Area, 'The EFTA Surveillance Authority at a Glance': http://www.eftasurv.int/about-the-authority/the-authority-at-a-glance-/ [accessed 29 November]; EFTA Court, 'Introduction to the EFTA Court': http://www.eftacourt.int/the-court/jurisdiction-organisation/introduction/ [accessed 29 November]*

77. Although the EFTA Court was considered to be "autonomous and independent", Dr Sverdrup argued that it had been "trying rather forcefully to put forward this idea that the main principle is to secure homogeneity" between its own rulings and those of the CJEU.[107] The Court's reasoning was typically "what would the European Court of Justice have ruled in a case such as this if it were presented with one?"[108] This approach meant that even if there was a gap between the EEA agreement and EU law, the policy of the EFTA Court was "to make rulings in the direction of homogeneity".[109]

78. Dr Sverdrup also noted that "for reasons of formal sovereignty", the powers of the EFTA Court did "not extend quite as far as for the [CJEU]". Although the Court could make "binding judgements on infringement proceedings against the member states", it could not "impose a financial penalty".[110]

## Trade with third countries

79. Non-EU EEA countries have to be members of EFTA, but can independently agree FTAs with third countries. Dr Sverdrup said that FTAs were often negotiated by EFTA, rather than by individual states, because it was easier to enter negotiations "if you have a slightly bigger market".[111] On the other hand, members could pursue independent and separate negotiations, and Dr Sverdrup told us that both Iceland and Switzerland had bilateral FTAs with China.[112] According to the IFS, EFTA has 28 trade deals with 38 different countries (excluding the EU), accounting for 13.1% of global GDP and 11.8%

107 Q 27; This idea of homogeneity finds its source in the language of the relevant treaties themselves, including Article 1(1) and Article 6 of the EEA Agreement, Recital 15 of the preamble to the EEA Agreement and Article 3(2) of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice. Carl Baudenbacher, 'The Relationship Between the EFTA Court and the Court of Justice of the European Union', in *The Handbook of EEA Law*, p 179

108 Q 27 (Dr Ulf Sverdrup)

109 Q 27 (Dr Ulf Sverdrup)

110 Written evidence from Dr Ulf Sverdrup (ETG0010)

111 Q 26

112 Q 26

of the global population, as well as 10% of UK exports. EFTA's trade deals include Hong Kong, Canada, Saudi Arabia, Singapore and South Korea.[113] In some cases agreements have been reached in advance of the EU—Dr Sverdrup noted that the EFTA agreement with South Korea was signed "a year or a year and a half prior to the EU's".[114]

80. At the same time, there are restrictions on the autonomy of non-EU EEA states, and Dr Holmes noted that they "would not be free to sign a free trade agreement with regard to non-tariff components". For instance, a non-EU EEA state "could reduce all its tariffs on Chinese products to zero", but it "would not be able to relax the conditions under which Chinese goods, or anyone else's goods, could be imported".[115] The IFS found that "few of the [EFTA] trade deals significantly enable trade in services", and that many "do not appear to go far beyond incorporating the General Agreement on Trade in Services (GATS) rules established by the World Trade Organisation (WTO) in 1995".[116]

81. Dr Sverdrup did not think it would be possible for the UK to become party to EFTA's existing FTAs, because "third countries would probably like to look into it and see whether they would like to renegotiate those agreements".[117]

### Conclusions and recommendations

82. **EEA membership would be the least disruptive option for UK-EU trade, not least because it would maintain membership of the Single Market for services. It would also provide partial membership of the Single Market for goods, though businesses would have to comply with rules of origin.**

83. **The process of joining the EEA as a non-EU Member State appears to be technically possible. It is unclear, however, whether other non-EU EEA countries would be amenable to the UK's entry.**

84. **We urge the Government to offer clarity on the legal question of whether the UK would have to leave the EEA Agreement altogether before joining as a non-EU country (under EFTA).**

85. **Becoming a non-EU EEA member would significantly restrict the UK's ability to limit the free movement of persons. It would also require the UK to adopt existing and future EU laws relevant to the EEA Agreement in the same way as an EU Member State, without having any voting rights.**

86. **We see little prospect that the EEA Agreement will be reformed to give the non-EU EEA states voting rights on new EU laws. Thus if it became a non-EU EEA member, the UK would be unable to exercise control over the pace of integration with the EU's laws and practices. As a non-EU EEA state, the UK would be able to negotiate FTAs with third countries, but would be constrained by its obligations to comply with EU law in areas covered by the EEA Agreement. It is unlikely that EFTA's existing FTAs with third countries would be open, or attractive, to the UK.**

113 Institute for Fiscal Studies, *The EU Single Market: The Value of Membership versus Access to the UK* (August 2016), p 23

114 Q 26

115 Q 28

116 Institute for Fiscal Studies, *The EU Single Market: the Value of Membership versus Access to the UK* (August 2016), pp 23-24

117 Q 26

## CHAPTER 4: MEMBERSHIP OF THE EU'S CUSTOMS UNION

87. We also considered the implications of either remaining part of, or leaving, the EU's customs union after Brexit. An overview of the customs union is given in Box 4.

### Box 4: The EU's customs union

Under Articles 28, 30, 34, 35 and 36 TFEU, individual Member States are not permitted to introduce charges that have an effect equivalent to that of customs duties on goods; nor are they permitted to impose quantitative restrictions or quotas. This means Member States are obliged to allow goods that are legally produced and marketed in other Member States to be circulated and placed on their domestic markets.

The EU's customs union has a Common External Tariff, which is imposed on all goods imported from third countries. Uniform implementation of the Common External Tariff by customs authorities across the EU's external borders is ensured through the Customs Union Code. Almost 80% of the revenue generated by tariffs go directly to the EU's budget (in 2015, this made up 13.6% of the EU's total budget).[118]

Goods imported into the EU need to comply with Single Market legislation. In support of this, the EU has legislated to harmonise regulations (such as product standards and safety requirements) and to enforce the principle of mutual recognition (which requires Member States to accept each other's certification and conformity practices). To expedite this process for third countries, the EU has concluded a number of Mutual Recognition Agreements, recognising compliance procedures which demonstrate that goods meet the required EU standards.

Goods imported into the EU need to follow 'rules of origin', which determine where a product and its components were produced in order to ensure that the correct customs duty is levied. If goods consist of materials from more than one country, special rules apply to determine which country will be judged to be the country of origin. This is based on the origins of the materials, the value added in the process, and where the final substantial production phase took place. Such formalities are not necessary for goods manufactured inside the customs union.

The EU's customs union is made up of EU Member States, and includes the Isle of Man and the Channel Islands.[119]

118 European Commission, 'Customs duties mean revenue': https://ec.europa.eu/taxation_customs/facts-figures/customs-duties-mean-revenue_en [accessed 28 November 2016]

119 The Isle of Man and the Channel Islands are part of the EU's customs union by virtue of Protocol No. 3 to the UK's Treaty of Accession. This protocol is limited in scope, and the Channel Islands and the Isle of Man do not, for example, participate in the EU's Single Market in services or financial services. The Channel Islands Brussels Office, *The EU and the Channel Islands*: http://www.channelislands.eu/eu-and-the-channel-islands/ [accessed 28 November 2016]. Gibraltar is outside the EU's customs union. Grant Thornton, 'European Union Status: Gibraltar': http://www.grantthornton.gi/gibraltar/european-union-status/ [accessed 28 November 2016]. We consider the position of the Channel Islands and Gibraltar with regard to Brexit in a forthcoming report.

*Turkey*

Followings its Association Agreement with the EU (the Ankara Agreement, signed in 1963), and the opening of accession negotiations, Turkey signed a customs union agreement with the EU in 1995.[120] This stated that:

"From the date of entry into force of this Decision, Turkey shall, in relation to countries which are not members of the Community, apply provisions and implementing measures which are substantially similar to those of the Community's commercial policy."

Turkey's customs union with the EU covers all industrial goods, but not agriculture (except processed agricultural products), services or public procurement. It also excludes the free movement of labour.[121] Although Turkey and the EU have negotiated to extend and deepen their customs union agreement to include services and public procurement, these negotiations were suspended in 2002.

Turkey imposes the EU's Common External Tariff on all goods imported from non-EU countries that are covered by the customs agreement. Turkey has no involvement in decisions about the Common External Tariff or setting the direction of the Common Commercial Policy. It is also not able automatically to secure additional market access via EU FTAs with third countries, but these third countries have access to Turkey's market. Turkey is expected to align itself to EU preferential tariffs by negotiating FTAs with countries the EU has concluded FTAs with, in order to gain access to their market. Turkey has signed FTAs with EFTA, a number of Eastern European and Middle Eastern countries and South Korea.

The EU also foresees that Turkey will align its national legislation with a number of essential internal market rules, notably on industrial standards.

*Source: European Commission, 'Trade: Countries and regions: Turkey': http://ec.europa.eu/trade/policy/countries-and-regions/countries/turkey/ [accessed 28 November 2016] and written evidence from Dr Peter Holmes (ETG0011)*

## Remaining part of the EU's customs union

88. The Committee considered whether and how it might possible for the UK to remain part of the EU's customs union after Brexit. Dr Holmes argued that it would be "extremely hard". The customs union was part of the foundation of the EU, enshrined in the Treaty of Rome, to such an extent that it was "not a separate entity that [EU] Member States all happen to belong to".[122]

89. Instead, Dr Holmes said that what was "in principle available" to the UK after Brexit was to "have a customs union with the EU's customs union"; Turkey was the only example of this.[123] He noted that Turkey's arrangement differed "sharply from the EU customs union itself". Some of these differences are outlined in the following paragraphs.[124]

120 Decision No 1/95 96/142/EC, 22 December 1995, of the EC-Turkey Association Council on implementing the final phase of the Customs Union, OJ L 35

121 We note that the agreement between the EU and Turkey includes a standstill clause on the free movement of service providers. See Selen Akses, 'Where does Turkey stand in the EU's new trade and investment strategy?' *Hurriyet Daily News* (16 November 2016): http://www.hurriyetdailynews.com/where-does-turkey-stand-in-the-eus-new-trade-and-investment-strategy.aspx?pageID=238&nID=91187&NewsCatID=396 [accessed 28 November 2016]

122 Written evidence from Dr Peter Holmes (ETG0011)

123 Written evidence from Dr Peter Holmes (ETG0011)

124 Q 20 (Dr Peter Holmes) and written evidence from Dr Peter Holmes (ETG0011)

90. First, Dr Holmes noted that the EU-Turkey customs union was "incomplete", in that there was not tariff-free trade on all goods between the EU and Turkey. For instance tariffs were still applied on agricultural goods.[125] We note that the EU is an important export market and source of imports for the UK agricultural sector.[126]

91. Second, there remained customs checks on the border between Turkey and the EU (while within the EU internal customs checks have been abolished). Dr Holmes told us that while the 1995 agreement between Turkey and the EU removed customs duties, it was not a regulatory union and so did not abolish technical barriers to trade. This resulted in the EU inspecting Turkey's goods, because it did not recognise Turkey's conformity assessments. A series of Mutual Recognition Agreements were subsequently put in place, which had allowed more Turkish goods to enter the EU without further technical inspections. However, these agreements only applied in areas where the EU had harmonised its rules internally—in areas where Member States apply separate national rules, customs authorities retain the right to inspect Turkish goods.[127] In return, Dr Pinar Artiran, Assistant Professor in Private International Law, Istanbul Bilgi University and WTO Chair Holder, noted that Turkey had also applied customs and 'rules of origin' checks on "woven fabrics and apparel" imported from the EU, even though they have already been "in free circulation in the EU".[128]

92. Third, Dr Holmes said that "very strikingly, anti-dumping is still possible between the EU and Turkey". This means that the EU and Turkey can impose duties on goods traded between them—the absence of which is one of the main benefits of a customs union.[129] Dr Holmes cited a World Bank study which showed that in 2014, the EU had actual or proposed anti-dumping duties on $500 million of Turkish exports to the EU, and Turkey had actual or proposed anti-dumping duties on $1billion of EU exports.[130]

93. Fourth, Dr Artiran noted that a key feature of Turkey's customs union with the EU was that "Turkey is expected to grant tariff-free access to goods from a third country with which the EU has negotiated a FTA, without necessarily having a vote or say in the negotiations". She continued: the "EU decides the FTA partner, the scope and timing of the negotiations based on its own priorities without necessarily taking into account its customs union with Turkey".[131]

94. Finally, Dr Holmes said there was "no sharing of customs revenue" between Turkey and the EU, which was somewhat anomalous: "If you are talking about a customs union, you have to ask: what happens to customs revenue on third-country goods? Does it go to the place where the good is actually consumed or is it shared?"[132] Dr Artiran wrote that Turkey's arrangement with the EU was that Common Customs Tariff revenue "would be collected by each party at the initial port of entry and … would accrue as income to the party collecting that revenue".[133]

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125 Q 20

126 For example, more than 70% of the UK's exports and imports of food and non-alcoholic beverages are with the EU. See Food and Drink Federation, *A new UK-EU relationship priorities for the food and drink manufacturing industry* (July 2016), p 4: https://www.fdf.org.uk/corporate_pubs/FDF-Manifesto-A-New-UK-EU-Relationship.pdf [accessed 28 November 2016]

127 Written evidence from Dr Peter Holmes (ETG0011)

128 Written evidence from Dr Pinar Artiran (ETG0012)

129 Q 20

130 Written evidence from Dr Peter Holmes (ETG0011)

131 Written evidence from Dr Pinar Artiran (ETG0012)

132 Written evidence from Dr Peter Holmes (ETG0011) and Q 25

133 Written evidence from Dr Pinar Artiran (ETG0012)

95. Asked whether the Government had met representatives from Turkey to discuss their participation in the EU's customs union, Lord Price said he had meetings scheduled "in the very near future."[134]

96. We note that these features of the Turkey-EU customs union arrangement might or might not apply to the UK if it remained part of the EU's customs union after Brexit. They show that having a customs union arrangement with the EU without being an EU Member State could radically alter the way in which the customs union works, and reduce its corresponding benefits for the UK.

## Trade with the Single Market

### *Goods*

97. Dr Holmes explained that while the FTA and customs union models shared the benefit of "countries [agreeing] to remove tariff barriers on each other's goods," the unique feature of a customs union was that "in principle you do not have rules of origin so goods can flow completely freely … you do not have to stop goods at the border".[135]

98. Rules of origin add costs through additional bureaucracy, including the difficulty of identifying the origin of goods with a complex supply chain, and an additional cost for consumers in importing goods.[136] They also slow down the process of trade. In the words of Mr Mike Hawes, Chief Executive Officer, the Society of Motor Manufacturers and Traders: "If it passes borders, you need a customs validation, that creates some delay, and anything that delays creates cost."[137] Leaving the EU's customs union would also involve developing an independent customs code, and the recruitment and retraining of customs officers.[138] This is why the Japanese government, in its open letter to the UK and the EU on Brexit, said its first priority for Japanese businesses investing in the UK was "maintenance of the current tariff rates and customs clearance procedures". It said being outside the customs union could mean that tariffs were "imposed twice, once for auto parts imported from the EU and again for the final products assembled in the UK to be exported to the EU, which would have [a] significant impact on their businesses."[139]

99. The estimates of the cost to the UK of leaving the EU's customs union are unclear. Open Europe estimated that applying rules of origin "could cost around 1–1.2% GDP", though we note that Mr Raoul Ruparel, then Co-Director of Open Europe,[140] described this cost as "not prohibitive".[141] A report commissioned by the Government in 2013 estimated that leaving the customs union could cost traders anything from 4–15% of the cost of goods

134 Q 54
135 Q 20
136 Q 20 (Dr Ulf Sverdrup)
137 Oral evidence taken before the EU External Affairs Sub-Committee, 3 November 2016 (Session 2016–17), Q 67 (Mike Hawes)
138 Oral evidence taken before the EU External Affairs Sub-Committee, 20 October 2016 (Session 2016–17), Q 3 (Steve Elliott)
139 Government of Japan, *Japan's Message to the United Kingdom and the European Union* (4 September 2016): http://www.mofa.go.jp/files/000185466.pdf [accessed 28 November 2016]
140 Mr Ruparel was the Co-Director of Open Europe at the time at which he gave evidence to the Committee. He is now a Specialist Advisor to the Secretary of State for Exiting the European Union.
141 Raoul Ruparel, Open Europe, *Post Brexit, leaving the customs union is a no-brainer* (28 July 2016): http://openeurope.org.uk/today/blog/post-brexit-leaving-customs-union-no-brainer/ [accessed 28 October 2016]

sold.[142] We will consider this in greater detail in our forthcoming report on UK-EU trade in goods after Brexit.

100. When asked what work the Government was doing to estimate the cost of leaving the EU's customs union, Lord Bridges said his department was "doing a lot of work both on standards and rules of origin". This work was being undertaken "sectorally and generically" and, in the case of rules of origin, "from the bottom up."[143] Lord Bridges also said he had "been in conversations with those involved in shipping and customs and business itself about exactly how those rules of origin operate". He was "very struck by the means by which we now have digital technology and data to help in the customs process". He continued: "we are absolutely aware of the administrative and implementation processes involved and what the various options might therefore entail."[144] Lord Price added that he had met the Swiss Trade Minister, who spoke "about the complexities of being outside the customs union in Switzerland, the procedures that they have to go through in importing and complexity in the costs".[145]

101. We note that, according to reports in the media, the EU Exit and Trade Cabinet Committee[146] in October considered a paper on leaving the EU's customs union.[147] However, neither Minister was able to estimate what complying with rules of origin might cost UK businesses. Lord Bridges said that "those are exactly the kinds of things we are looking at and working on as we speak … Your concern is my concern, and we are working on them". When asked whether this information would be ready before Article 50 TEU was triggered, he responded: "We are working with due and deliberate but precise speed on these issues."[148]

102. It is also unclear what impact leaving the EU's customs union would have on the UK's land border with the Republic of Ireland. This issue is addressed more fully in our report on the implications of Brexit for UK-Irish relations.

### *Services*

103. Customs unions principally eliminate tariffs, and so do not directly facilitate trade in services, which often face non-tariff barriers. Dr Holmes noted that this distinction came with some complications: "more and more trade today consists of goods and services bundled together". While the customs union did not have direct implications for services, "You cannot quite separate goods and services as much as you could in the past."[149]

142 Centre for Economic Policy Research, *Trade and Investment -Balance of Competence Review, Project Report* (November 2013), p 58: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/271784/bis-14-512-trade-and-investment-balance-of-competence-review-project-report.pdf [accessed 28 November 2016]

143 Q 54

144 Q 54

145 Q 54

146 Cabinet Office, 'List of Cabinet Committees and their members at 18 October 2016': https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/560912/cabinet_committees_list_18_10_2016.pdf [accessed 29 November 2016]

147 Anushka Asthana, Rowena Mason and Owen Bowcott, 'Theresa May given stark warning about leaving customs union', *The Guardian* (18 October 2016): https://www.theguardian.com/politics/2016/oct/18/theresa-may-given-stark-warning-about-leaving-customs-union [accessed 28 November 2016]

148 Q 54

149 Q 20

### Trade with third countries

104. According to Dr Holmes, being part of any customs union came at a price: "you completely lose your ability to have your own independent external trade policy". In areas covered by its customs union, Dr Holmes told us that Turkey had to have "exactly the same external trade policy" as the EU.[150] Dr Artiran explained that Turkey's commitments obliged it to "align itself on the Common Customs Tariff", and to "adjust its customs tariff whenever necessary to take account of changes in the EU's Common Customs Tariff".[151] Dr Holmes added that this meant that if there was another WTO round on lowering tariffs at a global level, "Turkey will have to go along with the EU position".[152]

105. At the same time, Dr Holmes acknowledged that on those areas excluded from the customs union (such as agricultural goods), Turkey had freedom to negotiate FTAs with third countries.[153] Dr Artiran agreed: "normally, Turkey is able to adopt a trade policy that is independent of the EU in areas not covered" by its customs union arrangement.[154] Thus Turkey has a FTA with Georgia, agreed before the EU agreed its Deep and Comprehensive Free Trade Area with that country. This would be impossible in a full customs union.[155]

106. Such autonomy is, however, limited. Dr Holmes said that "pressure is on Turkey to sign agreements with countries that the EU has signed with", and so to "follow behind" on areas covered by the customs union. Furthermore, because aspects of Turkey's external trade policy were already determined and not negotiable, there would be "no great incentive for Canada [for example] to sign an identical agreement with Turkey" after CETA comes into force, since Canada would "in principle get market access into Turkey" anyway.[156] Dr Artiran agreed that "Turkey becomes a vulnerable market for all countries which [sign FTAs] with the EU". She described this as the source of a fundamental "asymmetry" in the customs union relationship between Turkey and the EU.[157]

107. We note that, as discussed in Chapter 2, "substantially all the trade" between the constituent parties of a customs union or free trade agreement must be liberalised. Sectoral agreements (on issues outside a customs union arrangement, in this case) could fall foul of Article XXIV and so might not be available to the UK were it to pursue membership of the customs union after Brexit.[158]

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150 Q 20
151 These commitments derive from Decision No 1/95, 96/142/EC, 22 December 1995, of the EC-Turkey Association Council of on implementing the final phase of the customs union, OJ L 135; Written evidence from Dr Pinar Artiran (ETG0012)
152 Q 20
153 Q 20
154 Written evidence from Dr Pinar Artiran (ETG0012)
155 Q 21 (Dr Peter Holmes)
156 Q 21
157 Written evidence from Dr Pinar Artiran (ETG0012)
158 Article XXIV, General Agreement on Tariffs and Trade 1994: https://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_09_e.htm [accessed 22 November 2016]

108. Bearing these factors in mind, Dr Holmes argued that the only form in which the UK should contemplate a customs union after Brexit was as a transitional arrangement: "If the UK left the EU, it is extremely hard to see how it could be part of the EU CU, except as part of a transition process."[159] Such a transitional arrangement would be unprecedented, and it would have to address the collection of customs revenue—whether that would be pooled or kept separate.[160]

109. The Government set up the new Department for International Trade (DIT) in July 2016. Its responsibilities include "developing and negotiating free trade agreements and market access deals with non-EU countries",[161] which suggests that the Government's intention is to pursue a trade policy independent of the EU. Lord Price's evidence also suggested that the Government was holding preliminary talks with third countries about future trade deals.[162]

### Conclusions and recommendations

110. **A key aspect of Brexit will be the feasibility of the UK remaining part of the customs union: the Government will need to decide early on whether or not the UK should do so. Although Turkey offers an example of a country outside the EU having a customs union with the EU, its participation is fundamentally different from the UK's participation as a full EU Member State.**

111. **We are concerned that the Government appears not yet to have given sufficient consideration to the implications of leaving the EU's customs union. While there may be opportunities to use digital technologies to streamline customs procedures, we are troubled that the Government presently has no estimate of the cost to businesses of administrative delays, compliance with customs checks, and the rules of origin if the UK left the customs union, and that it was unable to confirm whether or not such information would be available before triggering Article 50. Our concerns are made more acute by the implications of leaving the customs union for the UK's land border with the Republic of Ireland.**

112. **Before Article 50 is triggered, the Government should undertake and conclude a rigorous analysis of the cost to business and to taxpayers of leaving the customs union. We will also investigate these issues in greater detail in our follow-up report on future UK-EU trade in goods.**

113. **A customs union with the EU similar to Turkey's arrangement would require the UK to adopt the EU's standards and regulations for all goods under the customs union arrangement. There would also be common customs procedures.**

159 Written evidence from Dr Peter Holmes (EGT0011)
160 Q 25 (Dr Peter Holmes)
161 Department for International Trade, 'About us': https://www.gov.uk/government/organisations/department-for-international-trade/about [accessed 22 November 2016]
162 Q 40

114. **Despite the Government informing us that all the possible frameworks for future trade between the UK and the EU were 'on the table', the remit of the new Department for International Trade suggests that the Government intends to pursue an independent trade policy.**

115. **Seeking to pursue an independent trade policy while coming to an arrangement with the EU's customs union, as Turkey has done, is a difficult balancing act, which would severely curtail the UK's leverage in future trade negotiations with third countries.**

116. **If it has not done so already, the Government should consider the merits of remaining a member of the EU's customs union as an interim arrangement, until the terms of the UK's future trading relationship with the EU have been settled. We are also conscious of the practical challenges of introducing full customs controls within two years.**

## CHAPTER 5: A UK-EU FREE TRADE AGREEMENT

117. Instead of remaining in the EEA or the EU's customs union, the Government could seek to negotiate a free trade agreement (FTA) with the EU. This would give it preferential terms of trade relative to those agreed at the WTO (the subject of the next chapter). Separately, the UK could also negotiate FTAs with key third country trading partners after Brexit. The implications of this approach are the subject of this chapter. More information about FTAs can be found in Box 5.

### Box 5: Free trade agreements

A FTA is an agreement between two or more countries that aims to liberalise the trade of goods and/or services. Rather than providing completely free trade, FTAs provide preferential market access relative to a situation in which no such agreement exists. The main benefit of FTAs is lower tariffs than those prescribed by the WTO: FTAs reduce or eliminate tariffs and remove quotas on imported and exported goods. FTAs can also include provisions on investment.

As tariffs have gradually fallen, and services have become increasingly central to the global economy, non-tariff barriers have become increasingly important. FTAs are therefore increasingly focused on these measures.

*The EU's process of negotiating FTAs*

Article 218 TFEU sets out the procedure for conducting international agreements on behalf of the EU. First, the Commission makes recommendations to begin trade negotiations, with a view to obtaining a mandate from the Council. When adopted, this mandate contains the 'negotiating directives', which guide the Commission's engagement with the relevant negotiating partners.

If this mandate includes areas of Member State competence, which means that the final agreement will be a 'mixed agreement', negotiations by the Commission on behalf of the Member States must be separately authorised by the Member States.

The mandate also specifies who will be conducting the negotiations—typically the Commission. A committee of the Council, normally the Trade Policy Committee, must be consulted during negotiations. A similar committee in the European Parliament must also be consulted. At the end of negotiations the Council must adopt a Decision to sign and conclude the agreement. The Decision has to be agreed by consensus if it is a mixed agreement. The consent of the European Parliament is required before the Council can adopt a decision concluding or ratifying any FTA.

When both the Council and the European Parliament have given their consent to the final FTA, if the FTA is a mixed agreement, it must also be ratified by all Member States.

*Source: HM Government, Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment (February 2014), pp 29-31*

## Negotiating a FTA between the UK and the EU

118. Mr Luis González García, Associate Member, Matrix Chambers, explained that before seeking to open formal negotiations on a FTA, the Government would have to undertake a "planning phase", consulting with the public and private sectors in order to understand their various interests. This was "hard work" and a "tremendous and complex exercise … As a trade negotiator, the first thing you need to do is to absorb information—statistics, information about supply chains". The Government would also have to take on board the views of "industry, listening to consumers associations, importers and exporters, farmers associations, industries, universities and science". It was also important that the Government engaged with Parliament, in the interests of transparency.[163]

119. Mr González García said that once the Government had completed its engagement with stakeholders, it would need to "define [its] negotiating objectives", and then analyse the "economic, legal and political implications of the trade model they want to propose to the other side". Only once this was complete would the Government "be in a position to decide when to trigger Article 50", thereby beginning formal negotiations to leave the EU and to agree a framework for the future trade relationship between the two sides.[164] These comments beg a number of questions over the scope of possible negotiations under Article 50, and the sequencing of the negotiations with the EU on the terms of exit and on future trade. These are discussed in the next section.

120. On the EU side, Mr González García said that once the Council had established a timeline for negotiations and working groups, it could begin to negotiate with the UK over the 'mandate'—in effect, "what should be included in the free trade agreement".[165]

121. Mr González García believed that this FTA was "very likely to be a mixed agreement", and that the UK would have to negotiate with the Commission's legal services about which aspects of the agreement were mixed. This he described as "a long process" and "not easy". The draft FTA would also need the consent of the European Parliament, which could mean the UK would have to re-enter "a political negotiation", and "revisit some issues that had been agreed from the technical side".[166] It would also need to be agreed by the Member States, according to their domestic constitutional arrangements.[167]

122. Mr González García also noted that "the UK's WTO status would form part of the guidelines" for negotiating a FTA, thus underlining again the importance of sequencing.[168]

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163 Q 11
164 Q 11
165 Q 11
166 Q 11
167 Q 11. We note that agreement to a FTA by Member States may require the agreement of regional parliaments, as was demonstrated in October 2016 by the parliament of Walloon in the ratification of the comprehensive FTA between Canada and the EU. 'EU presses Walloons over key Canada trade deal Ceta', *BBC News* (24 October 2016): http://www.bbc.co.uk/news/world-europe-37749609 [accessed 21 October 2016]
168 Q 11

123. More broadly, Mr González García argued that negotiations on a UK-EU FTA would be "unprecedented", because "the whole idea of a free trade agreement negotiation is to start from the status quo and then go forward for integration." This would be a negotiation where the "position of the UK in many aspects is to maintain the status quo and in other aspects to go backwards." However, he did concede that this might bring one advantage—it would remove the "the most complex issue of the negotiation", namely deciding which regulations to adopt. In this instance, the UK had already adopted the relevant regulations as part of EU law.[169]

*Order of negotiations*

124. Mr González García's description of the process of FTA negotiations relies on the assumption that the UK and the EU would be able to combine withdrawal negotiations under Article 50 with negotiations on the future framework for trade under a comprehensive FTA.

125. Mr González García argued that the reference in Article 50 to the "future framework" for a relationship between the Member State and the EU could encompass "the negotiation of a comprehensive free trade agreement." He continued: "It makes sense in its logic that the negotiators of Article 50, if they wanted just to narrow the scope of what can be negotiated under Article 50, could have set guidelines or principles, but the framework is broad enough to include the future trade rules." This would "give stability and certainty to the businesses, investors and consumers of Europe", by providing "clear, permanent and predictable rules for the future relationship between the two sides."[170]

126. Dr Markus Gehring, Lecturer, Faculty of Law, University of Cambridge, disagreed. While it might be possible to "establish a programme of negotiation and the broad outline of what a free trade agreement with the then former member state looks like", he did not think it was "very realistic … to use Article 50 as a legal basis for such an agreement". He continued: "The Commission is firmly of the view that first you leave and then you negotiate the future relationship. It would be very difficult for the UK to convince the Commission otherwise."[171]

127. Mr Ruparel reasoned that while "the Commission has its view … Member States have a slightly different view". Ultimately, he argued, "the mandate will be tasked by the Member States, and if they set a wide and broad mandate the Commission will have to fulfil it." He also noted that there was "a clear advantage for the UK in trying to keep the withdrawal agreement and the trade agreement as linked as possible", since the "types of areas where the UK has significant leverage", such as foreign policy and security were likely to be "be grouped in the withdrawal agreement".[172]

128. Lord Bridges also wanted to ensure that negotiations on the withdrawal treaty and the new relationship were "conducted together." He believed that the drafting of Article 50 supported this approach, but said the Government "would wish to clarify that".[173]

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169 Q 15
170 Q 13
171 Q 13
172 Q 13
173 Q 40

### *Transitional arrangement*

129. Even if a FTA could be negotiated alongside a withdrawal agreement under Article 50, Dr Gehring, Mr Ruparel and Mr González García agreed that it would not be possible to conclude that FTA within two years.[174] Mr Ruparel said timing was "the biggest technical risk" to the prospect of successful negotiations. He recommended that the Government seek to gauge "the willingness either to extend the Article 50 period or to consider some kind of transitional period after those two years".[175]

130. Mr González García agreed, noting that "the two-year timeframe is not very realistic … I think it is highly unlikely that in two years you can negotiate [a FTA]". He therefore recommended that the Government and the EU "agree on an extension to the two-year deadline."[176] This is consistent with evidence given to the EU Select Committee by Lord Kerr of Kinlochard GCMG, who told us that a future trade agreement "certainly cannot" be agreed in two years.[177] We discuss further the broader issue of, and need for, a transitional trading relationship between the UK and the EU (after the UK's withdrawal from the EU and before concluding a new agreement) in Chapter 8.

## Trade with the Single Market

### *What could a UK-EU FTA contain?*

131. There is no uniformity among FTAs. As Mr González García remarked: "There is a lot of creativity in the negotiation of an FTA." The content, he said, depended on "the objectives of the negotiation". On balance the EU negotiated four types of FTAs: those with political, developmental, economic or security dimensions. FTAs could also be combined with other wider agreements such as a "political co-operation agreement", and separate bilateral arrangements could be used to foster co-operation on other issues, such as scientific research. EU FTAs tended to include provisions on competition law and intellectual property rights, as well as "sustainable development, human rights, environmental protection and labour rights, because that is EU trade practice." They could also cover public procurement.[178]

132. Dr Gehring identified three constraints on the scope of an EU FTA: first, the jurisprudence of the CJEU; second, "the political will of the Member States"; and third, the "legal limits" set out in the EU Treaties. Items would be excluded from a FTA if they would require treaty change:

> "That is an entirely different kettle of fish. Renegotiating the foundational treaties of the EU is no small feat; some commentators have said it is virtually impossible."[179]

133. As a trade negotiator, Mr González García recommended taking a "look at what you have negotiated in other agreements and take the bits that would accommodate your interests and the interests of the other side."[180]

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174 Q 12 (Mr Raoul Ruparel) and Q 13 (Mr Luis González García and Dr Markus Gehring)
175 Q 12
176 Q 13
177 Oral evidence taken before the EU Select Committee on 6 September 2016 (Session 2016–17), Q 1
178 Q 14
179 Q 12
180 Q 15

134. Box 6 outlines the areas included in the EU's Comprehensive Free Trade Agreement with Canada (CETA) and its FTA and flanking bilateral agreements with Switzerland. Dispute resolution under FTAs is described in Box 7, later in this chapter.

**Box 6: The EU's FTAs with Canada and Switzerland**

*The Comprehensive Economic Trade Agreement (CETA) between Canada and the EU*

Negotiations between the Commission and Canada started in 2007, and the Council agreed to the signing and provisional application of CETA in October 2016. The European Parliament must also approve CETA, after which it will enter into force provisionally.[181]

CETA will eliminate tariffs on all industrial products, over two-thirds of tariffs on fishing and over 90% of tariffs on agricultural goods. For these goods and other sensitive agricultural products, the agreement includes increased tariff rate quotas (TRQs).[182] All goods traded between Canada and the EU will have to comply with rules of origin, which are used to determine the country of origin of these goods in order to judge whether they will be subject to preferential tariff rates under the agreement, and the relevant EU or Canadian regulations and standards.

In relation to services, the agreement requires both the EU and Canada to list discriminatory measures and quantitative restrictions across all sectors. It includes provisions to grant the EU greater access to Canada's postal, telecommunications and maritime transport services markets. It has also given the EU greater access to Canada's public procurement market. The agreement enables staff transferred inside their company to be accompanied by their spouses and families if working in the other territory, and extends the period for transfers of contractual service providers and independent professionals from six to 12 months. The agreement also establishes a framework for the mutual recognition of some professional qualifications. CETA does not, however, contain provisions on audio-visual media or aviation services. CETA does not require Canada to make a financial contribution to the EU budget.

181 As a mixed agreement, CETA will also be subject to ratification by national parliaments. Only the sections that fall under EU exclusive or shared competence will be subject to provisional application. Letter from Lord Price CVO to Lord Boswell of Aynho (29 September 2016)

182 TRQs provide lower duties on limited quantities of goods imported into a country.

*Switzerland's trade agreements with the EU*

Switzerland is a member of the European Free Trade Area (EFTA), but unlike the three other members of EFTA (Norway, Liechtenstein and Iceland) it is not a member of the European Economic Area (EEA). Over the last two decades, Switzerland and the EU have negotiated a bespoke bilateral arrangement which encompasses over 100 individual agreements covering diverse issues. Among the most significant of these agreements is the 1972 Free Trade Agreement, which laid the groundwork for trade relations. It also provided the foundation for seven sectoral agreements (known as 'Bilateral Agreements I') signed in 1999 covering the free movement of persons, technical barriers to trade, public procurement markets, agriculture, research, civil aviation, and overland transport, and nine further agreements (known as 'Bilateral Agreements II'), which cover topics beyond trade matters, signed in 2004.

The 'Bilateral Agreements I' are linked through a 'guillotine-clause': if one agreement is terminated, all seven lose effect. This means that in return for preferential market access for air transport, carriage of goods by rail and road, trade in agricultural products, mutual recognition, government procurement and scientific co-operation, Switzerland is also required to accept the principle of freedom of movement.[183] The Bilateral Agreements II are not linked through a guillotine clause.

Since 2014, Switzerland has sought to introduce restrictions on free movement, in response to which the EU has imposed restrictions on Switzerland's access to Erasmus and Horizon 2020 programme funding.[184]

While Switzerland has relatively comprehensive preferential access to the Single Market in goods, some agricultural products face tariffs, and Switzerland has to follow rules of origin. Switzerland has less comprehensive preferential access to the Single Market in services—with limited market access for professional business services, and a 90-day limit on Swiss nationals providing services in the EU. Switzerland has no general access to the EU's market in financial services—and does not have a 'passport'—meaning that Swiss banks are required to set up subsidiaries in an EU or non EU-EEA states. Attempts to include services in Switzerland's deals with the EU have failed.[185]

183 Schweizerische Eidgenossenschaft, 'Bilateral Agreements I' (23 September 2016): https://www.eda.admin.ch/dea/en/home/europapolitik/ueberblick/bilaterale-1.html [accessed 22 November 2016]

184 Jon Henley, 'Whatever you do, don't become Switzerland, Swiss academics tell UK', *The Guardian* (11 November 2015): https://www.theguardian.com/politics/2015/nov/11/whatever-you-do-dont-become-switzerland-swiss-academics-tell-uk [accessed 18 November 2016]

185 This is in part because in return for trade liberalisation in services, Switzerland would be expected to increase its integration with the EU (as is seen in the case of non-EU EEA states) and to accept the free movement of workers. Pawel Swidlicki, 'Swiss told to vote again on free movement–except this time the stakes are higher', *Open Europe* (10 April 2015): http://openeurope.org.uk/today/blog/swiss-told-to-vote-again-on-free-movement-except-this-time-the-stakes-are-higher/ [accessed 17 November 2016]

Switzerland makes financial contributions to the EU through grants to Member States that have joined the EU since 2004 and via contributions to various programmes funded by the EU budget including research, education and satellite navigation. Switzerland's contribution to the EU budget in recent years has been around £420 million per annum, or £53 per head, compared to current UK net budget contributions of £128 per head.[186]

In 2010, the Council of the EU described the model of EU-Swiss relations as "complex", "unwieldy to manage", and as having "clearly reached its limits". In particular the institutional component of the Agreements is weak and generally does not provide for a court system. The Council has stated repeatedly that any further improvement of market access would require efficient mechanisms for adopting secondary law, a court system and surveillance of implementation.

*Source: European Commission, 'CETA: Summary of the final negotiating results' (February 2016): http://trade.ec.europa.eu/doclib/docs/2014/december/tradoc_152982.pdf [accessed 29 November 2016]; Council of the European Union, Council conclusions on EU relations with EFTA countries (14 December 2010): http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/foraff/118458.pdf [accessed 8 November 2016]; HM Government, 'Alternatives to membership: possible models for the United Kingdom outside of the European Union' (March 2016), pp 26-29; Cottier et al., The EEA and the EFTA Court, Decentred Integration (London: Hart Publishing, 2014), p 576*

### *Goods*

135. Witnesses agreed that tariff-free access for goods to the EU's market could be included in a FTA. Mr González García said agreeing tariffs on industrial goods would be straightforward ("I do not see why there should be barriers or obstacles in the automotive industry"), though agreement on tariffs for agriculture and market access for fishing would be more of a "challenge."[187] He added it would be "very easy" to agree on "rules of origin, customs procedures, customs facilitation and co-operation".[188]

136. Mr Ruparel said that regardless of what might be included in a FTA, complying with rules of origin and incurring tariffs on goods with parts produced outside of the UK would be an "additional administrative burden for businesses and goods exporters."[189]

### *Services*

137. Witnesses also recognised that a FTA provided the possibility of some liberal terms for trade in services with the Single Market, though Mr González García suggested that some services might be easier to include than others, such as telecommunications and e-commerce.[190]

186 House of Commons Library, 'The economic impact of EU membership on the UK', Standard Note, SN/EP/6730, 17 September 2013, p 25; 'Reality check: How much does the EU Budget cost the UK?', *BBC* (April 2016): http://www.bbc.co.uk/news/uk-politics-eu-referendum-35943216 [accessed 4 November 2016]. The Swiss government has noted that this is not a one-way transfer: "funds also flow back into Switzerland". It cited the example of the sixth research framework programmes of the EU, under which more than 100% of its contribution flowed back into Switzerland as EU subsidies. Swiss Confederation, *Bilateral agreements—Switzerland–EU* (August 2009), p 18 and p 43: http://www.europarl.europa.eu/meetdocs/2009_2014/documents/deea/dv/2203_07/2203_07en.pdf [accessed 17 November 2016]

187 Q 12; The Committee is conducting a separate inquiry into the impact of Brexit on the UK's fisheries policies.

188 Q 14

189 Q 18

190 Q 14

138. Mr Ruparel went further, saying that services "will clearly be the most difficult sector, particularly financial services, as there is no precedent for third-country access to the Single Market in financial services and other services."[191] Both Dr Gehring and Mr Ruparel said that previous FTAs signed by the EU which included services were some distance short of the access the UK currently enjoys as an EU Member State. Dr Gehring said: "Let us be honest: the current *acquis* of EU rules is normally much broader [than a FTA]." While the CETA agreement included "some mild form of mutual recognition of qualifications", there were "quite a few areas of the existing EU *acquis* that I have not seen in any FTA in a bilateral relationship".[192] Mr Ruparel noted that while CETA provided "some rights of establishment, and the ability to set up subsidiaries and entities in the EU", it was "far short … of providing a passport and being able to provide a service from your home base in the UK". There were also "hundreds of pages of restrictions", and so he concluded that a similar agreement between the UK and the EU "would be a big change for the UK, particularly on the services side".[193]

### *Complying with EU law*

139. Mr González García, Dr Gehring and Mr Ruparel agreed that if the UK wanted comprehensive market access under a FTA with the EU, it would have to accept EU regulations and standards. Mr González García said that in negotiations, "the EU is going to ask, 'You want access to financial services. Which of my directives are you going to implement and replicate in your law?'" He suggested that "the easiest thing would be for the UK to adopt the EU law", to ensure that "level of access to EU services would be greater". On the other hand, he cautioned that "the more you want to be in the Single Market, the more locked into EU law you would be", and that this would result in "less flexibility in negotiation with third countries" on future FTAs.[194] Dr Gehring agreed, noting also that this might be "politically … very difficult, because sometimes you do not have political input into how the standards are made."[195]

140. In some cases, though, meeting EU standards and regulations would not necessarily require the UK to adopt EU law, if it could demonstrate that its domestic law had an equivalent effect. Dr Gehring referred to the example of the Emissions Trading System, where the UK "would rather have a carbon tax, but the overall price of carbon between the two systems was similar, [so] there could be an equivalence negotiation".[196] Mr Ruparel cautioned, though, that whether "you meet the equivalence standards … is a political not a technical decision".[197]

191 Q 12
192 Q 14
193 Q 15
194 Q 18
195 Q 18
196 Q 18
197 Q 18

### Dispute resolution

141. Dispute resolution under FTAs is described in Box 7.

**Box 7: Dispute resolution in FTAs**

Any FTA would require the establishment of some form of mechanism to resolve disputes. Countries can also use the WTO dispute settlement which allows for an appeal of the decision and for compensation if the case is won.

When set up within the framework of a FTA, the most common procedure for resolving trade disputes is state-to-state dispute settlement. In this case, a state complains about violations of the agreement by the other state to a joint panel. However, dispute settlement clauses in FTAs are as diverse as the FTAs themselves.

In FTAs containing an investment chapter, it is also possible to include a dispute settlement mechanism between investors and states (investor-state dispute settlement—ISDS). This grants an investor the right to resort to international arbitration against a country's government where the host state violates the rights granted to an investor under public international law.[198] In the case of the proposed Transatlantic Trade and Investment Partnership (TTIP) and under CETA, this has proved extremely controversial. The provisional application of CETA agreed in October 2016 does not include these investor-state dispute resolution provisions.

If there is a dispute about trade relations between the Switzerland and the EU, the CJEU will initially publish its decision, and this decision will then go to a joint committee of Swiss and EU officials, which decides on how this issue should be viewed in the context of their bilateral relationship.

*Source: European Commission, 'CETA: EU and Canada agree on new approach on investment in trade agreement' (29 February 2016): http://europa.eu/rapid/press-release_IP-16-399_en.htm [accessed 29 November 2016] and Q 12 (Dr Markus Gehring)*

142. According to Mr González García, the advantage of including dispute settlement clauses within FTAs was that they provided an extra (if indirect) benefit to business and investors by offering "an additional forum where the state will call the other state to say that they have an issue".[199] FTAs provided complainants with the ability to "challenge and appeal the decision by an impartial, neutral administrative tribunal, in quasijudicial or judicial proceedings".[200]

143. On the other hand, Dr Gehring argued that states seem to "prefer the WTO process".[201] That process can result in the complainant being allowed to impose countermeasures—such as breaking its own WTO obligations towards the member that lost in WTO dispute settlement (for example by imposing tariffs beyond the bound tariff rate)—which may convince the trading partner to bring its actions into line with WTO practice.[202] Dr

198 Similar rights are granted in many Bilateral Investment Treaties (BITs). The UK is currently party to almost 100 BITs. Dolzer and Schreuer, *Principles of International Investment Law,* 2nd edition (Oxford: Oxford University Press, 2012)

199 Q 17; We note that in the case of FTAs with ISDS clauses (such as CETA), these can also be used for investment-related disputes.

200 Q 17

201 Q 17

202 WTO, 'Legal texts: the WTO agreements': https://www.wto.org/english/docs_e/legal_e/ursum_e.htm#Understanding [accessed 9 November 2016]

Gehring emphasised that FTA dispute resolution clauses worked on a state-to-state level and so did not provide businesses with the opportunity to challenge the actions of their trading partners unless they had "access to the Government" and could "easily sway the entire United Kingdom to take on, say, the United States".[203]

144. Several witnesses urged the Government to consider developing more robust dispute settlement arrangements to police a future FTA between the UK and the EU. Referring to the EFTA Court, Dr Gehring said: "A joint court between EU judges and UK judges to administer the new comprehensive relationship could be possible".[204] Mr Ruparel agreed.[205] We note that such a proposal is unlikely to pass legal scrutiny by the CJEU. In 1991, it ruled against a proposal to establish an EEA court composed of eight judges—including five from the CJEU—on the basis that such a system was incompatible with Community law. As a consequence, the EFTA Court was set up pursuant to a different model.[206] Dr Gehring too warned that such "creativity may run into slight difficulties".[207] He referred to the Swiss model of dispute resolution (which does not have a court): "The practice over the last 10 years has shown that … it is basically impossible for the Swiss side to get any change negotiated in the joint committee, because the Commission officials feel legally bound by the definitive judgment of the Court of Justice."[208]

### Association Agreements

145. Another possibility would be for the UK to agree a FTA with the EU in the context of a wider Association Agreement. Association Agreements provide a framework for co-operation between the EU and a third country, including provisions on trade, but also cover many wider issues.

146. Mr Michael Emerson, in a paper published in October 2016, cited the 2016 Association Agreements between the EU and Ukraine and Georgia as recent examples. He argued that these provided a high degree of access to the Single Market for three of the four freedoms (goods, services, capital, but not the free movement of persons). He also suggested that such agreements provided for the first time a "departure from the doctrine that all four freedoms always come together in an indivisible package".[209] Mr Andrew Duff, Research Fellow, European Policy Centre (EPC), confirmed in written evidence that movement of labour under Association Agreements was subject "to work permits against the backdrop of visa liberalisation".[210]

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203 Q 17
204 Q 17
205 Q 17
206 The CJEU found that such a new court system posed a threat to the autonomy of the Community legal order. It concluded that this threat was not reduced by the fact that CJEU judges were to sit on the court: the different goals of the EEA and the European Community would mean that the judges of the CJEU who were also on the EEA Court would have to interpret the same provisions using different approaches, which would make it difficult for them to keep an open mind in the CJEU if they already tackled similar issues in the EEA Court. CJEU, Opinion 1/91, ECLI: EU: C: 1991:490
207 Q 17
208 Q 12
209 Centre for European Policy Studies, *Which model for Brexit?* (14 October 2016), p 6: https://www.ceps.eu/system/files/SR147%20ME%20Which%20model%20for%20Brexit.pdf [accessed 1 November 2016]
210 Written evidence from Andrew Duff (ETG0014)

147. At the heart of the EU Ukraine Association Agreement is a FTA, referred to as a Deep and Comprehensive Free Trade Area (DCFTA).[211] Mr Duff told us that this granted Ukraine "tariff free access for goods, co-operation on VAT and customs procedures (including the complex rules of origin)". Regarding services, he said that Ukraine could elect to deepen its trade relationship in key service sectors such as finance (including passporting), transport and energy.[212]

148. In order to gain this market access Ukraine is obliged to achieve conformity with the relevant EU sectoral regulation. This includes provisions on trade remedies, mutual recognition of equivalent technical standards and joint observance of EU policies on public procurement, competition, state aid and intellectual property. A mediation and trade dispute settlement machinery has also been established which involves a tribunal of three judges. Mr Duff stressed that the UK could potentially secure continued market access for certain sectors of the economy insofar as it also maintained "current standards of technical and regulatory equivalence with the *acquis*".[213]

149. The EU Ukraine Agreement also provides for increased co-operation in the fields of foreign and security policy, migration, asylum and border management, and combating international organised crime.[214] Mr González García noted that Ukraine's Association Agreement allowed it to contribute to the EU budget in instances where it was "interested in European funds and in European programmes".[215]

150. We note that there are questions around the extent to which the EU Ukraine Agreement would be available to the UK. In particular, the exemption from the principle of free movement contained in the Ukraine agreement reflects the EU's reluctance to extend full free movement rights further. This is very different from the UK's position.[216] We also note that as with the FTAs discussed above, a mixed agreement FTA within an Association Agreement would likewise be subject to Member State ratification. The political and co-operation provisions of the EU Ukraine Association Agreement have been provisionally applied since November 2014, and the DCFTA has been provisionally applied since January 2016.[217] In a referendum in April 2016 the Netherlands voted against the approval of the EU Ukraine Association Agreement, and the Dutch Government is currently seeking an opt-out from a number of aspects of the agreement.[218]

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211 EU External Action Service, *EU-Ukraine Association Agreement—Quick Guide to the Association Agreement*: http://eeas.europa.eu/archives/docs/ukraine/pdf/071215_eu-ukraine_association_agreement.pdf [accessed 21 November 2016]

212 Written evidence from Andrew Duff (ETG0014)

213 Written evidence from Andrew Duff (ETG0014)

214 The EU Ukraine Association Agreement also establishes an annual summit meeting, a ministerial council, technical committees and a joint parliamentary body. Written evidence from Andrew Duff (ETG0014)

215 Q 16

216 Michael Emerson, Centre for European Policy Studies, *Which model for Brexit?* (14 October 2016), p 6: https://www.ceps.eu/system/files/SR147%20ME%20Which%20model%20for%20Brexit.pdf [accessed 1 November 2016]

217 European Commission: 'Countries and regions—Ukraine' http://ec.europa.eu/trade/policy/countries-and-regions/countries/ukraine/index_en.htm [accessed 22 November 2016]

218 Arthur Beesley, 'Dutch objections threaten to scupper Ukraine treaty', *The Financial Times* (28 October 2016): https://www.ft.com/content/36b560c2-9d20-11e6-8324-be63473ce146 [accessed 21 November 2016]

151. In conclusion, while Mr Duff acknowledged that a UK EU Association Agreement would not be a matter of 'cut and paste' from the EU Ukraine Agreement, he suggested that, for the EU 27, "the Ukrainian deal provides a precedent which it would be difficult to deny its former Member State."[219]

152. The Committee asked the two Ministers whether they had met representatives from Ukraine to discuss their Association Agreement with the EU. Lord Price replied: "No, I have not met with the Ukraine yet."[220]

### Trade with third countries

153. We also considered whether the UK could enjoy continued access to FTAs agreed by the EU with third countries after Brexit, without which the UK would have to revert to WTO terms for trade (as discussed in Chapter 6).[221] Illustrating this issue, Mr Richard Eglin, Senior Trade Advisor, White and Case LLP, noted that without the EU FTA with Caribbean countries, the UK would no longer be able to import sugar duty free, unless it replaced the EU agreements with a scheme allowing least developed countries (LDCs) tariff-free access to the UK market, or if it granted duty free access to all members of the WTO on a MFN basis.[222]

154. Dr Gehring suggested that it would not be possible for the UK to continue to enjoy the benefits of such FTAs. Some were "just concluded by the EU, so there would be no access to the UK", while even mixed agreements (where the UK has signed and ratified them in addition to the EU) tended to "specify that the application of the agreement is really restricted to EU Member States".[223] Mr González García agreed, noting that the "language of the FTAs does not leave room to differentiate which commitments belong to the EU and which ones [are] for individual Member States". It followed that: "If a country ceased to be part of the Union the FTA is no longer applicable."[224]

155. Dr Gehring recognised that the forthcoming negotiations might provide an opportunity for the UK to become an individual signatory to such FTAs, but said that if this did happen, "either the EU or the third country partner would probably have a right to request some form of renegotiation." The likelihood of this depended on the shape of the UK's future relationship with the EU: "if the UK can no longer participate in the EU internal market, in my view it can no longer fulfil a good chunk of those free trade obligations, and that triggers the renegotiation." Dr Gehring noted that even if a third-country partner agreed to the UK being a signatory to a FTA on the same terms as it had when it was a member of the EU, the "EU could take the very drastic step of either withdrawing or terminating those kinds of agreements".[225]

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219 Written evidence from Andrew Duff (ETG0014)
220 Q 55
221 The European Commission lists 50 trade agreements. European Commission Memo, *The EU's bilateral trade and investment agreements–where are we?* (3 December 2013): http://trade.ec.europa.eu/doclib/docs/2012/november/tradoc_150129.pdf [accessed 1 November 2016]; Full Fact notes that not all of these are FTAs, as the list includes the customs union with Turkey and the non-EU EEA countries. Full Fact, *'How many free trade deals has the EU done?'*: https://fullfact.org/europe/how-many-free-trade-deals-has-eu-done/ [accessed 17 October 2016]
222 Q 8
223 Q 19
224 Written evidence from Luis González García (ETG0006)
225 Q 19

156. Mr González García therefore concluded that it was more likely that the UK would have to negotiate a separate FTA with a third country, which "might not look like the original FTA".[226] Mr Ruparel went further, suggesting that it "might be simpler for the UK to seek to sign new bilateral agreements with these states which mirror the current agreements".[227]

157. The Government acknowledged that the UK's ongoing access to EU FTAs was unlikely. In an appendix to a letter to Lord Boswell, Chairman of the EU Select Committee, on CETA, received on 3 October 2016, Lord Price wrote that the Government's assessment was that:

> "On leaving the EU, the UK will no longer retain access to the trade preferences contained within CETA unless arrangements to do so are put in place as part of our negotiations with the EU. This outcome will not be impacted by whether or not the existing trade deal was signed as a mixed agreement."[228]

158. Lord Price told us that around 11% of UK export trade relied on the EU's FTAs with third countries, and that "another 25%" would be added when FTAs with Canada, the US and Japan were concluded. Lord Price said that, in line with the Prime Minister's ambition to ensure "the best possible transition from where we are today to the new world", the DIT was looking "at what we might do with those countries that currently have an FTA with the EU, to see how we might have some kind of transition to make operations smooth for business." He and the Secretary of State's were making "trips around the world", to find out "how we might mitigate the impact of that going forward."[229] We note that while the CCP prohibits the UK from negotiating bilateral trade agreements, it does not prevent the Government from engaging in discussions with third countries to prepare the ground for future FTAs. Lord Price confirmed this: "The formal position is that we cannot sign and ratify until after we have left, but we can have discussions ahead of that."[230]

## Conclusions and recommendations

159. **The Government has made clear its desire to open negotiations on the future trading relationship between the UK and the EU as part of the withdrawal negotiations under Article 50. This desire will only be fulfilled if both sides agree. Before triggering Article 50, the Government must, as a priority, seek confirmation from all parties that the framework for a future trading relationship will be included within the Article 50 negotiations.**

160. **Negotiation of a Free Trade Agreement between the UK and the EU would be unprecedented. While FTA negotiations usually aim to increase market integration between two sides, the UK would start from a position of full integration, and would presumably seek to maintain many aspects of the status quo while reducing integration in some areas.**

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226 Written evidence from Luis González García (ETG0006)
227 Written evidence from Raoul Ruparel (ETG0002)
228 Appendix to the letter from Lord Price CVO to Lord Boswell of Aynho, 29 September 2016: http://www.parliament.uk/documents/lords-committees/eu-external-affairs-subcommittee/CETA-Canada-EU-trade-deal/Appendix%20Lord%20Price%20CETA-160929.pdf
229 Q 67
230 Q 40

161. **As, for the time being, the UK is compliant with EU law (and the announcement of the Great Repeal Bill by the Government suggests that in general much of EU law will be maintained in national law, at least in the period immediately following Brexit), the complex issue of harmonising rules and regulations between two sides can be deferred in the short term.**

162. **Nonetheless, experience demonstrates that FTA negotiations with the EU are complex and slow moving. We conclude that, even if it were possible to negotiate a FTA within the terms of Article 50, it would be impossible to agree it within two years. It follows that if the Government is minded to seek a FTA as the long-term basis for future UK-EU trade, it should clarify whether it is also considering a transitional trading arrangement.**

163. **Even the most advanced FTAs do not provide the level of market access for goods that the UK currently enjoys by virtue of membership of the Single Market. We also note that providing equivalent liberal market access for services in a FTA with the EU would be unprecedented.**

164. **The level of market access the UK is able to negotiate with the EU would depend in part on the extent to which it was willing to accept and adopt EU law or demonstrate equivalence with EU rules. In the medium to long-term the UK may have to continue to update its domestic law to be consistent with EU law.**

165. **The UK and the EU may require stronger institutions than are normally included in FTAs to police their trading relationship. While a UK-EU court could help to achieve this, we note any such arrangement could be subject the decisions of the Court of Justice of the European Union.**

166. **These constraints on a UK-EU FTA notwithstanding, its key benefit would be flexibility. It would not require the UK to accept the principle of the free movement of persons; it would give the UK autonomy over its laws and trade policy with third countries; and it could be supported by separate agreements regarding other areas of interest to the UK if desired. A FTA could also avoid the imposition of tariffs on goods traded between the UK and the EU, although rules of origin would apply.**

167. **We invite the Government to confirm whether it is giving consideration to an Association Agreement, incorporating a FTA, such as that agreed with Ukraine, as the basis for a future political and trade relationship with the EU.**

168. **On the balance of evidence, we conclude that the UK is unlikely to be able to retain access to the EU's FTAs with third countries following Brexit, whether they are mixed agreements or not. We urge the Government to confirm that this is the case.**

169. **We doubt that the UK would be able to conclude new agreements to replace EU FTAs with third countries within the two-year timeframe for withdrawal negotiations prescribed by Article 50. Nor, while the UK remains an EU Member State, is it able formally to conclude such negotiations, although we note that substantive preliminary discussions are already being conducted to prepare the ground for future FTAs.**

170. **It follows that the Government must develop a contingency arrangement to secure continuation of the level of market access currently enjoyed by the UK to third countries under EU FTAs, following the completion of withdrawal under Article 50.**

## CHAPTER 6: TRADE UNDER WTO RULES

171. The fourth possible framework for the UK's future trade relationship with the EU would be to rely on the rules of the World Trade Organisation (WTO). Information about the WTO is given in Box 8.

### Box 8: World Trade Organisation (WTO)

The WTO was founded in 1995 as a global framework for trade relations between countries. It aims to liberalise trade by lowering tariffs and reducing or eliminating other barriers to trade (thereby improving market access), and to create a stable and predictable trading system. Tariff reductions and increasingly the reduction of non-tariff barriers are negotiated between WTO members in 'rounds', such as the Uruguay Round or the current Doha Development Round.[231] The WTO currently has 164 members, which account for 95% of world trade.[232]

In order to create a predictable trading system, the WTO applies non-discrimination principles. One of them is 'most favoured nation' (MFN) treatment, which means that countries cannot normally discriminate between their trading partners. This includes the obligation to apply the same tariffs and to offer the same market access to all WTO members. If a country chooses to lower a trade barrier or to open up its market for one WTO member, it has to offer the same favourable conditions to all WTO trading partners. The MFN principle applies to trade in both goods and services. However, exceptions are possible, either if countries set up a free trade agreement (FTA) or customs union, or if they decide to give special trade conditions to developing countries. In services, countries are allowed to discriminate in additional limited circumstances.[233] MFN goes hand in hand with the principle of 'national treatment', which means that once a good or service has been imported into a market, it has to be treated like a local product.[234]

231 Also called the Doha Development Agenda.

232 WTO, 'Members and Observers': https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm [accessed 1 November 2016] and Institute for Government, 'Brexit Brief: 10 things to know about the World Trade Organization (WTO)' (2016): http://www.instituteforgovernment.org.uk/brexit/brexit-brief-10-things-know-about-world-trade-organization-wto [accessed 1 November 2016]

233 Both the GATT and GATS allow countries to discriminate in limited circumstances. For instance both contain general exceptions relating to health, security and prudential measures in financial services (found in Article II of GATS). Under GATS, WTO members may, in certain conditions, diverge from their MFN obligations in order to conclude Economic & Integration Agreements (under Article V of the GATS), or under Mutual Recognition Agreements (relating to licences or certificates) (under Article VII). Rudolf Adlung and Antonia Carzangia, 'MFN Exemptions Under the General Agreement on Trade in Services: Grandfathers Striving for Immortality?', *Journal of International Economic Law,* vol. 12 (2), (June 2009), pp 357-392: https://www.researchgate.net/publication/46511373_MFN_Exemptions_Under_the_General_Agreement_on_Trade_in_Services_Grandfathers_Striving_for_Immortality [accessed 28 October 2016]

234 In services this depends on the specific national treatment obligations which form part of members' specific concessions for their services' schedule. WTO, 'Principles of the trading system': https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm [accessed 28 October 2016]

WTO membership consists of a balance of negotiated 'rights' (for example the right to be able to export to other countries) and 'obligations' (for example to limit restrictions on imports). Both rights and obligations work through rules which apply to all members of the WTO, as well as country-specific commitments known as 'schedules' (for example individual countries agreeing limits on subsidies to their own agricultural sector).[235] Schedules of concessions include:

- Maximum tariff levels for goods, which are often referred to as 'bound tariffs' or 'bindings'; and
- Tariff rate quotas (quantitative restrictions on imports and exports) and some kinds of domestic support for agricultural products.[236]

*WTO agreements*

The WTO legal order consists of a number of agreements that are annexed to the WTO Agreement. They all came into force together in 1995. Besides rules on dispute settlement under the WTO Agreements, the three main pillars of the WTO Agreements are trade in goods (GATT), services (GATS) and trade-related intellectual property rights (TRIPS).

*The General Agreement on Tariffs and Trade (GATT)*

The GATT was the precursor to the WTO, and provided the rules for much of world trade from 1948 to 1994. It is binding for all members of the WTO and includes a number of agreements and annexes, dealing with the special requirements of specific sectors or issues, including: agriculture; health regulations for farm and food products; textiles and clothing; technical standards; trade-related investment measures; anti-dumping measures; customs valuation methods; pre-shipment inspection; rules of origin; import licensing; subsidies and countermeasures; and safeguards.[237]

*The General Agreement on Trade in Services (GATS)*

The GATS came into force in 1995 and applies to all WTO members. It applies to all but two service sectors: first, those sectors where services are supplied by a Government authority neither on a commercial basis nor in competition with other suppliers (such as education or health services); and second, all air traffic rights.[238]

Signatories to GATS have to comply with general obligations and specify commitments for each particular service sector, detailing levels of market access and treatment under national laws. Various limitations can be imposed on the number of suppliers, employees in the sector, value of transactions and the legal form of the supplier. Members can tailor their commitments in line with national policy. While some members have only scheduled commitments for a handful of sectors, others have provided market access in over 120 of the 161 services included in GATS.[239]

235 Institute for Government, 'Brexit Brief: 10 things to know about the World Trade Organization (WTO)' (2016)

236 WTO, 'Members' commitments': https://www.wto.org/english/tratop_e/schedules_e/goods_schedules_e.htm [accessed 1 November 2016]

237 WTO, 'General Agreement on Tariffs and Trade', *The WTO Agreements Series*: https://www.wto.org/english/res_e/booksp_e/agrmntseries2_gatt_e.pdf [accessed 28 November 2016]

238 WTO, 'The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines': https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm [accessed 25 October 2016]; Indian Institute of Foreign Trade, *FAQS- Services negotiations in WTO* (9 April 2009), p 4: http://wtocentre.iift.ac.in/FAQ/english/Services_FAQ.pdf [accessed 4 November 2016]

239 WTO, 'The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines'

## Process of agreeing the UK's schedules at the WTO

172. The UK is a member of the WTO in its own right. It does not, however, have individual schedules of concessions: it is part of the EU's combined schedules. In leaving the EU, the UK will have to separate its schedules from the EU, and its new schedules will be subject to approval by all WTO members. Professor Piet Eeckhout, Professor of EU Law at University College London, explained that the UK's WTO schedules would be the point of departure for its future trade negotiations with the EU and the rest of the world: "other parties will want to see … what the UK's tariff commitments are under WTO law, because that is the baseline from which you negotiate a free trade agreement".[240]

173. There are two options for amending schedules: rectification and modification. Rectification is possible for "rearrangements which do not alter the scope of a concession … and other rectifications of a purely formal character". Modification of schedules implies a substantive change of a concession.[241]

174. Mr Eglin explained that if the Government amended the UK's schedules by means of a rectification of the EU's schedules, this process could be completed in "three months in the case of the goods schedule and 45 days in the case of the services schedule."[242] He added: "there is nothing in the WTO rules that says you cannot adopt somebody else's schedule."[243]

175. Lord Price agreed that "one of the first things we have to do" is "go through the technical process of adopting our own schedules."[244] He continued: "the advice we have is that what we intend to do is predominantly technical, moving from an EU schedule to a UK schedule."[245]

### *Issues in agreeing the UK's schedules*

176. Witnesses recognised that a number of factors might complicate negotiations on the UK's schedules. Mr Eglin remarked: "I do not want to make it sound easy. A good deal of negotiation is going to be involved—probably clever negotiation as well, in parts".[246]

#### *Dividing up Tariff Rate Quotas (TRQs) and subsidies*

177. Before presenting its schedules to WTO members, the UK will have to negotiate formally with the EU to separate out its TRQs and levels of subsidies from those currently shared between the EU's 28 Member States.[247]

178. TRQs provide lower duties on limited quantities of goods imported into a country. By way of example, Mr Peter Ungphakorn, former Senior Information Officer WTO Secretariat, explained that in the latest EU schedule for goods there was a TRQ for approximately 280 tonnes of duty free lamb shared out among Argentina, Australia, Chile, New Zealand, Uruguay and nine others. The EU and the UK would need to agree how to divide this quota between

240 Q 5
241 GATT, L/*4962 1980 Decision on Procedures for Modification and Rectification of Tariff Concessions* (28 March 1980): https://www.wto.org/gatt_docs/English/SULPDF/90970413.pdf [accessed 28 October 2016]
242 Q 1
243 Q 5
244 Q 40
245 Q 44
246 Q 5
247 Q 1 (Prof Piet Eeckhout); Q 2 (Richard Eglin); written evidence from Luis González García (ETG0006); written evidence from Peter Ungphakorn (ETG0005)

them—a process that Mr Ungphakorn expected to be contentious: "TRQs are on the front line in the battle between exporters with offensive interests and import markets with defensive interests."[248]

179. Professor Eeckhout highlighted that the EU and the UK would also have to divide those quotas that currently enable the EU to export to third countries on preferential terms. The question was: "Would the European Union keep those quotas and would the United Kingdom have to negotiate preferential access itself?"[249]

180. The UK and the EU would also have to agree on how to divide the entitlement to domestic subsidies (most commonly agricultural subsidies), known in the WTO as the aggregate measurement of support (AMS). Mr Ungphakorn told us that "the appropriate basis for extracting the UK's AMS entitlement" was subject to "on-going discussion among legal and trade experts"; however, as the EU was currently well below its agreed limit, "some 'ballpark' calculation for the split ought to be agreed without too much difficulty".[250]

181. Mr Eglin noted a trade-off between TRQs and agricultural subsidies: "On the face of it, the EU presumably will want to give us as much of the tariff rate quotas as possible and as little of the farm subsidies as possible." Mr Eglin said negotiations on these issues "would have to be done before we could complete our [goods] schedule and present it in the WTO."[251]

182. Lord Price said the European Commission was aware of the UK's need to divide up TRQs and subsidies with the EU, and had been "constructive in early conversations." He told us the EU "wants to be supportive of our finding our own schedules".[252]

183. Mr Eglin also noted the wide constituency of domestic interests affected by an amendment to the UK's WTO schedules: it was essential that the Government was "joining … up" information about what effect changes to tariffs for goods might have on farmers, regulators, and customs authorities ahead of negotiations. Negotiators would end up "covering almost every ministry, every department", and thus "clear instructions are absolutely paramount".[253]

*The views of other WTO members*

184. Having divided up TRQs and domestic subsidies with the EU, the UK would then be in a position to present its schedules to other WTO members. Mr Eglin noted that they "will see opportunities … for better access to the UK market." He imagined a situation where another WTO member would feel that it had negotiated a concession with the EU on the "presumption that the UK was part of the EU market", and while it had provided a lot of market access to the UK, the UK "on its own" no longer provided a "reciprocal benefit".[254] Professor Eeckhout described the possible imposition of tariffs

248 Written evidence from Peter Ungphakorn (ETG0005)
249 Q 1
250 Written evidence from Peter Ungphakorn (ETG0005)
251 Q 2
252 Q 47
253 Q 6
254 Q 2

between the UK and the EU as a "modification in the terms of trade from the perspective of exporting nations to the UK and to the European Union".[255]

185. Mr González García thought reaching an agreement in the WTO on TRQs "will potentially become a problematic exercise", because some third countries "will feel they deserve a bigger share of the UK or EU market".[256] Mr Ungphakorn agreed: "most, if not all, countries that currently use the TRQs have an interest in negotiating the UK's, plus possibly some new players".[257]

186. In such situations, Mr Eglin advised the Government to "show openness, to listen to anybody who comes to us and says that they want bigger access for their beef, butter, milk or whatever".[258] Mr Eglin also said that if WTO members seriously wished to renegotiate parts of the UK's proposed schedules, then the Government should see this as an opportunity for "opening [up] free trade negotiations" outside the WTO.[259]

187. Professor Eeckhout said he was "uncertain" how far WTO members might insist on knowing the outcome of wider trade negotiations between the UK and the EU before certifying the UK's schedules. He said it made "a massive difference" whether the UK remained part of the EU's customs union, concluded a FTA with the EU, or traded under WTO rules only.[260] In the case of Japan, he said:

> "If there is an add-on tariff when they want to export the car to the European continent, they might want to negotiate on the tariffs on imports. They might want to ask the United Kingdom, 'Could you please bring down your tariffs on the components of cars so that we do not suffer from the fact that those cars no longer have free access to the European market?'"[261]

*Modifying or rectifying the EU and the UK's schedules?*

188. Bearing these factors in mind, some witnesses believed that the UK adopting the EU's schedules went beyond the simple 'rectification' outlined in Mr Eglin's opening remarks, to a 'modification' of the EU's schedules. Mr González García told us that rectification of schedules "can only occur in situations of [a] 'purely formal character' … The UK's negotiation will alter the EU['s] schedules and therefore cannot be considered a rectification."[262] Mr Ungphakorn agreed that other countries might see separating out the UK's TRQs as a modification of the EU's schedules.[263] Mr Ungphakorn also noted that the UK might wish to modify the EU's schedules to take into consideration the views of other members of the WTO or to meet domestic demand from UK retailers or consumers to have lower tariffs and cheaper products.[264]

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255 Q 9
256 Written evidence from Luis González García (ETG0006)
257 Written evidence from Peter Ungphakorn (ETG0005)
258 Q 2
259 Q 3
260 Q 2
261 Q 9
262 Written evidence from Luis González García (ETG0006)
263 Written evidence from Peter Ungphakorn (ETG0005)
264 Written evidence from Peter Ungphakorn (ETG0005)

189. Whatever the reason, Mr Ungphakorn said a modification of the EU's schedules would affect the format of negotiations, and could lead to a "lengthier process, with more specific requirements". He said it could lead to "a triangle of external negotiations between the UK, EU … and non-EU exporting countries".[265] Mr Eglin said it would be easier to agree changes that 'liberalised' the schedules (that is, that reduced tariffs), whereas increasing trade restrictions would be more difficult, requiring the UK to make concessions elsewhere: "the exchange would be that you would have to lower a tariff somewhere else". This would require "reciprocal bargaining".[266]

190. Asked whether the Government had decided to modify the EU's schedules, Lord Price said that "the simplest thing would be to adopt the current tariffs that we have with the EU". However, it was "fair to say that, as of today, we have not resolved how [tariff rate quotas] should fall out." He continued:" If you want me to say today that we have agreed that it is X, Y and Z, I simply cannot do that, because we have not begun the formal process of those conversations."[267]

*Certifying the EU's current schedules*

191. To allow for the EU's enlargement to 28 Member States, the EU's current schedules have not been formally 'certified' (agreed by WTO members).[268] Professor Eeckhout and Mr Eglin did not see this as a complicating factor, but rather a "narrow legal issue".[269] Mr González García, though, was less certain:

> "The EU-28 schedule has not been agreed and it is managed by the EU Commission on a bilateral basis in a non-transparent manner. This is likely to trigger further discussions between the WTO members and the EU which will have an impact in the UK's WTO renegotiation."[270]

Mr Ungphakorn pointed out: "If other countries wanted to be difficult they might insist on knowing the schedules and negotiating from official versions." He added that "we don't know how it would turn out".[271]

*What if there is no agreement to the UK's schedules?*

192. Mr Eglin was not concerned at the prospect that the UK's schedules might not be certified by all WTO members by the end of the two-year negotiating period under Article 50: "Does it pose a problem? In my view, no, none whatsoever."[272] He said the UK could continue to trade on the basis of its proposed schedules: "Our proposal, as a schedule, is the terms on which we continue to trade regardless of whether [they have] been certified or not—that is our MFN schedule—and nobody is going to object to that." He said these were "fine points of law", and that fundamentally the WTO

265 Written evidence from Peter Ungphakorn (ETG0005)
266 Q 4
267 Q 47
268 The EU had to revise its commitments as it added new members, first in 1995 (the year after the Uruguay Round talks ended, when it expanded from 12 to 15 members), then in 2004 (to 25), 2007 (to 27), and 2013 (to the present 28). The schedule for 1995 was not certified until 2010—it took 15 years to account for the addition of three countries. Peter Ungphakorn, 'The Hilton beef quota: a taste of what post-Brexit UK faces in the WTO', *Tradebetablog* (28 August 2016): https://tradebetablog.wordpress.com/2016/08/10/hilton-beef-quota/ [accessed 1 November 2016]
269 Written evidence from Prof Piet Eeckhout (ETG0003) and Richard Eglin (ETG0001)
270 Written evidence from Luis González García (ETG0006)
271 Written evidence from Peter Ungphakorn (ETG0005)
272 Q 4

was a "commercial contract", which existed "for the benefit of all members' businesses." He continued: "Chaos would break out if anybody were to suggest that the UK does not have a schedule … it would be absolute pandemonium". As a result, he argued, "it is not going to happen". While it might take many years for there to be consensus on the UK's proposed schedules, and therefore, for final certification, the UK "would continue to trade on the terms in which we proposed we should trade, as long as they were reasonable".[273]

193. Mr Ungphakorn was more cautious, noting that such an approach could be disputed by a WTO member, and that the UK might not prevail: "the complexity of WTO and international law" and "adjudicators' individual thinking" meant that "WTO dispute rulings are unpredictable." As the argument in favour of the UK simply adopting the EU's schedule was "based largely on law", it overlooked "processes, politics and diplomacy in the WTO", all of which would be in play.[274]

194. As we have already noted, Lord Price regarded the process as "predominantly technical, moving from an EU schedule to a UK schedule". He and the Secretary of State had already met Mr Roberto Azevêdo, Director-General of the WTO, and spoken to "19 Trade Ministers in the EU and outside", who were all "very supportive of the need in the first instance for us to have our own schedules". Following these discussions, Lord Price was "not anticipating any major issues", and he felt that this work would be completed in "good time".[275] Agreeing the UK's schedules was also "entirely doable … [the] WTO and the Commission are both saying that this is a reasonably straightforward thing that they want to help us to do".[276]

### *Trade defence measures*

195. As well as renegotiating its schedules, the UK will also have to consider its trade defence measures. Professor Eeckhout was "uncertain" about what would happen to the current anti-dumping measures that the EU applied to WTO members, which were the consequence of EU-wide investigations into dumping: "Whether the United Kingdom could simply continue to apply those or would not apply them may also be an issue that comes up in defining the UK's WTO status".[277] Mr Eglin agreed that if the UK were to try and impose EU anti-dumping measures on Chinese steel imports, for example, the Chinese could "object vigorously" and demand that the UK "carry out a new investigation and demonstrate domestic injury and unfair trade."[278]

196. Mr Eglin said "the biggest problem" was re-establishing an investigating authority in the UK that was "capable of undertaking trade remedy investigations and protecting the UK's interests".[279] There was an acute need for "capacity-building"[280] in an extremely specialised area of work, and he noted that "dispute settlement lawyers do not grow on trees."[281]

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273 Q 3
274 Written evidence from Peter Ungphakorn (ETG0005)
275 Q 44
276 Q 47
277 Q 1
278 Q 2
279 Q 2
280 Q 2
281 Q 6

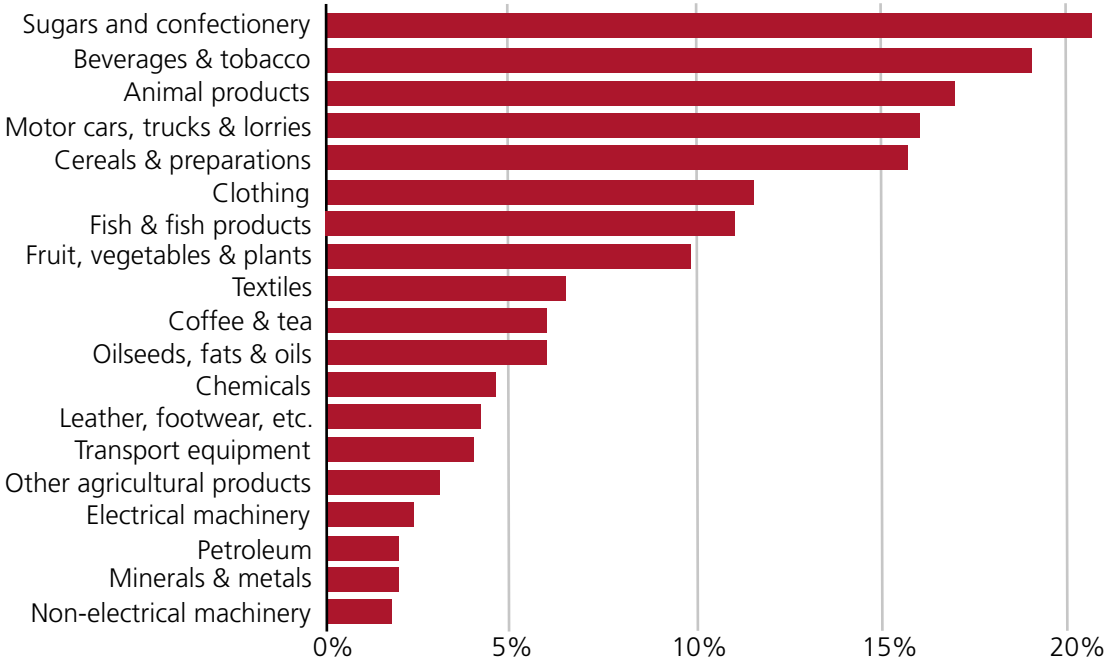
## Trade with the Single Market

197. Trading with the EU on the basis of concessions set at the WTO would provide the UK with a baseline of tariffs for trade in goods: the UK would have to apply those tariffs to imports from the EU. EU imports from the UK would, similarly, face EU tariffs. Trading under WTO rules would also provide limited commitments on services, as contained in the GATS. It would not provide the UK with any preferential access (which might be possible under a Free Trade Agreement or EEA membership) to the Single Market. Compared to the status quo of EU membership, Mr Eglin said: "We will be inferior if we are trading on WTO terms, MFN terms, with the EU, there is no question about it, both for goods and services."[282] He added that the "biggest problem" for the UK in trading with the EU under WTO terms would be that "we will not be able to influence future regulations". He commented that it would be "good to find a way, if we can, of maintaining some influence over those rules".[283]

### *Goods*

198. Mr Eglin said the EU's MFN tariffs "vary enormously", with a division primarily between industrial goods, with an average tariff of 4.5%, and agricultural goods, with an average tariff of 14.5% and schedules "riddled with quantitative restrictions".[284] The graph below provides an indication of this variation. The figures are based on average tariffs per category; actual tariffs vary still more widely.[285]

**Figure 1: Average final bound tariff rates applied by the EU by broad category of goods**




*Source: WTO, EU: http://stat.wto.org/TariffProfiles/E28_e.htm and Q8 (Mr Eglin)*

282 Q 7
283 Q 8
284 Q 8
285 Members of the WTO provide information regarding their 'bound tariffs' in their goods schedules. However, they are able to provide more favourable 'applied tariffs' if this is done on an MFN basis to all other WTO members. The WTO explains: "Although major developed economies, such as Japan, the EC and the United States, have bound rates and applied rates of duty that are very closely aligned, they also have bound rates in some tariff-quota products that have large amounts of 'water' in these bound rates: that is, the domestic market is priced well below the level implied by the bound/applied duty. This phenomenon of 'water' in the tariff, which indicates that the bound rate provides 'excess protection' to the domestic industry, also reduces the economic value of the binding." WTO, *A Handbook on Reading WTO Goods and Services Schedules*, p 15: https://www.wto.org/english/res_e/booksp_e/handbook_sched_e.pdf [accessed 1 November 2016]

199. In relation to industrial goods, Mr Eglin highlighted that automobiles were a "heavily restricted sector", with a 10% tariff on cars and a 22% tariff on trucks and lorries.[286] Similar tariffs apply throughout the supply chain, and Dr Christos Tsinopoulos, Senior Lecturer, Durham University, explained that "trade barriers and more specifically, tariffs, are often seen as a key issue in the decision making process of location of a part of the supply chain. Such barriers increase costs, and complicate decision making."[287]

200. Mr Eglin noted that trading under WTO rules would also affect the cost of agricultural imports to the UK: "There will be much more severe restrictions in certain sectors, primarily agriculture, than we face at the moment as a member of the Single Market." In the food processing sector, for example, the average tariff for beverages and confectionery was in the region of 45%, and it was much higher on certain products such as poultry, where the *ad valorem* tariff (a tariff based on the determined value of the item being taxed) was over 200%.[288] While the UK could unilaterally decide to lower its tariffs on agricultural goods, this could complicate the process of agreement to its schedules (as a modification rather than rectification) and reduce its leverage in future FTA negotiations, as the UK would be less able to offer preferential terms to other countries. It would also have deleterious implications for the UK's agricultural industries.

201. But tariffs are just one aspect of the restrictions that would be placed on UK exports to the Single Market under the WTO model. A host of other factors, including regulation, geographic indicators and standards, are largely untouched by WTO agreements.[289] Regulatory restrictions (such as those on car emissions standards) "generally are much more important than the tariffs", and are "important for goods, both agricultural and manufactured", according to Mr Eglin.[290]

202. Although the UK would not need to comply with EU standards when exporting to non-EU countries, the EU would remain a major player in setting global standards. Professor Eeckhout noted that the EU sought "convergence on regulatory issues", and even attempted to be "hegemonic", trying "to persuade other countries around the world to adopt concepts of EU regulation".[291]

### *Services*

203. Professor Eeckhout explained that when the General Agreement on Trade in Services (GATS) was agreed in 1995, it aimed to capture "the current state of domestic liberalisation", but did not strive to be "a major liberalising force".[292] Nevertheless, Mr Eglin said that there had "been a great deal of liberalisation" in the EU, and that it was no longer the "Fortress Europe" it was considered to be 20 years ago.[293]

204. The extent of market access in services provided by WTO agreements varies sector by sector, but both witnesses agreed that some industries would

286 Q 8
287 Written evidence from Dr Christos Tsinopoulos (ETG0008)
288 Q 8
289 Q 6
290 Q 8
291 Q 6
292 Q 7
293 Q 7

feel a significant impact. Professor Eeckhout gave the example of aviation, which "is hardly touched upon by WTO commitments". There were no commitments regarding the right to fly between WTO members, whereas in "huge contrast", in the Single Market "you have a full single market in aviation", where "any EU airline … can perform freely any flights across the European internal market".[294]

205. In order to understand which sectors "are relatively open" and which "are relatively closed", Mr Eglin urged the Government to "talk to business and find out which services are affected, the main restrictions that will face the service suppliers and how they can be overcome … all those things need to be calculated at a very detailed level. Before you go into the negotiation, you need … to know exactly what you want".[295]

206. Professor Eeckhout also suggested that the UK would "potentially … have to negotiate its entry" into the Agreement on Government Procurement (GPA).[296] This was not part of the package of WTO agreements, and the European Union signed and concluded it, not individual Member States. The GPA covers 47 WTO members (counting the EU and its 28 Member States as one). It aims to open up the government procurement markets among its parties. Following several rounds of negotiations, signatories to the agreement have opened up procurement activities estimated to be worth $1.7 trillion.[297] Mr Eglin agreed that the UK needed to become a signatory, but did not see it as "a big problem". Nor was it "contingent upon us having first reached agreement with the EU."[298]

### Dispute resolution

207. If a member of the WTO feels that a fellow member has violated trade rules, it can use the WTO's multilateral system of handling disputes, rather than taking unilateral action. More information can be found in Box 9.

**Box 9: Dispute resolution at the WTO**

The process for handling disputes is that, first, parties have to engage in consultation in order to determine whether their dispute can be settled. If this fails, then a panel of three to five experts is appointed to hear the case from both parties. On the basis of the evidence received, the panel makes recommendations to the Dispute Settlement Body at the WTO (which is the General Council), which then decides whether or not to adopt these recommendations. Both parties can appeal the outcome within 90 days via the permanent seven-person Appellate Body at the WTO. The whole process should be completed within one year to 15 months.

If a member that has been found guilty of violating trade rules fails to take corrective action within 20 days of the adoption of the panel's report, the complainant can request permission temporarily to suspend their schedule of concessions in relation to the violating country.

*Source: WTO, 'Understanding the WTO: Settling Disputes - A unique contribution' (2016):* https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm *[accessed 7 November 2016]*

294 Q 7
295 Q 7
296 Q 1
297 WTO, 'Agreement on public procurement', (2016): https://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm [accessed 22 November 2016]
298 Q 2

208. Professor Eeckhout highlighted "an enormous difference" between dispute resolution within the Single Market and under WTO rules. Single Market rules were "part of domestic law", so businesses in the Single Market could "use domestic courts to enforce any rights [they] have." In contrast, complaints to the WTO could only be brought by governments, which were understandably "somewhat selective". It followed that the WTO did not have the "capacity" to deal with the "myriad trade issues that may arise for companies in different markets". While dispute settlement at the WTO level was generally felt to be a "very robust system", which worked "reasonably well", there was no "automatic enforcement" of a final decision—members had to rely on others to comply under international law, or applied pressure through trade sanctions, which could take "many years" and were "of uncertain effect".[299]

## Conclusions and recommendations

209. **If a preferential trade deal were not reached with the EU, then WTO rules would govern trade between the UK and the EU. Of all the trading frameworks considered in this report, reliance on WTO schedules would lead to the most dramatic change in the UK's terms of trade with the EU.**

210. **Trade in goods would face significant tariffs, and trade in services would be subject to much greater restrictions. Regulatory restrictions, geographic indicators, and standards are largely untouched by WTO agreements. If it were to trade with the Single Market under WTO rules, the UK would therefore face a significant number of non-tariff as well as tariff barriers.**

211. **In order to have a trade policy independent of the EU, the UK will have to negotiate and secure agreement to its schedules of concessions (the commitments countries make at the WTO on tariffs, quotas and subsidies). We welcome the fact that the Government has begun to engage with the EU and the WTO about developing and securing UK schedules of concessions.**

212. **Although the Government is confident that this process will be purely technical, a number of political factors could complicate certification. For example, the views of other WTO members, particularly on tariff rate quotas, and on whether the UK and the EU's actions could be considered to be a 'modification' rather than simply a 'rectification' of the EU's schedules, may complicate agreement.**

213. **Under WTO rules, the UK would only have to comply with EU standards and regulations in those goods and services it traded with EU Member States. However, we note that the EU has played an important role in setting global standards: EU standards have been accepted by third countries with which the UK might wish to trade.**

214. **While the WTO has its own dispute resolution mechanisms, they are only accessible to businesses and individuals through governments and the process is often lengthy. Unlike in the EU, breaches cannot be remedied in the national courts, and it may take many years to change the practices of a trading partner through sanctions.**

299 Q 10

215. **Whatever framework the Government adopts, it will also need to establish a domestic authority for trade remedy investigations, to replace the work currently undertaken by the Commission on behalf of EU Member States. This will require capacity-building in a specialised area of law. This may take a considerable time, and should therefore be an early priority in preparing for Brexit.**

## CHAPTER 7: THE GOVERNMENT'S APPROACH

### Analysis of the impact of Brexit on the UK's economy

216. There is general agreement that, as part of the process of preparing for Brexit, there has to be thorough analysis of the impact on the UK's economy of the various possible future trading relationships with the EU. Lord Bridges confirmed the Government was carrying out such an analysis. The Government had looked at over 100 production sectors. It had then consolidated its analysis into 51 sectors, taking into account "the size and contribution that each of these sectors makes to the economy", and "the way those sectors are treated in EU law and how future negotiations might bear down on them". The 51 sectors were not necessarily "the most important or the biggest", but focusing on them had helped the Government to get the information into "a manageable format".[300] Lord Bridges confirmed that the Government was also considering the nature of EU regulations and different frameworks for trade with the EU, such as the customs union.[301]

217. Lord Bridges saw the Government's analysis as holistic: "to ensure that we also look at building up a picture of the challenges and opportunities that the UK faces in the round." The Government was attempting to do this work "well and with due deliberation but due speed".[302] While the Government would be "mindful" of "political noises",[303] its approach would be "a hard-headed, cool, calm look at what the impact of various options might be."[304] The Ministers did not say whether this work would be completed before Article 50 was triggered.[305]

218. When asked about work being done by the UK's European partners on a future trading relationship, Lord Bridges said that the Commission had assembled "quite a considerable team" to look into it. With regard to Member States, he could not be specific, but said that "certain Member States are focusing on this a lot more than others".[306]

### Engagement with stakeholders

219. Ministers explained that the Government was consulting with industry stakeholders on both the UK's future relationship with the EU, and the UK's future FTAs with third countries. Lord Bridges said: "the entire government machine is consulting different parts of industry and civil society". He described the Government's work as a "wide-ranging consultation with groups that represent different bodies of the public". This was "a good, proportionate way to approach this".[307]

300 Q 62
301 Q 54
302 Q 48
303 Q 65
304 Q 64
305 Q 62
306 Q 66
307 Q 56

220. Lord Bridges also told us that Ministers were "very keen to get out and about … to talk to people who are at the cutting edge and coalface of these issues". He wished to avoid "a real danger that we will be stuck behind our desks", looking at "facts, figures and percentages."[308] By way of example, Lord Bridges told us that "DEFRA will talk to the NFU [National Farmers' Union] and other organisations … agriculture Ministers [will] have open arms and doors in wanting to take ideas and views". He said that DExEU and DEFRA had already "co-hosted a round table", and that officials "in my department sit in round tables and other meetings with sectors to hear what specific groups and organisations are saying".[309]

221. With regard to future FTAs, Lord Price said "we want to engage with industry over the free trade agreements that we are going to sign". However, such engagement would vary because to a "large extent the input of business will depend on the country and the sector".[310] His Department was also "setting out the routes that we will take as we start to negotiate", and using Ambassadors in various third countries as conduits for the views of businesses in those countries.[311]

### Resources and capacity

222. We asked whether the Government had sufficient resources to manage the development of a new trade relationship with the EU, establish the UK's WTO schedules, and negotiate the UK's future trading relationships with third countries (a stated aim of the Government).[312]

223. Lord Price told us that a trade policy team of 40 people on 23 June had grown to "about 110 people", and was likely to rise to "about 150 by the end of this year." Lord Price said that "over 800" people had "voluntarily written" to offer their services.[313] Lord Price also said the Government did not plan to hire trade negotiators for future FTAs for the "next three or four months".[314]

224. Lord Price acknowledged that in comparison with the EU (which has "500 people who work in trade policy") and Canada (which has "100 people working on the Canada-EU FTA"),[315] the UK was in "the early foothills of where we need to get to". He also agreed that more resources would be required to "press for full-blooded implementation in the years after [an agreement] has been signed".[316]

225. Nevertheless, Lord Price was "confident that we will get the resource that we need to negotiate trade deals for the UK in the future". He said: "I have been given every encouragement that whatever we require will be provided. Clearly there will be a good level of scrutiny, but the requests that have gone in so far have been met with understanding."[317]

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308 Q 54
309 Q 60
310 Q 49
311 Q 60
312 For example, see Rt Hon Theresa May, 'Britain after Brexit: a vision of a Global Britain' (2 October 2016): https://www.politicshome.com/news/uk/political-parties/conservative-party/news/79517/read-full-theresa-mays-conservative [accessed 29 November 2016]
313 Q 57
314 Q 61
315 Q 57
316 Q 57 (Lord Green of Hurstierpoint)
317 Q 59

226. In written evidence, Lord Bridges and Lord Price told us: "All departments are equipping themselves with the resources they need to get the best deal for the UK." DExEU had "over 250 staff", but the Government was

> "not in a position to give a final total for particular groups of staff as recruitment is ongoing. Our aim is to have a streamlined Department, while hiring in the right skills and experience to get the best outcome for the UK."[318]

### Co-ordination across Government departments

227. Lord Bridges explained that while the Department for Exiting the EU (DExEU) was "responsible for policy with regard to the EU", the Department for International Trade (DIT) was "responsible for policy outside the EU".[319] Lord Price confirmed that DIT was focusing on the "WTO schedules" and "the FTAs to come".[320]

228. Lord Bridges said that officials from DExEU were "working absolutely hand in glove" with the Business Intelligence Unit at the Department for Business, Energy & Industrial Strategy (BEIS), which is collating the views of stakeholders.[321] He also referred to the "excellent officials" in the UK Permanent Representation to the EU (UKRep), who were "analysing a lot of this material in conjunction with the experts in the various departments".[322] Lord Price said that DIT was also working with DExEU by providing "specialist knowledge" through support from its trade policy team.[323]

229. Lord Bridges underlined the importance of close coordination between DExEU and other departments. This was partly because "otherwise our department and the four Ministers would be completely deluged" and "would not have the time to see everyone and do everything possible", and also because "we need to draw on the expertise in departments".[324] This approach also helped to ensure the Government could move with "speed to obtain the views of everyone on board".[325] He concluded: "We cannot and should not try to create an enormous department that sucks the life blood out of Whitehall."[326]

230. Lord Bridges said that such coordination was facilitated at a high level by the "Cabinet Committee on EU Exit and Trade", which was "a core decision-making body of Ministers". This Cabinet committee was supported by the Trade Policy Steering Board of officials, chaired by DIT, and run jointly with DExEU. They met fortnightly "to pool thinking on specific issues" and "to track the way ahead." So far this arrangement had been "working well", but he added that the Government was "absolutely not complacent".[327]

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318 Written evidence from Lord Bridges of Headley MBE and Lord Price CVO (ETG00013)
319 Q 52
320 Q 57
321 Q 60
322 Q 62
323 Q 57
324 Q 60
325 Q 56
326 Q 62
327 Q 57

## Conclusions and recommendations

231. **We recognise that the Government is engaging with industry stakeholders, but are not convinced that the level of engagement and expertise within government are commensurate with the scale of this unprecedented task, particularly given the Government's commitment to trigger Article 50 by the end of March 2017.**

232. **We shall address the issue of engagement with stakeholders further in our forthcoming reports on the future trade relationships between the UK and the EU for goods and services.**

233. **The Government appears to be underestimating the resources required to negotiate a bespoke deal with the EU, to adopt its WTO schedules, and to agree future trading relationships with third countries. We urge the Government to increase significantly the capacity of the Department of International Trade and the Department for Exiting the EU, and we also call on the Government to provide a clear estimate of the number of staff it will need to recruit to both departments, and the cost that this will incur.**

234. **We are concerned that Government will not be able to recruit the necessary additional skilled personnel to undertake engagement and analysis before Article 50 is triggered. We are also concerned that this timetable is putting considerable strain on resources across government, and has resource implications for the devolved administrations.**

235. **At this early stage, we note the framework that the Government has put in place to co-ordinate Brexit work across departments. In a fast-moving negotiation, the pressure on cross-departmental working will be intense, and we look to the Government to continue to monitor the framework, and to make improvements whenever they are necessary.**

## CHAPTER 8: EVALUATING THE FRAMEWORKS

236. All the frameworks discussed in Chapters 3–6 have important advantages in liberalising trade between contracting parties, but all also have significant shortcomings.

### The EEA

237. Becoming a non-EU member of the EEA would, in trade terms, be the least disruptive option—providing full membership of the Single Market in services and partial access to the Single Market in goods. It would also be one of the more straightforward options to negotiate and conclude within the two-year timeframe set by Article 50. The UK would be able independently to negotiate FTAs with third countries, but would be constrained by its membership of the Single Market with regard to non-tariff barriers.

238. On the other hand, membership of the EEA would entail rules of origin for trade, and tariffs on some goods between the UK and the EU. It would not provide the UK with the opportunity to influence future rules regarding the Single Market, reducing national control over regulatory standards, and would mean accepting the principle of free movement of persons. It would mean accepting the jurisdiction of the EFTA Court, and, by extension, that Court's principle of securing homogeneity with the CJEU wherever possible.

### The customs union

239. A UK customs unions with the EU after Brexit would overcome one of the difficulties with all the other options: the UK would not be required to comply with rules of origin. Thus, to a significant extent, trade in goods would not be disrupted.

240. Pursuing this policy in the long term would, though, require the UK to follow the EU's external trade policy and tariffs, thereby eliminating the option of having an independent international trade policy. A customs union with the EU would also provide no preferential trade in services with the EU. Nevertheless, extending the UK's existing status as a member of the customs union beyond the two year Article 50 period could form a valuable element of a transitional arrangement.

### A free trade agreement

241. A FTA with the EU would provide greater flexibility to the UK with regards to the issue of free movement, and the opportunity to increase or diminish the scope of the UK's future trading relationship with the EU, subject to negotiation with the EU-27.

242. However, there is no precedent for any country negotiating a FTA that provides terms of trade with the EU equivalent to Single Market membership. Services would be particularly challenging to negotiate in a FTA. Furthermore, witnesses were unanimous that it would be impossible to agree a comprehensive FTA within the two-year deadline set by Article 50,[328] not least because it would have to be agreed unanimously by the EU-27.

328 Q 12 (Raoul Ruparel) and Q 13 (Luis González García and Dr Markus Gehring)

243. The terms on which Switzerland trades with the Single Market (through its FTA and bilateral agreements) illustrate the limitations of existing free trade agreements. Switzerland's arrangements provide only limited preferential terms for services, and, as discussed in Chapter 5, the EU has described this arrangement as having "reached its limits".[329]

244. Our evidence also indicates that the UK would not be able to continue to benefit from the EU's existing FTAs with third countries after leaving the EU. It would not be able to conclude new FTAs until it had left the EU,[330] although this period could be used to begin discussions on future FTAs.

### Trade under WTO rules

245. In the absence of EEA membership, membership of the customs union, or a bilateral FTA, the UK's commitments at the WTO would form the baseline for trade with the EU. Regardless of the deal it reaches with the EU, the UK would in any case have to establish independent schedules at the WTO in order to continue to trade with third countries (including those with which it currently enjoys preferential market access via EU FTAs).These schedules would also be the fall-back option for trade with the EU.

246. Trading with the EU under WTO rules alone would be the most disruptive option, providing no preferential access to the Single Market for either goods or services. This option is therefore unattractive for UK-EU trade in goods and in services.

### Trade-offs

247. The liberalisation of trade requires states to agree to limit the exercise of their sovereignty, for example by agreeing to harmonise their rules for products, or to remove tariffs. A trade-off between market access and the exercise of sovereignty is required in all frameworks for liberalising trade, and is often most visible in the dispute surveillance and dispute resolution mechanisms established through these arrangements. As an EU Member State, the UK has full membership of the Single Market, but is subject to decisions of the CJEU in enforcing the rules of the Single Market. Joining the EEA as a non-EU member would make the UK subject to the decisions of the EFTA Surveillance Authority and the EFTA Court. Participating in the customs union would require the UK to cede to the EU the right to set tariffs and to determine its trade policy. A FTA with the EU would require the UK to agree to trade terms with the EU that would be binding under international law. Finally, agreeing its schedules of concessions at the WTO would require the UK to make legally-binding commitments to all members of the WTO, most notably on its tariffs, which would be enforceable under international law.

329 Council of the European Union, *Council conclusions on EU relations with EFTA countries* (14 December 2010): http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/foraff/118458.pdf [accessed 8 November 2016]

330 Q 40 (Lord Price)

### A bespoke arrangement for the UK

248. We note that there is no precedent for hybrid models combining elements of the existing frameworks outlined above. The Government made it clear that it intended to pursue a bespoke agreement with the EU.[331] We are not clear what the Government means by this term. The evidence we have heard underlines that not all the trade benefits of EU membership can be retained as a non-member. Any future UK-EU relationship will therefore include trade-offs between the closeness of relations with the EU and national sovereignty.

### Transitional arrangements

249. If the Government chose to negotiate a bespoke FTA with the EU, and even if it were possible to conduct such negotiations alongside the Article 50 negotiations, our witnesses indicated that it would be likely to take longer than two years.[332] The Government would therefore need to consider a transitional arrangement, to establish a bridge between the UK's withdrawal and agreement of these preferential trading terms. Lord Bridges said it was of "paramount importance",[333] and "in our interests and in those of our partners in Europe to have a very smooth and orderly process."[334] Lord Price concurred: "we want to make sure that we have the best possible transition from where we are today to the new world".[335] Lord Bridges said that while a number of businesses had "flagged with us the need for transitional arrangements", he could not specify what form they might take: "there are various meanings of this term". The Government was "cognisant of the need for us to look at this".[336]

250. Asked about the impact of uncertainty upon businesses, Lord Bridges agreed "101% that there is this concern in a number of sectors",[337] and accepted that "we need to try to get that clarity and certainty". Lord Price noted that uncertainty affected not just UK businesses but "all of Europe".[338] But Lord Bridges felt that the desire for certainty had to be balanced against the "national interests in our negotiating position". The Government's announcement of a 'Great Repeal Bill' demonstrated "our intent on certainty".[339] But he reiterated that "I am not going to start speculating on what may or may not happen".[340]

251. We heard about the different forms such a transitional arrangement might take. Dr Holmes recommended temporary membership of the EU's customs union to enable goods exporters and importers to avoid tariffs and rules of origin. While temporary membership of the EEA as a transitional arrangement between leaving the EU and firming up new trade terms was deemed unfeasible, Dr Sverdrup suggested that the UK needed to consider "second-best solutions" before a final deal was struck.[341] The technicalities of a transitional arrangement—how long it would last, how quickly it could be agreed to—are all important considerations for the Government.

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331 Q 40
332 Q 12 (Raoul Ruparel) and Q 13 (Luis González García and Dr Markus Gehring)
333 Q 40
334 Q 46
335 Q 67
336 Q 42
337 Q 50
338 Q 45
339 Q 45
340 Q 46
341 Q 25 (Dr Peter Holmes and Dr Ulf Sverdrup)

### Sequencing of negotiations

252. It will be essential for the Government to determine, as a priority, whether and to what extent, legally and politically, negotiations on a new trade relationship could be conducted under the terms of Article 50, as constituting part of the "framework" for the future relationship between the EU and the withdrawing state. This will have an impact on both sequencing and the timeline of negotiations.

253. The sequencing of negotiations on the UK's future trading relationship with the EU, the UK's schedules at the WTO and negotiations with third countries will also be critical. We were pleased that Lord Price recognised the importance of concluding the UK's participation in the WTO as soon as possible, and recognised that it must configure its new terms of trade with the EU before concluding FTAs with third countries.

254. Lord Price reasoned that because "we are tied with the EU", after certifying the UK's schedules at the WTO (which would rely in part on negotiations with the EU), the next step would be:

> "to come to an agreement with the EU on our trading relationship with the EU. Once those two things are shaped, we can of course begin negotiations with third parties, cognitive of the tariff or the non-tariff barriers, or the other regulations we have put in place. That would be the sequence."[342]

255. Lord Price continued:

> "One of the requirements to sign an FTA is that we have clarity on what our own tariffs and [non-tariff barriers] are going to be, so crystallising our agreements with the WTO and understanding better our agreement with the EU will lead us to be able to do those FTAs. One can imagine a scenario where those things become clearer over a number of years, and as they become clearer our discussions can clearly strengthen."[343]

256. Lord Price also noted that "we cannot sign and ratify [FTAs with third countries] until after we have left, but we can have discussions ahead of that". He said that working groups had already been formed with a number of countries to consider the possibility of new FTAs.[344]

257. What was missing from the Government's approach was an assessment of the consequences of leaving the EU's customs union, and therefore a developed position on continued participation, including as part of a transitional arrangement, in advance of triggering Article 50. This decision will have to be taken in parallel with determining the UK's schedules at the WTO (which would, in a customs union, need to be the same as the EU's) and its future relationship with the EU.

342 Q 40
343 Q 40
344 Q 40

## Conclusions and recommendations

258. **Negotiations on a new trade relationship with the EU will be conducted against an extraordinarily difficult political and institutional backdrop.**

259. **Many elements of the different frameworks for future trade between the UK and the EU and between the UK and third countries are interwoven. Nonetheless, it is clear to us that the current priorities are the UK's relationship with the EU and its schedules at the WTO. The UK's future trading relationship with third countries will be vital in the longer term, but will inevitably be contingent on what is negotiated with the EU and at the WTO. Negotiations need to be sequenced accordingly.**

260. **The notion that a country can have complete regulatory sovereignty while engaging in comprehensive free trade with partners is based on a misunderstanding of the nature of free trade. Modern FTAs involve extensive regulatory harmonisation in order to eliminate non-tariff barriers, and surveillance and dispute resolution arrangements to monitor and enforce implementation. The liberalisation of trade thus requires states to agree to limit the exercise of their sovereignty. The four frameworks considered in this report all require different trade-offs between market access and the exercise of sovereignty. As a general rule, the deeper the trade relationship, the greater the loss of sovereignty.**

261. **Businesses are operating in conditions of considerable uncertainty. Uncertainty undermines investor confidence, and is thus in itself a significant threat to the UK economy. An important step in reducing this uncertainty would be to confirm the Government's plans.**

262. **Brexit will dramatically alter the UK's trading relationship with its biggest trading partner, the EU. The evidence we have heard underlines the importance of establishing transitional or interim arrangements to mitigate the shock that would follow were the UK to leave the EU under the terms of Article 50 without securing agreement on future trading relations with the EU.**

263. **A transitional agreement will therefore almost certainly be necessary. We see little evidence that agreeing a transitional arrangement would put the UK's wider interests at risk. Quite the opposite: a transitional arrangement would allow negotiations to be conducted in a less pressured environment, benefiting all concerned. We urge the Government to establish at the outset of negotiations a clear 'game plan' for a future transitional agreement, with specific proposals as to what form it should take.**

## SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

### The UK's trade as a member of the EU

1. It is important to distinguish between 'access to' and 'membership of' of the Single Market. Many countries have access to the Single Market through trade agreements and the rules of the WTO. Only EU Member States have full membership of the Single Market—setting, implementing and enforcing all the EU's rules to enjoy highly liberalised trade in all the areas that the Single Market operates. (Paragraph 50)

2. We note that the Government's aspiration, to secure a bespoke agreement with the EU which ensures open and free trade and control over the UK's borders and laws, is in tension with the fundamental principles of the Single Market—which require members to accept all the Four Freedoms, including the free movement of persons. (Paragraph 51)

3. Moreover, the Government's desire for a bespoke deal will also need to be compatible with the rules of the WTO, where the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS) prohibit trade agreements focused only on one sector. (Paragraph 52)

4. The Single Market includes clear mechanisms through which to implement, enforce and handle disputes about the rules that govern trade between its members. When the Government is evaluating the different frameworks for trade between the UK and the EU, it should consider what mechanisms it will find acceptable to handle possible future disputes. (Paragraph 53)

### Membership of the European Economic Area

5. EEA membership would be the least disruptive option for UK-EU trade, not least because it would maintain membership of the Single Market for services. It would also provide partial membership of the Single Market for goods, though businesses would have to comply with rules of origin. (Paragraph 82)

6. The process of joining the EEA as a non-EU Member State appears to be technically possible. It is unclear, however, whether other non-EU EEA countries would be amenable to the UK's entry. (Paragraph 83)

7. We urge the Government to offer clarity on the legal question of whether the UK would have to leave the EEA Agreement altogether before joining as a non-EU country (under EFTA). (Paragraph 84)

8. Becoming a non-EU EEA member would significantly restrict the UK's ability to limit the free movement of persons. It would also require the UK to adopt existing and future EU laws relevant to the EEA Agreement in the same way as an EU Member State, without having any voting rights. (Paragraph 85)

9. We see little prospect that the EEA Agreement will be reformed to give the non-EU EEA states voting rights on new EU laws. Thus if it became a non-EU EEA member, the UK would be unable to exercise control over the pace of integration with the EU's laws and practices. As a non-EU EEA state, the UK would be able to negotiate FTAs with third countries, but would be constrained by its obligations to comply with EU law in areas covered by the EEA Agreement. It is unlikely that EFTA's existing FTAs with third countries would be open, or attractive, to the UK. (Paragraph 86)

### Membership of the EU's customs union

10. A key aspect of Brexit will be the feasibility of the UK remaining part of the customs union: the Government will need to decide early on whether or not the UK should do so. Although Turkey offers an example of a country outside the EU having a customs union with the EU, its participation is fundamentally different from the UK's participation as a full EU Member State. (Paragraph 110)

11. We are concerned that the Government appears not yet to have given sufficient consideration to the implications of leaving the EU's customs union. While there may be opportunities to use digital technologies to streamline customs procedures, we are troubled that the Government presently has no estimate of the cost to businesses of administrative delays, compliance with customs checks, and the rules of origin if the UK left the customs union, and that it was unable to confirm whether or not such information would be available before triggering Article 50. Our concerns are made more acute by the implications of leaving the customs union for the UK's land border with the Republic of Ireland. (Paragraph 111)

12. Before Article 50 is triggered, the Government should undertake and conclude a rigorous analysis of the cost to business and to taxpayers of leaving the customs union. We will also investigate these issues in greater detail in our follow-up report on future UK-EU trade in goods. (Paragraph 112)

13. A customs union with the EU similar to Turkey's arrangement would require the UK to adopt the EU's standards and regulations for all goods under the customs union arrangement. There would also be common customs procedures. (Paragraph 113)

14. Despite the Government informing us that all the possible frameworks for future trade between the UK and the EU were 'on the table', the remit of the new Department for International Trade suggests that the Government intends to pursue an independent trade policy.(Paragraph 114)

15. Seeking to pursue an independent trade policy while coming to an arrangement with the EU's customs union, as Turkey has done, is a difficult balancing act, which would severely curtail the UK's leverage in future trade negotiations with third countries. (Paragraph 115)

16. If it has not done so already, the Government should consider the merits of remaining a member of the EU's customs union as an interim arrangement, until the terms of the UK's future trading relationship with the EU have been settled. We are also conscious of the practical challenges of introducing full customs controls within two years. (Paragraph 116)

### A UK-EU free trade agreement

17. The Government has made clear its desire to open negotiations on the future trading relationship between the UK and the EU as part of the withdrawal negotiations under Article 50. This desire will only be fulfilled if both sides agree. Before triggering Article 50, the Government must, as a priority, seek confirmation from all parties that the framework for a future trading relationship will be included within the Article 50 negotiations. (Paragraph 159)

18. Negotiation of a Free Trade Agreement between the UK and the EU would be unprecedented. While FTA negotiations usually aim to increase market integration between two sides, the UK would start from a position of full integration, and would presumably seek to maintain many aspects of the status quo while reducing integration in some areas. (Paragraph 160)

19. As, for the time being, the UK is compliant with EU law (and the announcement of the Great Repeal Bill by the Government suggests that in general much of EU law will be maintained in national law, at least in the period immediately following Brexit), the complex issue of harmonising rules and regulations between two sides can be deferred in the short term. (Paragraph 161)

20. Nonetheless, experience demonstrates that FTA negotiations with the EU are complex and slow moving. We conclude that, even if it were possible to negotiate a FTA within the terms of Article 50, it would be impossible to agree it within two years. It follows that if the Government is minded to seek a FTA as the long-term basis for future UK-EU trade, it should clarify whether it is also considering a transitional trading arrangement. (Paragraph 162)

21. Even the most advanced FTAs do not provide the level of market access for goods that the UK currently enjoys by virtue of membership of the Single Market. We also note that providing equivalent liberal market access for services in a FTA with the EU would be unprecedented. (Paragraph 163)

22. The level of market access the UK is able to negotiate with the EU would depend in part on the extent to which it was willing to accept and adopt EU law or demonstrate equivalence with EU rules. In the medium to long-term the UK may have to continue to update its domestic law to be consistent with EU law. (Paragraph 164)

23. The UK and the EU may require stronger institutions than are normally included in FTAs to police their trading relationship. While a UK-EU court could help to achieve this, we note any such arrangement could be subject the decisions of the Court of Justice of the European Union. (Paragraph 165)

24. These constraints on a UK-EU FTA notwithstanding, its key benefit would be flexibility. It would not require the UK to accept the principle of the free movement of persons; it would give the UK autonomy over its laws and trade policy with third countries; and it could be supported by separate agreements regarding other areas of interest to the UK if desired. A FTA could also avoid the imposition of tariffs on goods traded between the UK and the EU, although rules of origin would apply. (Paragraph 166)

25. We invite the Government to confirm whether it is giving consideration to an Association Agreement, incorporating a FTA, such as that agreed with Ukraine, as the basis for a future political and trade relationship with the EU. (Paragraph 167)

26. On the balance of evidence, we conclude that the UK is unlikely to be able to retain access to the EU's FTAs with third countries following Brexit, whether they are mixed agreements or not. We urge the Government to confirm that this is the case. (Paragraph 168)

27. We doubt that the UK would be able to conclude new agreements to replace EU FTAs with third countries within the two-year timeframe for withdrawal negotiations prescribed by Article 50. Nor, while the UK remains an EU Member State, is it able formally to conclude such negotiations, although we note that substantive preliminary discussions are already being conducted to prepare the ground for future FTAs. (Paragraph 169)

28. It follows that the Government must develop a contingency arrangement to secure continuation of the level of market access currently enjoyed by the UK to third countries under EU FTAs, following the completion of withdrawal under Article 50. (Paragraph 170)

### Trade under WTO rules

29. If a preferential trade deal were not reached with the EU, then WTO rules would govern trade between the UK and the EU. Of all the trading frameworks considered in this report, reliance on WTO schedules would lead to the most dramatic change in the UK's terms of trade with the EU. (Paragraph 209)

30. Trade in goods would face significant tariffs, and trade in services would be subject to much greater restrictions. Regulatory restrictions, geographic indicators, and standards are largely untouched by WTO agreements. If it were to trade with the Single Market under WTO rules, the UK would therefore face a significant number of non-tariff as well as tariff barriers. (Paragraph 210)

31. In order to have a trade policy independent of the EU, the UK will have to negotiate and secure agreement to its schedules of concessions (the commitments countries make at the WTO on tariffs, quotas and subsidies). We welcome the fact that the Government has begun to engage with the EU and the WTO about developing and securing UK schedules of concessions. (Paragraph 211)

32. Although the Government is confident that this process will be purely technical, a number of political factors could complicate certification. For example, the views of other WTO members, particularly on tariff rate quotas, and on whether the UK and the EU's actions could be considered to be a 'modification' rather than simply a 'rectification' of the EU's schedules, may complicate agreement. (Paragraph 212)

33. Under WTO rules, the UK would only have to comply with EU standards and regulations in those goods and services it traded with EU Member States. However, we note that the EU has played an important role in setting global standards: EU standards have been accepted by third countries with which the UK might wish to trade. (Paragraph 213)

34. While the WTO has its own dispute resolution mechanisms, they are only accessible to businesses and individuals through governments and the process is often lengthy. Unlike in the EU, breaches cannot be remedied in the national courts, and it may take many years to change the practices of a trading partner through sanctions. (Paragraph 214)

35. Whatever framework the Government adopts, it will also need to establish a domestic authority for trade remedy investigations, to replace the work currently undertaken by the Commission on behalf of EU Member States. This will require capacity-building in a specialised area of law. This may take a considerable time, and should therefore be an early priority in preparing for Brexit. (Paragraph 215)

### The Government's approach

36. We recognise that the Government is engaging with industry stakeholders, but are not convinced that the level of engagement and expertise within government are commensurate with the scale of this unprecedented task, particularly given the Government's commitment to trigger Article 50 by the end of March 2017. (Paragraph 231)

37. We shall address the issue of engagement with stakeholders further in our forthcoming reports on the future trade relationships between the UK and the EU for goods and services. (Paragraph 232)

38. The Government appears to be underestimating the resources required to negotiate a bespoke deal with the EU, to adopt its WTO schedules, and to agree future trading relationships with third countries. We urge the Government to increase significantly the capacity of the Department of International Trade and the Department for Exiting the EU, and we also call on the Government to provide a clear estimate of the number of staff it will need to recruit to both departments, and the cost that this will incur. (Paragraph 233)

39. We are concerned that Government will not be able to recruit the necessary additional skilled personnel to undertake engagement and analysis before Article 50 is triggered. We are also concerned that this timetable is putting considerable strain on resources across government, and has resource implications for the devolved administrations. (Paragraph 234)

40. At this early stage, we note the framework that the Government has put in place to co-ordinate Brexit work across departments. In a fast-moving negotiation, the pressure on cross-departmental working will be intense, and we look to the Government to continue to monitor the framework, and to make improvements whenever they are necessary. (Paragraph 235)

### Evaluating the frameworks

41. Negotiations on a new trade relationship with the EU will be conducted against an extraordinarily difficult political and institutional backdrop. (Paragraph 257)

42. Many elements of the different frameworks for future trade between the UK and the EU and between the UK and third countries are interwoven. Nonetheless, it is clear to us that the current priorities are the UK's relationship with the EU and its schedules at the WTO. The UK's future trading relationship with third countries will be vital in the longer term, but will inevitably be contingent on what is negotiated with the EU and at the WTO. Negotiations need to be sequenced accordingly. (Paragraph 258)

43. The notion that a country can have complete regulatory sovereignty while engaging in comprehensive free trade with partners is based on a misunderstanding of the nature of free trade. Modern FTAs involve extensive regulatory harmonisation in order to eliminate non-tariff barriers, and surveillance and dispute resolution arrangements to monitor and enforce implementation. The liberalisation of trade thus requires states to agree to limit the exercise of their sovereignty. The four frameworks considered in this report all require different trade-offs between market access and the exercise of sovereignty. As a general rule, the deeper the trade relationship, the greater the loss of sovereignty. (Paragraph 259)

44. Businesses are operating in conditions of considerable uncertainty. Uncertainty undermines investor confidence, and is thus in itself a significant threat to the UK economy. An important step in reducing this uncertainty would be to confirm the Government's plans. (Paragraph 260)

45. Brexit will dramatically alter the UK's trading relationship with its biggest trading partner, the EU. The evidence we have heard underlines the importance of establishing transitional or interim arrangements to mitigate the shock that would follow were the UK to leave the EU under the terms of Article 50 without securing agreement on future trading relations with the EU. (Paragraph 261)

46. A transitional agreement will therefore almost certainly be necessary. We see little evidence that agreeing a transitional arrangement would put the UK's wider interests at risk. Quite the opposite: a transitional arrangement would allow negotiations to be conducted in a less pressured environment, benefiting all concerned. We urge the Government to establish at the outset of negotiations a clear 'game plan' for a future transitional agreement, with specific proposals as to what form it should take. (Paragraph 262)

# APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

## EU External Affairs Sub-Committee:

### *Members*

Baroness Armstrong of Hill Top
Lord Balfe
Baroness Brown of Cambridge
Lord Dubs
Lord Horam
Earl of Oxford and Asquith
Lord Risby
Lord Stirrup
Baroness Suttie
Baroness Symons of Vernham Dean
Lord Triesman
Baroness Verma (Chairman)

### *Declarations of interest*

Baroness Armstrong of Hill Top
*Part-owner of a property in Spain*

Lord Balfe
*Chairman, European Parliament Members Pension Fund*
*Vice President, European Parliament Former Members Association (FMA)*

Baroness Brown of Cambridge
*Chair, The Sir Henry Royce Institute for Advance Materials (a national research institute centred at Manchester University)*
*Chair, STEM Learning Ltd (not for profit company delivering teacher CPD in maths and sciences)*
*Non-Executive Director, The Green Investment Bank*
*Shareholder in Rolls-Royce plc, BP plc and Lloyds Banking Group*
*Vice Chair, The UK Committee on Climate Change*
*Former employee of Rolls-Royce plc*
*Husband is Engineering Director of the Institution of Mechanical Engineers*

Lord Dubs
*No relevant interests declared*

Lord Horam
*No relevant interests declared*

Earl of Oxford and Asquith
*No relevant interests declared*

Lord Risby
*No relevant interests declared*

Lord Stirrup
*No relevant interests declared*

Baroness Suttie
*No relevant interests declared*

Baroness Symons of Vernham Dean

*Chairman, Arab British Chamber of Commerce (trade and investment in the Arab Middle East)*

*Non-Executive Director, Manchester Airport Group (Open Skies)*

*International Consultant, DLA Piper (trade, investment and government affairs)*

*Chairman, Saudi British Joint Business Council (trade and investment in KSA)*

Lord Triesman

*Executive Director, Group Board, Salamanca Group Holdings Merchant Bank*

*Advisory Board Member, Joule Africa*

Baroness Verma (Chairman)

*No relevant interests declared*

## EU Internal Market Sub-Committee:

### *Members*

Lord Aberdare
Baroness Donaghy
Lord German
Lord Green of Hurstpierpoint
Lord Lansley
Lord Liddle
Lord Mawson
Baroness Noakes
Baroness Randerson
Lord Rees of Ludlow
Lord Wei
Lord Whitty (Chairman)

### *Declarations of interest*

Lord Aberdare

*No relevant interests declared*

Baroness Donaghy

*No relevant interests declared*

Lord German

*No relevant interests declared*

Lord Green of Hurstpierpoint

*President, Institute of Export (IoE); and member of informal advisory group on Brexit and trade, convened by the CEO of the Engineering Employers' Federation (EEF)*

Lord Lansley

*Adviser, Map Biopharma (Advises on pricing/access in European markets)*

*Senior Counsel at Low Associates, which provides event management and secretariat services to EC*

*Unremunerated: Chair, UK-Japan 21st Century Group*

*Unremunerated: Chair, Cambridgeshire Development Forum*

Lord Liddle

*Pro Chancellor of Lancaster University (unpaid): all aspects of Brexit that concern the university sector*

*Chair of Policy Network (unpaid): international centre left think-tank that accepts sponsorship from bodies with interests in European policy making. The think tank has organised a conference with the European Commission, completed a project for Nissan and written a paper for Open Britain*

*Cumbria County Councillor (in receipt of Member's allowance): Cumbria has important interests in future of structural funds, CAP, environmental regulation, energy policy post Brexit*

*Wife, Caroline Thomson, is Chair of Digital UK; Director of UITEC plc (with large European trading interests); Director of the English National Ballet; Director of CN Group; non-executive member of NHS Improve and UKGI; and non-executive director of London First*

Lord Mawson

*No relevant interests declared*

Baroness Noakes

*No relevant interests declared*

Baroness Randerson

*Governor at Cardiff Metropolitan University (unremunerated)*

Lord Rees of Ludlow

*No relevant interests declared*

Lord Wei

*No relevant interests declared*

Lord Whitty (Chairman)

*No relevant interests declared*

## European Union Select Committee

The following Members of the European Union Select Committee attended the meeting at which the report was approved:

Baroness Armstrong of Hill Top
Baroness Browning
Lord Boswell of Aynho (Chairman)
Baroness Falkner of Margravine
Lord Green of Hurstpierpoint
Baroness Kennedy of The Shaws
Earl of Kinnoull
Lord Liddle
Baroness Prashar
Lord Selkirk
Baroness Suttie
Lord Trees
Baroness Verma
Lord Whitty
Baroness Wilcox

During consideration of the report the following Members declared an interest:

Lord Boswell of Aynho (Chairman)

*Personal shareholdings and farming activities as declared in the Register of Members' Interests*

Earl of Kinnoull

*Shareholdings in Hiscox Ltd and Schroders plc*

*Farming business (in receipt of EU Funds)*

*Trustee of Blair Charitable Tryst with substantial farming business (in receipt of EU funds)*

Baroness Prashar

*Deputy Chair of the British Council*

Lord Selkirk of Douglas

*No direct interests, investments held in McInroy & Wood investment fund (with no influence in the management of the fund or the selection of the investments in that fund)*

A full list of Members' interests can be found in the Register of Lords Interests:

http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

Both Dr Holger Hestermeyer and Dr Ingo Borchert acted as Specialist Advisers for this inquiry and declared no relevant interests.

## APPENDIX 2: LIST OF WITNESSES

Evidence is published online at www.parliament.uk/brexit-uk-eu-trade-inquiry for inspection at the Parliamentary Archives (020 7219 3074).

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with a ** gave both oral and written evidence. Those marked with * gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

### Oral evidence in chronological order

| | | |
|---|---|---|
| ** | Professor Piet Eeckhout, Professor of EU Law, University College London | QQ 1–10 |
| ** | Richard Eglin, Senior Trade Policy Adviser, White and Case LLP | QQ 1–10 |
| * | Dr Markus Gehring, Lecturer, Faculty of Law, Cambridge University | QQ 11–19 |
| ** | Luis González García, Associate Member, Matrix Chambers | QQ 11–19 |
| ** | Raoul Ruparel, Co-Director, Open Europe | QQ 11–19 |
| ** | Dr Peter Holmes, Reader in Economics, University of Sussex | QQ 20–29 |
| ** | Dr Ulf Sverdrup, Director, Norwegian Institute of International Affairs | QQ 20–29 |
| ** | Professor John Manners-Bell, Chief Executive, Transport Intelligence Ltd | QQ 30–39 |
| ** | Dr Christos Tsinopoulos, Senior Lecturer, Durham University | QQ 30–39 |
| ** | Lord Bridges of Headley MBE, Parliamentary Under-Secretary of State, Department for Exiting the EU | QQ 40–67 |
| ** | Lord Price CVO, Minister of State for Trade Policy, Department for International Trade | QQ 40–67 |

### Alphabetical list of all witnesses

| | | |
|---|---|---|
| | Dr Pinar Artiran, Assistant Professor, Istanbul Bilgi University, and World Trade Organization Chair Holder | ETG0012 |
| ** | Lord Bridges of Headley MBE, Parliamentary Under-Secretary of State, Department for Exiting the EU (QQ 40–67) | ETG0013 |
| | Andrew Duff, Visiting Fellow, European Policy Centre | ETG0014 |
| ** | Professor Piet Eeckhout, Professor of EU Law, University College London (QQ 1–10) | ETG0003 |
| ** | Richard Eglin, Senior Trade Policy Adviser, White and Case LLP (QQ 1–10) | ETG0001 |

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|---|---|---|
| * | Dr Markus Gehring, Lecturer, Faculty of Law, Cambridge University (QQ 11–19) | |
| ** | Luis González García, Associate Member, Matrix Chambers (QQ 11–19) | ETG0006 |
| ** | Dr Peter Holmes, Reader in Economics, University of Sussex (QQ 20–29) | ETG0007<br>ETG0011 |
| ** | Professor John Manners-Bell, Chief Executive, Transport Intelligence Ltd (QQ 30–39) | ETG0004 |
| ** | Lord Price CVO, Minister of State for Trade Policy, Department for International Trade (QQ 40–67) | ETG0013 |
| ** | Raoul Ruparel, Co-Director, Open Europe (QQ 11–19) | ETG0002 |
| ** | Dr Ulf Sverdrup, Director, Norwegian Institute of International Affairs (QQ 20–29) | ETG0010 |
| ** | Dr Christos Tsinopoulos, Senior Lecturer, Durham University (QQ 30–39) | ETG0008 |
| | Peter Ungphakorn, Former Senior Information Officer, World Trade Organization Secretariat, 1996–2015 | ETG0005 |

## APPENDIX 3: GLOSSARY

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| AMS | Aggregate measurement of support. This refers to the level of subsidy agreed to under WTO schedules. |
| Association Agreements | An EU Association Agreement is a treaty between the EU, its Member States and a non-EU country that creates a framework for co-operation between them. |
| Brexit | The UK's withdrawal from the EU. |
| CCP | Common Commercial Policy of the EU—which includes reference to the EU's Common External Tariff, and the EU's wider trade policy with third countries. |
| CETA | Comprehensive Economic and Trade Agreement between the EU and Canada. |
| CJEU | Court of Justice of the European Union. |
| Common External Tariff | This refers the tariffs imposed on all goods imported into the EU's customs union from third countries. |
| DExEU | Department for Exiting the EU. |
| DIT | Department for International Trade. |
| EEA | European Economic Area, covering all those party to the EEA agreement: all EU Member States and Norway, Liechtenstein and Iceland. |
| EFTA | European Free Trade Area. This consists of a free trade area between the EFTA states (Norway, Liechtenstein, Iceland and Switzerland). EFTA conducts FTA negotiations on behalf of its members; and for those members party to the EEA Agreement, it also provides the basis for the EFTA Surveillance Authority and the EFTA Court. |
| FTA | Free Trade Agreement. |
| GATS | The General Agreement on Trade in Services at the WTO. |
| GATT | The General Agreement on Tariffs and Trade at the WTO. |
| GPA | Government Procurement Agreement. |
| ISDS | Investor-state dispute settlement. |
| MFN | Most Favoured Nation. At the WTO, members have to offer all other members the same levels of market access unless they have agreed a FTA or entered into a customs union. |
| NTB | Non-tariff barriers. This refers to all barriers to trade other than tariffs including quotas, embargoes, sanctions and other regulatory restrictions. |
| Rules of origin | These are used to determine the country of origin for a product for purposes of identifying what tariff should be imposed when a good is imported from outside a customs union. |
| Schedules of concessions | These detail WTO members' commitments on tariffs and restrictions to trade at the WTO. |

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|---|---|
| Single Market | The Single Market refers to the market which exists between the EU's Member States. It consists of the free movement of goods, people, services and capital through harmonised rules interpreted by the Court of Justice of the European Union. |
| Tariffs | Levies imposed on traded goods. |
| TFEU | Treaty on the Functioning of the EU. |
| TRQs | Tariff Rate Quotas. |
| TTIP | Trans-Atlantic Trade and Investment Partnership. |
| WTO | The World Trade Organisation. |